Attachement to BAI's response to ESMA's reply form Call for Evidence on the reveiw of the UCITS Eligible Assets Directive

Specific remarks regarding the asset class of insurance-linked securities/cat bonds

The Bundesverband Alternative Investments e.V. (BAI) welcomes the opportunity to respond to your Call for Evidence on the review of the UCITS Eligible Assets Directive.

BAI is the cross-asset and cross-product lobby association for the alternative investment industry in Germany and we consider ourselves as a catalyzer between professional German investors and suppliers of alternative investment products worldwide. We therefore focus our argumentation and answers primarily on specific issues our member companies have informed us about when applying the UCITS EAD.

Many of our member companies offer UCITS cat bond funds. The current market volume amounts to approximately $ 50bn (all outstanding cat bonds combined); thereof around $12-13bn, equivalent to more than 25% of the overall market size of existing UCITS exposures. UCITS funds are systemically important for the cat bond market. A substantial portion of the total UCITS cat bond market is managed by BAI member companies through their Luxembourg and Irish fund platforms.

We would like to point out hereinafter main arguments for the eligibility of cat bonds for UCITS, provided by BAI member companies (fur further references cf. also *F. Steiger*, Versicherung für den Klimawandel, Investieren in Katastrophenanleihen, 2022, with more literature and references).

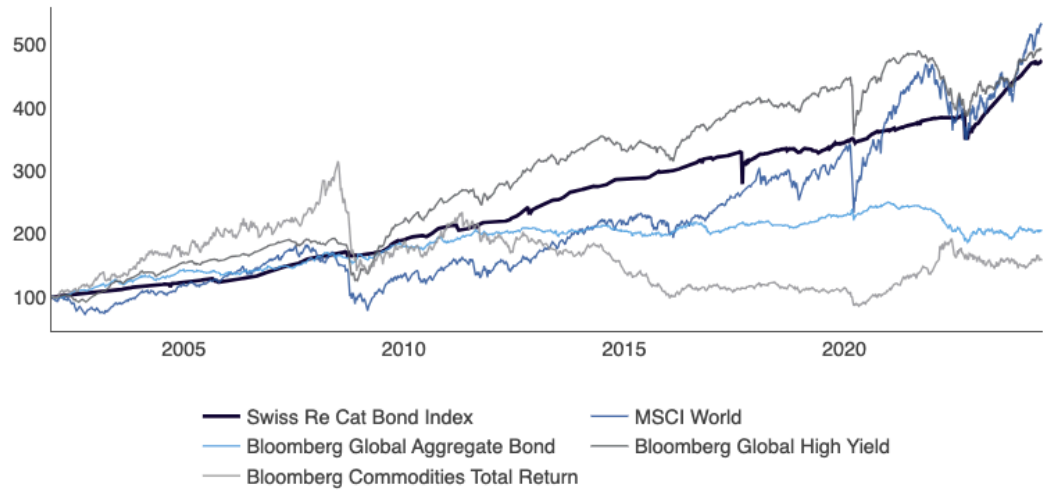
Detailed response for allowing direct/indirect exposure to cat bonds in UCITS format:

There are plenty of reasons why cat bonds should continue to be allowed in UCITS format, directly and indirectly. We believe that the merits of the asset class are best summarized by a recent paper of the ECB and EIOPA, who wrote the following:

"Investors in cat bonds benefit from low correlation with equity and credit markets. As such, cat bonds can provide useful diversification, particularly during episodes of crisis and high market volatility. Investors in the environmental, social and governance (ESG) space are also turning to cat bonds as an instrument for impact investment – an investment strategy aimed at generating social or environmental benefits while delivering financial gains. For example, investors in cat bonds intermediated by the World Bank to enhance resilience against natural disasters in lower income countries include pension funds, insurers and other institutional asset managers."
Source: ECB & EIOPA: Policy Options to reduce the climate insurance protection gap. April 2023. https://www.ecb.europa.eu/pub/pdf/other/ecb.policyoptions_EIOPA~c0adae58b7.el.pdf

