WCMA Interview: Morton Lane

Morton Lane is President of Lane Financial LLC

1) How did you get involved in the ILS space?

At the end of 1992 The Chicago Board of Trade first introduced derivatives on catastrophes. The contracts had been suggested by Richard Sandor and were approved by the CFTC and listed by the CBoT in December 1992, four months after Hurricane Andrew. The CFTC approval was for futures and options, and futures were the first to be listed. The contracts languished and did not trade very much at all. As it happens a climbing friend of mine (Pat Arbor) was elected as Chairman of the Exchange around that time and he asked me to get involved. I held a seat at the Exchange and acted as the Chair of the Catastrophic Insurance Task Force.

Essentially the Task Force did three things in the next few years. First we shifted the emphasis from futures to options spreads, which were more akin to excess of loss insurance. That first wind season in 1993 I twisted arms of “local” trader friends to put on spread positions and thereby generated open interest. Second, we shifted from an ISO-based contract to a PCS-based contract. Thirdly we (members and staff of the Exchange) did a whole lot of proselytizing about “cat options”.

2) How have things played out over time relative to your expectations at the inception of ILS solutions?

My expectation when I got involved was that insurance derivatives would take off as trading and hedging instruments for insurance companies as fast as interest futures and options had taken off in the banking industry. I had been involved in the introduction of interest futures and options to banks all over the world for the previous 15 years where we had gone from curiosity to essential instruments of risk management. I thought cat options would be adopted in half the time; instead it took almost double the time. We did not allow for the native conservatism of the insurance industry.

Nevertheless, that “cat options” period was an essential building block for the ILS industry. Among the earliest adopters and traders of cat options were Frank Majors and Greg Hagood, then at Willis and now industry leaders via Nephila. I met them and many of my current contacts in the industry as clients and prospects during this period.

The shift from exchange traded products to insurance linked securities happened because we were all very successful at selling the “alternative” message; we were less successful in showing that exchange economics could work for all concerned. Insurance brokers saw both the potential, and the threat. They formed capital market units (and I personally formed a joint venture with Sedgwick called Sedgwick Lane). Several small securitizations took place in the mid-nineties including several that we did with Darren Redhead, then at Reliance and now a leader at Lancashire. The ultimate “proof of concept” was provided with the $480 million issue of Residential Re sponsored by USAA in 1997. After that it has been “onward and upward” to today’s acceptance by nearly all concerned.

3) To get real specific, do you find the FINRA TRACE disclosure on certain ILS trades helpful? Also, did you expect that modeling would ultimately prove more important to investors than ratings?

The release of TRACE data is both helpful and intriguing. Prior to this event ILS valuation was largely based on quote sheet “price indications”, often from dealers who issued the securities in the first place and none of which was directly actionable. TRACE releases provide a check that helps gauge the price because it reports actual transactions, presumably between willing buyer and willing seller. TRACE releases will not solve all the problems; they just give additional helpful insights into a vexing issue - valuation. Exactly how we use the data is the intriguing part of my answer; there will still be an element of “art” to ILS secondary market pricing.

To some extent the rating was always redundant, if all ILS were structured the same and if they all had identical credit risk. At present nearly all ILS have equal credit risk (US Treasuries) and structure (Reg 114 Trust or similar) so it is not surprising see the rating as an unnecessary expense. But come the day that some ILS diverge and start to give LIBOR on collateral or invent looser structures, and it surely will come, that is when a rating will be valuable - provided they can detect the shift.

(continued on following page)
4) Where do you expect growth in ILS markets to originate from? Cat bonds, collateralized reinsurance, new products, etc?

Answer - all of the above plus geography, by which I mean the expansion of cedants from Asian and other emerging countries. I have learned that the obvious directions, e.g. auto, casualty, etc. require compelling economics for all concerned, not just clever ideas. One thing I do expect is that as we move into new areas we will see a resurgence of “modeled loss” ILS.

5) What would you like to see change going forward if you could wave a magic wand?

I am not a huge supporter of regulation but I do see virtue in some “standardization” and “best practice” conversations on the part of the industry itself. One example concerns valuation of NAV in hedge funds. Is every one using the same methodology - probably not? Is everyone marking-to-market, marking-to-model, seasonally adjusting or simply accreting linearly in their valuations? Is the practice consistent by instrument? At an even more minor level is everyone quoting secondary yields the same way? There are several ways to calculating discount margins, what should the standard method be? Ditto return calculations.

6) What will happen to ILS prices as, and if, US interest rates rise?

They will rise in concert, but not linearly. We periodically look at regression models for explaining what drives ILS prices (or equivalently, premiums). It is not a precise science but it is helpful to our understanding. The last time we did this was after the first quarter of 2014 and one of the leading results was that the market seems to start its pricing by looking at the competitive markets for investor funds - corporate bonds. Interestingly the best fit involved the spread between high yield and investment grade interest rates. (We use the FINRA-Bloomberg indices reported on TRACE.) The spread has widened out in the last month or so. We expect that to affect investor enthusiasm for ILS.

7) What does the ILS (or more completely the whole insurance alternative risk transfer market) portend for the structure of insurance / reinsurance going forward?

There are a couple of observations that can be made. First, it is striking to me that the current soft market (now three years old) has not until very recently brought forth traditional responses to soft markets - consolidation. Instead of mergers and acquisitions we have had sidecars and securitizations. This is a distinctly different response, protecting the balance sheet in contrast to joining balance sheets. Maybe this time round things are going to be different?

On the other hand, as reported in The Insider, we have seen at least one company, RenaissanceRe begin to plow the opposite path. This is interesting too. Back in the day in the earlier 1990’s there was a school of thought that a standalone catastrophe reinsurer was not viable or sustainable. Catastrophe reinsurance formally resided within a generalized reinsurer. RenRe (and others) was started as refutation of that argument and they have been extraordinarily successful. For a long time they only underwrote cat and were they very innovative, producing the first and arguably longest surviving sidecars. Now they are acquiring Platinum essentially diversifying into casualty and specialty lines. (They have been growing the line for a while but this action cements it.) The question provoked by their action is, is the former argument “standalone cat is not viable or sustainable” being resurrected by the former revolutionaries. We will see - RenRe is very smart - perhaps the adage “all revolutions eat their children” is true after all.

Note: Morton Lane is the President of Lane Financial LLC, and is not affiliated with Willis Capital Markets & Advisory or its affiliates. The views expressed herein by Mr. Lane are his personally and do not reflect the views of Willis Capital Markets & Advisory or its affiliates.