PCS

Fast Start:

PCS Q1 2014
Catastrophe Bond Report

OVERVIEW

First-quarter catastrophe bond issuance activity has once again surpassed the $1 billion mark. With sponsors raising approximately $1.2 billion, 2014 posted the second-busiest first quarter in the history of the market, behind 2012's $1.3 billion. Issuance activity climbed 37 percent from $881 million for the same period in 2013, with the six transactions completed revealing the continuing market trend toward underlying diversity. Last year, all first-quarter catastrophe bonds were exposed only to U.S. risks. This year, however, one includes Australia, and another covers Japanese risks exclusively.

Q1 2014 CATASTROPHE BOND ISSUANCE

According to data from the Artemis.bm Deal Directory, insurers and reinsurers issued approximately $1.2 billion in catastrophe bonds in the first quarter of 2013, up 37 percent year over year. Average transaction size fell 8 percent to $202 million, demonstrating the market's continued ability to complete smaller transactions to meet specific risk and capital management objectives. The average does not include the four publicly announced private or "lite" catastrophe bonds completed in the first quarter, which together accounted for $175 million across four transactions.[1] The fact that a sponsor can complete a $25 million catastrophe bond transaction — even using the "lite" structure — shows the full extent to which the catastrophe bond sector can support risk transfer.

Q1 2014 Issuance Activity

	Q1 2014	Q1 2013
PCS trigger use ($ millions)	465	0
PCS trigger use (# of transactions)	3	0
North American issuance ($ millions)[2]	965	881
North American issuance (# of transactions)	5	4
Total issuance ($ millions)	1,200	881
Total issuance (# of transactions)	6	4

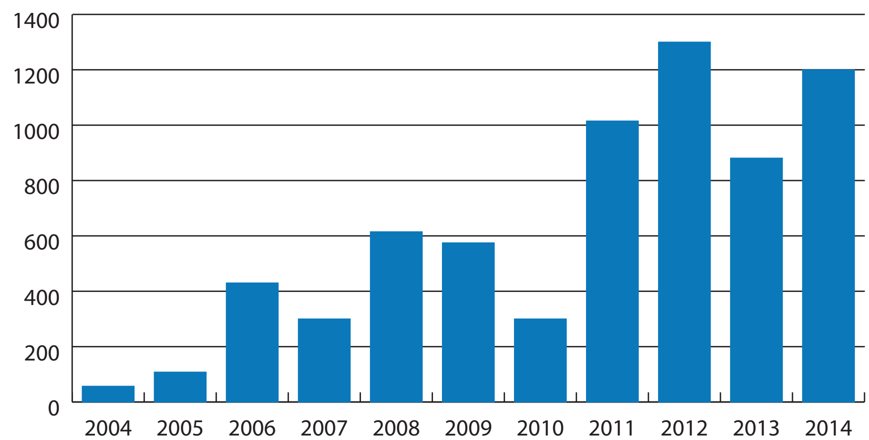
Sources: PCS, Artemis Deal Directory

1. Skyline Re is a private catastrophe bond that is differentiated from cat bond lite in this report as not having been issued through a cat bond lite platform, such as Tokio Tensai or Kane SAC.
2. This includes catastrophe bonds that covered the United States and other regions in the same transaction.

First-quarter issuance activity rose sharply from the first quarter of 2013 — which itself was among the three most active first quarters in the history of the catastrophe bond market. While having exceeded the $1 billion mark does put the first quarter of 2014 in rare company (ahead of 2011 and behind 2012), it is difficult to forecast whether the momentum will continue throughout the year and make a new record possible. In 2012, for example, full-year issuance reached $5.9 billion, making it the second-busiest year in the history of the market at the time. And in 2011, full-year issuance reached $4.2 billion. However, 2007 started with only $300 million in issuance in the first quarter — and ended the year with more than $7 billion. A year's defining quarters tend to be the second and fourth, driven by the Florida and annual reinsurance renewals, respectively.

Historical Q1 Issuance Activity

(in millions)



Sources: PCS, Guy Carpenter & Company, LLC

Eighty-three percent of first-quarter issuance activity — five of the six transactions — included U.S. risks. Sixty percent of them used PCS® data in their triggers — one as an index trigger and the other for catastrophe designation in indemnity triggers. In terms of capital raised, those using PCS data accounted for approximately half of U.S.-exposed transactions. While Queen Street IX used the PCS Catastrophe Loss Index, both East Lane Re VI and Riverfront Re opted for PCS catastrophe designation in indemnity triggers — which is among the most prominent trends in the market right now. The only two U.S.-exposed indemnity transactions that did not use PCS data were Gator Re and Merna Re V, the latter of which comes from a sponsor that has used only indemnity-triggered transactions.

