

On the Basis Risk of Industry Loss Warranties



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(Elliott Rempel MD)

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GRIN Verlag Mrz 2012, 2012. Taschenbuch. Book Condition: Neu. 210x149x2 mm. This item is printed on demand - Print on Demand Neuware - Seminar paper from the year 2012 in the subject Business economics - Banking, Stock Exchanges, Insurance, Accounting, grade: 2,0, Friedrich-Alexander University Erlangen-Nuremberg, language: English, abstract: The following paper discusses industry loss warranties (ILWs). The aim of this essay is to analyze basis risk with the help of Excel simulation study and to perform a risk and pricing sensitivity analysis. Furthermore, on the basis of obtained results the hedging effectiveness of ILW contracts in comparison to traditional reinsurance shall be assessed. In company with traditional reinsurance and catastrophic bonds (cat bonds) ILWs protect buyers against natural catastrophes. The increased number of natural disasters in last years (Hurricane Katrina and Ivan in 2005, Hurricane Irene in 2011) led to lack of supply capacity in the traditional reinsurance and retrocession market. Insurers required additional capital. Therefore new and innovative catastrophic instruments - such as industry loss warranties or cat bonds - were developed (see Gatzert and Schmeiser, 2009, p.2). These new index-linked instruments have several advantages in comparison to traditional reinsurance, e.g. reduction of moral hazard or lower underwriting costs, but a potential buyer has also to consider the drawbacks: The most important one is basis risk (see Gatzert and Kellner, 2011a, p. 132). In the beginning this paper describes the characteristics of ILWs and discusses their pros and cons in comparison to other insurance instruments. In addition, the most common definitions of basis risk are introduced. An introduction of simulation study follows, beginning with a theoretical presentation of the approach used in the study. Subsequently, every single step as well as the formulas and the methods used are described. A following numerical analysis discusses the obtained results from the...

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