Marketing ILS structures to EU investors

With the convergence market estimated to have grown by one-third to $60bn in 2014, the number of investors attracted to various ILS structures from within the European Union (EU) has also increased.

During the frenetic fundraising in the fourth quarter of 2014, and continuing into early 2015, a key hurdle to soliciting EU investors has been the phased implementation of the Alternative Investment Fund Managers Directive (AIFMD).

AIFMD represents the most significant European regulation of investment funds in recent times and directly impacts investor marketing and fundraising for ILS funds, as well as for cat bonds, sidecars and other collateralised reinsurance structures where an exemption is not available.

The directive applies to any alternative investment fund manager (AIFM) marketing to prospective investors in the EU either directly or via a placement agent.

Although AIFMD was intended to create a harmonised framework for marketing non-UCITS funds, the regulations vary depending on whether either the manager or the funds are established in the EU and on the level of funds under management.

There is currently no "passport" regime where authorised non-EU AIFMs can market throughout the EU. This has impacted the convergence market given that a large number of fund managers, ILS funds and collateralised structures are located in offshore jurisdictions such as Bermuda and the Cayman Islands. Without passporting rights, non-EU AIFMs must currently market under the private placement regime on a country-by-country basis.

Furthermore, as has been the case with other EU directives such as Solvency II, EU member states are at various stages of their implementation of AIFMD and many have chosen to "gold plate" the directive's provisions to add local requirements. Some also do not have co-operation agreements in place with particular non-EU countries, making it difficult for those AIFMs to market non-EU ILS structures.

In some member states such as the UK, Sweden and Luxembourg, short-form AIFM registration has proved useful for non-EU managers of ILS structures who manage an alternative investment fund with assets below certain thresholds. Other AIFMs were able to close an investment under a reverse-inquiry investor approach that is both fact-specific and country-specific.

For most cat bonds and some sidecars, the exclusion from AIFMD that is most useful is a provision for closed-ended structures issuing non-convertible debt – similar to typical capital markets securitisations.

In the late 2014 convergence fundraising, many managers of ILS funds balanced the regulatory burdens against the potential benefits of marketing their funds in the EU and declined to market to investors in particular EU countries. This limitation may change later in 2015 when a non-EU AIFM marketing passport may be introduced.

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Modelling in focus: Risk transfer for inland flood risk in the US

In the landscape of insurance risk transfer, US inland flood risk has been underrepresented. However, the increasing property concentration in flood-prone areas means that the risk of significant loss is higher now than ever before.

With new analytical tools available, there is a significant opportunity for reinsurance and capital markets to offer support to their clients and grow participation in this previously low penetration market.

Modelled analytical tools for US flood risk have historically been deterministic in nature, which, while useful, often lack the resolution and spatial coverage necessary to inform robust risk selection and pricing. However, a fully probabilistic solution is a highly complex and resource-intensive challenge. There are myriad intricacies involved in modelling inland floods, as these catastrophic events vary in size, scale, and duration.

The actual storm or storms that caused an inland flood event might not be obvious. Large land areas containing multiple river basins often flood in sequence as rivers are affected by multiple storms occurring over many weeks. In addition, many variables affect the likelihood and intensity of inland flood, including soil type, antecedent soil conditions, drainage conditions, land use, land cover and flood defenses.

In 2014, AIR Worldwide introduced its new Inland Flood Model for the United States. AIR leveraged a global circulation model, coupled with a numerical weather prediction model, to realistically simulate large-scale precipitation patterns across the US, as well as at the local level.

It leverages a high-resolution digital terrain model featuring 18 US Geological Survey hydrologic regions. It covers more than 2 million kilometres of rivers and streams, and more than 300,000 distinct drainage units. The fully probabilistic model can be used to capture losses both on and off floodplains, which is important since a significant portion of losses can occur off floodplains.

Flood hazard coverage has not been broadly considered commercially viable in the private US market. However, the introduction of sophisticated probabilistic modelling solutions enables underwriting of susceptible properties using a comprehensive understanding of the risk. As insurance carriers cultivate this line of business their growth will be facilitated by reinsurance and capital markets partnerships.

A nationwide probabilistic model enables risk managers and reinsurance and capital markets partners to understand a range of loss levels associated with geographically diverse portfolios of risk. To illustrate, the insurable aggregate loss estimate for the US is $65bn at the 1-in-100-year level, according to the AIR model. The flexibility afforded from such advanced modelling techniques enables the risk transfer, simply because single risks and portfolios can now be technically priced.

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