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03 Securis life fund
05 Lloyd's crackdown
08 Florence exposure
09 Private flood market
12 Monte Carlo highlights

Insight and Intelligence on (Re)insurance Convergence with the Capital Markets

ILS framework can flex to handle Irma loss creep

Steep deterioration in Hurricane Irma losses will focus attention on collateral release mechanisms in 2019, but with multiple methods used by the ILS industry to manage development risk, changes will be a case of adjusting existing infrastructure rather than wholesale alterations.

One instance has emerged of a cedant whose loss creep left them short on reinsurance recoveries after collateral had been released, as this publication reported.

Deals are written with a variety of terms and conditions on collateral release, but in the case related to Securis and Icat, sources said it was agreed on the basis of a commutation – in other words, winding up legal obligations under the cover.

Sources said several Lloyd's and Florida carriers may have faced similar issues, but with no further specific cases known, this is seen as an isolated instance rather than a problematic pattern.

Frustrations are also likely to have been felt among ILS firms in the past year in relation to capital lock-up, as losses deteriorated after the mid-year renewal.

Sources said Florida insurer reserves for incurred but not reported losses from Irma are running higher than historical trends, serving as a buffer against rising claims.

This is clearly understandable, as a cedant's top priority is to secure potential recoveries and litigated claims have been a problem for local carriers in pushing up their losses unexpectedly.

But some market participants said the trend pointed to a need to avoid overly prescriptive collateral release and commutation rules.

What some buyers may not have realised is that there are different terms on offer within the ILS market on collateral release and the duration of legal obligations to cedants. Contracts vary not only from one ILS manager to another but also among different cedants.

Collateralised reinsurance contracts might include automatic commutations following collateral release, but more typically the two are not linked. Collateral release is usually prescribed according to "buffer loss table" agreements that set out how close to attachment a loss must be to trap capital, based on reported loss figures.

But even if collateral is released, an ILS manager's legal obligations typically continue for an extended period if a

Continued on 4

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commutation is not separately agreed.

Ince & Co's Kiran Soar noted that if collateral has been released without an accompanying commutation of reinsurance liabilities, cedants still have the right to demand payment of any sums due if losses deteriorate.

"Subject to the terms of collateral documentation, such as the trust deed, the cedant will still have a reinsurance contract in place, and there is no reason why they cannot look to rely upon it," he said.

"Some contracts [may also] require the reinsurer to re-capitalise any shortfall in anticipated claims."

Automatic commutation would at least create more certainty over the outcome, similar to the mechanics used for cat bonds post-loss, some might argue.

But other sources said that if collateral release equated to commutation, then this would lead to too much emphasis on the buffer loss table provisions.

"You create an incentive for people to up their reserves," one manager said. "The rigidity of the buffer loss table is unnatural."

Any push to significantly lift the thresholds in buffer loss tables for trapping capital could come at a cost to cedants, as it would have a knock-on impact to cost-of-capital calculations.

These factors are reconsidered after every loss and have not just been prompted by Irma, lawyers said.

Willkie Farr partner Joe Ferraro said that in his experience, commutations are not common in the first six months to a year following a major loss event.

"Collateralised reinsurance agreements will usually give cedants a margin above their current reserving levels in order to have a capital buffer," he said. "The idea with the pre-agreed buffers, which decline as time passes, is to build in the possibility for adverse development and at the same time avoid inefficiencies in setting aside excess capital."

Commutation calculations ultimately come down to a judgement call for ILS managers over the cost of trapped capital.

> **"Usually there is a process of back-and-forth negotiations"**
> Joe Ferraro

Cadwalader, Wickersham & Taft's Robert Cannon said: "Is it better to agree to something somewhat less favourable than what you think you would end up with, but to release capital for investment elsewhere? This is the consideration people make."

Soar also said that the finality of commuting, even if it comes at an additional premium, could be attractive given the complex nature of events.

"The nature and complexity of some property cat losses means the tail is perhaps a little longer than it used to be and so commutations can be quite appealing.

At any rate, once commutations are agreed upon, the whole point is that these are a final settlement, said Cadwalader, Wickersham & Taft lawyer Matt Feig.

Therefore, parties need to be clear on what policies are being commuted, he added, as sometimes disagreements can arise following a commutation.

Typically, commutation agreements following collateral release will be settled over a protracted period.

"Usually there is a process of back-and-forth negotiations over what the amount might be. If the parties can't agree, it goes to an independent expert – which is usually an actuary – which can take another few months," Willkie Farr's Ferraro said.

There are various alternatives available to commutation that are employed by ILS managers.

These include novating legal obligations to a rated fronting carrier, or endorsements that allow prior-year claims to be met from current-year collateral, with provisions for ILS managers to top-up the current-year account at that point.

More and more funds have access to in-house rated paper, if not a fronting partner, to provide the former solution.

While the latter involves a cedant taking some credit risk on the ILS manager, the deep pockets of their investors and longstanding business relationships provide good underlying security – although no relationship is immune to the occasional dispute.

These solutions could potentially create some challenges for ILS managers in matching claims to the right investor base within open-ended fund structures.

But a bigger issue may be a question of who will pay for these solutions to offer continuing cover.

In the cat bond market, specific premium levels are required to trap collateral beyond the maturation of a contract – but this does not apply to collateralised reinsurance.

Hence, given how far cat margins have compressed in recent years, creeping Irma losses could factor into a more taut 2019 renewal than was the case this year.