Module K Unit 19

INDEX LINKED SECURITIES

Purpose

At the end of this unit the participant should understand the purpose of an Insurance Linked Security ("ILS"), perils typically covered by an ILS and the three most common structures of an ILS.

Assumed knowledge

None

Summary of learning outcomes
1. Explain the principal purpose of an ILS being to facilitate the efficient operation of the insurance market.
2. Describe the types of perils that are typically covered by an ILS.
3. Demonstrate awareness of the main structures of ILS currently utilised and how they differ from one another.
4. Explain the key activities performed by the Guernsey insurance manager.

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INDEX LINKED SECURITIES

19.0 INTRODUCTION

Insurance Linked Securities ("ILS") are financial instruments whose value is driven by insurance loss events and allow capital market investors to participate directly in the reinsurance markets.

Perils which are typically covered by ILS instruments include: -

- Natural Disasters
    - Windstorm/hurricane in the United States
    - Earthquakes in Japan
    - Wildfire in California
- Life
    - Longevity/mortality projections impacting a pension program or life insurer
    - Pandemic
- Cyber and other commercial risks

These perils have common features in that they are potentially catastrophic events and therefore insurers are exposed to highly concentrated risk exposures in certain areas. This pool of risks is growing with a recent trend of increasing interest in covering cyber risks for example.

19.1 INSURANCE LINKED SECURITIES – HOW THEY CAME ABOUT

Prior to the early 1990's, many insurance companies were unsophisticated in their approach towards pricing catastrophe risks. There was inadequate identification of risk trends, for example wealthy Americans moving to coastal towns and increased policy issuance due to increased competition in the market.

In 1992, Hurricane Andrew was the first billion-dollar catastrophe event that the insurance market had encountered (with an estimated bill of US$23-25 billion, 700,000 claims, 125,000 homes and 82,000 businesses either destroyed or damaged according to AIR Worldwide).

These numbers were more than twice the figures the insurance industry had modelled and a number of insurers ultimately filed for bankruptcy.

Following this event many insurers and reinsurers were unable to offer the same level of coverage to its clients and as a result the insurance market experienced a significant decrease in capital/capacity.

With capacity constrained, insurers and reinsurers looked to the capital markets for capacity and the first catastrophe bonds emerged. These instruments were/are the securitisation of insurance risks and provided an attractive source of capacity to (re)insurers and a diversifying asset (not linked to economic conditions) to investors. And so ILS product was launched and it has continued to grow on the back of further catastrophic hurricane seasons including hurricanes Katrina, Rita, Wilma, and Ophelia.

New forms of ILS vehicle/instrument were developed which we will discuss in the next sections.

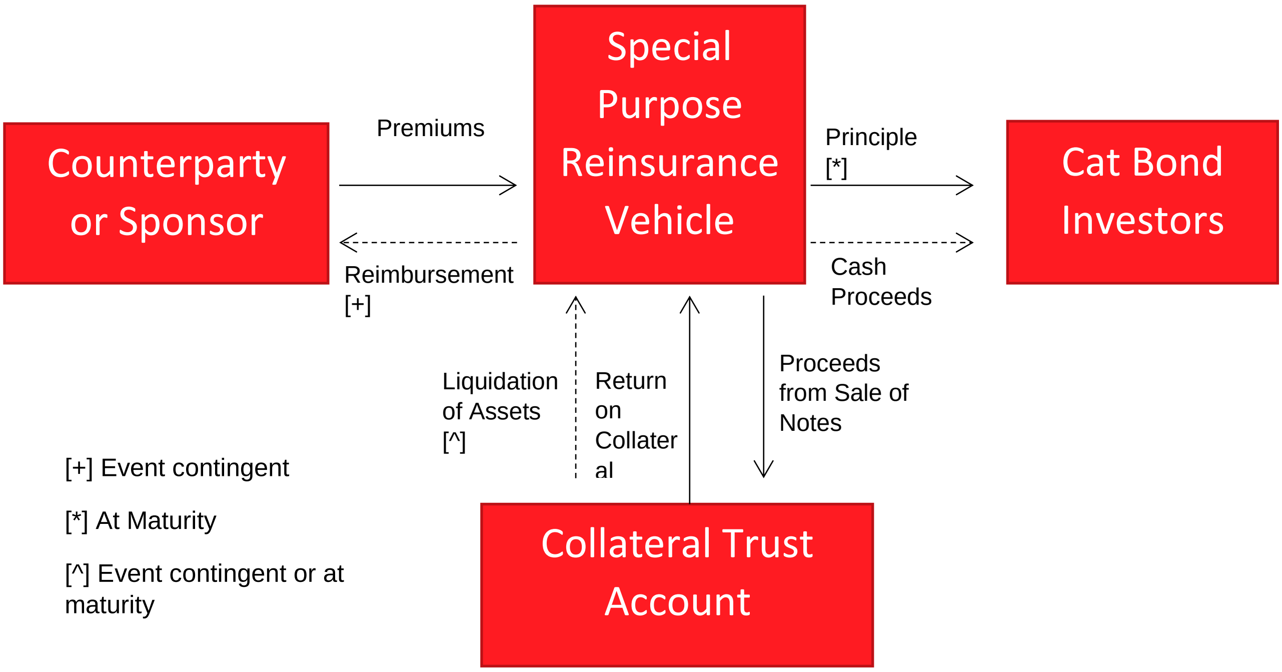
19.2 INSURANCE LINKED SECURITIES STRUCTURES