UNDERLYING CATASTROPHE BOND MARKET DIVERSITY

Superficially, the first quarter of 2014 resembles the historical catastrophe bond market. Five of the six transactions completed have exposure to U.S. risk, long the sweet spot for this sector. However, there are indicators of the underlying diversity that rose to prominence in 2013, including international risks, new sponsors, and representation of the Florida market.

Riverfront Re and Gator Re both represent new catastrophe bond market entries. This continues a trend that gained considerable momentum last year, as new sponsors found opportunities to transfer risk to the capital markets. While the risks these transactions covered may not indicate the underlying diversity of the sector, the appearance of new sponsors does, because it expands the base for future issuance activity and subsequent organic market growth.

Unlike the first quarter of 2013, in which all issuance activity was exposed only to U.S. risk, two transactions this year have international exposure. Queen Street IX Re includes coverage for Australia, and Kizuna Re II provides cover for risks in Japan. Both Japan and Australia were represented in transactions last year, as well.

East Lane Re VI marks Chubb's return to the catastrophe bond market, following the issuance of East Lane Re V in the first quarter of 2012. This time, however, the sponsor opted to use PCS for catastrophe designation. Along with Riverfront Re, this means that half of the U.S.-exposed indemnity-triggered transactions completed in the first quarter of 2014 have adopted this approach. Last year, three sponsors used PCS catastrophe designation in four transactions, raising more than $1 billion. Already, sponsors using this approach have raised a third of 2013's full-year results with only two transactions completed — neither of which involved a 2013 sponsor.

THE RISE OF CAT BOND LITE

The use of cat bond lite structures could increase cedent access to — and participation in — the global catastrophe bond market. The structure, rigor, and discipline involved in issuing through a cat bond lite platform may give this form of issuance an edge over private catastrophe bonds.

According to data in the Artemis Deal Directory, 2014 began with a flurry of cat bond lite transactions, with two Dodeka transactions from Twelve Capital and one (Omamori) through the Tokio Tensai platform. Had these transactions been included in the annual total, issuance activity would have reached approximately $1.3 billion, making the first quarter of 2014 commensurate with the first quarter of 2012.

The cat bond lite structure aims to provide a route to securitization that does not involve the onerous issuance requirements of traditional catastrophe bonds — while still providing the structural discipline and transparency that have characterized catastrophe bonds since the market's inception. As a result, sponsors can use increased flexibility to complete smaller and more targeted transactions quickly while managing their cost of capital. Additionally, the cat bond lite structure enables more participants to enter the insurance-linked securities (ILS) sector. Funds with a mandate to participate only in securitized transactions, for example, can use cat bond lite instead of collateralized reinsurance or industry loss warranties (ILWs) to issue and consume risk.

The impact of cat bond lite on the overall catastrophe bond market remains to be seen. First-quarter activity suggests increased adoption going forward. However, the sponsors using cat bond lite have not fled the traditional catastrophe bond space: They are new issuers. This suggests that, for now at least, cat bond lite is not being perceived as an alternative to traditional catastrophe bond issuance by existing sponsors. Rather than cannibalize the existing market, it appears more likely that cat bond lite transactions will help expand the overall sponsor base and contribute to future market growth.

Public sources have revealed the use of PCS in cat bond lite transactions in the first quarter of 2014. Nonetheless, PCS prefers not to provide further issuance and market share analysis and commentary on these transactions given their private nature.

TREND TRACKING

The ongoing shift in underlying market trends over the past year shows how dynamic the catastrophe bond sector has become. Innovation, increased geographical reach, and increases in market participation have continued to shape the catastrophe bond market, opening more opportunities to both sponsors and investors. The five key trends in the catastrophe bond market right now indicate the increases in flexibility that have been attained, as well as the expanding foundation for future market growth.

1. Catastrophe designation in indemnity triggers: In the first quarter alone, two sponsors used PCS for catastrophe designation in indemnity-triggered catastrophe bonds for the first time. One is a new sponsor, and the other returns to the catastrophe bond sector after a two-year hiatus. More activity could come later this year, if historical trends are any indication, and more sponsors may adopt PCS for catastrophe designation, especially if they have begun to use indemnity triggers. The increased use of this approach can help more sponsors transfer risk to the capital markets, as the independence and discipline inherent in the use of a third party for catastrophe designation can be attractive to investors and make it easier to analyze capital allocation opportunities. PCS catastrophe designation can be particularly useful for such perils as wildland fire, thunderstorm, and winter storm, where no other organization is available to provide an objective third-party designation (such as NOAA for hurricanes).

