

**United States House of Representatives  
Select Committee on the Climate Crisis**

**Hearing on October 1, 2020  
“Creating a Climate Resilient America:  
Strengthening the U.S. Financial System and  
Expanding Economic Opportunity”**

**Questions for the Record**

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**The Honorable Kathy Castor**

- 1. In your testimony, you described how insurance-linked securities (ILS), including catastrophe bonds, could be harnessed to accelerate resilient recovery from disasters. Could you please elaborate on some specific ways that state, local, and other public entities could further tap into these ILS resources, and how the U.S. federal government could be a helpful partner to make this happen?**

As noted in my testimony, ILS have played an important role in stabilizing the national insurance market and lowering property insurance costs for individuals and businesses in the United States. However, the ILS technology and the inherent benefits of the ILS marketplace can be applied more broadly and innovatively than they have been to date in the country.

As illustrated by examples from overseas, ILS can be applied to areas where insurance doesn't currently exist and to help local and national governments accelerate disaster recovery for their economy and for affected communities. While the functions of ILS and traditional insurance markets are similar, they differ in one key aspect: while traditional insurance tends to target individual policyholders, ILS focus on if an event will occur and once it does, payouts can be distributed in any way that is necessary for an effective, predictable and early response. This opens up a world of new possibilities where fully collateralized contingency funds can be rapidly deployed to areas and communities in need following a catastrophe. To unlock the full value of such contingency funding, it should be paired with contingency plans that outline how funds will be programed to facilitate a *resilient* recovery, that not only protects livelihoods in the immediate aftermath but that will also help those affected build back better for the future.

Investment in early, predictable responses to communities in disaster-prone regions is expected to be more cost-effective than a slow and late response that allows a crisis to become acute, and evidence from the ground increasingly supports this. For example, in Mexico, FONDEN was established in the late 1990s by the Mexican government to manage the risk created by natural disasters and to support emergency relief operations and the rapid rehabilitation of federal and

state infrastructure affected by these adverse events. The majority of FONDEN funds are spent on the reconstruction of low-income housing and public infrastructure after disasters. Facilitated by the World Bank, since 2009 FONDEN has been a regular sponsor of catastrophe bonds to help finance these response efforts. After nearly a decade and a half of operation, results indicate that, in the year following the disaster, municipalities with access to rapidly disbursed FONDEN disaster funds grew between 2% to 4% more than those without FONDEN.[1] Overall, with conservative benefit-cost ratios in the range of 1.5 to 3, the evidence shows that FONDEN, including the cost of the catastrophe bonds it has sponsored, has provided cost-effective protection from the public service disruptions caused by natural disasters. Other studies have shown similar net positive multiples that speak to the overall net positive economic benefit of responding early rather than late through insurance-like mechanisms.[2]

Many applications, pairing contingency planning with insurance-like mechanisms to provide contingency financing, can be conceived of in the United States at the state, local and public entity level to address the needs of vulnerable communities using the data and information available today. The U.S. federal government can do much to facilitate and encourage such innovation. As mentioned in my written testimony, technical assistance for entities that wish to design such new programs is a key way in which the federal government can provide support. The expertise to create deployable public-private partnerships that can effectively leverage the ILS market for the purposes of accelerated resilient recovery from disasters exists within the re/insurance and ILS markets – including within FEMA that has experience with catastrophe bond issuance – and, critically, within public entities and international organizations around the world that have pioneered such approaches and understand how programs should be designed to unlock the promise of timely and reliable disaster funding. Identifying ways in which funds of existing or new federal programs could be used to pay for such technical expertise, and encouraging their use for such a purpose, would be an important step towards transforming the idea of effective and timely disaster response using modern financing tools into an operational reality here in the United States. The Select Committee’s majority staff report, “Solving the Climate Crisis: The Congressional Action Plan for a Clean Energy Economy and a Healthy, Resilient, and Just America”, has many pertinent recommendations on how federal hazard mitigation programs, recovery programs and incentives can be aligned and leveraged to this effect.[3]

While much can be done now with the data that already exists, consistent, reliable, high-quality and actionable climate data and real-time earth observations are always important to developing better risk management and mitigation solutions, including ILS applications that respond more quickly and in a more targeted manner to needs. As such, the recommendations on actionable climate risk information in the Select Committee’s majority staff report, “Solving the Climate Crisis: The Congressional Action Plan for a Clean Energy Economy and a Healthy, Resilient, and Just America”, are also an important way in which the federal government can support innovation to harness the potential of ILS markets to accelerate resilient recovery from disasters.[4]

**2. In your testimony, you noted that investors are actively seeking Environmental, Social, and Governance (ESG) investment opportunities. Could you please describe some of the obstacles to meaningful ESG investing, including disagreement over standards and concerns over "greenwashing"? What are some actions that could be taken to overcome these obstacles to ESG?**

At FERMAT we believe the ILS asset class is inherently aligned with positive ESG principles, which makes it somewhat different to other, more traditional assets classes such as equities and bonds where investors are either owners of, or lenders to, companies. As a result, we have experienced an uptick in investor interest in the asset class in recent years and seen an increased number of ESG-related requests for information.

