Insurance-linked securities (ILS) – market update

October 2022

frontier

Summary

Purpose and recommendations

This paper reviews the ILS market, reporting on:

- **Performance H1 YTD 2022**
- **Key trends identified after the completion of the four main industry renewal periods**
- **Expectations for performance for the remainder of 2022 and peril season outlooks**

We encourage clients, prospects and industry participants to review this information with their unique circumstances and individual investment requirements in mind

Performance

Insurance and economic loss

Economic and insurance losses in H1 2022 are broadly in line with long-term averages

Total economic and insured losses in H1 2021/2022 (US$b in 2022 prices)

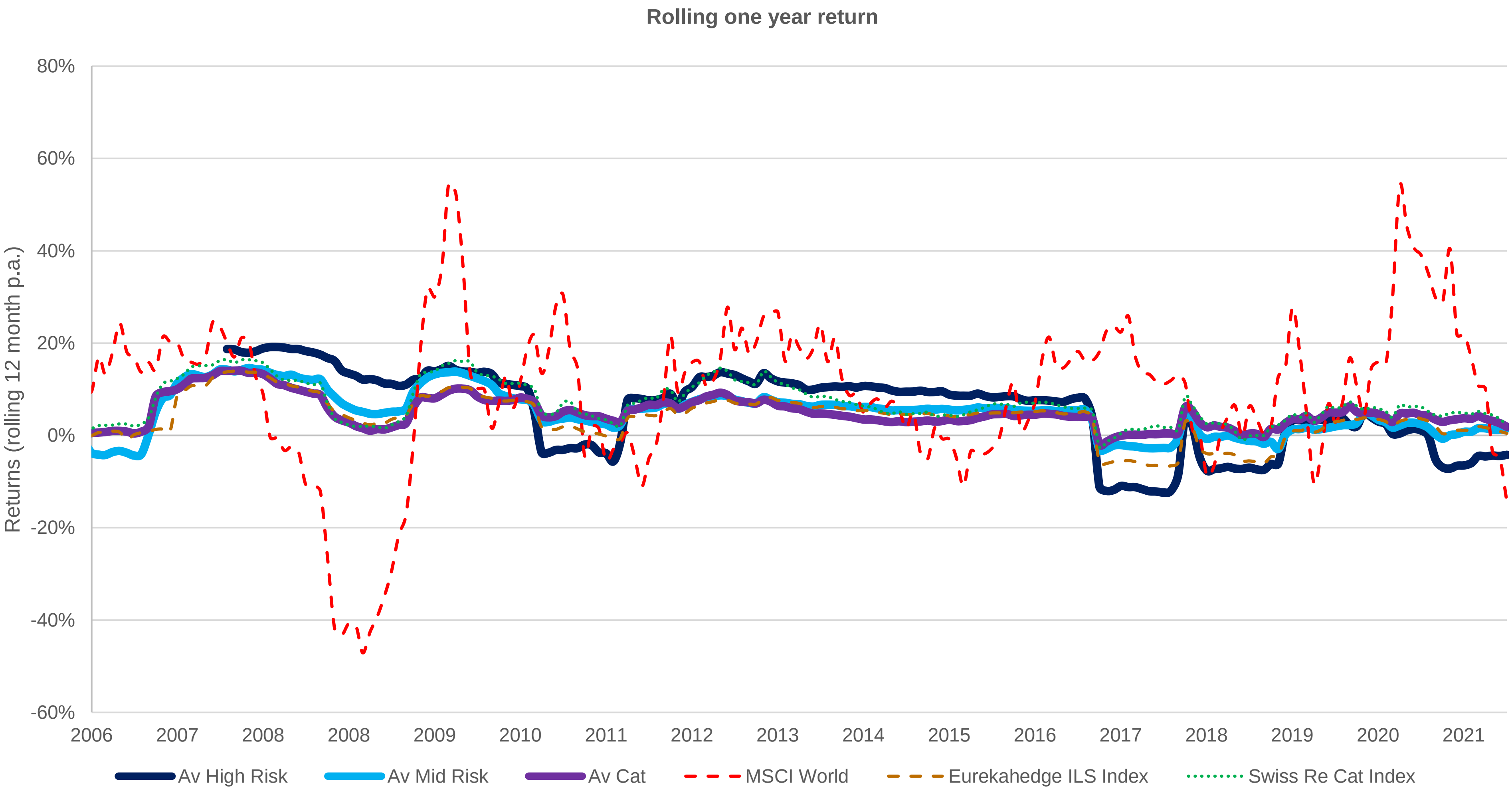
	H1 2022	H1 2021	H1 10 year average	% change from the 10 year average to 2022
Economic losses	**75**	**95**	**80**	**-7%**
Natural catastrophe	72	91	74	-3%
Man-made	3	4	6	-55%
Insured losses	**38**	**49**	**34**	**11%**
Natural catastrophe	35	46	29	22%
Man-made	3	4	5	-51%

