Back to ILS basics

Twelve Capital's Florian Steiger – cat bond strategy lead and member of the firm's group management committee – believes fully funded ILS structures are the best way for investors to access the sector

What questions do you currently get asked most often by investors?

The most frequent discussion is around why cat bonds have done so well, unlike quite a few private ILS deals which generated losses. My take is very simple – cat bonds are structurally more appropriate for most investors compared to many other ILS products.

It starts with the tenure – cat bonds might get trapped, but you've had two to three years of premium before that point. If you have a high-risk private ILS product you typically earn premium for a maximum of one year and you have a higher risk of getting trapped for another three years.

That's essentially what has happened frequently in the past five years. ILS managers dealing with trapped capital either need to accept deploying less capital, use fronting or invest into riskier deals to try to maintain returns. The range of performance outcomes from various private ILS strategies has consequently been quite large in recent years.

Do you see fronting as a solution to the trapped collateral problem?

If you have a fronting solution, you need to have a diversified business [to secure leverage]. That requires you to invest in risk which is often not that well modelled and not that well paid. We at Twelve Capital don't want to be in competition with rated reinsurers for that business. We believe fully funded is the sweet spot for ILS product from an investor's perspective.

Do you think there is enough headroom for ILS growth in fully funded structures?

I think there is, yes. The cat bond market has grown significantly in the past years using these structures. Insurance regulation is getting stricter and the need for reinsurance is getting bigger every day, the entire industry is growing.

Does Twelve have any aspirations to run a rated reinsurance balance sheet?

Unlike many cat bond portfolio managers, I do not have a reinsurance background. I always find it interesting culturally when I speak to a reinsurance person how even the language is different.

When they speak of a "buyer", they are referring to the "buyer of protection", when I (or must cat bond fund clients) speak about "the buyer", we are talking about the investor. In the end, a company which is active in ILS needs at some point to decide who is their client. Is it the investor, or is it whoever obtains protection? Do you want to mimic the balance sheet of a reinsurer or be an asset manager?

For us the answer is crystal clear, we want to be an asset manager and our client is the investor. Everything is structured around their needs.

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How are investors assessing the relative value of cat bond and private ILS strategies?

Investors are not particularly focussing on cat bond spread compression – they're looking at the losses and perceived underperformance they've endured over the past four to five years [from the private ILS space] and people are still exiting that business. In peak perils, cat bond spreads are still quite high and certainly of interest for investors.

Most of them are quite happy to give up a bit of premium for the structural benefits and liquidity. The consequence for us has been substantial inflows into our Twelve Cat Bond UCITS Strategy – it's almost doubled in size during 2021.

How has the investor base developed in recent years?

ILS was a pension-fund asset class initially, but in the past few years it has become open to everyone – single family offices, private banks, fund of funds. It's still institutional-only, but pretty much everybody is looking at cat bonds now.

How do you assess the relative value of pure liquid cat bond strategies as opposed to purely private strategies?

Our philosophy is that cat bonds should be the core of an ILS investment. You could complement this with private ILS deals – we particularly like the retro space these days – to create "cat bond plus" strategies with higher return profiles.

Twelve Capital has brought a new minority shareholder, Swiss bank GKB, on board recently. How will this impact the firm?

On a day-to-day level, there will be no difference in our operations. The strategic investment brings stability to our shareholder base and, together with GKB, we can continue to pursue our growth objectives.

How do you manage exposure to secondary perils?

In the past we've been trying to avoid them outright but our stance might become more nuanced in the future. It's not as obvious to say "no" as it was five years ago as now the models are getting better and spreads are hugely higher. There could be a point where it becomes interesting again, simply due to much better economics compared to recent years.