A defining year for Cat bonds

After a good start in 2008, the market for Cat bonds just stopped, says **David Priebe**. The worldwide meltdown has left 2009 unpredictable, can Cat bonds show their resilience?

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The catastrophe bond year ended back in July, and two quarters of virtual silence have signalled an abrupt change in the market. After 2006 and 2007, we had become accustomed to record-setting issuance years. Hopes were high for 2008, which was on track with the previous year through the beginning of the third quarter. Then, everything just stopped.

Given how 2008 progressed, we cannot judge the catastrophe bond market as we would in a normal year. A worldwide financial meltdown affected the (re)insurance industry deeply, creating conditions that will make 2009 unpredictable. Nonetheless, catastrophe bonds did demonstrate their resilience, indicating their likely importance this year.

In 2008, $2.7bn in catastrophe bond principal came to market, a 62% plunge from the $7bn in 2007. The number of transactions dropped by more than half, from 27 to 13. New catastrophe bond limits were down 40% (from $3.9bn). While the market was markedly slower last year than in 2007, it was fairly close to 2006 issuance rates. Yet, after a mid-July issuance of $320m, the market came to a halt. The prior year, $1.2bn was brought to market in the third quarter, with another $1.8bn coming in the fourth quarter. The normal flurry of activity in December was deferred, with execution planned for the first quarter of 2009.

The market changed dramatically and suddenly. Several factors were responsible. Catastrophe losses increased substantially relative to 2007, due in large part to hurricanes Gustav and Ike. A financial catastrophe joined the hurricanes in September, ripping through the world's financial centres with unparalleled ferocity. These two events squeezed the world's financial markets and made the recent renewal season one of the most unusual in several decades. With widespread uncertainty through the end of 2008 as the result, the only viable course of action for issuers was to wait and see.

Catastrophe activity increased in 2008, following two relatively quiet years. Potential issuers watched carefully to see if any catastrophe bonds would attach in the wake of hurricanes Gustav and Ike. While principal remained untouched, the storms did have an effect on issuer perspectives, as fears mounted about having to pay higher interest rates for new catastrophe bond issuances. Also in September, the turmoil experienced by several high-profile financial institutions caused concerns that credit risk would leak into catastrophe bond structures. Again, the apparent exposure was worse than the market result, but the threat nonetheless caused carriers to take a second look at how they transfer risk.

Constraints on leverage

Access to capital tightened last year, particularly in mid-September, making capital markets less attractive to (re)insurers. Increased redemption rates in the alternative investment space rendered these institutions less willing (or able) to invest in insurance risk, and the situation was exacerbated by the withdrawal of many multi-strategy hedge funds from the ILS asset class. Constraints on leverage also limited the amount of capital available for investment, and credit markets around the world showed signs of drought.

The overarching factor, of course, was uncertainty as to the direction of traditional reinsurance rates. As cedents and markets headed toward the year-end milestone, pricing showed little uniformity. Line of business, geography, and loss history influenced pricing, making most attempts at generalization futile. Few could say with confidence that they knew where reinsurance rates were going, and the market's ambiguity led carriers to wait for the overall implications of the January 1, 2009 renewal to become evident before pursuing issuances.

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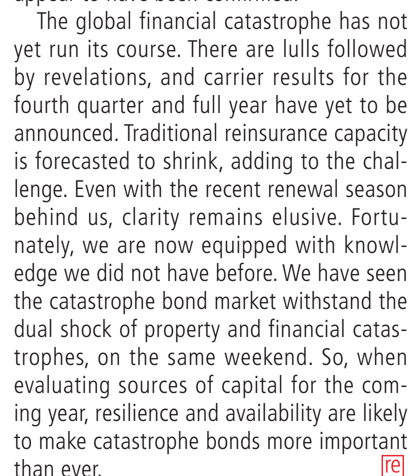

Despite the obvious challenges of 2008, catastrophe bond performances (for investors) held up rather well. Unlike other credit instruments, catastrophe bonds are linked to physical events —such as earthquakes and hurricanes — rather than the issuer's likelihood of default. For this reason, advocates have claimed that catastrophe bonds are not correlated with broader credit markets. Aside from the four bonds that many worried had been infected by the credit crisis, claims of non-correlation appear to have been confirmed.

The global financial catastrophe has not yet run its course. There are lulls followed by revelations, and carrier results for the fourth quarter and full year have yet to be announced. Traditional reinsurance capacity is forecasted to shrink, adding to the challenge. Even with the recent renewal season behind us, clarity remains elusive. Fortunately, we are now equipped with knowledge we did not have before. We have seen the catastrophe bond market withstand the dual shock of property and financial catastrophes, on the same weekend. So, when evaluating sources of capital for the coming year, resilience and availability are likely to make catastrophe bonds more important than ever. re

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