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PARADIGM SHIFT - COLLATERALISED REINSURANCE

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Justin Wallen, Managing Director of the Hexagon PCC Group in Guernsey, examines the trends currently emerging from the January 1, 2015 renewal season for collateralised reinsurance from his perspective as a transformer cell manager.

The growth of collateralised reinsurance has been well documented. Cat bond returns have been falling, yet bond placements are oversubscribed despite the fact that the multiple of pricing over expected loss also continues to fall. Faced with this environment, a number of ILS funds now seek alternative returns from private placements of reinsurance contracts where they provide the collateral but need a transformer cell reinsurer to write those risks and access the potential returns.

Guernsey has seen a dramatic rise in the number of these transactions over the past few years and has established a reputation of turning these transactions around quickly and efficiently.

Over the past couple of years we have already seen a movement towards some less well modelled risks and a diversification away from the more traditional property catastrophe covers as the ILS funds seek diversification of risks and look for higher returns on other classes of business. For example, during 2014 the protected cells that I manage have entered into reinsurance contracts for classes as diverse as property (both natural and non-natural perils), marine, energy, crop and prize indemnity among others.

Collateralised reinsurance contracts have also changed, with a move away from just excess of loss reinsurance and aggregate reinsurance to full quota share participations on books of business. In addition, protected cells are accessing risk using International Swaps and Derivatives Association (ISDA) contracts as a means of participating on transactions such as weather index derivative transactions or contingent option hurricane hedges.

Based upon the January 1, 2015 transactions seen so far for the three protected cell companies (PCCs) that we manage for three of the world’s leading ILS funds, I would say that there hasn’t been a huge amount of surprise from what has transpired to date. Everyone was expecting the market to be down by 10 to 15 percent at renewal and that’s about where we are, with as much as a 20 percent reduction on the odd account based upon the fact that we all know there is so much capital out there chasing these returns.

Key relationships

A key factor for ILS funds this renewal season is having strong relationships with their counterparties, resulting in more productive—not simply price-driven—renewal discussions. Although in some cases accounts could see larger price reductions through a remarketing process, many cedants are unwilling to sacrifice the relationships they have built with ILS funds to improve renewal pricing from an already very low, and possibly unsustainable, level.

We have certainly already seen more pressure this year on terms and conditions in slips compared to this time last year. As rates are already so low and therefore aren’t able to fall much further, cedants are trying instead to put more exposure into these deals. From the perspective of the ILS fund investors, it’s very hard to price those terms and conditions changes and as a result the ILS funds are, where possible, pushing back on such expansions of coverage, for example trying to include terrorism risks in what were traditionally natural perils-only deals.

We are also seeing an increase in the number of worldwide aggregate deals as the market gets softer, with no each-and-every-loss deductible, and losses instead being taken straight into the aggregate erosion layer.

This renewal season has been quite late and I have noticed that there are still a lot of firm orders to be agreed. It’s probably symptomatic of a market that is so soft in that the buyers are waiting to see what is out there. My perception is that the reinsured/brokers are trying their luck with what is being offered and the by-product of this tactic has been a lot of deals being declined by the ILS funds rather than following the market down. Instead, the ILS funds have been offering up alternative terms to those initial firm order terms to see if there is a deal that can be struck.

I haven't seen that much in the way of longer term transactions being completed using collateralised reinsurance. It's still very much the norm for most transactions to be of 12 months duration or less and that seems to be the preference for the ILS funds rather than entering into a multiple-year transaction. I would be very surprised if I do not see plenty of deals being closed in January rather than prior to year-end based upon the number of deals agreed to date.

It seems to me that the line below which my ILS clients are unwilling to go has already been reached and that should make for some interesting negotiations as final terms are agreed over the next few weeks.

Justin Wallen is Managing Director of the Hexagon PCC Group in Guernsey. At the time of writing the Hexagon PCC Group has created over 50 protected cells since 2012, the majority of which are writing collateralised reinsurance transactions with assets at risk exceeding US$500 million.

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