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Insurance-linked securities covering wider range of perils

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As alternative capital continues to pour into the reinsurance space, insurance-linked securities markets are finding novel ways to deploy the capital to maintain the sector's momentum.

Covering non-U.S. perils and indemnity-based triggers are some ways these markets are tapping the plentiful capacity brought by pension funds, endowments, and other investors.

One way the market is diversifying is bundling more than one exposure into a single transaction.

"Bundling of risks is really a great way to get new perils into the market and to get over some of the capital constraints for these additional perils," said Bill Dubinsky, head of ILS at Willis Capital Markets & Advisory in New York, a unit of Willis Group Holdings P.L.C.

Bundling is a cost- and time-effective way to market additional perils, he said.

"The marginal cost of adding Colombian earthquake or Canadian earthquake into a transaction which already has U.S risks or already has Canadian risk is much smaller than the stand-alone cost of doing that same deal," Mr. Dubinsky said.

One catastrophe bond issued in the second quarter, Residential Reinsurance 2014 Ltd. on behalf of the San Antonio-based United States Automobile Association, combined U.S hurricane, earthquake, severe tunderstorm, winter storm and wildfire risks.

Another shift in the market is growth in indemnity-based triggers, which pay out based on losses, as opposed to parametric triggers that rely on specific events, such as an earthquake of specified magnitude and location to trigger a payout.

"If you look at the percentage of indemnity triggers vs. parametric triggers, that percentage keeps rising," said Paul Schultz, CEO of Aon Benfield Securities in Chicago, a unit of Aon P.L.C.

"There has been an increasing trend this year toward the use of indemnity triggers as opposed to parametric triggers or index-based triggers," said Aileen Meehan, a New York-based partner at law firm Edwards Wildman Palmer L.L.P., which advises clients on cat bonds.

"I think to compete against the traditional reinsurance product, ILS funds, namely cat bonds, have had to include and move toward indemnity triggers, which require a higher level of underwriting analyses," said Romulo Braga, New York-based CEO of BMS Capital Advisory, a unit of BMS Intermediaries Inc.

"The investors have been showing a lot more sophistication and appetite to underwrite indemnity deals because they understand that that's going to be the most effective way to compete against the traditional product," he said.

Still, the insurance-linked securities market remains heavily weighted toward U.S. wind exposures, primarily hurricanes.

"If you look at peril breakdown for outstanding catastrophe bonds, U.S. hurricane accounts for 52%," Mr. Schultz said, with U.S. earthquake being No. 2 at 18%.

The cat bond market has concentrated on U.S. hurricane risk due to its high margins for investors, Mr. Schultz said.

But that is changing, Mr. Dubinsky said.

"As the capital markets become more competitive, relatively more perils are brought into the scope of the economically viable," he said.

The changing market "has led investors to consider accepting not only the named perils, especially in the U.S., but also risks that have not been modeled particularly well in the past," Mr. Braga said.

Another reason the majority of cat bonds have covered U.S. hurricanes is because the exposure is well-modeled, said Sherry Thomas, head of catastrophe management for the Americas at Guy Carpenter & Co.

The geographic weighting of the market toward U.S risk, which Mr. Schultz said is 72% of the global market, also is changing.

The second quarter saw several cat bond issues for foreign perils such as Japanese earthquake and European wind risk. One bond, Aozora Re Ltd. covering Japanese typhoon risks, was issued in yen, a departure from the typically dollar-denominated instruments, Ms. Meehan said.

The market has also branched out in other directions, too.

In September, a $250 million bond was placed for the California State Compensation Insurance Fund to provide workers compensation coverage against earthquake risks through 2018, a departure in coverage and duration.

In addition, the World Bank issued a $30 million cat bond in July to reinsure the Caribbean Catastrophe Risk Insurance Facility, a risk-pooling facility for catastrophic earthquakes and hurricanes affecting 16 Caribbean member governments.
