Reply form

**On the review of the UCITS Eligible Assets Directive**

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all comments received by **Wednesday 7 August 2024.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

Instructions

In order to facilitate analysis of responses to the Call for Evidence, respondents are requested to follow the below steps when preparing and submitting their response:

• Insert your responses to the questions in the Call for Evidence in this reply form.

• Please do not remove tags of the type < ESMA\_QUESTION\_EADC\_0>. Your response to each question has to be framed by the two tags corresponding to the question.

• If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.

• When you have drafted your responses, save the reply form according to the following convention: ESMA\_CP1\_EADC\_nameofrespondent.

For example, for a respondent named ABCD, the reply form would be saved with the following name: ESMA\_CP1\_EADC \_ABCD.

• Upload the Word reply form containing your responses to ESMA’s website (**pdf**  **documents will not be considered except for annexes**). All contributions should be submitted online at <https://www.esma.europa.eu/press-news/consultations/call-evidence-review-ucits-eligible-assets-directive> under the heading *‘Your input -*  *Consultations’.*

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘[Data protection](https://www.esma.europa.eu/about-esma/data-protection)’.

**Who should read this paper?**

This Call for Evidence is of particular interest for investors and consumer groups interested in retail investment products, management companies of Undertakings for Collective Investment in Transferable Securities (UCITS), self-managed UCITS investment companies, depositaries of UCITS and trade associations.

# General information about respondent

|  |  |
| --- | --- |
| Name of the company / organisation | ILS Industry Response |
| Activity | Click or tap here to enter text. |
| Country / Region | Multiple |

# Questions

1. In your view, what is the most pressing issue to address in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence across the EU?

<ESMA\_QUESTION\_EADC\_1>

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1. Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD rules with respect to financial indices? If so, please describe any recurring or significant issues that you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please specify what indices this relates to and what were the specific characteristics of those indices that raised doubts or concerns. Where possible, please provide data to substantiate the materiality of the issue.

<ESMA\_QUESTION\_EADC\_2>

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1. Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD rules with respect to money market instruments? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please describe the specific characteristics of the money market instruments that raised doubts or concerns.

<ESMA\_QUESTION\_EADC\_3>

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1. Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD provisions using the notions of « liquidity » or « liquid financial assets »? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to better specify these notions with a view to improving investor protection, clarity and supervisory convergence. Where relevant, please explain any differences to be made between the liquidity of different asset.

<ESMA\_QUESTION\_EADC\_4>

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1. The 2020 ESMA CSA on UCITS liquidity risk management identified issues with respect to the presumption of liquidity and negotiability set out in UCITS EAD. In light of the changed market conditions since 2007, do you consider such a presumption of liquidity and negotiability still appropriate? Where possible, please provide views, data or estimates on the possible impact of removing the presumption of liquidity and negotiability set out in the UCITS EAD.

<ESMA\_QUESTION\_EADC\_5>

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1. Please explain your understanding of the notion of ancillary liquid assets and any recurring or significant issues that you might have experienced in this context. Please clarify if these are held as bank deposits at sight and what else is used as ancillary liquid assets. Where relevant, please distinguish between ancillary liquid assets denominated in (1) the base currency of the fund and (2) foreign currencies.

<ESMA\_QUESTION\_EADC\_6>

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1. Beyond holding currency for liquidity purposes, do you think UCITS should be permitted to acquire or hold foreign currency also for investment purposes, taking into account the high volatility and devaluation/depreciation of some currencies? Where relevant, please distinguish between direct and indirect investments.

<ESMA\_QUESTION\_EADC\_7>

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1. Have you observed any recurring or significant issues with the interpretation or consistent application of the 10% limit set out in the UCITS Directive for investments in transferable securities and money market instruments other than those referred to in Article 50(1) of the UCITS Directive? If so, please explain the issues and how you would propose to address them in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence.

<ESMA\_QUESTION\_EADC\_8>

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1. Are the ‘transferable security’ criteria set out in the UCITS EAD adequate and clear enough? If not, please describe any recurring or significant issues that you have observed and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

<ESMA\_QUESTION\_EADC\_9>

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1. How are the valuation and risk management-related criteria set out in the UCITS EAD interpreted and applied in practice, in particular the need for (1) risks to be “adequately captured” by the risk management process and (2) having “reliable” valuation/prices. Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of these criteria and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

<ESMA\_QUESTION\_EADC\_10>

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1. Are the UCITS EAD provisions on investments in financial instruments backed by, or linked to the performance of assets other than those listed in Article 50(1) of the UCITS Directive adequate and clear enough? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

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1. Is the concept of « embedded » derivatives set out in the UCITS EAD adequate and clear enough? Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of this concept and how you would propose to amend UCITS EAD to improve investor protection, clarity and supervisory convergence.

