1.4 INTERVIEW

What innovations and changes have occurred since the inception of the ILS offering?

Interviewer

Jessica McGhie
Senior Publishing & Strategy Manager

Interviewee

Greg Hagood
Co-Founder, Nephila Capital

Jessica McGhie: Nephila was the first dedicated ILS manager established back in 1997. How has the industry and Nephila evolved over the last 18 years?

Greg Hagood: There have been a tremendous number of innovations over this period. In the mid 1990's, the first catastrophe (CAT) bond came to market and it was the first attempt to securitise and collateralise catastrophe risk. Simultaneously, exchanges such as the Chicago Board of Trade began offering exchange traded options to try and bring this risk to the market in an alternative form, to allow the investors to access to a non-correlated financial instrument.

In 2003, Nephila was the first company to set up a collateralised reinsurance company to provide fully collateralised coverage to counterparties and over the last ten years this market has grown to the point that there are a number of providers in the market.

In 2005, the hurricanes Katrina, Rita and Wilma were the largest series of catastrophes to date affecting the U.S. and the market became significantly dislocated after these events. Subsequently, this led to a whole series of innovations in the marketplace, including the role out of sidecars which essentially establish parallel underwriting facilities off the balance sheet of traditional reinsurance companies. Around this same time, Nephila issued and managed the first and only CDO of catastrophe risk and new ILS fund managers were established. A number of hedge funds also became involved in the space largely because of pricing opportunity post Hurricane Katrina, but most of them exited after the financial crisis in 2008/2009.

With all of these new developments and the attractive pricing in the market, there was an increase in sector knowledge from a capital markets perspective that was in many respects an inflection point, because prior to 2005 the ILS market was very niche. In the wake of the 2005 natural catastrophes, the general knowledge of the market increased because more managers were pitching their offering to various investors.

Fast forwarding to the 2008/09 credit crisis, another big inflection point happened for the asset class. Whilst there was much turmoil in the broader markets, ILS generally performed well as no natural catastrophes happened during this period. Subsequently, there was a rapid increase amongst pension funds allocating to the asset class and investment consulting firms accepting it as a much more viable and attractive asset class. Alternative capital today roughly equates to 20% of the overall market and we would expect that growth to continue for the foreseeable future.

Jessica: Traditionally CAT bonds have been associated with U.S. hurricane risk but there is fresh talk regarding the inclusion of new perils. What is your perspective on this and how new perils might enhance the CAT bond offering?

Greg: A lot of those perils have traded in the traditional reinsurance market for a number of years. The reason that CAT bonds tend to focus on U.S. hurricane risk is because that is where the biggest need for capital is. That is where historically there has been a shortage of capital.

If we take Japanese earthquake risk or European flood risk as examples, there is plenty of capital available in reinsurance market to handle those risks appropriately and as a result they are rarely packaged into a CAT bond. The World Bank is one organisation looking at where there could be risk transfer in developing regions going forwards, particularly in relation to the likes of China which experiences a lot of earthquake and typhoon risk.

Jessica: There is a lot of discussion around pricing pressure in the reinsurance market. Is the strategy still viable for investors?

Greg: Absolutely. Post credit crisis it was clear that the ILS market was virtually free from correlation with stocks and bonds. When people consider their portfolio construction, they see a truly non-correlated asset and positive expected return from ILS. Of course this expected return isn't quite what it used to be but overall there remains a place in asset owners' portfolios.

Our funds have been closed to new investments for about 2 years now, but despite that we continue to see much demand from both existing and prospective investors. We remain in conversations so that when we do want to raise additional capital again we can. The current signs in the market are that there is still demand from investors and investment consulting firms are still recommending the asset class to their

clients. Obviously spreads have come in recently, but there are still positive expected returns that aren't correlated to financial markets.

Jessica: You don't see any sign then that pension funds or any other groups who are allocated to this sector would then be looking to decrease their allocation at all?

Greg: Most of our investors have a strategic allocation of say 1%-2% of their portfolio. In a market like it was post Katrina, when spreads are dislocated, that may well increase to 3% or 4%. However, in today's market, investors might keep it at 2% or dial it down to 1%.

Most of our investors like that core strategic allocation because of its positive expected return and non-correlation, but like any asset class there are better times to be in it from a return perspective. Several of our clients dial up and dial down their exposure based on market conditions and this is something we whole-heartedly encourage. The overriding feeling though is that there is still interest in this space from a strategic standpoint and that there are many interested investors yet to make their 1-2% allocation.

