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Cedants are taking a strategic view of the cat bond market

Property catastrophe risk is growing around the world, primarily due to urbanisation, economic growth, global inflation and the impact of climate change. As the insurance industry faces the spectre of increasing catastrophe loss driven by multiple factors, it has been further sobered by loss amplification from recent extraneous factors of geopolitical conflict, supply-chain interruptions and a global pandemic.

Even excluding the impact of the Russia-Ukraine conflict and Covid-19, large insurance industry losses aggregated to $122bn in 2022. The resulting strain caused a material dislocation in the reinsurance market. Several major reinsurers have pulled back from property catastrophe risk to reduce volatility of their financial results and to appease their equity investors who have been pricing the sector below its book value. This pullback resulted in a shortage of capacity and one of the hardest property markets in recent memory at the 1 January 2023 renewals. The Guy Carpenter Global Property Catastrophe Rate on Line Index is at its highest level since 2000. Going forward, S&P is also proposing increased capital charges for catastrophe risk by factoring higher return periods, broader exposure base and contingent credit risk in their capital model.

In view of these evolving dynamics, ceding companies have started to take a more strategic approach to ILS. Specifically, they are incorporating catastrophe bonds as a core part of their reinsurance placement to access a different source of capacity, extend duration of their risk-transfer program to minimise annual pricing fluctuations, mitigate credit exposure by securing a fully funded cover, and create negotiating leverage in the market. Many companies are moving from an opportunistic issuance approach to a well designed laddered program that allows them to continuously access the market and add incremental capacity.

While catastrophe bonds historically have been a risk management tool for large primary companies and reinsurers, demand for and usage of them have broadened significantly over the past 18 months. Nine new sponsors tapped the catastrophe bond market for their very first issuance in 2022 and seven have already come to the market in the first half of 2023. These sponsors included national, regional, mutual and reciprocal US companies, international reinsurers, Lloyd's syndicates and a government risk pool. They have sought coverage based on parametric, index and indemnity triggers. In fact, several of these new sponsors have accessed the catastrophe bond market multiple times during this period.

Investors have responded to the demand with enthusiasm. A total of 42 separate catastrophe bond deals were completed by 37 unique cedants during H1 2023 for a total issuance of $9.3bn. This puts the catastrophe bond market on track for record issuance this year, with the total risk capital outstanding expected to exceed $40bn.

This activity is supported by fresh capital being injected into the space by pension and sovereign wealth funds, maturity of existing securities, and a rotation away from collateralised reinsurance and sidecar structures. Investors are attracted to disciplined pricing, rigorous disclosure and favourable terms and conditions. Recent legislative reforms in Florida have been very constructive. Further, the yield on the collateral invested in money-market funds has exceeded 5%, which results in the total coupon on catastrophe bonds typically being in the double-digit range, making them very competitive with other high-yield products. Most catastrophe bonds this year were oversubscribed in demand and have priced within or below the initial guidance. As the bond market remains active throughout the year instead of on discrete renewal dates, this positive momentum was conveyed early to the traditional reinsurance market and helped set the tone for more orderly mid-year renewals than was seen at 1 January.

More than $10bn of outstanding catastrophe bonds are scheduled to mature in the coming months and additional capital continues to flow into the market, setting the stage for robust ongoing issuance activity. As ceding companies optimise their risk-management strategy in the new normal paradigm of growing peak perils and limited appetite for volatility, capital markets risk transfer using catastrophe bonds has become a critical component of the solution.

How Guy Carpenter can help

The GC Securities team remains an industry leader in analysing, structuring and marketing ILS that provide clients with optimal solutions for their unique risk-transfer needs. The team takes a holistic, product-agnostic approach, extending beyond Guy Carpenter and employing knowledge and resources from across the Marsh McLennan organisation.

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