<ESMA\_QUESTION\_EADC\_12>

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1. Linked to Q11 and Q12, ESMA is aware of diverging interpretations on the treatment of delta-one instruments under the EAD, taking into account that they might provide UCITS with exposures to asset classes that are not eligible for direct investment (see also Section 3.2). How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence? Please provide details on the assessment of the eligibility of different types of delta-one instruments, identify the issues per product and provide data to support the reasoning.

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1. Have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in other UCITS and alternative investment funds (AIFs)? In this context, have you observed any issues in terms of the clarity, interaction and logical consistency between (1) the rules on investments in UCITS and other open-ended funds set out in the UCITS Directive and (2) the provisions on UCITS investments in closed ended funds set out in the UCITS EAD? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the relevant rules to improve investor protection, clarity and supervisory convergence. Where relevant, please distinguish between different types of AIFs (e.g. closed-ended, open-ended), investment strategies (real estate, hedge fund, private equity, venture capital etc.) and location (e.g. EU, non-EU, specific countries). In this context, please also share views on whether there is a need to update the legal wording used in the UCITS EAD and UCITS Directive given the fact that e.g. they refer to ‘open-ended’ and ‘closed ended funds’, whereas it might seem preferable to use the notion of ‘AIFs’ by now given the subsequent introduction of the AIFMD in 2011.

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1. More specifically, have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in (1) EU ETFs and (2) non-EU ETFs? Please describe any issues that you have observed in this respect and how you would propose to amend the relevant rules to improve investor protection, clarity and supervisory convergence.

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1. How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence with respect to the Efficient Portfolio Management (EPM)-related issues identified in the following ESMA reports: (1) Peer Review on the ESMA Guidelines on ETFs and other UCITS issues; (2) Follow-up Peer Review on the ETF Guidelines; and (3) CSA on costs and fees. In this context, ESMA is interested in also gathering evidence and views on how to best address the uneven market practices with respect to securities lending fees described in the aforementioned ESMA reports with a view to better protect investors from being overcharged.

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1. Would you see merit in linking or replacing the notion of EPM techniques set out in the UCITS Directive and UCITS EAD with the notion of securities financing transaction (SFT) set out in the SFTR? Beyond the notions of EPM and SFT, are there any other notions or issues raising concerns in terms of transversal consistency between the UCITS and SFTR frameworks?

<ESMA\_QUESTION\_EADC\_17>

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1. Apart from the definitions and concepts covered above, are there any other definitions, notions or concepts used in the UCITS EAD that may require updates, further clarification or better consistency with definitions and concepts used in other pieces of EU financial legislation, e.g. MiFID II, EMIR, Benchmark Regulation and MMFR? If so, please provide details on the issues you have observed and how you would propose to clarify or link the relevant definitions or concepts.

<ESMA\_QUESTION\_EADC\_18>

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1. Are there any national rules, guidance, definitions or concepts in national regulatory frameworks that go beyond (‘gold-plating’), diverge or are more detailed than what is set out in the UCITS EAD? If so, please elaborate whether these are causing any recurring or significant practical issues or challenges.

<ESMA\_QUESTION\_EADC\_19>

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1. Please fill in the table in the Annex to this document on the merits of allowing direct or indirect UCITS exposures to the asset classes listed therein, taking into account the instructions provided in the same Annex. Please assess and provide evidence on the merits of such exposures in light of their risks and benefits taking into account the characteristics of the underlying markets (e.g. availability of reliable valuation information, liquidity, safekeeping). To substantiate your position, please fill the table with any available data and evidence (e.g. on liquidity or valuation of the relevant asset classes and underlying markets). ESMA acknowledges that the availability of data on direct/indirect exposures to some of the asset classes listed in this table is limited and would welcome receiving any available data (whether on individual market participants and products or market-wide) and even rough estimates that help to understand the practical relevance of the relevant asset class for UCITS and the possible impact of any future policy measures.

<ESMA\_QUESTION\_EADC\_20>

This response focuses on Question 20 of the Call for Evidence and specifically on eleven merits of allowing *direct* UCITS exposures to cat bonds. The data underpinning the figures in this response is shared in the attached spreadsheet.

Noting the focus of the Call for Evidence being on asset class eligibility, we understand that "indirect UCITS exposures" in this context refers to synthetic instruments (e.g. derivatives, and instruments which incorporate the use of a benchmark). To the Signatories' knowledge there are no delta-one or derivative cat bond instruments or markets and, as a result, no indirect UCITS exposures to cat bonds.

As of May 2024, assets under management of cat bond UCITS across all fund managers and domiciles stood at approximately USD 12.2bn[[1]](#footnote-2).

