Nothing Happened: PCS® Q3 2014 Catastrophe Bond Report

OVERVIEW

The third quarter was quiet, even by historical standards. No property/catastrophe bond issuance activity occurred, although the one workers compensation transaction on the market renewed. As a result, 2014 had the quietest third quarter in the past ten years. That's a profound change from last year, when sponsors raised $1.5 billion during this period — most of it from a flurry of July activity that included three first-time sponsors raising more than $400 million.

The third quarter of 2013 was an anomaly, of course, topping the previous issuance record ($1.2 billion in 2007) by more than 20 percent. Average third-quarter catastrophe bond issuance for the past ten years is only $680 million, with the 2007 and 2013 highs offset by a period of quiet third quarters from 2008 through 2011. The market has not seen a silent third quarter in at least ten years.

Despite the lack of third-quarter issuance activity, 2014 could still become a record-setting year. The fourth quarter tends to be busy, with sponsors using catastrophe bonds as part of a broader risk and capital management plan ahead of the January 1 renewals. A repeat of fourth-quarter 2013 issuance levels would put full-year 2014 issuance far ahead of last year's.

9M 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 nine months of 2014, up approximately 6 percent year over year.[1] No activity occurred in the third quarter, a significant change from a year earlier, when sponsors raised close to $1 billion in July. From the third quarter of 2012 to the third quarter of 2013, new capital raised nearly tripled.

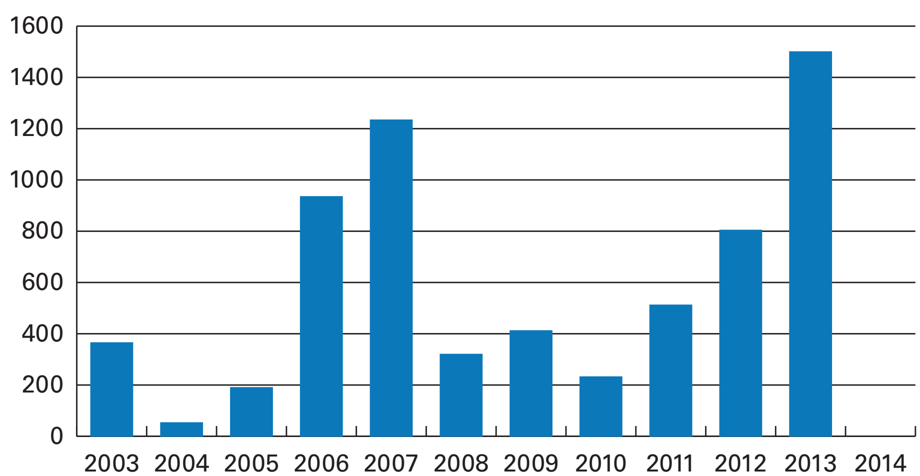
9M 2014 Issuance Activity

	9M 2014	9M 2013
PCS trigger use ($ millions)	$2,000	$2,100
PCS trigger use (# of transactions)	7	10
North American issuance ($ millions)[2]	$4,800	$4,300
North American issuance (# of transactions)	14	22
Total issuance ($ millions)	$5,700	$5,400
Total issuance (# of transactions)	18	25

Sources: PCS, Artemis Deal Directory

Despite the significant change in third-quarter activity year over year, year-to-date issuance activity is still up from $5.4 billion in the first nine months of 2013. The issuance of catastrophe bonds with at least some North American exposure is also up from the first nine months of 2013, growing from $4.3 billion last year to $4.8 billion this year. As a result, catastrophe bond issuance activity with North American exposure is up nearly 12 percent year over year — twice the growth rate of the broader market — reflecting the continued focus on the market's traditional sweet spot.

