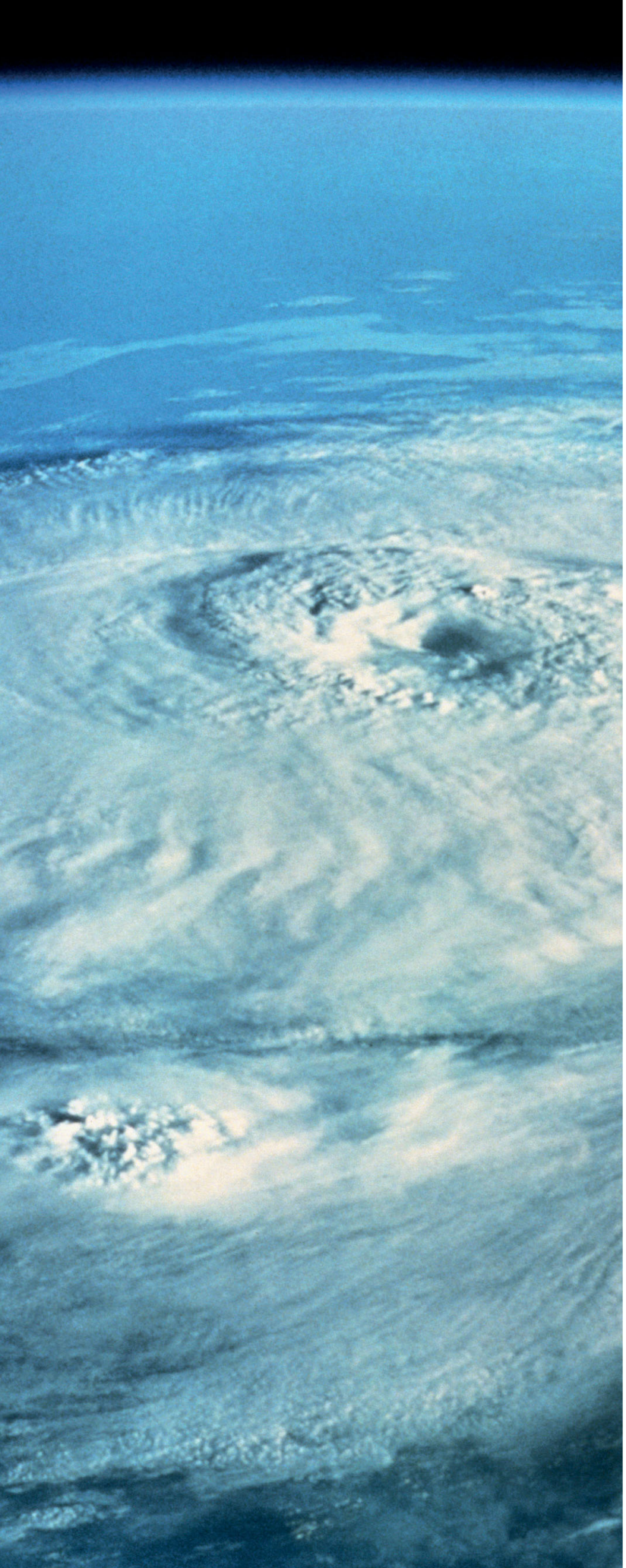

ILS 2018

UNSHAKEABLE MOMENTUM
The ILS market hit new heights in 2017 and investor appetite looks set to grow in 2018

MARKET DYNAMICS
Cat losses, pricing, supply and demand

AN EVOLVING PRODUCT
From emerging risks and captive issuance to the adoption of insuretech

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CAPTIVE REVIEW

ILS EXPLORES NEW TERRITORIES

The ILS market is keen to expand into new risks and geographies, but bringing new products to market has its challenges. And despite the hype, some believe cyber ILS may be a step too far

Property cat risk in the Americas will remain the mainstay of insurance-linked securities (ILS), but increasing competition and growing confidence in ILS underwriters is driving diversification into new risk layers, regions and lines.

Last year, for example, a new covered peril, Europe flood, was introduced to the cat bond market through Lion II Re DAC, issued on behalf of Generali, while several sources report an uptick in life ILS activity and there is even speculation of ILS being used to plug gaps in cyber coverage.

