Synthetic Transfer Of Risk Markets
News and features for the alternative risk transfer industry

Q: **Which sector of the synthetic transfer of risk markets are you/your firm primarily involved with?**
A: We look at all aspects of insurance risk transfer and so do not restrict ourselves by the form the transfer takes but focus on the substance of the risk. So we do not just look at 144A insurance-linked securities (ILS); we also look at exchange-traded derivatives, all types of OTC swaps, catastrophe securitisations and even any kind of insurance risk transformed into capital markets form via private transactions.

Leadenhall will eventually offer a number of strategies, but the first one that will be launched will be non-life focused. This strategy will be aiming to produce a higher return generated by higher expected loss levels, but without using leverage.

Q: **When, how and why did you/your firm become involved in the sector?**
A: I personally started looking at ILS when I was at GE Capital. I then went back to investment banking before moving in 2003 to head the European ILS team of Swiss Re Capital Markets.

I was hired at Swiss Re by John Wells – now chairman of Leadenhall Capital Partners – who left Swiss Re a couple of years ago and began working with Amlin. Amlin subsequently did a study on the convergence of the insurance and capital markets and came to the conclusion that it would be beneficial for Amlin to have a closer association with the capital markets.

That association has taken the form of Amlin supplying some seed capital to our venture, as well as some formal practical support. To set up the venture, John and I initially joined Amlin before leaving in November 2008, which is when Leadenhall Capital Partners started its operations.

In terms of why we wanted to launch Leadenhall, our background meant we clearly saw the potential for growth that the alternative risk transfer market has. It is a market that is now well beyond cat bonds – not just because cat bonds are reducing in size at the moment, but because there are now so many more tools available to the same protection buyer or seller to transfer the same risk.

The choice of instrument is now just a matter of the term of protection required, the cost of the structuring and the liquidity of the instrument. Most buyers and sellers of protection now operate across all those products and the Leadenhall concept is to try to bring all those strands together and find in each market the best assets in order to create a portfolio that is still diversified with the right risk-return profile.

Q: **In your view, what has been the most significant development in the markets you cover in recent years?**
A: One key development is, as I've mentioned, the growth of different types of instruments to transfer the same risk. So swaps, ILWs and so on are now as credible as ILS. They are not yet as liquid or as headline-catching, but they do represent important markets.

The other key issue is the question of collateral in ILS deals. The fact that you have more dollars affected by structural issues than natural catastrophes has come as a bit of a surprise to the market.

However, it should be emphasised that total return swap structures were already being enhanced a year prior to the Lehman Brothers bankruptcy and had increased mark-to-market and margining requirements. So, if the Lehman bonds had had some of these enhancements, they would have been less severely impacted – though not completely unaffected.

Q: **How has this affected your business?**
A: The fact that there are more instruments available means that we need to equip ourselves to analyse all those instruments. So a fund like ours has to recruit people who are able to review and model transactions, as well as people who can review other firms' models.

In terms of the collateral issue, our business is directly affected in that we now have to study what the consensus is in the market. Then we have to try to enforce what everyone sees as the solution with the structurers and protection buyers.

We have two choices in front of us in this regard. The purest structure would be to have collateral invested in money market instruments and government bonds. This would, however, require ILS funds to effectively be paid on a money market rather than Libor basis.

It is, of course, possible for the ILS business to change in that way and for funds to reduce their hurdle rates, but it leaves the question of how much non-dedicated ILS fund money would be attracted to investing in cat bonds. And, in order to have a market that is liquid and expanding, you have to have more than just a small number of dedicated investors to make it work.

So I think the only option is to develop the market by continuing to use Libor-based products. Today it is possible to have Libor-based products with government guarantees, which is great, but the question is what will happen when these disappear. We therefore need to explain to investors that they still have Libor, but that also means they have the risk associated with the Libor rate – this is not entirely a zero price risk!

Q: **What are your key areas of focus today?**
A: From my own perspective, my primary focus is keeping the investor community, who might potentially invest in ILS funds, informed about the market. Mainly to explain that the structural issues had been tackled before the Lehman debacle, but that the bankruptcy had served to highlight and prioritise them still further; and also to explain the diversification and transparency benefits of the products.

At the same time, the relative value that used to be a characteristic of ILS products is currently less obvious. There are now a number of credit products that have a similar risk profile in terms of expected loss that yield as much, if not more, than ILS.

So our focus is to explain that a diversifying asset should not necessarily also deliver a superior return at all times. However, we also explain that if a diversifying asset has in the past offered superior returns in normal market conditions, then when normal market conditions return it is very likely to do so again.

Q: **What is your strategy going forward?**
A: Of course, it is to optimise the risk-return profile of our investments. However, there is a major challenge to this because, while most ILS issuance today is designated multi-peril, it usually only covers US wind and quake.

With the vast majority of the issuance being around these perils, any fund with a diversification strategy is finding it difficult to provide that diversification. This means that we have to effectively do our own transactions and source our own risk to make sure we maintain a balanced portfolio.

Q: **What major developments do you need/expect from the market in the future?**
A: As I've just said, what is needed is different risks and different perils being referenced in new ILS. I don't mind multi-peril issuance, as long as it is not restricted to US wind and quake

I'd also like, expect and need more swaps being traded – and I'd like, expect and need more to exist outside the US. Derivatives allow more frequent and smaller transactions because the transaction costs are lower than fully-fledged ILS, which encourages new market participants such as local insurers, who may be big locally but are not big enough to issue cat bonds.

Consequently, we are closely monitoring the development of the European industry loss initiative by the Chief Risk Officers' Forum, which will facilitate swaps trading. If that initiative doesn't move on as we all hope, then some other pan-European parametric developments need to take place. Once that has happened, the market can then move on to the next area of focus, which is Japan.

About Leadenhall Capital Partners
Leadenhall Capital Partners is a joint venture between the Amlin Group, an international underwriter of insurance and reinsurance, and John Wells and Luca Albertini, both of whom have significant experience in insurance-linked capital markets, latterly at Swiss Re.

Leadenhall Capital Partners LLP is authorised by the UK Financial Services Authority to manage and advise third-party offshore funds. Its initial focus will be to manage funds investing in insurance-linked assets.

www.leadenhallcp.com

Go to STORM