

ILW vs Parametric

What's Best for Peak Perils Exposure?



ILW vs Parametric

Peak-peril catastrophe capacity may be extremely tight at 1.4, but a new, more effective choice for peak-peril reinsurance or retrocession coverage is now available.

Out with the ILW old...

ILWs, or Industry Loss Warranties, are an index-based reinsurance instrument which pays out when the estimated total industry-wide insured loss arising from a specific, covered event or group of events – typically wind, flood, earthquake, or more recently wildfire – exceeds an agreed threshold, as calculated by a third party.

ILWs can be used to cover a dead or live cat event, and are often purchased by cedants as a back-up cover to protect their balance sheets when multiple sequential events during the same storm season occur or are feared. They are a useful and well-established instrument in the risk carrier's capital management toolbox, although they're not without drawbacks.

One is **basis risk**. They typically use market-loss data compiled by commercial entities or major reinsurers to determine when an ILW is triggered for payment. This is inherently inconsistent with any specific cedant's actual value at risk. The inconsistency is exacerbated by reporting gaps which leave total losses underestimated or based on guesswork.

Perhaps worse is the **long wait for settlement**. ILWs – by design – do not pay until the industry loss has settled, or at least comfortably exceeds the trigger point. The naturally long period required to calculate a reliable industry loss can, in the extreme, be many years. In the interim, the cedant may not be able even to recognise the reinsurance recovery in their P&L.



Meanwhile, **ILWs lack flexibility**. Their structure is very rigid, with trigger conditions that take no account, for example, of variations in risk profiles across portfolios, or the evolving nature of tropical cyclone risk.

A further negative is a **potential lack of transparency**. The ILW market operates predominantly as an over-the-counter market, with limited regulatory oversight, and therefore transparency, relative to traditional reinsurance markets.

Lack of flexibility, transparency & limited geographically The scope of the ILW's **coverage is limited geographically**. Areas which are not covered by third-party industry loss collation services cannot be covered by ILW instruments.

Calculation of **total losses is often underestimated**, because certain types of losses may be excluded from industry loss calculations.





Basis risk is reduced

... and in with the parametric new!

Parametric reinsurance and retro structures share some characteristics with ILWs. They too can be index based, but they are triggered for payment when a specified event occurs, with no regard for the total (and irrelevant) industry loss arising from the event. They minimise or eliminate many of the issues associated with ILWs.

Parametric triggers can be designed to align very closely with the actual damages caused by an event to a specific re/insured portfolio. Through pre-event analysis of its exposed values and location coordinates, coverage can be designed to react with precision to relevant events, reducing basis risks substantially compared to ILWs.

The trigger events – or "parameters" – of the index, and the loss scales created and adopted for a specific coverage contract, can each be calibrated to minimise remaining basis risk. This may apply, for example, to the intensity triggers of the index such as windspeed, days of excess temperature, or the order of the event during a coverage period. Adjustment can be used to ensure triggers align with cedant objectives regarding the attachment and/or exhaustion probability of specific economic loss tranches, as well as budget.



This alignment ensures triggers match the modelled cat losses used in reinsurance purchasing and capital modelling. The parameters can even be optimised to align with the distribution probability of the cat losses that inform not just the overall reinsurance placement, but also the capital modelling behind it. They are, therefore, fully integrated within the purchaser's enterprise risk management framework.

Alignment makes the value of parametric coverage much greater, because it focusses more accurately on the reinsured's specific exposures, not those of the entire industry.

Claims settlement is extraordinarily efficient A major benefit of parametric reinsurance is that settlement is very much faster, often within a calendar month of the triggering loss event.

Reduced administrative burdens provide faster, certain access to funds underpinning liquid capital. The beneficial financial impact of parametric reinsurance can be recognised much faster.



Settlement is much simpler than with traditional indemnity-based reinsurance, which may also be said of ILWs, but with parametric reinsurance payments are not delayed while industry-level losses are calculated and left to develop.

Pricing isBecause of this flexibility, parametric reinsurance can be tailored to match the risk,keenand priced accordingly. That means cedants pay only for coverage that matches their
exposures precisely, no more, no less.

Coverage isAny type of economic loss associated with a covered event may be reimbursed by abroaderparametric reinsurance structure, including intangible exposures such as loss of
access.



| Flexibility is unlimited | Parametric triggers are highly flexible, and can be tailored to respond to parameters which precisely meet each cedant's specific needs. Triggers may take into account factors such as geographic location, risk profile, historical incidence, and/or almost anything which can be shown to contribute to loss and quantified. Payment structures can be varied to account for changing values at risk, or future changes of conditions. Risk nuances can therefore be measured more effectively, and covered more advantageously. Nor is parametric reinsurance limited to nat cat exposures. It has been used to reinsure perils ranging from cyber to marine cargo. |
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| Transparency and uncertainty | Parametric reinsurance structures typically operate in well- established regulated markets which ensures greater transparency and oversight relative to ILWs. Insurers can therefore gain access to a broader range of potential counterparties, and benefit from the expertise and financial strength of established reinsurance players. Most of them are already active in parametric. |
| Reduced counterparty risk | Regulated parametric products do not rely on uncertain Letters of Credit or unrated capital, which gives cedants reassurance over the reliability and stability of their reinsurance arrangements. |
| Solvency recognition is Improved | With lower basis risk, better counterparties, closer alignment with modelled outcomes, and a regulated nature, parametric reinsurance qualifies as Tier 2 Capital under European solvency rules. This is in stark contrast to ILWs which are considered derivative products . |

In Parametric vs. ILW, parametric reinsurance wins on transparency, certainty, responsiveness, simplicity, speed of payment, and balance-sheet benefits. Skyline Partners, the parametric catalyser, has everything it takes to get parametric reinsurance structures designed, built, and operational. We work daily with brokers, cedants, captives, and reinsurers alike to deliver the winning parametric advantage.



Laurent Sabatié Co-founder & Executive Director Skyline Partners Email: <u>Isabatie@skyline.partners</u>



Ken MacDonald Ri3K Consulting Strategic Advisor – Skyline Partners Email: <u>ken.macdonald@ri3k.co.uk</u>

