Expanding the potential of ILS

How the insurance-linked securities (ILS) sector has the potential to expand the scope of risk transfer by capitalising on untapped demand.

September 2013
Foreword

Welcome to ‘Expanding the potential of ILS’, a follow-up to our opening paper on how to capitalise on the rapid developments in the insurance-linked securities (ILS) market.¹
Following a year of tremendous change and convergence in the reinsurance market, we estimate that ‘alternative’ ILS capacity now makes up around 15% of the overall property catastrophe reinsurance (‘property cat’) market. Our paper examines some of the market trends that have surfaced over the past 12 months and looks at opportunities to release further the potential through convergence strategies.

Since the financial crisis, a combination of attractive spreads and diversification benefits have created a voracious appetite in the capital markets for ILS. It is also clear that some of the barriers we identified last year on the supply side are softening and that transparency and innovation have led to greater liquidity in the marketplace.

Property cat companies have launched ILS strategies en masse, with investment banking segments taking shape in the form of ILS funds, coupled with sidecars orbiting the core reinsurance platform – each attracting third-party capital. Pressure to compete with dedicated alternative ventures has driven more flexibility and innovation from traditional sources of capacity.

Similarly, dedicated capital markets businesses have continued to invest in ways of overcoming the impediments to mainstream success. For example, the predominant use of indemnity bonds in 2012 and 2013 points to an investor base that is prepared to be flexible as long as this flexibility is rewarded with increased transparency and yield.

Yet, there are warning signs that the surge of entrants and investment in the ILS market is bringing the risk of dislocation and creating fundamental concerns about the direction the market is heading. Competitive pressures are intensifying in an environment of constrained demand, in which asset managers with big mandates are scooping up previously unchartered capacity.

Cost of capital divergence between reinsurers and ILS funds is now manifesting itself in the variation in pricing between the traditional and alternative markets. Whatever form the cover takes, risk selection and price adequacy are fundamental in the catastrophe business.

As we reported last year, natural catastrophes could become potentially more frequent and severe, threats which are being compounded by accelerating urbanisation and widespread issues around supply chain connectivity and business interruption. A clear focus on the art of underwriting is therefore paramount. Models support this, but using them in isolation is dangerous.

1 “Unlocking the potential of ILS”, June 2012
www.pwc.com/insurance/unlocking-ils
2 PwC analysis of June 2013 renewals
Windstorm Sandy caught many in the industry and government off guard, causing $20 billion of losses in New York City alone. What if, however, the 1926 Category 4 hurricane that swept through Miami hit now. It is estimated that the losses would be closer to $180 billion.3

What is of some concern to reinsurers in the aftermath of Sandy is the extent to which their ability to ‘reload’ is being impeded by softening rates and the allure of new capital market products. As traditional and alternative markets evolve, it is critical that there is clarity of focus on how to preserve or develop shareholder, policyholder and counterparty value in the long run. In this respect, some of the developments we’ve seen over the past 12 months in property cat have been potentially game-changing. While the share of capacity held by alternatives has increased by only 1%, structural changes and innovation coupled with some dislocation are likely to lead to a permanent shift in the market.

With that change comes great opportunity for the ‘innovators’ and ‘fast followers’. And rather than seeking opportunities to compete more fiercely within the ‘red oceans’ of existing reinsurance capacity, these innovators need to turn the oceans blue. Over the past three years, alternative market capacity has grown by approximately $30 billion4 – ideally innovation and structural reform will bring growth in aggregate capacity by the same amount or a lot more!

We hope you find this report interesting and useful. If you would like to discuss any of the issues related, please feel free to get in touch with us.

