INSURANCE-LINKED SECURITIES FOR INSTITUTIONAL INVESTORS 2014

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Exploring the evolution of the insurance-linked securities market (ILS) and examining the role of specific instruments in an investor's portfolio.

Building a sustainable reinsurance model

Interviewer

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Interviewee

Tony Rettino
Founding Principal and Portfolio Manager, Elementum Advisors

Steve Evans: What would you say to those questioning the sustainability of insurance-linked securities (ILS) instruments and how will you respond if 2014 proves less benign than previous years?

Tony Rettino: There are 2 questions here: the first being can they, the second will they? Most of our investors are large institutions committing less than 2% of their assets to reinsurance. If they were to lose 40% of the capital that they committed, it's a bad month; whereas, if a reinsurer loses 40% of its capital, the reinsurer is likely to lose its rating. The institutional investors that form our capital base can therefore afford to be more concentrated because they are in a much better position to both sustain large losses and to have the financial resources to recapitalise after that loss.

The more interesting and complex question is: will they recapitalise? This is what I see as the central point in the sustainable market question. While clearly some investors in today's market environment are more temporary, owing to low interest rates and low credit spreads, we anticipate that most large institutional investors will return to the market. The reason being that they spend an enormous amount of time (up to 2 years) performing the appropriate due diligence before investing and have a history of re-investing in this and other asset classes. An interesting point about our model, relative to a traditional reinsurance model, is that we speak with each of our investors at least semi-annually and provide extensive details as to the risks in the portfolio. We are a lot closer to our investors and have a strong intuition as to their sustainability following a loss and manage expectations ahead of one.

The next question is, of course, what could change in the above? To have a stable market, the market has to collectively ask itself, "just because you can, should you?". The question for us managers is whether or not we should take on more capital just because we can. For example, should I take that extra $200-300 million that may be put to work in more marginal types of investments? As a privately held firm, we are cautious and look to match capital with opportunities to deploy it; and last year, we actually turned away certain capital. Any new capital has tended to be from new market entrants who are starting with a very small proportion of what they ultimately plan to invest in the long-term.

For both investment managers and reinsurers, one question that needs to be asked is whether we are providing the proper level of transparency to our capital providers. When you think about sustainability, a surprise small loss is worse than an expected big loss. If we, or the reinsurers running sidecars, have not been fully transparent with our investors collectively, then capital may not return and credibility may be questioned. Some of the sidecars cover business that reinsurers don't typically write or keep, which, from our perspective, could create some difficulties following a loss event. We have also seen some disruption in the catastrophe (CAT) bond market over time as a result of structural issues, including the more aggressive collateral structures in the years leading up to the financial crisis.

For brokers and insurers, the question is: just because I can reduce disclosure or push terms and conditions through in order to expand coverage and include un-modelled or poorly modelled perils, is this the right way to build long-term relationships?

There is a lot of discussion about relationships in this market. We work with our insurance clients to devise the right level of pricing and structure that works for us both over the long-term. That creates a more sustainable model. It's very clear that the large price increases put on insurance companies following past major losses has opened the door for alternative capital. The point to take from all this is that just because you can use leverage, you shouldn't automatically do so.

Steve: Do you think traditional reinsurers who aren't leveraging third party capital may have seen the end of goodwill price increases after events?

Tony: It will be path dependent. There are brokers and insurance companies really pushing the envelope. I've been in this market since 1994 and would add that those who 'push the envelope' in the soft market pay for it on the back end, whereas those who adopt a longer-term perspective reach more sustainable returns. I would gladly trade the excess returns of the peaks for higher troughs and, in particular, less deterioration of terms and conditions. Such a trade-off is one which I feel both our investors and our insurance clients would welcome. Twenty-five years ago all CAT losses were funded by equity on insurance and reinsurance company balance sheets. Today approximately 15%, or in peak regions around 25%, of losses are funded by flexible capital structures; these are funds such as ours and sidecar vehicles. This has helped create a more flexible capital structure, which in turn reduces volatility and should benefit all parties going forwards.

