

The Handbook of  
Insurance-Linked Securities

*Edited by*

**Pauline Barrieu and Luca Albertini**



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This edition first published 2009

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Chapters 6, 7, 10, 11, 14, 16, 20, 23 and 25 – copyright details are given in the footnote on the chapter cover pages.

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John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

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***Library of Congress Cataloging-in-Publication Data***

The handbook of insurance-linked securities / edited by Pauline Barrieu, Luca Albertini.

p. cm. — (Wiley finance series)

Includes bibliographical references and indexes.

ISBN 978-0-470-74383-6 (cloth : alk. paper) 1. Risk (Insurance)

2. Securities. I. Albertini, Luca. II. Barrieu, Pauline.

HG8054.5.H363 2009

332.63'2—dc22

2009019337

A catalogue record for this book is available from the British Library.

Typeset in 10/12pt Times by Aptara Inc., New Delhi, India

Printed in Great Britain by Antony Rowe Ltd, Chippenhan, Wiltshire

# Contents

<b>About the Contributors</b>	<b>xv</b>
<b>Acknowledgements</b>	<b>xxv</b>
<b>1 Introduction</b>	<b>1</b>
<i>Pauline Barrieu and Luca Albertini</i>	
<b>PART I NON-LIFE SECURITISATION</b>	<b>7</b>
<b>2 Non-life Insurance Securitisation: Market Overview, Background and Evolution</b>	<b>9</b>
<i>Jonathan Spry</i>	
2.1 Market overview	9
2.2 Market dynamics	14
2.3 The question of basis risk remains	16
2.4 ILS and the credit crunch	18
<b>3 Cedants' Perspectives on Non-life Securitization</b>	<b>19</b>
3A Insurance-linked securities as part of advanced risk intermediation	21
<i>Insa Adena, Katharina Hartwig and Georg Rindermann</i>	
3A.1 Motivation for Allianz to take part in ILS activities	21
3A.2 Objectives of insurance companies	23
3A.3 Case study: Blue Fin Ltd	24
References	28
3B Reinsurance vs Securitisation	29
<i>Guillaume Gorge</i>	
3B.1 Keeping risk vs transferring it	29
3B.2 Reinsurance vs securitisation	30
3B.3 Application to main P&C risks	31
3B.4 Case studies: AURA RE and SPARC	32
3B.5 Limits and success factors to securitisation	33
References	34
3C Securitisation as a diversification from traditional retrocession	35
<i>Jean-Luc Besson</i>	

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<b>4</b>	<b>Choice of Triggers</b>	<b>37</b>
	<i>Dominik Hagedorn, Christian Heigl, Andreas Müller and Gerold Seidler</i>	
4.1	General aspects	37
4.2	Indemnity triggers	38
4.2.1	Scope of coverage	39
4.2.2	Payout timing	39
4.2.3	Loss verification	40
4.2.4	Transparency	40
4.3	Non-indemnity triggers	41
4.3.1	Parametric triggers (pure and index)	41
4.3.2	Industry loss triggers	43
4.3.3	Modelled loss triggers	45
4.4	Choosing the optimal trigger	45
4.4.1	Comparison of trigger types	46
4.4.2	Choice of trigger and alternative solutions	47
<b>5</b>	<b>Basis Risk from the Cedant's Perspective</b>	<b>49</b>
	<i>David Ross and Jillian Williams</i>	
5.1	Introduction	49
5.2	Investor vs sponsor risk	50
5.3	Trigger types	50
5.4	Catastrophe models	52
5.4.1	Key components of catastrophe models	52
5.4.2	Uncertainty	54
5.5	Sources of basis risk	55
5.5.1	Source 1: Catastrophe model error/shortcomings	55
5.5.2	Source 2: Discrepancy between the modelled index loss and the modelled company loss	56
5.5.3	Source 3: Dynamic basis risk	56
5.6	Defining basis risk	56
5.7	Quantifying basis risk	58
5.7.1	Measures for pro rata hedges	58
5.7.2	Measures for digital hedges	59
5.7.3	Measuring positive basis risk	59
5.8	Minimising basis risk	60
5.8.1	Over-hedging	60
5.8.2	Choice of index	62
5.8.3	Reset clauses	62
5.8.4	Cat model input	63
5.9	Conclusion	63
	Acknowledgements	63
	References	64
<b>6</b>	<b>Rating Methodology</b>	<b>65</b>
	<i>Cameron Heath</i>	
6.1	Standard & Poor's ratings services' rating process	65
6.1.1	Initial interaction	65
6.1.2	Risk analysis	65



