



Episode 4: Developments in the insurance-linked securities (ILS) market

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WILLIAM DUBINSKY: The sum is greater than the parts when you have that alternative capacity mixed in with traditional reinsurance, and you got a reinsurance structure, insurance structure, that's more stable, efficient, and secure.

NARRATOR: You're listening to Rethinking Insurance, a podcast series from Willis Towers Watson, where we discuss the issues facing PNC, life, and composite insurers around the globe, as well as exploring the latest tools, techniques, and innovations that will help you to rethink insurance.

SINA THIEME: Hello. And welcome to Rethinking Insurance. I'm your host Sina Thieme, and today I'm delighted to be joined by my guests, Matthew Ball, and Bill Dubinsky. Matt is the ILS consulting leader for Willis Towers Watson insurance consulting and technology business as well as the Bermuda office leader. And he's been in the insurance industry for more than 20 years and is an actuary by trade.

And Bill is managing director and CEO of Willis Securities. And prior to Willis Towers Watson, Bill worked at Swiss Re Capital Markets, Merrill Lynch, and Aon Capital Markets. And Bill has a background in law. Great to have you with us Matt and Bill.

WILLIAM DUBINSKY: Hi, Sienna. Great to be here. **MATTHEW BALL:** Yeah. Hi, Sienna, great to be here likewise.

SINA THIEME: In today's episode, we're going to discuss the insurance linked securities, or ILS market. And before we get into that, and as usual for our podcast series, I would like to find out a little bit more about our guests. And so Bill, when I Google your name, things that come up after your LinkedIn page are your involvement in SIFMA, a trade association for broker dealers, and investment banks, and managers, and your Facebook page. But the William Dubinsky on Facebook who actually looks pretty different from you, he likes the Philadelphia Eagles and studied tech at Temple University. Do you like those search results? Or would you have hoped for something different?

WILLIAM DUBINSKY: Well, I'd love to have found out that I was a professional golfer or some such thing. But I think while I'm not a Philadelphia Eagles fan, the other stuff sounds pretty accurate.

SINA THIEME: And Matt, similarly, when I Google your name, the first thing that comes up is a website called matthewball.vc. And that Matthew Ball is a media analyst who writes blog entries

about Netflix and Disney. And then the next search result is Matthew Ball, a ballet dancer at the Royal Opera House. Are you jealous of your name twins?

MATTHEW BALL: Oh dear. Well, when I was at school, I did want to play for England football or cricket team. I'm not sure that's accurate though. I'm like Bill. I'm not sure people would say I'm that good on the dance floor.

SINA THIEME: Thanks. So Willis Towers Watson has just recently published a global survey report on ILS which you both worked on. And survey participants were from across the industry, from insurers and reinsurers, to fund managers, and end investors, and even some corporate risk managers. And I guess this allowed you to gain a pretty holistic view of the ILS market.

Now roughly 15% of the global reinsurance capital is alternative capital. And that's a steady increase over time. And the recent catastrophic loss years, tested the industry but didn't really slow it down. So what makes alternative capital such as ILS so interesting for insurers and reinsurers as well as corporate and public entities? Maybe Bill, if you want to go first.

WILLIAM DUBINSKY: Sure. So for cedants, the attraction really boils down to access to a diversifying and broader capital base for their reinsurance or insurance needs. I mean really, what we mean by alternative capital is capital that's not the common equity of a promise to pay rated reinsurer insurer. And the sum is greater than the parts when you have that alternative capacity mixed in with traditional reinsurance. And you get a reinsurance structure, insurance structure, that's more stable, efficient, and secure.

And really, that tenet has been driving the market since the beginning. And we've seen the results which are in some cases insurance has become more available and affordable for policyholders, for example, individual homeowners in the state of Florida.

SINA THIEME: Matt, anything to add?

MATTHEW BALL: I think Bill said most of it. I mean the only thing to add is some of the, again, the access to the capital markets, right? And there's some big numbers out there in terms of the supply side. I mean you think of global pension funds alone, that's probably in excess of \$30 trillion out there. If they only allocated 3% of the sector, then that would be \$900 billion. I think global property cap limit is around \$300 billion. So I think that's the other attraction as well as the mix of cover as Bill says. Just the potential for that supply is immense over time.

