

# The Past, Present and Future of Insurance-Linked Securities

Disruptive Forces in Investing

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**Anu Rajakumar:** The insurance industry is potentially facing the biggest loss event in history, as a result of COVID-19. Investors in the insurance-linked securities market, or ILS, are now dealing with these challenges head-on. What can we learn from the past to help us take advantage of the opportunity that this disruption has created? Peter DiFiore, head of Insurance-Linked Strategies, here at Neuberger Berman, is here to answer that question and discuss the ILS market more broadly. Peter, thank you for joining me.

**Peter DiFiore:** Hi, Anu. Happy to be with you today.

**Anu:** Peter, now, as I understand it, ILS is a fairly young asset class. So, maybe just to get started, can you share a brief overview of the evolution of the insurance-linked securities market, and really how it became to be the investment category that it is today?

**Peter:** That's right. It is a relatively young asset class, but there's been quite a lot of interesting developments along the way. So starting back in the late nineties, there was a real need for insurance companies, and the reinsurance companies that insure them, to secure essentially regulatory capital relief. So, these entities face regulators and rating agencies that are concerned that certain large events may actually deplete insurers' reserves and lead to an insolvency. So most events, they may be able to weather, but a very large hurricane or earthquake, may cause a significant disruption to the industry. And not wanting policy holders to fail to recover, post-event, is really the goal. And at the same time, investors were looking to find areas that were not related to the broader financial markets and the probability of a very rare hurricane or earthquake is fundamentally distinct from what drives the broader markets on a daily basis. So it was a really nice match. It started as an incredibly niche area, but following the loss events in 2004 and 2005, where we had a lot of hurricanes to Florida, and Hurricane Katrina impacting Louisiana, there was ever-increasing need for this type of risk transfer, and investors really stepped up to provide a large amount of capital. So we saw a growth from really \$10 or \$15 billion, to over \$100 billion. So opportunities that we see today.

**Anu:** I think that point about ILS being an uncorrelated asset class, versus traditional assets, is very important, here. Peter, I'm just curious, how did the global financial crisis and subprime mortgage crisis impact the ILS market, Peter?

**Peter:** Yeah. So investors really didn't have to wait long to really test that hypothesis around correlation. And, generally, the asset class proved to live up to the promise. Many of the ILS investments held their value incredibly well through 2008 and 9, and even saw price increases, because many of the insurers and reinsurers buying these ILS products needed to increase their solvency margins because their balance sheets were stressed. There were certainly some lessons learned around collateral solutions, and maybe not a good idea to collateralize a reinsurance obligation with exotic asset-backed securities. But, in general, the asset class did incredibly well through that period, and that led to even more interest from institutional investors.

**Anu:** Sure. And, you know, I think some of the big catastrophe events, like Katrina, for example, are important to think about. So what are some of the other key takeaways from the past that we can apply to today?

**Peter:** That's right. So coming out of the financial crisis, seeing better opportunities, many investors came into the space. In 2011, there were a number of large natural catastrophes around the world, starting with the very large Japanese earthquake and ensuing tsunami in the Tōhoku region, a number of large earthquakes in New Zealand, some tornado hail events in the US, and many other events worldwide that really created some fairly large losses. For the most part, ILS performed well through that year, but there were still some questions as to how a year in which there were really big US-focused loss events, how the asset class would perform. Because a majority of the opportunities really are focused on the US, which is the largest market for insurance, and the most heavily regulated.

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So, in 2012, we had Hurricane Sandy impact the Northeast. It wasn't really enough to cause any impairment on the ILS side. And then it was a fairly quiet time all the way up until 2017. So for investors, it was certainly an interesting asset class, but I think there were lots of questions about the risks embedded in these products. Much of the investor analysis was built around forward-looking models of hypothetical events. And so there were questions about when an event happens, when a loss happens, how that would actually play through and how these products would perform. And starting in 2017, we saw an incredibly challenging year for the market. Hurricanes Harvey, Irma and Maria impacting the U.S., all within a very short period of time – earthquakes in Mexico, the wildfires in California. And that really created a very clear stress test, and we saw manager performance really disperse. And investors, for the first time, for many of them, were really able to understand how these strategies and how these different managers were going to perform through this year. 2018 again, another year of large loss events, particularly in Asia, in Japan, and again, in 2019. So, we've been through three years of really important events for the industry, and the asset class has generally performed well. There have been investors I think who had expectations for the performance better than they had seen. But the lessons learned, I think that are really important, are understanding those risks that really sit below these products and sit within the insurance policies and really understanding the impact of the timeline. As these events happen, it does take a long time for the losses to filter through the claims' adjustment and potential disagreements, and how that rolls up through, the insurance companies to the reinsurance companies to ILS managers. So, investors now have a lot more information at their disposal, as they consider the value of this asset class in their portfolio.