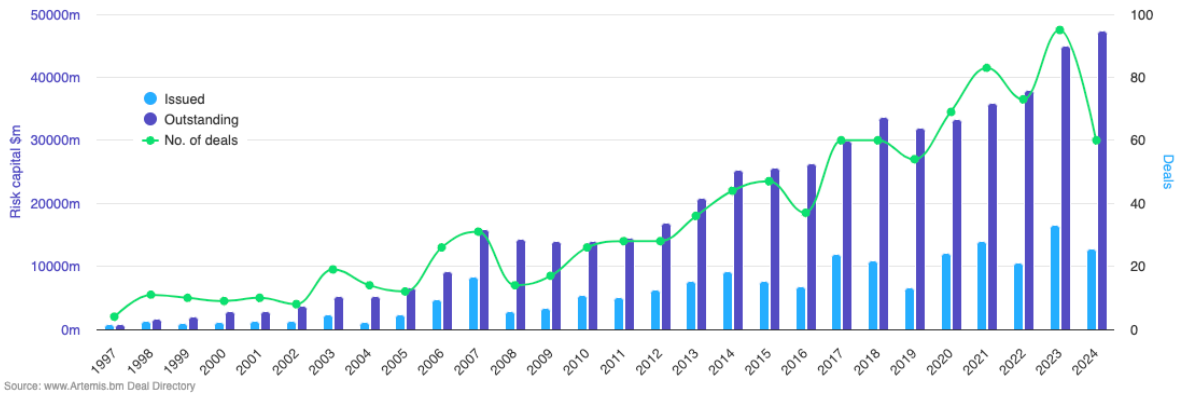
Cat Bonds are a proven success story with more than 25 years of reliable track record and are a great benefit for investors. We therefore are convinced that ECB and EIOPA are right in their assessment. The market has proven resilient during times of financial stress which affected almost every other asset class, but

also during natural catastrophes. The past 25 years brought many natural disasters, such as Hurricane Katrina, the Tohoku earthquake or the hurricanes in Florida in 2017 and 2022. Yet, the cat bond market has delivered excellent performance for investors. Additionally, the market has helped millions of people worldwide to cope with the effects of natural catastrophes and it has even provided valuable funding to the WHO at the height of the COVID-19 pandemic, when a cat bond covering that risk triggered and provided the necessary funding to the WHO to purchase emergency equipment. This transaction has saved countless lives.



Source: Graphic provided by Icosa Investments AG.

Cat bonds are systemically important for the reinsurance market. With a market size of almost $50 bn, cat bonds have become an important pillar in global risk transfer. In an interconnected economy that is increasingly exposed to climate risks, cat bonds are needed for the excess risk to be distributed. Without cat bonds, insurance coverage would be prohibitively expensive or even unavailable in some regions of the world, leaving entire economies exposed to the risk of natural disasters. Also, the traditional reinsurance market is not able to absorb this risk and cat bonds are an effective way of risk transfer, which helps to eliminate systemic risk within this market. Cat bond UCITS funds, which make up roughly a fourth of the cat bond market, are the biggest buyers of cat bonds. Eliminating UCITS cat bond funds as potential buyer of these instruments would potentially trigger a cascade of second and third round effects which might threaten the stability of the financial system itself.



Cat bonds are sustainable. A major player in the cat bond market is the World Bank. As one of the largest

sponsors of cat bonds, the World Bank sends a strong signal of their importance and effectiveness. For years, the World Bank has been issuing cat bonds to help countries and regions protect themselves against the financial damages of disasters such as earthquakes, hurricanes, and pandemics. This not only demonstrates the trust one of the most renowned international institutions has in these financial instruments but also underscores their positive impact on the global sustainability agenda.

Cat Bonds meet many of the criteria significant for ESG investments:

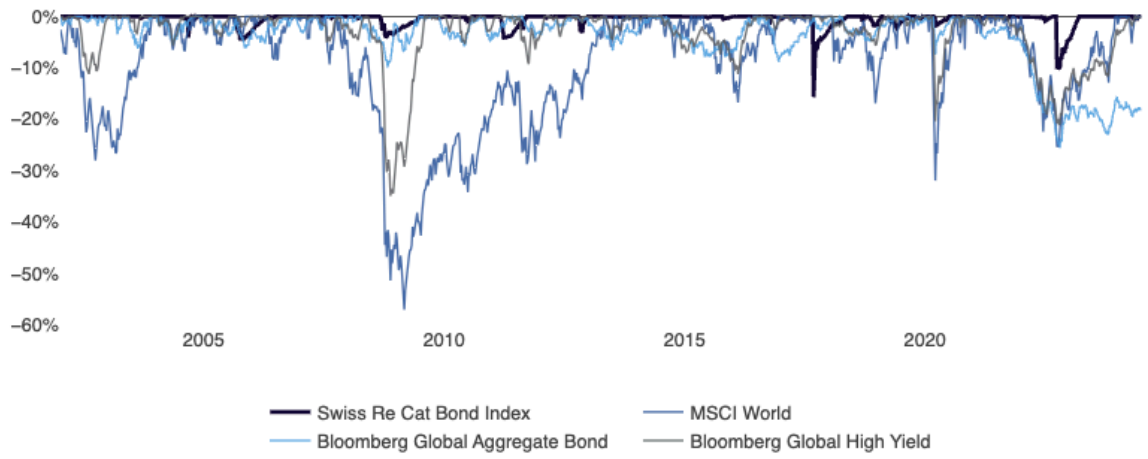
- *Environmental*: By financing protective measures against natural disasters, cat bonds help mitigate the impact of such events. They promote investments in preventive measures and strengthen the resilience of communities to the effects of climate change.
- *Social:* Cat bonds have direct positive impacts on populations. By enabling quick financial assistance after disasters, they help accelerate rebuilding efforts and alleviate the suffering of those affected. Additionally, they support economic stability in the covered regions.
- *Governance:* The structure and use of cat bonds require a high degree of transparency and accountability. The involved institutions, including insurers, reinsurers, and issuers like the World Bank, are subject to strict regulations and oversight, which strengthens investor confidence.

