Autumn 2019

TRADING Risk

MONTE CARLO ROUNDTABLE 2019

The big questions

Reconstruction in the ILS market continues, with ongoing concerns about investor sentiment, capacity growth and the impact of retro rates

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The reconstruction years

After several years of disruption from construction work, which cut off certain well-trodden routes from one hotel to another, 2019 marked the year that Monte Carlo unveiled a refreshed landscape to *Rendez-Vous* delegates.

The Hotel de Paris was revamped, the route to the Hermitage was unblocked and a brand new modern venue opened up.

The ILS market has also been in a phase of reconstruction and rebuilding within this timeframe – one that has meant that, for the third year running, the industry was one of the central talking points during the conference.

The trajectory, however, has been a little different. During Monaco's construction phase, the loss-struck ILS industry of 2017 and 2018 was still bullishly buoyant.

This year, however, the tone was much more muted as some capacity roadblocks have had their impact.

Cedants, brokers and reinsurers will all be grappling with some big questions in the coming months, over how investor sentiment towards the asset class will affect the upcoming January renewal season, how soon ILS capacity might return to growth and how retro rates may impact their underlying business.

And this year's pause and retraction of capacity – even at a muted or localised level – is unfamiliar turf for the reinsurance industry, more than 10 years after its last big shock.

Amid this pause, the industry is revising and softening previous received wisdom that promulgated the idea that the market would "always be soft" now that ILS capital had arrived.

As cedants and brokers recognise that investors will be looking for long-term healthy yields and adjusting their positions after losses, the market is swinging back to discussions around appropriate payback.

Some of these tensions were evident during our roundtable discussion, such as the recurring theme of transparency and looking for new ways of doing business.

But it also struck me that as well as the big-picture ideas, the market still loves to dig into a deep conversation about risk modelling metrics.

The thorny issue of confidence in higher attaching versus peak tail event risk modelling was one of the more heated points of debate during our roundtable discussion.

On the face of it, this kind of discussion might seem a little arcane, but perhaps we can see it as a positive selling point of the industry, that even very senior people really engage with the fundamentals.

Ultimately, more engagement in these kinds of debates might have helped to prevent the Markel Catco saga of extreme loss creep post-2017, with all the resulting disappointment that followed.

And perhaps, with more of this architectural focus in its rebuilding phase, we can expect that next year's Monte Carlo will welcome a newly resplendent ILS market back in growth mode.

Fiona Robertson
Managing Editor
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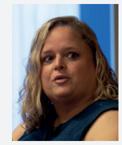

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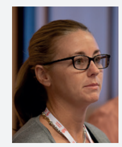

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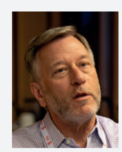

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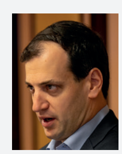

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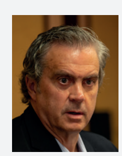

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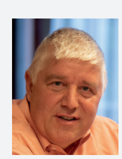

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Monte Carlo
Roundtable 2019

Fiona Robertson
The ILS market seems to be driving a lot of change in the reinsurance markets right now. Is the retro squeeze going to result in broader change or do we see it as a kind of blip?

Dirk Lohmann
There is still some momentum in the pricing on the retro side because some large chunks of capacity have been pulled out and they won't be easy to replace, even with some of the start-ups. The window is open – over time capital will come in and respond to that and then, if there are no losses, competition will erode those things away. But I see an opportunity for about two years.

Pete Vloedman
With respect to retro, we're in the phase where people may shed their opportunistic cover but the core programmes they buy will continue to be there. And because they are core, their prices won't be as reactionary. So whether it's broad-based I don't know, but it will be differentiated depending on who the cedant is.

"If you're going to be aligned with a capital partner, you need to ensure veracity of the underlying data"

Ben Rubin

Paul Schultz
To echo Dirk's comments, if some of the start-ups out there actually come into the market it will have a meaningful effect on the supply and demand balance. But where ILS has been leading is on transparency around terms and structure. That will drive some of the behaviour we see in the retro market.

Darren Redhead
A big driver, quite rightly, of the rate increase has been investors demanding a better return. They're saying "Don't use it if you can't get X return." So it isn't just a capacity shortage or crunch, it's investors wanting to get paid more for the risk we're running.

