TheActuary
The magazine of the actuarial profession

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Never has the principle of risk mitigation been so much to the fore as in the past few months following the turmoil in the financial markets. Sound capital and risk management have become even more critical in recent times with a corresponding need for organisations to enhance existing frameworks or develop and implement new frameworks for enterprise-wide financial risk control. Few in the actuarial profession would argue with the view that assessing and managing risk is the central cog in the actuarial machine, but perhaps we are about to see a further chapter of actuarial diversification with increasing opportunities for actuaries in the evolving risk management market.

One such area is insurance-linked securities (ILS) in the form of tradable instruments deriving from the securitisation of risks held by insurers. To the insurer, this is an opportunity to transfer risk and free up capital. To the investor, a diversification opportunity in what is still one of the newer asset classes, and independent from other traditional investments.

Due to the insurance nature of the risks, actuaries are expertly placed to give qualified views on the underlying risks, and hence provide valuable input to the assessment of the transactions. I asked Jillian Williams, who is the head of portfolio analysis with Leadenhall Capital Partners, for her views on the ILS capital market, and the evolving role of the actuary in such specialist areas.

What is your background and what attracted you to the ILS capital market?
Most of my previous experience was gained within a broking firm environment, specialising in the P&C markets and with a particular focus on property. I was involved fairly early in my career with technical areas such as catastrophe modelling but my desire was always for a view of the bigger picture. I became involved in ILS from the perspective of tying investment strategy with insurance buying and my current role is certainly focused on the bigger picture in this market.

What sort of underlying structures and risks are involved in ILS?
In reality, any insurance-related risk has potential for securitisation. For example, in a typical cat bond structure, (see Figure 1) a sponsor will enter into a financial contract through something known as a special purpose vehicle (SPV), which will effectively hedge the financial contract by issuing notes to investors in the capital markets.

The proceeds are invested in high-quality securities and held in trust and the investment returns are swapped in the market via a swap counterparty. Credit risk can be removed through the collateralising losses via the bond. One important feature in this structure is the choice of 'trigger' since it has consequences on the risk taken by the protection buyer, but also has implications for the transparency of the transaction to the investor and the degree of 'basis risk' for the protection buyer.

How do you view the opportunity for actuaries interested in the ILS capital market?
Given the diversity of risk sources in this market, there is potential for professionals with an actuarial skill-set from all sectors to play a part in the risk assessment. Knowledge about expected performance resulting from high-quality analysis is fundamental for the success of a fund. However, what is required is more than just a technical skill-set. It comes down also to the ability to think outside the box, to be clear on the risk that is being measured and how it can affect return, and to be able to communicate with investors who do not have a technical knowledge of insurance. Actuaries can play a pivotal role in providing key parties to the sharing of risk with an informed view on what might precipitate a loss or gain in the transaction, based on sound analysis.

What are some of the characteristics for actuaries to be aware of when seeking out ILS capital market opportunities?
For those working within large employer environments it is fairly likely that it will be a move to a smaller, more dynamic environment, with a less formal process. This sort of move will not suit everybody, but to many it represents a very positive aspect.

The underlying structures involve multiple parties with different interests. There will be regulatory requirements on each individual party rather than one overall regulatory regime, and this places a greater emphasis on putting the constraints and methodologies in place relevant to your own party risk. The timing requirement for analysis is almost real-time, taking account of current conditions. This is very different from the reporting and analysis cycles within the more traditional actuarial sectors.

What are the attractive features of ILS and where might the potential development be in this market? One of the attractions of the structures of typical securitisation deals from the perspective of the sponsor and the investor is that they can be constructed to deliver low correlation with traditional capital markets. This attracts investors interested in the low correlation and high relative return features of insurance-linked investments who can potentially benefit from investing in more diverse opportunities.

There is already a significant global market for investors through catastrophe-linked issuances and life-linked issuances. An example of further increased activity may well be through the implementation of Solvency II regulations across European life insurers. Further market development will be strongly linked to the appetite of sponsors to transfer risk and by investors increasingly looking for more diversified opportunities away from the traditional capital markets.

It is an exciting market because it is still developing. We know about existing forms of participation in the capital markets in the insurance market but there are others that have yet to evolve. It is a case of 'watch this space' or perhaps 'jump into this space'.

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