SINA THIEME: Yeah. And we see ILS as being particularly popular amongst insurance and reinsurers in the US and with US risks. And why do you think this is the case? And why don't we see more ex US risk or corporate and public entities to the same degree?

WILLIAM DUBINSKY: US based insurers and reinsurers exposed to US hurricane risk face the highest cost of reinsurance per unit of risk. Stated differently, for a reinsurance limit with a 1% expected loss, or average annual loss of 1% of the limit, a US cedant will pay more than a cedant outside the US. Why is that? That's because that the total reinsurance industry exposure to hurricane risk is greater. So reinsurers need to hold more capital per unit of hurricane risk they write relative to diversifying perils such as Turkish earthquake, and then pass along the resulting capital charge to their customers.

So just to be really clear, let's say that you could have a maximum insured industry loss for some return period of \$200 billion for US hurricane risk. And that's one of the numbers you might see. The maximum number for a Turkish earthquake is well under \$50 billion in US dollar equivalent. So that's really the rub. And that's the general rule. There are many, many exceptions. And we see ILS becoming a much greater tool for diversifying perils in recent years and expect it to be even more the case in the coming years.

MATTHEW BALL: So I mean the only thing, I've got a question for Bill. I guess the peak risk is a good one, is when we compare the US and Asia-Pacific, is the other variable there that could

affect things the relative penetration rates of insurance? So I guess my question is if insurance becomes as prevalent in Asia-Pac as it is in the US, do you think that could change the attractiveness over time if these risks do become a bit more peaky just because of the penetration rate?

WILLIAM DUBINSKY: Absolutely. So right now if-- and again, I hope this isn't too technical for this discussion. But if right now, you had a hypothetical reinsurer that said, I need \$0.50 of equity capital for each unit of hurricane risk that I write, and it's probably less than that. But just for sake of argument, \$0.50, because I could lose half of my equity capital from a peak hurricane event. Now they say I only need to hold \$0.25 of equity capital per unit of risk I write in Asia-Pac. And then suddenly the insurance penetration changes and there's economic growth, for example, in some of the coastal cities in China. Then that whole dynamic may change. And it might be \$0.40 per dollar for US risks and \$0.40 per dollar for that Asia-Pac risk. And you could have equalization over time.

But again, that's just one factor. And so I can't stress enough that right now, there are great opportunities for diversifying perils. And we've seen that shift towards the diversifying perils and also for corporates which have-- it's another side of the same coin as to why corporates are also more diversifying relative to insurance companies or reinsurance companies. But we expect all these things to continue to change. And there are great opportunities outside peak risk even now.

SINA THIEME: Yeah. And I guess you focus on property risk from natural catastrophes for now. And ILS is also really interesting in the life sector. And our ILS survey has shown that insurers and reinsurers would like to use ILS capacity beyond [INAUDIBLE] for example for covers against cyber and casualty risks. However, when you ask [INAUDIBLE] investors the same questions, they showed actually really little appetite for these risks. And why do you think that is, Bill?

WILLIAM DUBINSKY: Well, I think it's partially an artifact of the survey. In other words, we're talking to the existing end investors who are backing largely property catastrophe risk and life insurers. We're not talking to everyone. So those individual pensions, for example, have made it bet on property, [INAUDIBLE], and life. And they may lack understanding of some of these other perils like cyber risk, or like terror for example.

And then there's the second issue, which is correlation to the broader financial markets. And one of the advantages of property catastrophe risk is if you are running a pension portfolio and or another type of portfolio, natural catastrophe risk is diversifying relative to that equity risk and other things that you have in your portfolio. And there's a perception that cyber may be less diversifying. So that's another issue.

Finally though, I think it really gets down to, who am I allocating the money to? And what you will see time and time again, especially with pension funds more than, say, high net worth investors in totality, is pension funds are very deliberate about who they allocate the money to and doing due diligence to make sure that the people they're allocating to, managers, know what they're doing. And so they have spent a lot of time allocating money to their existing ILS funds and getting comfortable with some of the things that I think we might talk about later in the discussion. But in particular, that the people picking the risk know what they're doing.