And it isn't just paying more; the deductibles in certain programmes are way too low and need to be moved up. For me, it isn't just about increasing expected yield, it's actually about underwriting/optimising the portfolio to avoid increased attrition but not adding tail risk.

Eveline Takken-Somers
We did not have a large allocation to retro mainly because of transparency issues and alignment of interest. If you look at the past two years of losses, for some investors it has been devastating. Some investors doubled up and got hurt for a second time. Current rates are not reflecting that risk. If you think about going to your board and telling them you lost 60 percent of your investment, the downside, also from a reputational perspective, is not worth the upside.

Fiona Robertson
What would the retro market have to do to make it look attractive?

Eveline Takken-Somers
It's not only about pricing, but also about transparency. It's the negative surprises we don't like. If you're investing in a risky fund and are aware of the risk, investors are fine because that's their expectation. The retro performance of some funds came as a surprise to investors.

Pete Vloedman
Regarding transparency and retro, what does that mean to you?

Eveline Takken-Somers
We rely first on our managers because we're not writing on a direct basis. Our managers must know who they provide cover to, that the risk is known and that they

are able to model it. Then managers must provide decent reporting to their investors. We need both things to increase our confidence that such an investment will work.

Greg Richardson
The comment about what we know and don't know is interesting. Yes, retro is more opaque in a sense and you have the "underwrite the underwriter" phenomenon that might make people uncomfortable. But on the other hand, when you're writing a 20 percent rate on line retro with an expected loss of, say, 12 percent, you have more confidence, statistically, in that number than you do writing a remote tail risk with a coupon of 4 percent and a modelled EL of 1 percent. You have no real idea what the EL is at that level. None of us know.

Eveline Takken-Somers
The problem in retro was mainly in aggregate covers. I agree there's more uncertainty for remote layers, but we know for a fact that it's only a hurricane or an earthquake event that can attach these very remote layers.

Dirk Lohmann
The standards in the period after 2007 deteriorated rapidly. I would say that the underwriting basically deteriorated to: "What's the multiple on the EL you're getting?", and that was about all the underwriting being done.

In the same period, increasingly complex structures came about and that exposed issues with regard to the modelling and what you need to think about beyond that. Nobody priced the wildfire.

Now, there is a lot of reassessment. Clearly, investors are looking at their managers and saying "How much of what you've got is actually modelled? And if you can't model it this way, how do you deal with that, if at all?"

Pete Vloedman
It's also a question of named perils coverage versus all perils. The old-fashioned underwriter says "If I'm selling coverage I want to be paid for it."

Dirk, to your point on modelling, a famous statistician, George Box, once said that all models are wrong, it's just that some are useful. So you have to recognise the limitations of the models we're using.

Greg Richardson
I agree. We've all been bamboozled to some extent by models. I believe that for US hurricane, for example, the uncertainty around the mean of the industry loss, if you're honest, is at least 20 percent.

The uncertainty around the tail is easily a factor of 2x. And yet we talk about the 1-in-10,000 loss as if there is scientific certainty – it's just statistical nonsense.

Dirk Lohmann
Actually, modelling, having become standard in the industry, has been helpful because we now have a common language about exposure. Only after you had widespread adoption models did you have the basis for an intelligent discussion. You could then have a debate about what's right or wrong, or how far off it is.

"A big driver, quite rightly, of the rate increase has been investors demanding a better return"

Darren Redhead

Pete Vloedman
I think of retro as a more equity-type analysis whereby I'm underwriting the firm that's underwriting the business, as opposed to underwriting the original risk. There is an element of original risk underwriting in it, but I'm also underwriting the processes of the cedant like I do in an equity investment, as opposed to the direct risk underwriting.

Ben Rubin
The point that was made earlier with regard to retro that resonates with us at Axis is the alignment issue. And the difficulty with retro is that despite the higher EL, there is less granular data fundamentally. So if you're going to be aligned with a capital partner, whether it's your own capital or someone else's, you need to ensure veracity of the underlying data and be confident of the information you are sharing and validating.

We are both a buyer and seller of retro, but it is a more opaque market with regard to underlying data. And the sense of alignment that we spend an inordinate amount of time on, we find harder in retro.

