INVESTMENT & PENSIONS EUROPE

Insurance-Linked Investments: Appetite for catastrophe

April 2013 (Magazine) **By Charlotte Moore**

Investors cannot get enough of the catastrophe bond market, writes Charlotte Moore, but the potential for equilibrium, albeit at lower returns, is there

The global financial crisis highlighted the advantages of investing in catastrophe bonds to the pensions industry. All other risk assets proved to be strongly correlated in the turmoil but these insurance-linked securities, which provide protection from extreme weather and earthquake events, remained immune from the shockwaves. They also generate a decent return, making them very attractive to institutional investors.

"Since January 2002 to February 2013, the Global Swiss Re Cat Bond index has generated a compound annual growth rate of 8.9%, with very little volatility," says Judith Klugman, head of ILS distribution and sales at Swiss Re.

In addition to the general market's favourable risk-return profile, the evolution of the cat bond market is also encouraging some ILS specialists to make more customisable products, allowing investors to have more control over particular risks. "They can choose two out of the following three criteria: the type of peril; the coupon level; and the loss trigger," explains Bertrand Delarue, head of strategic advisory and solutions at BNP Paribas.

For example, the pension fund of a company that is based on the east coast of the US might steer clear of cat bonds because its sponsoring company would suffer a negative impact should there be an extreme event in that part of the world which could then be amplified by the cat bond. Such a pension fund may, however, be interested in a customised note that strips out east coast wind risk while still offering a high coupon.

According to Swiss Re, the ILS market had a banner year in 2012, with the second-largest issuance ever, of $6.3bn (€4.8bn) worth of bonds. The total value of outstanding bonds now sits at $16.1bn.

"The outlook for this year looks very optimistic," notes François Divet, senior ILS portfolio manager at AXA Investment Managers. "Some brokers forecast bond issuance to reach $7bn in 2013."

Nonetheless, issuance during the first few weeks of the year has been disappointing and demand is outstripping supply.

"There is an inflow of money into the asset class," says Delarue "Many more investors, both institutional and private, have realised the benefits of the lack of correlation of this asset class with other financial assets."

While some large institutional investors have the necessary resources and sophistication to invest directly in cat bonds, most will allocate money to this asset class via a specialist ILS fund, many of which are struggling to keep up with demand.

“It’s not unusual for the more liquid UCITs ILS funds to have up to 20% in cash because they cannot find enough cat bond supply,” says Delarue.

To understand why the flow of cat bond issuance is not matching investor demand requires a closer look at the market dynamics.

Cat bonds are a sub-sector of the enormous global property and casualty insurance market. They only cover extreme events, such as hurricanes, earthquakes and windstorms. When these catastrophes occur they can cause billions of dollars of damage; that can be too much risk, even for multiple insurance and reinsurance companies to keep on their balance sheets.

“There is a requirement for the insurance industry to offload some of the risk of certain peak zones onto the financial markets, otherwise it would have too great concentration of that risk on its balance sheets,” Klugman explains.

While there are plenty of extreme weather events around the globe, only the US, European and Japanese insurance markets are sophisticated enough both to offer insurance for these extreme events and to off-load some of it to the capital markets.

The majority of cat bonds, 65%, covers US wind risk. The other two major areas are European windstorm and Japanese earthquake, representing 17% and 4%, respectively. Until property and casualty insurance reaches the same levels of penetration in the Asian and Latin American markets as in the developed world, supply will remain primarily focused on the US, with some additional coverage for European windstorms and Japanese earthquakes.

In addition to these constraints on the size of the market, there is another important factor keeping a lid on supply. Insurance and reinsurance companies do not have to transfer this risk onto the capital markets; they can keep some of it within the insurance market.

“An insurer or reinsurer will not issue a cat bond if there is sufficient capacity for this risk within the reinsurance market,” says Divet. “Nor will it do so if it costs too much.”

At the moment, it costs the insurance company more money to issue a cat bond than it does to cede the risk to a reinsurance company. Structuring a bond always carries extra costs over traditional reinsurance but, at the moment, the risk premiums being paid on bonds are bigger, too.

“A reinsurance company uses its balance sheet when it adds on peril risk; it’s a diversification from the other insurance risks it already owns,” Klugman explains. “Unlike a cat bond, it does not have to stump up any collateral, which makes it cheaper for the reinsurer to keep the risk, compared with issuing a cat bond.”

However, the popularity of the cat bond market might well help margins to tighten as an equilibrium develops. Demand will push down premiums and encourage supply from insurance companies, while lower premiums will discourage some of the more spread-hungry investors. “This will be a beneficial development for the asset class, increasing efficiency and transparency,” says Delarue.

Klugman concurs: “We’re hopeful that the narrowing of spreads will make cat bonds a very attractive economic complement to the traditional reinsurance market and will spur more issuance.”

There are factors outside the ILS market which could help to boost cat bond issuance: forthcoming regulatory changes like Solvency II could help to encourage insurers to make greater use of the market. As cat bonds are collateralised and traditional re-insurance is not, the risk capital relief is higher for a cat bond than for the traditional insurance market.
“Under Solvency II, the credit risk that a reinsurance company might default has to be backed by a capital charge,” says Sandro Kriesch, a partner at ILS specialist manager Twelve Capital. “As a cat bond has collateral, there is no requirement for a capital charge.”

Jean-Louis Monnier, head of ILS Europe, Swiss Re adds: “We expect that Solvency II will be positive for the cat bond market because it would provide the insurers with appropriate risk capital relief and diversification benefits. It might also encourage greater transparency of these products, which would make them more attractive to investors.”

The huge demand for assets that are truly uncorrelated to more traditional financial investments will continue force the pace of change in the ILS market.