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Q&A: The Growing Market In Spreading Insurance Risk

Insurance-linked securities allow sponsors to transfer risk while providing investors attractive, uncorrelated returns. Last year was the second-biggest year historically for ILS, according to a Swiss Re report, with approximately $6.3 billion worth of bonds brought to market. New data from Clear Path Analysis suggests 2013 is on track to be even better.

Greg Hagood, founding principal of Bermuda-based Nephila Capital, which specializes in reinsurance risk, spoke to FIN*alternatives* Senior Reporter Mary Campbell about the growing investor appetite for ILS.

Can you give a brief definition of an insurance-linked security and some examples of the various types of ILS that exist?

ILS is a mechanism of packing natural catastrophe risk into a security where it can be transferred directly to the capital markets. The main instrument for this purpose is a catastrophe bond, but the market has evolved to where many other instruments are traded now where the risk ends up outside of traditional reinsurance company balance sheets.

What are the risks associated with ILS and how can they be mitigated?

The main risk embedded in ILS is exposure to a major natural catastrophe, such as Hurricane Katrina or the Japanese earthquake 18 months ago. The risk can be mitigated through geographic diversification. For example, Japanese earthquakes are not correlated to U.S. hurricanes. There is also diversification that can be obtained within a geographic region. For example, U.S. hurricanes can happen anywhere from Texas to Maine, yet the various U.S. insurance companies have different market shares all along the coastline which mitigates an investor's exposure to a single event.

How much do you expect the ILS market to grow over the next five years and what will drive that growth?

It depends how one defines ILS, but the general trend of catastrophe risk being transferred directly to investors outside of the traditional reinsurance market should grow significantly over the next five to 10 years. Catastrophe risk is not correlated to stocks and bonds and investors are seeking new sources of uncorrelated return streams.

What advice would you give an investor looking to allocate to ILS?

Take the time to understand the market as there are many different segments than just catastrophe bonds. The market is not particularly complex, but the terminology is different than the capital markets and it takes some time to fully understand the nuances of the entire market. However, it is a market that warrants the time to explore as the portfolio benefits of the asset class are significant and we would argue that ILS should be a part of all investors’ portfolios.

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