

## Position Paper

# Eligibility of Catastrophe Bonds under the UCITS Framework.

## 1. Introduction: The Strategic Role of CAT Bonds in Capital Markets

Catastrophe bonds (“CAT bonds”) have evolved over the past three decades into a mature, well-functioning relevant asset class within global capital markets. As part of the broader insurance-linked securities (ILS) universe, they perform a dual function that is of increasing importance in today’s economic environment. On the one hand, they provide essential risk transfer capacity to the insurance and reinsurance sector by enabling the securitisation and distribution of catastrophe risks. On the other hand, they offer investors access to a distinct and valuable source of non-traditional risk premia that is largely uncorrelated with traditional financial markets.

This dual functionality has become particularly relevant in light of structural global developments. The increasing frequency and severity of natural catastrophes, driven by climate change and urbanization, has led to a steady rise in economic losses, while at the same time the gap between insured and uninsured losses continues to widen. Traditional reinsurance markets are increasingly constrained in their ability to absorb these risks alone. In this context, CAT bonds play a critical role in mobilising private capital to complement existing insurance capacity and thereby enhance systemic resilience. Accordingly, the European Central Bank (ECB), the International Association of Insurance Supervisors (IAIS), the World Bank Group (WBG), the G20 Finance Ministers and Central Bank Governors (FMCBG), and the European Insurance and Occupational Pensions Authority (EIOPA) are actively engaged in promoting their development.

Within the European Union, CAT bonds have also become accessible to retail investors primarily through regulated UCITS fund structures. This has enabled retail investors to benefit from diversification opportunities that would otherwise be inaccessible, while ensuring that investments are embedded in a highly regulated and supervised framework. As such, CAT bonds contribute not only to portfolio efficiency, but also to broader policy objectives such as financial inclusion, the deepening of capital markets, and the mobilisation of private savings.

## 2. ESMA Technical Advice and Regulatory Implications

Against this background, the recent Technical Advice issued by the European Securities and Markets Authority (ESMA) on 26 June 2025 in the context of the review of the UCITS Eligible Assets Directive raises significant concerns. ESMA expresses a critical view of CAT bonds and suggests that they should no longer be considered appropriate eligible assets for UCITS. Instead, ESMA conceptually aligns CAT bonds with alternative investments and recommends that they should be confined to the Alternative Investment Fund (AIF) regime. While ESMA grounds its position in considerations of investor protection and the preservation of the UCITS label, this position paper submits that such a recommendation is not supported by sufficient evidence, is disproportionate in its

effects, and risks undermining key policy objectives of the European Union, including those of the Savings and Investments Union.

### **3. Conceptual Basis of ESMA's Position**

ESMA's position appears to rest on the assumption that CAT bonds are not fully compatible with the conceptual foundations of the UCITS framework. In particular, concerns are raised regarding their event-driven payoff structure, their reliance on catastrophe risk modelling, and their perceived proximity to insurance products rather than traditional transferable securities. Furthermore, ESMA emphasizes the need to preserve the clarity and integrity of the UCITS label as a regime designed for transparent and liquid investments suitable for retail investors. These concerns deserve careful consideration. However, they do not justify a categorical exclusion of CAT bonds from the UCITS framework.

### **4. Formalistic Regulation versus Economic Substance**

More fundamentally, ESMA's approach reflects a broader regulatory paradigm in which financial instruments are assessed predominantly on the basis of formal classification criteria, such as legal form, underlying reference variables, or perceived proximity to established asset categories. Rather than focusing on these formal attributes, a more appropriate assessment would consider their actual economic risk characteristics and their contribution to portfolio outcomes.

This increasingly formalistic approach represents a departure from a risk-based understanding of financial regulation. Instead of asking whether a given instrument can be adequately managed, understood, and integrated within a regulated investment framework, the analysis is reduced to whether it fits within predefined conceptual categories. In the case of CAT bonds, this leads to a situation where their classification as instruments linked to insurance risk outweighs a substantive assessment of their transparency, risk profile, market behaviour, and empirical track record.

Such a "form-over-substance" approach risks systematically misrepresenting the true risk profile of innovative financial instruments. CAT bonds, for example, exhibit a clearly defined and model-based risk structure, with transparent trigger mechanisms and limited exposure pathways. Their risk drivers are relatively narrow and well specified, often more so than those of traditional asset classes such as equities or corporate bonds, which are influenced by a wide range of macroeconomic, behavioural, and firm-specific factors. Nevertheless, under a classification-driven framework, these substantive differences are subordinated to formal distinctions, leading to regulatory outcomes that may not accurately reflect the underlying economic reality.