Source: Swiss Re Institute

- 2022 has started as a much more benign loss year, compared to 2020 and 2021. Losses from both natural catastrophe events and man-made disasters have been broadly in line with the ten-year average.
- The majority of natural catastrophes (cat) have been associated with secondary perils including extreme tornadoes in the US, severe flooding along the Australian east coast and heat waves in Europe causing wildfires and drought.
- As a result of a much more average loss year to date, returns across cat, mid and high risk ILS funds have been broadly in line with portfolio expectations. All three portfolios have outperformed equities in 1H 2022.

Rolling return

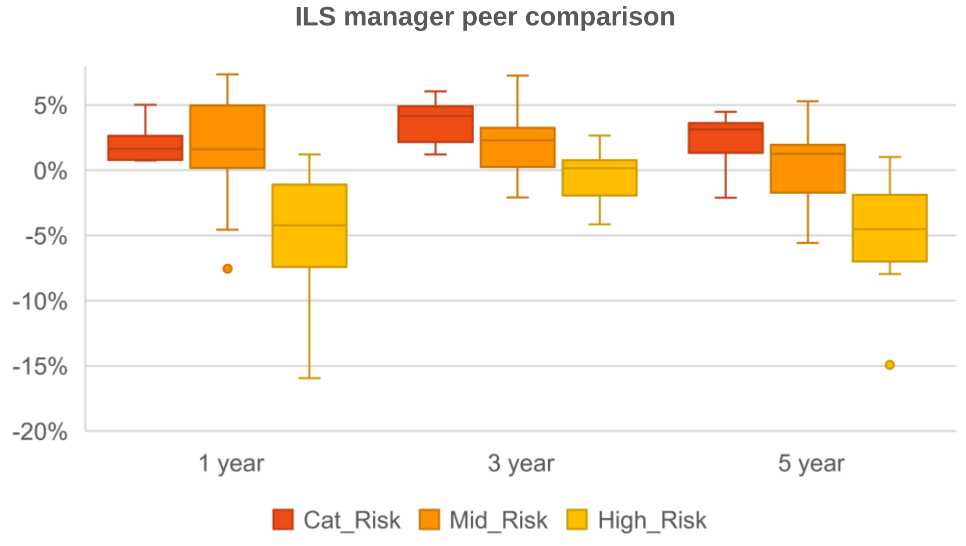
All ILS risk levels have outperformed equities in H1 2022 YTD



