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CAT BONDS ARE EVOLVING BUT ONLY TIME WILL TELL IF THEY REMAIN RELEVANT

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September 9 2016

Any fanfare at the growth of the cat bond market must be tempered by the fact the ILS market is small when compared with traditional reinsurance business. The increased popularity of cat bonds in recent times has been the subject of much debate and coverage and so outsiders to the insurance industry could be forgiven for assuming that these securities are a new phenomenon.

Instead, when viewed in the context of regulatory change, coupled with the needs of the international insurance and capital markets, one will see cat bonds not as an overnight success, but the result of an evolution that was decades in the making.

In recent times, the rise of insurance-linked securities (ILS) (measured by number and value of issuances) owes much to the fact that they are a means by which insurance risk is transferred by insurers to the capital markets.

This convergence of the insurance and capital markets first began to gather momentum in the aftermath of the financial crisis of 2008/2009. However, the insurance industry was only able to satisfy the appetite of the capital markets because the seeds of this potential investment opportunity had been planted years in advance.

In fact, cat bonds had been around since the 1990s, when they were developed by the property and casualty insurance industry as a result of Hurricane Andrew and the Northridge earthquake.

In the years that followed the first cat bonds, laws and regulations were enacted to facilitate the insurance industry's ability to meet the growing demand for catbonds.

A primary example of this development is the introduction in 2009 of a new class of insurer: the Bermuda special purpose insurer. A key facet of the Bermuda insurer is that it must be fully funded, and therefore perpetually solvent.

The fully-funded nature of the Bermuda special purpose insurer gives comfort to cedants and sponsors (who benefit from a purpose-built insurer with an impeccable credit rating), while affording investors an opportunity to diversify their portfolios by investing in instruments (e.g., cat bonds) that offered attractive returns (measured against other low-risk investments) that are uncorrelated with the risks associated with other asset classes.

Since the advent of the Bermuda special purpose insurer, evidence of the increasing popularity of cat bonds can be seen in the number of ILS instruments listed on the Bermuda Stock Exchange: a figure which surpassed $1 billion for the first time in 2010 and steadily rose to $19 billion by the end of 2015.

According to reports by the Bermuda Monetary Authority, approximately 72% of the global ILS market capitalisation was listed on the Bermuda Stock Exchange at the end of Q1 2016, with Bermuda special purpose insurers accounting for 62% ($1.4 billion of $2.2 billion) of new issuance volume during the first quarter of 2016 and Bermuda ILS representing 69% ($18.4 billion of $26.5 billion) of total outstanding capacity at the end of the first quarter 2016.

Any fanfare at the growth of the cat bond market must, however, be tempered by the fact that the ILS market is small when compared with traditional reinsurance business.

According to the Bermuda Monetary Authority, the $26.3 billion of risk covered by ILS represents only 5% of global reinsurance capacity (which is estimated to be $565 billion) and that, despite the number of ILS deals remaining consistent in 2014 and 2015, the aggregate volume of ILS deals had declined (by approximately $0.9 billion).

Before pointing to the contraction of the volume of ILS deals and proclaiming the fall of the cat bond, it is important to note that the ILS market has continued to evolve in recent years to meet the demands of the capital markets.

This can be seen in the development of so-called 'cat bond lite' transactions (collateralised reinsurance structures that require fewer parties and utilise standardised documentation, thereby facilitating greater speed-to-market and lesser costs than traditional cat bond transactions).

While the size of cat bond lite transactions tends to be smaller than that of a traditional cat bond, the cat bond lite market saw issuance levels exceed $500 million in 2014 and 2015. While this accounts for a relatively small share of the overall ILS market, it confirms a growing trend among investors to utilise this type of specialised cat bond.

The global ILS market has continually evolved since the mid-1990s, through the issuance of the first cat bonds in the mid-1990s, to the creation of special purpose insurers in the late 2000s and the advent of cat bond lite transactions in recent years.

Time will tell whether cat bonds continue to remain relevant as a product of the ILS market and, indeed, the overall insurance market. In the meantime, they will continue to provide the nexus between the insurance industry and the capital markets.

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