A further consequence of this approach is the neglect of the portfolio context in which financial instruments are held. Investor protection within the UCITS framework is fundamentally based on diversification and risk aggregation principles. However, when instruments are assessed in isolation, without considering their correlation structure and their contribution to overall portfolio risk, regulatory decisions may become disconnected from the actual risk experienced by investors. In the case of CAT bonds, their low correlation with traditional asset classes means that they can

significantly reduce portfolio volatility and improve risk-adjusted returns. Ignoring this effect leads to a paradoxical outcome in which instruments that enhance portfolio resilience are excluded, while more correlated and potentially more destabilising assets remain permissible.

Moreover, a formalistic regulatory approach can generate internal inconsistencies within the regulatory framework itself. If CAT bonds are excluded on the basis that they are linked to insurance risk, it becomes difficult to justify why equities of reinsurance companies – whose balance sheets are directly exposed to the same underlying risks – remain fully UCITS-eligible. This suggests that similar economic exposures are treated differently depending on their legal packaging, rather than on their actual risk characteristics. Such inconsistencies undermine the coherence and credibility of the regulatory framework.

Finally, this paradigm risks producing regulatory outcomes that are neither economically justified nor aligned with the stated objectives of investor protection. By restricting access to instruments that provide diversification and resilience, while allowing continued exposure to assets with higher systemic correlation and volatility, regulation may inadvertently increase rather than reduce investor risk. At the same time, it may limit investor choice, distort capital allocation, and hinder financial innovation.

In light of these considerations, there is a strong case for rebalancing the regulatory approach towards a more substance-based and risk-oriented framework. Such an approach would focus on the measurable risk characteristics of financial instruments, their transparency, and their role within diversified portfolios, rather than on rigid categorical distinctions. This would not only improve regulatory consistency, but also better align financial regulation with its ultimate objective: effectively protecting investors in a dynamic and evolving market environment that is further characterized by significant systemic risks.

## **5. Legal and Economic Nature of CAT Bonds**

A more accurate assessment of CAT bonds must start with their legal and economic characteristics. In multiple jurisdictions, CAT bonds are explicitly classified as debt instruments and treated as transferable securities. Economically, they resemble contingent corporate bonds, with the key distinction that traditional credit risk is replaced by a clearly defined catastrophe trigger. This structural feature does not render them incompatible with UCITS; rather, it reflects an alternative, but coherent, form of risk transfer. Even where a derivative component is assumed, a purposive interpretation of the UCITS framework would allow the underlying insurance risk to qualify as an admissible underlying, particularly given that CAT bonds are typically embedded in regulated reinsurance structures and fully collateralised with high-quality assets. Against this background, excluding CAT bonds while continuing to permit investments in the equities of reinsurance companies appears inconsistent and difficult to reconcile with a substance-over-form approach to regulation.

## **6. Historical Development and Proven UCITS Compatibility**

The historical development of the CAT bond market further undermines the case for exclusion. Since their emergence in the 1990s, CAT bonds have undergone significant standardisation and institutionalisation. They are issued through well-established structures, benefit from advanced modelling frameworks, and are traded in regulated market environments and are subject to regulatory review within the insurer's reinsurance program.

Importantly, CAT bonds have been successfully integrated into the UCITS ecosystem for more than a decade. Since around 2010, CAT bond strategies have been offered within UCITS-compliant fund structures without any evidence of systemic investor protection issues. Today, UCITS catastrophe bond funds account for approximately 30% of the outstanding global CAT bond market, demonstrating both regulatory acceptance and operational feasibility within this framework. This long-standing and well-functioning practice directly challenges the notion that CAT bonds are conceptually incompatible with UCITS.

## **7. Diversification Benefits and the Importance of Portfolio Context**

From an investment perspective, CAT bonds offer a unique diversification benefit that is both theoretically sound and empirically validated. Their risk-return profile is primarily driven by the occurrence of natural catastrophe events rather than by traditional financial market factors such as interest rates, credit spreads, or equity market performance. As a result, CAT bonds have historically exhibited low correlation with conventional asset classes. More importantly, their contribution to portfolio construction can only be properly understood in a holistic context. Assessing CAT bonds in isolation ignores the fundamental principle of modern portfolio theory, namely that risk must be evaluated at portfolio level rather than at instrument level. In practice, CAT bonds have consistently demonstrated their ability to reduce overall portfolio risk and enhance risk-adjusted returns, particularly during periods of financial market stress.