2. Cat bond lite: Cat bond lite innovation in 2013 led to early adoption in 2014. By February, issuance activity had occurred on both the Kane SAC and Tokio Tensai platforms. With three transactions already completed — and the awareness that others have been completed, although without fanfare — early adopters have paved the way for broader use. Each publicly revealed cat bond lite deal has provided $25 million in cover. However, reports of a $50 million deal have surfaced, showing that slightly larger cat bond lite deals are possible.

3. Continuing regional diversity: U.S. wind remains dominant in the catastrophe bond market, but sponsors and investors continue to see other opportunities. The inclusion of several international regions in first-quarter issuance demonstrates this, continuing last year's momentum, which was characterized by catastrophe bonds covering Canada, Turkey, New Zealand, Japan, Australia, and parts of Europe. As new regions and lines of business become available to the ILS community — through projects on which PCS is currently working — sponsors and investors will be able to increase their use of capital market capacity, as appropriate, to improve risk and capital management.

4. New market entry: A third of first-quarter issuance activity this year came from first-time sponsors, following slightly more than that for the fourth-quarter of 2013. Additionally, several companies have returned to the catastrophe bond sector after long breaks — such as Allstate (Sanders Re) and Catlin (Galileo Re) — which effectively expands the market. New entrants provide a foundation for future organic market growth, which would then be accelerated throughout the market by the addition of new regions and lines of business.

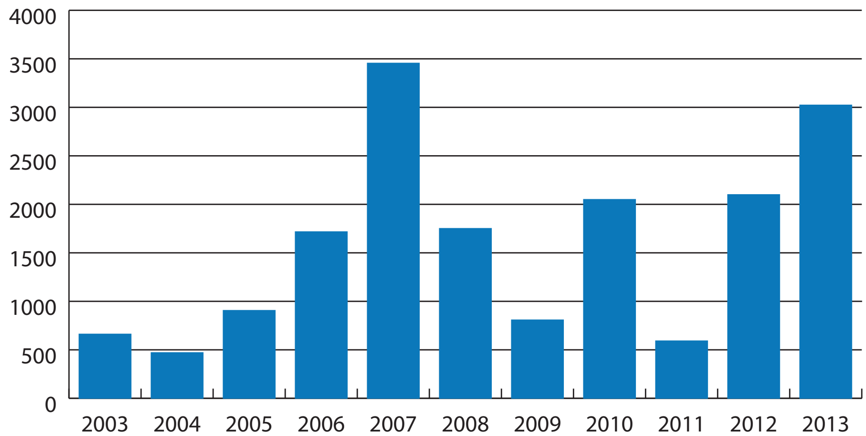
5. Amplified pressure: According to various reports at the January 1, 2014, reinsurance renewal, the quiet 2013 catastrophe year has resulted in downward pressure on the cost of catastrophe bond cover. With spreads tightening, sponsors have sought to reduce frictional costs with renewed vigor, given their magnified impact as the cost of cover falls. This trend is likely to continue in the absence of a market-changing event, such as a large catastrophe. PCS remains committed to helping the market manage frictional costs.

THE HURRICANE QUARTER

Historically, second-quarter issuance activity has been high, given the June 1 start of hurricane season. As the Florida market's interest in the catastrophe bond sector increases, the result could be more new market entrants and higher issuance volume. Other factors, including last year's quiet hurricane season, could also impact the use of the catastrophe bond market.

Historical Q2 Issuance Activity

(in millions)



Sources: PCS, Guy Carpenter & Company, LLC

Last year, total U.S. catastrophe losses reached only $12.9 billion, according to PCS. Florida was not named in any catastrophe events, a significant change for a state that had accumulated $32 billion in catastrophe losses over the previous ten years. Louisiana sustained only $593 million in catastrophe losses last year, in contrast to $33 billion over the previous ten years. If the quiet year in the Gulf of Mexico has the expected impact on the cost of catastrophe bond cover, more cedents may turn to this market.

Additionally, interest in catastrophe bonds is on the rise in the Gulf of Mexico. Last year, three Florida transactions had an impact on the catastrophe bond market: Sunshine Re, Armor Re, and Everglades Re, representing approximately $450 million in protection. The second Pelican Re transaction (for Louisiana Citizens) provided another $140 million in targeted cover for a hurricane-prone state. If that issuance momentum continues, having been bolstered by Gator Re in the first quarter of 2014, more insurers may see the catastrophe bond market as a viable alternative.

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