Market Insights

December 2021

From the home to the hedge fund.

Risk transfer in the insurance market.

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $500 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Donna Davis
Consultant

Donna joined Frontier as an Associate in 2019 and was promoted to Consultant in 2021. She works with the Alternatives and Derivatives and Debt and Currency teams, specialising in less liquid investment strategies such as insurance linked securities and opportunistic credit along with derivative structure and strategy modelling and assessment. Donna also has a particular interest in data analysis techniques and has completed research into cluster analysis and how it can be applied in client portfolios.

Prior to joining Frontier, Donna worked for AustralianSuper in their Options Management Team. She also has almost 10 years banking experience with the Commonwealth Bank and ANZ in Corporate and Commercial banking across relationship management, complex lending and transactional banking.

Donna holds a Bachelor of Quantitative Finance from the University of South Australia and is currently completing the CFA program.

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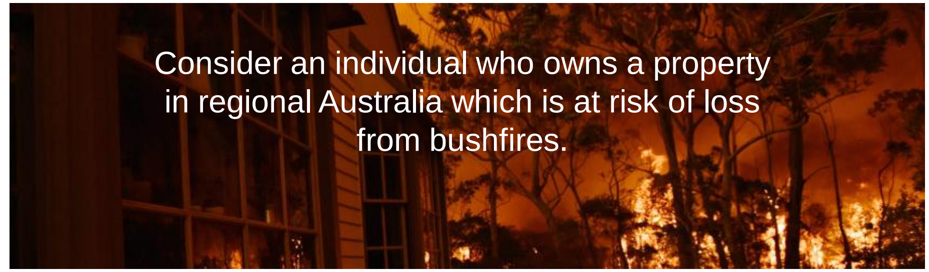
INTRODUCTION

Risk transfer in the insurance market.

A key focus of the Frontier Alternatives and Derivatives Team is understanding investment risk. We view this as a critical part of understanding what drives investment performance and the suitability of an investment for a particular client.

For investors new to the Insurance Linked Securities (ILS) sector, we illustrate how risk is transferred from the insurance policy holder across the main players in the insurance market.

The consumer



Pre-emptive risk transfer

This individual has several options for managing this risk. The individual could *avoid* the risk and choose to live in a less bushfire prone area. The individual can *accept* this risk themselves and set aside sufficient funds to address the loss should it occur. The individual could also look to *transfer* the risk by paying a premium to another party. In the third option, the premium is typically paid to an insurer in exchange for a payout in the event of an insured event occurring.

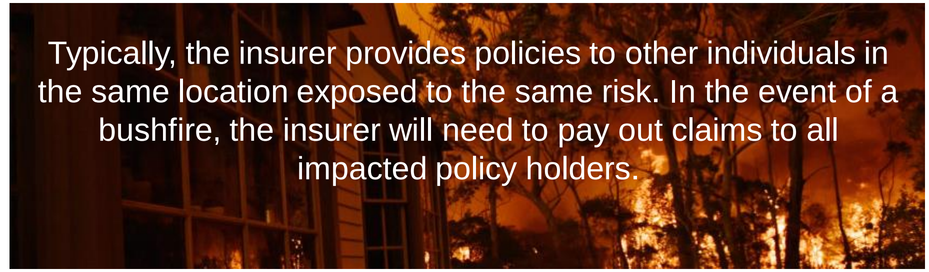
Post event impact

If an insured event occurs, the individual will submit a claim to the insurer and receive funds in line with the agreed policy terms.

How is the ILS sector involved?

Investors participating in the ILS market are an additional source of capital for the insurance sector. This assists in reducing the cost of risk transfer and provides additional sources for diversifying and transferring risk. This process increases the efficiency of the market and puts downward pressure on the cost of insurance.

The insurer



Pre-emptive risk transfer

To manage this risk, the insurer can either *accept* this risk and set aside sufficient capital to meet this loss. Alternatively they can *transfer* this risk to a third party. That is, the insurer may seek insurance of their own through a reinsurer. This policy may cover a specific event (e.g., a large bushfire) or it might cover a specific amount (e.g. aggregate claims larger than a certain amount).