**Merit 1: Fully-funded instruments that are a cornerstone of the global re/insurance marketplace**

Cat bonds, which represent a segment of the ILS market, are fixed income floating rate instruments sponsored primarily by insurers and reinsurers (“re/insurers”) to transfer risk exposures from large insured loss events to investors. These events are typically natural catastrophes, such as hurricanes and earthquakes. Instead of passing catastrophe risk on to reinsurers via traditional reinsurance, a cat bond sponsor aims to transfer it directly to the capital markets, where capacity for such risks is greater. By providing multi-year protection against large events which cannot all be provided by traditional re/insurance companies, cat bonds support the stability and efficient functioning of the global re/insurance marketplace and allow re/insurers to continue providing coverage to the areas that demand it most.

The transfer of risks to the capital markets through cat bonds helps re/insurers control and balance their re/insurance risks, bringing them financial stability. Likewise multi-asset investors investing in cat bonds also benefit from the asset class given (i) that they gain financial stability through its lack of correlation with the financial markets, (ii) the low volatility of a cat bond portfolio (as further described in Merit 8), and (iii) cat bonds provide attractive returns, underpinned by the fundamental economic reasoning that re/insurers are willing to pay an attractive structural premium to transfer the risk off their balance sheets in order to continue providing coverage to policyholders, including in areas exposed to catastrophes and where insurance coverage—and the financial certainty it brings for businesses and households—is therefore in high demand.

Rule 144A cat bonds (see description in Merit 2) represent USD 47.5bn of outstanding issuance as of 31 May 2024 (see Figure 1)[[2]](#footnote-3). UCITS cat bond funds therefore count for ~2% of global re/insurance and ILS capital and, as such, are considered to be of systemic importance to the reinsurance market[[3]](#footnote-4).

In a typical cat bond structure, a re/insurer sponsors the creation of an SPI. The cat bonds themselves are notes issued by this SPI and are typically short duration investments with a typical maturity of three to five years.

Cat bonds are *fully collateralized* (no financial leverage) with transparent structures and *strict collateral rules* designed to exclude unwanted counterparty and credit risks for investors and sponsors alike. Unlike a corporate bond, where money raised at issuance goes onto a corporation’s balance sheet, with a cat bond it is held in short duration, Aaa/AA+ (Moodys, S&P, Fitch)-rated securities such as US Treasuries. The underlying collateral is therefore highly secure, contrasting with securitisations such as asset-backed securities and mortgage-backed securities which are often backed by less secure assets. Cat bonds are floating rate instruments and bear minimal interest rate risk for investors. If the catastrophe event criteria as set out in the bond’s offering document are met, then some or all of the bond’s collateral is passed on to the sponsor, for example an insurance company, which in turn uses the proceeds to pay insurance claims to affected households and companies.

For avoidance of doubt, these are not derivative products. Although cat bonds do not embed financial derivatives, a particular type of cat bond which does not use an indemnity trigger may use the ISDA form instead of a reinsurance agreement between an issuing SPI and the re/insurance company sponsor. Under that type of cat bond, the sponsor may recover from the SPI, triggering a loss for the notes, based on the parameters specified in the ISDA form and not limited to the loss actually experienced by the sponsor. This type of cat bond is also equally fully funded and does not embed any leverage.

In contrast, a bond exposed to an indemnity trigger suffers a loss corresponding to the loss suffered by the sponsor of the bond above the specified trigger amount. So if, for example, a bond issuance covers earthquake losses in excess of USD 1bn for an insurer and the issuance is USD 100m, for the insurer to collect from the bond under an indemnity trigger it must provide evidence of loss of over USD 1bn.

A graph of a market

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(Source for Figure 1: Swiss Re Capital Markets (as of 31 May 2024))

The first cat bond was issued in 1996 and since then, steady and prudent growth in the market has created an established, viable, stable asset class. Historically, cat bond sponsors have primarily been US insurance companies, or reinsurance companies that provide coverage to US insurance companies, as the US insurance industry has the potential to generate the largest insured loss events. However, recent sponsors include an increasing number of European insurance companies—from France, Germany, Italy and the Netherlands—seeking additional reinsurance capacity in cat bond form for windstorm, flood and severe convective storm losses in their portfolios. Increasingly, large corporations and state and national governments are also turning to the cat bond market to manage the risk of large natural disasters to their balance sheets and programs. Recently the European Central Bank and the European Insurance and Occupational Pensions Authority called for greater use of cat bonds in the European Union to address the region’s climate insurance protection gap and to provide prompt liquidity for post-event response for government insurance schemes[[4]](#footnote-5).