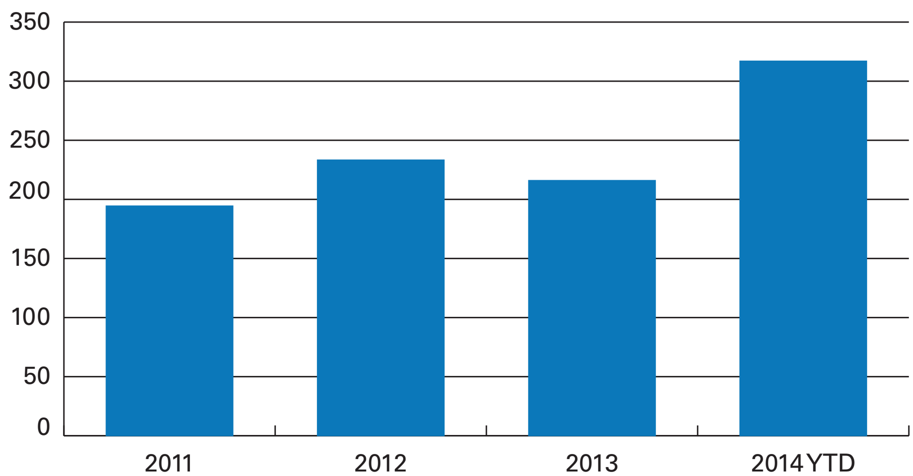
Historical Q3 Issuance Activity



Sources: PCS, Artemis Deal Directory

The change in the number of completed catastrophe bonds, however, is much different, having fallen 28 percent — from 25 to 18 — from the first nine months of 2013 to the same period in 2014. The number of catastrophe bonds with exposure to North American risk fell from 22 to 14 ~~— a~~ decline of 36 percent.

Average Catastrophe Bond Size



Sources: PCS, Artemis Deal Directory

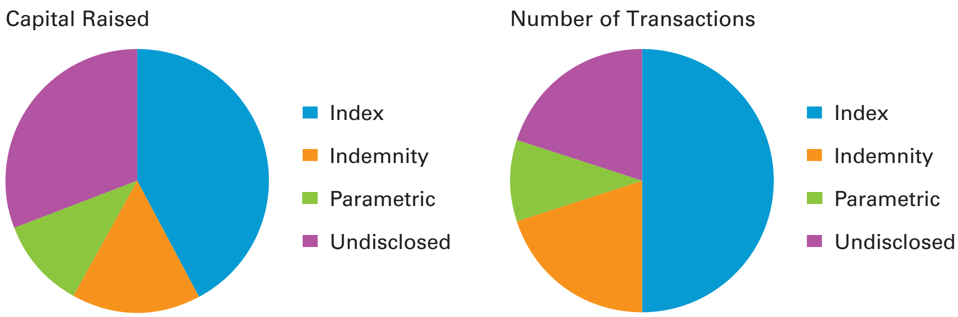
While sponsors have completed fewer transactions, the deals are larger, as demonstrated by the increase in raised capital and steep declines in the number completed. For the first nine months of 2013, the average catastrophe bond size was $216 million. For the same period this year, it's $317 million — an increase of nearly 50 percent. The profound increase in transaction size results primarily from three large transactions completed in the second quarter: Everglades Re, Sanders Re, and Kilimanjaro Re. An active fourth quarter could bring average transaction size down for the year, depending on the nature of sponsor activity.

CAT BOND LITE

The three cat bond lite transactions completed in the third quarter of 2014 brought the year's total up to ten, with $242 million in new capital raised through those innovative platforms. Of the three, the largest used a parametric trigger— the first of the year to do so — with another opting for index and the third undisclosed. Third-quarter cat bond lite issuance reached $47 million and accounts for 19 percent of the year-to-date total.

Dodeka III, the fourth PCS-triggered cat bond lite transaction completed, raised $10 million, making it the smallest in the series. Additionally, Tokio Millenium Re revealed use of the PCS Catastrophe Loss Index when it issued Omamori in January 2014. That brings the number of cat bond lite transactions with index triggers up to five, accounting for 50 percent of the transactions completed this year. When measured by capital raised, index triggers account for 42 percent of outstanding cat bond lite transactions.

Cat Bond Lite Issuance by Trigger Type



Sources: PCS, Artemis.bm

Cat bond lite transactions provide a new alternative for 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.