And they may have some concerns about allocating to for example or property [INAUDIBLE] person who is doing a wonderful job there and having them look at cyber. And why is that? Well, that's because the underwriting practices in the reinsurance and insurance industry are segmented. There are different experts who would look at cyber risk, for example. There are different models or concerns about models. And in my view, probably the most important is that the wordings are very different for something like cyber or a new and emerging risk relative to something that's a more established class. And even there with established classes, COVID-19 calls our attention to the fact that what you think you know can sometimes be a little different than what happens in practice. And that's some of the I would say imperfections in the wording around COVID-19.

SINA THIEME: Right. And then I guess looking at this from a different angle, I know you, Matt, you call it the [INAUDIBLE] test. Whenever something makes it onto [INAUDIBLE], this means it's included in the insurance world. And you could definitely argue that for example hedge fund reinsurers have a really big portion of casualty risks in their portfolio. So maybe you get back to this discussion on definitions. What's really ILS? And where do capital markets end? And where does the traditional insurance market start? And the other way around. And I guess people call this convergence. And maybe, Matt, you can elaborate a bit on that.

MATTHEW BALL: Thanks, Sienna. That's a great question. In terms of definitions, the broader definition, we could call alternative capital. So let's start there. And then we'll come back down to our last, really your total return reinsurance is a good example. Are they reinsurers that have an alternative asset strategy? Or are they leveraged mutual funds depending whether you're wearing your insurance hats or capital markets hat, you can look at them both ways. You could argue legacy players are similar in that respect on both the PNC and life side.

So they're on the PNC side, they've been accumulating casualty and long tail type risk for a number of years. So often it feels like it's just the taxonomy that separates the two. But I think there are some real differences as you get down to ILS, the ILS acronym. One of those would be, does it look like a security? So for example a cap bond is clearly a security that can be marketed and has liquidity. If you think of ILS funds, they will accumulate underlying assets and then provide liquidity to the external investors. That may be under a different accounting framework, fund fair value rather than an insurance gap. But there's liquidity there.

So I think on the terms if capital [INAUDIBLE] you could argue there's lots of cash out there already. Even if you narrow it down to ILS, there's already been examples of funds that-- or whether there have been examples of cap bonds, and Bill would know one very well himself that securitized also liability.

And then there's been examples of ILS funds that have securitized cash to risk. That could be providing loans, it could be providing limited cover under an ADC basis. But usually the tail risk would have to be taken back at some stage. Otherwise, the carry cost of capital for a traditional ILS fund structure is too high.

So there's lots of different definitions. I think in the narrow ILS fund sense, or ILS security sense, I think we are still in the early days of that evolution. I think it can be done. I think the reality is that on the property risk side, there's probably lots more of the low hanging fruit. There's a product there that people have confidence in and it's been there for a number of years now. But casualty has been securitized. I think it can be done. There are some barriers to it be done more widespread. But if that can be unlocked, I think there's a lot of good potential for the ILS market.

WILLIAM DUBINSKY: The only thing I would add to that, Matt, is that there's even more potential work for growth with alternative capital more or less improving the ability of insurers to deliver better products to their customers. And if we can grow the top line for the insurance industry through use of alternative capital, then we're going to see even greater growth for alternative capital itself.

MATTHEW BALL: Yeah. I'd agree with that, Bill. It's coming, right? And I think it's good for the industry, it's good for investors, and it's just good all around if we can crack that nut of getting more products or more lines into the ILS space.

SINA THIEME: Thanks, both. I guess I wanted to touch another angle off their survey. And that was that end investors cited the level of reporting and transparency as the most important characteristic of a good ILS fund. And that's above low fees, which is quite surprising. Do you think the drive for transparency and independence is one reason for the emergence of quite a few new ILS funds recently?

MATTHEW BALL: Whether you're an existing fund or a new fund, reporting and transparency, I mean the survey said it, is absolutely key. It's just a need to play. All ILS funds need that. We said this for a number of years now, I think, after the loss events of recent years that the

overall-- it's been great to see the resilience of the overall capital within the ILS sector. But end investors do switch. And all else being equal, if they think one fund has better transparency or reporting over another, they can reallocate their funds.

