THE WALL STREET JOURNAL.

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Hurricanes and High Yields Come Together on Wall Street

Catastrophe bonds set for record issuance after notching their best first-half performance

By Eric Wallerstein

Hurricane Idalia flooded streets in Tarpon Springs, Fla.

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The mounting cost of extreme weather events is turbocharging the market for catastrophe bonds.

Designed in the mid-1990s in the aftermaths of Hurricane Andrew and the Northridge earthquake, these bonds allow insurers, companies and even governments to transfer some of the risk of a disaster to investors. For offering what is essentially reinsurance, investors get relatively high yields in return for the possibility they lose their money if hurricane winds top certain speeds, or damages exceed certain dollar thresholds.

Now, more frequent disasters are prompting increased issuance of these bonds, even as investors demand double-digit rates in some cases. A cat-bond index compiled by Swiss Re had its best first-half of a year on record in 2023; through August, the index is up more than 14%.

"Cat bonds have performed better than many expected," said Jean-Louis Monnier, Swiss Re's head of insurance-linked securities. "You need extremely big events with very remote risk to hurt them."

Nearly $11 billion in cat bonds were sold through the first eight months of the year. The market has now topped $41 billion—double its size a decade ago, according to Artemis, an insurance-linked securities data firm.

The market's growth is prompted by not only more extreme events but also inflation—the cost of dealing with disasters has risen rapidly.

New York's Metropolitan Transportation Authority sold its fourth cat bond in May, receiving $100 million in protection against surges originating from named storms. It matures in 2026, a typical duration for cat bonds, paying 5.75 percentage points above short-term interest rates.

Since the Federal Reserve hiked rates to the highest in 22 years, MTA's bond has been paying more than an 11.1% annualized coupon. Because the rates float with those set by the Federal Reserve, its price doesn't suffer from rising rates—instead, bondholders benefit from higher yields. Cat bonds also don't trade in lockstep with corporate debt, helping large investors hedge their portfolios.

This year, Chile tapped financial markets to shore up protection from earthquakes and resulting tsunamis. Investors are receiving roughly 10.1% on bonds issued by the World Bank on Chile's behalf—they just have to be mindful of a risk that most struggle to model.

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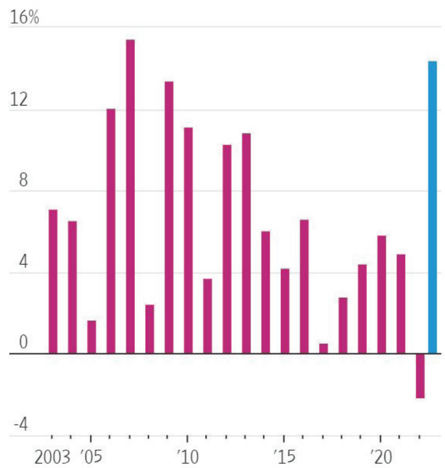
"There's always tension between the idea that cat bonds are attractive portfolio diversifiers, and concerns about climate change," said Peter DiFiore, a managing director at Neuberger Berman. "Are we properly pricing the risks? Or are we picking up pennies in front of the proverbial steamroller?"

DiFiore, a 42-year-old Princeton-trained geoscientist, didn't imagine he would be working on Wall Street, much less trading bonds. He now manages $3.2 billion for Neuberger Berman's insurance-linked strategies, structuring deals with insurers and other firms and ultimately investing in them on behalf of pensions, endowments and other large investors. More than $1 billion of those funds are invested specifically in cat bonds.

"Catastrophe bonds are a powerful idea to begin with—we are offered returns for risks that are fundamentally uncorrelated to everything else investors hold," said DiFiore. "Our most powerful hedge is choosing not to write certain risks."

Neuberger Berman counts on its cadre of catastrophe scientists to intensively model extreme events to find the best value. While an uncertain and increasing number of disasters sounds bad for bondholders, insurers' swelling need for protection has tilted the market in favor of investors, especially as higher rates have sequestered cash into traditional assets.

Swiss Re Total Return Cat Bond Index

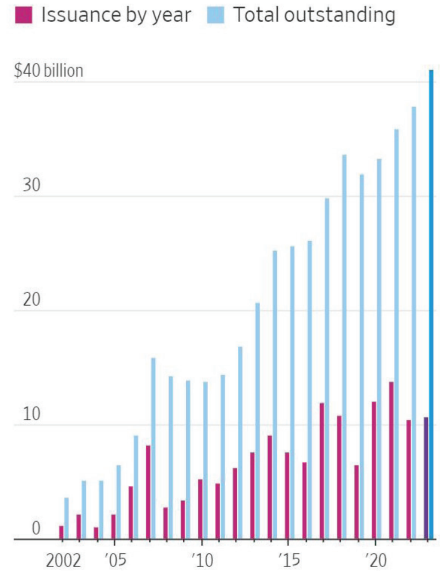


Note: 2023 data through Aug. 31
Source: Swiss Re

Hurricane Ian, the third-costliest natural disaster in U.S. history, upended the cat bond market last year. With the storm racking up $115 billion in damages, investors feared they would be on the hook for their principal. With high-water marks, or attachment points, on when the bonds would be triggered, many bondholders fared better than expected.

Insurers suffered, on the other hand. Reinsurance premiums—the amount insurance companies need to pay for their own coverage—jumped. In many cases, the premiums doubled in the aftermath of Ian, according to DiFiore.

Catastrophe bond market



Note: 2023 data through Aug. 31. Includes some other insurance-linked securities.
Source: Artemis

The wave of supply isn't expected to break soon, as the need to protect against potential losses continues to grow. That should keep terms attractive, encouraging investors to enter the cat-bond market.

Hurricane Idalia hit Florida before traveling to the Carolinas as a tropical storm. DiFiore said early analysis suggests much lower losses than Ian caused, and therefore limited risk for cat-bond holders. It is the latest prod for Florida's insurance industry to build more resilience, he added, which should keep cat-bond supply plentiful.