Cat bonds allow investors to access insurance risk without the need to invest in the corporate capital structure of a reinsurer and the associated risk of exposure to an evolving, active reinsurance company. Alternatives such as investing in the equities of re/insurers bring with it not only equity market beta risks but also the operational risks of a re/insurer. Cat bonds allow the investor to selectively choose what kind of insurance risks they wish to expose their capital to rather than allowing the management of a re/insurance company to choose. Credit investments bring similar issues as equities albeit with lower risk. Cat bonds are a complement to both and offer a favourable risk return framework for investors. Investors have the option with a cat bond to assume a fixed, targeted layer of risk, often incorporating annual reset mechanics so that exposure remains static.

**Merit 2: Robust Transaction Structures and Investor Protections**

Cat bonds offer investors a diversifying asset class (a financial markets event does not make an earthquake or hurricane any more or less likely) which typically offers higher levels of return relative to comparable main-stream debt investments.

The large majority of cat bonds are highly structured notes issued in accordance with the Rule 144A "safe harbour" exemption from the registration requirements of the US Securities Act of 1933 (the "US Securities Act") and only offered to and tradable between "Qualified Institutional Buyers" (as this term is defined the US Securities Act) in permitted jurisdictions. As such the notes issuances are offered by an initial purchaser, subject to the associated due diligence and scrutiny applicable in the 144A market. The risks of an investment in the notes are detailed among the disclosure in an offering circular. The underwriters/arrangers of the notes include well known and specialist firms such as Goldman Sachs, Swiss Re Capital Markets, Aon Securities, and GC Securities. The 144A cat bond market is deep, consisting of approximately 318 tranches of notes totaling USD 47.5bn notional value[[5]](#footnote-6).

144A bonds include features that protect the investor and underpin liquidity, including:

* Comprehensive transaction documentation, including an offering circular and the transaction's legal agreements are also made available to investors
* High levels of third-party legal oversight
* Initial purchaser due diligence, including issuance of their own representation letter attesting to the outcome of their due diligence Extensive risk analysis provided by a third-party catastrophe risk modelling specialist (see Merit 5)
* Legal opinions provided to address the applicable legal and regulatory issues
* Listing on a recognised exchange
* Indenture Trustee
* Minimal credit risk – proceeds held in “risk-free” investments; mechanisms to terminate and return proceeds in event issuer fails to pay coupon when due

144A bonds are freely tradable. At least five recognised broker dealers regularly execute secondary market trades. Trading occurs on a daily basis.

The leading arrangers of 144A cat bonds and a number of broker-dealers in the secondary market regularly publish indicative bid/offer prices for all bonds. Prices are driven by the most recent secondary market trade prices, which are impacted by any relevant covered natural catastrophe activity and seasonal earnings patterns typical to the cat bond market. The valuation policy of UCITS cat bond funds is typically based on these pricing sheets.

**Merit 3: Clearing, Custody and Safekeeping**

All major banks offer custodial services to investors and holders of cat bond securities. In the secondary market, cat bond trades follow T+1 settlement cycles. US broker-dealers and interdealer brokers trading in the cat bond market are also subject to SEC regulations on Customer Protection Rules.

Cat bonds either clear via Depository Trust Company or Euroclear/Clearstream. These entities operate as a central securities depository and provide safekeeping and transfer of securities. Safekeeping will involve the electronic recordkeeping of securities balances for participants and the transfer function involves the transfer of securities between parties. During the transfer process, these clearing entities will limit credit exposure of participants to each other.

**Merit 4: SFDR Article 8 and 9 Instruments**

Insurance by its nature is social capital. Insurance is a means of using private capital to support parties in need and during community crises. When a catastrophe occurs, insurers are on the ground helping families and businesses recover and rebuild.

By providing timely capital and liquidity in the event of disasters to improve the overall resilience of societies and economies to natural catastrophes—including the potential negative impacts of climate change—and by addressing the increasing ‘protection gaps’ between insured and economic losses in both developed and emerging economies and ‘disaster gaps’ between insured but not reinsured losses, cat bonds are regularly held within funds that fall under SFDR Article 8 or 9. To date, the majority of cat bond UCITS have been designated as either SFDR Article 8 or 9 funds since SFDR came into force in 2022. From an investment managers' perspective, we believe that the relevant ESG factors enhance investor interest in cat bond UCITS[[6]](#footnote-7).

In addition, cat bonds provide a forward-looking market-based indication to the re/insurance industry regarding the costs of the risks societies bear by building in environments exposed to natural perils and therefore, in the case of weather-related perils, to climate change. Informing society of the costs of those choices, and the potential benefits of environmental risk mitigation and adaptation measures, through a market-based pricing mechanism is an important part of sustainable risk management. As such, by supporting the global re/insurance industry with risk capital, cat bonds are an important adaptation tool for modern societies to manage the impacts of climate change.