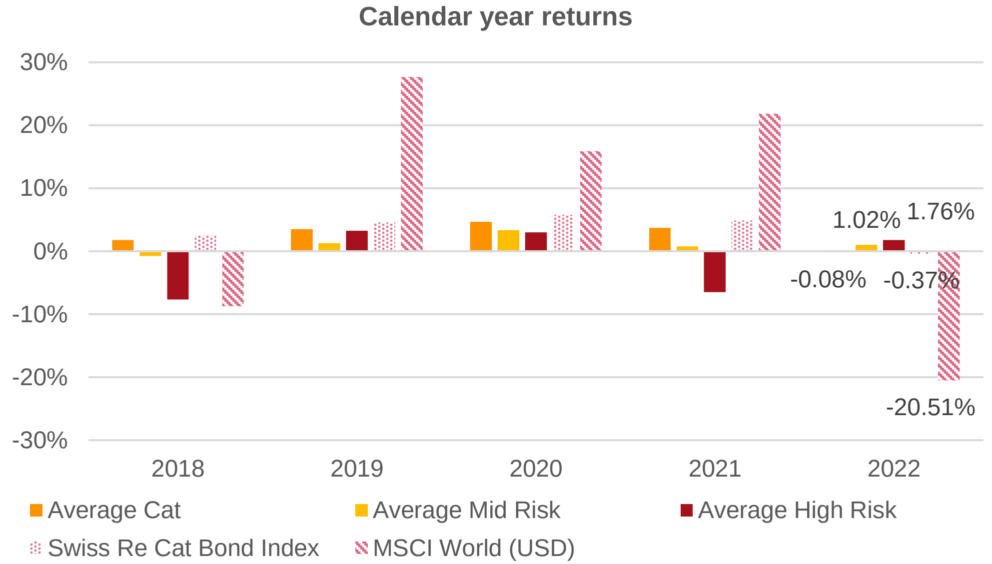
Source: Frontier, Bloomberg, Managers. Data to 30 June 2022

Return comparison by risk level

High risk managers have experienced the greatest divergence in historic performance



Source: Frontier, Managers. Data to 30 June 2022



Source: Frontier, Managers. Data to 30 June 2022

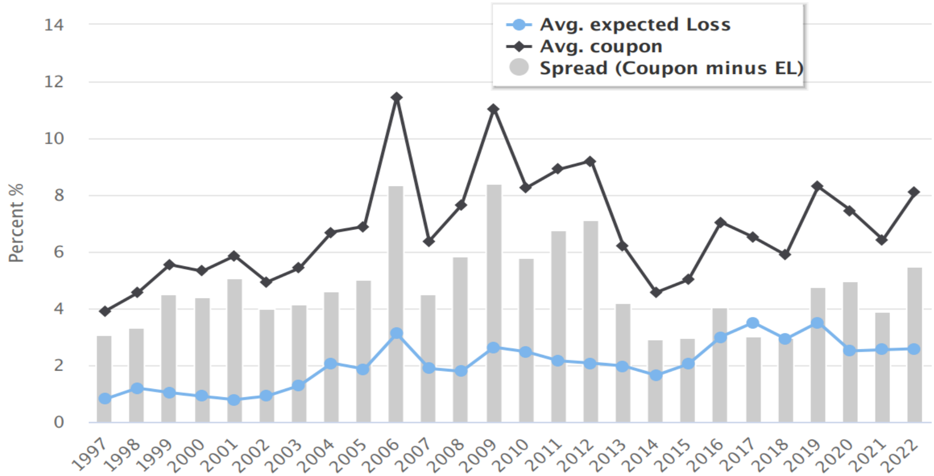
- For calendar year 2022, high risk ILS funds have outperformed mid risk and cat bond focused funds as the result of lower insurance industry losses than previous years and higher risk products experiencing the greatest rate increases.
- Reduced investor demand for cat bonds combined with some investors seeking liquidity for other areas of their portfolio saw ‘mark to market’ (MTM) moves impact cat bond returns in Q2 2022. This trend is expected to continue into Q3 2022.