"ILS technology is applicable to a broader range of risks," says Bill Dubinsky, head of ILS for Willis Towers Watson (WTW) Securities. "Last year, for example, we saw a third-party motor liability transaction and a large bank was able to hedge its operational risk using the ILS market. We have a lot of interest in cyber and flood, and attritional property losses is another potential growth area."

Having built successful track records in the property cat space, some ILS managers now believe they have the risk modelling capabilities to explore and unearth opportunities in a wider risk universe.

"People have to distinguish themselves from the competition and the need to develop innovative new solutions keeps everybody on their toes," says John Dykstra, partner with Maples and Calder. "It takes a while to get new ILS products out to the market, but there is a lot of potential business out there for those who do."

> "There has been a lot of talk about risks like cyber, but the focus of activity has actually been on expanding geographical coverage"
> JOHN DYKSTRA, MAPLES AND CALDER

However, barriers to entry exist on some prospective new lines. While some feel the ILS market is well suited to provide much-needed protection against potential systemic cyber risk, for example, others doubt the market is ready to tackle a fast-evolving risk with limited loss history.

"There is a lot of hope that ILS capital can support cyber risk in the future, but we don't see a high degree of willingness in the ILS market to go into it yet," says Dirk Lohmann, CEO of Secquaero. "Clients and investors want to know the risks they're taking are being fairly compensated, but we don't really have the loss data to know if a given cyber transaction is fairly priced."

"All areas of the economy are extremely vulnerable to cyber-attack, and potential

scenarios exist that we can't yet imagine. I struggle to see how we can underwrite an emerging risk like cyber when the full extent of the exposure is very hard to grasp," adds Luca Abertini, CEO of Leadenhall Capital Partners.

Lohmann also raises questions over the ability of cyber risk to satisfy one of the key objectives of many ILS investors – decorrelation. "One of the biggest selling points of ILS is that it is a non-correlating asset. But if there was a major meltdown in the banking payments system because of a cyber-attack, it seems highly likely that would be correlated to all other financial assets."

The same can be said of terrorism, another oft-hyped ILS line, yet Albertini warns that significant amounts of non-affirmative cyber and terrorism risks may already exist in current ILS deals.

While cyber and terrorism are both more speculative than concrete at this point, life activity has seen a material upturn. Lohmann notes several recent life mandates focused on both new business financing and deals to finance existing closed books of business by selling the present value of their future profits. "We see opportunities in this space," he says.

However, concerns over exit liquidity and longevity risk mean these longer tail liability risks aren't for everyone either. "Many ILS investors are pension funds, which clearly have a lot of longevity risk on their books already," says Chris Anderson, partner with Carey Olsen. "The last thing they want to do is go into a funky new asset class [ILS] and end up with exactly the same exposure."

While there have been a handful of notable recent non-property cat securitisations, investor capital is unlikely to move into new ILS classes quickly. Furthermore, this year's hurricane season may have swung the ILS market's attention back to traditional property cat risk.

ILS 2.0: BLOCKCHAIN SETTLEMENT

With the scope of ILS underwriting tipped to expand, technology is already transforming the way ILS is delivered. In 2016, for example, Aon launched a platform, 'CATstream', which allows for an expedited transaction structuring and issuance process.

In August 2017, Switzerland-based ILS specialist Solidum Partners facilitated the first ILS issuance using blockchain – a secure, real-time method for recording data. Issuer Dom Re now uses the mechanism, termed 'ILSBlockchain', instead of traditional settlement systems such as Euroclear or DTC.

Blockchain stores transactions, contracts and agreements in a way that allows users to access them at any time globally, while also reportedly reducing the risk of cyber-attack. Solidum Re hailed the innovation as ground breaking for the ILS sector and listed securities more generally.

"We are waiting to see how much of a role blockchain will play in the ILS space," says Robert Quinn, vice president, insurance collateral solutions, for Wilmington Trust. "Having seen one transaction, it will be interesting to see if the concept takes hold across the market if settlement efficiency is improved."

