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P/c sector must consider moving beyond cat bonds

KEN PIERCE, ELANA HAHN and GONYI AJAWIN consider some opportunities to increase property/casualty capacity

THIS article explores the scope for property/casualty (p/c) insurers' and reinsurers' use of insurance-linked products other than catastrophe bonds to manage their exposure to catastrophe risk while diversifying away from the traditional reinsurance marketplace.

When the market next hardens, whether as the result of catastrophes to come or other market-moving events, we foresee the rapid expansion of instruments and transaction structures such as sidecar reinsurers, industry loss warranties (ILWs) and catastrophe risk swaps in lieu of cat bonds and start-up reinsurers. This is owing to a number of relative advantages of these products as compared to cat bonds and start-up companies.

Continuing growth in insurance-linked products

Over the past 20 years, investors have shown growing acceptance of insurance-linked products. There has been a steady increase in specialised funds focusing on insurance-linked products, and in recent years multi-strategy hedge funds and pension funds have recruited experts in insurance linked risk to add this asset class to their broader portfolios.

Vjg"Łpcpekcn"etkuku"jcu"ugtxgf"vq" increase this demand because insurance-linked products held up relatively well. With some exceptions (in particular, where investor proceeds were invested in poor-performing assets), the solid performance of insurance linked products demonstrated empirically the very limited correlation between insurance risk cpf"vjg"ykfgt"Łpcpekcn"octmgvu0"

Sidecars' potential

Sidecars hold enormous potential for the market. We expect sidecars will drive the next wave of capital-raising for p/c insurers owing to present market fundamentals and the structural and trade execution advantages of the product.

From the insurer's perspective, sidecars provide quota-share reinsurance capacity and access to equity-type capital that is non-dilutive to shareholders. Indeed, because sidecar investors have a low cost structure and generally offer sponsoring insurers overtkfg"cpf"rtqŁv"eqo o kuukqp."vjg{" are an effective, potentially profitable and relatively low-risk method to leverage a insurer's franchise.

Because sidecars are typically fully collateralised up to the aggregate limit of reinsurance coverage, they do not expose the insurer to the credit risk of traditional reinsurers (which may be subject to the same catastrophe risks as the sponsoring insurer). Sidecars are łgzkdng"uvtwevwtgu"vjcv"ecp"dg" adapted to suit the needs of both sponsor and investor on a case-by-case basis.

Investors have a long memory and sidecar reinsurers, as a class, outperformed the class of reinsurers that started up after hurricane Katrina (*pictured*) in 2005 and 2006. Start-up reinsurers, like any new standalone company, require the complete panoply of infrastructure and management and their attendant costs, and lock up investors' capital in companies that may or may not ultimately be sold or trade in the public equity markets at a premium to book value.

By contrast, sidecars offer investors a focused "line of business" exposure at a very low cost because they are virtual companies with no full-time management, staff or infrastructure. Because sidecars are generally limited life

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