Broadening horizons

The insurance linked securities market is increasingly looking to the casualty and legacy sectors as it seeks to expand beyond the property catastrophe space.

Property catastrophe business may continue to dominate the insurance linked securities (ILS) sector but investors are increasingly looking at other risks with some of the major market players now trying to package casualty and legacy risks for trading.

And, as some of the ILS market's leading figures explained at the S&P Global Ratings and PwC jointly hosted 2016 Bermuda Reinsurance conference, these long-tail lines of business such as casualty and legacy risk can and will be adapted to the ILS market, although as ever with the re/insurance industry, it will not be a straightforward process.

"[A catastrophe bond], or any XoL securitisation, is very simple – you put money in a box and it collateralises a limit," explained Michael Millette, the managing partner of Hudson Structured Capital Management.

"If that limit isn't hit, the investor gets the box of money back with a premium. Casualty has a long tail, but casualty also has something else - it has a reserve. You have a premium up front, and that premium is going to sit around. If you have lots of casualty policies, that reserve can be put into the box along with the associated assets."

Essentially, Millette explained, re/insurers could use their large casualty reserves as collateral on a risk transfer deal.

"[The companies involved] aren't collateralising a limit in the style of a cat bond, they're effectively putting capital underneath a package of assets and liabilities," Millette added. "That package is effectively an adverse development cover, so it functions very much like a cat bond.

"Rather than treating it as a theoretical exercise – can casualty be treated the same way [as property catastrophe]? – casualty is in fact being dealt with in a similar and analogous in the legacy run-off companies."

As Dirk Lohmann, chairman and managing partner at Secquaero Advisors, explained, these deals can be compared with a reinsurance portfolio securitisation, adding there was significant potential for growth in this market. Lohmann suggested there was also the potential to tier deals by risk level in much the same way to standard debt securities.

It is not just the casualty market where the ILS sector can grow its business however, with various other options increasingly coming to the fore.

"We need to expand our tool box a little bit," said Millette, adding: "The cat bond is a nice enough invention, but it's certainly not the last one that we're going to come up with."

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>
> *Michael Millette, Hudson Structured Capital Management*

Such sentiment was shared by Lohmann who said some of the biggest opportunities for growth can be found in helping offset the costs that arise from earthquakes.

In California, take up of earthquake insurance remains very low with just mid-double digit percentage of homes in the state having such protection in place, Lohmann said. Similar issues exist in Japan where coverage may be offered, but is often highly restricted.

"There's huge potential to expand coverage," stated Lohmann.

Elsewhere, flood insurance could also make the move to the capital markets.

In September 2016, the US Federal Emergency Management Agency (FEMA) dipped its toe in the reinsurance market for the first time and purchased $1m of protection ahead of plans to establish a greater risk transfer programme in 2017.

FEMA's first ever reinsurance programme under the National Flood Insurance Program (NFIP) came into being on September 19, 2016 and is set to run for an initial six month period, ending on March 19, 2017. The programme contains two coverage layers, the first of which sees a trio of reinsurers indemnify FEMA for $1m for flood losses that exceed $5m. Under the second layer, the same three reinsurers have agreed to indemnify FEMA for a further $1m should flood losses from a single event exceed $5.5bn. Each of the three reinsurers holds 33.3% of the total coverage secured.

As FEMA explained at the time, the small programme is the first stage in its attempt "to successfully implement a high quality reinsurance programme at the federal level starting in early January 2017". By purchasing this small programme, NFIP's Reinsurance Initiative Team hopes to identify and resolve any barriers or issues in advance of the implementation of this far greater placement.

FEMA's foray into the commercial re/insurance space could pave the way for the capital markets to play a part in helping to manage the costs associated with flood.

"Flood could be moved to the capital markets in the next few years," said Lohmann, although he added that a change in thinking regarding pricing would need to take place for that to happen. As it stands, the NFIP is some $23bn of debt owing to coverage being given on un-actuarially sound pricing.

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> *Dirk Lohmann, Secquaero Advisors*

Consequently, the pricing of flood coverage under the NFIP would need to be addressed before the risk becomes attractive to ILS investors.

Millette pointed to the example of Florida and its improved ability to withstand hurricane losses as an example of how a major exposure can be better managed, especially as the capital markets are also being utilised to offset some of the exposure in the state.

"I'm just in awe of what a great job Florida has done," said Millette. "Part of it is they've had 11 years without the landfall of a major hurricane, but that happens. It happened in the 1970s and 1980s and [Florida] didn't develop such a good system then. What they did which was smart was after Katrina, they kept everyone in the insurance business, but then every year they chipped away it. Every year they depopulated Citizens and nipped, tucked and trimmed it, and now Florida is essentially a private system.

"As opposed to the question of whether we can just move flood insurance into the private market, if the NFIP would start buying excess layers, we would find our way to the right model. And it's the same with TRIA [the Terrorism Risk Insurance Act]. When the government starts these programmes, they should all be premised on the notion that every year they will be tucked in a little bit because that way the private market will, slowly over time, take up the slack."

Two other notoriously problematic areas of the re/insurance space could also ultimately make the move to the ILS market, although as Lohmann explained, getting capital markets investors to put their money into deals involving cyber or terrorism would again require some thought on how to accurately price the risk.

"[With cyber and terrorism], it's a question of how do you price that risk," said Lohmann, adding: "You may have to think about the potential correlation."

Rick Pagnani, the chief executive of Everest Re's ILS subsidiary Mt Logan Re, said the issue of correlation is one of the biggest problems facing the cyber and terrorism insurance markets. But he said if the ILS sector can get a handle on that, then these specialist sectors would find a home in the capital markets, especially because the limits that are available would far outweigh anything the conventional re/insurance industry can offer.

"The cyber lines lend themselves so much to the capital markets," said Pagnani. "Look at what the insurance market can put together. I don't know the exact number, but I can't imagine you can cover much more than $500m of capacity, but you need billions of dollars to really make this product effective, and the only way you're going to do that is you're going to need third party capital and a capital markets solution.

"There are modelling agencies that are making progress there, but again, it comes down to credibility and confidence."

Pagnani said there has been a general increase in appetite from investors to move into other lines of business and away from catastrophe risk, and not just because of correlation issues. Indeed, Pagnani said some investors wish to take on non-catastrophe lines of business from Mt Logan Re's parent company Everest Re.

"[Our investors] want expansion as long as we don't run afoul of correlation," Pagnani said.

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