Sidecars: capitalising on market cycles to improve client solutions

Following US hurricanes Katrina, Rita and Wilma in 2005 and the ensuing "hard" property catastrophe reinsurance market, reinsurers and investors increasingly started turning to sidecar insurance linked securities (ILS) to access new and replacement capacity.

Rather than simply launching new reinsurance startups with fresh balance sheets to take advantage of rising reinsurance prices as was done after Hurricane Andrew (1991) and the World Trade Center attack (2001), investors more frequently opted to partner with existing reinsurers in sidecar structures.

These vehicles allow investors to access a purer form of the non-correlating natural catastrophe risk they seek without the market, operating and execution risks associated with a direct investment in a startup reinsurer while augmenting the sponsor's capacity to empower more robust product offerings.

Furthermore, because sidecars typically have a limited term, they theoretically offer both investors and sponsors a structure that can capitalise on a rate opportunity in a constrained capacity environment and may avoid contributing to an eventual rate decline due to an excess of "permanent" capital.

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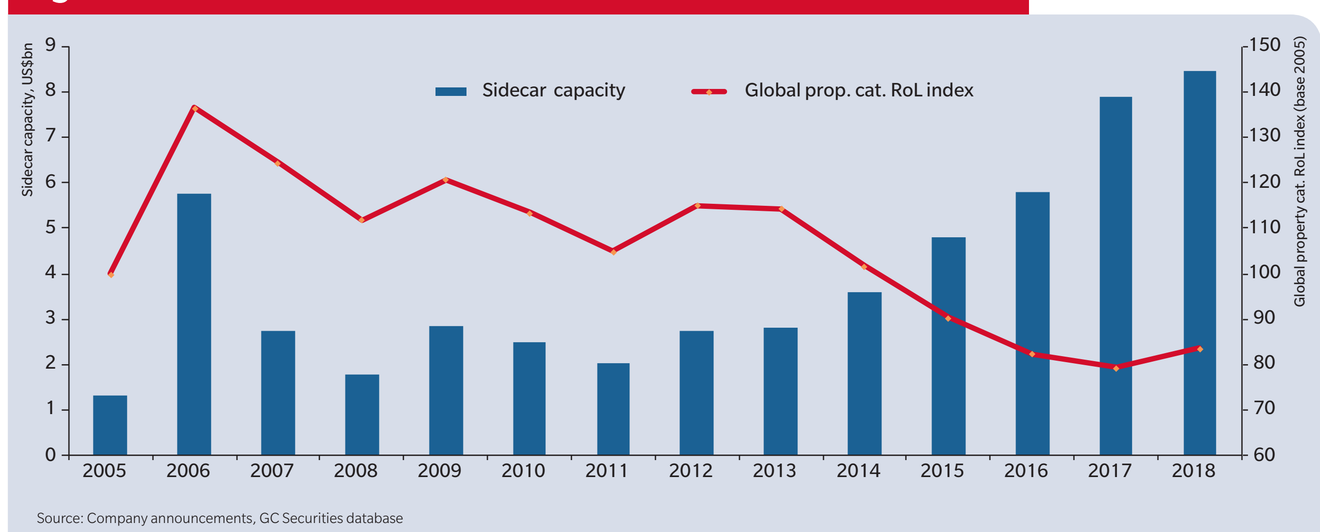
As evidenced by the growth of the space in recent years, sidecars potentially allow sponsors to more effectively manage underwriting cycles. In "soft" markets, the lower cost of this capacity allows the sponsor to meet the needs of, and retain, core clients.

In "hardening" markets, sidecar relationships allow sponsors to be nimble and take advantage of profitable growth opportunities. Sidecars help sponsors increase scale and offer more meaningful solutions to their clients while still managing net exposures and, though not typically the primary motivation, generating additional fee income for managing the third party capital.

A sidecar allows sponsors to leverage

Figure 1: Evolution of the sidecar market



Source: Company announcements, GC Securities database

convergence ILS capacity in their own underwriting rather than competing with it, and their limited duration allows both sides to periodically adjust to then prevailing market conditions.

A sidecar operates as a simple special purpose reinsurance company that writes an aggregate capped quota share arrangement on a targeted portion of the sponsoring (re)insurer's book.

The sidecar issues preference shares or participating notes to investors, and the proceeds are placed in trust to collateralise the quota share obligation, allowing the investor to "rent" the sponsor's distribution network, underwriting and risk modelling capabilities, claims adjusting expertise and policy administration services.

The investor pays the sponsor an "override" (effectively a commission for the services provided in originating and managing the business ceded) and a variable profit share on the subject business.

The majority of the sidecar market, like the broader ILS space in general, remains focused on peak peril reinsurance risk. This mirrors investors' attraction to the diversification of natural perils as an asset class.

However, the market is open to expanding the subject business for sidecars, and GC Securities has deep experience with these vehicles and other lines of business such as primary insurance risk, crop and specialty lines including aviation and marine and energy.

Following the historic catastrophe losses of the last two years, investors looking for more direct access to original risks can benefit from the quota share arrangement of a sidecar, which allows the investor to share in the profitability (and potentially the loss) produced by the subject book. The cap on the quota share defines the investors' maximum potential loss and provides some economic leverage to the investor, though consideration is often given for the sponsor taking back the tail of the risk distribution.

As Figure 1 shows, sponsorship of sidecars has continued since the mid-2000s, and accelerated somewhat starting in 2014 as the prolonged soft market caused reinsurers to search for greater return on equity.

Since that time, 16 sponsors have established at least 18 new sidecar or fund platforms, and overall the space has more than doubled in size from approximately US$4 billion to approximately US$8.5 billion in deployable capital.

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While sidecar partnerships are intended to be enduring, the underlying reinsurance is still typically a one year contract, and each year these segregated account companies need to establish a new cell account and collateral arrangement to support the new contract[1].

The majority of the funding comes from unencumbered collateral rolling out of prior year accounts. When the portfolio is relatively loss free, the process is straightforward and there is ample collateral available for redeployment.

However, if there are large losses, and especially if these losses come near the end of the contract year, the picture becomes more complicated.

This is the scenario we saw for the January 2019 renewals. Continuing development of 2017 losses combined with US and Japanese windstorm losses in the third quarter and another season of significant wildfire losses in the fourth quarter left sponsors struggling to calculate what collateral from 2017 and 2018 they needed to hold onto.

As a result, questions around available capital persisted late into renewals. The picture was further complicated by redemptions some investors faced after two consecutive years of disappointing performance.

The calendar was crowded with at least 11 renewing sidecars as well as at least six new opportunities. As renewals unfolded, investors prioritised funding existing relationships over new entrants, and some sidecars renewed smaller than their sponsors intended and a few new sidecars were postponed.

The complex market environment for 2019 placements highlighted the importance of flexibility, creativity and a willingness to compromise from sponsors, investors and intermediaries. It also provided another reminder that the balance between strategic capital partners and reinsurer panel diversity should always be considered.

Guy Carpenter's skill set and presence as a market leader for structuring and placing sidecars provides a valuable capital tool that gives sponsors greater control of risk transfer terms and conditions while still aligning with investors through greater access to underwriting practices, client relationships and distribution, creating mutually beneficial and sustainable long-term capacity and investment opportunities for all market participants.

Guy Carpenter's expertise and involvement across the entire strategy and spectrum of risk products also helps ensure that the sidecar fits seamlessly into the sponsor's franchise and overall risk management strategy.

Endnote

1 In some instances, particularly for renewals of in-force transactions, existing cells and trust accounts can be amended to support ongoing transactions.

Geoffrey Sweitzer, Managing Director, GC Securities