Time for catastrophe bonds?

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- Hurricane ‘Andrew’ that hit Florida in 1992 spurred the idea that catastrophe risk could be securitised and spread across investors
- The recent floods in Kerala have set off a debate about the need for timely aid required to kickstart the relief process.
- There is a market mechanism for providing relief to the people in a timely manner.
- The idea that catastrophe risk could be securitised and that it could be dispersed among a wide number of investors was first mooted in the nineties after hurricane ‘Andrew’ caused massive damages in the United States.
- The market for catastrophe bonds was initially pegged in the range of $1-2 billion dollars in the initial years of 1998-2001.
- Today, the total size of the catastrophe bond market is more than $30 billion
- Catastrophe bonds are issued by insurance companies which have exposure to property and calamity insurance.
- There is also insurance bought by U.S. State governments against calamities.
- The cost of issuing and managing catastrophe bonds is cheaper than the cost of reinsuring these risks and does the same function of transferring risk.
- Hence, insurance companies prefer issuing catastrophe bonds.
- The instrument is a bond where the investor loses a part or whole of the capital based on certain pre-agreed conditions being triggered.

Triggered Conditions

These could be:

- Indemnity on losses faced by the insurer; (or)
- modeled losses;(or)
- losses indexed to the total loss faced by the industry.

Helps investors diversify risk

For investors, there are two advantages.

- One is that of diversifying risk.
- This is perhaps the only class of bonds that is not tied to economic performance parameters which would be the case in equity.
- Second, the investors are compensated by a rate of return which is higher than that of normal government or corporate bonds.

The primary investors in catastrophe bonds are long-term bond investors such as life insurers, and primary pension fund managers. This helps them get extra returns on investment which in turn helps them to meet liabilities especially in a scenario where low interest rates have made meeting liabilities difficult in the west. Most rating agencies have started to rate these class of bonds. The rating given is normally a notch below the investment grade.

Drives preparedness

- Since investors will always have an eagle eye on the preparedness of dealing with catastrophes, it cuts the slack and bolsters more investments into technology and into people keeping an eye out for such events.
- It is high time that such instruments are introduced in India so that relief and reconstruction work in areas affected by natural disasters goes on unimpeded and are no stalled for only want of capital.

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