Diversified Surge: PCS® Q2 2014 Catastrophe Bond Report

OVERVIEW

For the second year in a row, the catastrophe bond market has posted a new first-half record. At $5.7 billion, total capital raised surged more than 40 percent year over year, providing cover to 16 cedents through 18 transactions. As a result, 2014 is already one of the top five full-issuance years in market history, even at the halfway point.

While the issuance numbers are eye-catching, the most important development is the underlying diversity in the market — a trend that continues to intensify. From indemnity-triggered European catastrophe bonds to increased Florida market activity and large index-triggered transactions, insurance-linked securities (ILS) sector stakeholders have demonstrated the risk and capital management flexibility that this form of risk transfer can provide.

H1 2014 CATASTROPHE BOND ISSUANCE

According to data from the Artemis.bm Deal Directory, insurers and reinsurers issued approximately $5.7 billion in catastrophe bonds in the first half of 2014, up more than 40 percent year over year.[1] Of the 18 transactions completed in the first half, 14 have exposure to North American risks, with one including Canada. So far, eight first-time sponsors have come to market, six of which focused on North American risks and two that came to market twice in the second quarter.

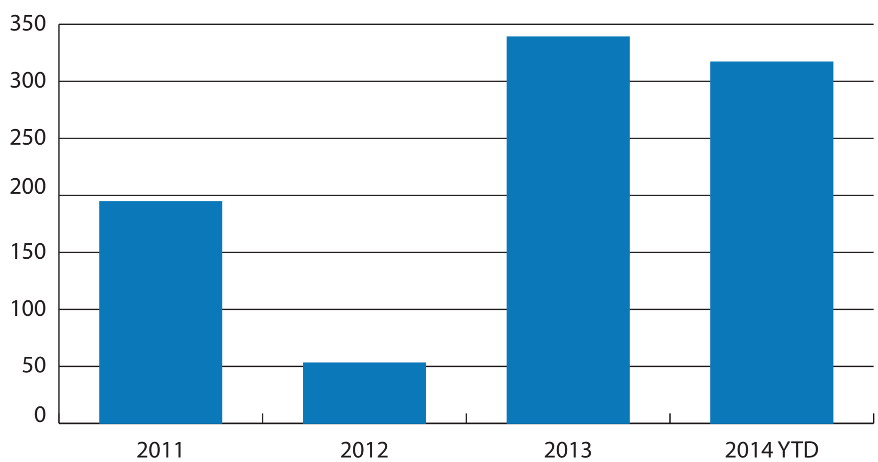
H1 2014 Issuance Activity

	H1 2014	H1 2013	Change
PCS trigger use ($ millions)	$2,000	$1,600	25%
PCS trigger use (# of transactions)	7	7	0%
North American issuance ($ millions)[2]	$4,800	$3,100	55%
North American issuance (# of transactions)	14	16	-13%
Total issuance ($ millions)	$5,700	$3,900	46%
Total issuance (# of transactions)	18	17	6%

Sources: PCS, Artemis Deal Directory

Average transaction size climbed significantly — up more than 35 percent to $317 million. The increase in average size represents a departure from last year's trend toward smaller transactions, although some very large catastrophe bonds skewed the results. Only four of the catastrophe bonds issued in the first half of 2014 exceeded the average transaction. However, at a total of $3.1 billion, they represent more than half of all first-half capital raised. Excluding those four catastrophe bonds, all announced in April, the average transaction size was only $174 million.