Steve: **New market entrants have pushed spreads and risks down; what impact has this had on the traditional reinsurance model's flexibility?**

Tony: There's been a lot of healthy convergence and innovation. The ability and willingness of reinsurers to provide more multi-year capacity and aggregate type structures is a good thing. Other mechanisms from the CAT bond market, such as the way premiums or layers are adjusted within or across years, are making their way into reinsurance, as are cascading limit structures. Likewise, many good elements from the reinsurance market are making their way into the capital markets, including more indemnity and reinstatable coverage. And let's not forget, proper alignment of interest, the loss of which we believe contributed to the financial crisis, has been a hallmark of the reinsurance market for centuries. The end result of all of this is better and more flexible solutions for reinsurance buyers.

Sidecars and third party funds have provided reinsurers with more flexibility in their capital structure. This, however, comes with some serious potential conflicts of interest, which some deal with very well, while others do not. It's going to be an interesting question as to whether or not the investors involved in those vehicles feel, post-loss, that the risks were fully disclosed. It's a tricky situation to balance and it remains to be seen how this will evolve.

Steve: **Capital markets are charged with leading the way on loss and damages, what considerations do you subsequently have for your long-term ILS model?**

Tony: In evaluating new risks, we first have to consider what the long-term value proposition is for our investors and how well can we understand and quantify that risk. Much time is spent considering the amount of risk currently being transferred in the market and the related excess capital because there is a clear opportunity for growth on the horizon. That said, not much time has been spent drilling down into where these growth opportunities will come from. Between 1980 to 2013 there was $3.8 trillion of losses, 70% of which was uninsured- it's a big hole. For me, the real question is who will ultimately fund these losses.

In emerging markets, we first need a developed insurance market and improved data/modelling for a reinsurance market to truly develop, but it's fair to say that there's a lot of additional capital that can be brought to bear. We see more immediate potential for the capital markets to absorb uninsured risks in the U.S. If you look at wind pools, the potential (and need for) higher take-up rates in California for earthquake risk and the potential privatisation of flood risk, it becomes clear that there is a lot of risk that can very easily be absorbed into our existing ILS model. Over time, this growth will be echoed by the developing markets, with China most likely leading the way.

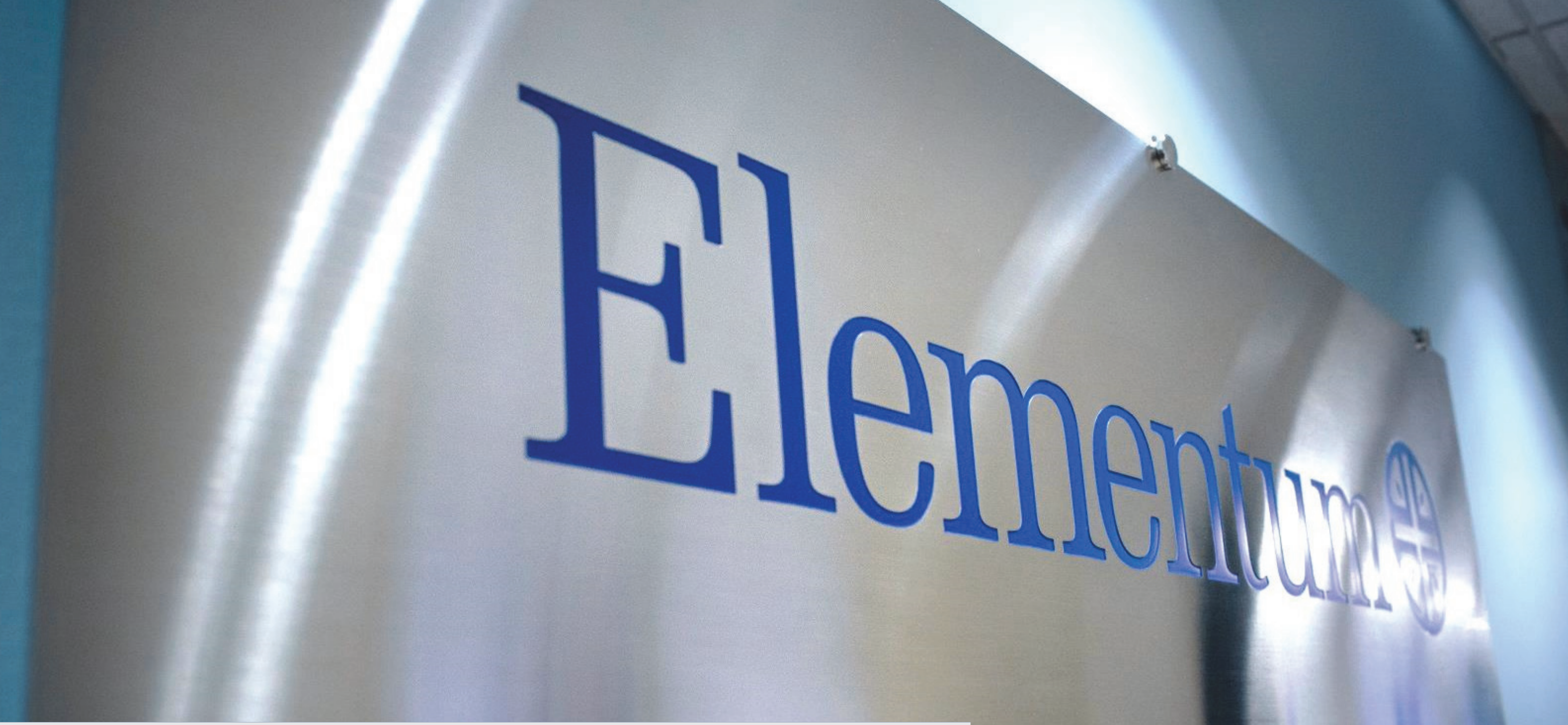
Steve: **Is an ILS and traditional reinsurance blend the only strategy for creating a sustainable model hedging against systemic risks? If not, what other strategic options are there?**

