



Southwestern Insurance Information Service

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Fact Sheet

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What Are Catastrophe Bonds?

Catastrophic events, such as hurricanes and earthquakes, are one of the major risks insurers and reinsurers face. Losses sustained by insurers can be monumental and create financing problems in the future. To reduce those losses insurers may hedge those risks through the purchase of traditional reinsurance, issuing catastrophe bonds to investors or a combination of both.

Were a Category 5 hurricane to strike a heavily populated area and its winds distributed across the globe, there would likely be no significant monetary loss. Catastrophe bonds were designed to dissipate the potential losses to insurers, just as the example of the of the Category 5 hurricane winds.

The buyer of a catastrophe bond is essentially selling insurance to cover a major weather-related event. They put down their money and will lose every penny if a specified event takes place, given a set period of time.

The most common consumers of CAT bonds are insurers wishing to lessen their losses in the event of an earthquake or hurricane. These bonds are typically purchased by hedge funds, reinsurers, banks, pension funds and asset managers.

CAT bonds are usually rated by such agencies as Standard & Poors, Moody's or Fitch Ratings. The bonds are rated on the probability of an earthquake or hurricane resulting in the loss of principle. These probabilities are based on a number of factors, including computer models.

The popularity of CAT bonds has been on the increase since 2005. A study by Swiss Re predicts the value of these bonds to more than triple to almost \$50 billion within the next five years from \$14 billion. Investors in CAT bonds often require the highest yields in the fixed income market because a major earthquake or hurricane

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poses the potential of the investors losing all of their capital. According to the Swiss Re study, CAT bonds have returned an average of 11 percent a year.

Catastrophe bonds typically provide protection on a multi-year basis with the most common transaction duration being three years. Reinsurance protection is typically purchased on an annual basis. CAT bonds therefore have the ability to lock-in a known pricing level and amount of capacity for longer than a traditional reinsurance contract.

CAT bonds and reinsurance help provide shields of protection for insurers and their customers. These financial tools are essential in safeguarding the solvency of an insurer and maintaining the monetary strength to pay the claims of their customers.

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