# Sidecars and collateralised reinsurers: liquidity considerations

**Over the past year the number of reinsurer sidecars and collateralised vehicles has proliferated, allowing reinsurers to leverage their underwriting expertise and distribution networks and giving investors exposure to unique asset classes.**

A fundamental issue in successfully running such vehicles is giving investors the ability to redeem or redeploy capital, while providing full security to cedants that claims will be paid.

Closed-ended vehicles typically do not allow for investor redemptions until the end of the underwriting period, as they issue securities that track the performance of a particular underwritten portfolio for a fixed period of time.

Structures vary from quota share sidecars to collateralised market-facing vehicles, but they each involve a set of contracts that can be segregated from others via separate special purpose insurers, or via tranches of securities or segregated cells for each portfolio.

Sponsors have typically used the ability to create segregated portfolios to cater for particular investors' specific risk appetites, but it is more difficult to cater for particular liquidity preferences.

Due to the complexities of issuing tranches of securities at different times on different portfolios, sponsors of many collateralised vehicles simply replicate a new structure each year with no special redemption or rollover provisions. Others use segregated cell or tracking share technologies, although these can raise tax issues.

Increasingly, collateralised vehicles can replicate some liquidity features that are more like open-ended or listed funds, such as giving investors in multi-year vehicles the right to opt out from ongoing participation.

Similarly, in one-year vehicles investors can opt in to successive years. These elections are given with enough notice to allow the sponsor to plan the amount of capital available at the renewal period.

Sponsors in some multi-year vehicles pre-agree with investors the provisions on rollover and collateral hold-back. Collateral is held back for estimated losses, typically with an excess margin for potential adverse development, and investors are permitted to redeem or reinvest the available capital following a development period that reflects the tail risk of such business.

Another approach is to estimate the gains and losses from a given portfolio, settle on the best estimate of the excess funds to distribute or rollover and, in the event of a potential shortfall, agree a strict procedure for clawback or new subscriptions from investors.

A reinsurance-to-close mechanism can provide a solution, which may or may not involve the sponsor, and could be deployed via a separate segregated cell. Others have considered bank liquidity facilities or third-party fronting.

These structural options can navigate the tensions that exist between the demand for prompt liquidity for investors, availability of underwriting capital for sponsors and full security for cedants.

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## Convergence Q&A

**Q How does the US hurricane season impact ILS valuations?**

A The word "seasonality" on the ILS market is used to describe the typical variation in prices that occurs throughout the year.

The market is most at risk of loss during the annual US hurricane season, which runs from 1 June to 1 November.

As a result, ILS valuations typically begin falling from March and hit an annual trough in June, when a full season of hurricane risk lies ahead of investors.

Prices typically begin rising gradually throughout the following months from around September, as each day that passes without a major loss means less exposure for investors.

In a similar fashion, ILS managers typically recognise investment income from their private reinsurance instruments in a seasonally adjusted pattern loaded towards the second half of the year.

*Based on Y/Y patterns of secondary market prices (benign years)
Source: Lane Financial

The US National Oceanic and Atmospheric Administration estimates that hurricane risk peaks between mid-August and late October, but notes that deadly hurricanes can occur at any time.

Analytical firm Lane Financial has calculated that during an average benign year for hurricane activity, cat bond prices may drop 0.17-0.19 percent in value during May and June (see graph).

Gains begin slowly in July, with ILS valuations rising on average 0.23 percent, but the pace picks up in August as average gains reach 0.37 percent.

The market typically makes most gains in September, rising 0.98 percent, with a further 0.3 percent increase in October before valuations steady off in November and December.

However, extraordinary levels of investor demand over the past few years have distorted these typical seasonal patterns. During 2013, the Swiss Re Global Cat Bond Price Return Index climbed from January into April before a seasonal dip occurred. The year before, prices began surging as early as June.