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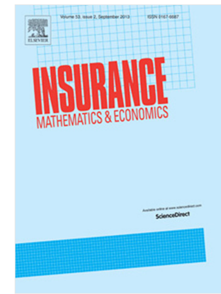

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Reinsurance Versus Securitization of Catastrophe Risk *

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Abstract

We provide a novel explanation for the low volume of securitization in catastrophe risk transfer using a signaling model. Relative to securitization, reinsurance features lower adverse selection costs because reinsurers possess superior underwriting resources than ordinary capital market investors. Reinsurance premia, however, reflect markups over actuarially fair premia due to the additional costs of underwriting. Insurers' risk transfer choices trade off the costs and benefits of reinsurance relative to securitization. In equilibrium, low risks are transferred via reinsurance, while intermediate and high risks are transferred via partial and full securitization, respectively. An increase in the loss size increases the trigger risk level above which securitization is chosen. Hence, catastrophe exposures, which are characterized by lower probabilities and higher severities, are more likely to be retained or reinsured rather than securitized.

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