Fiona Robertson
That's a topic I want to pick up a bit later as well. On this, one final question is whether there will be a knock-on effect in reinsurance from higher retro rates?

Greg Richardson
There absolutely has to be rate improvement. At current rates, reinsurers make enough money in cat to either cover their cost of capital or their expenses, but not both.

"There are ways we should collectively look at improving the illiquid nature of the trapped collateral issue"

Paul Schultz

Dirk Lohmann
The ILS market is often the kicking target for the fact that everything has got softer and there's no discipline. But if you take a look at what happened at 1 January 2019, the ILS market wasn't growing, it was retrenching. It was exercising a lot of discipline and the top four reinsurers all grew at double digits and said "We got 1 percent effective rate increases." If that continues, you're not going to see big rate rises on the reinsurance side; you're going to see some squeeze on their cost side from retro but you're not going to see much improvement on the reinsurance. They have to exercise some discipline.

Pete Vloedman
All the big Europeans are capable of being net line underwriters; they've done it before, they could do it again. They're not retro-dependent.

Dirk Lohmann
I'd say a lot less today than before. They have some fairly sizeable quota share or sidecar vehicles that absorb quite a bit of their aggregate.

Fiona Robertson
One of the things I want to pick up is a slightly different issue. One of the themes of the past couple of years has been trapped capital. As a result we are seeing a lot of ILS managers thinking about doing business in different ways, and more of a shift to the rated market. How do we solve for some of the trapped capital issues in a better way than we are now?

Helen Goonewardene
The issue of trapped collateral has been challenging for the industry and we've observed the same on the banking side. Our clients have approached the corporate banking teams, looking for liquidity solutions from a rollover perspective. Fundamentally, the structure doesn't allow that due to its limited recourse. And from a general banking and credit perspective, we're challenged in extending the balance sheet where we can't determine what our recourse is.

So it's not necessarily a one-size-fits-all approach but from a trapped collateral perspective, if banks could get comfortable with being able to extend balance sheets and provide some sort of contingent capital facility would be one way to evolve the trapped collateral issue.

Greg Richardson
We're in the third phase of the ILS market, at an inflection point. The first phase was introduction, novelty; then there was the second phase, the tipping point of rapid growth that led to ILS providers setting the market price. Now, in phase three, ILS has squeezed out the "zero beta" arbitrage – that's largely played out. Now we're back to old-fashioned underwriting and we're realising ILS isn't a perfect substitute product.

Collateral is perhaps better than rated paper in two ways: first, covering "the big one" where a buyer questions a reinsurer's ability or willingness to pay; and second, liquidity – immediate access to cash in the trust. However, the rated balance sheet offers an evergreen promise to pay. And, in reality, a well-rated and diversified reinsurer is unlikely to be insolvent due to cat risk. In my mind, hands down a well-capitalised reinsurer offers a superior product. But nobody prices that differential now. Perhaps they will in the future.

Pete Vloedman
To Fiona's point though, we're talking about the trapped collateral problem. Could it be that the problem exists because the product isn't appropriate for what it's being used for? When we started talking about insurance risk securitisation in the late 1980s and early 1990s, it was to address solvency concerns – the "big one".

But to use collateralised reinsurance in an earnings protection layer type of situation such as we see today, is that appropriate? Or is that best, as you said, Greg, for a rated balance sheet? It's a question of appropriateness of the product. Should we be going back to that differentiation between earnings protection and solvency protection, and what type of ILS product is best for that?

Greg Richardson
It isn't really solvency protection. It's rating agency capital protection. Rating agencies and regulators arbitrarily determined that they were going to make reinsurers capitalise based on 100 to 250-year PML metrics. That makes rated equity paper expensive for selling 100-year to 250-year PML risk. That is the systematic risk that gets transferred to capital markets that can bear it more efficiently.

Paul Schultz
There are ways we can improve the illiquidity of trapped

collateral, whether through a financing mechanism or via some of the technology that exists on the bond side whereby you can trade in and out of positions. There are ways we should collectively look at improving the illiquid nature of the trapped collateral issue.

For UNL structures we have to let the claims develop, it's part of the product, but during this time, are there better solutions? The answer is yes, and improvements would be helpful to all sides.

