Perfect storm

With the climate threat menacing ever more, is the catastrophe bond market set to see exponential growth? **Vincent Nadeau** investigates.

This year, the catastrophe bond sector reached a landmark anniversary, marking 25 years since its inception. This follows record levels of issuance in 2021, with the market seeing volumes of US$12.5bn, surpassing the previous record of US$11bn set in 2020. With currently over US$30bn of bonds outstanding and given the current political and scientific contexts around the climate threat, the sector could be set for exponential growth.

The notion of securitising catastrophe risks became prominent in the aftermath of Hurricane Andrew in 1992, initially as a niche form of risk transfer from insurers to investors. Cat bonds are fixed income instruments, typically structured as 144A floating-rate, principal-at-risk notes. On one side of the trade are insurers and on the other sit investors, willing to take on catastrophe-linked risks with their own capital, in return for regular interest payments.

Over the years, the growth of the asset class has consistently pointed to an increasing willingness to assume risk in the ILS market. Peter Nowell, global head of financial solutions at SCOR, notes that there have been three main reasons behind the success of the sector.

He explains: "The first is flexibility, as we've had a wide spectrum of very small and very large issues (US$1.5bn being the largest). The second has been to convince investors to support the current trend of indemnity structures (with issuers typically including a risk analysis from an expert third-party modelling firm). And the third being its de-correlation from mainstream assets."

An integral appeal of cat bonds from an investment perspective is their potential to deliver returns that are fundamentally uncorrelated to traditional financial markets. As such, the sector has not experienced the compression of spreads seen with corporate credits.

Peter DiFiore, md at at Neuberger Berman, says: "I think that cat bonds are a genuinely and fundamentally uncorrelated and diversifying asset class. There is very little outside of natural events that can lead to default."

He continues: "Cat bonds have a history of attractive returns. Clearly, the main determinant of cat bond performance over time has been and will be insurance events, whereas credit and equity performance is more tightly linked to broader economic and financial cycles."

The current macroeconomic and political contexts support this thesis. The combination of a war in Europe, a global sell-off in certain areas of the equity market, declining equity valuations, rising inflationary pressure and interest rate fears points to the sector's characteristic strength.

Additionally, there is an active secondary market in cat bonds. On average, according to a Neuberger Berman report (following data from TRACE and Tullet Prebon), around US$4bn of securities are traded each year – translating to an average of US$15m per day – with lot sizes of US$250,000 to US$10m.

DiFiore views such a feature as yet another strength for the sector: "Cat bonds are liquid and tradable and thus potentially more liquid versus other segments of the ILS market. They are also incredibly specific in what is being covered and provide excellent relative value for investors versus other risk assets – or other diversifying strategies (i.e. hedge funds) whose performance has been less impressive."

Unsurprisingly, climate change and its association with natural catastrophes is central to the outlook of the asset class. In fact, given the established prominence of the climate threat, it could be argued that the sector – although having just reached the 25-year milestone – is not, in fact, living through its early years. ▶

Peter DiFiore, Neuberger Berman

Such considerations have brought in recent years new participants to the market. Beneficiaries have included Google's holding company parent, Alphabet, seeking cover for its corporate real estate assets in California, and the state of Jamaica – helped by the World Bank – becoming the first Caribbean nation to step into this sector. The World Bank, which entered the market in 2017, has been able – through cat bonds – to provide financial capacity in developing economies in response to extreme events *(SCI 25 April 2019)*.

However, in merging climate risks with the capital markets, are investors fundamentally wagering, rather gloomily, against the environment? Furthermore, what would be the impact of a devastating year for natural catastrophes on the asset class as whole?

"Climate change is clearly an investor's concern, one which the industry needs to handle in a learned manner," states Luca Albertini, ceo of Leadenhall Capital Partners. "However, the fact is that we have already spent so much time and resources modelling climate change in pricing, portfolio construction and risk management. There is a clear understanding of the nature of the risk being underwritten."

Paul Schultz, ceo at Aon Securities, also highlights the sector's adaptability: "What suits cat bonds, and which is also true of the ILS market as a whole, is that it tends to be more innovative and faster-moving than other asset classes. However, the continuous challenge is the constant analysis of whether there is adequate return to the risk being assumed. There is persistent reassessment and recalibration of models."

Also inherent to this market are 'secondary perils', which include floods, wildfires and tornadoes. They differ from high-profile catastrophes, such as hurricanes and earthquakes, which have tended to generate the biggest losses for the sector. Again, climate change might act as a catalyst as these secondary perils could become increasingly dangerous and prevalent.

"The sector has a long history pushing outside 'normal' exposures," notes Schultz. "The ILS market can play a prominent role in tackling the impact of climate change, and the sophistication of the funds active in the market act as integral components for those looking to transfer risk. The diversity of issuers is being matched by the diversity in the risks being borne."

With the feeling that the core thesis of the sector has been tested repeatedly, the overarching sentiment in the market is that cat bonds are expected to grow strongly as an asset class. Schultz identifies non-traditional sponsors as key drivers of growth for the sector: "I think the biggest opportunity will be the expansion of the types of counterparties transferring risk. We are seeing corporations, sovereign states, multinationals all learning about cat funds."

This is a view shared by DiFiore: "We expect more sponsors to come to market. Following losses in the reinsurance market, rating agencies have revised many of their solvency calculations, which should translate into more issuance."

Luca Albertini, Leadenhall Capital Partners

"THE BIGGEST OPPORTUNITY WILL BE THE EXPANSION OF THE TYPES OF COUNTERPARTIES TRANSFERRING RISK. WE ARE SEEING CORPORATIONS, SOVEREIGN STATES, MULTINATIONALS ALL LEARNING ABOUT CAT FUNDS"

He adds: "We have seen more innovation in catastrophe insurance over the last 10 years than in the past 100 years before that. There is a lot of catastrophe risk which is under-insured or not insured. It makes sense to transfer it to the larger capital markets."

As the market grows, ESG considerations and factors are also expected to become one of the drivers of the ILS market, if not linked at the hip. Albertini notes: "I feel that that doing insurance-linked securities and neglecting ESG guidelines is simply not compatible. It is obvious that supporting cat bonds also means supporting ESG considerations."

Paul Schultz, Aon Securities

Asked if, all things considered, the sector is set for exponential growth, Nowell adopts a measured vision. "The ILS market's growth is tightly linked to the underlying growth of the insurance market. The insurance market is still highly dependent and skewed towards North America and, as such, a large part of the world is still not well insured. In that sense, I do not expect exponential growth overnight."

He concludes: "But it is a hardening market, with higher premiums, which in turn are more attractive for investors. We also need to think about what new risks can be put into a cat bond. Personally, I am very excited about the potential of life risks entering the market."■

SCI's Premium Content offers regular in-depth analysis of trends and developments across the market, in addition to our usual news output. To upgrade your subscription to access all premium content for a year, or for further information, email ***ta@structuredcreditinvestor.com****.*