Recent Developments and Current Status of the Cat Bond Market

Solidum Partners – July 2023

In the first half of 2023 the ILS market and its cat bond sub-segment delivered very pleasing returns. In the following we want to explain the reasons that lie behind these dynamics and what the development means for investors interested in the asset class today, mid-year 2023.

Following on a general increase of risk spreads during the first half of 2022 in nearly all asset classes – a consequence of central banks putting up the price tag of money again – hurricane Ian caused an additional widening of cat bond risk spreads in the last quarter of 2022. The hurricane affected the cat bond market through several different pathways, all of which lead to higher yields: i) the fear of imminent capital losses, ii) an objective increase of the risk of aggregating structures through partial erosion of retentions demanding higher risk premia, iii) a temporary reduction of trading in the secondary market at a time of a marked offer overhang and iv) a general resetting of the return expectations of market participants towards higher compensation levels for the assumed risk. As a consequence, the average yield to maturity of the cat bond market increased rapidly to levels not seen since the credit crisis a decade ago.

The situation around New Year showed clear signs of a temporary overshooting. Since then, the information situation in respect to hurricane Ian's effects on the cat bond market improved significantly, and it became obvious that initial worries were exaggerated. Though in few cases capital losses – typically only partial ones - had to be realized, the hurricane did not wreak havoc at all on the broader cat bond market. Additionally, even for the last aggregating structures the annual risk periods are over now, and those bonds have returned to their normal amortization pathways. Lastly, secondary marked flow set in again, and price indications today reflect the correct compensation levels rather than liquidity-driven astronomical prices without market depth.

Does the above mean that the rally is over now and it is too late for a general investor to join the party? We believe that rather the opposite is true: Indeed, in retrospect it would have been beneficial to have participated in the strong recovery of the market from its lows in the last quarter of 2022, but one should not forget that those extra returns came on the basis of very real risks associated with the final outcome of hurricane Ian, which to fully understand was not an easy task, especially for peripheral observes of the asset class.

As these ramifications have now dissipated, and only the base effect of the generally strong returns remains: The general resetting of the return expectations towards significantly higher compensation levels for assumed reinsurance event risk. We wish to emphasize that this enhanced return level does not come at the cost of higher underlying risk, as the probability of occurrence of catastrophic reinsurance events did not change from last autumn. In this aspect, the ILS asset class is different from most segments of the capital markets, in which risk is directly coupled to the economic development and its dependency on current challenges such as inflation, interest rate environment, and global political risks.

A final question remains: How long will this very favourable situation of the cat bond market remain? Evidently this is one of those crystal ball questions that are so difficult to answer because they relate

to the future… But one aspect seems to be relatively certain: The main reason for a weaker reinsurance market during the last years was the fact that central banks flooded money into all segments of the capital markets. With this, not only interest rates had been driven to historical lows, but as well the cost of risk had been devalued, and investors had a difficult time to get fair compensation for assumed risk. Inversing this argument, we believe that the current, very attractive state of the ILS market will remain, provided that central banks will not revert to a nearly-zero rate policy anytime soon, for at least 18 to 24 months, with only a gradual levelling off over time. Hence it is now possible to profit from this extra-ordinary state of the ILS market, without attention needed to be given to a special situation such as the effects of hurricane Ian, and without achieving these attractive returns by assuming the macro-economic risks embedded in the general sectors of the capital markets.

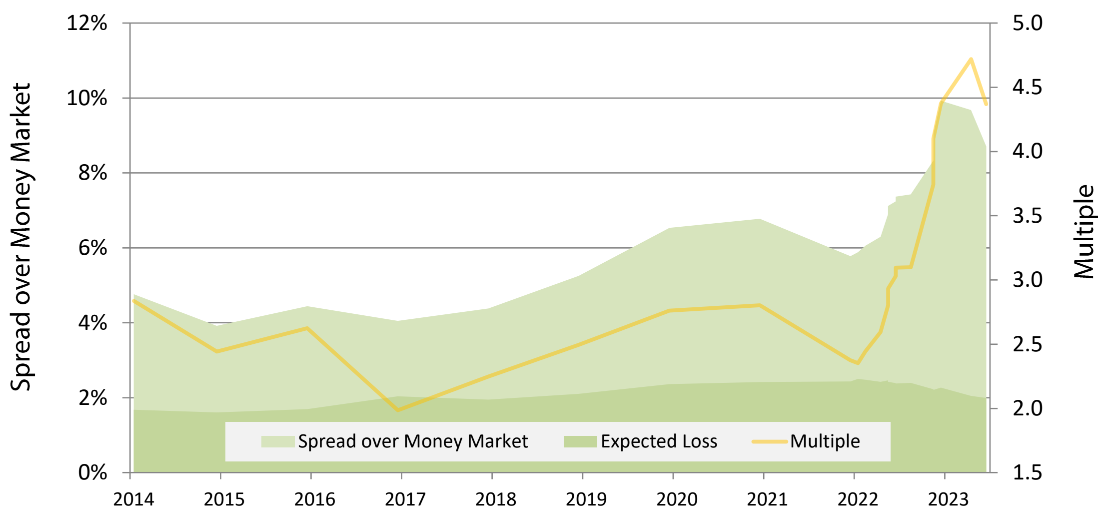

Figure 1: Spread over money market and expected loss of the cat bond market over time.

The quantitative analysis of the market in Figure 1 is based on different price sources for Cat Bonds. Yield-to-maturity was calculated on a bid/ask average price for each bond and weighted by issue size for the market average. (The figures refer to the risk spread only; cat bonds pay this risk spread in excess of an additional money market base return). 'Pathological cases', where market prices remain strongly influenced by past events, as well as securities with a residual maturity of less than 1 year, have been excluded to minimise distortions. The graph clearly shows the tightening of risk spreads in the first half of 2022 due to the adjustment to the general capital markets return environment, and the very strong additional expansion after Hurricane Ian. After the subside of Ian-related special effects, the market remains very strong in the first half of 2023.

In addition to broadening spreads, the modelled average market risk declined as well from around 2.4% to 2.0% over the past 18 months, as on average less risky bonds tended to be issued. This further improved the "multiple" of the market, the ratio of spread to expected loss. Furthermore, the market also benefits from the currently higher base rates, as the instruments are structured as floaters over money market, thus providing some shielding against inflationary risks.