The case for catastrophe bonds in Southern Africa

The flooding in KwaZulu-Natal in April of 2022 is largely regarded as the most severe flooding event in the province and potentially the country. Although much needs to be done to improve infrastructure within urban areas, especially drainage systems, the extreme volumes of rain from a cyclone cannot simply be managed.

The frequency and intensity of cyclones across Southern Africa may be increasing, and with the impact of flooding not only taking lives, but damaging infrastructure and livelihoods, the potential support provided through catastrophe bonds may need to be considered.

Catastrophe bonds were introduced in 1997 and have grown in number of issuances and outstanding debt to the order of around USD47 billion in 2024. With the World Bank issuing a catastrophe bond for earthquakes in 2023 for the government of Chile ($630 million), and in 2024 for named storms for the governments of Jamaica ($150 million) and Mexico ($420 million), there is appetite amongst issuers / risk holders to achieve more competitive pricing of the risk and to reduce geographic risk. For investors, the attraction to such assets is to achieve enhanced yields from highly rated fixed income assets, albeit with the risk of not getting one's capital back.

The mechanics of the catastrophe bond allow for a special purpose vehicle to issue the bond to potential investors with an attractive yield over a relatively short period from three to five years. If the event for which the bond is issued materialises, the catastrophe, then the interest and capital invested may be forgone or significantly reduced. The special purpose vehicle enters into an equivalent contract with the risk holder, enabling them transfer the risk via this insurance / reinsurance contract.

South Africa is acknowledged as having deep and liquid capital markets, the structuring of securities which enable the transfer of risk to the capital markets would provide an additional investment opportunity for investors comfortable with alternative assets. As an insurance linked security, the catastrophe bond, expands the pool of capital available to back the provision of such contingent payments, outside of the global reinsurance market, by introducing sophisticated investors such as hedge funds, asset managers and pension funds.

South Africa may be in a position to issue domestic and regional catastrophe bonds, as we have a well-regulated financial system including the securitisation market. A local bond issuance may also attract foreign investors to diversify their investment risks between the global north vs global south, together with local specialised risk-linked securities investors, while the domestic banks already have experience as they facilitate securitisation bond issuances and swaps.

With the international market being able to provide a risk history, risk modelling should be possible within current actuarial science skills or through risk modelling companies given the extent of modelling in the US and other areas where storms are more severe and frequent.

The policy maker, regulators and financial sector need to align on the opportunity to develop catastrophe bonds as a partial risk mitigant against flooding, drought and other perils so that there is funding available for the rapid recovery of society after such an event.

Mark Brits executive director and Karabo Morule former director.

END

2024/06/24