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# Does Size Matter? PCS® Q2 2016 Catastrophe Bond Report

## OVERVIEW

In some ways, 2016 has felt like a parallel catastrophe bond universe. Since we first issued the PCS® Catastrophe Bond Report four years ago, most have involved a story around everything getting bigger. And along the way, we've been careful to remind readers that bigger doesn't always mean better. The catastrophe bond market—with about 20 years of history—is still really in its infancy. For a while, continual annual growth was a helpful indicator of the market's ability to grow.

Today, though, that's really a settled issue.

While there are still corners of the market where there's a bit of a learning curve, the potential benefits of catastrophe bonds have been well communicated across the industry. And the barometer of market health has shifted to the completion of new and innovative structures, rather than just producing more of the same. Of course, such developments show how the insurance and reinsurance industry continues to improve how it manages risk and capital through the use of insurance-linked securities (ILS).

Last year, of course, we saw an abundance of innovation. The cat bond lite market demonstrated explosive growth, with nearly $400 million in fresh capital coming into the market. Panda Re, the first catastrophe bond covering China, was welcomed by the ILS community. And risk from Turkey came back into the market.

But 2016? Well, it's looked a lot different. Cat bond lite issuance is off nearly 25 percent, with none of it coming in the first quarter—a marked change from the year before. Only two catastrophe bond transactions came from first-time sponsors, although Espada Re represented a new approach for a frequent participant in the catastrophe bond market. The concentration of old pros demonstrates that the case has clearly been made for including catastrophe bonds in a strategic approach to capital management. But that's still a far cry from broad adoption, suggesting plenty of room for future growth.

## H1 2016 CATASTROPHE BOND ISSUANCE

According to data from the Artemis.bm Deal Directory, insurers and reinsurers' catastrophe bond sponsorship approached $3 billion[1] in the first half of 2016, marking the second annual first-half issuance decline in a row. By capital raised, new issuance activity fell 26 percent year over year, with the number of transactions completed off 12.5 percent. Average transaction size fell 21.5 percent to just above $200 million.

**H1 2016 Issuance Activity**

| | H1 2016 | H1 2015 |
|---|---|---|
| PCS trigger use ($ billions) | $1.7 | $1.3 |
| PCS trigger use (# of transactions) | 8 | 6 |
| North American issuance ($ billions)[2] | $2.4 | $3.8 |
| North American issuance (# of transactions) | 12 | 12 |
| Total issuance ($ billions) | $2.8 | $4.1 |
| Total issuance (# of transactions) | 14 | 16 |

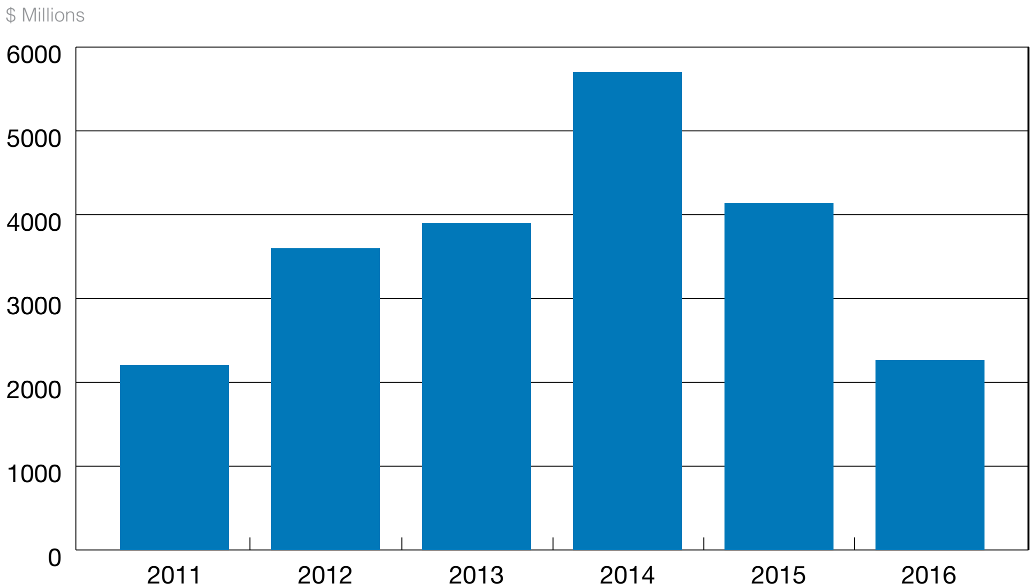
Sources: PCS, Artemis Deal Directory

The heavy use of indemnity triggers continued into the second quarter, with 10 of the 14 transactions completed this year using that trigger type. However, two second-quarter transactions did feature PCS Catastrophe Loss Index triggers, and two more used PCS for independent catastrophe designation in indemnity-triggered catastrophe bonds. In the first half of 2016, use of PCS increased 27 percent to $1.7 billion, representing nearly 70 percent of all North American issuance activity.

