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Would The US Government Want To Issue CAT Bonds At Scale To Finance Losses From Climate Change?

The alternative is taxation and greater deficits

Climate week just concluded in New York City. Instead of joining the chorus on how the US has withdrawn from the conversation, I thought I might write about something constructive. I have always worried that climate losses will eventually be socialized via greater deficits and eventually via greater taxation. What might an alternative look like? A private sector funded financing vehicle that can transfer risk from victims to a more risk loving investor, in exchange for appropriate returns. That is, something like CAT bonds.

How do CAT bonds work?

For those who may not be familiar, CAT bonds are effectively insurance on tightly defined catastrophic climate events. The actual structure is a bit complicated. An SPV (special purpose vehicle) is formed by an insurance company. Investors pay let's say $100 million to the SPV. This money will be used to pay out insured parties should the insurance company have to pay up if disaster strikes. Let's say the disaster is a 7.0 earthquake in a specific tightly defined region. The cash that comes in from investors is usually invested in US treasuries, which pay say 5% per annum.

The insurance company hands off the premiums it receives from selling coverage of $100 million to the SPV. Let's say that the premium is 6.5% on $100 million. The cumulative returns of 6.5% plus 5% on T-bills invested is passed on to investors every year till the disaster strikes. If disaster does not strike, the $100 million is returned to CAT bond investors at the end of the pre-arranged term, say at the end of three years. If the earthquake of 7.0 or higher does strike, the insurance company pays off the $100 million to insured parties.

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