## **8. Liquidity and Market Behaviour under Stress Conditions**

Concerns regarding liquidity and market functioning also require a more nuanced assessment. While CAT bonds are sometimes characterised as relatively illiquid, empirical evidence suggests that the market exhibits a stable and resilient liquidity profile. Unlike traditional financial markets, CAT bond markets are not driven by continuous news flow or macroeconomic expectations.

As a result, they are less prone to sudden liquidity shocks or panic-driven selling. Even in the face of major catastrophe events or global financial crises, no evidence of systemic liquidity stress or disorderly market behaviour has been observed. This stands in contrast to several UCITS-eligible asset classes, which have historically experienced significant liquidity disruptions under stress conditions (For further details, please refer to: [this report](#)).

Since its inception, the CAT bond market has not experienced any material liquidity shortages, neither as a result of financial market disruptions nor due to natural catastrophes. The inherently

long-term nature of the reinsurance business model, with its buy-and-hold characteristics, combined with significant structural liquidity, plays a decisive role in underpinning these favorable liquidity properties, which are not typically found in traditional capital markets.

## **9. Rethinking the Complexity Argument**

The argument that CAT bonds are excessively complex for retail investors should also be reconsidered. While they include specialized elements such as trigger mechanisms and special purpose vehicles, their core risk profile is, in many respects, more transparent than that of traditional financial instruments, which are often characterized by complex and sometimes opaque corporate group structures, which repeatedly give rise to investor protection issues, as most recently seen in the cases of Enron, Parmalat, Olympus, Bre-X Minerals, Wirecard, etc.

The primary risk driver of a CAT bond is the occurrence or non-occurrence of a clearly defined event. By contrast, equities and corporate bonds are subject to a multitude of interrelated and often opaque risk factors, including macroeconomic developments, corporate governance issues, market sentiment and geopolitical developments. From this perspective, CAT bonds may be seen as offering a comparatively clear and well-defined risk exposure.

## **10. Investor Protection and Effective Market Access**

In this context, the investor protection argument advanced by ESMA requires careful reconsideration. The UCITS framework is widely regarded as one of the most robust investor protection regimes globally, characterised by strict requirements on diversification, liquidity management, valuation, governance, and transparency. These safeguards are specifically designed to enable retail investors to access a broad range of investment strategies within a controlled and supervised environment. For specialised asset classes such as CAT bonds, the UCITS structure arguably provides the most appropriate access channel.

By contrast, relocating CAT bonds exclusively to the AIF regime would, in practice, result in a significant restriction of access for retail investors. Although ESMA suggests that indirect access may remain possible, the practical implications are far more restrictive. Retail investors would effectively be forced to gain exposure through multi-asset funds with limited allocations, thereby losing the ability to use CAT bonds as a targeted diversification tool. This represents not merely a change in distribution channel, but a material deterioration in the quality and effectiveness of portfolio construction for retail investors.

## **11. Proportionality, Legal Certainty and Regulatory Consistency**

Removing UCITS eligibility from an established and widely used asset class would constitute a far-reaching intervention and, to our knowledge, would represent an unprecedented step in European fund regulation. Such a move would undermine legal certainty, regulatory predictability, and investor confidence in the stability of the European framework. This concern is further reinforced when

considering the limited scale of the issue the proposed measure seeks to address. From a proportionality perspective, it is difficult to justify a structural exclusion of an entire asset class where the underlying investor risk appears to be both contained and mediated through existing distribution frameworks.

The principle of proportionality requires that regulatory interventions be suitable, necessary, and balanced in relation to the risks they are intended to address. In the present case, there is no compelling empirical evidence that CAT bond exposures within UCITS have resulted in systematic investor detriment, market dysfunction, or supervisory concerns. On the contrary, the historical experience suggests that CAT bonds have operated within UCITS structures in a stable and orderly manner, supported by professional portfolio management, robust risk controls, and established distribution channels. Importantly, available estimates indicate that fewer than 1 percent of retail investors invest directly in UCITS CAT bond funds without professional advice, meaning that the vast majority of retail exposure is already intermediated by regulated financial institutions. Against this background, a categorical exclusion appears neither necessary nor proportionate, as it targets a risk that is already effectively mitigated in practice while imposing significant costs on market access and investor choice.