19.2.1. Cat Bonds

A catastrophe bond ("Cat bond") is a financial instrument designed to raise money for companies in the event of a natural disaster. Such instruments are both sold and purchased by (re)insurance and ILS funds, they may also be purchased by other organisations to cover their catastrophe risk(s).

The coupon and principal payments to investors depends on the non-occurrence of a predefined catastrophic event, the performance of an insurance portfolio or the value of an index of natural catastrophic risks

Cat bonds benefit from being liquid products as they can be monetised (e.g. traded) relatively quickly which is beneficial to making funds available to investors.



In the above structure the Counterparty or Sponsor will typically be a (re)insurer looking to purchase protection against a portfolio of risks or perils.

A Special Purpose Reinsurance Vehicle ("SPV") will typically be structured as a Guernsey or Bermuda entity within a Protected Cell Company or an Incorporated Cell Company.

Collateral, up to the value of the full aggregate limit of the cover, is held in a trust account funded by the proceeds from the note issuance. Funds within this trust account are typically invested in Cash or Treasury Money Market funds to minimise counterparty credit risk

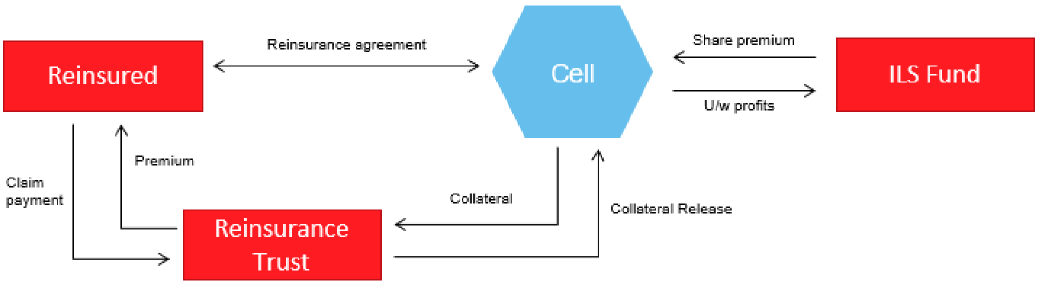
19.2.2 Collateralised Reinsurance – privately structured securities

Collateralised reinsurance usually refers to a reinsurance contract which is fully collateralised by third party capital market investors up to the full aggregate limit of the contract minus the net premiums charged to reinsure the contract.

Collateralised reinsurance allows capital markets investors (such as Hedge Funds, ILS Funds, pension funds) participate in major reinsurance programmes and provide a source of capital to the market.

As the cover is fully collateralised, (re)insurers are able take regulatory solvency credits for the reinsurance without having to rely on the counterparts rating.

Collateralised reinsurance transactions are not tradeable on an exchange unlike cat bonds and as such are less liquid to investors. However, they do provide a more flexible and customisable option to (re)insurers.



Transactions are executed through a cell, typically will be structured as a Guernsey or Bermuda entity within a Protected Cell Company or an Incorporated Cell Company.

