

From captives to the capital markets

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Captives are the oldest instrument of what the insurance industry calls alternative risk transfer, a term that covers all techniques for transferring or financing risks outside traditional insurance and reinsurance contracts. The second family of instruments transfers insurance risks directly to investors in the capital markets. It emerged in the 1990s, when a series of natural catastrophes exhausted the capacity of the reinsurance market. Hurricane Andrew, which struck Florida in August 1992, caused insured losses of about fifteen to sixteen billion US dollars at the prices of the time and led to the insolvency of several insurers. The Northridge earthquake in California followed in January 1994.¹ The reinsurers had too little capital to cover the growing values exposed to hurricanes and earthquakes, while the capital markets, with their trillions of dollars of investable assets, could absorb losses of this size with little effect.

The idea was to issue bonds whose principal would be lost, in whole or in part, if a defined catastrophe occurred. Investors received a high coupon as compensation for this risk. Because natural catastrophes are largely unrelated to the movements of stock and bond markets, the bonds offered diversification. The first transactions took place in the mid-1990s. In 1997 the American insurer USAA placed a bond covering hurricane risks in the Gulf and Atlantic states through a vehicle named Residential Re, while Swiss Re sponsored a bond covering Californian earthquake risks.² In the same year Winterthur Insurance issued a convertible bond whose coupon depended on the hail damage to motor vehicles in Switzerland, a Swiss contribution to the early history of the market.³

1 Notes

1. On Hurricane Andrew (August 1992), with insured losses commonly estimated at USD 15.5 billion at the time, and the Northridge earthquake (17 January 1994), and on their consequences for the

reinsurance market, see Swiss Re, sigma and the historical literature on catastrophe reinsurance. Figures to be verified. ↩

2. On the early catastrophe bonds, including USAA's Residential Re (1997) and the Swiss Re-sponsored California earthquake transaction (1997), see the literature on insurance-linked securities, for example Cummins, "CAT Bonds and Other Risk-Linked Securities: State of the Market and Recent Developments", Risk Management and Insurance Review 11 (2008). To be verified. ↩
3. On the Winterthur hail-linked convertible bond (WinCAT, 1997), see the literature on insurance-linked securities and the history of Winterthur Insurance. To be verified. ↩

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