Catastrophe bonds

Perilous paper

Bonds that pay out when catastrophe strikes are rising in popularity

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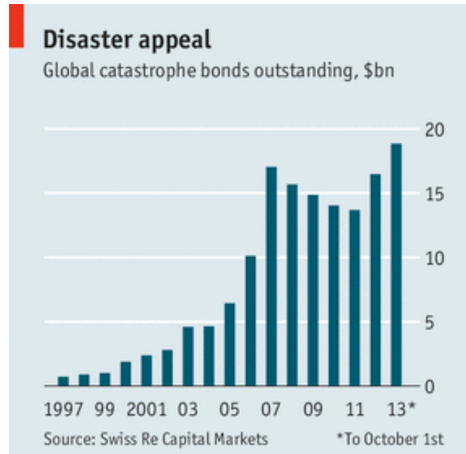
AFTER Superstorm Sandy flooded parts of the New York City subway late last year, insurers balked at underwriting the risks associated with future water surges. So the city tapped nearby Wall Street instead. Investors such as hedge funds and endowments paid $200m to buy a "catastrophe bond" issued by New York's transit authorities. In the event that flooding in the next three years reaches Sandy-style levels, that money will go to pay for the damage. If there is no repeat, the investors will get their principal back and pocket hefty interest payments as their return.

Such cat bonds are thriving. They first emerged in the mid-1990s after losses from Hurricane Andrew, which blew through Florida and other southern states in 1992, left insurance firms licking their wounds. Reinsurers, the firms that insure insurers against really big disasters, were particularly badly hit; capital markets swooped in to provide capacity. Since then each major catastrophe has boosted cat bonds further, from Hurricane Katrina in 2005 to the 2011 Japanese earthquake and tsunami.

Over $40 billion in cat bonds have been issued in the past decade, with $19 billion now outstanding (see chart). This is a small fraction of the $300 billion in catastropherelated payouts that insurers are theoretically on the hook for. But it is up from $4 billion a decade ago and the market could quadruple again in the next decade, thinks BNY Mellon, a financial group. Most cat bonds cover natural disasters in developed economies, particularly in America, where insurance is prevalent and losses from hurricanes, earthquakes and the like are well understood. But a broader range of risks, like Turkish earthquakes and Caribbean wind damage, are slowly coming to market.



Investor demand is strong. Pension funds and other institutional investors are on the hunt for assets generating decent yields, particularly if the returns are uncorrelated to stockmarkets. As recently as last year cat bonds paid up to 11 percentage points over Treasuries, for risks equivalent (at least according to the ratings agencies) to holding speculative-grade corporate debt. Large institutional investors buying cat bonds directly or via specialist funds now account for perhaps 80% of the market, says Bill Dubinsky of Willis, a broker.

The rise of cat bonds and other "insurance-linked securities" is starting to affect the price of insurance, particularly on the reinsurance side. The inflow of money from capital markets has helped push reinsurance premiums down by 15% this year, denting profits in the sector. Some weathered insurance executives are warning that naive investors are distorting prices, creating a frothy "shadow insurance" sector with systemic implications.

They are quietly hoping a well-timed calamity or two will lead to losses big enough for newbies to reconsider their approach. So far, however, the hurricane season in the Atlantic has been notable for its calm, delivering no August hurricanes for the first time since 2002, and only two in September. Even when catastrophes do occur, they do not necessarily wipe out cat-bond investors: only three of the roughly 200 bonds issued in the past 15 years have been triggered, says William Donnell at Swiss Re, a reinsurer.

Investors may lose interest if prices get too high. Yields on cat bonds have plunged to just six points over Treasuries in recent months, their lowest in a decade, amid an influx of new money and a dearth of catastrophes. “Pension funds are here to stay, but not at any cost,” says Luca Albertini of Leadenhall, an investor in the sector.

Many insurers and reinsurers say that the new investors are more a complement than a threat. Just as banks can profit either by lending money to a company or by arranging for it to tap capital markets, reinsurers can benefit from cat bonds. Some use capital markets to offset their own risk portfolio, leaving them more capacity to underwrite fresh risks. (There are equivalent products in the life-insurance business, paying out if fatalities spike because of a pandemic, for example.)

Cash pouring into insurance makes it cheaper—good news for those who need cover. The risk for insurers is that cat-bond investors keep swooping in just after a disaster, when firms usually put up prices; that would cut into the fat margins insurers have used to rebuild profitability. Britain’s financial regulator this week warned that the influx of new money into cat bonds could push insurers towards underwriting dicier business to keep profits up. Man-made disasters can be just as frightening as natural ones, after all.