So I just wanted to emphasize, I don't think it's the only reason new funds have been setting up. I mean there's some broader market dislocation out there.

WILLIAM DUBINSKY: A related point, and maybe something that's relatively important this year is that product choice can have an impact on transparency as well even if the managers stay the same for an existing end investor. And we've seen a lot of a drive towards cap bonds, especially in the second half of 2020 as something where there is a degree of inherent transparency in the ability of cap bonds to get mark to market based on secondary trading.

That's not to say that mark to model doesn't work really well in certain circumstances. And maybe that's a topic for a whole separate podcast and conversation. But it certainly is an aspect, a choice, that end investors have is what type of products they want their managers to utilize to access risk.

MATTHEW BALL: Just to add to that, Bill, I mean the valuation, yeah. I agree. That's definitely a topic for another conversation. But that's been an absolutely vital part of the transparency within the ILS funds. This is maybe more of a comment for the illiquid side of the equation rather than the cap bonds. But a good proportion of our work is related to independent third party valuation. And it's been fascinating for us to see how the need for that has increased over time.

Again, it's just driven by the investors. The losses over the recent few years have accelerated that. That was another one of the survey findings. I think two years ago, the number of funds who got independent third party valuation was around third. And now I think it's a majority. So just over 50%. So the whole area and valuation, which is a very important subset of reporting and transparency in general has really-- the message is being received loud and clear. But again, it's just very much driven by the investors. And I think it's been accelerated further by the events of the last few years. But I agree. Probably you would need a separate podcast for the ins and outs and dark arts of valuation.

SINA THIEME: So but I get that end investors do switch. That makes total sense. And I guess one aspect that is probably going to grow even further in the next years is that aspect of ESG values, right? So I guess that end investors are going to really investigate that more in the future. And our ILS survey has also shown that climate change just generally is going to really influence the ILS world. And maybe you can just briefly elaborate on sort of the potential threats and opportunities that climate change is going to bring to the ILS world.

MATTHEW BALL: Yeah. The whole ESG area is one that is certainly-- there's been a big acceleration of interest over the last year. I know it's been with us for many years. But it really does feel like the rubber's hitting the road here in terms of what countries are doing around the world and our regulators. I think there are opportunities and threats for the insurance industry and ILS industry in general.

On the face of it, I think ILS and reinsurance start off in a very good place because fundamentally, the underlying product is usually trying to help individuals and original policyholders to recover from events that can be related to climate change. But there's a caveat, right? Already, we've seen examples of insurers suffering some reputational risk when it becomes clear that they could be covering companies that may not have the best ESG record.

So I think there's both opportunities as threats. I think it ties in nicely with the earlier discussion on transparency and reporting in the fact that already, we're getting inquiries from our clients. It could be ILS funds and reinsurers about how they can improve their ESG reporting and maybe offer some sort of scoring mechanism.

And again, that just adds to when they're trying to attract end investors of funds who will

themselves have minimum thresholds or standards on ESG criteria. The funds need to be prepared for that. So I think they inherently start off in a good place. But they still need to prepare for that extra reporting and transparency requirements. They're already here from the end investors and they will only get more and more-- more and more clear on their requirements over time.

WILLIAM DUBINSKY: The immediate concern from some of the funds and the end investors is concerns that the models that are used to price net cap risk are biased to under [INAUDIBLE], the impact of climate change. And that's certainly a topic of hot debate, whether they're accurately adjusting for it, or undercooking it. But the flip side is that as climate change increases the demand for insurance, the ILS market can both provide accurate market signals of how that's affecting pricing in the insurance markets and crystalize the cost of that change.

But also it can provide capacity that especially sensitive areas, sensitive developing areas and so forth, need to address those needs and threats. As what we were talking about before occurs, which is economic growth in the developing parts of the world and in already developed areas like parts of Asia-Pac, you're going to need this capacity even more because of climate change.

SINA THIEME: Yeah. I think that sums it up really nicely, Bill. And so thank you so much for this great discussion, Matt and Bill. It's really interesting to see where and how risk and capital meet and how this would change in the future.

So thank you for listening to this episode. And if you found this interesting then join us on future episodes of Rethinking Insurance.

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