

Parametric insurance, industry loss warranties and sidecars

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The catastrophe bond is the best known instrument of insurance-linked finance, but it is accompanied by several others. Industry loss warranties are reinsurance or derivative contracts that pay when the losses of the whole industry from a defined event exceed a threshold, such as twenty billion US dollars for a hurricane in the United States. They are simple to document, quick to place and free of the moral hazard of an indemnity cover. Sidecars are vehicles through which investors take a share of the business of a reinsurer for a limited period, earning the corresponding premium and bearing the corresponding losses. They multiplied after the hurricanes Katrina, Rita and Wilma in 2005, when reinsurers needed additional capital quickly.¹ Collateralised reinsurance, in which an investor fund writes a reinsurance contract backed fully by cash, is the largest segment of the alternative capital market today.

Parametric insurance applies the logic of the parametric trigger to direct insurance. The policy pays a fixed amount when a measurable event occurs, without the need to assess the actual loss. Farmers in developing countries can be insured against drought according to rainfall data, while governments in the Caribbean, Africa and the Pacific have pooled their risks in regional facilities, beginning with the Caribbean Catastrophe Risk Insurance Facility in 2007.² Corporate clients use parametric covers for risks that traditional policies exclude or price poorly, such as business interruption without physical damage, low water on rivers or a lack of snow at ski resorts. Swiss Re and several specialised insurers offer such products.

Weather derivatives are close relatives of parametric insurance. They pay according to temperature, precipitation or wind measured at a defined station and are traded on exchanges or over the counter. After the first contracts had been concluded in the American energy market in 1997, the

Chicago Mercantile Exchange introduced exchange-traded weather futures in 1999.³ Energy companies, farmers and leisure businesses use them to protect their earnings against unusual weather. From a legal perspective, the distinction between a weather derivative and a parametric insurance contract matters, because it decides whether insurance supervisory law or financial market law applies. Swiss law draws the line according to whether the contract compensates an insurable interest of the policyholder, a question that FINMA examines case by case.⁴

1 Notes

1. On industry loss warranties and reinsurance sidecars, including their growth after the 2005 hurricane season, see the literature on alternative reinsurance capital and the publications of the major brokers. To be verified. ↩
2. On the Caribbean Catastrophe Risk Insurance Facility (CCRIF, established 2007), African Risk Capacity (2012) and the Pacific Catastrophe Risk Insurance Company, see the publications of these facilities and of the World Bank. To be verified. ↩
3. On the origins of the weather derivatives market (first over-the-counter transactions in 1997 in the United States energy sector) and the weather futures of the Chicago Mercantile Exchange (from 1999), see the literature on weather risk management. To be verified. ↩
4. On the distinction between insurance and derivatives under Swiss law, in particular the concept of insurance activity under Art. 2 ISA and the treatment of parametric covers, see the FINMA practice and the Swiss literature on insurance supervisory law. To be verified. ↩

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