Reinsurance a tradeable asset

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Abstract

This is not a research or scientific paper. This is meant to serve as a thought-provoking journey on how reinsurance can help make the world a better place. We are currently witnessing massive growth in the investor base and a growth of socially responsible people. We are also being presented with the opportunity to explore how reinsurance can be at the intersection of this growth whilst providing a potential solution to both the (re)insurance industry and the financial markets. This paper explores why rather than how reinsurance could be the next tradeable asset. It also briefly considers how the (re)insurance industry and financial markets can assist at this perfect moment of increased social consciousness.

Contents

Introduction

This paper takes a generalistic approach to the topics covered in the first section, where a research paper could well be dedicated to each standalone topic. This paper introduces these themes and confirms why the timing is inspirational for further exploring. The paper then flows into a second section which explains how these could be interlinked within the reinsurance industry.

Timing is everything

Rise of retail investors

When the next person sitting next you on a Tuesday morning on the District line in central London thinks of the next best investment to put some of their savings on, their mind might ponder on what is available on the latest mobile application they are using for investments. This will usually showcase a plethora of stocks, potentially exchange-traded funds (ETFs) and, in line with more recent trends, cryptocurrencies may be included as well.

Recent developments in technology, with fintech at the forefront, place the whole financial sector at the fingertips of every other individual you cross paths with, in your everyday life. Young people are given the opportunity to frequently discuss trading and investments in this context, and there is a huge shift in the type of individuals or groups of individuals who can play their hand in this space vis a vis the past.

This is all of course driven by technology, the fact that new exchanges have set up zero commission trades and successfully attracted those who would originally be deterred by smaller investments. The fact that fractional shares are now possible means any retail investor can invest minimal amounts, and coupled with commission free trades, a whole new playing field is created. The fact that some of the recent exchanges are designed in such a way that gamify trading, coupled with the fact that so many people were unavoidably locked up at home during the latest lockdowns and had time to find new ways to entertain themselves, as well as the COVID-19 crash happening not long before that, definitely were factors which led to what has been dubbed the "rise of the retail investors" [1].

The Gamestop saga might be over, but these new younger social media-savvy people that entered the world of investments, are here to stay. Social media backed by advanced technology is a new dynamic in the world of investments that has never been seen in history. Youngsters with smartphones, videos on Youtube, Instagram and TikTok explaining how investing works,

[1] The Growth of the Retail-Investor Revolution, Anthony Denier, March 10, 2021

being able to open up trading accounts within minutes, and finding viral events through social media, are definitely new factors that are changing investment dynamics.

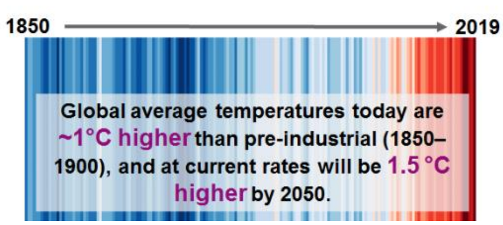
Millenials, social consciousness and climate change

Another topic which can be related to millennials is the topic of sustainability.

In recent years, with the growth of knowledge that passes through the masses and with concepts going "viral" through social media, we have also seen peoples' awareness growing in respect of health issues, society, and the environment.

Take for example documentaries which stream on streaming platforms such as Netflix, which have gained profound popularity in recent years. "Cowspiracy", "Seaspiracy" and several David Attenborough documentaries address wildlife and the planet and in most cases, highlight the growing exacerbation faced by the planet in the face of ever-growing consumption. More people are now conscious of recycling, over-consumption and the impact every day actions have on the planet. If you are to look around, packaging is slowly moving to paper and more generally use, the use of plastic is being minimised. A ban on single-use plastic straws, stirrers and cotton buds came into force in England in 2020, for example[2]. Also, products you see in shops which are based on natural or plant-based ingredients are growing exponentially. People are turning vegan. There is a massive and booming market of meat alternatives or "meat analogue" at the moment as well as alternative dairy-free and vegan milk products.