A NEW RECORD?

Already, 2014 is among the most active issuance years in history, closely following 2012 but still well behind 2007 and 2013. However, fourth-quarter market activity of only $1.5 billion could put 2014 at last year's level. Last year, sponsors raised $1.9 billion in the fourth quarter through six transactions (half of them index-triggered). Two of them — Galileo Re and Queen City Re — came from first-time sponsors. Both used PCS® data, with Galileo Re using an index trigger and Queen City Re using PCS for catastrophe designation in an indemnity trigger.

A repeat of 2013's fourth-quarter issuance volume would result in the most active catastrophe bond year in market history, at $7.7 billion. However, several factors could influence fourth-quarter issuance activity.

The abundance of available capital in the reinsurance market has left a wide range of strategic and tactical options for risk transfer available. That factor could cause cedents to choose traditional reinsurance or other forms of ILS, such as industry loss warranties (ILWs) or collateralized reinsurance, instead of catastrophe bonds. Additionally, some sponsors have not integrated annual catastrophe bond issuance activity into their risk transfer programs, and transactions with longer tenors may obviate the need for annual issuance. Finally, there's the question of how many new sponsors will enter the market in the fourth quarter, which is difficult to forecast. While it seems that ample interest exists, some prospective sponsors may either decide not to enter or push their decisions to the first quarter of 2015.

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. Cat bond lite proliferation: With ten transactions revealed publicly, 2014 has been active, following limited use of the cat bond lite structure in 2013. And three platforms now exist to facilitate issuance. But the cat bond lite sector is still in its early days, and activity in the fourth quarter (and into 2015) will help show whether the structure will be seen as a tactical solution or as having broader applicability.

2. Cat bond "heavy": Through the first half of 2014, large catastrophe bonds took center stage. The average issuance this year reached $317 million, up 50 percent from the first nine months of 2013. Three large transactions accounted for more than $2 billion — an interesting development given the cat bond lite activity occurring at the other end of the spectrum. A continuation of this trend in the fourth quarter could put a full-year issuance record within reach.

3. Innovation trajectory: The market has absorbed much of the innovation that has occurred over the past few years, demonstrating the usefulness of new ideas. For example, cat bond lite structures gained momentum, showing that efforts to streamline the completion of smaller transactions have addressed a particular need. The return of Sanders Re with a $750 million transaction using the PCS Catastrophe Loss Index only for personal and auto risk transfer (excluding estimates for commercial losses) demonstrates the utility of that approach, and the continued growth of international issuance indicates the opportunities the ILS community sees in new markets. Continued innovation will be crucial to the continued rapid growth of the catastrophe bond market.

4. Strategic flexibility: The innovation trajectory, along with the abundance of capital available in the market, has led to an many of risk-transfer alternatives. Sponsors can use that flexibility to develop risk and capital management programs that address their specific needs more directly. Additionally, the catastrophe bond market has evolved through the sector's investment in innovation to support more regions and trigger types. The use of PCS for catastrophe designation in indemnity triggers, for example, continues to grow. In 2013, three sponsors used that approach in four catastrophe bonds. This year, four sponsors have done so. And half of last year's use of PCS for catastrophe designation occurred in the fourth quarter, suggesting that more indemnity-triggered catastrophe bonds using PCS for catastrophe designation could come to market this year.

5. New heights: Despite a silent third quarter, 2014 remains poised to set a record for total capital raised through catastrophe bonds. In fact, all it would take is a repeat of last year's fourth-quarter issuance activity of $1.9 billion. However, the catastrophe bond market has shown us this year that history doesn't always repeat itself annually. The likelihood of a new record this year will depend in large part on the entry of new sponsors into the market; and favorable rates and terms and conditions in traditional reinsurance could divert those sponsors.

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[1] Total excludes private catastrophe bonds, cat bond lite activity, and transactions not involving property, such as extreme mortality and medical benefit bonds. Specifically, the total excludes Hoplon II, which provides lottery winnings protection.

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

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