New Swiss Re sigma study sees tenfold growth for securitisation of insurance risk

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In recent years, firms have developed a new class of financial instruments that transfer insurance risk to the capital markets. Approximately USD 12.6 billion of these capital market insurance solutions have been issued since 1996. A newly released Swiss Re sigma study, "Capital market innovation in the insurance industry", examines the process of financial innovation and assesses the prospects for capital market insurance solutions. The study concludes that these securities have vast market potential.

Among the key findings:

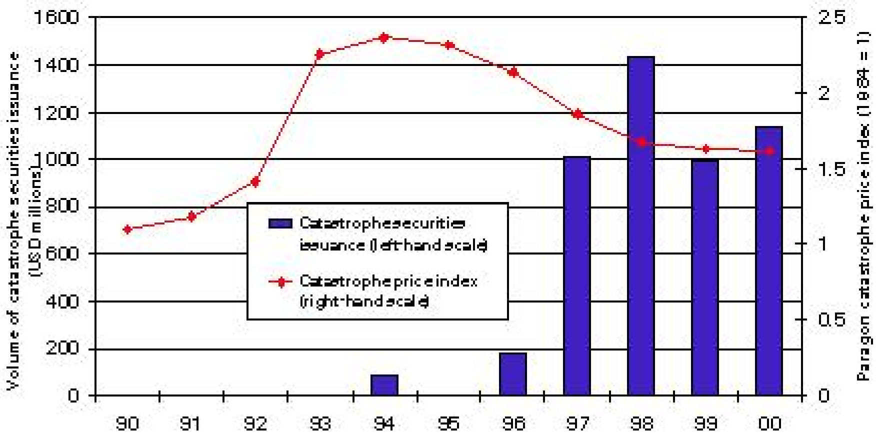
- To date, the issuance of catastrophe bonds has accounted for nearly half of insurance risk securitisation transactions.
- Annual issuance of catastrophe bonds, now about USD 1 billion, is expected to reach USD 10 billion by 2010.
- Capital market insurance solutions linked to non-catastrophic risks have an even greater market potential. Promising areas include life and automobile insurance.

The study examines capital market insurance solutions in the context of the global wave of financial innovation that has occurred since the 1970s. A variety of forces have stimulated this innovation: the need to protect against market risk; technological progress facilitating the innovation process; and a desire to minimise the costs imposed by taxes and regulation.

Capital market insurance solutions are a recent financial innovation. Following Hurricane Andrew and the Northridge earthquake of the early 1990s, property catastrophe reinsurance was in short supply and premium rates more than doubled. In reaction to this rate spike, insurers began developing a new class of financial instruments that transfer insurance risk to capital markets.

Because global capital markets are so vast – publicly traded stocks and bonds have a total value of more than USD 50 trillion – they offer a promising means of funding protection for even the largest potential catastrophes. Capital market insurance solutions also allow the industry to reduce counterparty risk and diversify funding sources. Investors purchasing the securities can earn high-risk adjusted returns while diversifying their portfolios.

In the early 1990s, high reinsurance rates stimulated interest in the securitisation of catastrophe risk.



Sources: E. W. Blanch; Swiss Re Capital Markets.

One factor critical to the success of capital market insurance solutions are higher reinsurance rates. Indeed, the low reinsurance rates of the late 1990s placed an extreme damper on the growth of this innovation, just as it was starting to take hold. Therefore, according to the sigma report, the rebound in reinsurance rates in 2001 bodes well for increasing issuance of insurance securitisations.

After identifying and discussing factors critical to the success of capital market insurance solutions, the report concludes that the range of these solutions will grow over time. In particular, the study finds vast market potential for capital market solutions linked to non-catastrophic insurance risks. If this potential is realised, the range of risks that are insurable will continue to expand.

How to access *sigma*:

The English, German, French, Spanish and Italian versions of the *sigma* study are available electronically in the **sigma section** of the website.

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