In the absence of demonstrated harm, a categorical exclusion represents the most restrictive regulatory option and therefore fails the necessity test. Less intrusive and more targeted measures – such as enhanced disclosure requirements, strengthened risk management standards, or clearer guidance on portfolio construction – would be available to address any residual concerns without eliminating access altogether. A blanket exclusion, by contrast, disregards the principle of regulatory calibration and risks imposing disproportionate costs on investors and market participants.

Moreover, the proposed approach raises issues of regulatory consistency. As noted above, comparable or even higher-risk exposures remain permissible within the UCITS framework, including investments in equities of reinsurance companies or other cyclical and volatile asset classes. These instruments are subject to complex and often opaque risk drivers, yet are not subject to similar exclusionary treatment. By contrast, CAT bonds, whose risk profile is well-defined, model-based, and historically stable, would be removed from the eligible universe. This asymmetry suggests that the regulatory assessment is driven more by formal classification than by a consistent evaluation of risk.

Finally, the proportionality assessment should also take into account the broader economic and structural effects of the proposed measure. By restricting access to CAT bonds, the regulation would not only affect individual investors but also have wider implications for capital allocation, market development, and risk distribution. In particular, it would limit the ability of retail investors to participate in a diversifying asset class and could reduce the flow of capital into markets that play a critical role in supporting insurance capacity and financial resilience.

## **12. Investor Access, Consistency and Equal Treatment**

Building on these proportionality concerns, the proposed approach also raises broader questions regarding investor access, as well as the consistency and coherence of regulatory treatment across

asset classes. Under the current EU regulatory framework, retail investors are permitted to invest directly in equities, including highly volatile and complex securities, provided that appropriate disclosure and suitability requirements are met. These instruments are often subject to a wide range of interdependent and difficult-to-assess risks. By contrast, CAT bonds are not directly accessible to retail investors and can only be accessed through professionally managed and regulated fund structures.

If access to CAT bonds is further restricted at the level of UCITS, retail investors would, in practice, be effectively excluded from this asset class altogether. The remaining access channels would be limited to indirect and diluted exposure through multi-asset funds, typically subject to strict allocation caps. This would not merely constitute a regulatory adjustment, but a substantive limitation on the ability of retail investors to participate in a distinct and diversifying segment of the capital market. This raises broader questions of consistency and equal treatment. It is not immediately apparent why retail investors should be permitted to assume direct exposure to traditional market risks, while being denied access (through regulated and professionally managed structures) to an asset class that has demonstrated diversification benefits and stable market behaviour. Such an asymmetry may give rise to questions regarding the coherence of the regulatory framework and, over time, could expose it to legal and interpretative challenges.

These considerations are particularly relevant in light of the proportionality principle. As noted above, fewer than 1 percent of retail investors invest directly in UCITS CAT bond funds without professional advice, meaning that the vast majority of retail exposure is already mediated through regulated intermediaries. Against this backdrop, a measure that effectively excludes retail investors from the asset class altogether appears difficult to reconcile with a risk-based and proportionate regulatory approach.

In a broader sense, the proposed restriction risks introducing additional legal and regulatory uncertainty at a time when the European Union is actively seeking to strengthen investor participation and confidence in capital markets. The question therefore arises whether such uncertainty is justified, particularly in a case where the underlying risks appear limited, well understood, and effectively managed within existing frameworks.

### **13. Implications for European Capital Markets and Competitiveness**

These restrictions on investor access also have broader implications for the European capital market. A restrictive approach to CAT bonds would not only reduce investment choice for retail investors, but also limit product innovation and risk driving capital and expertise to other jurisdictions. Countries such as the United Kingdom, Singapore, and Hong Kong are actively positioning themselves to expand their presence in the CAT bond market. A regulatory stance that discourages the development and distribution of such strategies within the EU would weaken Europe's competitiveness in a strategically important and growing segment of the financial industry.

