

Capital Market Risk Financing Plans as an Alternative to Catastrophe Reinsurance

Susan Kearney, CPCU, ARM, AU, AAI
American Institute for CPCU/Insurance Institute of America

In our January article on InsWorld.com, we provided an overview of catastrophe reinsurance and how the demand for it has continued to increase as a result of unprecedented costs associated with natural and man-made disasters over the past 15 years. Catastrophe reinsurance can be expensive after a single catastrophe or a series of catastrophes reduces the global reinsurance capacity, and these events cannot always be suitably addressed through traditional risk financing methods. Capital markets have emerged as tools that organizations can use to finance risk as an alternative to insurance. Instead of purchasing reinsurance to cover its potential liabilities, the insurer uses traded security instruments to finance insurance risk.

Capital market products for risk financing fall into the following categories:

- Insurance securitizations
- Insurance derivatives
- Contingent capital arrangements

An insurance securitization is a form of securitization that creates a marketable insurance-linked security based on the cash flows that arise from the transfer of insurable risks. These cash flows are similar to premium and loss payments under an insurance policy. Investors are attracted to the portfolio diversification aspect of insurance-linked securities, as they constitute a distinct asset class with risk that normally has a low correlation with that of other asset classes, such as traditional stocks and bonds. The insurance-linked securities issued to date have been mainly in the form of catastrophe bonds. Other insurance-linked risk transfer business includes reinsurance sidecars and collateralized debt obligations.

An insurance derivative is a financial contract whose value is based on the level of insurable losses that occur during a specific time period. An insurance derivative increases in value as specified insurable losses increase, and, therefore, the purchaser of the derivative can use this gain to offset its insurable losses. The buyer of an insurance derivative accepts insurable risk and receives a commensurate return for doing so. The value of an insurance derivative can be based on the level of insurable losses experienced by a single organization or on the level of an insurance industry index of insured losses. Financial contracts based on the insurance derivative concept include forward contracts, swaps, and insurance options.

A contingent capital arrangement is an agreement, entered into before losses occur, that enables an organization to raise cash by selling stock or issuing debt at prearranged terms after a loss occurs that exceeds a certain threshold. The entity that agrees to provide the contingent capital receives a commitment fee in exchange for its promise to reimburse the partner organization for its loss costs. Under a contingent capital arrangement, the organization does not transfer its risk of loss to investors. Instead, after a loss occurs, it receives a capital injection

in the form of debt or equity to help it pay for the loss. Because the terms of the capital injection are agreed upon in advance, the organization generally receives more favorable terms than it would receive if it were forced to raise capital after a large loss, when the organization is likely to be in a weakened financial condition. The major types of contingent capital arrangements are standby credit facilities, contingent surplus notes, and catastrophe equity put options.

Capital market risk financing plans allow organizations to access the capital markets to offset risks that insurance or reinsurance policies have traditionally covered. Theoretically, capital market products can be used to finance any type of insurable risk. However, insufficient underwriting data for some categories of risk and regulatory and accounting uncertainty associated with the use of capital market products have limited their market and capacity growth. Each type of capital market product involves a great deal of time and expense to implement. Most successfully implemented capital market products finance catastrophe risk. It is also important to note that the recent, unprecedented turmoil in our economic climate will make it increasingly difficult and expensive for insurers to access capital markets as an alternative way to finance insurance risk.

Susan Kearney, CPCU, ARM, AU, AAI, is senior director of knowledge resources for the American Institute for CPCU/Insurance Institute of America (the Institutes) in Malvern, Pa. She based this article on material published by the Institutes, independent, not-for-profit organizations offering educational programs, professional certification, and research to people who practice or have an interest in risk management and/or property-casualty insurance. The material in this article is covered in the Associate in Reinsurance (ARe) designation program, which is among the Institutes' numerous educational offerings. Ms. Kearney can be reached at kearney@cpcuia.org.

© 2009 American Institute for CPCU/Insurance Institute of America
www.aicpcu.org