Segment by segment

Catastrophe (cat) bonds

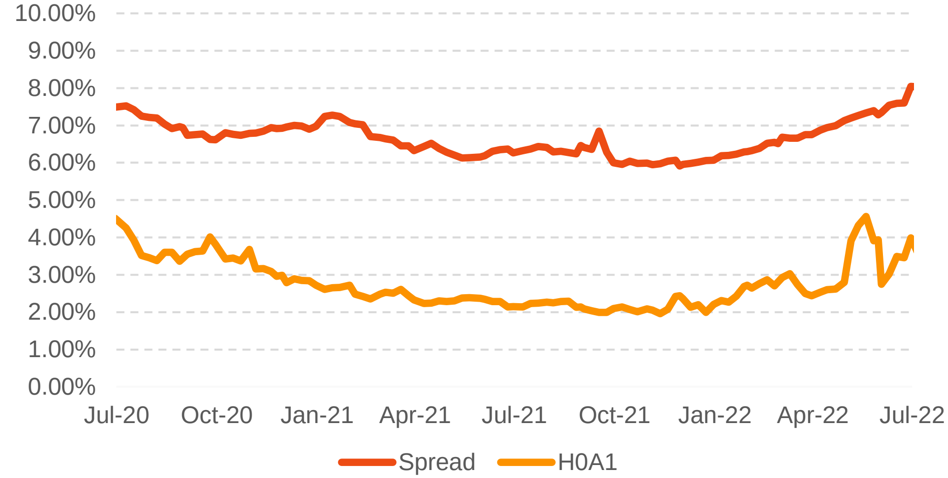
Volume of cat bond issuance is similar to prior years but no bond impairment in 2022 YTD

Bonds impaired and losses



Source: www.Artemis.bm Deal Directory

Cat bond market spread vs Merrill Lynch high yield BB Index

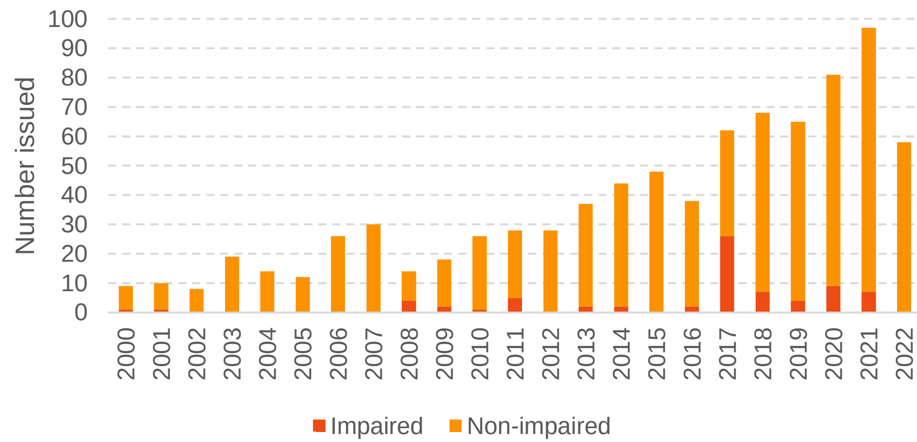


Source: Elementum. Note: spreads have spiked further post Hurricane Ian.

Cat bonds impaired and losses (% of notional value)