Beyond these immediate effects, the proposed restriction would also have longer-term structural consequences for the European financial ecosystem. By limiting the role of UCITS as a gateway

for innovative and diversifying asset classes, the EU risks narrowing the range of investment solutions available to households and reducing the efficiency of capital allocation across the economy. In particular, constraining access to CAT bonds may diminish the ability of European capital markets to channel private savings into areas of real economic relevance, such as risk transfer mechanisms that support the resilience of the insurance sector and the broader economy in the face of increasing climate-related risks. At the same time, regulatory fragmentation may incentivise asset managers and capital market participants to develop and domicile such strategies outside the EU, thereby weakening Europe's position as a global hub for asset management and financial innovation. In this sense, the proposed approach risks not only limiting current market activity, but also undermining the long-term development, depth, and strategic autonomy of European capital markets.

#### **14. Inconsistency with the Savings and Investments Union**

Most importantly, the ESMA recommendation appears to be fundamentally at odds with the objectives of the European Commission's Savings and Investments Union. This initiative seeks to increase retail participation in capital markets, broaden access to investment opportunities, and improve the allocation of household savings. At the same time, the EU is actively promoting access to complex and less liquid asset classes (such as private equity or infrastructure investments) through frameworks like ELTIF. In this context, restricting access to CAT bonds creates a clear inconsistency in regulatory policy and risks undermining the credibility of the broader capital market agenda.

#### **15. A Balanced and Forward-Looking Regulatory Approach**

In light of these considerations, a more balanced and constructive regulatory approach is warranted. Rather than excluding CAT bonds from the UCITS framework, the European Commission should focus on clarifying their eligibility within the existing legal framework. Such an approach would be consistent with the principles of proportionality, evidence-based regulation, and technological neutrality that underpin the European regulatory architecture.

In practical terms, this would primarily require greater clarity regarding the classification and admissibility of CAT bonds under the UCITS Eligible Assets regime. Clear and consistent guidance – whether through legislative clarification or interpretative measures – would enhance legal certainty and ensure a harmonised application across Member States. This would address the core source of regulatory divergence without introducing unnecessary complexity or additional regulatory burden.

Where appropriate, existing regulatory tools within the UCITS framework, such as disclosure requirements, portfolio diversification rules, and risk management obligations, already provide a robust and well tested mechanism to address potential risks associated with CAT bond exposures. These tools have proven effective in practice and do not require fundamental recalibration to accommodate this asset class.

A targeted clarification of eligibility would achieve the desired regulatory objective of ensuring legal certainty and investor protection without the unintended consequences of a categorical exclusion. At the same time, it would signal that the European Union remains committed to a pragmatic and innovation-friendly regulatory approach that allows well-functioning asset classes to be integrated within established frameworks.

## **16. Conclusion**

CAT bonds represent a mature, well-understood, and economically valuable asset class that has been successfully integrated into the UCITS framework over an extended period of time. Their exclusion is neither justified by empirical evidence nor consistent with the principles of proportionality, regulatory coherence, or investor empowerment that underpin European financial regulation. On the contrary, such a measure would restrict retail investor access to a distinct and diversifying source of risk premia, despite the fact that access is already largely intermediated through regulated channels and subject to established investor protection safeguards.

Beyond its immediate impact on investors, a categorical exclusion would also weaken Europe's capital markets by limiting product innovation, reducing the diversity of available investment solutions, and potentially redirecting capital and expertise to more accommodating jurisdictions. In doing so, it would not only diminish the role of UCITS as a globally recognised and adaptable investment framework, but also risk undermining confidence in the stability and predictability of the European regulatory environment.

Moreover, the proposed approach would stand in clear tension with the objectives of the Savings and Investments Union, which seeks to broaden retail participation in capital markets and enhance the mobilisation of private savings. Restricting access to an asset class that demonstrably contributes to diversification, resilience, and efficient capital allocation would run counter to these policy goals and create inconsistencies within the broader regulatory agenda.

A categorical exclusion of CAT bonds from the UCITS framework should be considered disproportionate. A more balanced, evidence-based, and targeted regulatory approach would be better aligned with the principles of European financial regulation, as well as with the objective of protecting investors while supporting efficient and resilient capital markets.

The European Commission is therefore respectfully urged not to adopt ESMA's recommendation in its current form. Instead, it should pursue a differentiated, evidence-based, and forward-looking regulatory approach that clarifies the eligibility of CAT bonds within the existing framework, preserves appropriate investor access, and relies on established regulatory safeguards. Such an approach would better balance investor protection with market development, while reinforcing the European Union's commitment to a coherent, proportionate, and innovation-friendly regulatory framework.

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