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3 Source: ICAT Top Ten Damage Estimator, evaluated for 2013 prices (www.icatdamag estimator.com/toptendamages)
4 Source: Trading Risk, Issue Number 56
5 Source: W. Chan Kim and Renée Mauborgne of The Blue Ocean Strategy Institute at INSEAD
Fast followers:
Companies that don’t want to be first, but are adept at following the leaders and establishing a strong presence

Red and blue oceans
Red oceans represent all the industries in existence today – the known market space. In the red oceans, industry boundaries are defined and accepted, and the competitive rules of the game are known. Here, companies try to outperform their rivals to grab a greater share of product or service demand. As the market space gets crowded, prospects for profits and growth are reduced. Products become commodities or niche, and cut-throat competition turns the ocean bloody; hence, the term, red oceans.

Blue oceans, in contrast, denote all the industries not in existence today – the unknown market space, untainted by competition. In blue oceans, demand is created rather than fought over. There is ample opportunity for growth that is both profitable and rapid. In blue oceans, competition is irrelevant because the rules of the game are waiting to be set. Blue ocean is an analogy to describe the wider, deeper potential of market space that is not yet explored.5
Section 1: Emerging trends

Over the past year, the ILS and broader property cat markets have experienced transformational and potentially permanent changes. So, what are the strategic implications for the reinsurance sector?
Price decoupling
ILS investors are increasingly setting their own price hurdles rather than following the curve of the traditional property cat market as investor sophistication and confidence in ILS continue to grow. Aside from the relative frequency of alternative versus traditional pricing, key spurs for these developments have been the investment made by asset managers in improving transparency and bringing in specialist talent. A further driver has been the availability of capital to invest in alternative underwriting, over and above the capital required to support traditional property cat underwriting.

Currently compartmentalised to upper layers, as well as aggregate covers and other index-based products, pricing in new ILS issuances has softened dramatically. Looking ahead, we expect to see increasing activity beyond lowering rate-on-lines (RoLs) in the upper areas of the market, with asset managers penetrating middle layers. This will create pricing pressure further down the ‘stacks’ than has normally been experienced to date.

On a more positive note for the property cat market as a whole, there are early signs that the reduced ILS pricing is bringing new exposure into (or in some cases back into) the market as risk managers view opportunities to hedge risk that previously they could not access within their price range. Furthermore, alternative products are being developed that help reinsurance companies to more efficiently manage capital through reducing the capital charges associated with writing property cat.

Testing the tail
The yield on catastrophe bonds over the last decade has been accompanied by relatively low standard deviations. This makes for an interesting comparison with traditional high-yield products. For an asset class that converges with a risk class in which losses are historically volatile and potentially severe, the standard deviations on catastrophe bonds appear low on a relative basis. This would make catastrophe bonds look relatively inexpensive for portfolio managers starved of yield and seeking to access an uncorrelated asset class.

Concern has been raised during the year about whether such pricing reflects the tail risk associated with underwriting property cat. Conversely, the ILS market has stood up well to a period of significant, frequent and volatile catastrophe losses.

Managing an uncorrelated asset class
As portfolio managers of the larger funds assess the absolute and relative valuations of their securities, the relative yields and low correlation between the occurrences of catastrophic events and broader performance of the financial markets have created a strong catalyst for investment into the sector.
Typically, however, portfolio optimisation strategies look at the recovery of the position, relative to the performance of the portfolio overall. With the occurrence of a major hurricane or earthquake (particularly given the layers in which alternative risk transfer is participating), ILS is more binary. As economies recover, ILS spreads compress and the financial markets create broader opportunities for favourable spreads in other asset classes; this is a feature of this uncorrelated asset class that adds complexity and risk.

**Alpha and beta mandates**

There is strong investor demand for ‘alpha-based’ strategies in the current market – these active strategies rely on risk-adjusted returns that are derived from the skill of the asset manager in running a portfolio within defined parameters. The leading managers have been taking positive steps to differentiate themselves through a variety of actions. These include increasing their reinsurance expertise, further developing their sophisticated analytical techniques and constantly creating innovative new products to further address the needs of investors and sponsors alike. As pricing in the market has softened, many of these managers have stopped taking on further mandates as a result of their discipline towards rating, fee and yield hurdles.

