



Specialty and casualty insurance emerge as pathways to ILS and convergence expansion



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Increased competition and under-deployed capital among institutional third-party capital providers and underwriters of traditional risk-sharing products continue to focus the attention of the insurance-linked securities (ILS) and convergence markets as they seek new and innovative avenues for growth.

Migrating casualty and specialty insurance risk from traditional (re)insurers in particular, remains the subject of anticipation, debate and uncertainty in the ILS market. Three key concerns until now have limited the evolution of these products into a form that is readily distributable (and transferable) in a manner to which the broader investor base – whether ILS or otherwise – is accustomed.

The first is available modelling, followed by tenor of risk and finally the nature of the insured loss event(s).

While loss from property catastrophe risk is largely binary – it is typically apparent whether or not an insured event has occurred within the risk term of a given instrument – casualty risk, even that written on a claims-made basis, can be much less so. As the experience of asbestos losses in the US indicates, casualty losses can be heavily influenced by social and political forces that challenge the ability to predict accurately and in a timely fashion the extent and final outcome from such coverages.

For casualty insurers and their lawyers, there are three words that are uttered so often as to

have become a mantra: “The next asbestos.” What is it? When will it “hit”? And how can underwriters avoid its pitfalls? The answers can have a significant impact on the attractiveness of certain types of casualty risks – notably for the ILS market – because they go to the heart of risk uncertainty. In the case of asbestos, that uncertainty has persisted for more than 45 years, since Clarence Borel won the first significant product liability suit in 1969. Casualty re/insurers that survived the asbestos crisis did so by capping their losses via commutation, placing their casualty books into run-off (often at a substantial loss) or simply carrying large reserves for years, resolving the onslaught one claim at a time.

That the majority of the policies involved were “occurrence-based” as opposed to “claims-made” policies, was a principal factor behind the long tail typical of the asbestos crisis. Under the former, it is conceivable (and, in-

deed, often the case) that courts will find the occurrence that gives rise to claims can extend backward in time for several years and span many policy periods.

One response to the asbestos crisis, then, was the increased use of claims-made policies in place of the more traditional occurrence-based policies. Under a claims-made policy, only those policies on risk when a claim is “made” (or notified) respond to the loss. While this, in theory, provides for more predictable loss development than occurrence-based policies, there remains a significant degree of uncertainty with regard to the “tail” in many cases. The economic downturn of 2007 to 2009, for example, gave rise to a deluge of cautionary notifications by brokers and insureds under financial institution (FI) liability policies such as directors’ and officers’. The result was that FI underwriters were forced to carry large incurred but not reported (IBNR) reserves until the nature of the risk associated with thousands of notifications could be assessed and analysed for both coverage and quantum.