Dirk Lohmann
There could be a secondary market for buying trapped collateral. You have companies that buy blocks of run-off so it's not rocket science. This issue is how much of a haircut you are willing to take.

Pete Vloedman
It's basically a Lloyd's reinsurance to close contract by a different name.

Darren Redhead
Fledgling trades have happened already, I know of occasions where investors have sold their position in certain ILS funds and other investors have purchased them. So there is a mechanism in place. It might need to be standardised, but there is a fledgling industry.

Paul Schultz
On the bond side, you may not like where the market is pricing but if you want the liquidity, you have that option.

Greg Richardson
Isn't virtually every fund pursuing some sort of rated vehicle right now? Aren't you doing that at PGGM, Eveline?

Eveline Takken-Somers
Yes. That's what we are constantly looking for, the most efficient investment solution. A rated vehicle is in our view the leanest investment structure. Efficiency, for us at least, is the answer. If rates are not improving, costs should reduce and efficiency should increase, otherwise we will not get to the long-term target return we promised our clients. As rates are the harder piece to influence, at least we can take care of the efficiency piece.

Regarding Fiona's comment, it's fair to say that a lot of investors did not take trapped collateral into consideration when making their investment decisions.

Fiona Robertson
Before we move off this topic, Dirk do you want to contribute, as the collateralised writer?

Dirk Lohmann
My view is that we will have products for people who want to invest in funds and they will have their liquidity as per the terms of the fund. But it will be not rated. You may use some leverage from third-party providers if it's economically attractive; most of the time it's too expensive.

Rated reinsurers are just one of the tools you could have in your toolkit but it would be more client-specific (by client, I mean the investor giving us the mandate to run such a vehicle). I don't see us having a rated reinsurer capitalised by Schroders fronting all the business for the funds we manage. That's essentially the aligned model of reinsurers with a third-party platform.

Schroders would manage a third-party client's money if they wanted a rated reinsurer. We have the capabilities to do that. If you set up a company with your own capital and then you front for the funds and charge fees for the fronting and also for managing the funds, you face potential conflicts of interest. That's a thing Schroders would prefer to avoid.

Fiona Robertson
You've transitioned to one of the other topics I want to talk about which is the shift at reinsurer-managers towards quota share deals and away from market-facing funds. But one thing I've always struggled with is trying to differentiate between when can you see these kinds of aligned vehicles as truly managed capital that's part of an ILS offering, and when it's part of the retro strategy. Is there enough differentiation?

Ben Rubin
When we think about alternative capital, that to us is either transactions or structures that allow sources of capital to leverage what we think we do well, which is access and price risk and utilise capital to access our underwriting capabilities. That's very different from retro, which is executed from a portfolio management standpoint and can be much more transactional in nature. The former is core to our business.

"A lot of investors did not take trapped collateral into consideration when making their investment decisions"

Eveline Takken-Somers

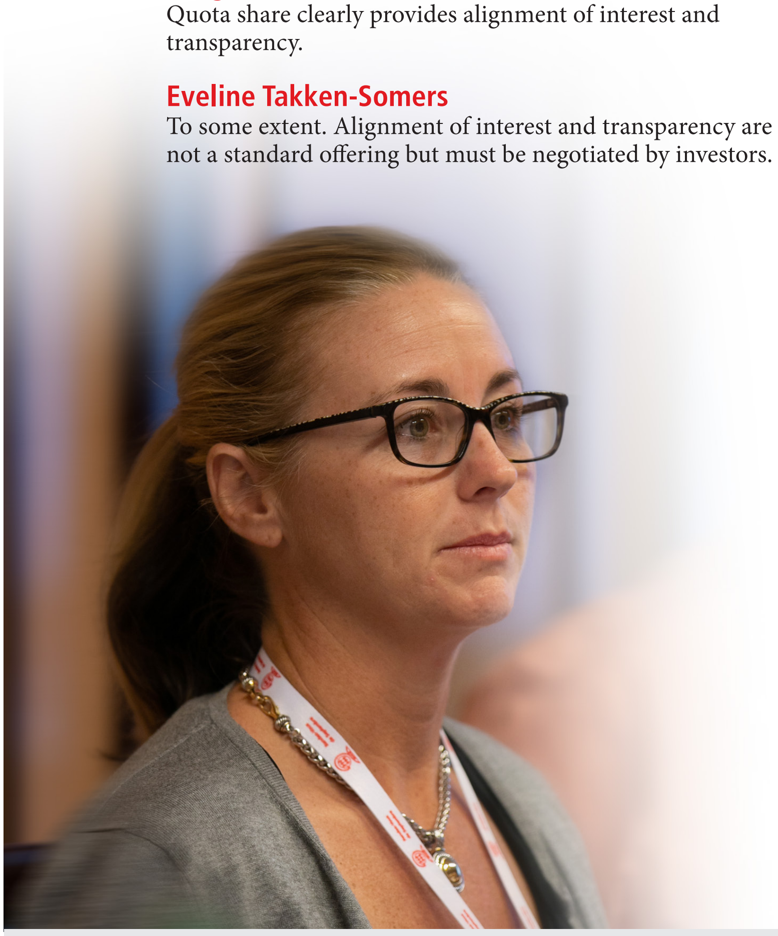
We have about $7bn of our own capital and around $2bn of alternative capital. Because of that, we're able to grow, we're able to write larger lines in conjunction with our capital and the capital from our strategic partners.