[1] This does not include cat bond lite transactions, private catastrophe bonds, or transactions focused on lines other than property catastrophe (such as medical benefits and workers compensation).

[2] This includes catastrophe bonds that included the United States and other regions.

**Historical H1 Issuance Activity**

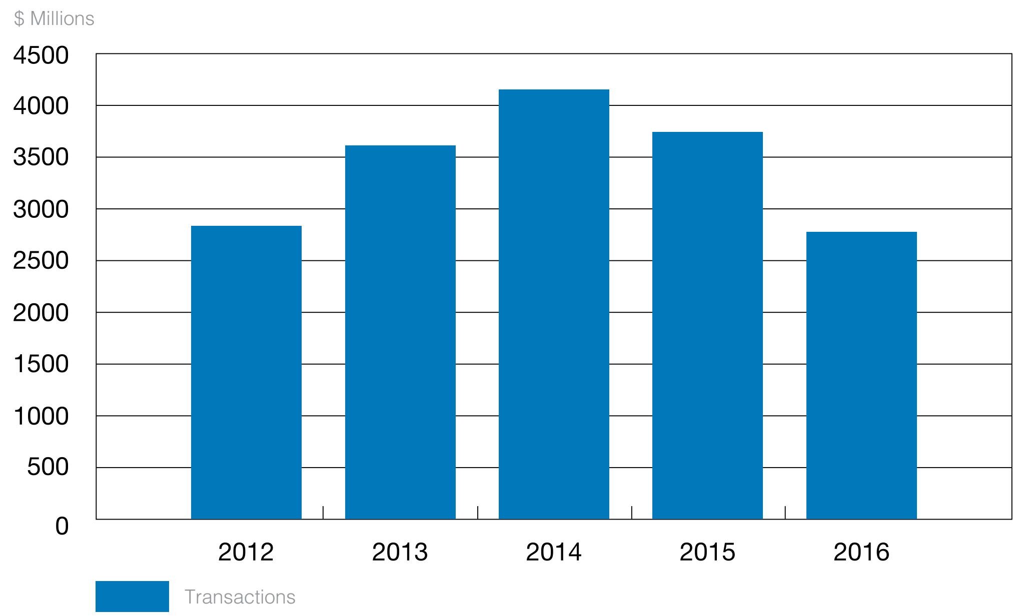



Sources: PCS, Artemis Deal Directory

At this time last year, we observed that the first-half year-over-year decline may have provided a sense that the ILS market was changing—and that a closer look at issuance activity was necessary to truly appreciate the transition that appeared to be in the works. The nature of the shift may be a work in progress, but the notion of a shift remains evident. Last year, we noted that—year to date—publicly managed entities accounted for 53 percent of the capital raised in the quarter. The publicly managed sector didn't return to the catastrophe bond space this year, but several other factors appear to be at work.

The absence of a large Everglades Re transaction contributed significantly to the decline in issuance activity from 2014 through 2016. The drop from 2014 to 2015 was somewhat expected, given the sponsor's usual issuance cycle, with $1.5 billion in 2014 and $300 million in 2015—following $750 million in 2012 and $250 million in 2013. If a transaction comparable to 2014's had been completed this year, the year-to-date issuance total would have been $4.3 billion, a modest year-over-year increase from the first half of 2015.

**Capital Raised by Year (Net of Everglades Re)**




Sources: PCS, Artemis Deal Directory

Everglades Re has led to some lumpiness in industrywide issuance totals over the past few years, but it's certainly not the only series of transactions to have had the potential to do so. Merna Re in 2007, Sanders Re in 2014, and the Kilimanjaro Re issuances of 2014 and 2015 were also quite large and had the potential to affect market perception year over year. That's why it's important to resist the temptation to use the headline number as an indicator of catastrophe bond market health.

Competitive pricing for traditional reinsurance and the growth of collateralized reinsurance, among other factors, may contribute to headwinds for catastrophe bond market growth. But more broadly, they reinforce the notion that cedents are gaining better access to the tools needed to manage risk and capital more effectively as a result of continued industry innovation.

