Capital Partners

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Insurance-linked strategies

Looking ahead

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"It is in the fundamental interest of insurers, reinsurers and ILS managers to establish a greater resilience against losses from natural disasters, and to ultimately generate sustainable positive returns."

Front cover: stock.adobe.com, Basket of dried chili pepper

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ILS returns of the past five years – a recap

After three major disasters so far in 2021, returns in insurance-linked strategies (ILS) are struggling to meet investor expectations for yet another year. US-winter storm "Uri", the severe weather and flooding events in Europe and lastly hurricane Ida have put significant pressure on ILS returns. 2021 therefore marks the fifth consecutive year where all or a significant portion of the income has been eroded by natural catastrophe event activity. Investors in the asset class are increasingly questioning the validity of the investment case, and two fundamental questions are being raised:

- Given the threat of climate change, is the risk of investing in ILS not simply increasing?
- Considering the recent event activity, is the premium income sufficient to justify an investment in ILS?

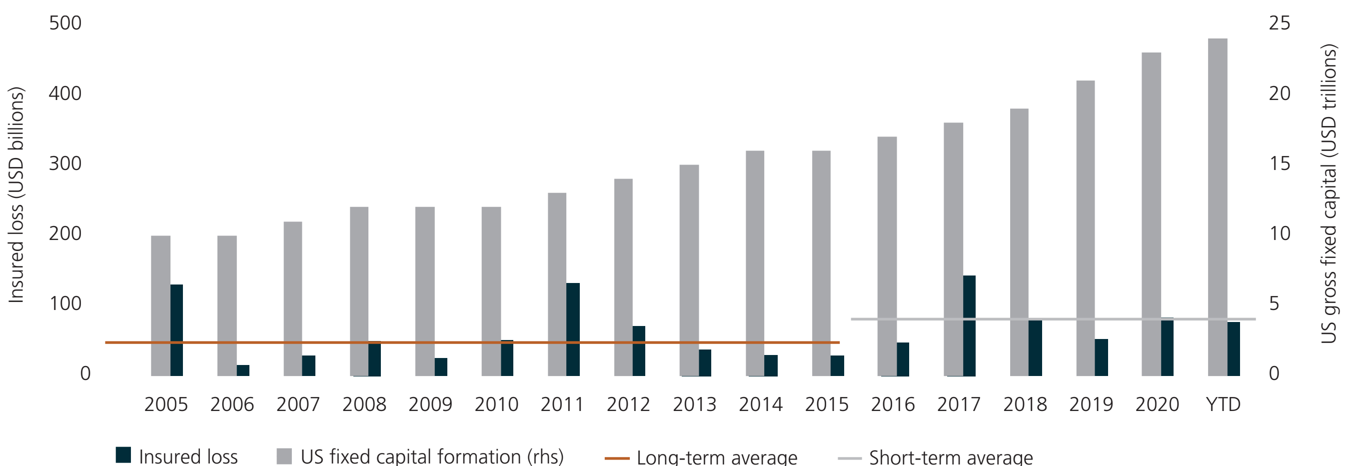
In essence, investors are asking whether they are being adequately paid for taking the event-driven risk. Since 2017, natural disasters have caused insured losses in excess of USD 400bn worldwide. A significant share of these losses was passed on to the reinsurance and ILS market. And the landfall of three major hurricanes on US territory in 2017 (Harvey, Irma and Maria) presented the asset class with the first real stress test since 2005, the year of hurricane Katrina. The subsequent years were further dominated by above-average event activity, which has eroded a large part of the premium income.

Whilst LGT's investment focus on limiting the downside risk and protecting investors' capital has worked well overall, the realized returns have been somewhat disappointing – at least from an absolute return perspective. The key question going forward is thus whether the increasing insured losses – mostly from weather-related natural disasters – are outweighing the diversifying benefits of the asset class, especially when taking the uncertainty component imposed by climate change into account.

