Leadenhall: Rated ILS launch Nectaris will sweeten risk profile

Leadenhall Capital Partners head of non-life portfolio management Ben Adolph explains that the firm will vary its use of rated Bermuda balance sheet Nectaris depending on market conditions

When ILS managers started up in business, cash collateral was king as these nimble asset managers struck away from the business dominated by traditional rated balance sheets.

But in the past few years, as disaster events have highlighted the operational challenges of dealing with cash collateral lock-ups and releases, more ILS managers have set up their own points of access to rated platforms.

This enables them to supplement service providers who lend out their balance sheets – known as fronting carriers in industry parlance – and build portfolios that contain more lower-yielding (re)insurance risk. Crucially, this next generation of ILS rated vehicles look different to their traditional counterparts – they typically run much lower levels of leverage, and have a narrower business focus and equity base, as well as a low-cost operational footprint with higher levels of administrative outsourcing.

Ben Adolph, Leadenhall Capital Partners head of non-life portfolio management

Leadenhall became the latest ILS manager to back a rated vehicle in May through the launch of Bermuda-domiciled Nectaris. Ben Adolph, the firm's head of non-life portfolio management and director of Nectaris underwriting, walks through how the firm will invest through the vehicle to reshape its portfolios.

What led Leadenhall to launch Nectaris, when it also has access to rated paper through its ownership by Mitsui Sumitomo Insurance via Lloyd's subsidiary MS Amlin?

There are a few key benefits for the ultimate investor. We're getting a lot more efficiencies on the back end – rather than having a lot of collateralised structures either facing MS Amlin or open market cedants, most investments will face Nectaris. We don't have to go through a collateral release exercise with third parties at the end of a contract in order to conclude any ongoing liabilities. Nectaris is also a third party, but we can be more pragmatic about the collateral release and commutation decisions [than an external party]. Even when you're using a fronting provider, you need to agree a release at the back end anyway.

This wasn't a problem in benign years but in 2017-2019 the series of catastrophe events meant that commutation and release agreements have been challenged by a wide range of different behaviours, some managed efficiently in line with the letter and the spirit of the arrangement and others being far from acceptable.

The second main efficiency is that rather than having to collateralise at the individual deal level, we can pool that risk and get all the benefit of diversification. That's not a new approach for the traditional reinsurance market but the ILS market is starting to converge on this approach now.

> *"There is no incentive to load the tail for the sake of it"*

The tail of a collateralised portfolio is fairly inefficient. You can unlock that collateral and manage reinstatement risk – it gives us an additional tool.

We also want to provide counterparties another point of contact and the ability to transfer risk in the way in which they choose. Some brokers and counterparties have a desire to access this new relationship for various reasons.

Does this mean you expect to write more diversified cat risk in the future or change your underwriting strategy?

I don't think it will necessarily change the original business but it gives us the ability to change how we structure it for the investors. We have always taken some diversifying risk but there is no interest from us to over-diversify the portfolios.

The cost of capital to run this type of risk is potentially lower – but there is no incentive to load the tail for the sake of it.

The individual deals and the overall portfolio have to make sense, just because it's available doesn't mean you have to use it. We don't want to face a huge draw-down for a risk we're getting a low margin for.

What difference could using leverage from Nectaris make to returns?

The efficiency of pooling risk means we can either give more return to investors, or maintain return and make the portfolio less risky. You have both those levers available and that's a key benefit.

The right answer is different for each investor – some funds will want to maximise return, whereas others want to minimise risk for a given return level.

You may also have a different answer in different stages of the pricing cycle – the traditional model is you take more risk when rates are good and deleverage when rates soften. We would anticipate following the strategy that is most efficient in the market that is in front of us.

We think the structural benefits could boost returns in a material way on a risk-adjusted basis.

What are the cost implications for investors?

First, it's a relatively low-cost development – a lot of the infrastructure behind Nectaris already existed. We're just using the infrastructure in a different way.

The ongoing costs are relatively small. We have staffed the business with myself as director of underwriting, and a second employee on a part-time basis, with our service provider Horseshoe managing and administering operations.

The AM Best costs are additional but this has replaced a rating fee on our prior structure which used an S&P rated note for some of our funds.

Key points about Nectaris

- A Excellent (Stable) rating from AM Best
- Based in Bermuda
- Collateral provided up to either a 1-in-1000-year (if sourced via MS Amlin) or 1-in-2000-year level (if written directly)
- Nectaris takes tail risk on directly written business after the 1-in-2000-year point, and retains no risk on MS Amlin-fronted business
- Currently ramping up after writing its first risk in May 2021
- $200mn of permanent equity, plus collateral of more than $370mn

What led to the decision to have Leadenhall's funds provide the equity for Nectaris?

The structure makes it easy to bring in new investors or funds. It doesn't matter how small a new fund might be, the fund or any new investor can easily buy in and get the benefits of Nectaris, whilst sharing the costs with the existing Nectaris investors.

The equity allocation is proportionate to the size of overall assets, based on usage of the vehicle. We do regular true-ups to check equity split is in line with usage.

"Some funds will want [to use leverage] to maximise return, whereas others want to minimise risk. You may have a different answer in different stages of the cycle"

Getting their equity out shouldn't be a problem, because it sits senior to their other holdings. It's the underwriting capital that is generally more subject to trapping. We have assessed the use of third-party capital in the vehicle but due to minimum return issues third-party capital would have created a cost leakage for our investors by providing very limited risk transfer, so we opted for keeping the economics to investors in our existing funds. In addition, this approach also affords the greatest alignment of interest and ensures investors using the structure are not adversely impacted by changes in risk appetite of a third party who may wish to trade out of their position due to other outside factors – this is important for creating credibility in the market as it provides the best chance of continuity for counterparties facing Nectaris Re.

What other differences will it make to the firm?

There's some other benefits in terms of origination, we're adding a string to the bow. We're agnostic to form, whether we're investing in traditional reinsurance, cat bond, derivative or other products.

But the ease of execution is a real attraction [for traditional reinsurance buyers], making it easier for cedants and brokers to access the capital.

This factor will become more important if the market starts to transition back to a more orderly stage in the pricing cycle, where capacity is less constrained and other factors such as ease of execution become increasingly more important.

The greater opportunity set we have, the greater opportunity to select the risks that work best for investors.

Finally, what's behind the name Nectaris?

Nectaris is a lunar sea which sits between the seas of tranquillity and fecundity.