ILS: Pricing Extreme Events in a Changing World

February 2025

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Executive summary

- Investing in insurance-linked securities (ILS) provides returns largely uncorrelated with broader financial markets, as risks are primarily driven by the occurrence of natural disasters.
- Globally the insurance protection gap remains high, highlighting the need for greater risk transfer capacity. As climate change amplifies extreme weather events, demand for both traditional (re)insurance and ILS is expected to grow.
- Catastrophe modelling has evolved significantly since its inception in the late 1980s, with the current generation of models capable of addressing the dynamic risk landscape arising from climate change and rapidly developing exposures.
- Twelve Securis leverages deep analytical expertise, proprietary risk insights, and a dynamic approach to catastrophe modelling. By refining model outputs, integrating real-world climate and exposure trends, and critically assessing data quality, we construct resilient, high-conviction portfolios.

What are Insurance-Linked Securities

ILS are investments tied to insurance-related, non-financial risks such as natural disasters. They offer investors a source of returns that is largely uncorrelated with broader financial markets – a stock market crash does not make the occurrence of an earthquake in California, a storm in Europe, or a Typhoon in Japan any more or less likely.

ILS can take various forms, depending on the party transferring the risk (the cedant) – which could be a (re)insurer, a corporation, or a government – and the structure of the transfer, which can range from proportional to non-proportional. For a (re)insurer, ILS serve as a form of capital relief and/or a risk management tool to reduce volatility in underwriting results. For a corporation, ILS serve mainly as a risk management tool, for a government, ILS can protect budgets and cover the cost of responding to disasters. Typically, ILS represent an integral element of a disaster risk management strategy or a core part of an insurance or reinsurance company's strategy.

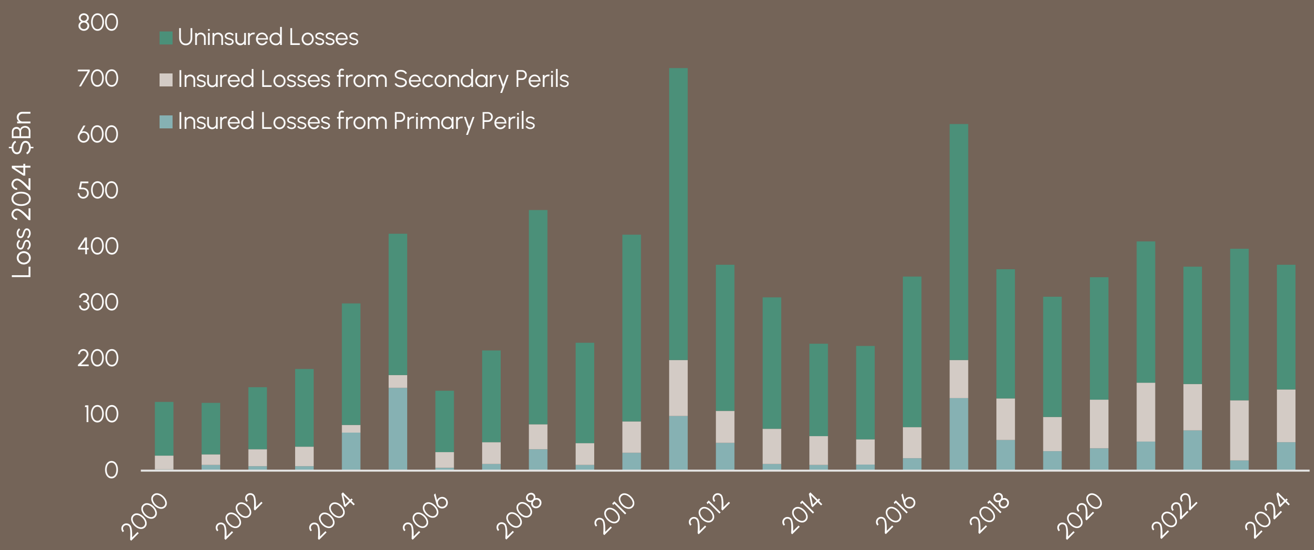
ILS has traditionally focussed on natural perils, specifically providing protection against so called primary or 'peak perils' – low-frequency, high severity events such as hurricanes and earthquakes. These perils are characterised by severe impacts over a large geographic area with high insured values and significant correlation across the extent of the event. However, secondary or 'frequency' perils such as convective storms, wildfires and floods have driven an increasing proportion of the total economic burden of natural disasters, particularly across the US. These perils are characterised by much more localised geographic impacts, but a much higher frequency across national or sub-national scales. As a result, cedents are increasingly seeking protection from these smaller scale but recurrent events.