As an investment manager, we obviously value accurate, pertinent and informative disclosures. At FERMAT, we prioritize the analysis of the risk disclosures in ILS submissions in our underwriting and investment process. As one of the main risks underpinning investments in the ILS sector is weather risk, quantifying physical climate-related risks to ILS is a core component of the ILS underwriting and investment process. For this reason, environmental considerations – the E of ESG – are closely linked with ILS. For example, every U.S. hurricane catastrophe bond indicates the risk of the bond both with and without the impact of factors such as elevated sea surface temperature to assess the possible effects of climate change on hurricane activity.<sup>[5]</sup> These types of analyses and different views allow investors to evaluate the sensitivity of specific ILS transactions and their portfolios to potential climate-related changes to hurricane activity. Risk disclosures, that provide transparent and appropriate data, risk modelling and sensitivity analyses helpful for establishing a reasonable bound on the risk of an ILS investment for the risk period in question, are welcome in our market. Looking forward, as our market grows, such high-quality disclosures will be even more important. They will help investors overcome climate change concerns with respect to deploying more capital to the sector and they will help the market establish an appropriate price – and provide that critical market indication – to ILS sponsors for the risks they cede.

Weather-related risk disclosures in general are standard in the ILS market, as ILS investments specifically target these risks, helping ILS sponsors manage the consequences of risk events when they occur. Such disclosures, however, are not standard in other financial markets. Given the increasing interest in the impact of weather and climate change on organizations and their operations, there is much know-how within our market that can be applied to quantifying such risks for companies, and other private and public entities. As more organizations begin to identify, quantify and then disclose their weather and climate risks, we believe the ILS market is also well positioned to help these entities manage their financial impact.

Speaking more broadly, as an investment manager we observe that many other investment managers are committed to ESG principles and increasingly perceive them as imperative inputs into their investment decision-making process. They are very aware of the risk of “greenwashing” and actively seek to avoid such investments and the negative reputational risk associated with them. We believe the main obstacle for ESG-oriented investors, therefore, is further transparency from companies on ESG issues.

## References

- [1] Source: de Janvry, A., et al., “Insuring Growth: The Impact of Disaster Funds on Economic Reconstruction in Mexico”, June 2016, World Bank, Washington DC. Available online at: <https://openknowledge.worldbank.org/bitstream/handle/10986/24631/Insuring0growth0nstruction0in0Mexico.pdf?sequence=1&isAllowed=y>
- [2] Clarke, D. J., and R. Vargas Hill, “Cost-Benefit Analysis of the African Risk Capacity Facility”, Discussion Paper 01292, September 2013, International Food Policy Research Institute, Washington DC. Available online at: <https://ebrary.ifpri.org/digital/collection/p15738coll2/id/127813>
- [3] In particular, see the *Reduce Climate Disaster Risk and Costs* (p390) and *Accelerate Resilient Disaster Recovery* (p401) sections of the Select Committee’s majority staff report, “Solving the Climate Crisis: The Congressional Action Plan for a Clean Energy Economy and a Healthy, Resilient, and Just America”. Available online at: <https://climatecrisis.house.gov/report>
- [4] See the *Develop and Deploy Actional Climate Risk Information* section (p374) of the Select Committee’s majority staff report, “Solving the Climate Crisis: The Congressional Action Plan for a Clean Energy Economy and a Healthy, Resilient, and Just America”. Available online at: <https://climatecrisis.house.gov/report>
- [5] The IPCC’s most recent AR5 report states it is very likely that anthropogenic forcings have made a substantial contribution to increases in global upper ocean heat content, and hence SSTs, observed since the 1970s. Source: “Fifth Assessment Report of the United Nations Intergovernmental Panel on Climate Change”, 2014, Intergovernmental Panel on Climate Change. Available online at: <https://www.ipcc.ch/assessment-report/ar5/>