Source: Artemis. Data to July 2022

Cat bonds issued by year

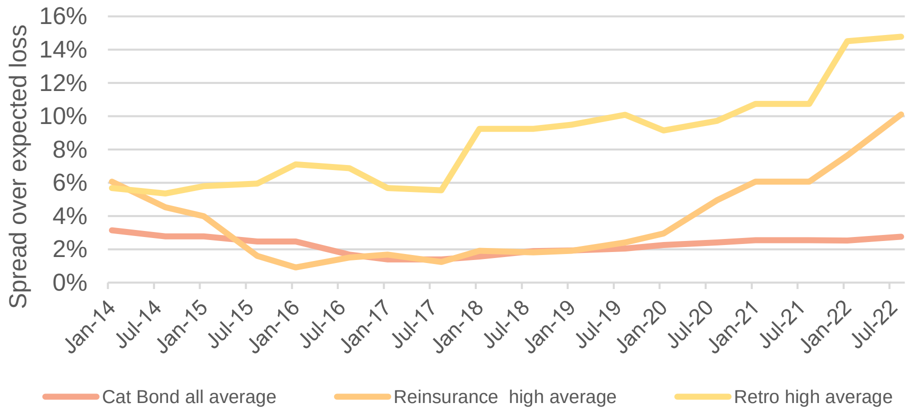


Source: Artemis

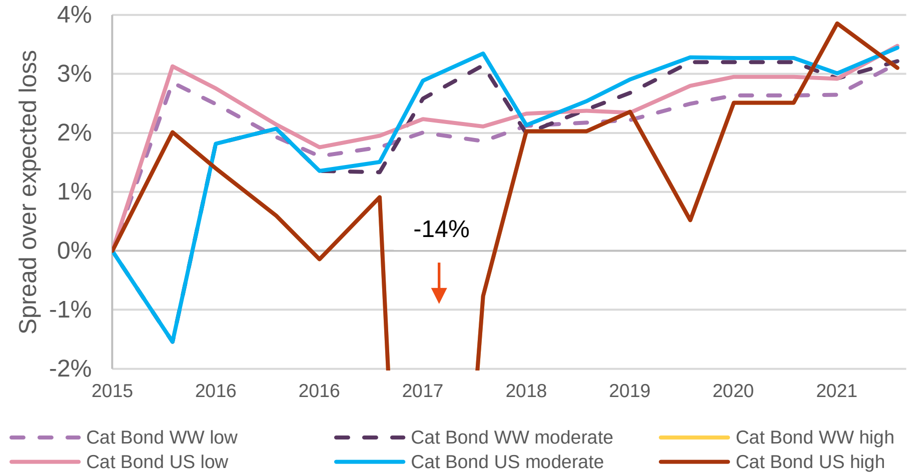
Spreads across markets

Transaction spreads for higher risk and loss impacted layers improved the most

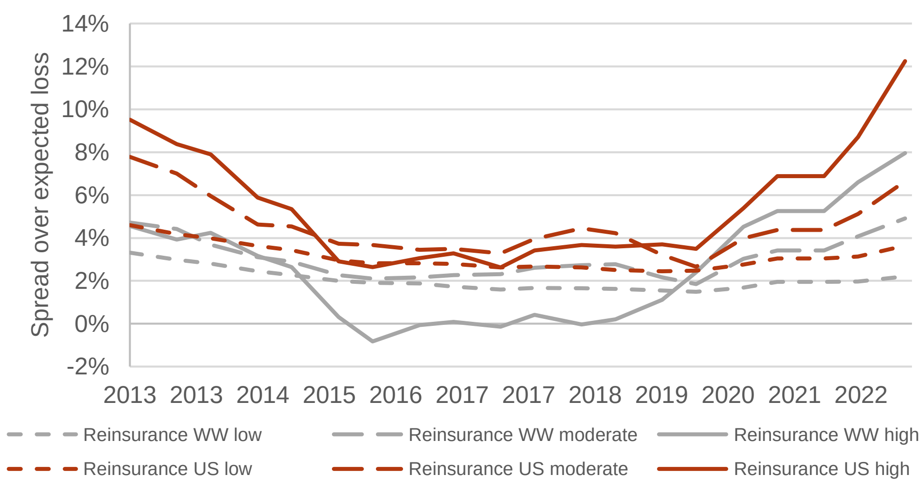
Average Spread



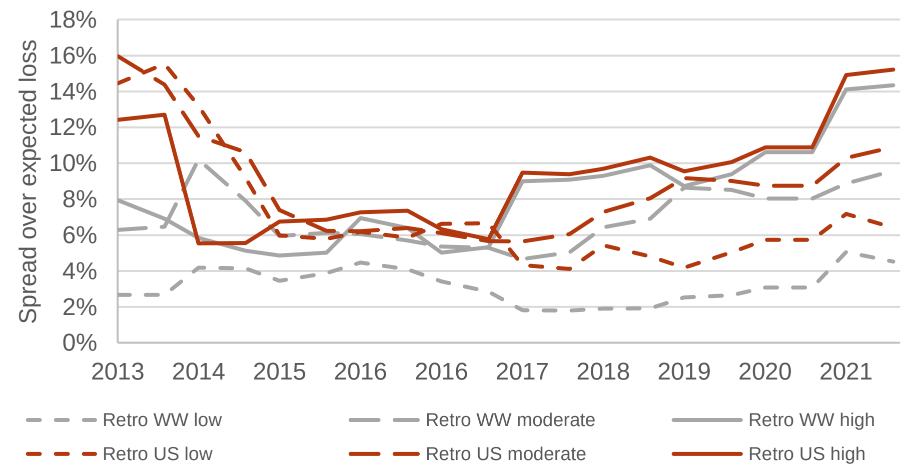
Cat bond spreads



Reinsurance market spreads



Retro market spreads



Source (all charts): AlphaCat. WW means Global policies.