Post event impact

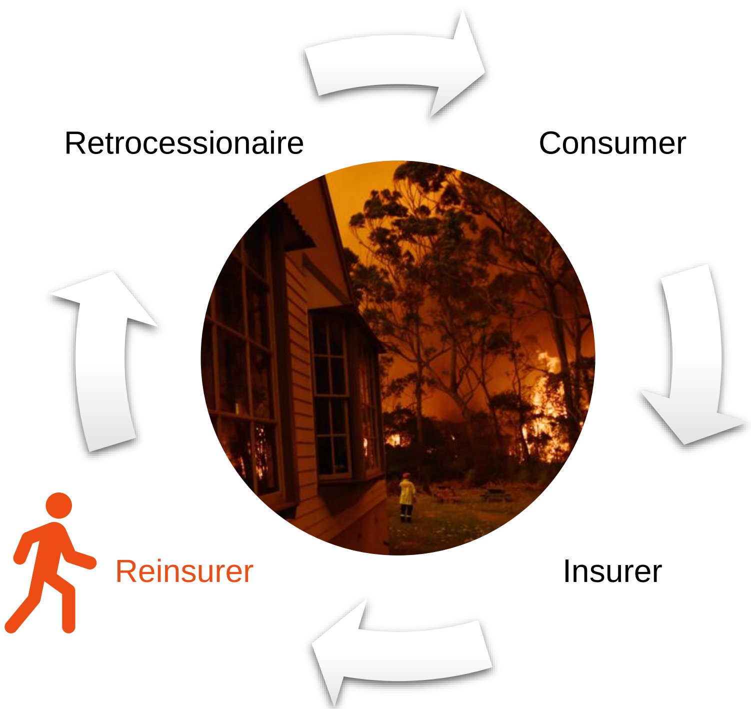
In the event of a bushfire, the insurer will complete an estimate of the amount of damage caused by the bushfire. This estimate will assist in providing an estimate of how much it expects to pay out in claims to policy holders. If losses from the bushfire are large enough, the insurer may submit a claim to its reinsurer and receive payment in line with the terms of the cover.

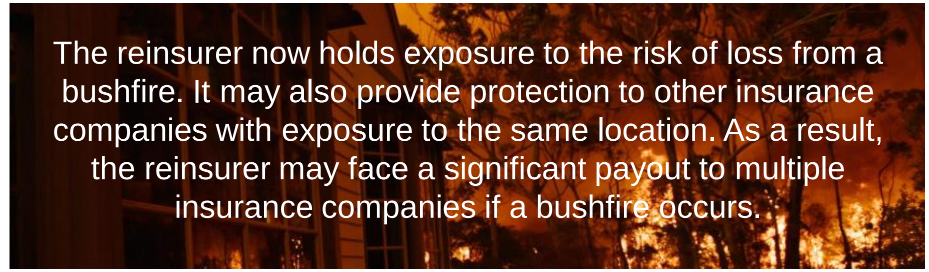
How is the ILS sector involved?

An ILS manager may seek to provide risk transfer to an insurer in the form of a product known as a *quota share arrangement.* The ILS manager receives a certain share of the premiums paid but is liable for a fixed share of losses. The provision of this capital is an alternative source of risk transfer to more traditional reinsurers. It assists the sector by providing additional sources of risk transfer, potentially reducing the cost of premiums the insurer may pay for the transfer of risk.

The reinsurer

Stepping through insurance risk transfer





Pre-emptive risk transfer

Similar to an insurance company or individual, the reinsurance company may seek to *transfer* this risk. This transfer may occur via a reinsurer of reinsurance companies known as a *retrocessionaire*. They may also transfer risk via an insurance linked security (ILS), which is an alternative source of capital or risk transfer. These instruments allow for external investors to participate in the risk transfer process and to collect the associated premiums. The structure and format of the ILS investment will depend on many factors including the amount and severity of risk the investor is prepared to assume along with how these amounts are defined and a loss can be triggered.

Post event impact

Post the bushfire hitting, the reinsurer will estimate the damage caused by the bushfire and the number of insurance companies it provides cover to that will be impacted. The level of loss impacting the reinsurance company may be partially offset by the reinsurance it took out.

A key challenge is the delay between the event occurring and the actual insurance loss it created being claimed. An individual has up to three years in some areas to submit a claim. The reinsurer will estimate the loss right after the event. This estimate will be reassessed regularly as claims are submitted and paid by the reinsurer.