6.1.3	Documentation review	67
6.1.4	Transaction closing	67
6.1.5	Surveillance	67
6.2	Risk analysis	68
6.2.1	Trigger options	68
6.2.2	Indemnity vs non-indemnity triggers	68
6.2.3	Risk factors	70
6.2.4	Adjusted probability of default	72
6.2.5	Application of methodology	73
6.2.6	Default table	74
6.2.7	Multi-event criteria	74
6.3	Legal and swap documentation review process	75
6.3.1	Insurance focus points	75
6.3.2	Legal and structural focus points	75
6.4	Impact on sponsor	75
6.4.1	Capital model treatment of ILS	75
6.4.2	Summary of basis risk analysis	76
6.4.3	Sources of basis risk	77
6.4.4	Link to ILS revised probability of attachment	82
	References	82
<b>7</b>	<b>Risk Modelling and the Role and Benefits of Cat Indices</b>	<b>83</b>
	<i>Ben Brookes</i>	
7.1	Components of a cat model	84
7.2	Insurance-linked securities	84
7.2.1	General overview	84
7.2.2	Insurance-linked security triggers	85
7.2.3	Basis risk	90
7.3	Cat indices	93
7.3.1	Property Claims Service (PCS)	93
7.3.2	Re-Ex – NYMEX	93
7.3.3	Insurance Futures Exchange Service (IFEX)	94
7.3.4	Carvill Hurricane Index (CHI) – Chicago Mercantile Exchange (CME)	94
7.3.5	Paradex	95
7.4	Summary	99
<b>8</b>	<b>Legal Issues</b>	<b>101</b>
	<i>Malcolm Wattman, Matthew Feig, James Langston, and James Frazier</i>	
8.1	The note offering – federal securities law implications	101
8.1.1	The distribution of the notes	101
8.1.2	Application of the anti-fraud provisions of the federal securities laws	102
8.1.3	Securities offering reform	103
8.1.4	Provision of information	103
8.1.5	The Investment Company Act of 1940	104
8.2	The note offering – the offering circular	104
8.2.1	Important terms	104
8.2.2	ERISA considerations	106

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8.2.3	Other considerations regarding the proceeds and payment of interest	109
8.2.4	The risk analysis	110
8.2.5	Opinions	110
8.3	Types of transactions	110
8.3.1	Parametric, index and modeled loss transactions	111
8.3.2	Indemnity transactions	111
8.4	Conclusion	115
<b>9</b>	<b>The Investor Perspective (Non-Life)</b>	<b>117</b>
	<i>Luca Albertini</i>	
9.1	The creation of a sustainable and liquid market	117
9.1.1	Creation of common terminology	118
9.1.2	Risk analysis	119
9.1.3	Correlation with other investments in the portfolio	119
9.1.4	Relative value	121
9.1.5	Valuation and liquidity	121
9.2	Key transaction features from the investor perspective	122
9.2.1	Assessment of the underlying risks being securitised	122
9.2.2	Risk assessment of the instrument	124
9.2.3	Pricing and risk-return profile	125
9.3	Market evolution: the investor perspective	127
9.3.1	Collateral arrangements	127
9.3.2	Data transparency	128
9.3.3	Exposure monitoring	129
9.3.4	Modelling rigour	129
<b>10</b>	<b>ILS Portfolio Monitoring Systems</b>	<b>131</b>
	<i>Tibor Winkler and John Stroughair</i>	
10.1	Introduction	131
10.1.1	Completing the circle	131
10.1.2	‘Square peg in a round hole?’	132
10.2	Miu – An ILS platform in a convergent space	133
10.2.1	Overview	133
10.2.2	Nuts and bolts – how the platform works	133
10.2.3	Step by step – entering a contract	134
10.2.4	Portfolio analysis	134
10.3	RMS library of cat bond characterisations	137
10.3.1	Motivation and objectives	137
10.3.2	How is it done? A bird’s eye view	137
10.3.3	Apples to apples – a leap for the market	138
10.4	Conclusion	138
<b>11</b>	<b>The Evolution and Future of Reinsurance Sidecars</b>	<b>141</b>
	<i>Douglas J. Lambert and Kenneth R. Pierce</i>	
11.1	A brief history of the brief history of sidecars	142
11.2	Sidecar structures	143
11.2.1	Basic structure	143
11.2.2	Market-facing sidecar	144