Fiona Robertson
Perhaps this is something Eveline can talk about as you've obviously done Leo Re with Munich Re and they've also had a sidecar, and it's ultimately run by the same people, the retro team. How did you get comfort around that?

Eveline Takken-Somers
Alignment of interest is the biggest challenge with sidecar investments. Most importantly, we look at alignment of interest which we safeguard by a minimum treaty by treaty retention. Furthermore, we negotiate to not be forced to commute if reserves are still high. So we do a lot to not face adversity.

Greg Richardson
Quota share clearly provides alignment of interest and transparency.

Eveline Takken-Somers
To some extent. Alignment of interest and transparency are not a standard offering but must be negotiated by investors.



"The clients we've been dealing with have come to us in the changing interest rate environment looking for more focus on yield on their collateral returns"

Helen Goonewardene

Greg Richardson
But fundamentally, if you go back to why we have ILS in the first place, its role has been to bring down the cost of the peak zone tail risk that reinsurers cannot effectively diversify away. That risk belongs in a pension or large investment fund, and that's where it will end up.

That should be good news – Florida buyers could get properly capitalised and highly rated companies to write their insurance because ILS provides the tools to efficiently finance the risk. Capital markets will help solve the problem of rationing capacity and under-insurance in Florida, California and elsewhere.

To get to this state, some sort of an excess of loss ILS product – such as cat bonds – is essential. Rigid reliance on alignment of interest is not going to get us there. ILS investors have to recognise there is unknown extreme tail risk and do enough work to justify taking on that risk.

Fiona Robertson
Another topic I want to pick up is M&A in the ILS market. It touches on the aspect of connecting ILS to insurance risk because of deals like Axa-XL and AIG-AlphaCat. How will these transactions change what the ILS market does?

Dirk Lohmann
There will always be a cohort of independent managers and there will be aligned managers. What you have seen is the continuing institutionalisation of business. ILS historically has been a handful of boutiques and we're now working on initiatives to get some common information with regard to reporting, standards and things like that.

If you work in the asset management business, you are heavily regulated and you have to comply with all kinds of stuff already. That will continue and you will see some independents get absorbed, either by asset managers or by reinsurers, as we've seen. They'll also bring an institutional framework when it comes to risk management, process, compliance, valuation and all that stuff.

Darren Redhead
There will always be independent management but it's moving more towards being aligned with traditional carriers. As Dirk said, it's a tool for a traditional carrier.

Eveline Takken-Somers
There's some potential for conflict. The risk is that insurance companies cede out their unwanted risks to capital market investors. As an investor, you should look at such takeovers with caution, ask the right alignment questions and think about accepting or not accepting related party transactions.

Paul Schultz
Fundamentally, giving cedants choice has been an integral part of growing the ILS market, delivering diversification of programmes and access to capital that behaves differently. There has to be a role for both independent and affiliated or aligned because if you don't have that, capital will have a tendency to behave the same way across traditional and alternative capital.

