Government Actuary's Department

Investment News

Monthly Bulletin from the Insurance & Investment Team

July 2018

Last Month in Brief

The Office for National Statistics (ONS) announced that the UK's economic growth grew at a faster rate than initially thought for the first quarter of 2018 with growth of 0.2%, double the previous estimate of 0.1%. The revised figure has been attributed to the construction industry performing better than initially anticipated and improved techniques for measuring growth in this sector.

The European Central Bank has announced that it intends to gradually exit its quantitative easing programme following a governing council meeting in Riga, Latvia. The ECB has signalled that it intends to end quantitative easing by the end of 2018. The bond-buying programme undertaken by the ECB cost €2.4tn and has been credited by some economists as the reason for the revived eurozone economy.

The University of Cambridge sold £300m of 50-year index-linked debt based on the consumer price index (CPI) measure of inflation. In addition, the University of Cambridge has also sold £300m of 60 year conventional debt. Market stakeholders have noted this as a significant moment in the UK bond market and follows comments from The Bank of England governor, Mark Carney, for the careful withdrawal of RPI as a measure of inflation.

Chart 1: Equity Indices
Equity markets rose before declining at the end of the month.

Chart 2: Sterling Credit Spreads
Credit spreads on lower credit ratings fell before rising again near the end of the month.

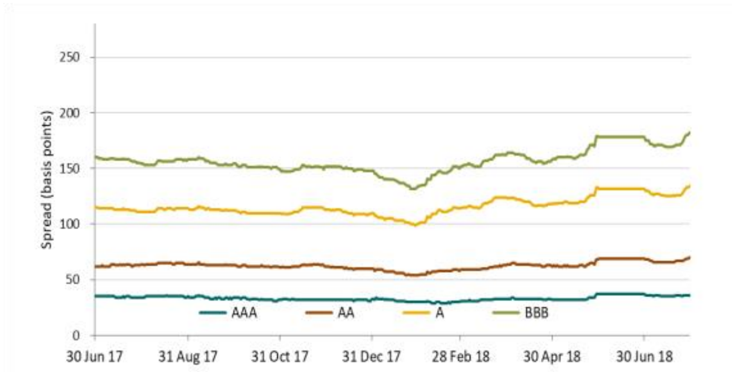


Chart 3: Gilt Yields
All yields slightly fell over the month.

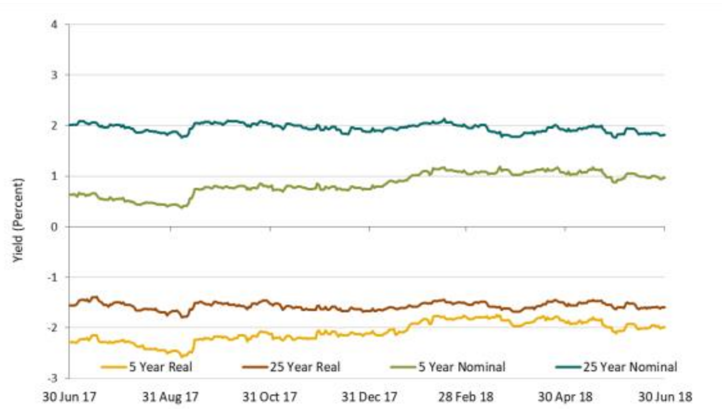
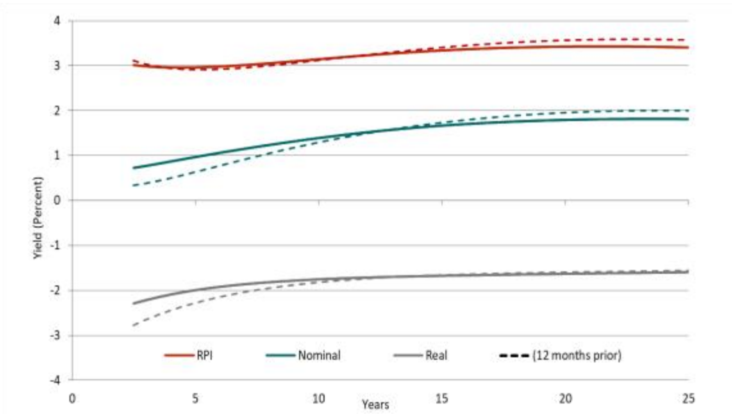


Chart 4: Gilt Spot Curves
The yield curves were stable over the month



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.3%	+2.4%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	94.5%	95.1%	**$/£ exchange rate**	1.32	1.33
Halifax house prices (monthly change)*	+1.8%	+1.5%	**VIX (volatility) index**	16.09	15.43

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Insurance Linked Securities (ILS)

In this issue we revisit Insurance Linked Securities which have been in the news recently. The reinsurer SCOR became the first company to issue a catastrophe bond (Cat bonds) in the UK under the new Insurance Linked Securities regime introduced by the Government in December 2017. The bond is intended to provide SCOR with a multiyear risk transfer capacity of US$300 million to protect itself against named storms in the United States, earthquakes in the United States and Canada, and windstorms in Europe.

What are Insurance Linked Securities?

