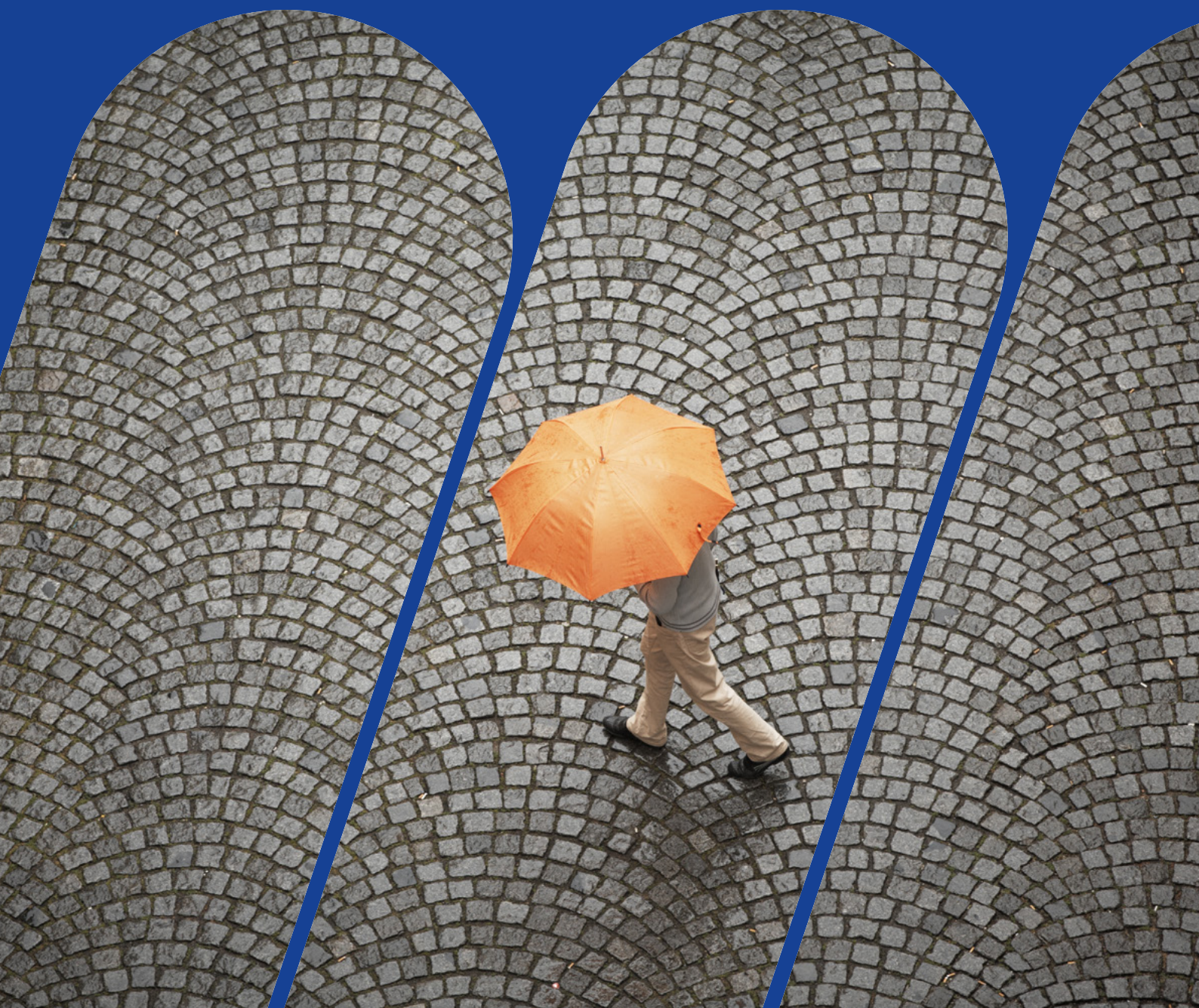


E-BOOK



# The mechanics of reinsurance sidecars

A deep dive into insurance-linked securities



*The insurance-linked securities (“ILS”) industry has seen significant growth in recent years, as insurers and investors alike seek alternative forms of risk transfer and investment opportunities. Collateralized/ collateralised sidecars (“CS”) are an increasingly popular aspect of this industry. Here we provide an in-depth understanding of CS and how they differ from other types of ILS.*

## What are collateralized/ collateralised sidecars?

CS are special purpose vehicles (“SPVs”) that transfer insurance risk from insurers to investors. Typically, the SPV is set up as a reinsurance vehicle and is funded by investors, which provide collateral in the form of cash or other liquid assets. This collateral is used to back the insurance policies underwritten by the SPV. The collateral backing these securities is generally held in a trust account, where it is invested in low-risk, short-term assets.