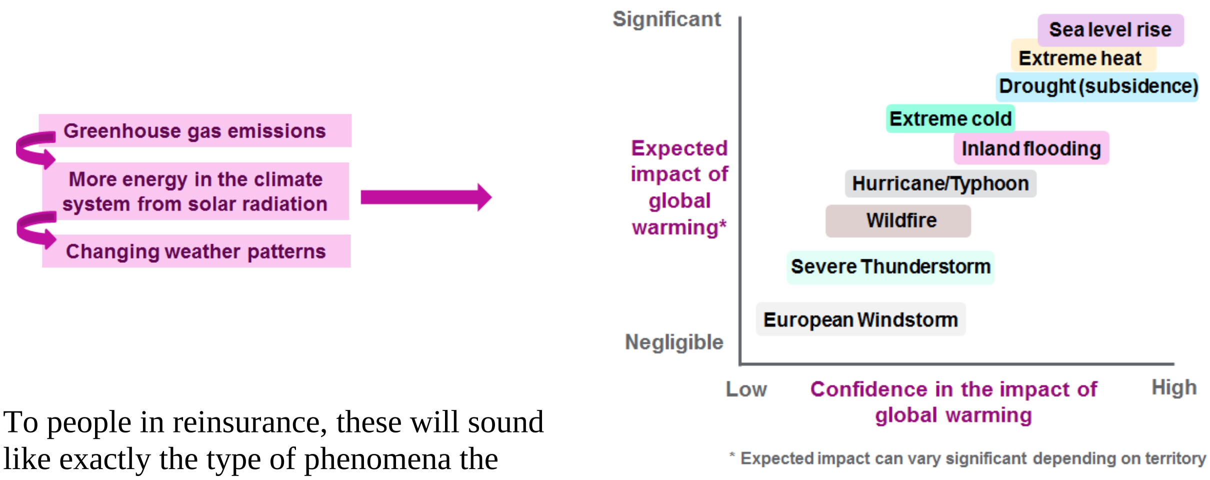
This is all a testament to the fact that society is cautiously moving towards a more accepting mindset – a mindset which acknowledges climate change and as a result of this an acceptance that weather patterns are changing. It has become more and more clear that climate change is linked with larger numbers of natural disasters.



It is well known that greenhouse gases are causing more energy to be trapped within the planet's atmosphere through solar radiation, which in itself causes changing weather patterns. The latest Intergovernmental Panel on Climate Change (IPCC) report was heavily reported on in the news during the summer of 2021, highlighting once again the fact that humanity has changed the climate in an irreversible way[3]. It has been described by the UN chief as a "code red for humanity". Wildfires in Greece, Cyprus, Italy and the US, floods and storms in Europe, record temperatures in Canada

[2] Straws, cotton buds and drink stirrers ban: rules for businesses in England, Department for Environment, Food & Rural Affairs, September 21, 2020
[3] Climate change widespread, rapid, and intensifying – IPCC, August 9, 2021

and Russia, snow in Madrid and winter storms in Texas have been some of the extremes we have seen throughout the summer 2021.



To people in reinsurance, these will sound like exactly the type of phenomena the industry is here to protect. With more such events anticipated to occur in the future, the industry's positioning has never been more needed than now, as is the need to prove that it can remain resilient and provide the necessary capacity to bridge the insurance gap.

Spawn of Socially Responsible Investors (SRI)

Are we then saying that millennials are now increasingly dabbling in investments, but at the same time possess social awareness, knowledge of climate change and social responsibility as to the health of the planet?

I think the answer is potentially yes, at least for the majority, within jurisdictions like the United Kingdom, and through the pandemic a new generation of socially responsible investors has been bred, with future aspirations and hopes of a better tomorrow. Research shows that of those aged 25-34 years old who hold investments, 60% have invested more of their money in the last year, as opposed to 38% in the wider population. Adding to this, the number of new investors choosing SRI portfolios doubled in 2020 compared to the year before.[4]

It is clear that investment providers need to take into consideration the changing appetite of new investors. A new asset class might be needed that can boost the social aspect and green rating of the investment, but at the same time be a differentiating factor to

[4] How the pandemic has bred a new generation of SRI investors, Nutmegonomics, March 17, 2021

existing asset classes.