**Merit 5: Risk Controlled**

Each cat bond comes with a formal independent quantitative expert risk analysis in the offering documents outlining the expected loss and other risk metrics for the security. Cat bonds are also atypical as an asset class in that metrics are provided for the tail risk of portfolios. This risk analysis is performed for the benefit of investors by a designated independent expert, typically one of leading global catastrophe modeling companies such as Moody’s RMS or Verisk. Since 2006, the expert risk analysis of every US hurricane cat bond has also included a forward-looking view on climate change by providing the expected loss of the bond with and without the impact of factors such as elevated sea surface temperature. Such analysis, unique to cat bonds, allows investors to evaluate and quantify the sensitivity of the bond to potential climate-related changes.

Unlike other asset classes based on financial performance and/or behaviour, the source of risk for cat bonds is most often based on the physical environment, and the modelling of the risk is based on modern meteorological, geological, environmental and physical sciences. For many perils in the cat bond market event, data goes back centuries providing broad data sets for probabilistic assessments. The models avoid many of the biases created by “risk-neutral” or cash flow financial models which support traditional financial valuations. They avoid the pro-cyclicality and sometimes circularity embedded in such models.

**Merit 6: Highly Regulated & Supervised Sponsors**

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(Source for Figure 2: Swiss Re Capital Markets)

Figure 2 shows the breakdown of the outstanding cat bond market’s current ~100 sponsors by type as of 31 May 2024. As noted above, nearly 72% of sponsors are re/insurance companies, which are highly regulated and supervised entities in their respective jurisdictions. Nearly 25% of sponsors are classified as ‘government’, which includes U.S. state-level insurance entities and residual insurance pools formed by statute, national-level insurance programs, public-private reinsurance pools, local municipalities, transit authorities, as well as international organizations such as the World Bank. Since the inclusion of cat bonds in UCITS in 2011, the Signatories have not encountered any regulatory or investor issues with cat bonds.

**Merit 7: A Diverse Market**

As the cat bond market has grown, so have the number of deals and tranches (i.e. classes of notes within deals) available in the market for investment (see Figures 3a and 3b). These deals are sponsored by a growing number of entities around the world looking to cover an increasingly broad set of perils (see Figure 4) beyond the US ‘peak peril’ risks such as hurricanes in Florida and earthquakes in California[[7]](#footnote-8). Diversification also exists within the Florida hurricane and California earthquake risk categories, as sponsors cede risk to the market in different ways, for different sub-perils (e.g., hurricane-induced flooding versus wind) and for different event severities. Given the range of deals, issuers, tranches and perils available for investment, it is easy for funds to meet UCITS diversification requirements within the cat bond market.

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(Source for Figure 3a: Swiss Re Capital Markets (as of 31 May 2024))

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(Source for Figure 3b: Swiss Re Capital Markets (as of 31 May 2024))

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(Source for Figure 4a: Swiss Re Capital Markets)



(Source for Figure 4b: Swiss Re Capital Markets (as of 31 May 2024))

**Merit 8: Liquidity & Low Market Volatility**

Cat bonds can be purchased by UCITS investors at issuance directly from the initial purchaser (the primary market) or bought and sold in the secondary market. The increasing adoption of the cat bond market by re/insurers and a growing number of new sponsors has meant that, even in the immediate aftermath of a major event, liquidity in the secondary market has tended to remain high. In particular, in March 2020 at the start of the COVID pandemic and in the aftermath of Hurricane Ian in 2022—the largest cat bond market loss to date—the secondary cat bond market continued to trade, with investors seeking to liquidate positions able to find buyers.

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Figure 5 shows the secondary market cat bond trades by month from January 2015 to September 2023, as reported to the US Financial Industry Regulatory Authority’s (FINRA) Trade Reporting and Compliance Engine (TRACE)[[8]](#footnote-9). TRACE records cat bond trades executed by U.S. broker-dealers regulated by FINRA and the SEC, and therefore only captures a portion of secondary cat bond market trading[[9]](#footnote-10). Over the 2015-2023 period, Figure 5 shows a record number of secondary market trades by volume in March 2020 as investors, seeking to liquidate cat bond positions due to COVID-related distress in their other investments, were able to sell. Figure 6a shows the histogram of the TRACE bid-ask spreads for all ~300+ trades recorded in that March 2020 period[[10]](#footnote-11). The chart shows little absolute variation in the bid-ask spread. Figure 5 also shows secondary market trading occurred in October and November 2022 following Hurricane Ian which made landfall in Florida on 28 September 2022. Figure 6b shows the histogram of the TRACE bid-ask spreads for all trades recorded in October-November 2022, which also shows little absolute variation[[11]](#footnote-12).

