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Securities Litigation Law ALERT

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Expanding Market for Insurance and Risk Securities Promises High Risk, High Reward – and High Potential for Claims

The securities marketplace has experienced a resurgence of interest in insurance- and risk-linked securities, primarily as a result of Hurricane Katrina and Superstorm Sandy. First introduced after the Northridge earthquake and Hurricane Andrew (and later, after 9/11), the market for these securities subsequently softened. Recently, these securities have returned to popularity, because investment banks, broker-dealers, hedge fund operators and high-end investors have become more willing to accept higher risks in exchange for higher returns.

The investments are high risk and high reward, and they diversify virtually any investment portfolio. They reduce insurance and taxpayer costs, are less expensive than traditional reinsurance (the cost of which has increased over the same period), and they permit insurance companies and investment banks to transfer risk through the use of capital markets.

Typically, these investments take the form of either a catastrophe (cat) bond or a reinsurance sidecar:

Cat bonds transfer specified risks to investors, permitting insurers to eliminate the risk of a damages award in an amount exceeding premiums collected. Cat bonds are risky and are typically rated no greater than BB (securities that are investment grade, an industry benchmark, carry ratings of BBB or higher). Investors receive healthy returns on coupons paid to them - if catastrophes do not occur. They help create portfolio diversity, because cat bonds are insurance and risk related and are not closely associated with economic conditions or with equities, corporate bonds or other, more traditional stock market investments.

Reinsurance sidecars allow capital market investors to take greater risks and reap higher rewards by investing in a group of policies issued by an insurer (or reinsurer). These investments permit the ceding insurer to lay off risk at lower cost than traditional reinsurance and permit them to write more business, insure more risks and increase profits. The sidecar can aggregate different forms of investments, including debt (usually bank loans), preferred stock and equity. Again, the vehicle's risks are high, its rewards are high and its ratings typically are no greater than BB.

The purchase and sale of these vehicles create a fertile area for claims based on a lack of understanding of the product and an underappreciation of the significant risks. Anyone considering entering the increasingly large market for these securities must understand the significant exposure to claims resulting from a lack of understanding of the product, the failure of proper and full disclosure, and the unsuitable nature of the investments for uninformed, unsophisticated and risk-averse investors.

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