Gibraltar's "tremendous potential" in the Insurance Linked Securities market

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Insurance Linked Securities (ILS) have been proven to be one of the most successful manifestations of the convergence of the insurance industry with capital markets. ILS provide a mechanism for insurance related risk to be transferred to capital market investors and Gibraltar has developed a secure but competitive regime to become a key European hub in the ILS space.

If we define ILS as an asset class, we might say that they are characterised as a pooling of insurance related cash flows which are transformed into tradable securities, typically done by utilising securitisation techniques with the underlying assets and associated income then serving as collateral.

Risk securitisation is a product of the 1990's when traditional reinsurance markets reached capacity limits as a result of a number of 'catastrophe events'. Since the 2005 losses of hurricanes Katrina, Rita and Wilma, the ILS market and the market for catastrophe bonds (cat bonds) witnessed significant growth, primarily because losses sustained created a capital shortfall (with the resulting risk transfer prices skyrocketing). The sector then evolved and accepted that capital markets were not only there to offer protection in the 'vacuum' of traditional capacity, but also as a valuable source of significant amounts of high quality risk transfer capacity.

A significant portion of the ILS market is the reinsurance of high severity, low probability events through cat bonds. A cat bond allows the transfer of risk relating to, for example, earthquake risk, from an insurance or re-insurance undertaking to an investor.

A typical cat bond structure begins with the formation of an SPV, which issues bonds to investors. The proceeds are invested in safe, short term securities which are held in a trust account. The cat bond will have an embedded call option that is triggered by a defined catastrophic event. If the event, such as an earthquake, occurs, the proceeds are released from the SPV to assist claims payments. The release of funds can be proportional to the event size rather than being completely binary. However, in most cat bonds the principal is fully at risk which means that investors could lose their entire principal investment. In return for the option, the insurer pays a premium to the investors. The fixed returns on the securities held in the trust are swapped for floating returns based on the LIBOR rate (or another widely accepted index), and this in turn immunizes the insurer from the interest rate and default risks. Ultimately investors receive the LIBOR rate plus the risk premium in return for their capital and if no contingent event occurs the principal is returned to the investors at the end of the bond term. The SPV acts to isolate the investment risk made by an investor from the general business and credit risk of the insurer. As such, the investment exposes the investor to the catastrophe risk only.

The Gibraltar proposition

Gibraltar has tremendous potential to establish itself in the ILS space, particularly the growing European segment of the market which is expected to continue to develop and grow along with the increasing number of perils that have been modelled for capital market transactions. In a European environment ILS is expected to complement reinsurance with the development of Solvency II and with the total return from the cat bond market measured at 10.9% over 2013 (Swiss Re Global Cat Bond Performance Total Return Index) a continued interest is expected from institutional investors seeking returns largely uncorrelated to financial markets. Gibraltar's position as being fully EU compliant is key. In 2009, the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS, (which was subsequently superseded by EIOPA in 2010)) published the Insurance Linked Securities Report which outlines the importance of Solvency II for the ILS market. This report proposed that the new principles based Solvency II framework would be a major development for the ILS market and that Solvency II would recognise securitisation and derivatives as effective risk mitigation techniques.

While some jurisdictions are taking a view as to the legislative framework required to provide the legal infrastructure for ILS business, Gibraltar has its existing Insurance Companies (Special Purpose Vehicles) Regulations which were adopted in 2009, along with Protected Cell Company legislation enacted in 2001, which provide an ideal framework for ILS offerings. Gibraltar also has a vibrant existing insurance sector (with gross premium income in 2012 of £3.8bn).

The initiative to develop and diversify the insurance sector in Gibraltar has been driven conceptually by Gibraltar Finance, and in particular their insurance specialist Mike Ashton. What we have seen is a coming together of a Government initiative, supported by the Financial Services Commission (FSC) and by the industry locally, to put Gibraltar into a position that it is ready to do business. The Gibraltar ILS Guidelines, generated in large part by the FSC, have been constructed with the input of an international and expert working group to ensure that they work from both a practical and legal angle. From that perspective we can be confident that as well as being Solvency II compliant based on the most up to date EIOPA position, the Guidelines also meet with the approval of the international practitioners who offered their input throughout the process. Critically, both in terms of pricing but even more importantly in terms of timing and time to market, the Guidelines and the processes set out therein have already been met with approval of the industry.

Initial momentum

ISOLAS is delighted to act for the Horseshoe Group- one of the largest ILS managers - in its Insurance Manager's application in Gibraltar. Andre Perez, CEO of Horseshoe sees a good percentage of growth in the sector coming from Europe and is 'quite bullish about Gibraltar's potential for ILS.'

This is positive news and we expect this to send a strong message to the sector. There will be other Insurance Managers looking at developing operations in Gibraltar, and there are also managers already in Gibraltar with ILS business currently existing outside of Gibraltar that we would hope to develop locally. I am confident that Gibraltar will have a good choice of service providers to support the ILS sector as it develops, and the future looks very positive.

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