Fiona Robertson
Does anybody want to pick up on the question of how long

it takes insurance conglomerates to connect the two bits of their business when they have acquired an ILS platform?

Cory Anger
I don't think the mergers themselves were about the ILS end game and the access to ILS capital. If you look at some of the merger opportunities, they've been in the strategic plans by the acquirers for a long time.

If someone is a visionary, it's going to take a while for them to turn ILS capital into an engine supporting the primary insurance risk-taking in addition to the reinsurance undertaking. Baby steps are being taken but this industry in general moves at what some would call a glacial pace. We're probably a decade out from knowing the potential ILS capital synergies bring to such risk-taking opportunities.

Ben Rubin
We have transactions and partnerships whereby we have married alternative capital with insurance directly. But we don't skip nine steps in that process; we are dedicated to our broker partners, we rely on them heavily and will continue to do so. But insurance is a tremendous growth opportunity and capital will continue to move closer to risk. That doesn't necessarily mean the exclusion of certain parties, it means a more efficient path for risk to meet capital.

Will it move as fast as we want? I don't know, but it is a tremendous opportunity for us, especially in moving into non-catastrophe lines of business.

Greg Richardson
I'm a little more sceptical about the insurance play. My sense is that the keys to success in insurance have more to do with distribution and less to do with risk financing. And if your strategy is to become a great insurance company because of cheap risk financing capital, you are likely to lose focus on the importance of getting your distribution partnerships and fundamental underwriting right.

An exception to this may be innovative products like parametric covers where incentive alignment problems are solved or bypassed. Innovations like this may also help address under-insurance or protection gap issues.

Charles Collis
Indexed triggers were popular six to eight years ago and then they disappeared. Why?

Paul Schultz
Everyone has different objectives they're solving for, and some buyers look at the possibility of not recovering based on their actual losses as kind of a career-impacting outcome. So they're less interested in pursuing something different. What's going to be interesting is providing parametric and other solutions that can create liquidity quickly for those in need and distress. The opportunity around that is immense.

Cory Anger
But it goes broader than just the public sector and municipality-type transactions. There's a false comfort in indemnity-based coverage. The way the type of losses are sub-limited, a client is actually taking basis risk in its cover even when triggered on an indemnity basis. For corporate clients, it increasingly resonates that parametric deals can cover unanticipated losses that wouldn't be covered in traditional (re)insurance products.

Also, a corporate client typically focuses on protections that protect earnings. What's so interesting about what or when they buy is that they're not always focused on the big surplus-depleting events because the equity market tends to give them a pass in terms of the impact on their stock price.

"There will always be a cohort of independent managers, [but] you will see some get absorbed, either by asset managers or by reinsurers"

Dirk Lohmann

Fiona Robertson
We spend so long in this Monte Carlo huddle talking about reinsurance rates and what's going to happen, it's not often we stop and think about how ILS looks right now from an outside investor's perspective and what that means in terms of influence on inflows and outflows.

Helen Goonewardene
On the banking side, the clients we've been dealing with have come to us in the changing interest rate environment looking for more focus on yield on their collateral returns. Partners like our asset management teams within HSBC have been looking to engage with industry and see how they can develop separately managed accounts that might provide higher returns, maintain principal and meet regulations.

Cory Anger
ILS still is a small component in investors' portfolios. Some have outsized participation in this space and so maybe they feel that more meaningfully but whatever is happening here,

we're a decimal place in the overall scheme of the return profile.

Additionally, the volatility we've seen recently in the equity market along with the inverted yield curve in the US means we could be tipping into an adverse capital markets environment. In such situations, where this asset class differentiates itself is that ILS valuations depend more on predominantly cat risk activity, not necessarily what's going on in the broader economic environment.

Eveline Takken-Somers
As an industry, we need to address some issues that were highlighted in the past two years, such as negative loss development, trapped collateral and the lack of transparency. We can no longer rely on the positive results generated during the global financial crisis and the years thereafter. If we resolve these issues, the ILS market will be more robust and sustainable.

Fiona Robertson
Should retail money play a long-term part in the ILS market? Obviously, it's been shrinking and having a knock-on effect on the sidecar market this year.