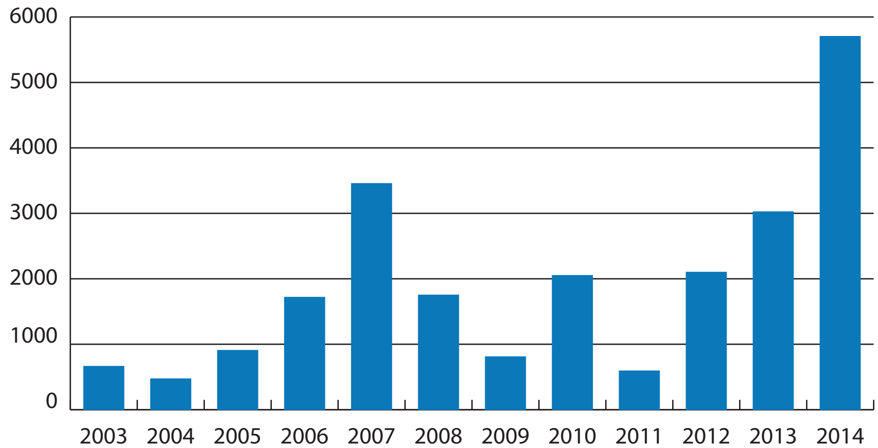
Average Catastrophe Bond Size



Sources: PCS, Artemis Deal Directory

Of the $5.7 billion raised in the first half of 2014, $4.5 billion came in the second quarter. Two of the quarter's nine North American–exposed transactions featured index triggers (the first Sanders Re and Kilimanjaro Re), together representing 31 percent of North American second-quarter issuance. Excluding transactions sponsored by publicly managed entities, which do not have an appropriate risk profile for index trigger use, index trigger use represented 69 percent of issuance exposed to North American risk.

Historical Q2 Issuance Activity



Sources: PCS, Guy Carpenter & Company, LLC

While transactions with exposure to North America dominated the quarter — 78 percent of transactions and 84 percent of capital raised — regional diversity did occur. Two catastrophe bonds covering Japanese risks were issued, following Kizuna Re in the first quarter. The two second-quarter transactions raised $400 million, bringing the region's first-half total to $645 million this year. Additionally, Generali completed its first catastrophe bond, Lion I Re, in the second quarter of 2014, which brought $263 million in cover for risks in Europe. All four non–North American catastrophe bonds used indemnity triggers. North America is the only region covered by index-triggered catastrophe bonds so far this year.

The use of PCS® data in catastrophe bonds grew 25 percent from the first half of 2013 to the first half of 2014. Following $465 million in transactions using PCS in the first quarter, sponsors completed four transactions in the second quarter using PCS data — amounting to more than $1.5 billion in new limits. Two transactions (totaling $1.2 billion) used the PCS Catastrophe Loss Index, and two used PCS for catastrophe designation in indemnity-triggered catastrophe bonds.

H1 2014 PCS Data Use

	H1 2014	H1 2013	Year-over-Year Change
PCS Catastrophe Loss Index	$1,300	$800	63%
PCS Cat Designation (Indemnity)	$700	$800	113%
Total	$2,000	$1,600	25%

Source: PCS

PCS CATASTROPHE DESIGNATION

The use of PCS data for catastrophe designation in indemnity-triggered catastrophe bonds continues to grow. Last year, two sponsors joined USAA in using that approach, bringing the total to four transactions (two in the fourth quarter) with limits of approximately $1 billion, including the $500 million Tar Heel Re catastrophe bond. This year, four sponsors used PCS for catastrophe designation in indemnity-triggered catastrophe bonds to raise $615 million in fresh capital. Two of those issuances came from first-time users of catastrophe designation in indemnity triggers. Great American Insurance Group's Riverfront Re is the company's first foray into the catastrophe bond sector. The second Sanders Re issuance of the year, by Allstate, uses catastrophe designation for Florida market risks.

With PCS catastrophe designation, only claims assigned a PCS catastrophe number count toward attachment and exhaustion points. That approach provides an independent third-party perspective and offers protection against moral hazard. Some investors may find those benefits attractive. PCS catastrophe designation can be particularly useful for perils such as thunderstorm, tornado, and wildfire, where another third-party standard (such as NOAA) is not available.

For PCS to designate an event a catastrophe, it must generate an industrywide insured loss of at least $25 million and affect a significant number of insurers and insureds. The PCS team reviews 40 to 50 events each year in the United States that have the potential to become catastrophes and designated 29 catastrophes in 2013.

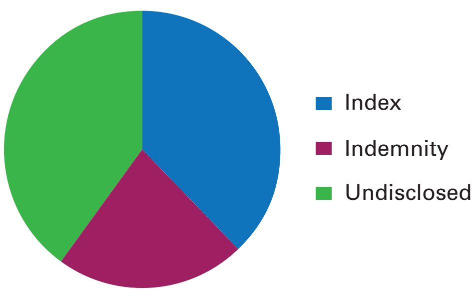
CAT BOND LITE

Three cat bond lite transactions came to market in the second quarter, representing $70 million in new limits. Dodeka IV is the third cat bond lite of the year from Twelve Capital and uses the Kane SAC program. It provides $28 million in protection and uses the PCS Catastrophe Loss Index. The other two transactions, from the Market Re facility, provide $42 million in indemnity-triggered cover ($10 million for the first, $32 million for the second). Market Re uses a new platform from JLT Capital Markets and Horseshoe Group.

