ILS IN BERMUDA

by Stacy-Ann Maharaj

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Insurance-linked securities (**ILS**) are instruments by which insurance risk is transferred to capital markets. For insurers and reinsurers, ILS represent an alternative to traditional reinsurance and retrocession.

The benefits that ILS offer to insurers and reinsurers include additional ways to manage risk, additional capacity, diversification of counterparties, potential reduction of credit risk (i.e. in collateralised transactions) and, in some cases, a way to obtain financing.

The benefits that ILS offer to investors include the opportunity to obtain attractive returns and to diversify an investment portfolio since the return on ILS is dependent on the occurrence of triggering events and is generally uncorrelated to the return on other asset classes.

In an ILS transaction, payment is usually dependent on the occurrence of such a triggering event, of which there are four basic types:

- indemnity triggers, which are based on the actual loss of the insurer (i.e. the cedant) or other originating or sponsoring party (i.e. the sponsor);
- industry index triggers, which are based on an industry-wide index of losses;
- parametric triggers, which are based on the occurrence of an actual physical event (such as the magnitude of an earthquake or the wind speed of a hurricane); and

- modelled loss triggers, which are based on estimated losses generated by a model.

There are also various hybrid triggers composed of multiple types of the triggers listed above.

The following is a high level summary of selected ILS instruments or structures:

Catastrophe Bonds: Catastrophe bonds (**cat bonds**), which provide protection for extreme events such as hurricanes and earthquakes, have been the most popular form of ILS. A cat bond is issued by an insurance or reinsurance company, typically a special purpose vehicle (**SPV**), to reduce the possible impact of claims resulting from a specific large natural disaster for which it was provided insurance. Such cat bonds transfer part or all of the financial impact of the specified catastrophe from the (re)insurer to investors in the capital markets.

If the specified catastrophe occurs and is of sufficient size, the bond is triggered and the investors' principal is partially or fully paid to the reinsurer to meet its claims. In return for the bond's protection, the reinsurer pays a premium to the investor. In addition to insurance premiums, the investor receives a return on the principal, which is held in a separate collateral account.

If the catastrophe does not occur during the life of the cat bond (or if it occurs but is not large enough to trigger a payment), the bond's principal and investment return is repaid to the investor.

Reinsurance Sidecars: A reinsurance sidecar is a special purpose reinsurer that provides reinsurance capacity (typically via a quota share reinsurance agreement) to a ceding insurer or reinsurer. Sidecars are generally created for a limited period of time to take advantage of a short-term opportunity and then to dissolve. Sidecars are generally dependent on the sponsor or some other party for underwriting, pricing and servicing. The sidecar or its holding company raises capital through private placements, most of which is deposited in a collateral account to support the sidecar's obligations under the reinsurance agreement. If the sidecar has to pay a claim during the period that it is exposed to risk, the assets in the collateral account are used to pay the claim. If the sidecar does not have to pay claims during this period, the assets in the collateral account are paid to the investors at the end of the period.

Swaps: Another way to transfer risk is via a swap. In a property/casualty cat swap, an insurer agrees to make periodic payments to a counterparty and the counterparty agrees to make payments to the insurer based on the occurrence of an insured event. There have also been mortality swaps and longevity swaps.

Life Insurance Securitisation: Life insurance securitisation is also a segment of the ILS market. Mortality and longevity risk securitisations fulfil a similar function for life insurers, as catastrophe bonds and sidecars do for property/casualty insurance and reinsurance companies—the transfer of risk to the capital markets.

The Bermuda ILS sector started to distance itself from other offshore centres in 2009 with the introduction of a special category of insurer – the "special purpose insurer" (**SPI**). SPIs are fully funded (re) insurance vehicles that are established for a limited period for a specific purpose. SPIs can only be used by sophisticated cedants and sophisticated investors and the particulars of the structures and transactions have to be fully disclosed to all parties.

Today, thanks to its favourable regulatory environment and reputation as a leading offshore financial centre, Bermuda is the market leader and domicile of choice for ILS. Figures from Artemis.bm show that 75 per cent of ILS transactions completed during 2015 took place in Bermuda.

Appleby (Bermuda) Limited acted on more than two-thirds of Bermuda's ILS deals during 2015, including the majority of Bermuda's collateralised reinsurance (or "cat bond lite") transactions.

This article has been written by:

Bermuda
Stacy-Ann Maharaj
Associate
+1 441 298 3234
smaharaj@applebyglobal.com

Lawyer Stacy-Ann Maharaj is an associate in the Corporate Department at Appleby.

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