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As the first full year of TRACE data is 2015, Figure 7 shows the market-weighted average bids and asks from Swiss Re Capital Markets indicative pricing sheets for the cat bond market since 2000[[12]](#footnote-13). The chart shows little volatility in market bids, asks and bid-ask spreads during normal conditions with little absolute widening of spreads in stressed (Q4 2008, March 2020 and Q4 2022) conditions, supporting the notion that investors can trade in and out of cat bond positions without inducing large price movements under a broad range of market environments.

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In terms of liquidity, cat bond UCITS naturally benefit from being part of this broader investor and re/insurance universe.

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Over the past two decades, the performance of cat bonds has been robust and consistent through all financial crises and notwithstanding major natural catastrophes and global re/insurance industry losses (e.g., Hurricane Katrina in 2005, the Global Financial Crisis in 2008, the Eurozone Debt Crisis of 2010-2012, Covid-19 and Hurricane Ian in 2022). As seen in Figure 8, compared to other asset classes, cat bonds have demonstrated significantly lower volatility, producing consistent long-term returns for investors even during times of heightened market stress. The figure shows that since its inception in 2002 the Swiss Re Global Cat Bond Total Return Index (a monthly market cat bond index produced by reinsurer Swiss Re and available on Bloomberg) has exhibited more than 4x less volatility than equities (represented by the MSCI World Index), 2.8x less than high yield bonds (represented by the Barclays Macro Global High Yield Bond Index) and nearly 2x less when compared to the global aggregate bond index (represented by the Bloomberg Global Aggregate Bond Index)[[13]](#footnote-14). The chart and indices show how cyclical assets (equities, corporate bonds, real estate, etc.) can correlate when there are economic downturns. Cat bonds have been valued by UCITS investors as they have provided them with a fundamentally different source of returns allowing them to access genuine diversification when other cyclical markets have correlated and fallen.

**Merit 9: Ability to Satisfy Redemptions**

As demonstrated by Figures 5-8, the cat bond market is able to service investor redemptions in an orderly manner in non-stressed and stressed market conditions. The Signatories can confirm they have been able to satisfy all investor redemption requests in a timely manner in the UCITS cat bond funds they manage.

Notably, instrument maturity (since cat bonds have relatively short duration, cat bond funds offer natural liquidity to investors) and secondary trading provide significant capacity for redemptions to be met in general:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Year** | **Issued**  ***(Source: Swiss Re Capital Markets)*** | **Outstanding**  ***(Source: Swiss Re Capital Markets)*** | **Maturities**  ***(Source: Swiss Re Capital Markets)*** | **Est. Trading Volume (incl TRACE and estimated Non-TRACE)**  ***(Source: Tullett Prebon)*** | **Total Redeemable from market as a whole** | **Percent of Prior year Outstanding redeemable** |  |
| 2019 |  | 30.1 |  |  |  |  |  |
| 2020 | 11.3 | 31.7 | 8.9 | 5.77 | 14.66 | 49% |  |
| 2021 | 12.8 | 33.9 | 10.3 | 4.06 | 14.35 | 45% |  |
| 2022 | 9.4 | 35.5 | 6.9 | 4.26 | 11.18 | 33% |  |
| 2023 | 15.5 | 43.2 | 7.3 | 5.15 | 12.47 | 35% |  |
| 2024\* | 12.3 | 46.5 | 8.7 | 3.28 | 11.93 | 28% |  |
| \* as of 30 June 2024 (all numbers in USD billions) | | | | | | |  |

**Merit 10: Cat Bonds Improve Resilience of Developing Countries**

The World Bank recognized long ago that cat bonds can enhance the resilience of societies, including those in developing countries. These countries typically have low insurance penetration, leaving them vulnerable to the impacts of natural disasters without the safety net of commercial insurance coverage. To address this, the World Bank, through its International Bank for Reconstruction and Development (IBRD), has issued several cat bonds aimed at insuring infrastructure losses following natural catastrophes[[14]](#footnote-15). The IBRD, an international organization owned by 189 member countries, is the largest multilateral development bank in the world and a key institution within the World Bank Group.

Cat bonds issued by the IBRD often serve as diversifiers in UCITS cat bond funds. Without UCITS eligibility, the IBRD would be unable to rely on the cat bond market as a significant source of capacity.

