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Catastrophe Bonds Avoid Direct Hit From Hurricane Irma.

Recent events appear likely to affect only a few, if any, of the outstanding $26 billion

What looked like a dark turn in the booming market for catastrophe bonds may wind up being little more than a blip.

With damage estimates for Hurricane Irma tumbling, investors in "cat bonds" will likely avoid the significant losses they may have absorbed had earlier, more aggressive estimates borne out.

Cat bonds are essentially a vehicle for insurance companies to transfer some of their financial risk to the global capital markets. Wall Street and other middlemen help insurers sell these bonds to sophisticated investors with the understanding that they could lose some or all of their principal to help pay claims.

These high-yielding bonds have surged in popularity in recent years among investors including pension funds, endowments and wealthy families. The rally has also come during a long stretch of few hurricanes hitting the U.S.

So the past couple of weeks have tested investor appetite as North America suffered three of its worst natural disasters in a decade. Private-sector insurers face as much as about $60 billion in costs in the U.S. from Hurricane Irma, which landed in Florida Sunday, Hurricane Harvey with historic flooding in Houston, and an 8.1-magnitude earthquake in Mexico, according to some risk-modeling firms' estimates.

But these events appear likely to affect only a few, if any, of the outstanding $26 billion in cat bonds.

The spate of catastrophes "may cause some investors to rethink their positions in the market" and expect a higher rate of return, said Gary Martucci, a director at Standard & Poor's Global Ratings. But "these bonds are generally two to three times oversubscribed, so even if a few investors walk, there's still sufficient capital available to buy the risk that is being offered in the market."

Hurricane Irma made landfall in the Florida Keys early Sunday, then moved up the state's west coast. Even at the upper end of Monday's projections of roughly $40 billion of damage, the storm is well below the $130 billion mark that put cat-bond investors on edge last week as Irma barreled across the Caribbean and seemed destined to strike Miami.

Mr. Martucci said he doesn't expect any of the cat bonds rated by S&P, representing a slice of those outstanding, to suffer a principal reduction based on the current $40 billion upper-end damage estimate.

Many insurance executives and cat-bond promoters are gathered in Monte Carlo for one of the biggest annual industry confabs. As the conference began over the weekend, attendees said they were getting frequent updates on the storm's trajectory from various sources, and using smartphones to stay on top of the U.S. National Hurricane Center's forecasts of Irma's strength.

Which cat bonds might suffer, and how much will have to be paid out, will become clearer in coming days as the industry tallies up actual losses.

“There is a mountain of alternative capital on the sidelines that will be available to be deployed if the insured loss from Irma results in significantly higher expected returns for cat bonds,” Tony Ursano, president of TigerRisk Partners LLC, a risk and capital adviser to insurers and reinsurers, said from the conference.

In simplest terms, a catastrophe bond works like this: An investor buys the bond, taking into account a calculation by an independent risk-modeling firm of the odds of a specified disaster occurring. The principal and interest are held in escrow and typically invested in Treasurys.

These bonds are typically sold in tranches, each with a different trigger. Triggers vary across the bonds. Some specify a deductible amount that an insurer must pay before tapping into the principal, while others are based on metrics tied to a weather event. Some are tied to a single event, while others reference damage accumulated over designated periods.

Florida hurricane risk is so large that around half of the $26 billion in outstanding cat bonds include that as a risk exposure. Bonds also cover other types of storms, wildfires, meteorite strikes and even solar flares among a growing array of choices for investors. In return for their investment, owners of the bonds are paid interest rates higher than conventional bonds for taking on the risk.

Aon Benfield’s U.S. hurricane bond index had an 8.7% average annual return over the past 10 years, compared with a 6.9% average over the decade for high-yield bonds. But cat bonds returned less over the 12 months through June 30: 6.4% compared with 7.9% for the high-yield index.

Over the years, investors have lost some principal and as Irma barreled toward the U.S. last week, S&P said at the time that 13 cat bonds it rates totaling $1.35 billion could be at risk.

These included $250 million in a class of notes issued in 2014 by Kilimanjaro Re Ltd., an entity affiliated with the reinsurer Everest Re. Payouts from the bond would be made to Everest if insured industry losses in Florida exceed $68 billion, a figure that now seems unlikely.

Last week in thin trading on a secondary market, part of a series of bonds tied to Florida-focused Heritage Insurance Holdings traded as low as about 50 cents on the dollar before recovering to 68 cents, market participants said.

But as estimates of the insurance industry’s costs fell Monday, “the cat-bond market has basically recovered,” said Dirk Lohmann, chief executive of Switzerland-based insurance advisory Secquaero Advisors AG. Mr. Lohmann was among the pioneers of cat bonds in the early 1990s. “There will be some isolated hits” but not widespread loss of principal, he said.

For insurers, the growth of cat bonds has given them an alternative to traditional reinsurance, in which they pay other insurance companies to take responsibility for some of their claims. Many like that the bonds have increased price competition with reinsurers and make them less dependent on those reinsurers.

The bonds were born in the 1990s, when Mr. Lohmann and other then-colleagues at Hannover Re in Germany were inspired to turn to the capital markets after Hurricane Andrew hurt many insurers’ capital bases. That hurricane, which cut across southern Florida in 1992, counts as the second costliest U.S. storm, behind Katrina in 2005.The securities took off after the 2008 financial crisis because investors were attracted to their relatively high returns and to the fact that their performance was uncorrelated to market swings.

A record $11.3 billion of new cat bonds were issued in the 12 months through June, according to Aon Securities. Cat bonds and other "alternative" reinsurance investments collectively stand at roughly $90 billion, or about 15% of the $605 billion in capital within the global reinsurance industry, according to Aon.

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Updated Sept. 11, 2017 10:04 p.m. ET

The Wall Street Journal