Short-term versus long-term average insured losses

A common way to track the financial burden from catastrophe losses is the so-called "industry loss" for any given year (i.e. the total loss to the private insurance sector from the combined catastrophe events in one calendar year). The chart below shows the worldwide insured losses from natural disasters over the last 15 years. Looking at the insured losses on a stand-alone basis suggests an increase in the financial impact to the broader insurance industry and ultimately the ILS market due to natural catastrophe event activity. However, considering the loss levels only as a function of event activity is somewhat misleading, as one of the key drivers of higher loss cost is the long-term trend of building activity and ever-increasing value of properties, contents and infrastructure in the affected regions. This long-term trend ultimately leads to a higher concentration of insured values in the most developed markets, which in turn are at risk of suffering damage from natural disasters. This increase in insured values is depicted in the chart by the steady growth of US fixed-income capital as a proxy for wealth formation resulting from investment activity.

Chart: Economic growth is a key driver of insured values



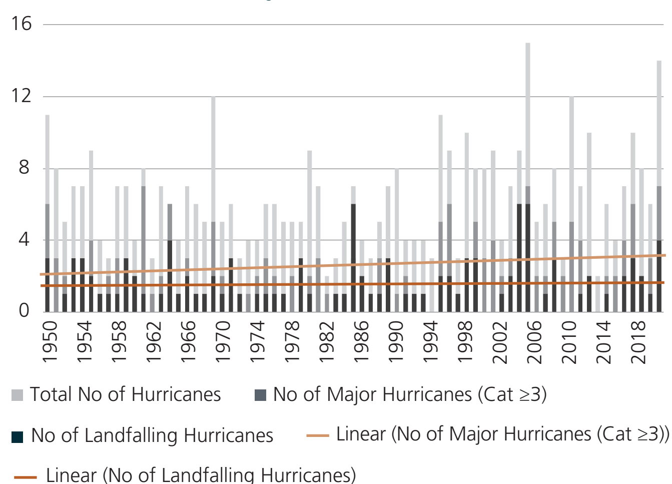
Source: LGT ILS Partners, Swiss Re Sigma; data as of 31 August 2021. Long-term average includes years 1997-2020. Short-term average includes years 2016-2020. Gross fixed capital formation is a measure of gross net investment in fixed capital assets by enterprises, government and households within the domestic economy

Higher temperatures driving climate change

Changes in global climate are currently predominantly measured as increases in average global temperatures, with the root cause for this phenomenon likely to be found in the "greenhouse effect" caused by global industrialization that has occurred over the last 150 years. Higher average temperatures lead to a variety of fundamental changes in the global climate – such as rising sea surface levels caused by melting ice in the north and south poles, rising ocean temperatures, desertification and droughts in some areas, and extreme precipitation with resulting flooding in others.

The general assumption is that the insurance industry is ultimately affected by these various climate-induced environmental changes due to increasing event count and loss cost. However, as stated above, considering the absolute loss to the insurance industry as a sign of climate change is somewhat misleading, as the year-on-year driver behind higher loss costs are construction and investment activity. Another common assumption is that climate change is leading to more frequent and more severe tropical cyclone formation, such as hurricanes and typhoons – so-called "primary perils". An interesting observation is that the overall hurricane activity in the North Atlantic basin follows a pattern of increased and decreased event activity, and currently still remains within the long-term modeled expectation. And whilst the scientific research points towards a potential increase in the number of major hurricanes per season (and at the same time a potential decrease in weaker storms), no such statement can be made about the number of landfalling hurricanes – which are the ultimate loss driver for the insurance industry.

Chart: Hurricane activity in the Atlantic basin



Source: LGT ILS Partners, NOAA; data covers period from 1950 to 2020

Rising importance of "secondary" perils

On the other hand, experts agree that the main impact from climate change is coming from an increased volatility of so-called "secondary" perils, such as severe convective storms, wildfires or local flash floods. In 2020, more than 70% of the losses in natural catastrophe reinsurance worldwide were caused by such secondary perils, with convective storms and wildfires being the main contributors. For 2021, the loss activity is again skewed towards secondary perils, with US winter storm "Uri" and the severe flash floods in Europe being truly extreme events in terms of financial damage caused.

The currently applied natural catastrophe models are specifically designed to evaluate stress test scenarios to the capital base of insurers and reinsurers and thus focus on extreme single events such as major hurricanes, earthquakes and river floods. As a consequence, the aggregation of losses from rather localized events is not well captured in catastrophe risk models. For such perils, the insurance industry is typically applying an economical model, which is based on the loss history from previous years. On the back of the significant increase of such secondary perils, the industry is now applying a much sharper focus on individual risk selection and data accuracy.

