THE EVOLUTION OF ILS

Kathleen Scott and Harold Fudali of BNY Mellon discuss recent developments in the ILS market

The Insurance Linked Securities (ILS) market has expanded exponentially in the last few years, outpacing the growth in many other asset classes. The appetite for these instruments has been strong mainly because they provide an opportunity to diversify portfolios by investing in assets that are not correlated with traditional financial risks. ILS offer the potential to achieve higher rates of return compared to other markets. Moreover, investors perceive that the rewards will likely offset the risk of loss resulting from natural perils.

Along with the rise in transaction volumes and values, the number and types of market participants has also increased. Previously, specialist investors dominated the ILS market, but as the market has matured, new entrants have emerged. On the buy-side, pension funds and other institutional investors have become more active participants. On the sell-side, new types of sponsors are issuing ILS to raise reinsurance capacity and benefit from the cost efficiencies made possible by structural changes in the way ILS are issued.

Kathleen Scott

Kathleen Scott is head of BNY Mellon's Corporate Trust Corporate and Insurance segment, where she oversees sales and relationship management for customers in the US and Bermuda. She also manages client service for products including straight debt and insurance trust.

Harold Fudali

Harold Fudali is a group manager for the US Corporates and Insurance Companies client segment within BNY Mellon's Corporate Trust Division. He manages a sales and relationship management team based throughout the US and is responsible for new business generation and client management.

Catastrophe bonds

Catastrophe bonds (cat bonds) enable sponsors, through special purpose vehicles as issuers, to enter into a risk transfer contract. The SPV issues notes to investors such as banks, hedge funds and money managers in the amount equal to the limit of the risk transfer contract. The proceeds from the securities offering are then transferred to a collateral trust and invested. If a risk event occurs during the specified period, funds are withdrawn from the collateral trust and are paid to the sponsor. If no risk event occurs by the end of the contract, the bonds are redeemed at face value.

Over the last decade nearly $56bn of cat bonds have been issued. This has propelled the outstanding volume of bonds in the ILS and cat bond market to grow from $9bn to nearly $26bn, according to Artemis, a news, analysis and data company. The volume is expected to continue growing in 2016, driven by higher demand for risk diversification from investors and increased need for alternative capital sources from sponsors.

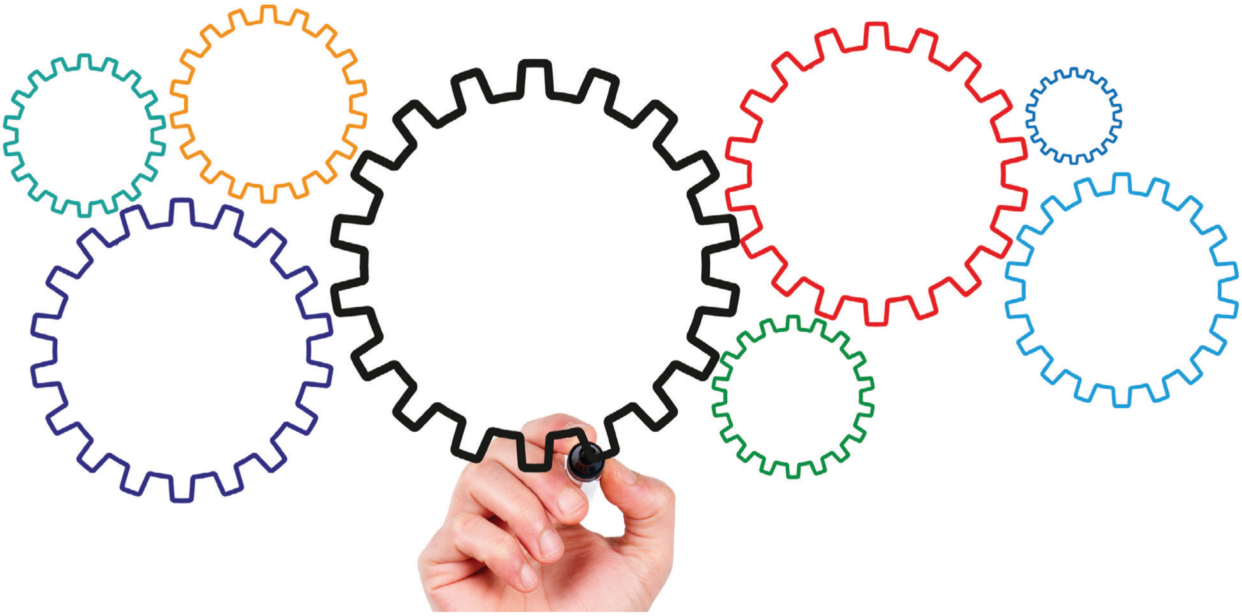
Historically, cat bond sponsors have mostly been large reinsurance companies. But some corporates issued cat bonds in 2015, leading some to believe the market is on the cusp of a new trend.