## How does it work?

First, an insurer creates a SPV. The SPV then underwrites insurance policies that are typically in the form of reinsurance contracts. Once this has been completed, the insurer then transfers a portion of its risk to the SPV, and the SPV assumes responsibility for paying claims. In the instance of any losses incurred on the insurance policies, the SPV will use the collateral provided by the investors to pay the claim. At maturation, investors receive a return based on the performance of the underlying insurance portfolio.

## What are insurance-linked securities?

In contrast, an ILS transfers risk through the issuance of securities. The insurer transfers the risk to the investor through an SPV that issues bonds or other securities. These securities are sold to investors, which receive a return based on the performance of the underlying insurance portfolio. If there is a loss on the insurance policies, the SPV will pay the claim using the proceeds from the sale of the securities.

The most common type of ILS is the catastrophe bond. These bonds transfer the risk of catastrophic events, such as hurricanes or earthquakes, from the insurer to the capital markets. If a specified event occurs, the bondholders may lose part or all of their principal, which is then used to cover the insurer's claims.

## How does it work?

An insurer creates an SPV that issues bonds or other securities that are sold to investors. The SPV then underwrites insurance policies, typically in the form of catastrophe bonds or other securitized/ securitised instruments. The insurer will transfer a portion of its risk to the SPV, and the SPV assumes responsibility for paying claims, following which, investors will receive a return based on the performance of the underlying insurance portfolio.

## CS and ILS: what's the difference?

While both involve transferring insurance risk to the capital markets, the difference lies in their structure and risk profile.

CS enable investors to participate in a broader range of insurance risks, while ILS typically focus on specific catastrophic events. Additionally, sidecars tend to have shorter investment horizons than ILS, often lasting one or two years. The shorter duration of sidecars may allow for more frequent repricing of risk, potentially increasing their appeal to investors.

The structure of the SPV is another important difference. CS are structured as reinsurance vehicles, while ILS are often structured as catastrophe bonds or other securitized/ securitised instruments.

Notably, from a structural perspective, sidecars are separate legal entities created by insurers or reinsurers, while ILS are financial instruments issued by these companies. While both vehicles demonstrate risk-sharing attributes, sidecars involve sharing risks and premiums with investors, while ILS investors assume the risk in exchange for coupon payments.

It is also worth noting that ILS payouts are typically triggered by specific events, while sidecars share profits and losses with investors based on the overall performance of the ceded risks. Generally, ILS are also more liquid, as they can be traded in the secondary market, while sidecar investments are often less so.

Despite these differences, both CS and ILS are important tools for insurers looking to manage their exposure to catastrophic events. By transferring a portion of the risk to investors, insurers can reduce their capital requirements and improve their financial stability, while investors have the opportunity to earn a return while diversifying their portfolio.

As the market for insurance-linked investments continues to grow, CS and ILS are likely to play increasingly important roles in the insurance industry. Insurers and investors alike must be aware of the differences between these two types of investments in order to make informed decisions about risk and return.

## How can we support you?

Our experienced Insurance fund product team provide the broadest range solutions to insurance clients including ILS funds. Our services include fund structuring, fund accounting, investor services, anti- money laundering, tax compliance, financial reporting and regulatory compliance. All insurance clients can benefit from our ability to deliver tailored solutions offering the stability of a well-known global service provider.

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# Insurance-linked securities

ILS is an umbrella term for financial securities that are linked to pre-specified events or insurance-related risks.

## SIDECARS

The sidecar reinsurer assumes a percentage of the ceding company's underwriting risk in exchange for a percentage of the premiums.

