

# Dog Days of Summer: PCS<sup>®</sup> Q3 2015 Catastrophe Bond Report

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## COMMENTARY

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The third quarter has been quiet for the past couple of years. Following strong issuance activity in the third quarters of 2012 and 2013, issuance of property catastrophe bonds fell to zero last year. This year, we saw an interesting mix of activity, though light. Including the cat bond lite space, nearly \$700 million in issuance occurred. Outside the “lite” market, sponsors completed three relatively small transactions for \$600 million in new limit, bringing the year-to-date total to \$4.7 billion.

With deals covering Turkey and China last quarter, it’s easy to see how the insurance-linked securities (ILS) market is adapting to the broadening needs of cedents and capital providers around the world. And in the cat bond lite space, nearly \$100 million in third-quarter issuance brings the annual total to almost \$700 million in publicly revealed activity — more than twice the full-year 2014 result.

Clearly, the ILS market continues to evolve. A wider range of risk-transfer instruments with high rates of adoption demonstrates that innovation is addressing real needs in the market. However, the need to expand coverage to new regions and lines of business remains. ILS market capital keeps growing, increasing the need to bring more — and new — risk to the market. Without this, innovation is forced to focus on efficiency in tight markets — a role with only decreasing potential returns.

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## 9M 2015 CATASTROPHE BOND ISSUANCE

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According to data from the Artemis.bm Deal Directory, insurers and reinsurers issued about \$4.5 billion<sup>1</sup> in catastrophe bonds in the first nine months of 2015, down 20 percent from the same period last year. The slight improvement from the first half's year-over-year decline of 28 percent comes from the fact that three small transactions were closed in July 2015, while none were completed in the third quarter last year.

### 9M 2015 Issuance Activity

	9M 2015	9M 2014
PCS trigger use (\$ millions)	1,300	2,000
PCS trigger use (# of transactions)	6	7
North American issuance (\$ millions) <sup>2</sup>	4,100	4,800
North American issuance (# of transactions)	16	14
Total issuance (\$ millions)	4,700	5,700
Total issuance (# of transactions)	20	18

Sources: PCS, Artemis Deal Directory

Despite the decline in capital raised, issuance frequency is up slightly from the first nine months of 2014. Sponsors completed 20 transactions in the first nine months of 2015, up 11 percent year over year, with the number of deals exposed to North American risks up from 14 to 16. A significant contributor to the sharp decline in capital raised year over year is last year's \$1.5 billion Everglades Re transaction. Since the "big" Everglades Re transaction appears to come every other year, off years can look disproportionately small for original issuance activity. Because of that one large catastrophe bond last year, average transaction size fell from \$317 million for the first nine months of 2014 to \$237 million for the same period this year.

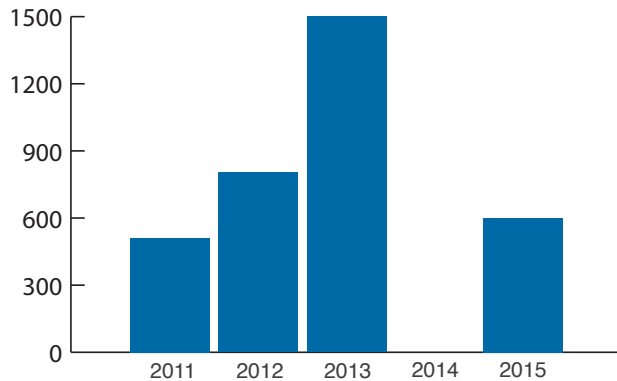
Only four catastrophe bonds came to market in the third quarter. Two were from experienced sponsors: Bosphorous Re and Ursa Re (both from publicly managed entities). Ursa Re and Panda Re (from a first-time sponsor covering risks in China) used indemnity triggers. Bosphorous Re has returned with a parametric trigger, although providing only \$100 million in cover. The previous iteration of this transaction had limits of \$400 million.

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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 Q3 Issuance Activity



Sources: PCS, Artemis Deal Directory

This is the second quarter in a row in which no index triggers were used, following a very strong first quarter for them. Of course, the nature of third-quarter issuance activity was such that the industry loss index approach wouldn't make sense. Ursa Re and PennUnion Re come from publicly managed entities with a risk profile for which industry loss isn't appropriate, and Panda Re covers a region for which a loss aggregation solution isn't available. Bosphorous Re's parametric index is consistent with the previous iteration of this bond, although [PCS Turkey](#) has potential for future use. Index trigger use remains robust in the cat bond lite market (more on that later).

