TRENDING TOPICS

MITIGATING BUSINESS INTERRUPTION RISKS WITH CATASTROPHE BONDS

Trending Topics represents an executive summary compilation of news, information and perspective on matters affecting businesses and business leaders today. This insight is being provided to keep you up to date on the latest developments and trends influencing these topics. These views do not necessarily represent the views and opinions of PNC. For additional research on these topics, please consult the sources cited in this article.

Issuing catastrophe (CAT) bonds as a way of mitigating the financial risks of natural disasters — a strategy primarily used by insurance companies and reinsurers in the past — is now being adopted as a risk management tactic by some large companies and municipalities.

A RESPONSE TO FINANCIAL IMPACT OF DISASTERS

In 1992, Hurricane Andrew left in its wake approximately $25 billion in damage impacting businesses, consumers, states and municipalities.[1] Since then, weather and climate events have increased with major hurricanes such as Katrina and Sandy, tornadoes, wildfires, inland floods and earthquakes affecting the United States. Year to date through September 2016, the National Centers for Environmental Information (NCEI) reported 12 climate and weather related events across the country with losses exceeding $1 billion.[2]

Insurers and reinsurers began introducing CAT bonds in the early 1990s to mitigate the risks of natural disasters. A CAT bond is a high-yield debt instrument intended to provide funds in case of a specified natural disaster.[3] These insurance-linked securities can be used to distribute risk from natural events across a wider scope. Pricing is based on CAT modeling that analyzes potential exposure to weather and other catastrophes.

Because investors take on the risk of extreme events over years, the bonds pay relatively high returns. The downside is that CAT bondholders lose their principal if a disaster strikes. The maturity for CAT bonds is relatively short, typically three to five years.

CAT bonds usually cover risk limited to certain geographic areas and specific climate or weather events such as storms, earthquakes or hurricanes. They are designed with "parametric-loss" stipulations that trigger payouts when a pre-defined measure for a natural disaster is reached, such as an earthquake measuring a certain level on the Richter scale. They also can carry indemnity triggers that pay out after a pre-determined level of monetary loss is reached.

STRATEGY BROADENS BEYOND INSURERS

Some business entities such as Kaiser Permanente and Amtrak have begun issuing their own CAT bonds in the capital markets.[4] The CAT bond market now includes insurance brokers, corporations, and other entities such as local governments, transit authorities and pools of municipalities — all seeking insurance against natural disaster risks.

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Companies wishing to supplement their business interruption and catastrophic event coverage can consider purchasing CAT bonds as supplemental coverage to address insurance coverage gaps.

After Superstorm Sandy struck the northeastern United States in 2012, many companies found they had large gaps in insurance coverage for business interruption risk. When they tried to buy more insurance, many found they still lacked adequate coverage or that their insurance carriers weren't willing to extend coverage without substantial hikes to their premiums. By issuing CAT bonds, corporate entities and municipalities have been able to supplement their insurance policies and address gaps in their business interruption risk coverage.

A GROWING MARKET

In addition to serving as protection against damage from natural disasters, CAT bonds gained in popularity as a coveted security for investors during the 2008 financial crisis. Interest rates had dropped during the recession and many pension plans, government funds and wealthy investors sought higher returns, so they turned to high-yielding CAT bonds.

With interest rates remaining low, the market for CAT bonds and similar investments has exploded and bond issuance was expected to reach $7 billion in 2016.[5]

The latest Allianz Risk Barometer found that 51% of companies surveyed expect that natural disasters and weather events will likely pose business interruption losses during the business year.[6] Companies wishing to supplement their business interruption and catastrophic event coverage can consider purchasing CAT bonds as supplemental coverage to address insurance coverage gaps.

To discuss these topics in more detail, please contact your PNC Relationship Manager.

1 "The Insurance Industry Has Been Turned Upside Down by Catastrophe Bonds," by Leslie Scism and Anupreeta Das, *The Wall Street Journal*, Aug. 8, 2016. Available at: http://www.wsj.com/articles/the-insurance-industry-has-been-turned-upside-down-by-catastrophe-bonds-1470598470

2 "Billion-Dollar Weather and Climate Disasters: Overview," National Centers for Environmental Impact, data as of Sept. 30 (data does not include Hurricane Matthew, which occurred in October 2016) Available at: https://www.ncdc.noaa.gov/billions/

3 CAT bond definition found at Investopedia, available at: http://www.investopedia.com/terms/c/catastrophebond.asp

4 "How Cat Bond Deals Can Mitigate Business Interruption Risk," by John Hintze, Association of Financial Professionals, Feb. 18, 2016. Available at: https://www.afponline.org/trends-topics/topics/articles/Details/how-cat-bond-deals-can-mitigate-business-interruption-risk/

5 "Catastrophe bonds attract investors despite concerns over lack of information," by Matthew Lerner, *Business Insurance*, Feb. 28, 2016. Available at: http://www.businessinsurance.com/article/20160228/NEWS06/160229859/catastrophe-bonds-attract-investors-despite-concerns-over-lack-of?tags=%7C302

6 "Opportunity for ILS to mitigate BI losses from natural catastrophes," Artemis blog, Jan. 22, 2016. Available at: http://www.artemis.bm/blog/2016/01/22/opportunity-for-ils-to-mitigate-bi-losses-from-natural-catastrophes/

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