11.2.3	Non-market-facing sidecar	145
11.2.4	Capitalising sidecars	146
11.2.5	How sidecars and catastrophe bonds are different	147
11.3	The appeal of sidecars	148
11.3.1	From a cedant/sponsor perspective	148
11.3.2	From an investor perspective	149
11.4	Structuring considerations	149
11.5	The outlook for sidecars	150
11.6	Conclusion	151
<b>12</b>	<b>Case Study: A Cat Bond Transaction by SCOR (Atlas)</b>	<b>153</b>
	<i>Emmanuel Durousseau</i>	
12.1	Introduction: SCOR's recent history	153
12.2	Atlas III and IV: Background	153
12.3	Atlas: Main characteristics	155
12.4	Basis Risk	158
12.4.1	Reset	158
12.4.2	Gross up	158
12.4.3	Overlap	158
12.4.4	Synthetic covers	159
12.5	Total Return Swap	160
12.6	Conclusion	160
	Appendix A	161
A.1	Definition of events	161
A.2	Extension events	162
<b>13</b>	<b>Case Study: Swiss Re's New Natural Catastrophe Protection Program (Vega)</b>	<b>163</b>
	<i>Jay Green and Jean-Louis Monnier</i>	
13.1	A positive evolution of Swiss Re's ILS strategy	163
13.2	Swiss Re accesses multi-event natural catastrophe coverage	164
13.3	The first ILS to use a cash reserve account as credit enhancement	164
13.4	Innovation leads to more efficient protection	165
<b>PART II</b>	<b>LIFE SECURITISATION</b>	<b>167</b>
<b>14</b>	<b>General Features of Life Insurance-Linked Securitisation</b>	<b>169</b>
	<i>Norman Peard</i>	
14.1	Life insurer corporate and business structures, risks and products	170
14.1.1	Mutual life offices	170
14.1.2	Proprietary life offices	171
14.1.3	Other forms of life office	173
14.1.4	Principal risks associated with life insurance business	173
14.1.5	Principal product types and associated risks	176
14.2	Actors and their roles	177
14.2.1	Sponsor	177
14.2.2	Investors	179

14.2.3	Regulators	179
14.2.4	External professional advisers	179
14.2.5	Ratings agencies	181
14.2.6	Monoline insurers	181
14.2.7	Liquidity providers	181
14.2.8	Swap providers	182
14.2.9	Others	182
14.3	Process	182
<b>15</b>	<b>Cedants' Perspectives on Life Securitisation</b>	<b>189</b>
15A	A cedant's perspective on life securitisation <i>Alison McKie</i>	191
15A.1	Why securitise?	191
15A.2	Life ILS can be complex	194
15A.3	Outlook for life ILS	198
15B	A cedant's perspective on life securitisation <i>Chris Madsen</i>	199
15B.1	Key considerations	199
15B.2	Examples of securitisation opportunities	202
15B.3	Differences between securitisation and reinsurance	205
<b>16</b>	<b>Rating Methodology</b>	<b>207</b>
	<i>Harish Gohil</i>	
16.1	Fitch's approach to the rating process	207
16.2	Insurance risk analysis	208
16.2.1	Risk modelling	208
16.2.2	Ratings benchmarks	209
16.2.3	Analysis of sponsor and other counterparties	210
16.2.4	Surveillance	210
16.3	Zest: a VIF case study	211
	References	212
<b>17</b>	<b>Life Securitisation: Risk Modelling</b>	<b>213</b>
	<i>Steven Schreiber</i>	
17.1	Modelling of a catastrophic mortality transaction	213
17.2	Modelling of a VIF transaction	216
<b>18</b>	<b>Life Insurance Securitisation: Legal Issues</b>	<b>219</b>
	<i>Jennifer Donohue</i>	
18.1	Monetisation of future cash flows	219
18.1.1	Some background on monetisation	219
18.1.2	The market drivers of monetisation	220
18.1.3	Monetisation in the current climate	221
18.1.4	Some transaction structures	221
18.2	Legal aspects of life insurance securitisation – some key features	222
18.2.1	Closed book/open book	222
18.2.2	Unit-linked policies – not 'with profits' policies	222

