

€61m-€81m The minimum viable size for a cat bond



Keep a cat in the bag

Angus Duncan and Robert Cannon consider why catastrophe bonds might be a viable alternative to traditional reinsurance for captives

Catastrophe bonds have become an increasingly significant aspect of the risk management strategies of insurers and reinsurers, even at a time where the reinsurance market for catastrophe risk has available capacity and pricing seems to be soft.

Cat bonds offer a number of advantages (see box below). These advantages are not only available to insurers and reinsurers but also to corporates looking to acquire protection against catastrophe risk. To date, only a handful of cat bonds have been sponsored by corporates. But many of the factors that have limited use of cat bonds by corporates do not apply in the case of captive insurers.

Cat bonds may be a viable alternative to traditional reinsurance for corporates with captive insurance programmes and developed risk management strategies, especially in the case of large and discrete catastrophe risks for which it is difficult and/or expensive to acquire protection.

The minimum viable size for a cat bond issuance is around \$75m-\$100m (€61m-€81m). A cat bond generally relates to only one or two specific perils relating to a small geographic area. The level of loss above which cover is provided by the cat bond needs to be set relatively high, as cat bond investors are prepared to assume relatively low risks of loss.

For many captives, the risks for which they require protection are sufficiently large, and the captives themselves are prepared to absorb losses up to a sufficiently high level.

The cat bonds sponsored by corporates to date have had parametric triggers, so that payment to the sponsor is based on the occurrence of a weather or geological event meeting a certain threshold, rather than on the actual loss to the sponsor as a result of the event.

In such case, the sponsor takes on a risk that the amount received under the cat bond may be less than its actual loss. This risk is referred to as 'basis risk' and can be modelled. Some corporates are not comfortable with any basis risk.

But captives tend to have more sophisticated risk management strategies and data collection systems, which facilitate the modelling of the actual loss that they will incur on the occurrence of a catastrophe event. The better this modelling, the more the parametric trigger used in the cat bond can be tailored, so that the amount

received on the cat bond by the captive matches the actual loss the captive incurs on the catastrophe event.

Cat bonds can be issued with indemnity triggers, so that payment to the sponsor is based on the actual loss incurred by it. Records of historic losses on the insured assets are important in being able to model a cat bond with an indemnity trigger and investors require such modelling before investing in such a cat bond.

The completeness and accuracy of data maintained by corporates in respect of their historic losses may be insufficient to allow for modelling to the extent required for a cat bond with an indemnity trigger.

Captives are subject to statutory obligations in relation to managing and modelling risk, including collation of data in respect of historic losses.

Therefore, issuance of cat bonds with indemnity triggers may be more feasible for captives than for corporates.

Insurance regulation can make it problematic for European corporates to sponsor cat bonds. Under EU insurance regulation, primary insurance, as distinct from reinsurance, can only be provided by authorised insurers and not by special purpose vehicles like a cat bond issuer.

But captives are regulated insurers and would be acquiring reinsurance, and not direct insurance, from the cat bond issuer, making it more straightforward for them to use cat bonds. ■

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ADVANTAGES OF CAT BONDS OVER TRADITIONAL REINSURANCE

- 1 Cat bonds access capacity from a source other than the traditional reinsurance market, which is not subject to the capacity constraints that periodically arise in the traditional reinsurance market.
- 2 They acquire protection for a period of generally three to four years, with premiums fixed for that period rather than the one-year renewals and associated fluctuation in premiums found in the traditional reinsurance market.
- 3 They decrease credit risk exposure to reinsurers, as obligations of the cat bond issuer are collateralised.

SOUNDBITES

“ It is definitely not an easy task to make a compelling case for setting up a captive today ”



Stefan Sigulla, president of DVS, the German insurance buyers' association

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“ I think over time more and more employee benefits will move into captives ”



Clive James, consultant at Kane Global

Could a new healthcare law in the USA spark the growth of employee benefits captives? Find out on page 22

“ Some captives were able to lose 15% of their investment portfolio and still not be in trouble with us ”



AM Best vice-president Steven Chirico explains how investment strategies can affect a captive's rating

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