World Bank sustainable development bonds as collateral solutions for the catastrophe bond market

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The World Bank has been an active participant in the catastrophe bond market since 2009. That year, the World Bank arranged a US$290m, multiple-series catastrophe bond (covering high severity earthquakes and hurricanes) for the Government of Mexico. Since then, the World Bank has arranged or issued over US$2.6bn of catastrophe bonds, including a ground-breaking transaction covering global pandemic risk and the second largest catastrophe bond ever issued, a US$1.36bn earthquake transaction for the four countries of the Pacific Alliance (Chile, Colombia, Mexico and Peru).

The World Bank in the catastrophe bond market[2]

Through these transactions, the World Bank has made the risk bearing capacity of the catastrophe bond market available to its member countries that are highly vulnerable to natural disasters and other types of catastrophic events.

In addition to acting as an arranger and issuer of catastrophe bonds, the World Bank has become an important supplier of collateral for catastrophe bonds issued by third parties. As collateral in third-party transactions, World Bank bonds offer several important benefits to both transaction sponsors and investors: (1) they carry a rock solid, triple-A rating; (2) they pay a premium over most other preferred forms of collateral; and (3) the proceeds of the issues are used to support the World Bank's sustainable development mission across a diverse range of sectors including health, education, transportation and renewable energy. In other words, World Bank bonds are a safe, cost-efficient and socially responsible option as collateral.

Collateral in the catastrophe bond market

The World Bank issues catastrophe bonds in its own name backed by its own balance sheet. However, in a typical catastrophe bond transaction, issuances are done by special purpose vehicles (SPV) set up by the transaction sponsor. Since the SPV has no credit strength of its own, the proceeds of the issue must be held as collateral during the life of the transaction. Sponsors, therefore, must decide on how to invest those proceeds.

Three considerations are paramount for sponsors: safety, liquidity and return. A catastrophe bond with a stated maturity of five years could redeem early at any time over that five-year period if the insured event occurs. The issuing SPV must therefore ensure that the collateral is safe and liquid enough to be immediately sold at par and at very short notice. The yield from collateral is equally important. Because the catastrophe bond coupon comprises both the risk premium and the return from this investment, the choice of collateral can have a significant bearing on the overall returns earned by investors.

As with any financial instrument, all three criteria come with trade-offs. With memories still fresh from the 2008 global financial crisis, the catastrophe bond market has been prudent to avoid all but the most liquid and safe investments. The default investment choice for many years has been US government securities or government securities money market funds. Over the last 10 years, however, the World Bank has successfully positioned its sustainable development bonds as an attractive alternative. These bonds are issued off the same global debt issuance program that the World Bank uses to issues roughly US$50bn per year to fund its sustainable development activities.

For more than 70 years, the World Bank has been a frequent issuer in debt capital markets. Backed by commitments from its 189-member countries, a loan portfolio with an extraordinary, 70-year history of performance, prudent risk management policies and a proven track record of implementing those policies, the World Bank has been triple-A rated since 1959. Not only safe, World Bank bonds also offer a pick-up over comparable yields offered by US Treasuries or money market funds. Liquidity in these bonds is enhanced through quarterly put options that offer the right, but not the obligation, to the SPV to redeem the bonds early at par.

World Bank bonds have now been used as a collateral solution for more than 60 catastrophe bonds in an aggregate amount of approximately US$13bn. Such bonds covered a variety of perils ranging from earthquakes and tropical cyclones to wildfires and longevity across a broad geographical area. The World Bank is comfortable with the uncertain redemption profile of these bonds because they cover a diverse range of risks (meaning the early redemption risk with respect to any single event is limited). In addition, these bonds make up a small portion of the World Bank's overall debt portfolio (currently at more than US$200bn).

Safety, liquidity, return, and doing good

Much of the capital in the catastrophe bond market comes from pension funds, asset managers and family offices, and these investors are increasingly conscious of the environment, social and governance (ESG) aspects of their investments. Given such investor concerns, the World Bank's mission to alleviate poverty and boost shared prosperity in our member countries becomes a strong selling point for using World Bank bonds as a collateral solution. The proceeds from every single bond issued by

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the World Bank support the financing of projects that promote sustainable development around the globe.

In this way, investors in World Bank bonds contribute towards the achievement of the 17 Sustainable Development Goals (SDGs) – a set of interrelated goals related to critical development priorities such as health, gender, environment and education that were adopted by the international community in 2015. Investors also benefit from the Bank's strong policies, safeguards, and due diligence process, while at the same time not being not exposed to project specific risk. The impact from these investments has been transformative. For instance, just in two years between 2015 and 2017, World Bank projects helped 13.4 million individuals get access to clean water.

Choice

According to the United Nations, achieving the SDG targets by the year 2030 will take investments of US$5 trillion-US$7 trillion, including roughly US$2.5 trillion in developing countries. By providing valuable risk-taking capacity to the global reinsurance market, catastrophe bond investors are already providing risk capital for a worthwhile cause. By choosing World Bank putable bonds as a collateral solution, investors in catastrophe bonds can further enhance the sustainability of their investments, without giving up on return or taking any additional risks.

Notes:

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2 As of the end of 2018, the volume of outstanding catastrophe bonds stood at more than US$30bn (roughly twice as much as at the end of 2012). One factor driving this growth has been the increasing pool of alternative capital, from catastrophe bond funds, pension funds, and asset managers, looking for diversified, uncorrelated, and high yielding assets. This increased supply has been matched by growing interest for risk transfer solutions from sovereign and local governmental entities as well as corporates and insurance companies.

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