18.2.3	Risk transfer versus no transfer	222
18.2.4	Warranties	222
18.2.5	Monoline wrap (payment obligation)	223
18.2.6	Recharacterisation risk	223
18.3	Some examples of value-in-force securitisation/monetisation	225
18.3.1	A classical VIF structure: Gracechurch	225
18.3.2	A private but reported transaction: Zest	226
18.4	Outlook	227
<b>19</b>	<b>The Investor Perspective (Life)</b>	<b>229</b>
	<i>Luca Albertini</i>	
19.1	Life insurance-linked risks and investor appetite	229
19.1.1	The role of the monolines	229
19.1.2	Understanding the risk	230
19.1.3	Correlation with other investments	234
19.1.4	Relative value	236
19.1.5	Valuation and liquidity	237
19.2	Key transaction features from the investor perspective	237
19.2.1	Risk assessment of the instrument	237
19.2.2	Pricing and risk-return profile	240
19.3	Market evolution: the investor perspective	242
<b>20</b>	<b>Longevity Securitisation: Specific Challenges and Transactions</b>	<b>245</b>
	<i>Jennifer Donohue, Kirsty Maclean and Norman Peard</i>	
20.1	Mortality and longevity risk	245
20.2	A market for longevity risk	246
20.2.1	Potential sources of longevity risk for securitisation	246
20.2.2	Demand for longevity risk	247
20.3	Key structural aspects of longevity risk securitisation	248
20.3.1	Isolating longevity risk	248
20.3.2	Analysis of longevity risks	249
20.3.3	Longevity risk – legal explanation	250
20.3.4	Examples and legal aspects of transaction structures	252
20.4	Some features of longevity risk	255
20.4.1	Model risk	255
20.4.2	Ratings	258
20.4.3	Pricing	258
<b>21</b>	<b>Longevity Risk Transfer: Indices and Capital Market Solutions</b>	<b>261</b>
	<i>Guy Coughlan</i>	
21.1	The nature of longevity risk	262
21.2	The market for longevity risk transfer	263
21.2.1	Hedgers	263
21.2.2	Investors	265
21.2.3	Intermediaries	265
21.3	Importance of indices, tools and standards	266
21.3.1	Longevity indices	266
21.3.2	Trading and liquidity	268

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21.4	Capital market instruments for longevity risk transfer	268
21.4.1	Longevity bond	268
21.4.2	Survivor swap	269
21.4.3	q-forward	269
21.4.4	Survivor forward	271
21.4.5	Instruments and liquidity	272
21.5	Customised vs standardised longevity hedges	273
21.5.1	Customised longevity hedge	273
21.5.2	Standardised index-based longevity hedge	273
21.5.3	Advantages and disadvantages	274
21.6	Case study: customised longevity hedge	274
21.7	Implementing a standardised index-based longevity hedge	275
21.7.1	Liability sensitivity and hedge calibration	276
21.7.2	Hedge effectiveness analysis	278
21.8	Conclusions	280
	References	280
<b>22</b>	<b>Case Study: A Cat Mortality Bond by AXA (OSIRIS)</b>	<b>283</b>
	<i>Sylvain Coriat</i>	
22.1	Catastrophic pandemic risk	283
22.2	Considered risk transfer tools	284
22.3	Detailed structure	285
22.4	Risk analysis	287
22.4.1	Modelling approach	287
22.4.2	Index construction	287
22.5	Investors' reaction	288
22.6	Spread behaviour	288
22.7	Next steps	288
	Reference	291
<b>23</b>	<b>Case Study: Some Embedded Value and XXX Securitisations</b>	<b>293</b>
	<i>Michael Eakins and Nicola Dondi</i>	
23.1	Embedded value securitisation – Avondale S.A.	295
23.2	XXX securitisation	299
<b>PART III</b>	<b>TAX AND REGULATORY CONSIDERATIONS</b>	<b>305</b>
<b>24</b>	<b>The UK Taxation Treatment of Insurance-Linked Securities</b>	<b>307</b>
	<i>Adam Blakemore and Oliver Iliffe</i>	
24.1	The Directive and the taxation of UK ISPVs	308
24.1.1	The implementation of the Directive in the UK	308
24.1.2	Implementation of the ISPV framework in the UK	308
24.1.3	UK tax treatment of ISPVs	310
24.2	Non-UK insurance special purpose vehicles	315
24.2.1	Tax residence status of the issuer	316
24.2.2	Tax residence status of the issuer's agents	317
24.2.3	Location and management of the issuer's assets	318

