PHASE 2

RISE UP

Cyber, Terror, and the Curse of the One-Off Success

PCS

#RiseUpRe

Last year, 90 percent of catastrophe bonds featured (or covered) only U.S. property-catastrophe risk. Of $10 billion in original issuance, only $1 billion covered risks exclusively outside the United States. And the broader insurance-linked securities (ILS) space isn't much better. U.S. risk accounts for roughly two-thirds of industry loss warranty (ILW) trading, according to most estimates.

It's easy to get the impression that ILS doesn't do much else. Of course, our industry knows that's not the case—even for new and emerging risks. Two catastrophe bonds covering Turkish earthquake have come to market, and in 2015, we saw Panda Re, a small transaction for China. Operational risk, energy, workers' compensation, and motor have appeared in catastrophe bonds since the inception of this market. And the ILW market has picked up a wide range of specialty lines risks, including marine, aviation, and terror. It just doesn't happen often enough.

Innovation seems to have taken on a "test and forget" character. Someone gets an idea for an exciting, unique, and groundbreaking trade. The goal is to get the trade done. When that happens, the market celebrates. Unfortunately, this generally tends to be a one-shot deal. Such innovative trades rarely have a second act (Turkey in the catastrophe bond market is a rare exception). Our industry has a solid track record of innovation—we just aren't as adept at driving adoption. For the ILS sector to grow dramatically (even in comparison to 2017), we need to find solutions that stick. Showing that you can "get a deal done" is important, but it doesn't fuel sustainable growth. ILS—and even insurance—market expansion requires that the industry ***rise up*** and overcome the temptation of innovation without repeatable utility.

Joining Together for a Common Purpose

Historically, our industry has seen innovation as an individual achievement (with rare exceptions). An insurer, reinsurer, intermediary, or ILS fund does something unique and interesting. That player collects the kudos, while the rest show sufficient admiration. And after the headline is pushed to the second page of Artemis, memories begin to fade. Collective innovation, on the other hand, has the potential for greater long-term effect. If we work together to develop the industrywide solutions the market needs—and would use—our industry would accomplish the progress we truly crave: repeatable innovation. Not innovation once, for its own sake—real innovation that makes a long-term difference in the market.

Of course, joining up to support progress toward a common goal is a happy thought. Without some substance, though, the whole concept is vapid. Even if we're all willing to work together…toward what? Industrywide collaboration requires a shared purpose—that's the most important part. We can agree to work together, but if the objective of that shared effort isn't of any consequence, then all we've done is waste our time together!

When you contemplate the best application of collective effort, it helps to focus on your clients. Yes, reinsurance and ILS are naturally people-centric industries, and we all invest heavily in our client relationships. Sometimes, though, momentum takes over, and actions don't always align with client needs. It's hard to let go of an idea once you've fallen in love with it. The tendency is common, and it's holding us all back.

Lest someone take offense, I'm only going to point the finger at myself: PCS®. Like everyone, we've had a few moments in the past few years where our innovation eye wasn't focused on client need. There were a few projects that seemed useful but ultimately didn't satisfy a clear need in the market. This caused us to reflect a bit, and we brought our focus back to where it belongs. For any organization, periodic soul-searching, gut-checking, and otherwise just making sure that you're doing the right thing for your clients are time and effort well spent. This thinking should take priority both in the industrywide context and in general.[1]

In addition to making your clients happy, the needs-based approach to innovation has incredible benefits. First, by developing a solution that people want, you're taking the first step in driving adoption. And that has the next step built into it: if something's useful, folks will use it over and over again. That's the clear sign that "useful" is becoming "market standard."

1. To demonstrate our commitment to this statement, PCS's new product launches and current strategy are entirely defined by market needs through extensive client interaction and other forms of market research. If nobody wants it, we don't allocate resources to it.

To achieve this outcome, of course, we need to think back to the notion of repeatability. A useful innovation that satisfies a clear need in the market will be used repeatedly. Frequency of use speaks directly to client benefit—such as return on investment (ROI). Deliver something that generates returns for your clients, and they'll keep using it.

That's the sort of innovation our market craves!