While the burden of these secondary perils continues to grow, a significant part of the world's catastrophe losses remains uninsured. Figure 1 shows the estimated global disaster losses, both un-insured and insured. On average, over the last 25 years, over 70% of losses have gone uninsured. The scale of this insurance protection gap, in a world of rising and increasingly interconnected risks, highlights the ever-increasing need for insurance, and consequently the potential for growth of ILS strategies as a partner to traditional (re)insurance markets. Most industries rely on insurance in some form to carry out their business, homeowners and households rely on insurance to access mortgages and to ensure the necessary funds in the aftermath of a crisis. Globally, mechanisms to raise capacity for effective climate change-related planning and management are increasingly seen as critical, with insurance being seen as the front-line and a primary contributor to achieving the United Nations' Sustainable Development Goals.

> Over **70%** of global disaster losses have gone **uninsured** over the **past 25 years.**

Figure 1: Global Insured and Uninsured Losses 2000-2024

Source: Twelve Securis, Aon Climate and Catastrophe Insights 2025. All figures are in USD 2024 billion.



How to price extreme insurance risk

Within this context of increasing demand and escalating impacts, it is vital for investors and fund managers across the spectrum of ILS to achieve an acceptable balance between risk and return. Traditional financial market relies on continuous price discovery and frequent trading, which help refine risk assessments over time. However, this approach does not translate directly to ILS, where the distribution of potential outcomes is fundamentally different. Severe natural catastrophe events occur infrequently and with significant variability, while a changing climate (both human-induced and natural variations), population growth, inflation, changes in reconstruction costs, and developing infrastructure, lead to a dynamic and continuous evolution of the risk.

To address these challenges, a specific analytical framework has evolved. Led by the development of commercial catastrophe loss ('Cat') models in the late 1980s, catastrophe risk modelling has underpinned the analytics of property catastrophe insurance for over 40 years. These models are designed to address two key issues in pricing 'cat' risk. Historic experience is simply too short to reliably inform the risk of rare extreme events, and the correlation of impacts across large geographic areas requires spatially resolved models to manage a portfolio of risks.

By combining physical models of the hazard events (borrowing from disciplines such as meteorology, climatology and weather forecasting communities), with engineering and building vulnerabilities, as well as robust statistics of extremes, synthetic event sets representing many 10 or 100s of 1,000s of years of realistic, spatially resolved events and associated damages can be generated which address both these issues.

Figure 2 shows a simplified schematic of the key components of a Cat model. Figure 3 highlights the value of this framework, expanding our view of risk backward to give a more comprehensive view of historic experience, but also forward to expand beyond observed events to include low probability events which have not been observed in the historic record.

Figure 2: Schematic Representation of a Catastrophe Loss Model
Source: Twelve Securis.