24.3	Indirect taxes and withholding of income tax	320
	Further reading	321

**25 The US Federal Income Taxation Treatment of Insurance-Linked Securities 323**

*David S. Miller and Shlomo Boehm*

25.1	Avoiding US corporate income tax for the issuer	324
	25.1.1 Overview	324
	25.1.2 Trade or business in the United States	325
	25.1.3 Procedures followed by catastrophe bond issuers to avoid substantive business activities in the United States	326
	25.1.4 Section 864(b)(2) safe harbor	328
25.2	Withholding tax and excise tax	328
	25.2.1 Overview	328
	25.2.2 Descriptions of insurance-linked instruments written on standard ISDA forms	330
	25.2.3 Federal income tax definition of notional principal contracts	331
	25.2.4 Put options	334
	25.2.5 The <i>Bank of America</i> case (income not clearly described within any other generally recognised category)	334
25.3	US federal income tax treatment of an investor in a catastrophe bond issuer: overview	335
	25.3.1 US investors	335
	25.3.2 Timing and character of income and gain of the issuer with respect to the permitted investments, the total return swap and the insurance-linked instrument	338
	25.3.3 Foreign investors	339
	25.3.4 Notes that are treated as indebtedness for federal income tax purposes	339
	Reference	339

**26 Regulatory Issues and Solvency Capital Requirements 341**

*Mark Nicolaidis, Simeon Rudin, Rick Watson and Katharina Hartwig*

26.1	Regulatory issues relevant for ILS sponsors	341
	26.1.1 Solvency capital	341
	26.1.2 Recognition of sponsors' claims against SPV as eligible assets	342
26.2	Solvency I	343
	26.2.1 Overview	343
	26.2.2 Requirement to maintain a solvency margin	344
	26.2.3 Structuring ILS under EU Directives to enhance solvency margins	348
26.3	Solvency II	351
	26.3.1 Valuation of assets and liabilities	353
	26.3.2 Determination of technical provisions	353
	26.3.3 Solvency capital requirement	354
	26.3.4 Minimum capital requirement	358
	26.3.5 Own funds	359
	26.3.6 Investments	360

Appendix A: Standard formula, solvency capital requirement (SCR)	361
A.1 Calculation of the basic solvency capital requirement	361
A.2 Calculation of the non-life underwriting risk module	361
A.3 Calculation of the life underwriting risk module	362
A.4 Calculation of the market risk module	362
<b>Index</b>	<b>363</b>



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## Acknowledgements

This project would not have been possible without the energy, time and effort of all the contributors, who have supported us in our initiative despite the difficult environment and busy schedules of year-end 2008. We would like to thank all of them for having completed their contributions, almost always within the tight timeframe we imposed on ourselves, and for the quality of the work done. We thank also those who believed in the project, but could not stay with us to see it finished due to events affecting their organisations, and are very grateful for the support of those who stepped in to complete the relevant chapters.

Special thanks are due to our editor, Caitlin Cornish, who has been extremely supportive, immediately and throughout this adventure. We are also very grateful to Andre, Anne-Marie and Annie, who have contributed to this project by working on the butterfly effect, and have been of constant and essential support; and to Claudia Ravanelli, for her patience and infallible support.

Editing this handbook required the editors to dedicate a considerable amount of time (which we found very exciting and professionally very rewarding) and we are very grateful to our colleagues for their patience, support and advice throughout the period.

Finally, a special thank you to Josie Green, who, without realising it, is at the origins of the whole project.