The rapidly increasing capital markets focus on reinsurance risks has also caused a surge in ‘beta mandates’. The concern is that the large volume of capital being placed into the market under these beta mandates could be very difficult to contain or deploy. There is evidence that these beta mandates and the fierce competition they’ve generated are directly and indirectly leading to concerns around discipline and longer term profitability in certain areas of the market where overall capacity is finite.

A comparable situation in traditional reinsurance would focus on an alpha approach (or at least strict underwriting and risk selection guidelines) versus writing loss-making basis. In the collateralised part of the market, similar concerns have been raised by the potential for dislocation created by growing competition. One clear sign that tends to raise concerns is when property cat reinsurers or retrocessionaires are buying up collateralised cover cheaply.

**Private placements**

The influx of capital has provided a catalyst for the rapid growth in private deals between cedents and investors. With a lot of capital chasing a limited amount of bond issues, many investors are finding it difficult to put all their cash to work. The competition among capital providers is also putting pressure on spreads. Investors are therefore looking to private placements as a way to increase their access to the market, bolster spreads and be more selective over the risks they take on. Many are developing their own modelling and due diligence capabilities to support these developments. In turn, cedents are looking to direct deals as a way of enhancing choice and flexibility and securing more competitive prices.

**Bridging the information divide**

The increased transparency in risk disclosure for investors in catastrophe bonds has been one of 2013’s most positive market developments. Furthermore, the market has been creative in its ability to provide both flexibility and yield, which means that investors are more comfortable with taking on basis risk through indemnity products. This improvement in the market’s ability to bring together the needs of the sponsor and that of the capital markets represents swift progress in reducing a key barrier to entry to ILS.

The reduction in the number of ratings being sought does not necessarily reflect a positive development in terms of managing that gap between sponsors and investors. While transaction fees are often an area of concern for sponsors, a rating is a helpful benchmark for an investor.

**Here for the long term?**

The significant increase in liquidity into the catastrophe bond market has helped to cement the asset class for money managers and investors. Allocations from hedge and pension funds would appear to form part of a longer term strategy rather than simply the pursuit of short term yield.
Similarly, with respect to both reinsurance-sponsored ILS funds and sidecars, there is an increasing trend whereby third-party capital providers are strategic business partners with contractual opportunities to invest first in future vehicles or reload existing vehicles after a catastrophe event. As a result, a significant portion of new capital is long term in nature.

However, there are questions over whether a substantial portion will move out of the segment after a major catastrophe and not return thereafter. Whether long or short term in nature, the impact would disrupt the existing model.

**Third-party capital management**

In the nine months to March 2013, the collateralised reinsurance market and the retrocession market grew by 42%, whereas the catastrophe bond and Industry Loss Warranty (ILW) markets grew by 14% in the aggregate. Investors drew comfort from the traditional reinsurance value proposition. The collateralised market tends to be easier and more cost-effective to access than the catastrophe bond market, but as a result may be more susceptible in the near-term to the impact of growing competition. Reinsurers have demonstrated a strong commitment to extend their alternative propositions and third-party capital management segments. There are some good reasons why a traditional platform presents an ideal backdrop to an alternative strategy including cost and expertise sharing, capacity for the reinsurer to deploy, access to a different type of investor, etc.

Reinsurance investors are a broad constituency, each of which is attracted by different risks and has a potentially greater access to those risks and ability to match them. More longstanding investment in analytical and modelling capabilities would help to evaluate multiple internal and vendor models and hence enhance management decision making around risk selection. Access to the broader marketplace and counterparties helps to foster sophisticated discussions around risk transfer, which could allow for better blends of traditional and alternative capacity to hedge sponsor risk.

The model of asset management and third-party capital management from within a reinsurance company presents three principle areas for further evolution:

1. The first relates to the different skills required to operate as an asset manager as opposed to a reinsurer. The trading environment and expectations of investors deploying capital are very different from the expectations of managing shareholders in a reinsurance company. As we’ve seen, dedicated and niche ILS fund managers are developing technical reinsurance expertise; likewise, we can anticipate the establishment of trading desk-type units within reinsurance-sponsored funds.