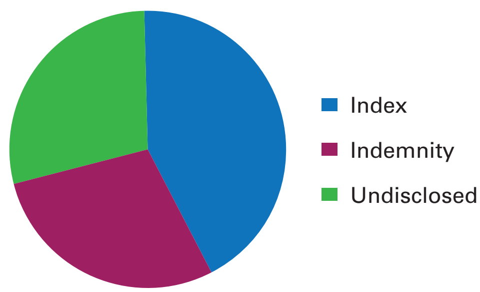
Of the six publicly announced cat bond lite transactions completed in the first half of 2014, three are revealed to have used the PCS Catastrophe Loss Index, raising $78 million in capital. Additional issuance activity from the first quarter includes Omamori, completed on the Tokio Tensai platform, and an undisclosed cat bond lite on Kane SAC that raised $50 million; both have undisclosed trigger types. Total first-half cat bond lite activity — including the unannounced Kane SAC transaction — now stands at $195 million across three platforms.

Cat Bond Lite Issuance by Trigger Type

Capital Raised



Number of Transactions



Sources: PCS, Artemis.bm

Based on publicly available information, sponsors used the PCS Catastrophe Loss Index in 43 percent of cat bond lite transactions, as measured by number of transactions (including the unannounced Kane SAC transaction). As measured by capital raised, sponsors used the PCS Catastrophe Loss Index in 40 percent of cat bond lite issuance activity.

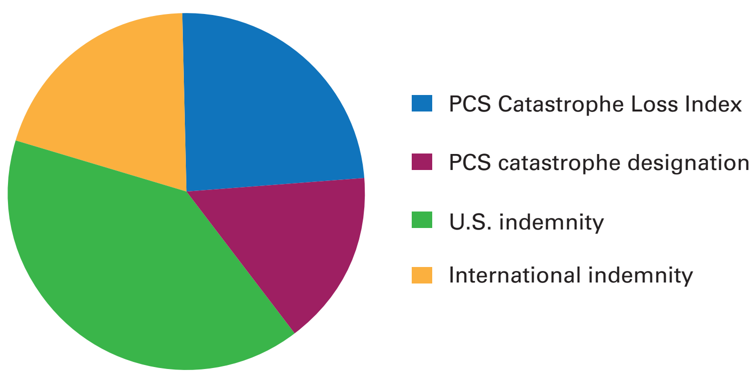
Cat bond lite transactions provide a new alternative to sponsors seeking targeted risk transfer and a way to manage frictional costs, offering yet another example of innovation in the sector. Use of the PCS Catastrophe Loss Index in cat bond lite transactions shows the effectiveness of index triggers in making transactions easier to understand, which can be important for smaller issuances.

CONTINUED CATASTROPHE BOND MARKET DIVERSITY

Despite the resurgence of North American–exposed issuance activity, the catastrophe bond market has continued to show the signs of underlying diversity, which is crucial to future market expansion. Four catastrophe bonds, with total limits of $808 million, cover two regions outside North America. Additional market support came from new sponsors, last year's first-time sponsors returning to the capital markets again this year, and continued engagement in the Florida sector.

The second quarter brought six first-time sponsors, representing $1.6 billion in fresh capital.[3] The largest of them, Kilimanjaro Re, uses the PCS Catastrophe Loss Index and provides Everest Re with $450 million in cover. International first-time sponsors used two transactions to raise $363 million in capital. Both used indemnity triggers, as did the first-quarter non–U.S. transaction. Through the first half of the year, first-time sponsors raised $1.9 billion across eight transactions — with $750 million raised in three transactions using PCS data.