Key challenges of past events

Peril	Challenge
Wildfires	California and Australia wildfires have been modeled in the past, yet the extent of the losses has been underestimated due to the relatively localized nature of the peril.
Japan typhoon	The hazard modules of the catastrophe models is applying the most recent extreme event, which was typhoon "Mireille" in 1991. As a result, loss estimates for super-typhoon "Jebi" in 2018 were based on too optimistic average loss levels, which resulted in adverse loss developments.
US winter storm	US winter storm is a modeled peril and potential losses from burst water pipes are considered by the models. Whilst the severity of the 2021 winter storm "Uri" was not totally unexpected from a model point of view, the return period for such a storm in the models is extremely low – perhaps too low, and models are reviewed to apply a more conservative approach.
Europe flood	Flood and windstorm in Europe are the key drivers of risk and thus fully captured in the catastrophe models. However, flood models focus on large river flood events. The geographical resolution of exposure data and local ground elevation information is not sufficiently captured to allow for a full assessment of localized flash flood events.

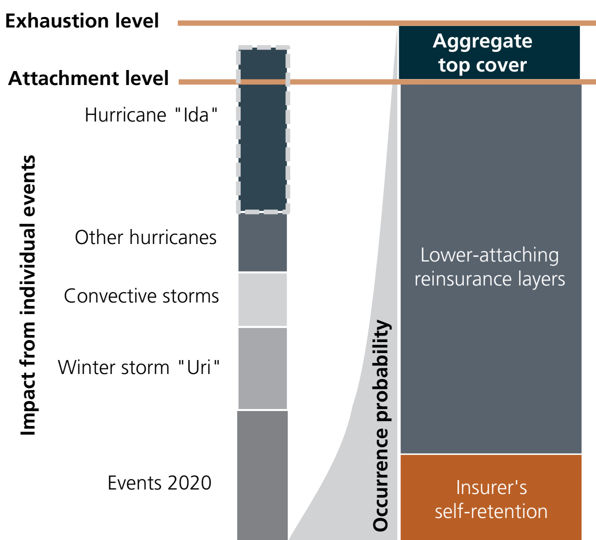
Resetting the game – the industry's response to a changing environment

In 2021, the industry had again to face a series of very "localized" loss events, caused by secondary perils – meaning that the disaster led locally to massive destruction, but left other (nearby) regions virtually unharmed. Such secondary perils are typically part of the key reinsurance programs which provide cover for "all natural perils", and are structured either as stand-alone, low attaching (higher risk) contract, or through so-called "aggregate" covers, which accumulate loss events over a 12-month period.

Due to this localized event pattern of the recent years, some primary insurance carriers had very bad years, whereas other carriers were much less exposed – all due to the specific composition of the underlying portfolio of insurance policies for each company. The main reason for the mediocre return in reinsurance and ILS is thus not necessarily to be found in the catastrophe models – which may admittedly at times lack the granularity to account for smaller, localized events – but rather lies in the specific portfolio composition of individual insurance carriers.

This specific loss event pattern has also led to an increased pay-out of aggregate reinsurance structures, which are typically used to improve the diversification within an ILS portfolio and serve to limit the drawdown risk from single, extreme events.

Chart: Structure of an aggregate reinsurance transaction



Source: LGT ILS Partners; for illustrative purposes only.

The default reaction: increase premiums…

Higher insured values driven by construction activity partly explain the higher absolute industry loss levels in recent years. On the other hand, the increase of insured values is of course taken into account when assessing individual reinsurance or ILS transactions. The insured value of the underlying portfolio is factored in when renegotiating coverage on an annual basis. Risk-adjusted premium levels for key zones such as the US, Europe and Japan have also undergone a substantial increase over the last 24 months. Yet, despite the fact that premium levels have gone up, such higher premiums were eroded by an unusual loss accumulation caused by a large number of mid-sized disasters.

… versus the required action: "The great re-underwriting"

Simply increasing premiums did not bring about the necessary improvements in underwriting results. In response to the accumulation of insured losses from secondary perils and more localized events, the entire insurance industry is now applying a holistic review of the insured perils and individual transactions within their portfolios.