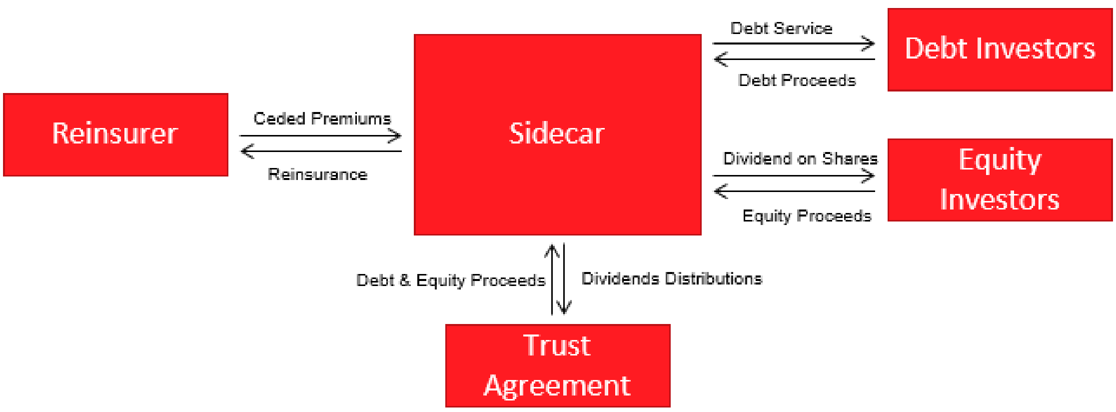
As the transaction is completed, the ILS fund/Investor places capital into the reinsurance trust, via the cell, as collateral for paying claims that may be made on the policy. The reinsured pays premiums directly into the reinsurance trust which tops up the level of collateral to the aggregate limit on the contract.

Ultimately, on expiry of the risk, the transaction is unwound and remaining funds in the trust account can be retrieved by the ILS fund, via the cell, representing any balance left over after any claims paid.

19.2.3 Sidecars

Sidecars are financial entities created to allow investors to participate in the risk and return of a small and limited portfolio of insurance policies – generally short-tailed property catastrophe policies written by a (re)insurer – without taking on the long-term investment risk associated with a (re)insurer's entire book of business or legacy loss reserves. Sponsors in turn benefit from reinsurance capacity and management fees.

A.M. Best defines sidecars as “limited-life special purpose entities that generally provide property catastrophe quota-share reinsurance exclusively to its sponsor.” Others refer to them as “disposable reinsurers”.



Sidecars are typically structured as a Guernsey or Bermuda entity within a Protected Cell Company or an Incorporated Cell Company.

19.3 INSURANCE LINKED SECURITIES – KEY ACTIONS AND POINTS FOR THE GUERNSEY INSURANCE MANAGER

Many of the key actions expected of an insurance manager will be similar to those of a captive, for example governance and compliance functions, but some key differences are discussed below:

19.3.1 Regulations

Due to the fully collateralised nature of these transactions, with the Guernsey entity controlling funds up to the aggregate limit of the policy, regulators consider such business to be lower risk than other insurance licensed activity, in recognition of the lower risk, rules for Special Purpose Insurers, ("SPIs") were introduced in 2017. These rules were drafted in collaboration with the Guernsey International Insurance Association with the aim of keeping Guernsey at the forefront of growth in the ILS sector and can be accessed via the following link.

https://www.gfsc.gg/sites/default/files/20180209%20-%20Insurance%20Business%20%28Special%20Purpose%20Insurer%29%20Rules%202016%20as%20amended%20Feb%202018.pdf

Assuming transactions meet certain criteria as set out in the rules, ILS cells or vehicles can be categorised as category 6 licencees within Guernsey's solvency rules. This allows for a lighter touch regulatory reporting process including:

- Fast track approvals/pre-approvals
- No requirement to complete OSCA's or Regulatory Solvency Assessment

19.3.2 Collateralisation

ILS vehicles operate using a 30-day window within which to fully collateralise the vehicle/cell from the date of signing the underlying insurance contract. In the event that funding is not received by this date, the regulator should be informed.

19.3.3 Claims payments

All ILS vehicles/cells should be fully collateralised at all times. Albeit when a loss event occurs, the reinsured may have the ability to withdraw funds from the trust account unilaterally without the authorisation of the Board of the entity. In practice all releases from the trust account require the signatures of both the beneficiary (reinsured) and grantor (cell) of the contract. It is important that the Manager confirms with the investor that they are satisfied with the calculated loss amount before releasing funds.

19.3.4 Policy Wording

Particular attention should be paid to the policy wording to ensure that the limits are understood and therefore the exposures are fully collateralised.

Limited recourse language/cell limitation clauses should be included in all contracts involving protected cells to reinforce ring fencing and protection of investor capital for each contract.

Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. Which catastrophe event first led to the development of ILS?
2. Name the three forms of ILS and a key differentiator of each?
3. Does a Cat Bond structure include an insurance or reinsurance contract?
4. What rules does the GFSC apply to ILS business?
5. What rules apply to all bank payments made by a Special Purpose Insurer?

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