Reinsurance capital shortage drives Cat Bond spreads to multi-year highs

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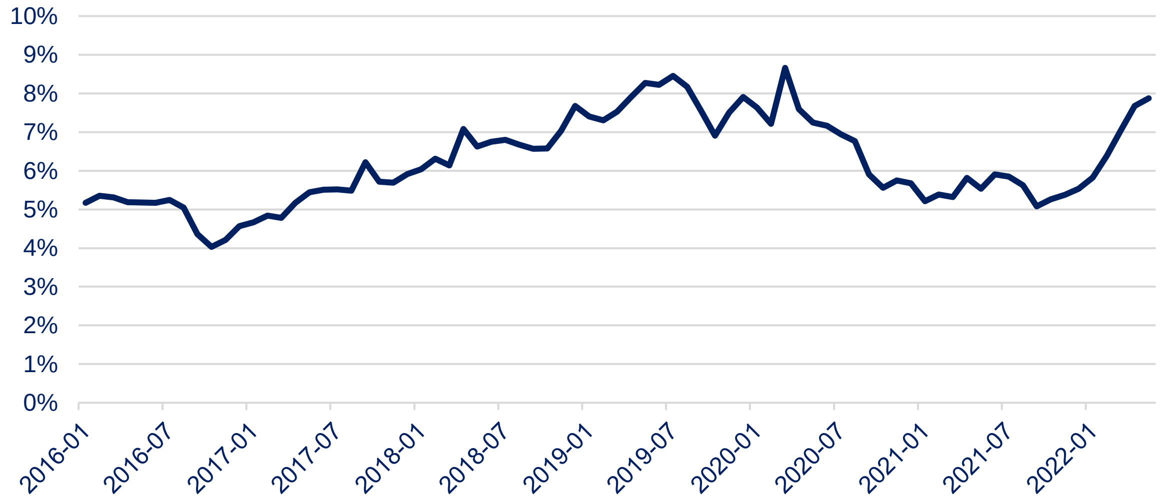
Whilst the year has started calm for Cat Bonds in relative terms compared to broader financial markets, the perception that it might be business as usual in the reinsurance world would be a massive understatement of the issues currently facing the sector. Several years of elevated catastrophe activity that have eroded capital reserves in traditional reinsurance markets, the exodus of investors from high risk collateralized reinsurance strategies and the massive cash impact of FX hedging in Cat Bond strategies result in a significant liquidity squeeze in the Cat Bond market.

As a result, we see record primary market issuance volumes in the Cat Bond markets, which cannot be fully absorbed by existing investors. Deals with weak quality are not purchased at all and other transactions can only be sold at significantly higher spreads compared to recent years. For example, a bond covering windstorm risk in Louisiana that in 2020 got issued at a spread of 350bps is now marketed to investors with a spread of 900bps, whilst the risk of the transaction is essentially unchanged. Other transactions, such as a Cat Bond with a trigger linked to losses suffered by the entire industry and a risk level of around 7%, can be purchased at coupons of almost 20%.[1] With currently more than ten active deals in the primary market and with brokers indicating that there are more transactions to come, a sudden reversal in spreads also seems unlikely at this stage. The current opportunity set might well persist for a few more weeks even into the start of the 2022 hurricane season.

Performance wise, spread widening has also left its mark on existing transactions, which consequently were marked down. As a result, performance across Cat Bond vehicles YTD is flat or even slightly negative, despite a lack of any noteworthy new catastrophes[2]. The Cat Bond market now exhibits an overall spread of more than 650 bps above money market rates. Given the steep forward rates curve in money markets, we might even see the overall yield of Cat Bonds exceeding 10% within the next year.

Discount Margin + 3M MMF Rates



Source: Twelve Capital, Bloomberg. As at 12 May 2022.

For investors who have yet to deploy capital in the asset class or for existing investors willing to increase their allocation, this marks an excellent entry point. Yet, one should understand that the 2022 hurricane season is approaching fast and that the ability of Cat Bond funds to absorb larger inflows could become limited very soon. Speed is of the essence and we would strongly encourage investors to get in touch in order not to miss this exceptional entry point into a diversifying asset class.

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[2] Past performance is not indicative of future returns.

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