2. The second relates to managing the demands of different sources of capital, each with its own expectations on risk-rated return and sometimes in direct conflict across sources. Managing the potential conflicts of interest between equity shareholders and third-party capital providers is complicated. And certainly, viewing alternative capital sources as a way to solely underwrite more of the same capacity will stall aggregate growth in the long term.

3. Furthermore, accounting rules afford some flexibility towards consolidation, based on underlying structural terms, and so while a number of special purpose vehicles (sidecars or fund vehicles) consolidate into holding companies, many feature more as satellite operations. As reinsurance companies both manage capital and present their strategies to stakeholders, transparency and clarity become even more important as these ‘orbital’ models add complexity.

Taking each of these together, it is important for the reinsurance industry to find a structural response to how it accesses and deploys capital, which strengthens the value proposition of risk transfer and is more transparent and straightforward than today’s model.

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6 Source: Guy Carpenter. (Note that the aggregate capacity provided by collateralised reinsurance, retrocession, Industry Loss Warranties and Catastrophe Bonds is a now commonly adopted definition of alternative market capacity in property cat.)
Section 2: Expanding the potential of ILS

Over the past 12 months, there has clearly been evolution in ILS. But as some commentators have noted, there hasn’t been the levels of revolutionary change that the property cat industry is potentially capable of. Much of that is attributed to the barriers noted in our report last year\(^7\) and the drivers for dislocation outlined in the previous section.
And in spite of the growth in alternative capacity, during the year the word ‘convergence’ has been interchanged with ‘cannibalisation’. PwC’s view is that both traditional and alternative capacity have an important role to play in realising the expectations of the market’s stakeholders.

And this is reflected across the industry as reinsurers offer combined solutions or niche managers form strategic partnerships with sponsors or traditional providers. It is with that backdrop that the potential of both risk transfer and risk financing need to be unlocked in order to truly access the opportunities that global trade flows and markets present.

**Accelerating aggregate growth**

1. *Geographical diversification*

The ILS market is certainly now part of the mainstream. However, its geographical diversification is limited. It’s principally focused on wind and earthquake exposure in the US, with limited access to European wind and Japanese earthquake. This helps to explain the deep rate adjustments that have been occurring in Florida for instance, but less so in reinsurance elsewhere around the globe.

Looking more broadly at reinsurance capacity, the US and Europe both present relatively finite markets and limited growth in demand for risk transfer. It is the rapidly expanding markets of Asia, Africa, South America and the Middle East that offer greater potential for expansion (Figure 1 outlines the major recent events and the shift in global trade flows).

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**Figure 1: Emerging market growth and risks reshape ILS market potential**