ILS are an alternative means of transferring risk from insurance and reinsurance companies to the capital markets. Insurers and reinsurers benefit from these instruments because they are able to spread their risk over a larger number of participants in the capital market and obtain favourable pricing terms due to investor demand for ILS. For investors, alongside the opportunities of receiving attractive returns, ILS are deemed to be helpful in diversifying their investment portfolios due to the uncorrelated relationship ILS returns are deemed to have with the economic cycles or stock market fluctuations.

Structure of an Insurance Linked Security Deal

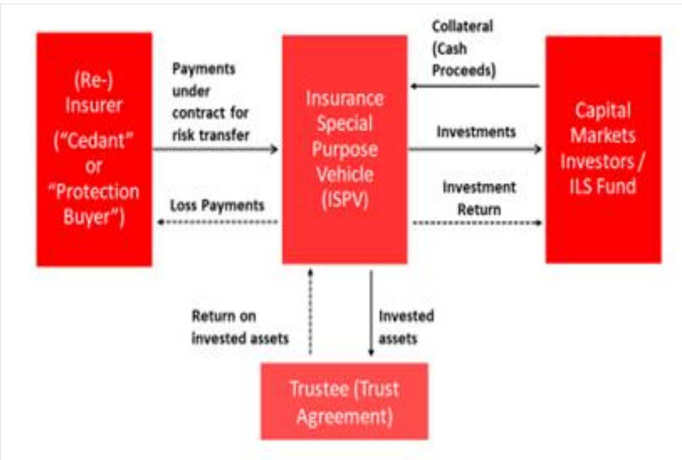

Figure (1): Financial flows in an ILS
(Source: HMT – Insurance Linked Securities: Consultation)

There are four parties to an ILS deal. The first party is the insurance/reinsurance firm (the **Cedant**), which seeks protection from the insured losses it is exposed to. The Cedant creates a legally separate corporate entity, known as an Insurance Special Purpose Vehicle (**ISPV**) to transfer this risk to capital market **investors**. The ISPV issues insurance linked securities to investors with the promise of paying regular coupons, and the principal at maturity if no triggering event occurs before then. The proceeds from the sale of the securities are placed in a collateral fund that can only be used for paying claims on the reinsurance contract to which it is linked. The ISPV makes an agreement with a **Trustee** to administer and invest the collateral fund and the premiums paid by the Cedant, and these returns are used to pay the coupons to the investors.

In the event of a triggering catastrophe, the investors will lose their money, and the proceeds from the ILS issuance by ISPV will go to the Cedant to cover their claim.

Outlook for ILS Market

Insurance-linked securities are one of the fastest growing parts of the specialist insurance market. Their use has grown significantly in recent years and are now an established part of the global reinsurance market. Recent market statistics shows that the capital backing insurance linked securities stands at around US$ 90 billion. Consultancy firm EY has estimated that this market could grow to a value of US$ 224 billion by 2021. Catastrophe bonds which are one of the most common forms of ILS currently available, also reflect this growth. The graph in figure (2) shows Cat bond issuance has seen a steady increase from 2010 to 2014 amounting to around US$ 8.1 billion in 2014. After a dip in volumes in the next two years, issuance rose to record breaking levels year in 2017 totaling around US$ 10.6 billion worldwide. This trend has continued into the first quarter of 2018, with US$ 3.7 billion of issuances.

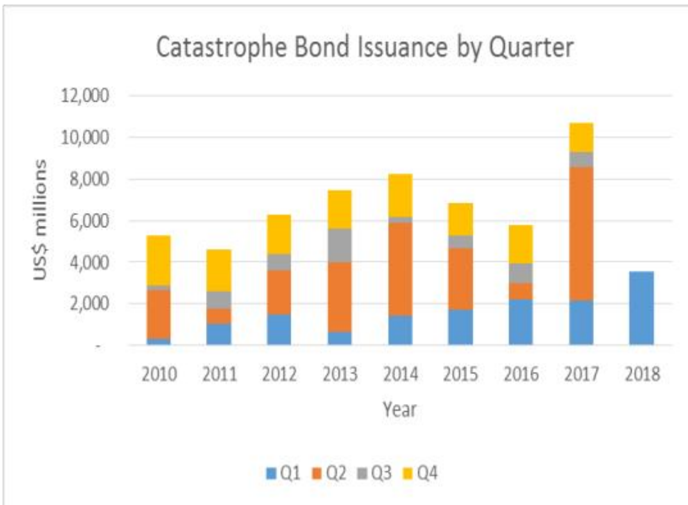

Figure (2): Catastrophe Bond Issuance by Quarter (source Aon Benfield)

Changes in the UK ILS Regime

Identifying the potential for London to become a world-wide ILS hub, the UK Government introduced a new set of regulations in parliament recently. These new regulations (ie the Risk Transformation Regulations 2017 and the Risk Transformation (Tax) Regulations), came into force in early December 2017, are intended to provide a safe and robust corporate structure for the ISPVs and favourable tax rules on the ILS transactions to grow the ILS market in UK.

The Economic Secretary to the Treasury Stephen Barclay was quoted as saying that *"…By bringing Insurance Linked Securities deals to the UK, not only can we open up a valuable new market, but we can also ensure its world-class regulation, bringing benefits to the economy, UK businesses, and consumers."*

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