World Forum of Catastrophe Programmes
October 2011 Session—Jamaica

Diversifying Risk
Accessing Capital Markets through Transformer Reinsurance
The CEA Today

Publicly managed, privately financed residential earthquake insurer

More than 800,000 policies in-force
- Largest residential earthquake insurance provider in United States
- Covers 70% of earthquake insured risk in California

$10 billion in claims paying capacity

One of the largest purchasers of reinsurance in the world
- In recent years, annual purchases have averaged about $3 billion
This transaction is an opportunity for the CEA to accomplish four key objectives:

1. Accessing the capital markets for a part of its risk-transfer needs, thus diversifying the CEA’s pool risk-transfer counterparties and expanding the CEA’s available sources and amounts of risk-transfer capacity;

2. Obtaining risk transfer at a cost lower than traditional reinsurance pricing;

3. Providing for a repeatable reinsurance contract for the future; and

The CEA continues to explore additional sources of risk transfer to diversify its risk-transfer capacity, and seek the highest-quality financial products, at the best terms, and at the lowest possible cost.

Embarcadero Re
A newly-formed Bermuda company licensed as a special purpose reinsurer.
Transfer earthquake risk to capital market.

Capital Markets
Direct access without use of traditional reinsurer.
Repeat issuances diversify CEA claim-paying resources.
Manage price shocks from traditional reinsurance market.

The transformer reinsurance transaction is a multi-year reinsurance contract that allows the counterparty, as special purpose reinsurance vehicle (SPRV), to pass the CEA’s risk through to the capital markets. This type of transaction is sometimes referred to as a “transformer” reinsurance catastrophe bond transaction.
CEA Transformer - Reinsurance Structure

California Earthquake Authority

Reinsurance/Collateral Agreement

Premiums

Claim Payments

Finance Funding

Special Purpose Reinsurance Vehicle

Reinsurer

Notes: Interest & Principal

Proceeds

Capital Markets Investors

Return on Capital

Proceeds Trust Claim Payments

Collateral Trust Account

Trust Claims Payments/Collateral Agreement
Positive Effects of Transformer Structure

- Repeatable – A multi-year, repeatable method of risk transfer that is currently less costly than traditional reinsurance. Modest initial size ($150 million) in relation to capital markets demand presents potential for additional access in the capital market every four to six months as long as there is interest from investors. Transaction costs for repeat transactions are expected to be significantly lower than costs of initial transaction.

- Use of same structure for future transactions makes it easier for investors to understand and be comfortable with the terms, and builds investor base to increase market capacity for follow-on deals.

- Indemnity transfer – CAT Bond transferred CEA risk to capital market investor on full indemnity basis, without use of parametric or market index triggers, providing minimal basis risk to CEA.

- Fully collateralized reinsurance through CAT bond proceeds—100% of limit placed in Treasury securities in on-shore trust account to back up the transformer reinsurance transaction.

- Expands sources of claim-paying capacity beyond the finite amount of capacity available in the worldwide reinsurance market for California earthquake cover.

- Diversification opportunity for insurance-linked security investors.
Risk Management Through Diversified Risk-Transfer Solutions

Developing access to capital markets and post event bonding capability will allow the CEA to offer more affordable, higher value coverage – and will strengthen the sustainability of the organization.