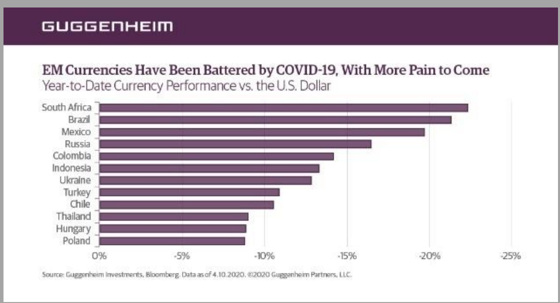
Why the ILS Market is Perfectly Positioned to Save Emerging Markets.

Toby Pughe ACII

In the wake of COVID-19 economies around the world are on the brink of collapse. According to the IMF, global GDP is expected to shrink by around 3% in 2020 and the United States alone is expected to rack up a deficit running into the trillions. However, developed countries like the US find themselves in a somewhat comfortable position when compared to their peers in emerging markets. They can drop helicopter money with relatively little consequence and have the cushion of the US dollar being the global reserve currency[1]. Nevertheless, emerging markets don't have this luxury, with monetary and fiscal solutions likely to weaken their currencies even further, making the already short supply of US dollars even harder to come by.

Let's say a country or business pays its creditors in USD, what happens when they can't get hold of dollars to pay their debts or the spread between their currency and the USD skyrockets? Suddenly they're unable to meet their obligations and begin to default on their debt. But what does this have to do with the ILS market and natural disasters?



[1] https://www.investopedia.com/articles/forex-currencies/092316/how-us-dollar-became-worlds-reserve-currency.asp

Problems with Traditional Insurance

I would argue traditional methods of insurance aren't suitable for natural catastrophe risk in emerging markets. After an event, transportation links can be down for months, therefore, making it near on impossible to settle claims. Moreover, the likelihood of litigation and public adjuster involvement only inflates the final figure further. It can take months if not years for those suffering to receive payment. It's the modern-day equivalent of British insurers putting gold bars on a ship and sending them to San Francisco to settle claims after the 1906 earthquake. By the time a claim is settled, it's often too little too late.

Why emerging markets need ILS

Figure 3 shows a natural disaster vulnerability index and illustrates the most vulnerable regions are often the poorest. If these countries were to default on their debts, thus reducing their sovereign credit rating, what happens when a devastating earthquake or cyclone strikes? With an already depleted economy and inability to borrow capital, how do they survive let alone rebuild? The secondary impacts would be catastrophic, unemployment rates rise, the economic outlook becomes bleak, and poverty rates increase. It's everyday people that will suffer in the year ahead regardless of natural disasters, but if one were to strike, which in certain regions is inevitable, the consequences will be devastating.

ILS can help to alleviate these problems. A catastrophe bond with a parametric trigger, for example, can help combat the main problem emerging markets face post natural disaster, liquidity to pay for emergency food, water, and housing. Parametric instruments are objective and are derived from an independent index, i.e. the policy either hits the *strike* or it doesn't. This results in fast claims settlement, as seen with the Caribbean Catastrophe Risk Insurance Facility (CCRIF) and Pacific Alliance catastrophe bonds, which have paid out around $140m and $150m respectively to date, all within 14 days of the disaster. As blockchains evolve, parametric triggers can be integrated into the payment methods and claims could be settled in seconds.

Criticisms of the ILS market often include high transaction costs and the requirement for large deal sizes for them to make financial sense, so on the surface, ILS doesn't look like a suitable solution for cash-strapped emerging markets. However, past transactions have shown how effective ILS can be. Take the CCRIF and Pacific Alliance transactions as an example. By pooling the risk of multiple countries around Latin America, they were able to benefit from economies of scale making the product more affordable for members and big enough to entice investors (see below figure). Dominica is a CCRIF member and is the perfect example of how advantageous ILS can be to emerging markets. After Hurricane Maria, they suffered damage totalling 224% of their annual GDP but received a near 10% of GDP capital injection within 14 days of the event, which helped them with the immediate issues mentioned above.