Jessica: Is size an advantage or disadvantage when trading in the market today?

Greg: Size has always been an advantage in the marketplace. The poster child for that would be Berkshire Hathaway who historically have a substantial presence in the reinsurance market. When counterparties have experienced a problem or a specific need, they would go to Berkshire Hathaway because they could execute sizeable transactions with a superior credit rating compared to the traditional reinsurance market.

Over the last several years, alternative solutions to Berkshire have become available and the reinsurance market has developed into two-tiers of players. The first tier is the largest, well-rated or collateralised players who can solve problems outside of the syndicated market in a similar fashion to Berkshire. The second tier represents the smaller, lesser rated reinsurers who can't offer sizeable solutions or comparable credit ratings, so therefore can only compete on price in the syndicated market. There are approximately 10 or so players in the top tier and these are the preferred counterparties for insurers. The benefits to being in this top tier is typically better pricing and better allocations on transactions compared to the broader syndicated market.

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A public example of this two-tiered market was recently provided by Ace. Information on their most recent reinsurance program showed that 10 reinsurers, of which Nephila was one, accounted for 75% of their reinsurance placement and the remaining 25% was syndicated to the rest of the global reinsurance market. This clearly demonstrates how the larger insurance providers are logically gravitating towards the more strategic, bigger and well known players. Thus, if you don't fall into the top tier category you are at a distinct disadvantage in today's marketplace.

One final indication that the market is reacting to the need and benefits for scale is the recent wave of industry consolidation. We have seen XL-Catlin, Partner Re-Axis, Renassance Re-Platinum and Montpelier-Endurance all combine in the last several months. The main strategic rationale for these combinations was the need for scale to compete in the market.

Jessica: The ILS strategy was largely a niche and not well understood strategy 5-10 years ago but today it has become more mainstream. As a result how has investors' thinking changed in regards to any ILS allocation?

Greg: 10 years ago the asset class was much more niche in that there were a number of fund to fund, endowments and early adopters who liked the non-correlation, but were very much focused on the return the asset class generated. It typically fell into their hedge fund bucket for the early adopters of these new strategies. As the asset classes became better understood, the allocations began to broaden.

Today, it is much more institutional in nature with the largest consulting firms such as Towers Watson endorsing the space as a strategic allocation for pension funds. As these funds have long-term liabilities, they can use ILS to be a real diversifier with a positive expected return over time. Moreover, the allocation no longer completely sits in the hedge fund bucket and increasingly is being classified under the fixed income bucket because it is generating a mid, single digit expected return without correlation.

Jessica: If you were an investor conducting due diligence on ILS managers today, what are some of the tougher questions you would ask?

Greg: We are sympathetic to investors who talk to a number of providers, as it can sometimes be difficult to differentiate among the various investment approaches in the market.

If I were a potential investor, I would ask what the strength or value of a manager's origination capabilities are. I mentioned the two tiered reinsurance market earlier and given that this bifurcation is common knowledge in today's market, the real questions should relate to what percentage of a provider's transactions are truly non-syndicated and asking "is this provider privy to the top tier of trades".

Another question around the provider's origination network is do they use "quota shares" or pay other companies to originate and underwrite reinsurance business on the fund's behalf. If so, investors are paying an additional management fee and incentive fee that isn't captured in the provider's headline management & incentive fees.

Other fees that can be material are "prime brokerage" type fees relating to the "fronting" of reinsurance transactions and also leverage services. To transact in the traditional reinsurance market, one needs reinsurance paper to execute as insurance instead of a security. Many managers pay third parties meaningful fees to front business and also provide leverage to their funds. Also, investors should ask what type of leverage the provider uses – is it non-recourse or recourse leverage? If it is non-recourse, managers will be in a very strong position after a big catastrophe whereas by contrast, if it's recourse leverage you may be selling bonds post event to meet margin calls. This isn't a strong position to be in with a dislocated market and therefore one that investors should take steps to avoid.

Finally, I would say it's important to find out what kind of research team the manager has and whether or not they make quantitative adjustments to the baseline industry catastrophe models. We hear much about qualitative adjustments in the market, but quantitative adjustments as it relates to climate, data quality and other issues that might change the risk assessment from the baseline model assumption need to be considered.

Jessica: Thank you for sharing your views on this subject.

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