"The ILS market is always trying to diversify into different assets, but this year we had a distraction in the form of three hurricanes, wildfires and floods," says Albertini. "Rather than trying to securitise the next crazy thing, the current emphasis is on reissuing the bonds that have been triggered in the traditional areas of property cat and the Americas."

Risk layers

When it comes to investing their own assets, Robert Quinn, vice president, insurance collateral solutions, for Wilmington Trust, says ILS trusts remain "particularly conservative" in their strategies. However, Albertini notes that the level of risk being underwritten in cat bonds is increasing, describing the inclusion of riskier layers to offer investors a broader choice of risk-return profiles as both "welcome and worrying".

"In the past, ILS was only pitched at a very remote layer of risk. Now certain programmes – such as the first two transactions launched after the hurricanes by XL and USAA – offer riskier-than-usual layers alongside the more remote layers, which has been welcomed by the market," he says, adding: "Investors don't appear to have been scared by the losses or the risk."

Investors are also seeking opportunities in a broader range of geographies, sources say. "There has been a lot of talk about risks like cyber, but the focus of activity has actually been on expanding geographical coverage," says Dykstra, pointing to risks being covered in South America, Africa and Mexico (following this year's catastrophic earthquake), while Lohmann sees opportunities in Southeast Asian risks.

Albertini believes the private ILS space may be better suited to exploring new risks than the cat bond arena, as cat bond issuers are required to fully articulate underlying risks in their prospectuses and rely heavily on third-party modelling companies' transparency and willingness to provide data.

"The traded liquid cat bond doesn't lend itself too well to covering un-modelled territories or perils," he says, though he notes that some recent cat bonds have included components of modelled risk to add diversification, from US flood risk to meteorites striking Earth.

"Bilateral transactions using cells do not have a prospectus, so the participants have to ask their own questions about the perils and decide if they like the risk. That's why the non-traded cat bond business should have traditional insurance underwriting expertise at its base," Albertini adds.

ILS AS A SOLVENCY CAPITAL TOOL

According to Dirk Lohmann, CEO of Secquaero, European insurers are investigating how ILS can help them optimise their balance sheets under Solvency II. "European insurers are looking for structures to give them solvency capital relief, and there has been a handful of structured reinsurance transactions already," he says. One high profile issuer was Generali, which used the ILS markets to securitise its motor loss ratio. Lohmann added that ILS could also support run-off capital requirements under Solvency II. "ILS could become another form of risk capital that management can use to optimize their overall balance sheets, though the market needs education."

A VIABLE ALTERNATIVE: CORPORATE ILS

Cheap traditional insurance has kept ILS issuance off the radar for most corporates to date. Should rates turn, it may be easier than many of them think to find a home for their risks in the capital markets

Insurance-linked securities (ILS) have for years been the domain of major insurance and reinsurance carriers, but with ILS investors keen to diversify into new risks and cells and private deals offering feasible mechanisms for smaller issuers, the door is open for corporations and their captives to access this alternative form of risk capacity.

"I think the number of corporates directly accessing the ILS market will rise," says Steve Britton, managing director of ILS for Aon. "We're going to see a lot more granular corporate deals using transformers, and captives will increasingly be used to help corporates access ILS capital."

Corporations are most likely to consider ILS-type protection when traditional insurance capacity is scarce or expensive, so it is little surprise that the last decade has seen only occasional strategic forays into the space given the enduring soft conditions in the traditional insurance market.

From power companies covering transmission lines to film studios covering earthquake risk, corporate interests are already playing a role in cat bonds and other forms of ILS. Public entities such as the New York MTA have tasted the most success in ILS so far, though they remain the exception rather than the rule.

"When traditional reinsurance is plentifully available, captive managers are not incentivised to think outside the box," says Luca Abertini, CEO of Leadenhall Capital Partners.

However, captive owners should be aware that ILS can help them obtain cover that would usually be excluded in the traditional market. "Trees falling on power lines is a classic exclusion on traditional wind coverage, but this has been covered in the ILS market," Albertini adds.

Historically, ILS came at a significant premium to traditional insurance, but today rates are closer to parity. With property catastrophe rates expected to harden somewhat following 2017's record-breaking cat losses, more companies may soon begin investigating what the capital markets have to offer.