ESG oriented investors and businesses

ESG or Environmental, Social and Governance criteria are criteria that investors would want to consider when assessing the merits of a potential investment and constitute criteria other than financial quantitative measures one would consider before investing.

These criteria have developed the way people and businesses are considering actions and investments now. In the world of millennials and social media, it is increasingly important to have a good reputation, as actions can easily become detrimental and with the speed of the internet more so. These criteria look at the soft factors that could impact valuations of companies beyond simply financials.

With the recent awareness of climate change, the **Environmental** element introduces an image of the impact a specific investment or business will have on the environment, its carbon footprint, etc. The **social** aspect is focussed on the impact this investment or business will have on society, it incorporates an element of inclusion and diversity, an awareness of mental wellbeing for employees, and overall, the good of those around the operation of the business. G**overnance** criteria touch on the running of the business, the transparency and professionalism with which a business or investment is run.

The social status of a company is now evolving from everything being based on financial strength, to a more "green" valuation. Rating agencies have started quantifying the resilience businesses have, to long-term, industry material environmental, social and governance (ESG) risks.[5]

This has led to more and more organisations making pledges for net zero carbon emissions by a specific date. If we take the United Kingdom for example, the government announced that nearly a third of the largest domestic businesses pledge to eliminate their contribution to carbon emissions by 2050. This includes companies like AstraZeneca, BT Group, Sainsbury's, and Unilever, representing a total market capitalisation of £650 billion.[6]

Regulations, international treaties and conventions are being implemented, with most countries on the planet signing the Paris agreement, a pledge to keep global warming limited. In the United Kingdom and focusing on the insurance industry, we have been seeing stress-testing becoming a

[5] Five ways that ESG creates value, McKinsey Quarterly, November 14, 2019
[6] Third of UK's biggest companies commit to net zero, UK Gov press release, March 30, 2021

requirement, and from 2022 Climate-related disclosures will be mandatory. Similarly, regulators around the world are incorporating the physical, transition and litigation risk elements of climate change into all reporting going forward.

With a changing legal and regulatory landscape, businesses need to adapt to stay ahead of the game, to remain compliant and to uphold a certain reputational standard. Ultimately law and regulation is there for the benefit of society and should theoretically lead to people changing their mindsets. In the case of environmental issues this may eventually lead to businesses and individuals striving for higher ESG ratings, and "greener" investments.

Green investments & high ESG ratings

ESG criteria, law and regulation, and changes in investors' appetites, are creating a trend of what are called "green" investments. One would think that it would be quite exciting and even rewarding for a young retail investor to opt to invest in a solar energy company. This investor would undoubtedly discuss the decision to invest in renewable energy with peers and might also discuss how this is good for the planet and how financially, this could offer a favourable return.

Another retail investor might check through their investment provider, the Social Responsibility Score on their investment portfolio[7]. These trends are now becoming the norm and investment decisions could potentially be affected by these factors, not just financial indicators. It is no wonder that inflows into ESG products have risen by 140% in 2020 as reported by Moody's Investors Service[8].

Following on from the topic of climate change, there is no doubt that with the additional uncertainty in weather patterns, extremes and catastrophes, there is more and more need for insurance and subsequently reinsurance. How does the (re)insurance industry tackle green investments?

A green investment for a reinsurance company could be to essentially issue green bonds to fund environmentally friendly activities, and hence making the organisation more "green". Is there a way however of creating an even greener asset through reinsurance? Let's first investigate how reinsurance itself can be an asset class.