Investing in cat bonds is not only financially attractive but also an expression of responsibility and commitment to a sustainable future. They allow investors to contribute directly to addressing the challenges of climate change. Institutions like the World Bank demonstrate that these bonds are not only theoretically sound but also practically effective. In a world increasingly affected by extreme weather events and natural disasters, cat bonds offer an innovative solution that promotes economic and social stability. They are clear evidence that financial returns and sustainability can go hand in hand. It is time for more investors to recognise this opportunity and invest in a future that is both profitable and sustainable.

Cat bonds are liquid. Thanks to liquidity generated through regular coupons, secondary markets and maturities, the cat bond market often surpasses other fixed income markets in liquidity. With cat bonds typically maturing within three years, the market generates approximately $15 billion in annual liquidity from maturities alone, given a market size of $45 billion. Additionally, annual coupon payments contribute another $6 billion, distributed evenly throughout the year each month or quarter. Secondary market trading volume is estimated to have ranged between $8 billion and $12 billion in recent years, with projections for 2024 exceeding $20 billion. Cumulatively, the market is expected to exhibit over $40 billion in liquidity for 2024, nearly matching the entire market size and reinforcing the high liquidity of the cat bond market. Moreover, the independent risk profile of cat bonds from traditional financial market risks further enhances their appeal. Liquidity stress in conventional financial markets has minimal impact on cat bonds, as demonstrated by their resilience during the COVID-19 crisis. This unique attribute not only ensures sufficient liquidity within the cat bond UCITS funds but also contributes to reducing overall liquidity risk in investors' portfolios, thereby stabilizing financial markets. In conclusion, maintaining the UCITS eligibility of cat bonds is crucial. Their demonstrated liquidity, diversification benefits, and resilience to traditional market stresses make them a vital component in investors' portfolios and a stabilizing factor in financial markets.

Cat bonds are robust and diversifying. Even during the most severe events in the past 25 years, the performance of cat bonds has surpassed that of investment-grade corporate bonds. In over 20 years, the cat bond market has never experienced a drawdown exceeding 20%, presenting a more favorable drawdown profile than the investment-grade corporate bond market, which is generally considered very safe. The data clearly demonstrates that cat bonds, while bearing certain risks, have consistently proven to be a stable and

rewarding asset class for investors. Over the past 25 years, the cat bond market has exhibited significantly less volatility and drawdown risk compared to almost all other asset classes. Importantly, drawdowns in cat bonds occur independently of financial markets, providing investors with valuable diversification. Consequently, this asset class has a stabilizing effect on broader financial markets. Cat bond UCITS funds effectively protect investors from excessive drawdown risk and volatility in their overall portfolios.



Source: Icosa Investments AG per 30 June 2024.

Detailed response to Q20 of ESMA's CfE regarding the characteristics of the underlying markets (such as availability of reliable valuation information, liquidity, safekeeping) and the UCITS EAD regulatory definition of transferable securities:

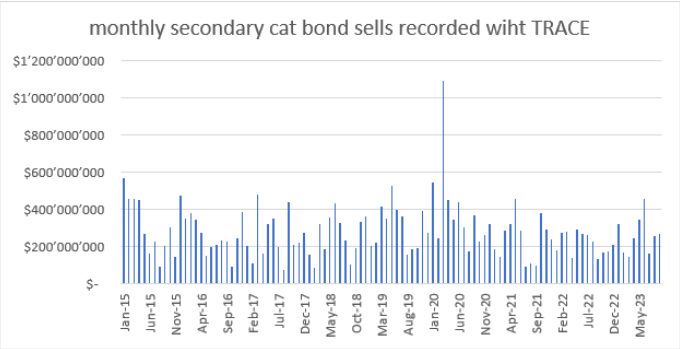
Cat bonds represent a distinct risk transfer mechanism where the potential loss is explicitly defined and capped at the amount invested/limited to the amount paid for it. The structured nature of cat bonds ensures that investors have a clear understanding of their maximum risk exposure, which is strictly limited to the capital they invest in the bonds. This characteristic aligns with the regulatory requirement for UCITS that the potential loss must be confined to the initial investment amount, thereby ensuring that the risk associated with holding these securities remains transparent and well-contained.