First-Time Sponsor Trigger Use



Source: PCS

After watching the market demonstrate its ability to complete smaller catastrophe bonds last year, big deals appear to have made a comeback. Everglades Re, the latest from Citizens Property Insurance Corporation (CPIC), became the largest catastrophe bond ever completed ($1.5 billion). At half its size, the first of the two 2014 Sanders Re transactions is still among the largest issuances in market history. At the other end of the spectrum is Market Re, a $10 million cat bond lite transaction. It's the fifth cat bond lite of the year and the first completed using a new platform developed by JLT Capital Markets and Horseshoe Group. On June 1, 2014, Dodeka IV came to market and, like its predecessors, used the PCS Catastrophe Loss Index.

The Florida market has increased its use of capital markets capacity, realizing an expectation many shared a year ago. At this time last year, Sunshine Re and Armor Re brought $203 million in protection to Florida insurers (not including Everglades Re), and the market generally saw that as a first step toward greater Florida participation. This year, a second Armor Re transaction raised $200 million in cover. Additionally, Gator Re, two Citrus Re transactions, and a second Sanders Re catastrophe bond (using an indemnity trigger with PCS for catastrophe designation) came to market, providing a total of $750 million in protection for Florida market risks.

ILS TREND TRACKING

The rapid growth of the catastrophe bond market can be attributed to many factors, some of which extend back for years. However, PCS sees five trends as particularly important this year, highlighting the expanding platform for market growth.

1. Catastrophe designation in indemnity triggers: Seven of the 18 transactions announced this year use data from PCS, either as an index trigger or for catastrophe designation. Measured by capital raised, those bonds account for 61 percent of first-half issuance exposed to North American risk (excluding publicly managed entities). Four of the eight catastrophe bonds that use PCS have indemnity triggers with catastrophe designation, providing an important independent service that makes that sort of trigger more attractive in some situations. The four catastrophe bonds using PCS for that purpose amount to $700 million.

2. Activity at the extremes: Three more cat bond lite transactions this year were completed in the second quarter, following three in January (two of which were revealed to have used the PCS Catastrophe Loss Index). Further, sponsors completed the transactions using all three cat bond lite platforms. At the other end of the spectrum, the three largest catastrophe bonds of the year (Everglades Re, the first Sanders Re, and Kilimanjaro Re) provide an aggregate $2.7 billion in cover. As sponsors push the outer boundaries of the market, the flexibility that the catastrophe bond market affords becomes increasingly clear.

3. Florida market: Sunshine Re and Armor Re, issued in May 2013, signaled to the market an increased likelihood that catastrophe bonds would begin to play a bigger role in June 1 renewals. Five Florida-focused catastrophe bonds came to market in the first half of 2014, including two from first-time sponsor Heritage Property and Casualty Insurance Company. American Coastal Insurance Company, a first-time sponsor in the second quarter of 2013, has also returned to the capital markets with another Armor Re this year. And Sanders Re issued the first Florida market catastrophe bond that uses PCS for catastrophe designation in an indemnity trigger.

4. Cat bond "heavy": The four largest catastrophe bonds of the year are well above the first-half average transaction size of $317 million, and two more fell just short at $300 million. Based on this year's activity, it's clear that sponsors can attain size in a variety of conditions. Kilimanjaro Re comes from a first-time sponsor, Everglades Re comes from a publicly managed entity, and Sanders Re uses an index trigger. Nakama Re ($300 million) provides cover in Japan. While sponsors have tested the market's ability to handle smaller catastrophe bonds over the past few years, it's clear they remain committed to testing the other end of the spectrum as well.

5. First-time sponsors: Eight of this year's 16 sponsors are first-time participants in the catastrophe bond market, together raising $1.9 billion at an average transaction size of $243 million. Of the six catastrophe bonds completed this quarter by first-time sponsors, index-triggered Kilimanjaro Re was the largest at $450 million, followed closely by Alamo Re at $400 million. Riverfront Re and the second Sanders Re issuance are both catastrophe bonds from first-time sponsors that use indemnity triggers with PCS for catastrophe designation.

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[1] Total excludes private catastrophe bonds, cat bond lite, and transactions not involving property, such as extreme mortality and medical benefit bonds.

[2] Catastrophe bonds that included the United States and other regions.

[3] This includes the first Citrus Re transaction (but not the second) and the second Sanders Re transaction. Issued to cover a Florida-focused subsidiary of Allstate, the second Sanders Re transaction is being considered a first-time sponsor issuance, even though two (index-triggered) catastrophe bonds preceded it.

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