"Corporates were actually some of the first issuers of ILS, such as Disneyland Tokyo," notes John Dykstra, partner at law firm Maples and Calder in Cayman. "Since then, corporate issuance hasn't really caught on in a big way, but there is clearly scope for corporates to move into this space."

> "Some types of corporate risk may not be insurable in the classical sense, but may be through derivatives"
>
> DIRK LOHMANN, SECQUAERO

While a handful of huge corporate deals have been placed via liquid cat bonds, Albertini suggests companies looking to transfer less than $100m of risk are better off operating in the private ILS space.

"In the non-traded, bilateral ILS space, issuers can negotiate with investors, place smaller transactions of $10m to $50m, and

scale up once they understand the sensitivities of the asset class and the investor base."

Derivative appetite

Corporates can choose to access the ILS markets through their captive vehicles or directly on their balance sheets via derivative-type transactions.

Several sources note increased interest in index-linked weather derivatives (parametric or 'cat in a box' products) through which protection is triggered by weather measurements meeting a specified level at a specific location (earthquake magnitude, rainfall or wind speed at a designated local weather station, for example).

These products may be particularly effective, says Dirk Lohmann, CEO of Secquaero, at protecting companies against business interruption revenue losses in the event of disruption to their own operations or others in their supply chain, as derivatives pay out faster than insurance cover, at a pre-agreed value.

"Derivatives allow them to mark to market, and immediately recognise a gain if they have the right to recovery, giving more immediate P&L relief than they would get under insurance," he explains.

"There is still a huge amount of risk the corporate world does not hedge fully. Some types of risk may not be insurable in the classical sense, but may be through derivatives," he adds, suggesting that increased collaboration between insurance buyers and their CFOs could lead to greater corporate ILS issuance.

"Insurance buyers are usually occupied with finding the cheapest coverage for their exposures in the insurance market, and don't typically consider the impact on the stock price if they lose their lead facilities, market share or sales. If the CFO was more involved, they might see the value in buying index-linked derivatives to hedge their exposures."

According to Dykstra, risk managers bringing the idea of issuing ILS to their boards should be prepared to educate, as ILS is not a concept everyone readily understands. "There is an upfront cost, and a learning curve on your first transaction," he adds, noting that meeting disclosure requirements required in offering documents is also a significant task.

"However, if you commit to ILS and get your first deal out of the door, subsequent deals are comparatively easier and you start seeing the cost benefits," he says.

Once ILS capabilities are established, the transactions themselves require little active management – ILS transactions are highly structured, with service providers brought in to administer and analyze if a policy is triggered.

"A traded ILS instrument takes time to deliver, but once you've done a test transaction, you know you can use the ILS to complement your insurance buying," says Albertini. "When capacity is constrained, you can go to market fast."

Right risk, right price

Bill Dubinsky, head of ILS for Willis Towers Watson Securities agrees it is "relatively straightforward" for a corporate or its captive to access the ILS market if the economics make sense, though often this is not the case.

"Issuing a cat bond or fully collateralised structure can be inefficient for corporate risk, particularly when you consider the natural diversification in the cat risk of an insurer's balance sheet which makes insurer capital quite efficiently priced," he notes. "It's often very difficult for fully collateralised cover to compete."

Modelling and pricing niche localised risk is a challenge given the lack of experience among ILS managers and brokers. However, there is no doubt ILS has a role to play in bridging the corporate protection gap, and Britton insists there is strong appetite for esoteric corporate risk among ILS investors. "Their ears prick at the prospect of selling granular parametric protection to corporates or their captives," he says.

"If you're an ILS investor, there are only so many cat bonds done each year and you have to competitively bid to get a piece of that capital. Direct access to corporate risks no-one has seen before gets them closer to the risk and they can pick and choose the risks, sectors and geographies they want. They'd love it all day long."

According to Britton, the first question potential issuers should ask themselves is where the gaps exist in their existing coverage, what protection is available in the primary insurance market and at what price. If better terms are available in the capital markets (including considerations such as the investor's charge for providing capital protection, plus the set-up and running costs of forming a captive or cell), "there is motivation to do an ILS deal", he says.