The following cat bonds have so far been issued by the IBRD:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Transaction** | **Sponsor** | **Risks/Perils Covered** | **Size** | **Issuance Date** |
| IBRD CAR 135 | Government of Mexico / AGROASEMEX S.A. | Mexico Pacific coast named storm | $175m | May 2024 |
| IBRD CAR 136 | Government of Jamaica | Jamaica named storm | $150m | May 2024 |
| IBRD CAR 132-134 | Government of Mexico / AGROASEMEX S.A. | Mexico earthquake and Atlantic coast named storm | $420m | Apr 2024 |
| IBRD CAR 131 | Republic of Chile | Chile earthquake | $350m | Mar 2023 |
| IBRD CAR 130 | Government of Jamaica | Jamaica named storm | $185m | Jul 2021 |
| IBRD CAR 125-128 | FONDEN / AGROASEMEX S.A. | Mexico earthquake and named storm | $485m | Mar 2020 |
| IBRD CAR 123-124 | Republic of the Philippines | Philippines earthquake and tropical cyclone | $225m | Nov 2019 |
| IBRD CAR 120 | Republic of Peru | Peru earthquake | $200m | Feb 2018 |
| IBRD CAR 118-119 | FONDEN / AGROASEMEX S.A. | Mexico earthquake | $260m | Feb 2018 |
| IBRD CAR 117 | Republic of Colombia | Colombia earthquake | $400m | Feb 2018 |
| IBRD CAR 116 | Republic of Chile | Chile earthquake | $500m | Feb 2018 |
| IBRD CAR 113-115 | FONDEN / AGROASEMEX S.A. | Mexico earthquake and named storm | $360m | Aug 2017 |
| IBRD CAR 111-112 | Pandemic Emergency Financing Facility (PEF) | Pandemics | $320m | Jul 2017 |

Artemis, a reinsurance and ILS news reporting website, highlighted in June 2024 that: “The World Bank has now facilitated and issued over USD 4.8bn in cat bonds[[15]](#footnote-16) across 17 transactions we have covered over the years, with USD 745m issued over the course of just a few weeks in 2024 to support Mexico and Jamaica’s disaster risk transfer and financing needs”. Artemis further highlighted that “The World Bank has been active in the catastrophe bond market for almost two decades, leveraging the cat bond structure as a way to access private institutional capital to support and augment with efficient and responsive funding, its member country’s disaster insurance needs.”

**Merit 11: Performance of Cat Bonds Depends on Clearly Defined Parameters**

A cat bond’s performance depends on the occurrence of defined catastrophes, most often natural in nature. Major loss events are usually front-page news and known immediately after occurrence. There is no information asymmetry between a cat bond buyer and the reinsured in respect of such loss events. It is impossible to have insider knowledge or to front-run a catastrophe. From the perspective of the issuing SPI, cat bonds are simple bonds with the write-down mechanics clearly described in the offering circular, as noted above. Catastrophes are rare, hence there is usually little news flow impacting individual cat bonds. As a result, volatility of cat bond prices is low. However, low volatility is not an indicator for a lack of liquidity, as noted in Merit 8 above.

<ESMA\_QUESTION\_EADC\_20>

1. Please elaborate and provide evidence on how indirect exposures to the aforementioned asset classes (e.g. through delta-one instruments, ETNs, derivatives) increase or decrease costs and/or risks borne by UCITS and their investors compared to direct investments.

<ESMA\_QUESTION\_EADC\_21>

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1. Under the EAD, should a look-through approach be required to determine the eligibility of assets? Please explain your position taking into account the aforementioned risks and benefits of UCITS gaining exposures to asset classes that are not directly investible as well as the increased/decreased costs associated with such indirect investments. A look-through approach would aim to ensure that the list of eligible asset classes set out in the UCITS Level 1 Directive would be deemed exhaustive and reduce risk of circumvention by gaining indirect exposures to ineligible asset classes via instruments such as delta-one instruments, exchange-traded products or derivatives. Where possible, please provide views, data or estimates on the possible impact of such a possible policy measure.

<ESMA\_QUESTION\_EADC\_22>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_EADC\_22>

1. What are the risks and benefits of UCITS investments in securities issued by securitisation vehicles? Please share evidence and experiences on current market practices and views on a possible need for legislative clarifications or amendments.

<ESMA\_QUESTION\_EADC\_23>

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<ESMA\_QUESTION\_EADC\_23>

1. What are the risks and benefits of permitting UCITS to build up short positions through the use of (embedded) derivatives, delta-one instruments or other instruments/tools? Please share evidence and experiences on current market practice and views on a possible need for legislative clarifications or amendments.

<ESMA\_QUESTION\_EADC\_24>

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<ESMA\_QUESTION\_EADC\_24>

1. Apart from the topics covered in the above sections, have you observed any other issues with respect to the interpretation or consistent application of the UCITS EAD? If so, please describe the issues and how you would propose to revise the UCITS EAD or UCITS Directive with a view to improve investor protection, clarity and supervisory convergence.

