FOCUS/INSURANCE-LINKED SECURITIES

The ILS market must increase its focus on risk assessment and price adequacy

Catastrophe losses over the past 18 months have raised tough questions for reinsurers and ILS investors, but over-reacting is not the right response

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This year has proven to be another difficult catastrophe year so far, with global industry losses for the year to date likely to be in excess of $80bn.

This includes several notable cat events including Hurricane Ida, the freezing weather in Texas and the European floods, among others. Two of these – the Texas freeze and the European floods – have contributed $25bn to $30bn of the total.

These losses, combined with others in the market, have put the focus on so-called secondary perils, which may be under-modelled. There is fresh debate about the true severity and frequency of natural disasters.

Additionally, the flooding that was associated with Hurricane Ida, although it will be at least partially covered by the National Flood Insurance Program (NFIP) or excluded as an insurance loss, adds fuel to the fire of climate change speculation.

On top of everything, we are also coming out of the Covid-19 pandemic. While the pandemic may qualify as a black swan event, it has nevertheless been a correlating event that affected property coverage globally, exacerbating losses via supply chain disruption and material cost inflation.

From an insurance perspective, not everything is doom and gloom. For instance, this season, headlines in the US that have described extreme drought as the hottest season on record have implied greater wildfire risk.

However, as of mid-September 2021 has about 10% lower acreage burned compared to the 10-year average. Similarly, the spring tornado hail season in the US was relatively mild.

Climate change loss costs

There will be continued debate about climate change and its impact on loss costs for specific perils and geographies.

At the macro level, climate change is an existential crisis that is having – and will continue to have – a devastating impact. SiriusPoint, like all reinsurers, will continue to play a role in building resilience in the face of this threat. Specifically, within insurance, some perils such as earthquake are not affected by climate change, while others, such as flood, are more clearly linked to it.

Regardless of cause, it is clear the industry must re-underwrite select risks, especially flood, where model uncertainty is high, and for which insufficient reinsurance premiums may have been charged as these perils were considered “non-peak” and may have been added to coverage without sufficient premium for the risk.

Alternative capital has become a mainstream offering within the industry and this sector is now approaching 30 years since the first securitised transactions in the mid 1990s.

However, not all insurance-linked securities (ILS) are created equal. Certain fund managers have outperformed others and products within the sector have also shown differentiation.

Cat bonds, for example have generally performed extremely well since inception. They are typically structured as remote high excess risk and the remoteness has proven true. Some cat bonds with higher risk tranches have been affected, but the losses have not had an impact on investor demand. In general, the ILS products have performed in sync with industry performance on cat bonds where reinsurance markets have had similar experience for peak zone remote risk, but experience on some structures such as collateralised aggregate retro has been worse given the frequency of losses from medium-sized events lower down the curve.

Industry loss warranties (ILWs), in particular, have performed more in line with cat bonds as they have tended to be structured for specific perils and regions, have attached higher up, and typically only cover natural perils, avoiding losses such as Covid-19. ILWs are generally used for retrocessional protection by reinsurers and will be a growing segment of the ILS market via collateralised reinsurance and cat bond issuance as reinsurers remain a core buyer of ILS capacity.

Given recent events and heightened uncertainty – or at least, perceived heightened uncertainty – we expect capital providers to be more discerning about which vehicles, counterparties, and perils to support. Like reinsurers, investors have relied on models, but there is a risk of over-reliance on models, especially for perils where the underlying weather dynamics may be changing.

However, given continued low interest rates, lack of correlation from alternative reinsurance investments, and the historically strong performance because of concentration in remote peak zone risk, there continues to be strong investor interest across most ILS products.

For investors who choose to allocate capital to originators and underwriters of risk, there will be a continued flight to quality to those counterparties who are perceived to be more sophisticated – who blend industry models, who resort to internal research and development to build their own proprietary view of risk, and who have judgment-based calibration when modelled output conflicts with common sense.

Repricing

At SiriusPoint, we have a globally diversified portfolio with a long and successful track record of underwriting cat risk. Our use of the ILS markets has been via the purchasing of ILWs for retrocession protection. In addition, we have an outwards proportional reinsurance programme that has ILS-like features and leverages our track record, which is based on our proprietary views of risk and decades of experience.

In our view, the increased frequency and severity of losses coming from secondary perils has shown that they are underpriced, with the recent floods in Europe as one example. While underpricing starts with primary insurance, all capital providers, from insurers who sell product to reinsurers and ILS investors who support it, need to acknowledge that select perils across numerous geographies require higher rates and, in some cases, structural change and re-underwriting.

If history has taught us anything, it is that over-reacting to recent experience is not the right answer. Capital providers need to earn an adequate return for the risk they are taking, or they will deploy capital elsewhere. Industry returns have been poor and the highest expected return product, property cat, has not earned an adequate return for several years.

Clearly, more focus on risk assessment and price adequacy is required. ILS investors and reinsurance companies need to avoid being the bastion of volatility for primary companies at inadequate returns.

ILS investors, by design or luck, have largely focused on better modelled higher excess peak zone risk, often restricting coverage to avoid coverages arguably not contemplated in price setting prior to observed losses such as pandemic risk. As ILS investors and reinsurance companies support transfer of volatility for less well modelled risk and more frequent medium-sized catastrophes, they will expect significant and sustained rate increases. The good news is, we see clear awareness of this need within primary insurance companies and expect re-underwriting to continue and be sustained. ■


Flooded streets in Belgium in July

Abaca Press/Alamy Stock Photo

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