Catastrophe Bonds

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The recent floods in Kerala have set off a debate about the need for timely aid required to kickstart the relief process.

- The damage from natural disasters can impose severe financial burden on governments.
- Specially in developing countries, governments may have to **divert state funds**, including those earmarked for development projects, to disaster relief and rebuilding efforts. One way to **bridge this financial gap** is through the issuance of catastrophe bonds.
- The idea that catastrophe risk could be securitised and that it could be dispersed among a wide number of investors was first mooted in **1992 after hurricane 'Andrew'** caused massive damages in the United States.
- The **World Bank** has also set up the **Multicat Program in 2009** to facilitate access of member countries and public entities to the catastrophe bond market. It also assists the country on its natural disaster risk management policy.

What Is It?

- Catastrophe bonds, also known as **Cat bonds**, allows the transfer of risks to bond investors.
- For **the issuer—typically governments, insurers, and reinsurers**—cat bonds signify financial protection in case of a major natural catastrophe, such as a hurricane or an earthquake.
- For **the investor**, buying the bonds means they may **get high returns** for their investment, which is not subject to financial market fluctuations.
- In case a qualifying catastrophe or event occur the investors will lose the principal they invested and the issuer (often insurance or reinsurance companies) will receive that money to cover their losses.

- Generally, insurance and reinsurance companies currently dominate the cat bonds market, but more and more sovereign cat bonds have been issued as governments seek ways to transfer risks amid increasing frequency of natural disasters.

How It Works

- Cat bonds are also a type of **insurance-linked securities**.
- A **Special Purpose Vehicle (SPV)** is set up to facilitate the transaction.
- The SPV invests the money from investors and pay interests to them.
- At the end of the term, the SPV will return the investors' money if a disaster does not happen.
- However, a payout is made to the issuer upon the occurrence of a specified climate event.

Advantages

- It addresses the risk of loss and damage from climate change because it allows vulnerable countries to raise capital that can be disbursed quickly in the event of a catastrophe.
- Cat bonds can also provide multi-year coverage to the issuing governments.
- Reduces the stress on the balance sheets of governments at Centre and State.
- They are a class of bonds that is not tied to economic performance parameters and therefore diversify the risks.

- The investors are compensated by a rate of return which is higher than that of normal government or corporate bonds.

- Since investors will always have an eagle eye on the preparedness of dealing with catastrophes, it encourages more investments into technology and also raises awareness among people for such events.

Disadvantages

- They have **high transaction costs, long structuring period, and strict terms** and conditions compared with traditional risk financing, such as insurance.
- In addition, they do not always meet countries' needs, as governments may prefer longer term protection, while investors tend to prefer shorter term bonds.
- Another obstacle is that cat bonds are usually available only to institutional investors, **limiting their market reach.**