[7] A rating based on ESG Data provided by MSCI ESG Research LLC

[8] Moody's - ESG investing a boon for asset managers as product skepticism diminishes, Moody's Investor Service, February 23, 2021

Opportunity not to be missed

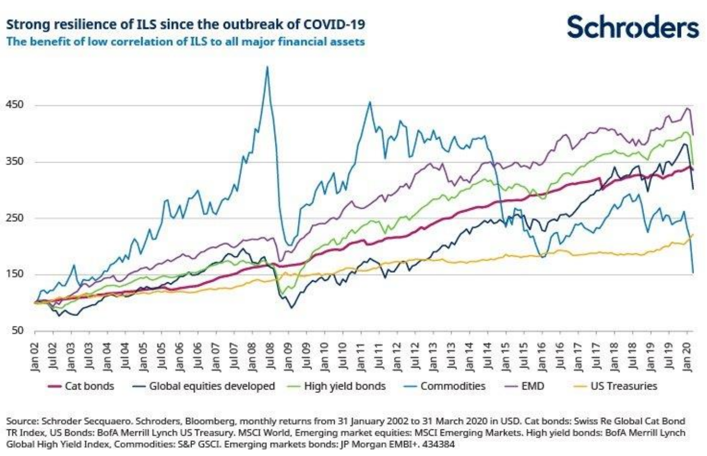
Transitioning to the reinsurance industry

At the moment, an institutional investor can access the reinsurance market and directly become an alternative capacity provider to an insurer. This is managed through investing in various forms of Insurance-Linked Securities (ILS). A retail investor on the other hand is quite limited in their potential involvement in reinsurance. It can only take the form of directly investing in the shares of a reinsurance company, which is quite limited in terms of the benefits the institutional investors are getting and defies the purpose of a "new asset class".

A brief intro to ILS – how is reinsurance securitised

An insurance company can pass on risk to a traditional reinsurance company or it can package up the risk in a financial instrument and pass this on to the financial markets. Usually these markets would be pension funds or institutional investors. These Insurance-Linked Securities (ILS) can take the form of catastrophe bonds, collateralised Quota shares, Industry Loss Warranties and often also weather derivatives. This gives the opportunity to an investor to act as the capacity provider to the insurance company. In simple words, an investor becomes a reinsurer, with the initial capital put into the investment acting as the collateral in which insurance or reinsurance losses will be paid in the case of a loss up until the term of the contract.

One may wonder why an institutional investor would enter the direct reinsurance market. The answer is of course, diversification, a new asset class, higher returns, and most importantly the low correlation ILS has with the other asset classes.



Cedants might also prefer to pass on risk to the financial markets given the capacity is collateralised, potentially a faster payment of claims is offered (especially in the case of a parametric reinsurance cover) and there are lower costs compared to traditional markets. With the massive increase in alternative capital available in the form of ILS investors over the last 20 years, the reinsurance markets are beginning to shift.

Secondary market liquidity

Institutional investors are locked in to the ILS they invested in, be that a cat bond, sidecar or any other instrument, for a particular amount of time. They can only liquidate their position if they can pass this on to another investor. Passing this on is not as easy as one might imagine, given the investor base is quite limited. It would, however, only make sense that such investment products, with all the benefits described above and the added bonus of potentially being greener assets, could have a much wider investor base. To enable this, we would need to find a new army of retail investors; a group of people who are up to date with technology, who are continuing to get educated and are aware of the risks to the planet, are socially conscious, who can get things around the globe in a matter of minutes through social media and who are now socially responsible investors. Could we somehow introduce these people to ILS? Could these new millennials solve the issue of liquidity in the secondary ILS market, and therefore make reinsurance a more tradeable asset?

The answer is potentially yes, but it might not be as straight forward in creating an entryway for these investors to reinsurance. Reinsurance brokers, however, may be the best suited to become the facilitators of bridging this gap in the investor base. At the time of writing, over 60% of ILS deals had reinsurance brokers involved in either structuring or book-running.[9]

Cedants are needed to pass on risk, and who better than the reinsurance brokers who have access to the majority of the cedants and international reach. With the infrastructure and network reinsurance brokers have, it is possible to reach out, educate and attract new investors into this arena. At the same time, they could be hand-picking the right cedants who they think have a better underlying business in order to structure outperforming ILS solutions. The broking industry is at a stage now where it could even help make the world a better place by participating in more and more Public-Private initiatives, tackling the insurance gap and sourcing reinsurance capacity, to where it is most needed. It is however lacking a crucial element in this. ILS issuance needs to speed up, and for that to happen traditional reinsurance placement needs to become more automated.