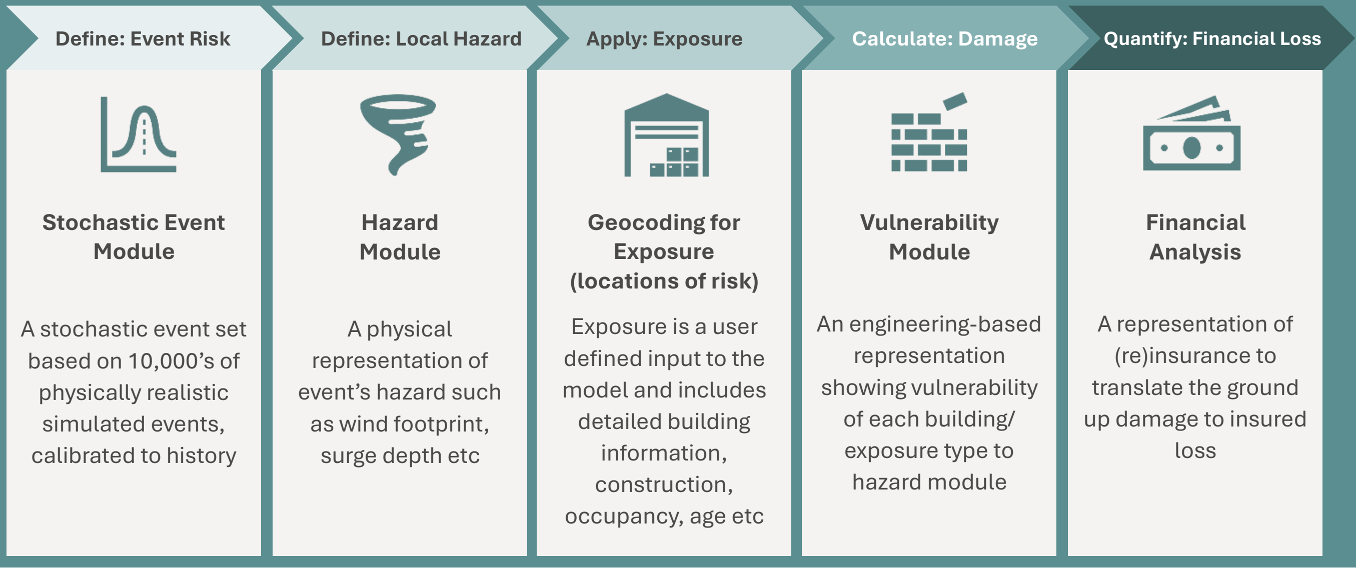


Figure 3: The Value of Catastrophe Loss Models: Reported Loss History to a Stochastic Representation of Risk
Source: Twelve Securis.