UCITS cat bonds' liquidity does not compromise the ability of the UCITS to comply with Article 37 of the UCITS Directive, relating to its redemption responsibilities towards unit holders. Cat bonds are generally issued in markets with sufficient activity to support robust secondary trading mechanisms. Liquidity is also supported by relatively short maturities of cat bonds. Additionally, cat bonds function as effective diversifiers during periods of market volatility, contributing to overall market stability by providing a source of liquidity when traditional markets experience turmoil. This characteristic enhances their value in an investment portfolio, particularly in the context of risk management and capital preservation strategies.

The cat bond market functions on both primary and secondary levels, enabling price discovery, access to bids and offers, and vastly enhancing liquidity management. During the COVID-19 crisis, cat bond funds were able to serve elevated levels of redemption requests smoothly and efficiently. This period is a strong illustration

of the liquidity of the cat bond market during times of broader market distress and a testament to the effectiveness of the liquidity management tools provided by the UCITS framework.

US Financial Industry Regulatory Authority's (FINRA) Trade Reporting and Compliance Engine (TRACE) data also supports this market trend, showing a 4-time increase relative to the average monthly volume in March 2020, when the traditional market liquidity has dried up.



UCITS cat bonds' clients' feedback indicated that cat bonds were the only asset class in their portfolios that did not lose significant value (the biggest cat bond fund lost 1.1% in value in March 2020, the Swiss Re Global Cat Bond Total Index – a monthly market cat bond index produced by reinsurer Swiss Re and available on Bloomberg – 1.8%, and both returned to pre-crisis value by June 2020), thus clients seeking liquidity reduced their cat bond positions. This demonstrates that cat bonds are not only diversifying in terms of performance but also in terms of market liquidity.

To further illustrate the resilience of cat bonds, one may examine the financial crisis of 2008. The Swiss Re Cat Bond Total Return Index recorded a relatively moderate decline of 4% from September 2007 to February 2009. In contrast, the S&P 500 dropped by over 50%, and high-yield bonds fell by more than 25% during the same period. This comparison underscores the lower correlation of cat bonds with traditional financial markets, emphasizing their value as a diversification tool in investment portfolios.

Moreover, during periods of financial instability such as the Federal Reserve's tapering of quantitative easing (commonly referred to as the "Fed tapering"), the cat bond market demonstrated significant resilience. The tapering period, which began in late 2013, caused substantial volatility in equity and bond markets. However, cat bonds remained stable, highlighting their unique risk-return profile and limited sensitivity to broader market fluctuations.

The uncorrelated nature of cat bonds with traditional markets is also evidenced in the table below:

Pearson Correlation [-1,1]	Cat Bonds	Global Equities	Hedge Funds	Real Estate	Commodities	Global Bonds
Cat Bonds	1.00	0.25	0.14	0.25	0.15	0.23
Global Equities	0.25	1.00	0.50	0.82	0.42	0.32
Hedge Funds	0.14	0.50	1.00	0.45	0.50	0.06
Real Estate	0.25	0.82	0.45	1.00	0.36	0.54
Commodities	0.15	0.42	0.50	0.36	1.00	0.15
Global Bonds	0.23	0.32	0.06	0.54	0.15	1.00

Pearson Correlation amongst various asset classes; Source: Twelve Capital AG based on Bloomberg monthly time series data spanning from December 31, 2002, to June 28, 2024.

Valuation of cat bonds is based on well-established methodologies that incorporate modelled risk scenarios and actuarial data. Therefore, reliable valutation is available. Many cat bonds are assessed by regulated and widely known investment brokerage firms who frequently issue valuation sheets, providing a standardized approach to valuation. Furthermore, independent pricing services and regular updates from the issuing entities contribute to the reliability of these valuations. Hence, UCITS funds can obtain accurate and reliable valuations for cat bonds, satisfying the requirement for reliable valuation for the purpose of net asset value calculations.