It starts at the level of the primary insurer: The scrutiny in the selection process of individual policies has fundamentally shifted. Companies apply a much sharper focus on individual risk selection, down to the exact location of each insured property. Equally, the quality of the structure and the year of build is becoming an ever more important driver of portfolio composition, to take the changes in building codes into account. Newer buildings show a much stronger resilience against extreme events, as a result of the stricter building codes.

The result of this re-underwriting exercise is thus not necessarily a continued trend towards higher premiums, but rather a fundamental re-assessment of the quality of individual risks – with the aim to significantly improve the portfolio compensation (by lowering risks at a given premium level). This does not necessarily translate into a higher expected yield-to-expected-loss multiple, but rather leads to a fundamental qualitative improvement of the return patterns of a portfolio. In combination with firmer premium levels and stricter contract wordings, this is expected to result in a substantially higher resilience against the impact from secondary perils and high-frequency events.

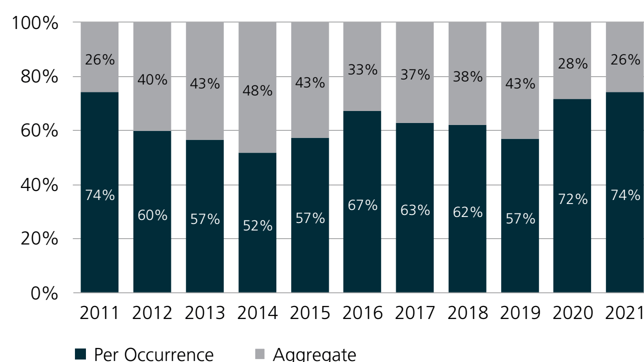
Will this portfolio fine-tuning work? A case study

We have already implemented this very approach for the peril US wildfire – driven by the losses from this secondary peril in our portfolios. In 2020, total insured losses from US wildfires were the third-highest ever, after the record seasons of 2017 and 2018, with most of the wildfire losses occurring in California. The rising financial losses from wildfires in recent years can be attributed to the following factors:

- Changes in climatic factors lead to longer and more active wildfire seasons (population growth and agricultural activities reduce the water levels in the ground and lead to longer dry periods)
- Expansion of the interface between natural areas and urban dwellings (i.e. building activity close to or in the middle of undeveloped woodland)
- Absent or sub-optimal fire management strategies and loss prevention measures

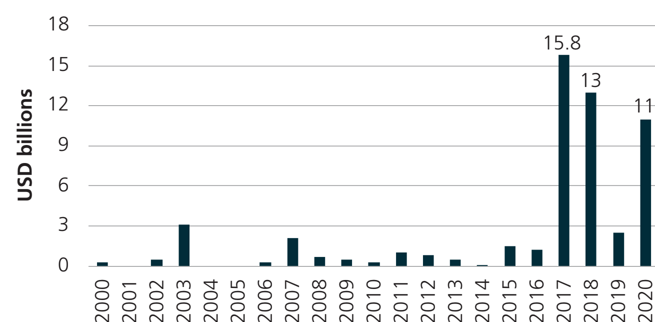
After the devastating fire losses suffered of 2017/2018, local insurance carriers conducted a thorough review of their portfolios, and realized that high-level hazard maps are not conclusive to assess the risk of wildfire for an individual building. Companies introduced new assessments for wildfire risk, with a focus on individual building data. This re-assessment resulted in a shift within the portfolios; certain buildings in California have simply become uninsurable by the private sector – or policyholders have to provide information around fire mitigation actions (e.g. establishing safety zones around buildings) in order to still receive coverage.

Chart: Exposure per trigger type of the CRI allocation in the LGT ILS Balanced Strategy



At LGT ILS, we have experienced losses due to wildfires in both 2017 and 2018. In 2019, we have restructured our wildfire exposure to reduce the pay-out risk by selecting counterparties that in turn have concluded their "re-underwriting", by participating on reinsurance layers with higher attachment levels, and focused on "per occurrence" versus "aggregate" structures. As a result, in the very active season of 2020 and also 2021 year-to-date, our funds have not been affected by the fires.