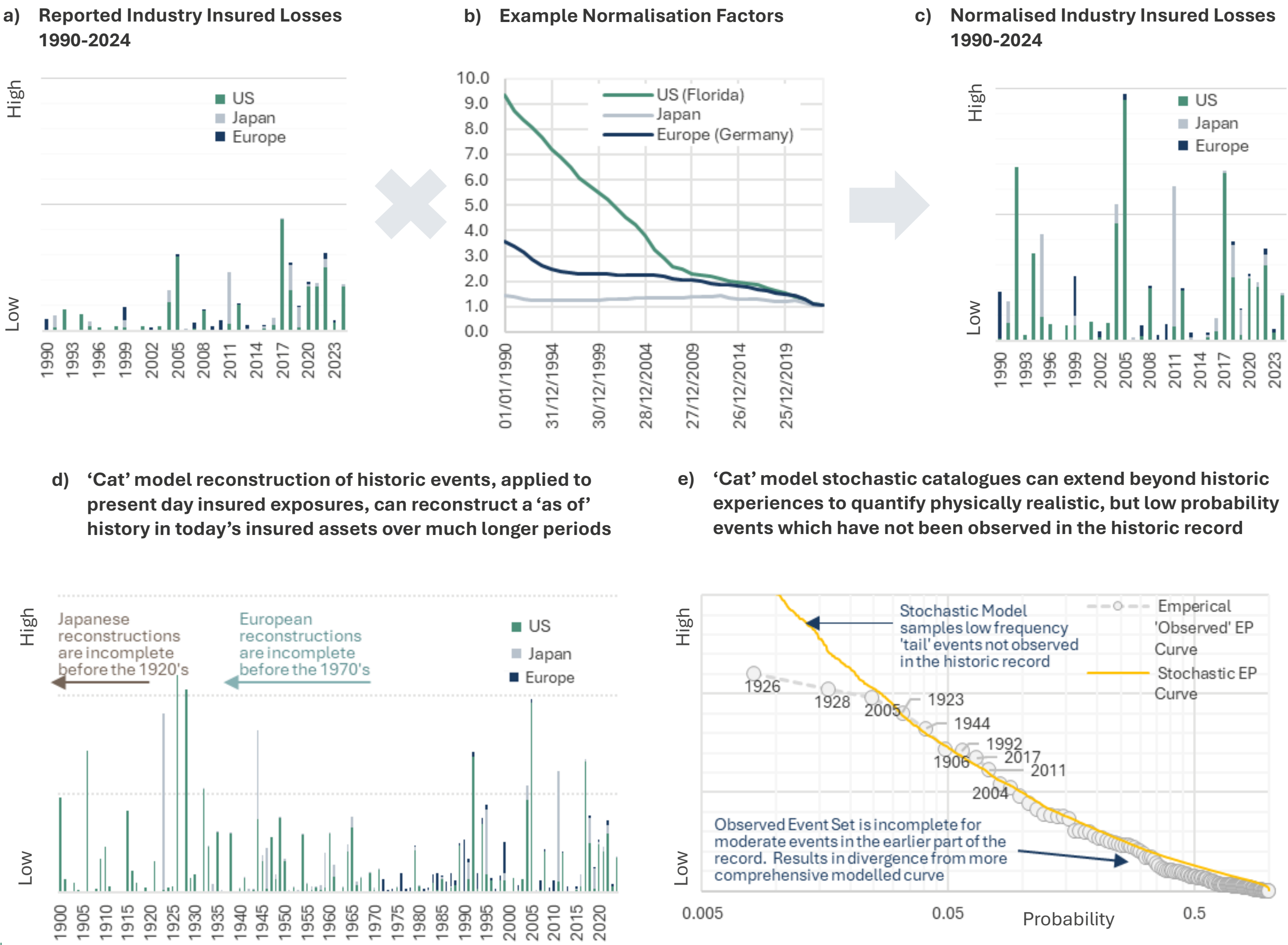


Figure 3a shows insured losses as reported for 'peak-perils' across the US, Europe and Japan. Figure 3b shows example normalisation factors that can be used to adjust reported losses to present day value. Normalisation will consider multiple factors; growth in building stock / housing units (or population as a proxy), inflation, and wealth. Application is typically differentiated by geography (country or state) and line of business (residential, commercial, auto). Figure 3c shows the normalised losses equivalent to losses that could be expected on present day exposure.

Figures 3d and 3e show how catastrophe loss models extend beyond reported losses. Figure 3d shows how modelled reconstructions of historic events, applied to present day vulnerabilities and exposures can extend our experience back well beyond the available records to provide a more comprehensive view of history. Figure 3e shows the exceedance probability curve output of a catastrophe loss model, overlaid with the empirical 'historic' curve to show how a modelled view expand beyond historic experience to quantify physically realistic, but low probability events which have not been observed in the historic record.

The adoption of these tools (as the optimal approach to assess and price natural catastrophe risk), is often credited to the devastating impacts, and subsequent insurance company insolvencies, which followed Hurricane Andrew and the Northridge Earthquake in 1992 and 1994. However, in reality, it was a much longer series of major global catastrophes in the late 1980s and early 1990s, following an unusually benign period in the late 1960's and 1970's that showed traditional approaches lacking and primed a market for the emergence of a new technology. Cat models are currently widely used by both ILS managers and traditional (re)insurance market participants.

Dynamic risk requires dynamic tools

2024 marks the 5th consecutive year with global insured losses from natural catastrophes exceeded USD 100bn. Perhaps more significantly, every year since 2017 has experienced insured losses above the 21st century average (see figure 1).

The influence of climate change on recent experience simply cannot be dismissed. The Intergovernmental Panel on Climate Change's (est. 1988) 6th assessment report is clear; "Evidence for measurable changes in climate due to greenhouse gas emissions is unquestionable". Critically, it is via the changing intensity and frequency of extreme weather events that climate change is most immediately affecting people, nature and the economy.

Table 1 outlines the expected impacts of climate change on extreme weather events.

> 2024 marks the **5th consecutive year** with global insured losses from natural catastrophes **exceeded $100bn.**[1]

Table 1: Impact of climate change on various natural perils
Source: Twelve Securis.

