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Bond Markets Flash Warning About Environmental Catastrophes.

Investors in the $35 billion catastrophe bond market are demanding the highest premiums in years to cover issuers against disasters, as weather events become more extreme while interest rates rise.

Margins on new issuances of catastrophe bonds covering US wind events are now at the highest since 2019, at 5.3%, according to a report from reinsurance broker Gallagher Re. For other risks the premiums offered are at the highest since at least 2017.

The rise in margins comes after disasters including Hurricane Ian — the costliest storm for insurers since Katrina — saddled catastrophe bond holders with losses last year. An index by reinsurer Swiss Re AG which tracks the total return of such bonds, also known as cat bonds, tumbled 10% after the hurricane struck, causing devastation along the coastline of Florida.

And unfortunately for cat bonds, the hurricane, along with other natural disasters, happened during a year when global central banks hiked interest rates aggressively to combat soaring inflation. That means that safe corporate bonds now offer a yield of 5% globally, and come without complex risks like flooding and volcanoes to consider.

"Extreme weather events have led to high insured losses in 2022, underpinning a risk on the rise and unfolding on every continent," Martin Bertogg, head of catastrophe perils at Swiss Re, wrote in a recent report. "When Hurricane Andrew struck 30 years ago, a $20 billion loss event had never occurred before – now there have been seven such hurricanes in just the past six years."

Catastrophe bonds are issued to backstop risks that could include anything from natural disasters to lapses in the judgment of Credit Suisse Group AG's risk managers. The instruments generally have short maturity dates and promise returns to investors outside of the insurance industry by taking on the risk that their principal could be wiped out by a severe event. The value of such bonds outstanding last month was around $35 billion, according to Gallagher's report.

Rising interest rates might also affect issuance in the cat bond market this year, according to DBRS Morningstar.

"In an environment of higher interest rates, the cat bond market is going to have a tough time," said Marcos Alvarez, head of insurance at DBRS Morningstar. At least $10 billion worth of cat bonds have been issued each year since 2017, but that number will probably fall this year, according to Alvarez. Some deals failed to materialize last year, with issuers turning to traditional reinsurance instead, he said.

Natural catastrophes caused at least $115 billion of insured losses in 2022, well above the average over the last ten years and including an estimated insured loss of up to $65 billion from Hurricane Ian alone, according to Swiss Re's report. That adds to a longer-term trend of an estimated 5% to 7% annual increase in insured losses over the past decade, the reinsurer said.

The increasing threat of losses from disasters make issuing new cat bonds all the more important for the insurance industry, but it might be difficult to find enough investors.

The Cat bond pipeline is “quite strong” into 2023, Gallagher said in its report. However, demand constraints “may make it difficult for some of the deals to succeed.”

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by Lucca de Paoli and Tasos Vossos

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