Appropriate Information is available for cat bonds. Cat bonds come with comprehensive documentation, including detailed prospectuses, offering memoranda, and periodic reports. These documents provide essential information on the bonds' terms, risk profile, and underlying catastrophe events covered. The availability of such detailed and transparent information ensures that investors, including investors in UCITS funds, can make informed decisions regarding their investment in cat bonds. Furthermore, under SEC rule 144A, standard documentation practices are well established, further enhancing transparency and investor confidence.

Cat bonds are negotiable. Cat bonds are traded in established secondary markets and can be bought and sold by investors. Furthermore, all trades are supported by standard Bloomberg trading tickets significantly reducing trading execution risk. Hence, they are clearly negotiable. This means that they meet the requirement of being transferable securities as they can be traded between parties, ensuring they are negotiable within the framework of the UCITS Directive.

Furthermore, the safekeeping of cat bonds adheres to the same established infrastructure and procedures used for traditional securities. Custodians and depositories that manage traditional securities are equally equipped to handle cat bonds, employing identical protocols for registration, settlement, and record-keeping. The processes for ensuring the security and integrity of cat bonds are indistinguishable from those used for other fixed-income securities, thereby providing the same level of safety and regulatory compliance. Similar to other fixed-income markets, cat bonds trade on a standard settlement, and are supported by data

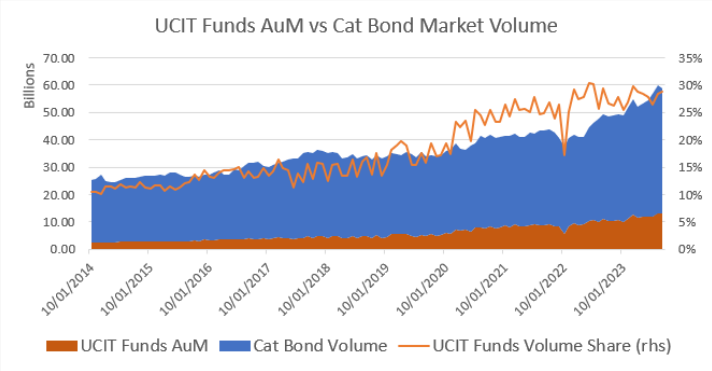
available via TRACE. This ensures that investors and regulatory bodies can have full confidence in the safekeeping of cat bonds within the existing financial system.

The acquisition of cat bonds is consistent with the investment objectives or the investment policy, or both, of the UCITS, pursuant to the UCITS Directive. Cat bonds can be consistent with the investment objectives of a UCITS, especially for funds seeking diversification beyond traditional asset classes or those aiming to include investments that provide returns exhibiting low correlation.

By incorporating cat bonds, UCITS funds can align their investment strategies with their objectives, such as achieving higher returns while managing specific risk exposures in line with their investment policy.

Cat bond risks are adequately captured by the risk management process of the UCITS. UCITS funds are required to have robust risk management processes in place. The risks associated with cat bonds, such as catastrophe risk and (limited) credit risk, are well-understood and can be quantified using established risk management frameworks. UCITS funds can integrate, and indeed have successfully incorporated, these risks into their overall risk management strategies, ensuring that the risk exposures related to holding cat bonds are adequately captured and managed.

Since the inclusion of cat bonds in UCITS in 2011, the volume of UCITS funds has grown steadily and now accounts for about 28% of the total 144A cat bond securities universe.



Source: artemis.bm

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Contact:

Michael Bommer
lic.iur. HSG, attorney-at-law (CH)
Senior Consultant Regulation & Policy
Bundesverband Alternative Investments e. V.
Poppelsdorfer Allee 106
D-53115 Bonn

Telephone: +49-(0)228-96987-51
Email: bommer@bvai.de
Internet: www.bvai.de

Frank Dornseifer
Attorney-at-law
Managing Director
Bundesverband Alternative Investments e. V.
Poppelsdorfer Allee 106
D-53115 Bonn

Telephone: +49-(0)228-96987-50
dornseifer@bvai.de
Internet: www.bvai.de

The **Bundesverband Alternative Investments e.V. (BAI)** is the cross-asset and cross-product lobby association for the alternative investment industry in Germany and we consider ourselves as a catalyzer between professional German investors and suppliers of alternative investment products worldwide. The overarching goal is that German institutional and professional investors must be able to diversify their investment with regard to alternatives better and more easily. The BAI is promoting a broad diversification which includes alternative investments as indispensable, in particular in terms of safeguarding long-term retirement pensions and the provision of money for construction, maintenance, and development of public infrastructure and renewable energies.
BAI members are recruited from all areas of the alternative investments' industry, e.g., AIF managers and banks as well as service providers. At present, the BAI counts almost 300 national and international member companies and is growing continuously.