Hazard	Impact of Climate Change
Tropical Cyclones	High confidence in increased flood risk due to enhanced precipitation and rising sea levels amplifying storm surges. Higher confidence in increases storm intensity and the proportion of storms that reach strongest categories. Lower confidence in changes in overall storm frequency and other characteristics: forward speeds, size of storms, likelihood of rapid intensification.
Wildfires	High confidence in increasing severity of events when they occur due to rising temperature, and more volatile precipitation regimes with impact on vegetation conditions. Low confidence in changes to wind conditions or ignition events (which are often human caused).
Inland Flooding	High confidence of increasing flood risk due to increasing frequency of extreme rainfall albeit with significant regional variation.
Severe Convective Storms	Lower confidence in changes storm frequency and intensity across hail, tornado and derecho events, although there is a growing consensus that environmental conditions conducive to severe convective storms will become more likely.
Extra-Tropical Cyclones and Winter Storms	High confidence in increased flood risk due to enhanced precipitation and rising sea levels amplifying storm surges. Lower Confidence in changing frequency, intensity or shifts in storm tracks.

[1] Source: AON.

Looking back over the recent catastrophe events the signature of climate change is clear:

- More energy in the climate system – both ocean and atmosphere – has expanded the traditional storm seasons and geographies. In 2024 Hurricane Beryl became the easternmost and earliest-forming Category 5 storm on record. Rapidly intensifying storms, such as Hurricanes Milton and Helene in 2024 and Otis in 2023, continue to challenge the forecasting ability of warning centres worldwide. Altered environmental conditions have also fuelled severe convective storms, with tornados, hail- and thunder-storms across the continental US quietly accumulating over USD 50bn of insured losses in 2024, second only to 2023's record breaking USD 57bn.
- An enhanced hydrological cycle with a warmer atmosphere, capable of holding more moisture has led to devastating flooding. In 2024, major flood events struck Valencia in October, Central Europe in September, South East Asia following cyclone Yagi in September, the US following Hurricane Helene, Canada in July, South America in May and even Dubai in April.

Extreme event attribution, i.e. establishing how climate change has already influenced the intensity and likelihood of these extreme weather, is increasingly undertaken for a range of natural disasters having emerged as a discipline following the deadly European heatwave of 2003. Since 2004, over 600 studies have been conducted, revealing that 74% of the events were made more likely or severe due to climate change, compared to just 9% that were made less likely or severe.

This detailed, quantitative understanding of the impact of climate change on frequency and severity of natural catastrophes is essential for insurers and reinsurers to provide sustainable products that support people, livelihoods, and property reconstruction. Historic backwards-looking risk assessments are no longer sufficient for pricing catastrophe risk.

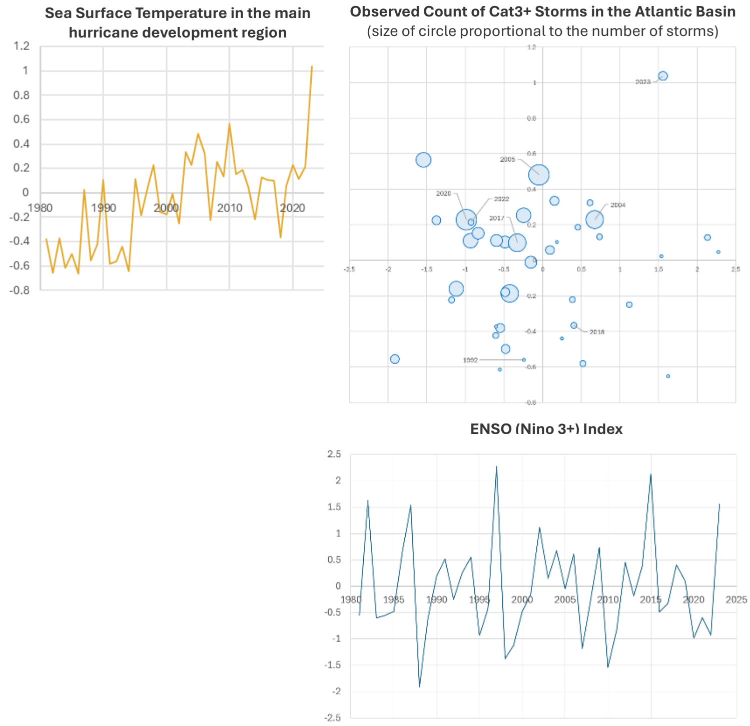
The first 'Cat' models to consider the longer-term variability and changes in our climate were introduced in response to the historic 2004 and 2005 Atlantic hurricane seasons. The severity of these seasons prompted the development of models that incorporated a forward-looking view of hurricane frequencies, as well as views conditioned on 'warm sea-surface' temperatures and phases of large-scale climate variability.