Portfolio expectations for 2022

Risk adjusted returns have improved post renewal seasons

High risk

	No loss return	Expected return	Expected loss	95% VaR	99% VaR
Jul-22	16.9%	8.7%	8.2%	-16.5%	-44.2%
Jul-21	16.6%	7.6%	8.9%	-18.0%	-44.0%
Jul-20	15.5%	7.2%	8.4%	-17.9%	-41.7%
Jul-19	14.1%	6.0%	8.1%	-14.6%	-34.8%
Jul-18	11.6%	4.9%	6.8%	-15.6%	-37.9%

Source: Frontier, Managers. All metrics are net of fees and cash, assumed as 0.9%

Mid risk

	No loss return	Expected return	Expected loss	95% VaR	99% VaR
Jul-22	9.8%	5.6%	4.2%	-9.6%	-33.3%
Jul-21	8.7%	4.5%	4.2%	-9.6%	-32.1%
Jul-20	8.3%	4.4%	3.9%	-8.9%	-31.4%
Jul-19	7.2%	3.6%	3.6%	-9.1%	-30.0%
Jul-18	6.5%	3.2%	3.3%	-10.5%	-32.6%

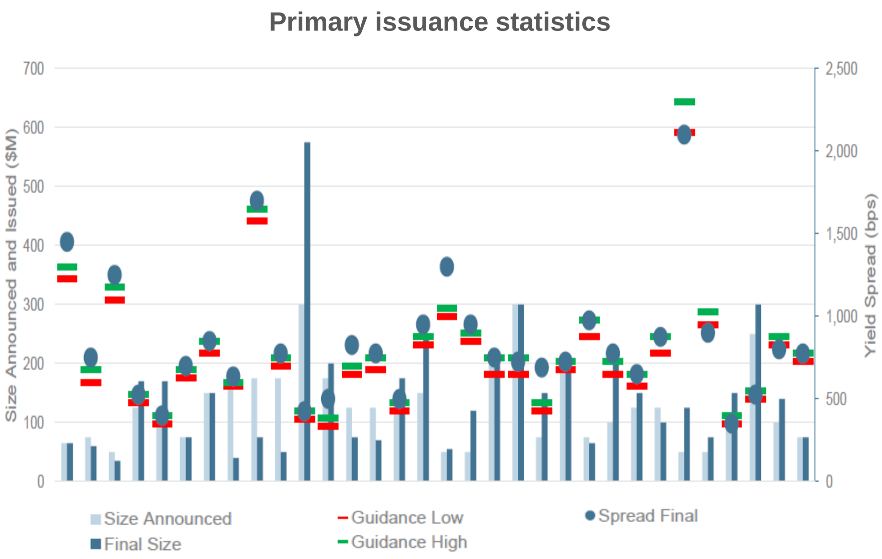
Source: Frontier, Managers. All metrics are net of fees and cash, assumed as 0.9%

- Several trends have become evident over the last five years, with an increasing divergence of risks between high and mid risk style portfolios.
- High risk managers have on average targeted increasingly riskier portfolios, with no loss returns consistently increasing over the last five years. This increase in returns is due in part to several years of large insurance losses pushing up premiums. Tail risk in portfolios has also increased but to a much lower degree, resulting in an overall net increase in risk adjusted returns.
- Mid risk managers have exhibited a similar trend, with no loss returns also consistently increasing. Tail risks in portfolios have remained broadly similar, as clients have shown a trend towards less volatility and products have been rotated to suit client appetites.
- In 2022 we have seen investors continuing to have lower appetite for volatility in strategies, seeking to move to more risk remote layers. This trend came up several times in renewal discussions, with a particular focus on reduction of volatility within the middle risk portion of portfolios, in those risks associated with 1-in-5 to 1-in-20 year loss events.