<ESMA\_QUESTION\_EADC\_25>

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1. Source: Artemis.bm. See: https://www.artemis.bm/ucits-catastrophe-bond-fund-assets/ [↑](#footnote-ref-2)
2. Source: Swiss Re Capital Markets (as of 31 May 2024). As with all market size calculations, the number varies by source. [↑](#footnote-ref-3)
3. As of April 2024, the size of the global reinsurance market was USD 670bn (Source: Aon Reinsurance Market Dynamics report). [↑](#footnote-ref-4)
4. See: https://www.ecb.europa.eu/pub/pdf/other/ecb.policyoptions\_EIOPA~c0adae58b7.en.pdf [↑](#footnote-ref-5)
5. Source: Swiss Re Capital Markets (as of 31 May 2024). [↑](#footnote-ref-6)
6. See the increase in cat bond UCITS AUM in 2022: https://www.artemis.bm/ucits-catastrophe-bond-fund-assets/ [↑](#footnote-ref-7)
7. Source: Swiss Re Capital Markets as of 31 May 2024. The peril breakdown is given by the contribution to expected loss disclosed in the bond offering materials and weighted by notional. The peril codes displayed are: USWS\_FL - Florida Windstorm, USWS\_GULF - Gulf Windstorm, USEQ\_CA - California Earthquake, USWS\_NE - Northeast Windstorm, USWS\_SE - Southeast Windstorm, USWS\_REST - Other US Windstorm, EUWS\_FR - France Windstorm, USEQ\_PNW - Pacific Northwest Earthquake, JPWS - Japan Windstorm, JPEQ - Japan Earthquake, US\_TOWH\_ST - US Tornado/Hail/Severe Thunderstorm, MXWS - Mexico Windstorm, USWF - US Wildfire, USEQ\_NM - New Madrid Earthquake, EQ\_OTHER - Other Earthquake, CYBER - Cyber, EUWS\_NL - Netherlands Windstorm, USEQ\_REST - Other US Earthquake, CANEQ - Canada Earthquake, MXEQ - Mexico Earthquake, EUWS\_GE - Germany Windstorm, EUEQ - Europe Earthquake, EUWS\_UK - UK Windstorm, WS\_OTHER - Other Windstorm, EUWS\_REST - Other Europe Windstorm, OTHER\_NAT\_CAT - Other Nat Cat, US\_WINTER\_STORM - US Winterstorm, LIFE\_HEALTH - Life & Health, EUWS\_BE - Belgium Windstorm, AUEQ - Australia Earthquake, EUWS\_CH - Switzerland Windstorm, EUWS\_IE - Ireland Windstorm, EUWS\_DK - Denmark Windstorm, US\_INLAND\_FLOOD - US Inland Flood, AUWS - Australia Windstorm. The US Windstorm perils also include losses related to hurricane-induced flooding. [↑](#footnote-ref-8)
8. Source: TRACE Enhanced Historical Data and analysis by Fermat Capital. Only unique TRACE “sells” with execution dates in the period January 2015-September 2023 inclusive were considered, i.e., canceled and reversed “sells” were removed from the data prior to analysis. Figure 5 shows the sum of all unique TRACE “sell” quantities by month in the TRACE Enhanced Historical Dataset. TRACE only began tracking cat bonds in July 2014, so 2015 represents the first full year, see Herrmann, M., & Hibbeln, M. (2023), “Trading and liquidity in the catastrophe bond market”, Journal of Risk and Insurance, 90, 283–328, available online at: https://doi.org/10.1111/jori.12407 [↑](#footnote-ref-9)
9. We estimate that TRACE represents ~75-90% of all secondary cat bond trading volume. [↑](#footnote-ref-10)
10. Source: TRACE Enhanced Historical Data and analysis by Fermat Capital. The histogram shows the price points of the bid-ask spreads of all paired TRACE trades with an execution date in March 2020. Unpaired were excluded from the analysis (~10 trades). The bid-ask spread is defined as the “Sell” price minus the “Buy” price and is given in percentage points, i.e., a bid-ask spread of 0.1 is a price difference of 0.1%. [↑](#footnote-ref-11)
11. As above for Figure 6a, the histogram shows the price points of the bid-ask spreads of all paired TRACE trades with an execution date in the period October to November 2022. One unpaired trade was excluded from the analysis. [↑](#footnote-ref-12)
12. Source: Swiss Re Capital Markets, based on Swiss Re Capital Markets historical indicative pricing sheets. The market weights are based on the notional outstanding amount by tranche. [↑](#footnote-ref-13)
13. Source: Bloomberg for all except MSCI, which is the source for the MSCI World Index. [↑](#footnote-ref-14)
14. Source: ECB & EIOPA: Policy Options to reduce the climate insurance protection gap. April 2023 (page 22). <https://www.ecb.europa.eu/pub/pdf/other/ecb.policyoptions_EIOPA~c0adae58b7.el.pdf> [↑](#footnote-ref-15)
15. https://www.artemis.bm/news/world-bank-has-now-facilitated-over-us-4-8bn-in-catastrophe-bonds/ [↑](#footnote-ref-16)