OPINION

ILS arrival marks fundamental change

Innovation has proved to have been the primary driver in the the growth of the insurance-linked securities (ILS) market, claims **DENNIS KUZAK**

Much of the discussion in the run-up to the January 1 renewals has been the steady growth of the insurance-linked securities (ILS) sector with investor appetite for the increasing range of securitised products seemingly unabated.

Over the past months a number of senior figures in the insurance market, including Swiss Re chief executive, Jacques Aigrain, have stated their belief that the arrival of ILS will see a fundamental shift in the industry and its approach to the management of catastrophe risk. Swiss Re's latest update on the ILS market published in August shows that for the first seven months of 2007 there has been $5.7bn of new issuance in the non-life bond sector, a 17% increase on the entire issuance for 2006.

One of the significant trends identified in the first seven months of the year has been the increase in investment-grade issuance with approximately $2.1bn of non-life issuance now being investment grade. There has also been a noticeable rise in the number of primary insurers sponsoring new issues, with the result that structures using indemnity and industry index triggers have risen significantly. This comes as little surprise.

Eqecat has been a market leader in ILS risk analysis, having played a role in 32 deals totalling $7.5bn since 1997. And 14 of the transactions were placed since the beginning of 2006, demonstrating the significant ramp-up in recent market activity. These transactions have included industry index, pure parametric, parametric index and modelled loss. Cedants have included primary insurers, reinsurers and most recently a corporate – East Japan Railway – which operates the biggest passenger railway in the world.

Our catastrophic world: the exposures of primary-risk carriers continue to grow, whether to wildfire in California or to other risks elsewhere

Innovation

The market is continuing to grow and innovate, emulating products seen in the fixed-income markets. The year has been marked by the moves of some major financial institutions to develop exchange-traded indices which are designed to create standardised products across a range of events. This would facilitate trading of catastrophe risk, thereby improving the liquidity in the ILS market.

Looking at the current market and its dynamics, it is hard to believe that the ILS market has been with us for just a decade. The first deals concentrated on US hurricane and earthquake risks, while Japanese earthquake and European windstorm offerings followed. Now risks from Australia, Mexico, Taiwan, Turkey, Greece, Israel, Cyprus and Portugal have been securitised. Since 1997 there has been $22.4bn of ILS issued and the initial 2007 figures show that if anything the market is now expanding at a faster rate than ever.

Exposures grow

The exposures of primary-risk carriers across the world to catastrophe-prone regions continue to grow. The debate over windstorm coverage in Florida has yet to reach any real conclusions and in California in the past week we have seen that the ravages of wildfire and the threat of earthquake are never far from the thoughts of US risk carriers.

The booming economies of China and India bring opportunity and exposure to the insurance industry in almost equal measure and the threat of increases in loss frequency due to the effects of climate change have yet to be fully quantified.

It has driven the real desire among cedants to diversify their risk-financing sources, with Swiss Re stating that it is seeking to securitise up to one-third of its risks. And there remains a large base of capital market investors seeking catastrophe-risk products seemingly as fast as they can be issued.

Despite the rapid growth of the sector there remain some in the market who see ILS as completely subsuming the traditional reinsurance products. Many believe we are heading for a dual system incorporating elements of the securitised credit markets alongside the traditional insurance and reinsurance products. This approach will give cedants more flexibility in placing risk while injecting risk-based capital market pricing into insurance products.

Arbitrage will force convergence in insurance and capital market prices for similar products. Indeed, the diversity in terms of the sources of risk capital enables the ILS market to be free of the constraints of looking for finance from a single market and the products enable the diversity of risk pricing with the ability to dampen annual risk transfer volatility either by term, by source or by loss trigger.

In other words, the reinsurance and/or the retro managers will have risk-financing options similar to those available to the debt-financing options of company chief financial officers.

Innovation has remained the major driver of the establishment of the ILS market which, without doubt, has transcended the view of many that these products would simply be utilised when the rates hardened rather than across the insurance-pricing cycle.

The use of multi-year protection, the ability for continual price discovery through secondary trading and the adoption of non-indemnity triggers such as parametric, modelled loss and industry loss have played significant roles in the ability for ILS to meet the need for the mitigation of catastrophic risk.

Full collateralised cover

The security structure provides full collateralised cover for cedants while permitting "naive" fixed income investors to access risk uncorrelated with traditional credit markets. Access to the capital markets offers particular advantages to both the market and investors alike, particularly the ability for rapid loss determination via the use of parametric triggers that can substantially aid post-event liquidity.

Much talk in the infancy of the ILS sector was over the frictional set-up costs that came with the products. While those costs have been reduced over time, the multi-year nature of the transactions also enables the spread of those costs across the term of the issuance, which can be anything up to a decade.

The fact that they are fully collateralised creates greater credit security and the diversified risk suppliers further spread the credit risk outside the insurance and reinsurance industry alone.

Modelling agencies have had a major role to play in the ILS sector. Their major influence has been to act as the third party in the relationships between investor and issuer while assisting the issuer in structuring their overall risk management programmes via the use of cat models provided by the modelling agencies.

Independent evaluation

They provide independent evaluation of the risk that is being offered and investors are increasingly looking to the firms as expert advisers on just how much of risk the product could prove to be in the medium term given the multi-year nature of the products.

And they will continue to play a major role with more perils and a growing world demand for property catastrophe insurance.

Despite the growth and the backing of leading financial institutions both inside and outside of the insurance markets, the growing maturity of the ILS sector has brought new challenges which have been created by the size and scope of the market and its undoubted potential for the future.

The potential for a soft market could test the resolve of some investors who had been keen to be involved in the high premium market which arrived post-hurricane Katrina but may be less attracted to a market of lower returns but seemingly no lower risk.

There are also calls from a number of quarters for a greater degree of standardisation in the underlying contracts and the creation of independent loss indices in all areas of the market rather then just a chosen few.

But the future looks to be one where the insurer will seek to refine its ability to distribute its risk to a broader base of capital providers and it will be one where the brokers, reinsurers and banks will be forced ever closer as cedants look for a multi-faceted solution to its catastrophe-risk mitigation and increasingly its non-catastrophe risks alongside.

Dennis Kuzak is senior vice-president at Eqecat