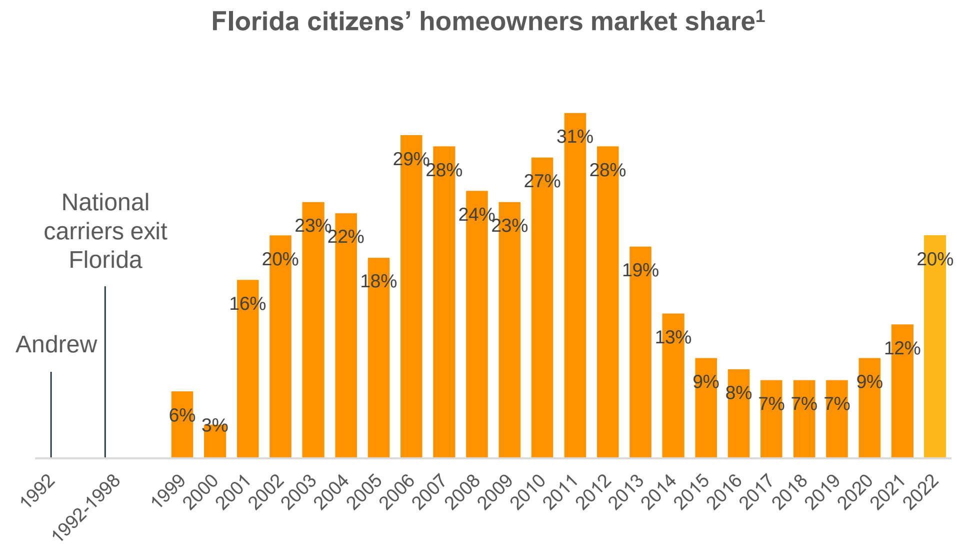
Market sentiment

Market themes from manager engagement

Reduced investor flows and Florida market distress



Source: RenaissanceRe



1. Citizens as of June 2022; 2022 figures are estimated based on year end 2022 policy forecast.
Source: Nephila Capital Ltd.

Cat bond market

- Investor flows have reduced, as investors have sought liquidity for other portfolio reasons, for example FX moves and rebalancing due to equity/bond market movements.
- The reduction in investor capital has led to several impacts on cat bonds, including delays in the completion of cat bond transactions and increase in spreads on these cat bonds. While the increase in spreads has improved returns for new bond investors, they have also triggered negative MTM movements for existing bond positions, causing losses in some existing cat bond products.

Florida market

- The Florida market is in significant distress due to a history of fraud and poorly capitalised insurance providers.
- With a reduction of available capital, these providers have had increasing difficulty obtaining reinsurance.
- ILS managers have become more selective in the risks they take in Florida, rotating away from smaller providers which provided higher premiums in favour of more reputable US insurance providers with greater resources to assess and manage claims.

Market themes from manager engagement

Expectations are for above average perils with uncertainty in the impact of inflation

Atlantic hurricane season outlook 2022

	Named storms	Hurricanes	Major hurricanes	Direct US impact
2021	21	7	4	8
2022 forecast	16-20	6-8	3-5	4-6
‘Normal’ year	14	7	3	3.5

Source: https://www.upi.com/Top_News/US/2022/03/31/Accuweather-hurricane-season-forecast/5261648727363/

Peril season outlook

- Climatic factors have led most ILS managers and forecasters to agree on an above average hurricane season.
- Drought in California and continued high temperatures has led to an above average expectation for wildfire in the area.
- Some managers have rotated portfolios in expectation of these events.
- Other managers place lower reliance on climatic indicators and hurricane forecasts, viewing the risks to be more linked to shorter term weather factors.