CCRIF	
Issuer	World Bank
No. of Members	16
Type	Catastrophe Bond
Trigger	Parametric Modelled Loss
Perils Covered	Earthquake and Hurricane
Size	$30m
Coupon	LIBOR + 6.3-6.5%

Pacific Alliance	
Issuer	World Bank
Beneficiaries	Chile, Colombia, Mexico, Peru
Type	Catastrophe Bond
Trigger	Parametric Modelled Loss
Perils Covered	Earthquake
Size	$1.36bn ($2.5bn orders)
Coupon	LIBOR + 2.5-8.25%

Furthermore, COVID-19 has brought global trade to a halt and countries like Dominica rely heavily on exports to drive their economy, with exports of goods and services as a percentage of GDP at around 43%[2]. Imagine what the loss to GDP would be if a hurricane akin to Maria went through the Caribbean later this year. These regions are already suffering massive GDP hits because of COVID-19, another disaster on top of this would have devastating long-term implications.

Investor appetite

Investors typically only allocate a small percentage of their portfolio to ILS and the market saw redemptions during the *dash for cash* in 2008, so questions around the volatility of the market would be understandable. However, the typical ILS investor has evolved since 2008, with pension funds, who take a longer-term view to risk, now dominating the investor pool[3].

In a time where risk parity turned out to be more risk than parity, it has left investors looking for a truly uncorrelated, less volatile basket of risks. ILS and weather risk offer both. Sure, there are still hurdles to overcome, the cat bond market isn't as liquid and there are still concerns over trapped collateral, but with the volatility in the capital markets at an all-time high the ILS market offers welcome diversification and yields.

To entice investors further, developed nations and multilaterals need to incentivise investors to purchase ILS, perhaps classing certain instruments as Environmental, Social, and Governance (ESG) approved. This would bring more capital to the market and allow regions to transfer more of their risk away from their balance sheet to investors.

The year ahead

What will the markets look like in the coming year? Will we see a V shape recovery, or will we see a lightning bolt recovery, the panic phase, the hope phase, and then the insolvency phase? It's during this final stage that people, businesses, and governments begin to suffer the most. It's at this point their vulnerability to natural disasters is at its highest. Now you're probably asking, how are these countries going to pay insurance premiums if they are defaulting on their debts and their surplus capital, if any, is razor thin? This is where the World Bank et al. can play their part, to continue to subsidise deals for the most vulnerable through the structuring of regional risk pools. Moreover, it's the role of the ILS market to ensure innovative products are readily available, bespoke, and affordable.