However, Britton believes an uptick in corporate ILS requires a broad shift in industry mindset. "People are used to doing business a certain way, but unless you collaborate with colleagues in other fields, you will end up doing this year exactly what you did the year before," he says.

CORPORATE ILS CHECKLIST

- Which risks could your company improve coverage on?
- Compare scope and price of coverage available in ILS versus traditional insurance.
- Is the risk big enough for a cat bond or is it better suited to a small private transaction?
- Choose structure - SPV, cell, derivative, etc.
- Consider set-up, compliance and running costs of chosen structure.
- Engage ILS service providers with proven track records.

TO ISSUE OR TO INVEST?

As well as considering ILS for the first time as issuers, many captives may also be investigating the merits of ILS as a diversifying asset class for their investment portfolios. "ILS is a great investment product for captives to consider," notes Abraham Thoppil, partner of Maples and Calder. Captives in Cayman, for example, can hold part of their capital in securities including cat bonds, which can provide valuable diversification from the traditional equity and fixed income markets.

"There is a lot of appetite from captives to move into non-traditional investments, and cat bonds give you a fixed price trajectory," Thoppil explains. It is important, however, for captives to ensure there is diversification within their cat bond allocations. "Investing just in one cat bond is not a good idea as they could lose their investment if the cat bond is tripped," Thoppil adds.

LONDON STAKES ITS CLAIM

On 29 November 2017, the UK Parliament passed legislation marking the inception of London as a potential new force in ILS. However, UK regulators must improve the cost of doing business and speed to market if the UK capital is to win market share from established offshore ILS hubs, sources say

London is now on the way to becoming a bona fide ILS centre, and not a minute too soon for a city slowly losing its share of the global reinsurance market. While London is unlikely to be able to compete for big ticket ILS business with the likes of Bermuda any time soon, its aim is to leverage its deep specialist underwriting, actuarial and capital market talent pools to create an environment for innovating new ILS covers and structures.

According to sources, UK regulators will face a steep learning curve and must be willing to adapt quickly if London's new ILS market is to hit the ground running.

"We're certainly keeping an eye on the development of London's ILS market and are not complacent about the ILS business we have here in Guernsey. London is a very competitive insurance centre, so should be taken seriously. Brexit could play out in London's favour, as London can effectively become a large offshore ILS player [in relation to the EU]. However, speed to market and cost are always an issue, and it remains to be seen how quickly the UK can react to that." – **Chris Anderson, partner, Carey Olsen.**

"There are only a handful of European cat bond transactions done each year, which is hardly worth the UK enacting dedicated legislation. However, there is great opportunity in private collateralised insurance deals, which is why I am firmly behind the establishment of cell structures in the UK.

Working with SPVs in Bermuda, Cayman or Guernsey has never been a problem, so on the face of it, not much will change. But all things being equal, if you are a UK ILS manager you would probably rather deal with a UK entity as there are always tax complexities when transacting across borders. Remove that disincentive and people may be more willing to experiment with ILS.

If the UK is given equivalence status, it will be closer to the EU than the likes of Bermuda and even conservative countries like France and Germany, who are reluctant to go offshore, may start looking at these structures.

As far as speed to market is concerned, I don't care if it takes me two or three months to establish the right structure as long as I can agree pre-approval with the regulator for subsequent transactions. I'm happy to spend time setting up a business plan, then operate fast with no surprises down the line.

We know we have a lot to learn and some fast catching up to do, but I'm optimistic." – **Luca Albertini, CEO, Leadenhall Capital Partners.**

"It's promising that the UK is attempting to build an ILS market. It has made a sensible tax change that effectively puts it on an equal footing with Ireland, Bermuda and Cayman Islands.

However, Cayman and Bermuda are extremely efficient, and if the cost of transactions is substantially higher in the UK than in Ireland, Irish business is not going to move to the UK, even if everything else is perfect. Ireland will not stand still either – it will try to further improve its process to be more competitive, regardless of what happens with Brexit.