Inflation

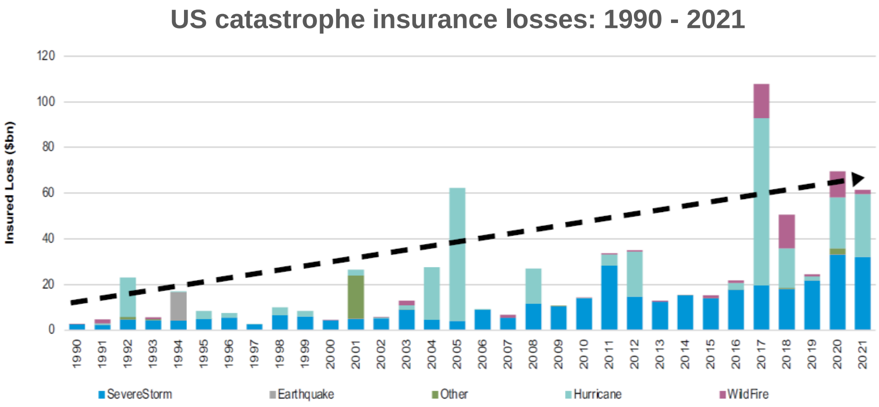
- Inflation impacts ILS investors in two ways:

  - rising interest rates increase returns on collateral

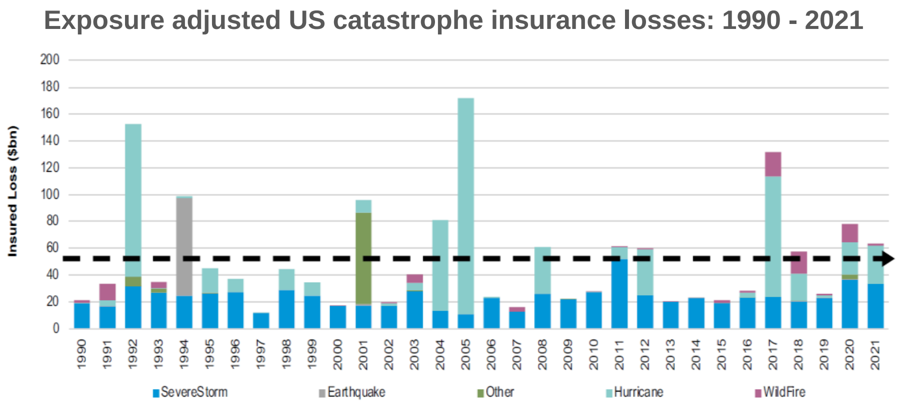
  - higher cost of claims due to increasing labour and replacement costs.
- Most ILS managers have increased loss estimates by an additional 5-30% on a cedant-by-cedant basis. This is partly to allow for an expectation of increased losses post any events occurring.
- Premiums have also increased, with resulted expected returns experiencing reductions below the inflation adjustments applied by managers.

Market themes from manager engagement

ESG considerations continue to evolve



Source: Fermat Capital Management



Source: Fermat Capital Management

ESG

- ILS managers have often been considered to have strong focus on environmental and social factors.
- The recent dislocation in the Florida market has highlighted the importance of placing equal focus on the governance factor.
- Most managers agree that lack of governance both internally and state based has driven some of the issues.
- ILS managers are increasingly incorporating stronger ESG assessments, with focus on all three elements into their cedant review and investment process which is positive for investors.

Climate change

- Managers continue to hold a consensus view climate change will increase the frequency and severity of some natural perils.
- Differing views continue regarding the timing, severity and increase in frequency to natural catastrophes climate change may bring.
- One manager has completed work to highlight that after adjusting for inflation and real-estate development, there is no identifiable trend. This highlights the man-made element associated with increasing insurance losses.

The final word

The final word

Historic performance

Returns H1 2022 have been in line with portfolio expectations following strong rate increases and insurance losses YTD in line with long-term averages.

Portfolio expectations

Most portfolios have experienced an increase in both total and risk adjusted returns over the last five years, with the greatest return increases evident in high risk and risk impacted layers.

Market sentiment

Climate change continues to be a key investor theme. Managers remain mixed in terms of timing and perils impacted.

The importance of strong governance has been re-highlighted with recent challenges in the Florida market.

Inflation is front of mind for managers and investors.

Want to learn more?

For further information on the ILS sector, please contact Frontier and we would be happy to engage with you.

Level 17, 130 Lonsdale Street
Melbourne, Victoria 3000
Tel: +61 3 8648 4300

frontieradvisors.com.au
@frontier_adv

Disclaimer:

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266