Final thoughts

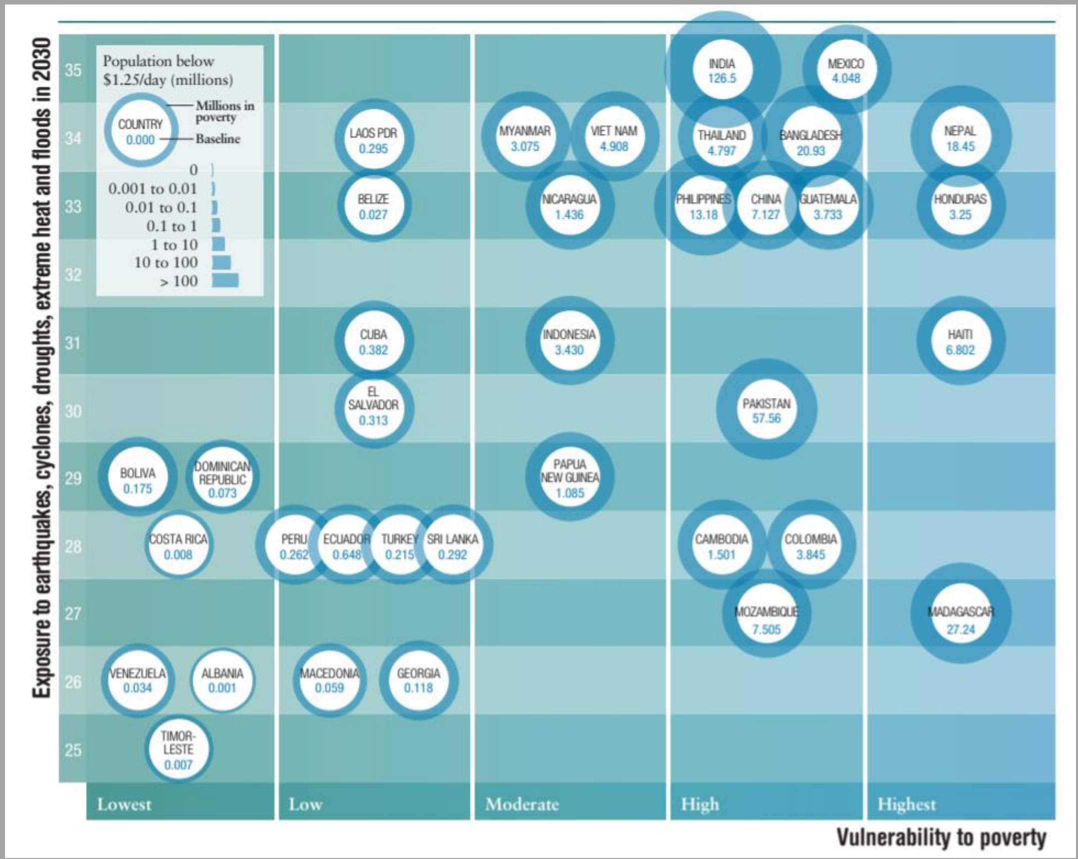
The ILS market should embrace market volatility and use it as an opportunity to soak up capital from distressed markets. The demand is there on both sides, investors want diversification, and sovereigns need protection from natural disasters in a time where fiscal budgets and domestic economies are on the brink of collapse. The World Bank, among other organisations, needs to help subsidise deals or risk seeing mass devastation throughout emerging markets. One thing is for certain, we're living in unprecedented times and the year ahead will be different from anything we have seen before.

[2] https://www.theglobaleconomy.com/rankings/exports/

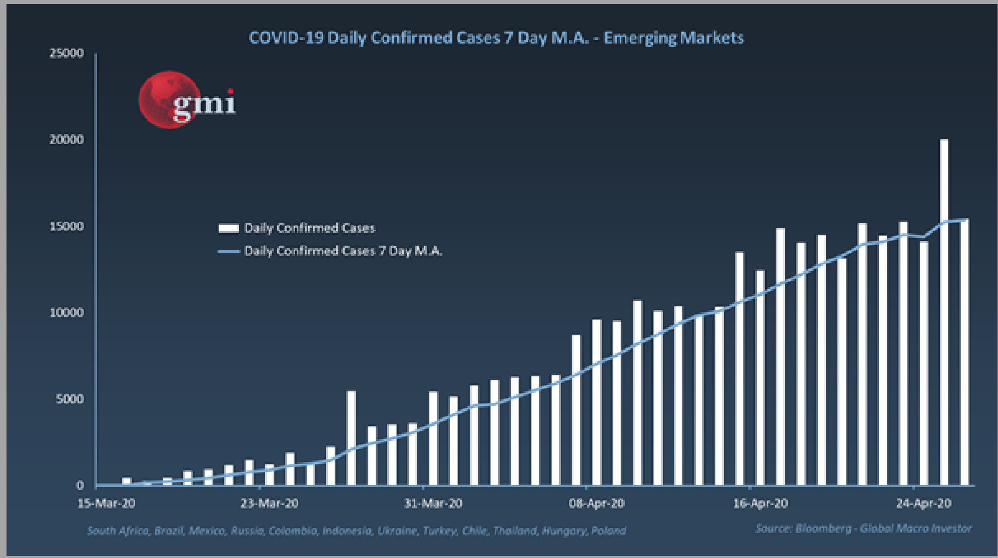
[3] https://www.artemis.bm/news/artemis-live-interview-with-frank-majors-nephila-capital/

Vulnerability Index

Figure 3 shows the projected poverty levels in 2030 for countries who ranked highest in the multi-hazard index.
(See odi.org)



COVID-19 Active Cases in Emerging Markets
(as at 27.04.2020)



Volatility Index (CBOE)

The VIX represents the markets expectation of 30-day forward looking volatility.