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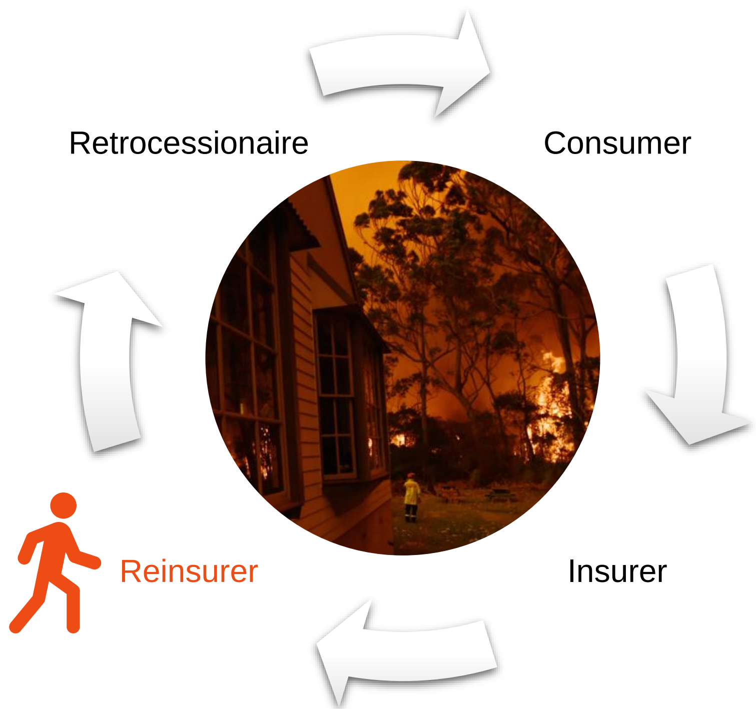
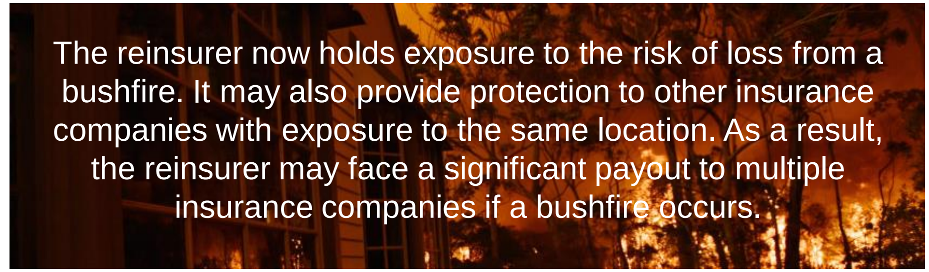
The reinsurer

Stepping through insurance risk transfer





How is the ILS sector involved?

An ILS manager will assess the level of risk associated with the specific ILS instruments it holds. This includes looking at the probability of the bushfire hitting the specific location, how many houses are insured in that area and the expected payout of claims if a bushfire hits. This analysis provides an indication of the risk and return. Depending on this risk level, the manager may allocate the risk to a variety of products with different risk and return profiles.

As claims are submitted post an event occurring, the level of premium received by the ILS fund is reduced. A loss will result if the amount of claims submitted is greater than the premium received for the policy.

The retrocessionaire

Pre-emptive risk transfer

Given how far removed the entity is from the original risk transfer, there is an additional challenge of transparency and timeliness in understanding the level of risk undertaken. To transfer this risk, the retrocessionaire may seek risk transfer via an insurance linked security.

Post event impact

The post event impact is similar to a reinsurance company, with the additional complexity of being one step further removed from the original insurance policy and resulting claim. This additional complexity can make the estimation and subsequent actual resulting loss complex and time consuming to manage.

How is the ILS sector involved?

Similar to the post event impact, the retrocessionaire is involved in the ILS sector in a similar way to a reinsurance company. Investments of ILS instruments will be assessed to determine risk level and associated expected risk and return. Upon an event happening, the portfolio is reviewed to determine the level of loss which may impact these instruments.

The further removed from the original risk transfer an investment is, the more multifaceted the assessment of potential losses prior to the event occurring and valuation of actual losses once an event has occurred can be.

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Conclusion

The introduction of external sources of capital into the insurance market has provided opportunity both for insurers and investors alike.

From an insurance perspective it has increased available capital which aids capacity.

For the individual this has assisted in maintaining premiums at affordable levels along with ensuring more frequent and extreme perils can continue to form part of the risk transfer process and not remain with the individual.

For investors this has created a diversified return stream with key drivers uncorrelated with traditional asset classes.

Understanding how this transfer of risk flows from the individual to the various risk transfer providers in the space can assist in the investment decision making process.

Want to learn more?

If you would like to find out more about Insurance Linked Securities, please reach out to the Alternatives and Derivatives team or your consultant.

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