

Business interruption risk not a significant concern for the Cat Bond market

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Executive Summary:

- The Cat Bond asset class continues to meet investor expectations, delivering returns lowly correlated to broader investment markets during this period of COVID-19 led volatility.
- Possible (re)insurance industry exposure to business interruption claims due to the pandemic is under close stakeholder scrutiny given the scale of economic loss being suffered.
- Cat Bonds are standardised transactions providing coverage for natural perils or, in some cases, named perils only. Pandemics are usually not part of this coverage and hence there is no exposure to COVID-19 related business interruption claims across almost all Cat Bonds.
- Twelve's legal analytics team has identified only one Cat Bond programme (from the approximately 200 bonds assessed), as theoretically being at risk to business interruption losses due to the inclusion of unspecified naturally occurring 'other perils' coverage.
- As a result, Twelve views the risk of COVID-19 related business interruption claims feeding into the Cat Bond market as very low, highlighting again the resilience of the asset class and the benefits of standardised structuring and legal documentation.
- A small handful of Cat Bonds are exposed to the COVID-19 situation, but this is by design. This includes the bonds sponsored by the World Health Organization which specifically cover pandemics (both of which have suffered either a partial or full default).

Business interruption insurance risk

In Twelve's view the Cat Bond asset class continues to meet investor expectations during this period of widespread COVID-19 pandemic led market volatility. Demonstrating its ability to deliver returns lowly correlated to broader investment markets, year to date the Swiss Re Cat Bond Index¹ has returned +0.66% (as at 1 May 2020).

Nonetheless, Twelve believes the (re)insurance industry as a whole does have potential sources of pandemic claims exposure. These include excess mortality, workers compensation, event cancellation and travel. However, it is another potentially exposed line of business that is receiving most attention from insurance investors, regulators and the media globally, namely Business Interruption (or 'BI') insurance.

Standard BI insurance is designed to provide compensation to a business for lost income sustained from the suspension of operations caused by direct physical loss, damage, or destruction to property. The loss or

¹ Swiss Re Global Cat Bond Index Total Return, calculated by Swiss Re Capital Markets, is a market value-weighted basket of natural Cat Bonds tracked by Swiss Re Capital Markets, calculated on a weekly basis.

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damage must be caused by or result from, a covered cause of loss, insurers compensating for lost income whilst the damaged or destroyed property is rebuilt, repaired or replaced. The coverage is typically purchased as an extension to standard property insurance policies, but can also be given as an extension under a public or products liability policy.

The main reason why BI insurance is receiving so much attention is the scale of economic loss being suffered. To illustrate, the US based American Property Casualty Insurance Association (APCIA) has estimated that pandemic closure related economic losses for US small businesses, with fewer than 500 employees, could reach between USD 393bn to USD 668bn per month.

The (re)insurance industry has taken the stance that standard BI policies do not cover losses related to viruses and therefore the pandemic. However, as the debate has developed over recent weeks it is clear, in Twelve's view, that the impact of potential BI related loss will not be equally felt across the industry or indeed by asset class, reinforcing the importance of the extensive fundamental analytics undertaken by Twelve. This reflects that issued insurance policies can broadly be summarised into three categories, i.e. those where:

1. Pandemic is explicitly included as covered risk;
2. Pandemic is explicitly excluded as covered risk; or
3. The policy is silent or unclear on whether pandemic coverage is included or excluded.

To illustrate, in Canada, some companies have put their reinsurers on notice for potential claims, implying that their original insurance policies include pandemic coverage. In contrast the US original property insurance policies are typically based upon a standard 'ISO' form, leading to a high standardisation of policy wording. For commercial property insurance the standard ISO form is the Business Owners Policy (or 'BOP'). This form can provide BI coverage for income lost due to 'direct physical loss' and specifically excludes losses due to 'contaminants' (though the definition of 'contaminant' does not specifically include viruses).

Twelve expects an extended period of uncertainty for some (re)insurers whilst the assessment is made over the extent to which pandemic related lost income can be recovered from the industry. This is expected to be most significant for (re)insurers where the policies they have issued are silent or unclear on whether pandemic coverage is included or excluded. In relation to these specific (re)insurers, Twelve believes the greatest investment performance volatility will be felt by their equity investors, with credit investors relatively well insulated.

Many uncertainties remain, including whether or not ongoing political action in some US states to retroactively extend cover to pandemic related losses proves successful (not Twelve's central case assumption).

Refocusing on Cat Bonds, Twelve believes that if primary insurers honour pandemic related BI claims under their property insurance policies then they will likely seek recoveries from their reinsurers, presuming the coverage afforded within the reinsurance programme can be interpreted to provide such coverage. It is sensible and prudent therefore to assess whether BI risk could find its way into the Cat Bond market.

Assessing BI risk in the Cat Bond market

Typically Cat Bonds are standardised transactions providing coverage for natural perils or, in some cases, named perils only (e.g. named windstorm). Extensive legal analysis performed by Twelve as part of its proprietary Cat Bond investment process has identified that there are only very few transactions where additional coverage is provided. This is typically classified under unspecified naturally occurring 'other perils' coverage and often requires an 'event' to be declared by a specialist agency or in some case the sponsor themselves. These legal conditions provide some starting level of comfort in Twelve's view, that the risk of BI claims leaking into the Cat Bond Market is minimal.

To further assess potential portfolio exposure, Twelve has reviewed in detail all Cat Bonds held across portfolios. The following 'decision tree' approach was used as part of a broader process to identify potentially problematic Cat Bonds:

1. Coverage

- i. What are the covered perils?
- ii. Is there any direct exposure to pandemic/BI?
- iii. Is there any possible indirect pandemic exposure? The potential for indirect exposure might exist if 'other perils' are included in the coverage and are not clearly defined.

2. Contract language/exclusions

- i. Are there any mitigating factors that could limit exposure, i.e. specific exclusions of pandemic or virus contamination?
- ii. Is a catastrophe code required for the event to qualify for coverage?
- iii. Does a catastrophe code need to be generated by an independent third party agency, or can one be assigned by the Cat Bond sponsor?
- iv. Does the event need to be naturally occurring?
- v. Is there an applicable hours clause?

Twelve's conclusion: Cat Bonds face very limited potential BI exposure

As a result of this extensive process only one Cat Bond programme from the approximately 200 bonds assessed has been identified by Twelve as theoretically being at risk to BI losses. Noting material legal uncertainties, Twelve sees a limited risk given that the sponsor can assign a catastrophe code and the commercial element of the subject business is likely to have at least some exposure to BI risk (the extent of this being highly uncertain at this stage). Additionally, the contract language would require the pandemic event to be classified as naturally occurring, which is not a given in Twelve's view.

Twelve believes that BI risk from a pandemic is not an eligible peril, unless it is explicitly covered. Should a sponsor try to opportunistically claim COVID-19 related losses from their Cat Bond programme, this would likely be met by strong resistance from investors. Sponsors would likely incur heavy reputational damage that would hamper their access to capital markets in the foreseeable future.

For completeness, aside from potential BI exposure Twelve believes only a small handful of other Cat Bonds could be exposed to losses due to the pandemic. These include the bonds sponsored by the World Health

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Organization which specifically cover pandemics (both of which have suffered either a partial or full default) and others which have clear excess morbidity exposure by design.

Overall, Twelve Capital believes that the standardised structuring and robust legal documentation commonly found in the Cat Bond market highlights the resilience of the asset class. Twelve Capital sees the risk of BI related losses for Cat Bonds as very low and therefore does not expect a major impact on the asset class from this source.

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