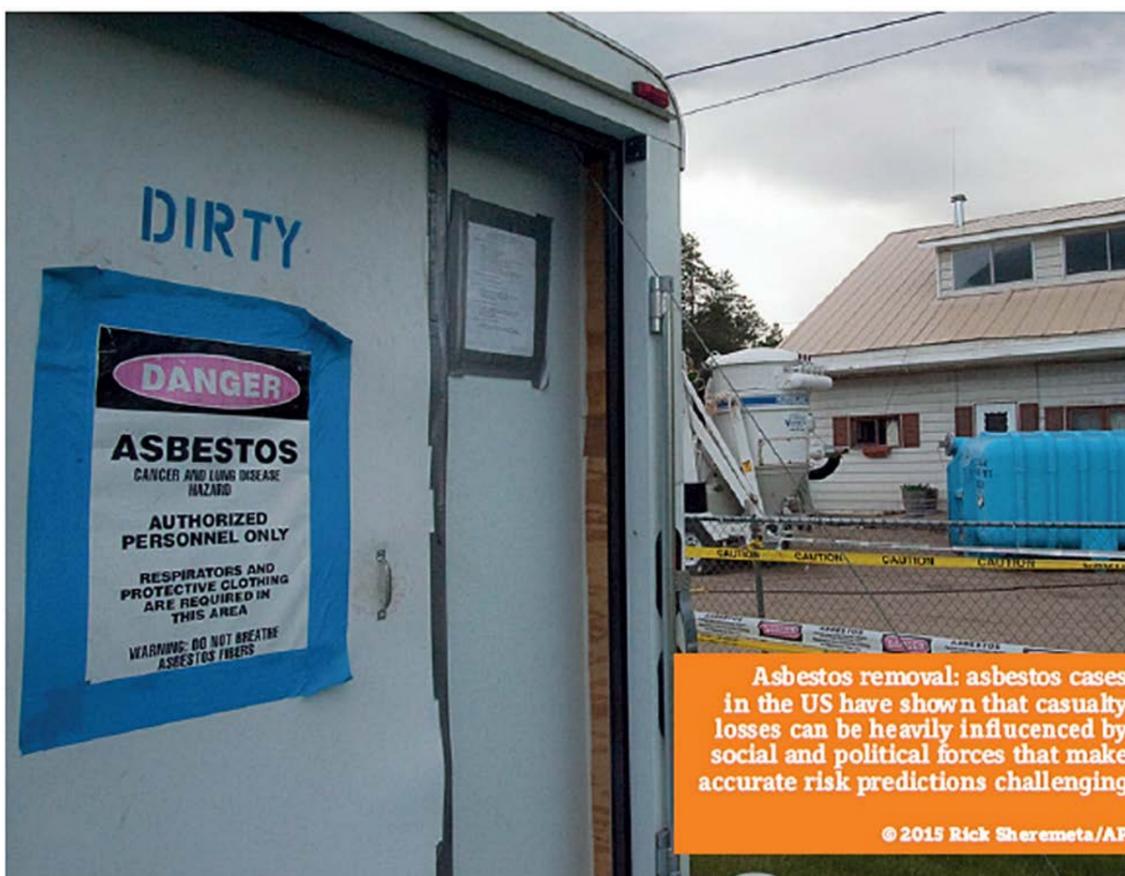
Such scenarios would be challenging to typical ILS investors. One of the chief advantages of cat risk as an investable asset is that there are well-tested and market-approved modelling methodologies that can be used to project – within acceptable margins of error – how a given book of business might develop. As numerous commentators have noted, casualty modelling and reserving – at least on the level of individual portfolios – is less developed.

Be that as it may, a number of casualty indices exist and continue to be refined. Some, focused more upon developments in the broader casualty market itself, rather than on the expected performance of a given portfolio or group of portfolios, could well evolve into reference-style indices in time. Other structures, tools and hedging mechanism,

albeit imperfect and somewhat basis-exposed – think, for instance, inflation swaps, specific name or industry-basket CDS, and the like – continue to emerge, as do more familiar commutation and settlement mechanisms. Underlying data granularity and collection, modeling and technological development – including, for example, blockchain(s) and trading platform advances for illiquid and alternative assets – continue at a brisk pace. In a September 2015 equity research report, Citigroup Global Markets highlighted Extraordinary Re, a start-up looking to change radically the way certain insurance risk is syndicated and expand upon the narrow lines of business that one typically thinks of in such platforms.

The pathway to innovation in the ILS and convergence market is likely to proceed along two axes, and perhaps others. The first is greater certainty and transparency – both in modeling and loss determination. The second is delimiting (or mitigating) a more discrete tenor and nature of exposure. Indeed, as the investor base continues to grow, it gains sophistication and understanding regarding the less predictable nature of the forces at play in casualty and specialty risks that can impact the ultimate loss outcome in significant ways – for example, long-tail reserving and claims inflation. The authors fully expect it is but a matter of time before structured solutions, capital markets hedges, advances in trading platforms and other tools will soon expand the field of ILS play in a variety of ways that we may not even have yet contemplated. ■

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Asbestos removal: asbestos cases in the US have shown that casualty losses can be heavily influenced by social and political forces that make accurate risk predictions challenging

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