## CAT BOND LITE (FINALLY) COMES BACK

After an active year for cat bond lite activity, the market slowed in the first half of 2016, largely a result of market pricing and the abundance of capacity available. After a silent first quarter, six transactions were completed in the second quarter, representing approximately $300 million in fresh capital. Four transactions used indemnity triggers, with one opting for the PCS Catastrophe Loss Index and the remaining transaction's trigger undisclosed. In the first half of 2015, 12 transactions resulted in nearly $400 million in new limits.

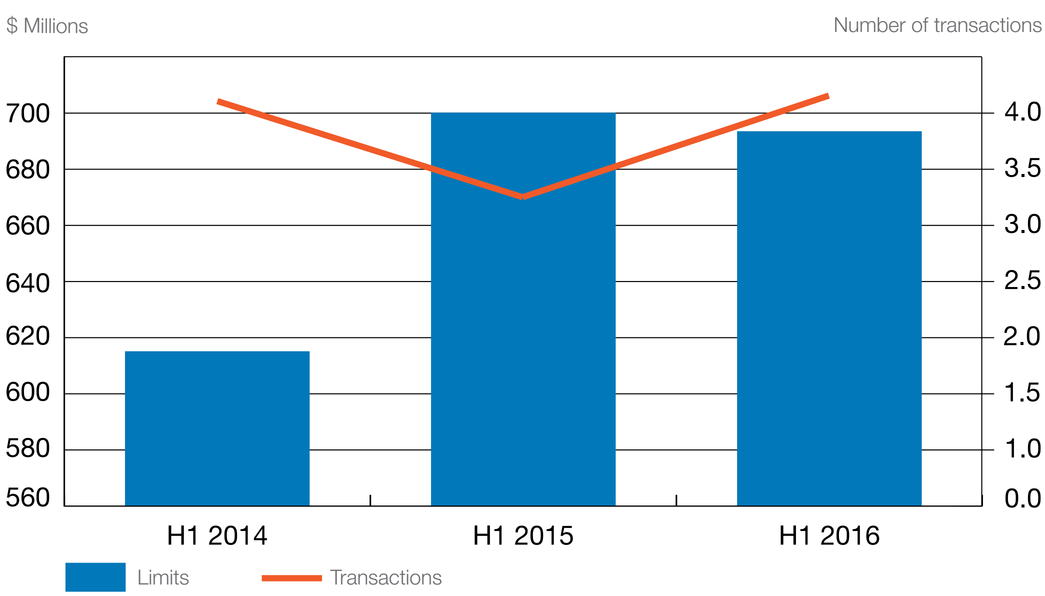
Interestingly, the average transaction size climbed significantly year over year—from $33 million to $50 million. Two transactions exceeded $75 million, showing a continued upward creep into what historically has been the domain of 144A transactions. In fact, both were larger than First Coast Re, a debut transaction with limits of $75 million.

The cat bond lite structure aims to provide a route to securitization that doesn't 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 have greater 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 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.

## CATASTROPHE DESIGNATION IN INDEMNITY-TRIGGERED TRANSACTIONS

Four catastrophe bonds from three sponsors have taken advantage of the increased discipline and clarity that result from the use of PCS data for independent catastrophe definition in indemnity triggers. One came from a first-time catastrophe bond sponsor (First Coast Re) and another from an experienced sponsor using this approach to indemnity triggers for the first time (Caelus Re, a first-quarter transaction). The number of catastrophe bonds using PCS for independent catastrophe event designation has returned to the first-half high-water mark of four (in 2014), with capital raised a mere $25 million below 2015's $700 million. The historical peak was reached in 2013, with Tar Heel Re responsible for half the $1 billion raised with this type of trigger.

**H1 2016 PCS Catastrophe Designation Use**




Source: PCS

For PCS to designate an event a catastrophe in North America, it must generate an industry insured loss of at least $25 million and affect a significant number of insurers and insureds (the threshold for Turkey is $10 million). The PCS team generally reviews 40 to 50 events in North America every year that have the potential to become catastrophes. In the first half of 2016, PCS has designated 27 catastrophe events in the United States and Canada, including the Fort McMurray wildfire event, which has a preliminary estimate of $4.6 billion. Through the end of the second quarter, year-to-date catastrophe losses for the United States and Canada have reached $15 billion, although reinsurance activity remains on 11 events.

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