No one is totally sure whether Brexit will help or hinder London's ILS market. Either way, this has created uncertainty at an inconvenient time for London." – **Bill Dubinski, head of ILS, Willis Towers Watson Securities**

"London definitely has the talent to develop innovative structures and a broader range of ILS covers. However, one key advantage for a domicile like Cayman is the speed with which it can react to the market. Key players can make decisions fast, and a substantial cat bond deals can be delivered in just a fortnight. When London says it has managed to reduce its licensing turnaround time down to eight weeks, that's still not competitive with Bermuda or Cayman. That's the challenge for the onshore domiciles. Offshore jurisdictions are often smaller, less bureaucratic and therefore much nimbler." – **John Dykstra, partner, Maples & Calder.**

TIME TO EMBRACE TECHNOLOGY

ILS investors may have taken a hit from 2017's natural catastrophe losses, but according to John Dykstra and Abraham Thoppil of Maples and Calder, demand for ILS remains robust and the outlook for deal flow in 2018 is positive. The next step, they say, is the adoption of insuretech and other innovations

"This isn't the first time the ILS market has proved its resilience in the past decade," says Cayman-based John Dykstra, partner of Maples and Calder. "The financial crisis put capital markets to the test, yet ILS was arguably the only active source of capital flow while most other products stagnated for a year or two. This year, the market stepped up again in the face of hurricanes, earthquakes and wildfires."

Property cat rates are expected to rise in the wake of the Gulf of Mexico hurricane season and the Mexican earthquake though Dykstra says the extensive volume of investor capital sitting on the sidelines waiting to come into the ILS market is likely to offset some of this hardening, with rate rises likely to be moderate.

According to Dykstra, the ILS market was prepared to absorb losses on this scale, and investors are already pouring capital back into ILS products. "There is no shortage of demand for ILS. The main challenge is supply," he says.

"In the early days, people wondered what would become of ILS in periods of financial distress or when multiple big transactions were tripped in quick succession, but we've gone through this process a few times now," Dykstra notes, adding: "ILS investors are highly professional and well diversified. They expect transactions to occasionally get triggered and the market continues to prove resilient."

Opportunities to expand and diversify the ILS market into new geographies and risks exist, though Dykstra acknowledges it takes time to bring new participants into the market.

"With each year that passes, people become more convinced the ILS market is here to stay and will continue to grow at a steady rate," he says.

"When the ILS market started, many people considered ILS a capital markets product because on the surface it appeared very similar to securitisation, just with a different set of underlying assets. Now people probably see ILS more as an insurance product or a hybrid between the two," Dykstra adds.

This, he says, bodes well for Cayman, given its expertise as both the leading offshore domicile for securitisation and structured finance products and a leading offshore insurance domicile.

"While ILS may not have grown at the exponential rate many predicted it would ten or 15 years ago, developments such as the adoption of insuretech could potentially tip the market into a period of explosive growth," Dykstra notes.

Improving efficiency

ILS is often perceived as an expensive product, especially when structuring a transaction for the first time. However, increasing competition has made costs more affordable in recent years, while the adoption of innovative technology and analytics should also improve efficiency of delivery in the coming years.

"Having already disrupted the traditional insurance market, we're now seeing insuretech creeping into the cat bond space," says Abraham Thoppil, partner at Maples and Calder. One recent key innovation, he notes, was the use of blockchain to replace traditional forms of settlement for notes issued by Dom Re *(see page 10 for more)*.

"This technology may go on to play a big role in ILS transactions going forward," he says. "Insuretech is no longer a buzzword – it is already influencing the market."

According to Thoppil, the insuretech market is evolving very fast and regulators around the world will have to keep on their toes and make sure they are comfortable with each innovation, he says.

"The Cayman Islands Monetary Authority has been very proactive in learning about the role technology can play, with the aim of making Cayman a preeminent jurisdiction for insuretech innovation," Thoppil adds.

Insuretech is also playing an increasingly important role in helping insurance underwriters model risk, and could also increase the speed at which issuers and managers can bring ILS products to market.

"If we can better harness the vast quantities of data held by big insurance carriers, it will push ILS growth," adds Dykstra. "Right now, insurers' modelling data isn't being used optimally in ILS transactions. If we can directly plug into those databases we can much more accurately model ILS risk, which could greatly improve the efficiency of product design and pricing in the ILS market."