"I think that 2016 could be the year in which we see corporates express more interest in cat bonds," says Kathleen Scott, head of BNY Mellon's US corporate and insurance business in the Corporate Trust group. "We see good reasons why more companies will choose to transfer risk using these instruments," she adds.

Companies worldwide are looking for ways to mitigate the potential risks associated with weather events such as hurricanes, tornados, earthquakes and tsunamis. Further, new weather patterns could cause mass migration, which in turn could spark geopolitical conflicts and healthcare emergencies. Against this backdrop, companies must protect their manufacturing and distribution facilities, supply chains and their human resources.

There are several examples of cat bonds that were issued to insure against the risk of tsunamis and floods in Asia. Additionally, a US transportation company recently issued a cat bond to protect against natural perils along its heavily travelled rail system.

"Corporates can take advantage of various non-traditional structures for transferring risk, including cat bonds," Scott highlights. "In doing so, they could significantly lower their costs for insuring these risks."



Collateralised reinsurance

One of the fastest growing components of ILS is collateralised reinsurance. These products accounted for $32bn of the total amount of alternative capital in 2015, according to reinsurance broker Guy Carpenter – up 19% from 2014. They now make up a 47% share of the total convergence capital.

Collateralised reinsurance enables investors to be part of the reinsurance underwriting process without having to maintain the supporting infrastructure, such as ratings, because the contracts they underwrite are fully collateralised. Investors provide capital to cover reinsurance policies on a specific risk basis in exchange for the opportunity to earn relatively attractive returns. For the cedant who benefits from this coverage, collateralised reinsurance can represent a cost-effective and diversified source of protection risk capital.

"Some interesting partnerships have been emerging in the collateralised reinsurance space," says Harold Fudali, head of BNY Mellon's US sales and relationship management for corporate and insurance businesses in the Corporate Trust group. He continues: "Traditional reinsurance underwriters are combining their risk expertise with investment managers to launch hedge fund-backed reinsurance vehicles where the collateral is used to create portfolio investment strategies. We think that's going to be a growth area."

Role of the service provider

Sponsors and investors have come to recognise the complexity and diversity of ILS structures. To this end, it is more important than ever for both types of stakeholders to partner with a servicing institution that has the operational expertise and resources to be efficient as well as being responsive in execution and delivery.

> "ILS offer the potential to achieve higher rates of return compared to other markets"

The corporate trust provider is one servicing partner that carries out several responsibilities.

A trustee for a cat bond indenture represents bondholders' interests in accordance with the transactional agreements, which ultimately ensures the integrity of the debt issuance. As registrar, it keeps records of bondholders and shareholders, and as the paying agent it serves as the designated disburser of coupon and principal payments to the security holders on behalf of the issuer. The calibre of the service provider's strength, stability and technology infrastructure is crucial to the lifecycle of the cat bond transaction.

The corporate trust provider also serves as a collateral agent that administers the collateral trust for a cat bond. It enforces the security over the assets in accordance with the transactional agreements as well as the legal and jurisdictional requirements. It is responsible for the safekeeping of the assets and administers the operational and counterparty requirements inherent in these transactions.

While the focus of the ILS market has traditionally been on natural perils, observers expect to see more new types of protection risks being transferred to innovative structures as new sponsors come onto the global scene. For instance, mortgages, cyber-security, life and healthcare are emerging areas of interest. Europe, Asia and Latin America could become more open to alternative capital. Moreover, sovereign sponsors are said to be considering the market.

Best practice is for existing sponsors and new entrants alike to partner with a corporate trustee who has both a global presence and local knowledge of the ILS market across multiple jurisdictions. Sponsors should look for a service provider that is financially sound, has a solid reputation for servicing excellence, operates on sophisticated technology systems, and who can demonstrate a proven track record in meeting clients' objectives. The corporate trust service provider plays an important role within the ILS ecosystem, ultimately providing a platform for growth in the years ahead.