THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 34 No. 3 March 2018

CATASTROPHE BONDS: THE CONVERGENCE OF CAPITAL MARKETS AND INSURANCE

In this article, the author provides an overview of the cat bond industry, discussing the cat bond market, the structure of such bonds, offering materials and the investor community, and types of loss triggers. She closes with a review of the factors accounting for the popularity of cat bonds and the outlook for the cat bond market.

By Lorraine D. Mandel *

The year 2017 is estimated to have been one of the costliest years on record for the insurance industry. Weather-related natural disasters, including Hurricanes Harvey, Irma, and Wilma in the U.S. and the Caribbean; Typhoon Halo in China; and Cyclone Debbie in Australia; caused insured losses to be 139% higher than reported losses in 2016.[1] Yet, paradoxically, 2017 was a record year for success in a market that also provides protection against losses from weather-related events — a class of securities known as catastrophe or "cat" bonds.

Cat bonds are investments whose performance depends upon the occurrence of a pre-specified catastrophic event. They are the best known and the most common form of insurance-linked securities or "ILS" — vehicles for investors to participate in the insurance business. This article provides an overview of the cat bond industry. The focus will be on the typical designs for the cat bond, its risk/return characteristics, and the factors contributing to the growth of the cat bond as a financial asset. The increased investor interest in cat bonds has quickened the pace of the convergence of the capital markets and insurance industries.

DEVELOPMENT OF THE CAT BOND

Catastrophe bonds are principal-at-risk, variable-rate debt securities. They were first designed in the early 1990's after major natural catastrophes, such as Hurricane Andrew and the Northridge earthquake, caused billions of dollars in insured losses. Following these events, premiums for insurance rose dramatically, but the demand for protection outstripped available capacity of insurance companies to write insurance and

[1] Insurance Journal, "*Insured Natural Disaster Losses Were 38% of Economic Costs of $354B: Aon,*" https://www.insurancejournal.com/news/international/2018/01/24/478246.htm.

* *LORRAINE D. MANDEL is currently in private practice in New York City, specializing in capital markets and insurance law. Formerly, she was General Counsel, Government Affairs and Global Derivatives, of XL Group, Ltd., the global insurance and reinsurance company. Her e-mail address is lmandel@rcn.com.*
She acknowledges gratefully the assistance of Rachel B. Coan (Partner, Carter, Ledyard and Milburn), and John Seo (Co-founder and Managing Director, Fermat Capital Management) in the preparation of this article.

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