The anticipated evolution of the European cat bond market

Quentin Perrot, managing director at GC Securities, on the future of cat bonds in the region

With €955mn of issuance in 2023 and a further €350mn in H1 2024, the European cat bond market is still a fraction of the broader ILS space, but it is growing rapidly. Five sponsors – Axa, Pacifica, Allianz, VKB and Groupama – either accessed the market for the first time or returned after years of absence, suggesting renewed interest in the product.

> An increasing number of European cedants have been looking at sponsoring cat bonds to secure additional capacity, diversify their sources and reduce reinsurance pricing cycle volatility

Market drivers

Climate change has been impacting Europe meaningfully, leading to a rapid increase in the frequency and severity of climatic events. Combined with the impact from inflation in 2022 and 2023 and improved rates on underlying policies, this has resulted in greater demand for limit at a time when many traditional reinsurers have been taking a stricter stance on coverage terms, deployable capacity and pricing. Further, some European countries, such as Germany and Italy, are considering government-led schemes to increase insurance penetration for natural catastrophe perils.

As a result, an increasing number of European cedants have been looking at sponsoring cat bonds to secure additional capacity, diversify their sources and reduce reinsurance pricing cycle volatility. Cat bond sponsors can be in a better position to negotiate at their traditional renewal, simply because they have the option to divert more of their risks to capital market investors.

Broadening peril set

Most European bonds are limited to peak perils, namely windstorm and earthquake. These are the two perils investors are most comfortable with and, therefore, pricing can be competitive. However, with climate change, other perils historically viewed as ancillary – such as flood and hail – are growing in importance. We anticipate European cat bonds will start including more of these perils, albeit at additional cost.

Extended engagement with investors will likely make them more comfortable with these perils. This may be achieved with the assistance of new models, such as the RMS HD model and the upcoming version of the Verisk flood model.

Nevertheless, cat bonds are unlikely to offer the same breadth of coverage or reinstatement as traditional reinsurance. To ensure seamless coverage, a wrap may be required, whereby the risks left uninsured by the bond are assumed by reinsurers. Increased familiarity for both brokers and reinsurers has resulted in innovative solutions such as inuring structures, ensuring economic viability of the cat bond product.

Diversification benefit for investors

Investors remain extremely interested in bonds with exposure to European perils, ensuring a supply of capacity to any new cat bond. This is due to the diversification benefit offered by European cat bonds in what remains a US-centric market, with over 80 percent of new issuance in 2024 to date exposed to North American perils.

Put simply, most investors (especially UCITS funds) must keep a portion of their portfolio exposed to non-US perils to meet their internal diversification targets. The majority of European cat bonds sit in the middle of a cedant's reinsurance program, with a risk profile justifying a return well above investors' minimum spread requirements. These cat bonds optimise portfolio construction because they provide this diversification without a loss in return, unlike many other diversifying bonds exposed to perils elsewhere in the world.

This convergence of interest between cedants and investors bodes well for accelerated development of the European cat bond market. GC Securities is at the forefront of the global ILS market and is committed to continued development of the European cat bond market through deep engagement with cedants and investors.