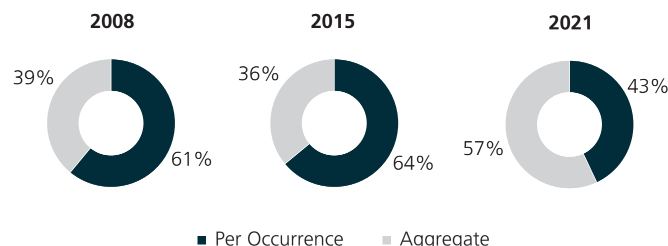
Chart: Insured losses caused by US-wildfires



Performance impact from US wildfires	2016	2017	2018	2019	2020
LGT ILS Balanced	0.0%	0.0%	-1.2%	0.0%	0.0%
LGT ILS Enhanced	-0.2%	-1.2%	-1.6%	0.0%	0.0%

Source: LGT ILS Partners, Aon Catastrophe Insights, Munich Re NatCat Service. Impact in % of NAV represents cumulative loss reserves of CRI contracts and payouts on cat bond transactions.

Chart: Exposure per trigger type of the cat bond market



And whilst the share of aggregate transactions within our portfolios has always been lower compared to the overall market, they remain an important part of our portfolio strategy. The payout structure of such aggregate deals efficiently limits the drawdown risk from large, single events – such as a Category 5 hurricane hitting Miami.

Source: LGT ILS Partners, data as of 31 July 2021.
LGT ILS Balanced = LGT (Lux) III – ILS Plus Fund; LGT ILS Enhanced = LGT (Lux) II – ILO Fund.

Looking ahead – the case for ILS

On the back of this recent event activity, ILS investors with a shorter investment horizon are now potentially reducing their allocation to ILS. This in turn leads to a reduction in available capacity – whilst at the same time, the demand for capacity from insurers is seeing a substantial increase due to a combination of the recent event activity and stricter capital requirements from regulators and rating agencies. The result of this reduction in supply and increase in demand is leading to a "reinsurance capacity crunch", whereby demand from primary insurers for peak risk cover such as hurricane, flood and earthquake significantly surpasses the capacity offered by reinsurers and ILS markets. Both traditional and alternative reinsurance markets have entered a hard market cycle. Such a hardening market shifts the focus from pure premium income. Instead, the event activity and the pressure on capacity allows for the industry as a whole – and ILS specifically – to go through a fundamental re-underwriting of the transactions and covered risks, to reduce short-term loss volatility, and to push through stricter contractual language.

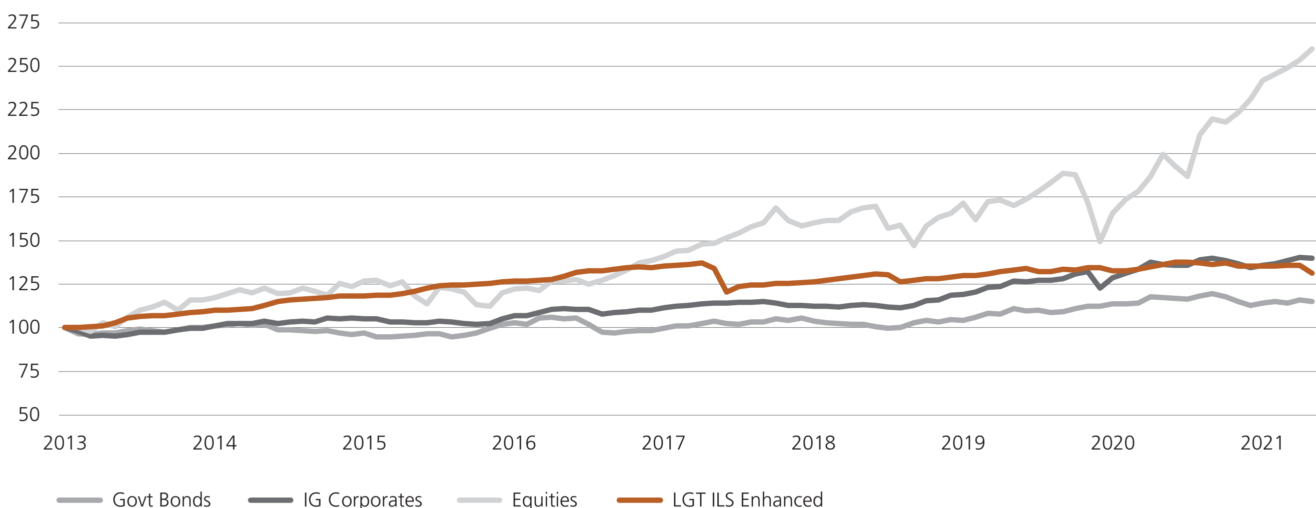
As proven in the case of California wildfire risk, this action is expected to result in sustainable return patterns going forward.