Tony: There is not a one size fits all model that's right for everyone. In general, I think a combination of ILS and traditional reinsurance creates the most value for our insurance company clients. Elementum is not a hedge fund or a reinsurer but an alternative investment manager focused on property catastrophe risk. One of the fundamental components being that we're indifferent to the form of instrument providing the risk transfer, whether it's equity, debt, CAT bond, private CAT bond, collateralised reinsurance or exchange traded derivatives. To our clients we simply stress that we aim to bring capital to risks through a variety of innovative solutions. Any inefficiencies are in silos, but that will ultimately change. Those successful in the market will be indifferent to form, whereas those that struggle will be the ones sitting on a single box solution. There is limited equity, hybrid equity or debt type solutions but of course this can and will change. The sidecar is a hybrid capital instrument that, if done correctly, offers real market development.

Steve: **Where do you see Elementum in 5 years' time? Do you see your current focus on property changing?**

Tony: We believe that a focus on our core expertise is paramount and, for the foreseeable future, there's enough runway in property catastrophe risk to provide value for both investors and clients. Markets such as marine and aviation are tiny, and there isn't a crying need for capital. Reinsurers can provide that off of a levered balance sheet with much more efficiency than we can. The value proposition has to be there for it to make sense for our investors and insurance company clients. There's all sorts of horror stories regarding style drift, which is why I'm cautious of who is writing a line of business just to cede it out to capital markets. Our focus is on product development and innovation. So, in the intermediate term, our efforts will be on new structures and forms of capital and finding ways to bring more risk into the private market (such as earthquake risk and risk from wind pools) and exploring other areas of growth such as U.S. flood and risks coming from emerging markets.

Steve: **Thank you Tony.**



Elementum, meaning "element" or "first principle," was chosen to emphasize the firm's focus on natural catastrophe event exposed investment strategies and its dedication to its clients.

Elementum Advisors, LLC

Elementum is an independent, SEC-registered alternative investment manager specializing in collateralized natural event reinsurance investments (RLI). Elementum and its principals and associates possess a lengthy track record of alpha generation and experience managing portfolios across a range of RLI investment mandates-from liquid catastrophe bonds to high-alpha collateralized reinsurance investments.

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