# Introduction

Pauline Barrieu<sup>a</sup> and Luca Albertini<sup>b</sup>

There has been much said about the convergence of the insurance industry with the capital markets. Such convergence has taken many forms, and of the many attempts, some have been more successful than others. Insurance-linked securities, often referred to as ILS, have proven to be one of the most successful manifestations of this convergence, of how capital market technologies can find applications within the insurance industry, and how insurance-related risk can be transferred to capital market investors. As outlined in later contributions, there were approximately \$13 billion of tradable non-life insurance-linked securities and \$24 billion in tradable life insurance-linked securities as of the end of 2008. In addition, whilst traded insurance-linked securities are the most visible and headline-catching forms of risk transfer to the capital markets, there are a number of other forms of placement of insurance risk into the capital markets, including:

- Private placements of insurance-linked securities (also called ‘club deals’) which involve a small number of skilled investors, and which are estimated to be of significant size.
- Sidecars on non-life insurance risk, which reached an estimated \$6 billion of capacity after Hurricane Katrina, and found new interest in 2008 with reduced retrocession capacity being available in the market.
- Insurance-linked derivatives, which are mostly over-the-counter contracts in life and non-life risk, transacted by financial institutions, brokers and regulated exchanges.
- Weather derivatives, also available via financial institutions, brokers and regulated exchanges.
- Traded life insurance policies – life settlements – which have been warehoused in significant size by financial institutions and are being distributed to capital markets as well as private investors.
- Collateralised reinsurance and industry loss warranties (ILW), which are typically reinsurance contracts but frequently backed by capital market investors (such as dedicated insurance-linked securities investors and hedge funds) which fund the collateral posting and assume the ultimate risk of the relevant insurance events.

The outstanding capacity deployed by capital market investors on the above mix of instruments was estimated to be well above \$50 billion in 2008.

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<sup>a</sup>London School of Economics

<sup>b</sup>Leadenhall Capital Partners

Moreover, the market has been enriched by a wider and deeper range of market participants over the last decade:

- Each year, new *originators* have approached the insurance-linked securitisation market, including a number of insurance and reinsurance companies, corporations and government institutions.
- Some of these originators who have tapped the insurance-linked securities market with a transaction have then sponsored *new transactions* covering new risks or *repeat transactions* on the same perils, thus capitalising on their positive experience with the technology, and in some cases have established *risk trading units* with the task of constantly monitoring opportunities for purchasing or ceding risk to the capital markets.
- A number of *modelling* and *actuarial firms* have the ability to perform risk analysis on different life and non-life risks with the rigour and methodology needed to describe them to capital market investors.
- A growing *number of risks* have been modelled for capital market transactions, thus enriching the potential for diversified exposures for investors.
- Diverse range *investors* have approached life and non-life insurance-linked securities across the risk spectrum. Investor types have ranged from money market managers, pension funds, banks, other institutional investors, insurance and reinsurance companies to a growing number of asset management companies dedicated to investing only in insurance-linked securities risk.
- There is a larger community of *arrangers*, *financial institutions* and *brokers* who have equipped themselves for origination and structuring of transactions, secondary trading of insurance-linked securities and in some cases providing secondary market pricing indications (although not yet at the level of market making).

After a decade of continuous growth, the insurance-linked securities market is now at a stage of consolidation of its past successes and further expansion, despite the recent turmoil in the capital markets, as discussed later in various chapters of the book. However, one could argue that the actual size of the market is still very small compared to its full potential. Supporting market participants with a transparent discussion on various aspects of this market and introducing insurance-linked securities to a wider class of originators and investors are essential in making this niche market more understandable, more transparent and more accessible. This is really what has motivated us in undertaking this project and what we would like to achieve with this handbook.

The main objective of this handbook is to present the state of the art in insurance-linked securitisation, by exploring the various roles for the different parties involved in the transactions, the motivation for the transaction sponsors, the potential inherent pitfalls, the latest developments and transaction structures and also the key challenges faced by the market.

To do so, we have decided to gather specialists with different backgrounds and experts with many years of experience in this field, representing the various perspectives and aspects of this market. Each chapter is therefore a contribution by one or several experts in insurance-linked securitisation. As a result, this book presents an independent view on the sector, with contributions from some of the key market players who have agreed to support our initiative. On the other hand, due to the healthy growth of the market and to the number of credible market players, it has not been possible to include all of those institutions that would have been able to provide valuable contributions within the targeted size of this handbook.