LUCA ALBERTINI

The ILS asset class can evolve to fit fixed-income appetites, says Leadenhall Capital Partners CEO Luca Albertini

Q: What prompted Leadenhall's launch of a new remote-risk ILS strategy this year?
Historically, ILS has competed as an asset class targeting near double-digit returns to fit in with an investor's traditional alternative allocation bucket, alongside other hedge fund strategies. It took time for ILS to find a space in this bucket, but now it's important to offer something to lower-risk, lower-return investors.

In order to make remote risk layers palatable to investors, we need to change the definition of the ILS asset class from "alternative" to that of a quasi fixed-income product.

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At the remote-risk layers, there's less volatility. And for ILS risk with an expected loss of 2 percent or below, you can still earn more yield than from BB credit instruments.

Q: How much room is there for ILS markets to grow by taking these low-risk layers of business?
This is where the vast majority of the reinsurance market's limit is derived. I tell investors to think of it as a martini glass – the reinsurance tower spreads out at the top. It's not necessarily capital efficient for rated reinsurers to take this low rate-on-line business, so there's scope for the ILS market to grow here. Also protection buyers may like the benefit of collateral protection in the wake of a very large event.

Previously, more of Leadenhall's business had been skewed towards the mid-layers of risk. Rebalancing our portfolio will make us more valuable to protection buyers who want to deal with reinsurers across all layers of their programme.

I think we're providing something that investors will appreciate, and we are diversifying our portfolio and provide our protection buyers with broader support at the same time.

Q: Are you seeing a notable shift in demand towards more risk-remote products from investors?
While we've done work to find the investors who want lower-risk layers, the reality is that most investors will still want more yield than this can offer – so we will mix remote risk into our overall portfolios as well.

You can grow this portion of business with people who have a 2-3 percent return target or with people who want to leverage these risks. If you still want spicy returns, there's space for remote risk – with a bit of leverage, the returns could be 2-3 times as high.

In our case, we have been offering leveraged remote portfolios in a managed account form to high-quality investors.

Q: What lessons do you think the ILS market can take from the deterioration to last year's losses that has occurred in 2018?
There are several things that are important here – ultimately it's down to investor education.

We always made it clear to our investors that the loss numbers we were giving were the best estimates at the time.

There's ample historical evidence that catastrophes can have unexpected development tails – for example, the New Zealand earthquake loss of 2011 is still deteriorating. Earthquakes are expected to be more tricky, but even wind losses can develop unexpectedly.

We acknowledge it is important to update investors frequently, but we didn't want to rush out meaningless numbers. The first thing we did after Harvey was to close our funds to new investors for a couple of months, to allow us to create side pockets when we had some more information.

One thing we emphasised was actively seeking information from every possible source – we were making calls to counterparties, brokers, other underwriters, anything that could help us to form a view on the loss before loss notices were released. Even at the end of November, it was still a long time before we got loss notices from some counterparties.

One thing I would like the industry to consider in the future is to find better ways for listed companies to have better input into valuations.

Listed companies are very careful in the information they can give out ahead of official financial reporting. Informal discussions can help, but some listed companies have recently surprised many with their reserving creep, and surprises are always harder to manage than frequent open dialogue.

This may be something to discuss with the legal departments of listed companies.

Q: What was your firm's experience with loss creep?

The side pocket is taking the sting out of it. It has insulated the loss to the right set of investors.

I'm told our losses started creeping earlier than others, but others then caught up to us. I think that's because we put so much emphasis on calling people and bugging our counterparties to give us information.

We also don't have any Puerto Rican primary reinsurance business, which helped limit our exposure to Maria development.

Florida has created a bit of volatility, but only within certain layers. Then reflecting the industry experience, some of the retro and aggregate layers were full losses – so there was a limit to loss development.

Q: You've previously said that 2017 wasn't "the great test" for the ILS market. What kind of test was it?

It wasn't the great test, but it did prove some points about the ILS asset class on a number of fronts. There haven't been any court cases related to cat bond payouts and most investors have reloaded their losses.

It has proven the role of the pension consultants in education of investors and that this role matters.

What we have not yet seen is a big event just before a key renewal – it's one of the few events that remains to be seen.

But I would argue that the conversations we as ILS markets would have in that event would play out in a similar way to those with rated balance sheets.

Q: Did the dynamics of the 2018 renewals hold any surprises for you?

It was a surprise that rates didn't rise as far as the market had anticipated after last year's losses.

Some reinsured parties chose to take up cheaper new offers of capacity, reducing allocations to loss-affected partners who were demanding a reasonable premium increase due to the claims experience.

But we were giving investors messages which were not that far from what actually happened.

We didn't allow people to expect the 40-50 percent increases which some anticipated.

I question whether some capital was being raised on unrealistic rate expectations – and whether that capital might exit next year. Hope not: it would not be good for anyone.

Q: How would you advise ILS investors to react to the 2017-2018 experience?

When you have a loss, it's valuable to look at what went well and what didn't go well and to take corrective actions on your portfolio.

My opinion is that there's nothing in what happened that is contrary to expectations for those types of events. 2017 was not a year of surprises.

It also reminds you that the only way to invest in ILS is to be a long-term investor. Being a short-term investor in an asset class with this kind of tail risk is more akin to betting.

Some investors have rebalanced their risk appetite across the risk spectrum in light of their experience. This is a healthy approach as many of our investors have a bespoke risk and return appetite which fits the rest of their portfolio, and would not be available to take a beta risk and return profile.

Q: How are you planning to react as a manager to the post-2017 opportunities?

Ten years after our launch, it's incredible to be in the position of being able to make choices about our growth in the knowledge that we had more capital being offered than we could accept.

We are looking at the sustainability and quality of prospective investors – we don't have to take mandates on a first-come, first-served basis, as we don't need to accept hefty fee discounts for new large tickets.

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We plan how much we can grow our business by looking at the additional business opportunities we think we will have in the next 12 months – then we consider how much of that will be absorbed by natural growth and then we allocate new capacity to our marketing team.

Around 85 percent of our investor base is made up of pension funds and another 6 percent is from family offices. They are the more long-term sustainable investor base.

On the underwriting side, in 2018 we have focused on deploying our capital with markets that have performed in line with, or better than, expectations and that have behaved before and after a loss as true partners.