Over time, approaches to adjusting and conditioning 'Cat' models on near present or future climates have continued to evolve. Figure 4 shows how the observed variability in risk due to key physical drivers can be modelled with a stochastic framework. The latest generation of 'Cat' models are significantly more transparent and 'open' to flexible conditioning on various climate states, historic baselines, or specific states of natural variability, or future projections of climate change.

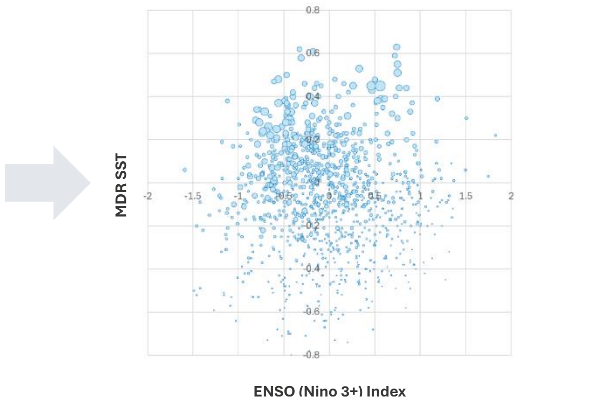
Figure 4: Climate Conditioned Catastrophe Loss Models

Source: Twelve Securis.

a) Observed influence of Sea Surface Temperature and El Nino Southern Oscillation on the count of Cat3+ Storms in the Atlantic Basin



b) Generating many 1000's of climate conditioned stochastic catalogues allows the observed sensitivity of these key drivers to be translated into risk relevant metrics such as the annual expected insurance losses.



Catastrophe Loss Models can increasingly be conditioned on specific states of the climate to capture the sensitivity to natural variability and the influence of a dynamic changing climate. Figure 4a shows how the variation in the two key physical drivers of Atlantic hurricane activity (ocean temperature in the Atlantic and the phase and amplitude of the El Nino Southern Oscillation) correlate with above average activity and higher risk of above average insurance losses. Figure 4b shows how by generating many 1000's realisation of climate conditioned stochastic catalogues allows the observed sensitivity of these key drivers to be translated into risk relevant metrics such as the annual expected insurance losses.

Beyond the impact of climate change

However, attributing the impacts of recent events purely to changes in climate, shifts in the physical characteristics of the hazard, is misleading. Catastrophe impacts are primarily a function of the exposure, which include the nature, behaviour and location of people, infrastructure and property. Vulnerability also plays a crucial role, as the ability of buildings to withstand the hazard directly influences the scale of destruction. When looking at insurance losses, additional factors come to play such as the financial terms of underlying policies, the level of litigiousness, and robustness of the insurance company's claims settlement processes.

Increases in exposure are recognised as the principal driver of increases in insurance losses over the past decades. The effects are however nuanced, and non-linear. Urban expansion can amplify the impact of smaller, localised, 'frequency' perils -such as severe thunderstorms, tornados, floods and wildfires- more than larger traditional 'peak' perils such as Hurricanes, which affect much broader areas.

Vulnerability also changes over time. Improvements in building code and enforcement strengthen homes and reduce risk, while aging building stock increases susceptibility to damage. Additionally, regions that have not experienced recent storms will typically be more vulnerable than those that have. Events such as Hurricane Ian in 2022 and Helene in 2024 have clearly demonstrated both the effects.

'Cat' model software and model design has however always fundamentally been designed to represent the present-day value and characteristics of assets. When used to analyse an insurance portfolio, these models rely on detailed schedule of assets, detailing not just the location of every building, but at a minimum, its value, occupancy and construction type and details of the relevant insurance terms. Further characteristics can refine the model's assessment of the risk, and provide vital information on the cost-benefit of mitigation measures to homeowners, communities and insurance providers, examples include:

- the height of the building - particularly relevant to geological perils and earthquakes.
- the year built and roof age - accounting for improvements in building codes as well as the deterioration of roofs older than expected lifespan of the material.
- the elevation above ground or presence of a basement - particularly relevant in coastal or flood exposed regions.
- the defensible space around the property - particularly relevant in regions at risk of wildfires.
- the presence of hurricane shutters or other protective measures - which can act to protect against projectiles and debris in hurricanes and other storms.