**World loses**

<table>
<thead>
<tr>
<th>Event Type</th>
<th>Location</th>
<th>Value</th>
<th>CAGR 2002–10</th>
</tr>
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<tbody>
<tr>
<td>Floods</td>
<td>United Kingdom, Europe</td>
<td>813m USD</td>
<td></td>
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<tr>
<td>Winter storm Andrea</td>
<td>Europe, 5-6 January</td>
<td>443m USD</td>
<td></td>
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<tr>
<td>Flash floods</td>
<td>Russia, 6-8 July</td>
<td>30m USD</td>
<td></td>
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<tr>
<td>Cold wave, Eastern Europe</td>
<td>Jan-Feb 280m USD</td>
<td></td>
<td></td>
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<tr>
<td>Typhoon Haikui</td>
<td>China, 8-9 August</td>
<td>183m USD</td>
<td></td>
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<tr>
<td>Typhoon Bopha</td>
<td>Philippines, 4-5 Dec.</td>
<td>N/A</td>
<td></td>
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<tr>
<td>Floods</td>
<td>China, 21-24 July</td>
<td>140m USD</td>
<td></td>
</tr>
<tr>
<td>Cold wave, Afghanistan</td>
<td>Jan-March 140m USD</td>
<td></td>
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<tr>
<td>Severe storms</td>
<td>USA, 28-29 April</td>
<td>2,500m USD</td>
<td></td>
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<tr>
<td>Severe storms, tornadoes</td>
<td>USA, 2-4 March 2,500m USD</td>
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<tr>
<td>Severe storms, severe storms</td>
<td>Canada, 12-14 August 532m USD</td>
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<tr>
<td>Drought</td>
<td>USA, Summer 11,000m USD</td>
<td></td>
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<tr>
<td>Earthquake</td>
<td>Mexico, 20 March 160m USD</td>
<td></td>
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<tr>
<td>Earthquake</td>
<td>Italy, 20/29 May 1,622m USD</td>
<td></td>
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<tr>
<td>Hurricane Isaac</td>
<td>USA, Caribbean 22-28 April 4,600m USD</td>
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<td>Hurricane Sandy</td>
<td>USA, Caribbean October 35,000m USD</td>
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<tr>
<td>Floods</td>
<td>Nigeria July-Oct. 10m USD</td>
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<tr>
<td>Floods</td>
<td>Pakistan 3-27 Sept. N/A</td>
<td></td>
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<tr>
<td>Floods, hailstorms</td>
<td>South Africa, 20-21 Oct. 118m USD</td>
<td></td>
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<td>Floods</td>
<td>Nigeria July-Oct. 10m USD</td>
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<td>Floods, flash floods</td>
<td>Australia, Feb-March 137m USD</td>
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Source: Munich Re and Swiss Re

**Changing global trade flows**

- **Non-SAAAME**
  - Trade value: $1.67tr
  - CAGR 2002–10: 12.9%

- **SAAAME**
  - Trade value: $2.67tr
  - CAGR 2002–10: 13.6%

- **World loses**
  - Trade value: $6.92tr
  - CAGR 2002–10: 8.0%

Sources: WTO and PwC analysis

Note: Russia and the Commonwealth of Independent States (CIS) have not been included in SAAAME definition because trade is largely international and/or with Europe. Mexico is excluded as it trades mainly within the North American free trade zone and less with SAAAME. Both areas remain very important growth markets and should be considered in relation to the SAAAME region.
However, the divergent speed of global growth creates challenges on both sides of the developed and developing markets divide. Developing competitive scale in key emerging markets is proving challenging for many Western insurers and reinsurers as access can be impeded by licensing and ownership restrictions.

Once access has been established, the potentially more complex challenge is how to transfer risk at an acceptable price. For both the traditional and alternative markets where data and modelling is at the core of all activity, an absence of one or both provides either absolute or relative barriers to entry.

While surprises often manifest in even the most data intensive and analytical environments such as US windstorm, writing a profitable cat bond or excess of loss contract in a data poor environment, as Thailand was when the floods of 2011 occurred, is exceptionally difficult. In China and Latin America, for example, the potential for catastrophic loss and demand for reinsurance is huge and growing, but the ability to price such risks with any precision is limited.

To meet these challenges, sharper and deeper analytics and greater automation of routine underwriting will be critical. It will also require a step change in the basic economic equation of determining an acceptable price.

Fortunately, there are opportunities to automate a considerable amount of mature market underwriting; the necessary data is there; and the technology is now coming on-stream. This does not, however, mean purely mechanical underwriting without the involvement of expert decision making based on technological analysis.

Combined with a redistribution/reallocation of talent within the organisation, greater automation within mature markets would have the particular advantage of allowing the top underwriters to concentrate on assessing and pricing risks in the less data rich markets.

During the course of the year, there has been an attempt to access newer markets while leveraging diversification benefits from existing business in the form of a parametric catastrophe bond exposed to both data rich and data neutral perils.

It is our belief that for certain perils in certain countries (e.g. Australia and potentially, New Zealand) the tipping point will be reached in the near- to medium-term where sufficient data and analytics will enable the alternative market to access the risk.

