The ___________________________ monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. A list of archived Capital Markets Bureau Primers is available via the INDEX.

Insurance-Linked Securities Primer

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Executive Summary

- Insurance-linked securities (ILS) transfer specific insurance risks to investors from primary insurers
  - Catastrophe (cat) bonds are the largest category of ILS
- $40.5 billion ILS outstanding as of February 2020[1]
- Indemnity, prevalent trigger determining coverage

Background

In 1992, Hurricane Andrew became the second costliest natural catastrophe to ever hit the U.S. with insured damages of about $25 billion, according to the Insurance Information Institute. The claims payouts weakened many U.S. insurers, while others failed. The damage and resulting payouts from Hurricane Andrew led to the creation of an alternative risk transfer market (risk transfer).

Statement of Statutory Accounting Principles

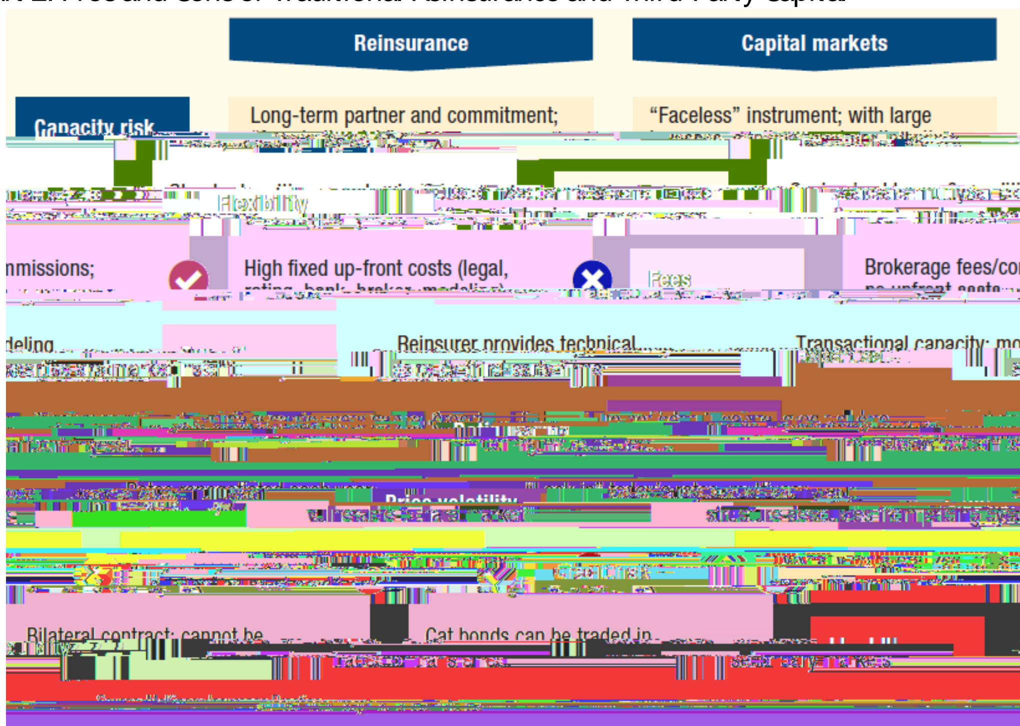
Through risk transfer, primary insurers can purchase protection from potential loss by transferring a specified risk to investors; cat bonds were the initial securities offered to investors. According to

insurance-linked securities (ILS) are securities whose performance is linked to the possible occurrence of pre-specified events that relate to insurance risks. While catastrophe bonds (cat bonds) may be the most well-known type of ILS, there are other non-cat-bond ILS, including those based on mortality rates, longevity and medical-claim costs. ILS may be used by an insurer, or any other risk-bearing entity, in addition to (or as an alternative to) the purchase of insurance or reinsurance. Note, however, that the statutory accounting treatment for an ILS is very different from reinsurance.

[1] The market data in this report is from www.artemis.bm, a news, analysis and data media service in the alternative risk transfer, catastrophe bond and insurance-linked security, non-traditional reinsurance, insurance-linked investments and associated risk transfer markets.

Since the financial crisis, and due in part to

Chart 2: Pros and Cons of Traditional Reinsurance and Third-Party Capital



Market risk is the potential loss due to price movement. Early liquidation of fixed-income collateral to meet an unexpected claim by the sponsor may expose investors to market risk.

- Conversely, decreasing market value can erode collateral to a level lower than the required bond payout to the sponsor.

Credit risk is the potential loss due to a default on the payment of principal in the collateral trust, which decreases the amount of funds available to pay investors.

Counterparty risk arises from the potential default in the payment of premiums to the SPV by a sponsor. For example, there may be legacy transactions with TRS. Counterparty risk in such transactions would mean the failure of the swap counterparty to guarantee the liquidity and performance of the investments held by the collateral trust according to the swap agreement.

Liquidity risk is a lack of capital availability. Investor capital is an alternative to traditional reinsurance. Unlike traditional reinsurance, investor capital is not permanent. Capital may be withdrawn at maturity and allocated to another asset class in search of higher yield investments.

Key Terminology

Act of God bond
A bond where redemption value is related to the occurrence of catastrophes.

Aggregate retention
Amount of loss absorbed by a policyholder prior to a trigger event. Unlike a policy deductible, a retention is not subtracted from the total coverage amount.

Alternative risk transfer (ART)
Describes various nontraditional forms of reinsurance and techniques where risk is transferred to the capital markets.

Annual aggregate limit
Maximum amount an insurer will pay for covered losses during a policy period.

Blended cover
Mix of insurance, reinsurance and other risk management techniques on a single policy.

Catastrophe equity put (CatEPut)
An options contract that gives the purchaser the right, but not the obligation, to raise additional capital in the event of a catastrophe.

Cedent
An insurance company buying reinsurance cover.

Disintermediation
The process of eliminating the "intermediary." Such as an insured going to the capital markets for insurance-like products without the use of a reinsurer.

Event risk
The insurable risk from an occurrence such as a catastrophe (e.g., earthquake, hurricane).

Excess of loss reinsurance
Reinsurance that pays on the basis of the excess of claims over and above a pre-determined retention limit.

Experience account
Reserve fund set up to hold the premiums for finite reinsurance from a single insured. Earns interest over the fixed term, and returns to the insured whatever principle and interest is not paid out as losses.

Finite risk
Re/insurance policy with an ultimate limit of indemnity often with direct link between premium and

Risk of