Investing in Real Risk – Guernsey's Growing ILS Sector

By Mark Helyar

I always found complex physics and chemistry less challenging than the twisted logic of economics when I was a young student. I was much happier with long meteorological equations involving the Stephan-Boltzmann constant and adiabatic lapse rates than factors affecting things like exchange and interest rates.

Over the past few years it feels as if the logic of economics (if there ever was any) has disappeared and horizons have shortened so much that financial advisers have become passengers and reactive observers of our times rather than predictors of sustained, beneficial future performance.

So much of our financial system is interlinked, involving a complex and confusing web of computerised market triggers and irrational, emotional responses to geopolitical events that it is difficult to discern what is happening in real time, let alone what may happen next week or next month. These interconnections are leading to substantial volatility in an environment of low interest rate for savers and no true safe havens to achieve investment returns.

It is in the midst of this continued confusion that investment in what I call "real risk" has shown remarkable and sustained growth since 2008 amongst savvy investors. By real risk, I mean the types of physical risk which real insurance and reinsurance companies underwrite in order to generate profit.

Why Real Risk?

Why would anyone want to invest in real risk? Well, for a start it isn't prone to the illogical, confusing miasma we see in the markets. I speak regularly with and receive the published wisdom of many of the most distinguished investment advisors. They seem to be converging on an unhelpful consensus that everything is simply very complex and uncertain.

We seem to be living in an age where the inter-reaction of our financial systems is now so complex, turbulent and irrational that few investment theories appear to work for more than a limited time. Hence, real risk's main appeals to the intelligent investor:

Real risk is simple to understand – you either have a huge hurricane or an earthquake which wipes out your money, or you don't, and the frequency of these things and their effects can be modelled

Real risk isn't correlated in any way with what people are scared of – hail storms and hurricanes happen or don't happen irrespective of whether there is Brexit or Trump, or oil prices are $10 per barrel. In other words you can make profits even when the financial markets are melting. Also, unless you subscribe to obscure conspiracy theories, a hurricane in the US doesn't cause an earthquake in Japan. Catastrophic events are generally discrete from one another.

Real risk may provide returns far in excess of current bank interest and even high quality bond rates and with less volatility than most current equity markets, but the flip side is you also risk losing all your money in return. It is therefore suitable as a high proportion of a portfolio rather than an all-in poker game. But there are ways of spreading risk too, as we shall see.

It's a real ethical investment – really? Yes, you only make a profit when nice things happen and a loss when people and businesses need help after a disaster. The reinsurance market is the one which picks up the bill for events like hurricane Katrina, rebuilds people's houses, businesses and lives. It's the commercial last resort before the government steps in during a disaster, and as we know, governments don't actually have any money or they wouldn't be asking for more and more tax from you, would they?

How?

How do you access this market? What are the products and how do you buy them? Reinsurance companies in the CAT (for "catastrophe") arena have for many years been issuing "CAT bonds" – you buy the listed bonds and the reinsurer uses the cash to underwrite reinsurance for insurers who carry CAT risk, usually US windstorm but also earthquake, crop damage and flooding in other areas. This can be a limited group of potential catastrophic events so that you can keep track of hurricanes on your TV, and can, depending on the spread across different events, provide some reduction in risk.

CAT bonds are a species of "insurance linked securities" – these are financial markets investment instruments such as bonds or preference shares whose performance is linked to an underlying insurance outcome. Increasingly, and particularly to reduce the euphemism of counterparty risk, otherwise known as the danger of your bank going bust with your money, investors have been looking at ways to invest in more direct and indirect ways.

The first and rapidly growing sector is collateralised reinsurance. It's a given that most investors don't own a reinsurance company, so traditionally they have purchased securities issued by reinsurers. However, there were problems in 2008 when banking counterparties to certain bonds went down, leaving investors with no direct contact with the reinsurers who issued their bonds.

This failure led to a desire for more bespoke peer-to-peer solutions. In a collateralised re transaction, a licensed (re)insurer, often a protected cell of a protected cell company, takes a retroceded risk from a reinsurer by writing a re-reinsurance. The capital representing the underwriting total, plus premium, is usually placed into a secured holding or trust account. Then you sit back until the contract (usually one year) expires and receive the capital, modest interest (accounts are usually put into US Treasury or similar) and premium back.

Guernsey's fast-growing ILS industry predominantly administers and writes this type of business. These sophisticated transactions are not for public consumption. They are conducted usually between substantial regulated counterparties and can involve significant slices of risk amounting to tens of millions of dollars per transaction.

The second trend has been new growth in ILS funds. These are not by any means new but there has been growth in number and size of these investment funds which the public can buy. The ILS fund will, under the advice of specialists in the field, purchase CAT bonds and undertake many collateralised reinsurance transactions, often through a bespoke insurance vehicle controlled by the advisers or fund itself. By investing in many classes of reinsurance, at different levels of risk and across different types of catastrophes and in different continents it is possible to spread risk and produce a return based on a consolidation rather than a single event.

What Does the Future Hold?

I can't tell you, and it seems neither can anyone else, whether the stock market will go up or down this year with even a reasonable degree of certainty. I can safely say, with 100% certainty, that there will be natural events, and I can also safely predict that there will be insurance losses arising from them. I can't say where or when, obviously, but to some extent that doesn't matter, the fact is that risk is being assumed and that capital is required to back it up, and the market will pay for that capital.

Although reinsurance premium rates have dropped considerably this is largely due to absence of large "trigger events" in recent years. One wag was quick to point out that despite the groaning about reduced premium rates, reinsurers were in effect "crying into their champagne" due to a lack of losses.

Many still believe firmly that the new investment capital in this market will flee after the first sign of a major loss. I disagree. There is too much capital which is not being put to use for the sector to be abandoned, and too much volatility and uncertainty. Until there are viable, stable and long term investment alternatives I believe the ILS market will continue to be supported and will continue to innovate. We will do our best to ensure that Guernsey remains at the forefront of the growth.

Mark Helyar is a lawyer and partner at Bedell Cristin in Guernsey. He has won international accolades for innovation and structuring in the ILS space and regularly advises companies, investors, banks and reinsurers worldwide on insurance, reinsurance and ILS. Mark has advised a number of sovereign governments on the inception and regulation of protected cell companies and is a non-executive director of a number of insurance, reinsurance and ILS structures.