Clearly, ILS managers such as LGT with a focus on direct reinsurance are in a much better position to optimize their portfolios compared to peers who focus on retrocession covers (reinsurance for reinsurers). The latter act as "allocators" and depend on the reinsurer to conclude the due diligence on the underlying portfolios and to conclude the "re-underwriting". Furthermore, access to a rated reinsurance carrier is key – LGT ILS' "A" rated carrier Lumen Re allows to directly engage with counterparties, which in turn permits the fine-tuning of the portfolio composition through customized transactions.

A view on sustainability

Lastly, whilst the key focus is currently on improving the profitability of the asset class to investors, the important topic of sustainability has almost gone amiss. The new European Sustainable Finance Disclosure Regulation (SFDR) has a strong impact on the broader asset management industry – and ILS is playing an important and likely very attractive role: Based on the most recently released details around SFDR, the taxonomy, non-life (re-)insurance is specifically categorized as a sustainable investment. As a consequence, ILS mandates and funds with a focus on property natural-catastrophe reinsurance are able to be classified as sustainable products under the SFDR guidelines.

Chart: ILS still works – low correlation with traditional assets



Source: LGT ILS Partners, Refinitiv; data as of 31 August 2021. Performance is in USD, gross of fees. Management fees and other fees will influence the performance negatively. **Past performance is not a guarantee, nor an indication of current or future performance. Returns may increase or decrease as a result of currency fluctuations.**

Summary

The key challenges of the industry are now being addressed by all market participants – insurers, reinsurers and ILS managers – as it is in the fundamental interest of all players to establish a greater resilience against losses from natural disasters and the impact of climate change, and to ultimately generate sustainable positive returns.

Insurance-linked strategies represent an extraordinary pick in today's challenging investment environment, where real value is increasingly hard to find: ILS is one of very few asset classes that delivers truly uncorrelated returns and resilience against economic or political shocks.

In addition, ILS provide a passive hedge against inflation through their floating rate component and through the short contractual terms. At LGT ILS, we are confident to being able to optimize the portfolio composition, which allows for a significant reduction in volatility and improved returns for 2022 and beyond.

Appendix

Instrument	Description	Key benefits	Challenges
Cat bonds	Tradable risk transfer instruments with a pre-defined maturity – typically around 3 years. The risk assumed by bondholders relates to specific, predefined insurance events (e.g. earthquakes or wind storms)	Cat bonds provide liquidity within the portfolio context	Limited market size and strong focus on US-wind risk limit the possibility to construct a well-diversified portfolio
Traditional reinsurance	Reinsurance protection bought by a primary insurance company. Standard term is 12 months	Portfolio look-through allows to be "closer to the risk" and to gain better data transparency compared to retrocession transactions	Requires well-established relationship with insurance company, deployment of new capital may need time
Retrocession	"Reinsurance for reinsurers". Standard term is 12 months	Quick deployment of large amounts of capital (especially in the case of quota share retrocession deals)	Limited /lagging information flow and longer loss development periods compared to traditional reinsurance structures
Sidecars	A sidecar is a retrocession structure that allows investors to participate on the return of a portfolio of reinsurance contracts. This allows the reinsurer to assume more risk as its activities are now backed by additional capital	Investors can assume a share in the portfolio of the reinsurer without any delay for ramp-up	Often permanent structures (i.e. no fixed maturity)
Industry loss warranty (ILW)	Derivative contract that pays out when the financial loss experienced by the insurance industry exceeds a specified threshold. The industry loss is calculated by an independent agency using data from a large number of insurance and reinsurance companies	The pricing of ILWs is much more sensitive to overall market environment and can move quite quickly, compared to more traditional reinsurance business	The payout of an ILW depends solely on the final industry loss estimate published by the relevant agency

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