

## INSURANCE LINKED SECURITIES

### Securitisation - Non Life Risks

What are the different sectors that lend themselves to securitisation in the non life risk space? Please elaborate on each stating why.

There are a number of risks which lend themselves to capital market risk transfer, or securitisation. They include catastrophe peril such as earthquakes, windstorms (including hurricanes and typhoons) and floods, and other non life risks associated with motor coverage, industrial liabilities and aviation.

Investor appetite for insurance linked securities (ILS) continues to grow since they bear little to no correlation with the defaults of most other securities, and therefore offer greater diversification in an investment portfolio. In 2006 alone, Swiss Re Capital Markets placed nearly USD3.1 bn of total non life issuance of approximately USD4.9 bn.

All the perils mentioned above, have the potential for additional securitisation in geographical areas where similar securitisations have proven to be a mutually beneficial transfer of risk - for the reinsurer and for the investor. Outside of those geographical areas, the potential for securitisation must be evaluated on a peril-by-peril basis. New peril is introduced each year and this is subject again to available models. Investors have demonstrated a significant appetite for new, diversifying perils.

#### How many of these prospects have actually been securitised to date?

Since its inception in 1996, the market for insurance linked securities has witnessed worldwide issuance in excess of USD9.5 bn. In recent years, insurance linked securities have shown strong growth both in volume and deal numbers, indicating a growing risk bearing capacity in the coming years.

#### What are the main barriers to realising securitisation of the above?

One of the principal barriers to securitisation is lack of reliable models. What is more, the decision to transfer risk to the capital markets may be partially driven by a reinsurer's tolerance for a given risk. There are multiple actuarial and financial considerations that go into this decision.

#### How can they be overcome and ... under what time frame can one expect to realise them?

Catastrophe models are continually being refined - as long as this happens and new models become available, more perils should emerge over time in the securitisation space.

#### From known examples, such as motor insurance, how lucrative is it/can it be?

An ILS solution is in development for Motor securitisation. This is important in that it creates a benchmark. I am confident that it can be adapted to provide capital markets a solution that delivers risk management and solvency capital benefits to primary insurers (under the new regulatory environment being developed in Europe in preparation for Solvency II). We believe that capital markets have the potential to grow capacity available to Motor insurers significantly.

#### Who would typically buy/invest in these securities - and what sort of risk/reward profile would they deliver when compared with cat bonds? (would investors demand higher spreads ... or would spread be relatively tight?)

Generally speaking, there are different types of investors for different securitisations. For example, investors in Motor are seeking occurrences that are high frequency with low severity and low volatility. Notes on Motor securitisations to date have been investment grade. On the other hand, cat bond investors are looking for low frequency, high severity events - trades which are non-investment grade.

#### Plans/prospects for securitisation as applied to the agriculture sector?

We are looking at this space with interest, but cannot comment on specific plans or actions.

#### What role has and do hedge funds, private investors play/ed in this respect (securitisation of non life risks)?

Hedge funds and dedicated cat bond funds are the largest players in the securitisation market.

Hedge funds purchase ILS, but some also provide protection through industry loss warranties - ILWs and collateralised reinsurance. In addition, hedge funds have many other connections to the insurance industry. For example, they purchase the stocks and hybrid capital issued by (re)insurance companies, set up reinsurance vehicles and companies and fund side-car capital arrangements, and take other non-cat risks (life, life settlement, aviation, terrorism, etc.) whether or not in rated bond form.



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Motor insurance provides a huge pool of risk to be potentially securitised. Motor insurance has been discussed for a while as a risk with good potential for securitisation - the first deal was finalised in 2005. The potential for motor bonds is large, due to the huge volume of insured motor risk. In 2006, motor insurance incurred estimated losses of USD350 bn. This is expected to grow to USD 660 bn by 2016. Securitisation of 3% of the claims - which is equivalent to the penetration of property catastrophe risk five years ago - would require a volume of USD20 bn of motor bonds, while a penetration comparable to property catastrophe today would result in motor bonds of USD42 bn. This would presuppose overcoming the regulatory impediments to growth raised above.

Complementary solutions could develop along with ILS securitisations, as in the banking industry. For example, banks use the credit default swap market in tandem with the securitisation market to manage their credit exposures, and something similar could evolve along with the development of the motor insurance securitisation market or other ILS techniques.

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