To Each According to His Need

So, where has our industry focused on the individual instead of the collective and failed? Cyber and terror are instructive. There have been a few interesting moves, but they've all been severely limited, absent an industrywide perspective. Global terror ILWs have suffered from the lack of a reliable, independent trigger that's purpose-built and updated regularly. Cyber has involved bespoke solutions that defy repeatability—and thus struggle to scale.

Both terror and cyber have received significant efforts at innovation, and the need for risk-transfer tools in both classes of business is palpable. An occasional clever solution provides immediate relief for one client and a glimmer of hope for the rest of the market, but excessive tailoring ultimately becomes a barrier to repeatability. While both risks may be somewhat exotic, the market clearly craves a risk-transfer solution that is not. A traditional ILW—with the same sort of industry loss index trigger that's supported the U.S. property-catastrophe market for decades—could provide the greatest good for the greatest number.

Think about terror, for example. The risk may seem remote: only three events since 1990 have driven industry property damage and business interruption losses of at least $1 billion (unadjusted for inflation), according to data from PCS Global Terror™, with only one topping $2 billion (the terror attacks of September 11, 2001). However, terror is traded fairly actively, and there's plenty of demand in the ILW market. Through years of soft market conditions, terror and cyber have crept into natural catastrophe reinsurance programs, resulting in hidden accumulations that could prove problematic. An ILW solution would help, particularly as reinsurers have assumed terror without additional rate, instead using it to maintain original pricing on the property-catastrophe business. With an ILW, it may be easier to manage the cost of risk transfer.

Terror ILW trading has slowed in recent years, though. Ambiguous triggers have made it difficult for parties to be willing to participate. One-sided estimates that can take a year to come out (and several years to develop, if the updates are even published) don't make the process any easier. Some transactions may list a variety of approved data sources, some of which would ultimately fall under "any other credible source of information." The process isn't reliable or repeatable. While the occasional trade can be completed, there's pent-up demand because the masses won't accept such a risky trigger.

In cyber, an ILW market has yet to emerge. However, some reinsurance trading has occurred with the ILS community using traditional risk-transfer structures with high levels of customization. The need for retrocessional capacity is growing quickly, and many suspect that acute capacity needs could be right around the corner. To fuel future market growth, some sort of commoditization of cyber reinsurance risk must occur. Otherwise, the process will become too cumbersome and expensive, ultimately constraining future expansion. Repeatable risk transfer is an important part of the future of the cyber insurance market. And we're already uniting as an industry to make that possible.

A Collective Approach to Accessing Original Risk

Repeatability and simplicity are crucial to new solution adoption. Getting a complex trade done may provide momentary satisfaction and near-term relief, but the long-term benefits are wanting. Each effort requires significant analysis, internal discussion, external negotiation, and ultimately, expense for everyone. The resulting cover may be perfectly tailored to a company's needs, but not every company will have the ability to secure that sort of protection—and not every broker will be able to support placing such a labor-intensive program routinely. Fortunately, the reinsurance industry collective can help deliver repeatable solutions to address the routine needs of the masses, with bespoke structures reserved for those occasions where they truly make sense.

If they're useful and address a real ongoing need, repeatability and adoption will come naturally into the equation. It just takes time, effort, and commitment from a central entity (in the case of cyber and terror, for example, an independent loss reporting agency). Original risk can be difficult to transfer throughout the insurance and reinsurance value chain. Tools that make it easier to free up capacity, of course, can help a fledgling market endure its early days and then mature more easily in the future. In particular, industry loss index triggers can be crucial to the risk-transfer process as a market develops.

Throughout the new risk adoption cycle, retrocession and even some reinsurance can become more easily available via ILWs. These early industry loss index–triggered trades provide much-needed capacity to reinsurers—and ultimately, insurers—to help them write more business, which is exactly how a market grows. Over time, increased market penetration naturally yields more (and larger) loss activity, which cycles new information into the market and facilitates a transition to traditional risk transfer on a commodity basis (such as indemnity-style retrocession). As a market matures, a healthy mix of risk-transfer approaches emerges because the community takes advantage of all available tools to optimize risk and capital management.

The early repeatability of ILWs in a market (like cyber) can ultimately clear the way for the repeatability of other structures. Repeatability begets repeatability. Collective growth, therefore, comes only from a shared effort to subvert the norm—and advance the reinsurance revolution. When we rise up together, we welcome a bright new future!

RISE UP!

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