'Cat' models are designed to capture present day exposure characteristics far more precisely than relying on historic claims experience to price a future risk.

Complex models require deep expertise

Catastrophe loss models have become a widely used benchmark across the (re)insurance industry, including among regulators. The output of models provides a shared common framework of risk for risk transfer – establishing a baseline for adequate pricing. However, like all complex models, they have inherent limitations. A key function of an ILS fund manager is to possess the expertise needed to critically assess these models, understand their constraints, and stay ahead of scientific and societal developments that impact risk dynamics. This requires deep industry knowledge, the ability to interpret the latest climate research, and the skill to integrate these insights with model output.

At Twelve Securis we developed a proprietary View of Risk, a structured approach that refines and adapts standardised model outputs to reflect the evolving risk landscape and the specific characteristics of each transaction we analyse. Our methodology revolves around four areas.

Twelve Securis combines deep analytical expertise, proprietary risk insights, and a dynamic approach to catastrophe modelling.

Data validation

We conduct a rigorous assessment of the data provided by cedants, focusing on both its granularity and reliability. This involves identifying inconsistencies, trends, and deviations from previous submissions. Rather than accepting data at face value, we evaluate its relevance to each specific transaction. For instance, in a flood risk transaction, knowing whether properties have basements is far more critical than roof age. Additionally, the vintage of exposure data might be insufficient to adequately assess risks of cedants undergoing rapid growth or shifts in risk composition. In such cases, a deep understanding of portfolio evolution is essential to ensure model outputs remain valid. When data quality is poor and introduces significant uncertainty, we may adjust our assumptions or, in cases of low confidence, decline the transaction altogether.

Model-specific assessment

With multiple catastrophe model providers in the market, it is essential to understand the strengths and limitations of each. For example, certain models structurally underestimate losses in specific regions. We also recalibrate model outputs by benchmarking against recent event history and simulating new potential loss scenarios. Additionally, we assess how non-standard exposures – such as corporate risks with potential business interruption – are captured by models. Based on these evaluations, we apply appropriate loadings to model outputs or, in some cases, reject transactions altogether.

Climate and exposure dynamics

Understanding the interplay between climate change, population growth, and exposure shifts is fundamental. We regularly back test model outputs against actual catastrophe events – for instance, verifying whether a model's estimated return period for a given event aligns with historical occurrences. Our proprietary climate research allows us to develop independent views on the frequency and characteristics of catastrophic events in specific regions, which in turn informs portfolio construction and risk selection.

Non-quantitative factors

Beyond quantitative analysis, we ensure that model assumptions align with the legal framework and contractual specifics of each transaction. This involves a detailed review of key factors such as Loss Adjustment Expenses, peril definitions, and other contractual provisions, ensuring consistency between model outputs and actual policy terms. This process complements our in-depth legal due diligence, reinforcing the robustness of our risk assessment

In summary, **Twelve Securis** combines deep analytical expertise, proprietary risk insights, and a dynamic approach to catastrophe modelling. Our ability to refine standardised model outputs, incorporate real-world climate and exposure trends, and critically assess data quality enables us to construct resilient, high-conviction portfolios. By continuously challenging model assumptions and integrating the latest scientific advancements, we deliver a sophisticated, forward-looking approach to insurance-linked investments.

Risks associated with investments in ILS	
Concentration in one industry risk	When a portfolio is reliant on one industry or market segment (i.e., insurance industry), this creates concentration risk. Thus, it increases the likelihood that a single impact can have a big effect.
Event risk	Should an insured event occur and the defined threshold values be exceeded, then the value of a specific ILS instrument may decrease to the extent of a total loss.
Liquidity risk	Potentially situationally dependent, certain instruments may not be liquidated in a reasonable time frame.
Model risk	The calculated event probability of certain events is based on risk models. These only represent an approximation of reality and may be fraught with uncertainty and errors. Consequently, event risks can be significantly under- or over-estimated.
Valuation risk	Due to a wide variety of market factors, there is no guarantee that the value determined by the Administrator will represent the value that can be realised on the eventual disposition of the investment or that would, in fact, be realised upon an immediate disposition of the investment.

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