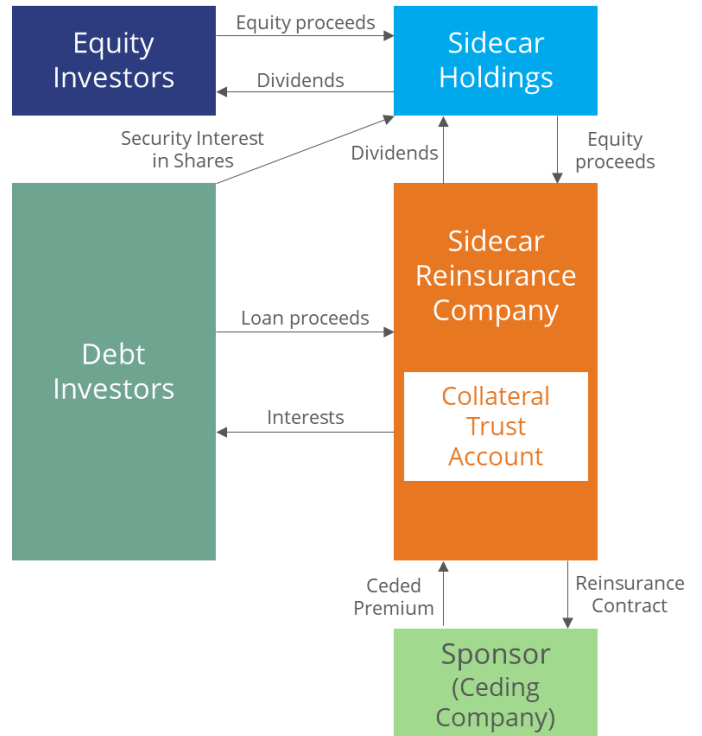
Sidecars are similar to the SPVs that issue catastrophe bonds, but issue both equity and debt.

## CATASTROPHE BONDS

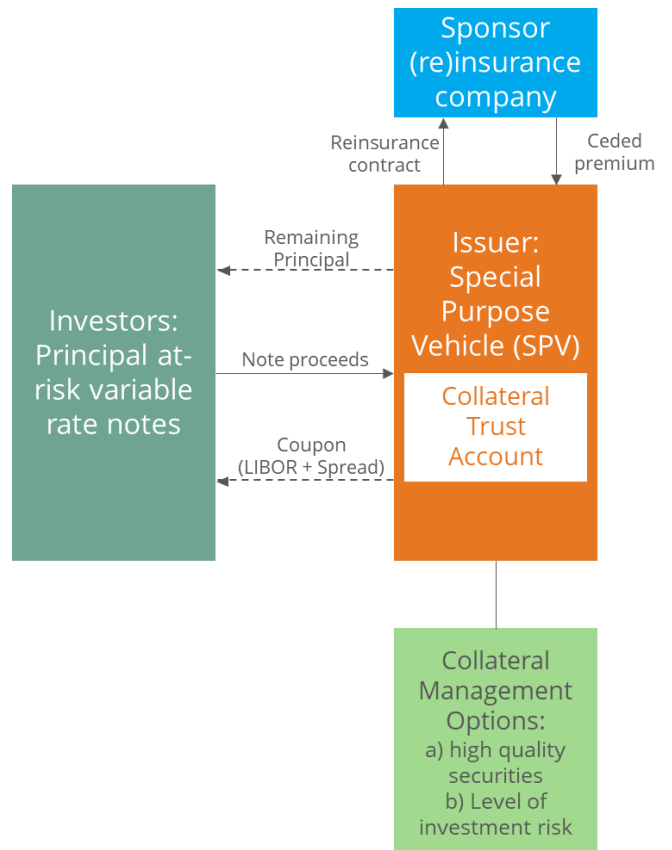
Catastrophe bonds transfer a predefined set of catastrophe or natural disaster risks from an issuer or sponsor (ceding company) to investors.

Catastrophe bonds are paid to insurance companies only if a specified catastrophe occurs.

### SIDECAR STRUCTURE



### CATASTROPHE BOND STRUCTURE





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