2. Product innovation

During 2013, the ILS market has focused on solving structural challenges between a sponsor wanting to transfer basis risk and an investor being reluctant to accept it. As discussed, we’ve seen evidence of improvements in transparency and modelling, developments which...
can enhance the ability of indemnity products to close the gap for a fee. In the index area, we have seen more precise demarcation of perils so that risks can be transferred, based on finite geographical zones. There has been transfer of risk of two distinct geographies as well as perils in the same product.

As the market evolves, this continuous focus on further enhancing the value that is delivered to a risk manager or an investor will allow for further growth in the ILS sector and potentially in aggregate capacity.

3. New perils and capacity
The type of products on offer at different RoI levels is potentially attracting new capacity into the market – whether this is through private middle market sponsors or bigger participants – who can now hedge risk because alternative pricing is acceptable where traditional options were not.

Furthermore, there are perils, even in fairly developed markets (e.g. flood or terrorism in the US) where a capital markets response would likely enhance the effectiveness of the current state solutions.

Whatever the route, increasing the size of the market is the healthiest way of managing the interests of all stakeholders in the long term.

Concentrating on the customer
As mandates have increased or new mandates emerged – approximately $3 billion in new assets under management have come into the market in the first-half of 20138 – much of the ILS debate has been about investors and deploying capacity. It is critical, however, that the industry remains focused on managing the risk transfer objectives of sponsors and its claims’ paying ability.

In the 16th Annual PwC Annual CEO Survey,9 building up the client base and improving customer service were the top two strategic priorities for the CEOs of insurance, reinsurance and alternative organisations. The industry’s success is founded on its ability to pay out on losses quickly and with certainty. This equally applies to the market share of any one participant.

Risk managers have become far more sophisticated in the last decade and are looking for more bespoke solutions for their programmes, as well as additional value from their interactions with the risk transfer marketplace.

An important element of this is product innovation, part of which relates to structural changes which unlock barriers and part of which is providing platforms to enable purchasers to hedge effectively across a variety of solutions that optimise capital. Increasingly, programmes are being built with a broader combination of traditional and alternative protections.

Whatever the route, increasing the size of the market is the healthiest way of managing the interests of all stakeholders in the long term.

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8 Source: Trading Risk, representing an increase for the top-10 ILS managers
9 PwC. ‘16th Annual Global CEO Survey: Dealing with disruption - Adapting to survive and thrive.’ (www.pwc.com/ceosurvey)
We anticipate that the next wave of big data and predictive modelling will allow risk transferors to move from insight to foresight.

sometimes from the same provider utilising a ‘one-stop-shop’ approach to risk management and pricing.

There remains a gap between cedent information flows for reinsurance and catastrophe bonds post-event, which could lead to a dislocation between the traditional and alternative markets. Further, the timing of settlement of payouts can vary, often substantially so. Improved customer-centric approaches to claims’ payment need to be at the forefront of industry priorities as significant time spent on arbitration or litigation is not in the best interests of anyone.

There is no doubt that in several corners of the market there has been a gradual commoditisation of the product – a catastrophe either happens or it doesn’t. However, the nature of the risk that is being transferred is becoming evermore complex and will need significant innovation to continue to be successfully mitigated for the customer. It is in these corners that margin can be made and where time should be focused.

**Model transparency and benchmarking**

Both traditional and alternative capacity puts significant demands on the models. With respect to public and rated catastrophe bonds, for example, issuers are required to utilise and publicise modelling information from one firm chosen as the official modelling agent of the bond (the choice of a vendor is often a commercial decision), whereas in reality, they make use of multiple internal and external models in-house to manage the risk. The mismatch between the internal model results and what is published as the official risk metrics of the bond will become even more apparent as more insurance and reinsurance companies decide to develop and maintain their own view of catastrophe risk. This view is often based on a weighted blend of multiple vendor models, supported by the company’s own analytics and research, which aims to reflect more closely the sponsor’s understanding of risk and claims’ experience. As the reliance on a single ‘out of the box’ vendor solution recedes, the numbers of unrated bonds powered by unprecedented investor demand for cat risk rises and companies look to reduce the transactional cost of issuing a cat bond, the role of catastrophe modelling companies in the bond issuance process could soon need to be redefined.