**Anu:** You mentioned the big events of the last few years. And 2020, of course, has been the year of COVID-19, which has resulted in the biggest loss event in history. Could you explain in a bit more detail how exactly the global pandemic and recession are impacting the asset class?

**Peter:** It's been a one-two punch for these insurance companies. Their balance sheets are incredibly stressed by the movements of the market. The fact that yields have come down creates asset liability mismatches into the future, and so, they're facing investment losses. And then, on the underwriting side, they're also facing insurance losses. So, for many lines of business, there will be direct significant losses tied to the COVID situation. Think about event cancellation insurance, worker's compensation, trade finance, credit – a wide range of different product lines will see losses. There's estimates anywhere from \$40 billion to \$140 billion worth of insurance loss, which is one of the largest events that's ever been seen.

**Anu:** Staggering, really, yeah, huge.

**Peter:** Yeah. And the more interesting aspect is the range of the estimates. Because there is a lot of uncertainty, and a lot of the outcomes will be very dependent on how insurance companies wrote their contracts. How specific those contracts were about what is and what is not covered. And ultimately a lot of those decisions may be made by the courts, or by regulators. So, all of that uncertainty is creating a really interesting opportunity because that unknown loss has to be backed by capital. So, you have reserving, where capital is set aside for this potential loss and that's all capital that's coming out of the space and can't be used for future risk. So the demand for ILS protection, the demand for reinsurance, has really spiked up. And now we're in our fourth year of these stressful events on the industry and so pricing has gone up, demand has gone up, and so the opportunities set for investors, is actually quite interesting at the moment.

**Anu:** Maybe speaking of the opportunity set, it sounds like this is a seller's market, right now. Where is your team finding the most promising opportunities?

**Peter:** Definitely is a seller's market. We continue to think the US is really the best region, in terms of opportunities. It continues to be where the majority of the buyers of these products, the issuers of these products are, and where they're facing regulatory challenges. As far as the types of products that are seeing the most opportunities right now, the industry loss warranty products, which is something that we've always favored has really ticked up in terms of interest. In particular, because reinsurance companies, which used to look to other reinsurers to hedge out certain parts of their risk, through what's called retrocession. So that market has actually contracted quite a lot over the last four years, and those groups are not able to buy that protection in what's viewed as a more traditional manner. So, they're turning to industry loss warranties, which are privately negotiated, short duration, and very targeted covers around very specific events.

They're also turning to the catastrophe bond markets. These are 144A notes, and the reinsurers are going to that market, seeking three, four or five hundred million dollars of protection for the next three or four years. So we've seen a real uptick in deal volume there, and commensurate increase in pricing. We've also seen a continued interest in these products from non-insurance counterparties, which has been a really interesting development, whether it's corporations that are in the travel and hospitality industry and they're concerned about business interruption during a hurricane, or a specialized manufacturer who's worried about supply chain disruption if there's an earthquake at a particular location. So that's created a lot of really interesting

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products that are very diversifying for investors' portfolios because they're not necessarily tied to the same type of events that the broader insurance and reinsurance markets are – are targeting. And that's created a wide range of new opportunities and new products to look at.

**Anu:** Sure, understood. Now, as we just wrap here, I would love to get a sense of your market outlook. So going forward, Peter, how do you see the market evolving from here?

**Peter:** So, we're incredibly bullish on the segment. There's a large amount of risk out there. If you look at the amount of properties and businesses that are exposed to natural catastrophes, we're talking about trillions of dollars of risk. Not a lot of it is actually being transferred. There's what's called the disaster gap that we often talk about, which is the difference between [an] economic loss around an event and how much of that loss is actually picked up on a private insurance market. And it's a really an incredibly big challenge, not just for developing markets, where unfortunately you have the people's least prepared to bear the burden of these events taking on the losses. But, also, even within the developed markets, like the US, when you see that only 10 to 15 percent of Californians have earthquake insurance, or only 10 percent of North Carolinians have flood insurance. And, you see events like Florence and others really create a lot of terrible impacts for these regions. So, we're hopeful that as we and others create new and innovative products that we can help address those needs and help really expand this asset class. At the same time, being able to deliver that uncorrelated return to the institutional investors.

**Anu:** Terrific. Well, Peter, I just want to thank you so much for joining me for this episode. Your insights on the ILS market at this pivotal time is really greatly appreciated. So, thank you again.

**Peter:** Thank you. Appreciate the time.

**Anu:** And to our listeners, if you're interested in this topic, please visit the Insight section of our website, at [www.nb.com](http://www.nb.com), to read a recently published white paper from Peter and his team on parametric insurance, an innovative area of opportunity within the ILS market. And, as always, if you like what you heard, please subscribe via Apple podcasts, or Google podcasts.

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