Automating reinsurance placement

People within the industry know that traditional reinsurance is still in the dark ages in terms of growth and development when compared to the banking sector. Only in the last 5 years have organisations started developing technology and expertise that will help the industry take a big step forward.

Enter data science, artificial intelligence, and advanced analytics. From a process of passing on information and data in excel tables (or even pdf files in some cases) from client, to broker, to reinsurer, the industry should be aiming at an automated data framework that captures and validates information straight from inception of the policy from direct insured and insurer, all the way to the reinsurer.

[9] https://www.artemis.bm/dashboard/cat-bond_ils-issuance-banks-brokers/

Such an automated data capture mechanism can shift the way pricing of reinsurance is done. Traditionally actuaries and catastrophe modellers, take a static snapshot of the portfolio as at a specific date in time, and try to project this portfolio in the future to create gross loss models. Imagine if this "forecast" was unnecessary by way of having an instant view and Expected Loss of the portfolio at any point in time. This would invalidate the idea of a price for a yearly contract and it would welcome an instant price of the portfolio at each moment. Such an approach, with automating placement could also revolutionise pricing, and therefore the secondary exchanging of who is at risk in a reinsurance contract. Trading reinsurance would in this way be more feasible. Even though in theory this idea might make sense, in practise of course there are a multitude of questions to ask and issues to solve before reinsurance placement can become automated.

Considerations

Reinsurance brokers or any external firms who might be aiming at automating reinsurance placement, might be a long way from streamlining the process in a way that allows a reinsurance contract to exchange hands in a liquid manner. Furthermore, the complexities of specific lines of business might not even allow this to be possible, unless capital is collateralised and no more is to be recovered by the cedants. Long delays, court proceedings and uncertainties around claim development are factors that might keep certain lines of business from becoming tradeable reinsurance assets.

Closing the insurance gap might sound like a socially responsible thing to do, but at the same time governmental decisions and politics are involved, which might go beyond the reach of the reinsurance industry. In principle, reinsurance becoming a tradeable asset could help in closing the gap, but there are a lot of other factors to be considered.

Data availability and transparency will be an issue especially for retail investors. Any investor who wants to participate in the reinsurance treaty of a particular insurer, will want to know what this insurer is covering, what the underlying portfolio is, whether it is sustainable, and how that changes over time. These are issues, that traditional reinsurers solve by creating long standing relationships with their clients, where trust is built over the course of years. If the process of reinsurance placement is to speed up and if part of the placement (if not all) is to be replaced with an investor, then this investor would want to have an understanding of the client. Perhaps this is again a space for the reinsurance broking industry to shine in, as the brokers would be in a position to know the client and at the same time facilitate the placement or trading of reinsurance.

One final element to consider is the impact this could have on the pricing of reinsurance, the sustainability of existing reinsurance markets and on whether this could be the end of smaller reinsurers.

Food for thought - Conclusions

We have seen in the last 18 months a growth of people with time in their hands, a motivation to invest, and the means to do so. At the same time, we are seeing people opening their eyes to various issues that affect the planet, and more importantly changing weather patterns and the increased prevalence of catastrophes. We are also seeing regulators and similar bodies and organisations taking action regarding ESG factors that affect each industry.

With the reinsurance industry now at a stage of rapid transformation and technology being increasingly incorporated into it, coupled with advanced analytics being required more and more, a new asset class can enter the arena. This can potentially enable new investors in a market place with traditionally very few players, whilst at the same time offering to such investors a completely new, transparent, alternative asset, with a high social responsibility score and fundamental value, which is completely uncorrelated with the rest of the financial markets, whilst helping make the world a better place.