Dirk Lohmann
There's a place for it. Clearly, it depends on the level of the investor. It shouldn't be small tickets of $25,000. It has to be people who have a good understanding of the markets and the benefits this asset class brings. We sell a lot of it through the wealth management channel. But it's only for qualified investors in the high-net-worth category. That has been a stable source of capital for the bond market. That's where the liquidity is; they want to have the option to pull back if they need to. It's worked quite well and delivered a fairly decent return for those clients.

Cory Anger
I agree. You will continue to see retail money but it will fluctuate with the market environment. By virtue of the fact of their size – trillions of dollars – they have to be a part of the ILS space.

Dirk Lohmann
The issue is what kind of liquidity you offer if sold as a liquid alternative.

Pete Vloedman
Aside from absolute return, liquidity is one of the highest priorities of the retail investors we have spoken with. Because of that, it can be challenging to put collateralised reinsurance into a retail ILS product. In Europe, to your point Dirk, they've successfully done ILS in the private client market using cat bonds since 2002. In the US, it's a more recent phenomenon.

When we were asked to do an ILS product for a mutual fund family, we said – collateralised reinsurance isn't really what your investor base needs; they're looking for a yield diversifier for their high-yield corporate bonds. We designed a hybrid insurance yield product with ILS exposure coming from cat bonds. Currently, cat bonds are less than half our portfolio. Because our investors value liquidity, they're willing to sacrifice some equity market beta at times for a more liquid portfolio.

Fiona Robertson
One last question then – what is one area of better self-regulation you would like to see in the ILS markets?

Eveline Takken-Somers
I'd like more standards around loss reserving.

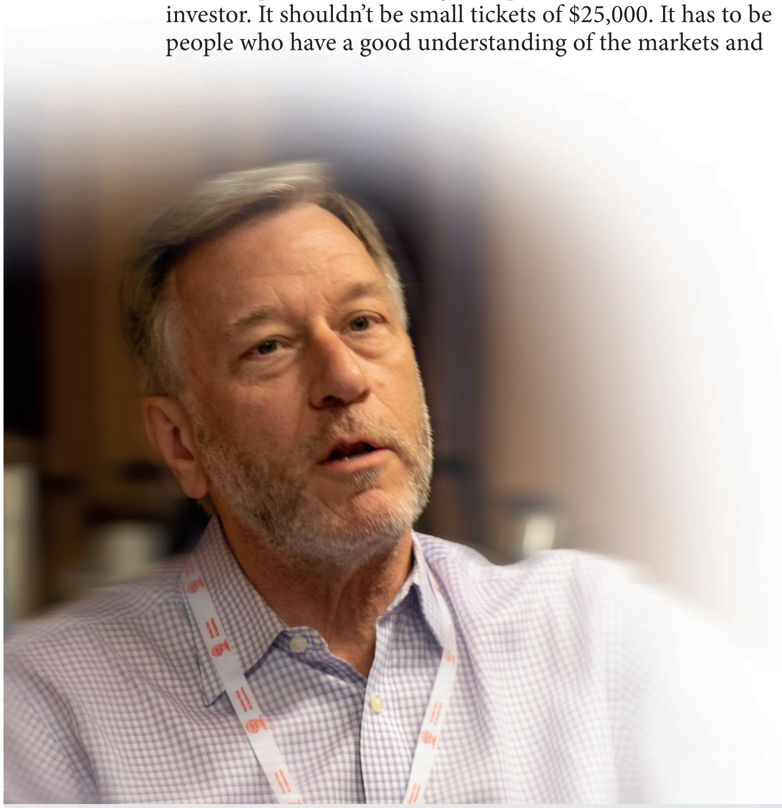
Darren Redhead
As fund managers what we should be able to do, whether you're traditional or non-traditional, is have a view of the original loss soon after the loss has happened.

Eveline Takken-Somers
But that loss estimate should be accurate as well.

Pete Vloedman
Sometimes it's not going to be initially accurate. That's the nature of an insurance loss reserve.

Eveline Takken-Somers
Then ILS managers should at least use a side pocket for their co-mingled funds.

Fiona Robertson
It feels like valuation is the big thing. That's something we can agree on.



"ILS investors have to recognise there is unknown extreme tail risk and do enough work to justify taking on that risk"

Greg Richardson

conyers.com

Risk Capital Market Leaders

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