(Re-) Insurance linked investments

Executive summary

That type of investments (known as «ILS») can offer attractive returns for a simple reason: Insurers are willing to pay substantial premiums to hedge and spread the risk of a major, but unlikely, catastrophe that could jeopardize their continued surviv-al. Investors on the other hand are in a position to take on this risk, therefore work with *pure* insurance risk unlike insurance debt / equity which *bundles* insurance risk with operational, credit, market, and other risks.

ILS market allows *buyers* to acquire attractively priced, significant, secure, dedicated, protection while affording *investors* unique opportunity to participate in a totally un-correlated asset class with attractive returns relative to instruments of similar rating/ risk profile.

Protection *buyers* (risk-exposed entities) and protection *sellers* (investors) use rapidly growing ILS market to facilitate hedging, investment, and trading of a broad spectrum of worldwide insurance risks.

Global *natural catastrophe risk*, at the moment, remains the most actively transacted risk in the ILS market. Although many programs have regional or even particular country focus with different insured events triggers (As an example: USA All Natural Perils, US Florida Wind, Japan Earthquake, European Storm, etc.)

ILS market has steadily grown from its origins in mid-1990's to an estimated $60bn market today, and is projected to triple in size by 2020. Goldman Sachs has recently identified ILS market, also known as "alternative insurance capital", as "*disrup-tive force*" responsible for a seismic shift in how insurance risk is being financed.

Investors in ILS market comprise global *public* and *private* pension funds, asset man-agers, hedge funds, family offices and high-net worth individuals. Interestingly that as uncorrelated asset this is common now for allocation of 5-6% of AUM (Assets Under Management) to be invested in ILS as the way of diversification for custodians of massive pension funds.

Investment opportunities within the ILS asset class comprise 4 main types of transac-tions: *Retrocession*, *ILWs (Industry Loss Warranties), Cat Bonds & Sidecars.* Here is a brief description of each:

1) Retrocession (Collateralised reinsurance): When insurer protecting its peak expo-sure to major catastrophe on top of certain self-retention (Excess of Loss reinsurance). These programs have trigger known as UNL (Ultimate Net Loss) and very straight-forward deals with one-year maturity and premium payment upfront or bi-annually.

Provided there is no loss *investor,* who already had its premium, released from collat-eral, which is done either in a form of Standby Letter of Credit or Collateral Trust Agreement with approved bank.

The most risk concentrated but rewarding type of transactions. Usual range of gross premiums 25-30%, which means net to investors return at around 20%.

Sample deal: Property portfolio reinsurance of XYZ company for UNL in excess of 30 million. for Gross rate on line of 30%

2) ILW (Catastrophe derivatives): Similar to retrocession with the difference that the trigger for the event is the loss to the industry as a result of major catastrophe. Loss to the industry is based on the index provided by specialist organisations predominantly being: PCS (US), PERILS (Europe) or SIGMA (Worldwide). Also based on annual tenor with similar protocols for premium payment and collateral release.

Gross premiums for such deals are in a region of 15-25%, i.e. around 12-17% net to *investor.*

Sample deal: Reinsurance of XYZ company for US All Natural Perils catastrophe loss in case industry loss exceeds USD 5 bln. Based on PCS ANP index

3) Catastrophe Bonds (Insurance Linked Securities): The way of transferring risk from insurance to capital market through sponsorship and issuance of securities known as Catastrophe Bond. These are OTC traded securities with 3 years maturity but contrary to other forms of ILS they have immediate liquidity. Interest calculated and paid monthly.

Average interest is about 8-12% p.a., paid monthly.

Sample deal: Turkish CAT Pool issues *"Bosphorus"* bond covering earthquake event in the country.

4) Sidecars (Quota shares): Pure investment of capital into the business of particular insurer whereby *investor* totally *"follow the fortune"* of the designated partner and performance of portfolio of the company.

This is not yet equity investment but closest way of cooperation with insurer requiring significant knowledge of insurance business. In fact can be described as funds given to insurer "to play with" in respect of designated class of business. Usually used by insurers from other regions to enter Lloyd's market through provision of capital into Lloyd's syndicate.

Profitability for investor depends on profitability of the portfolio and can vary from 20% return on capital to negative result.

Sample deal: Entrance into the Lloyd's market by China Re through Quota Share arrangement with Catlin. Eventually led to set up of separate Syndicate for China Re at Lloyd's after 3 years of cooperation with Catlin.