We anticipate that the next wave of big data and predictive modelling will allow risk transferors to move from insight to foresight, where they can tailor interactions and pricing at a customer level and use real-time data for decision making.

For the ILS market to take advantage of these developments, however, more ground needs to be covered with respect to model transparency and benchmarking. For example, there is considerable variability in model vendor data and outputs, particularly outside the US. A clear understanding of the potential for loss is critical for investor and sponsor alike.

**Pushing back the frontiers**

So what kind of ILS market is set to emerge from these developments? The surge in interest and investment in ILS is creating a situation where investors will have to accept new types of risks or more extreme risks to maintain their target yields and offer cover to the market in areas where it is currently difficult to acquire. These areas include pandemic risk, longevity risk and non-life risks such as terrorism or specific earthquake and flood covers in the US and Europe. At the launch of the April 2013 Green Paper from the EU on ‘Strengthening Europe’s preparedness against natural and man-made disasters’, Commissioner Michel Barnier said: “Natural and man-made catastrophes are on the rise, while the capacity of the insurance sector to insure against them is not fully utilised”. Investors may also have to embrace areas where there is less data and advanced modelling available. Many investors may be reluctant to make these leaps and the transition may be slow, but without an extension into new areas, the market will be left cannibalising itself. In each of these cases we would expect that investor interest would drive data availability and model development including the development of third-party models.

Finally, ILS has thereby far focused on peak risk. There is an argument that the securitisation of long term profit streams could provide another avenue for investors and much needed capital relief for companies. AXA’s securitisation of its French motor liability remains the standout transaction in this area. While there have been a number of other smaller private transactions of similar design, no company has yet cracked the market and brought out a breakthrough product that meets all the various demands.

However mainstream ILS becomes, these developments underline the vital importance of innovation in moving the market forward and realising its full potential.
Investors will have to accept new types of risks or more extreme risks to maintain their target yields and offer cover to the market in areas where it is currently difficult to acquire.
Conclusion: Innovation holds key to success

The convergence of the reinsurance and capital markets is happening at an unparalleled pace and in the short term, risk managers are accessing a mass of new capital to hedge risk.
Structural changes are enabling ILS to be unlocked as a mainstream component of the risk transfer value proposition and the resulting level of interest from investors into the segment is unparalleled.

For the property cat market as a whole, however, there are more participants swooping in on a familiar and static prey and this is putting pressure on the system. This pressure is manifesting itself in both softening prices and what risks are being financed or transferred.

To gain share, without sacrificing the fundamentals of appropriate risk selection and pricing adequacy, participants need to innovate and change. Reinsurance companies are actively driving alternative strategies and asset managers are providing transformative reinsurance services. The challenge is to increase the overall market size – in other words sail in the blue oceans.

Geographical diversification, product innovation, customer-centric approaches to risk transfer, simplification and transparency, data and analytical advances will all open up new opportunities and demand. As the search for premium and diversification continues, mass urbanisation and developing wealth and infrastructure in Asia, Africa, South America and the Middle East open up important opportunities, increasing the demand for risk financing and the data that supports this.

The structural conditions of the property cat marketplace are no longer a given. Those participants that can differentiate themselves will fare better than those that continue with the status quo – even those where traditional and alternative strategies sit side by side if the latter is a replicate of the former. Further consolidation in the marketplace for both reinsurers and asset managers is inevitable.

Market discipline in this period of dislocation is critical. Those that ultimately stand to thrive – the innovators – will embrace this transformative change and create and access new demand at a premium.
Contacts

If you would like to discuss any of the issues raised in ‘Expanding the potential of ILS’ in more detail, please speak to your usual PwC contact or any of the contacts listed below:

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