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### CAT BOND LITE REACHES NEW HEIGHTS

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While the traditional catastrophe bond market was fairly quiet in the third quarter, the cat bond lite market continued to push forward. Four transactions led to approximately \$94 million in new limits. The triggers for three were undisclosed, with the fourth, Dodeka VII, using the PCS Catastrophe Loss Index.

The flurry of July activity has brought the year-to-date publicly revealed total to \$490 million across 16 transactions. That's twice the full-year 2014 total.<sup>3</sup> In all of 2014, ten publicly revealed cat bond lite transactions resulted in \$242 million in risk transfer. Clearly, this market continues to gain momentum rapidly.

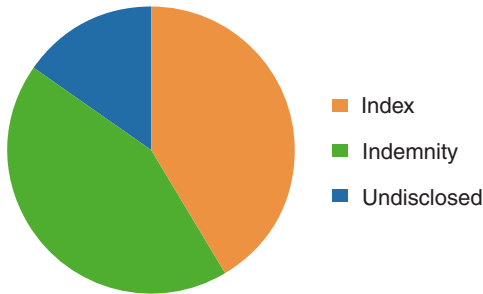
Index remains the trigger of choice for this corner of the market. Eight transactions and \$203 million use the PCS Catastrophe Loss Index. Indemnity-triggered lites were fewer in number but larger in size, with five transactions accounting for \$212 million in issuance. Nobody has used a parametric trigger so far this year, and the three July lites with undisclosed triggers account for \$75 million in issuance.

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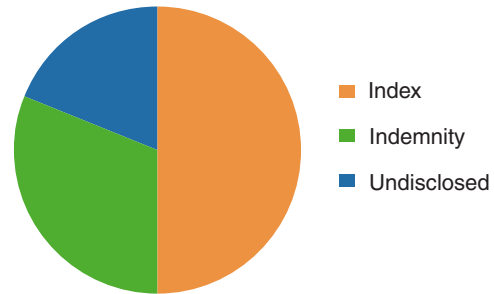
3. Compass Re is not included as a cat bond lite transaction because of the legacy Compass Re special purpose insurer.

## 9M 2015 Catastrophe Bond Lite Issuance by Trigger Type

Capital Raised



Number of Transactions



Source: PCS, Artemis Deal Directory

The continued growth of cat bond lite adoption indicates that the market has seen the value of securitization for private transactions in conjunction with a streamlined issuance process. And 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.

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 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 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.

Interest is growing in the cat bond lite structure across the market, with the greatest opportunities for traditional insurers and reinsurers seeking to securitize ILWs and other risk-transfer instruments. Inquiries to PCS about cat bond lite have accelerated this year, particularly from untapped areas of the market.

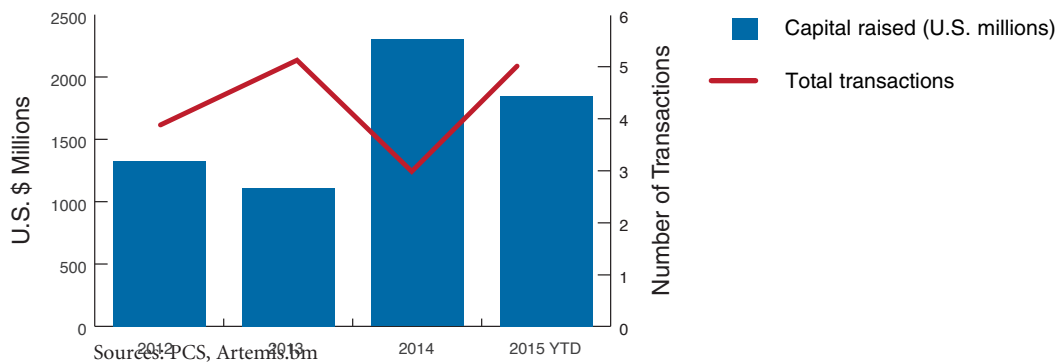
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## PUBLICLY MANAGED ENTITIES

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The use of the catastrophe bond market by publicly managed entities has gained even more momentum. Year to date, U.S. publicly managed entities have raised \$1.9 billion through the catastrophe bond market, with Alamo Re the year's largest at \$700 million. The number of transactions completed doubled from last year's total of three (one of which came in the fourth quarter). Capital raised fell 20 percent because of last year's \$1.5 billion Everglades Re transaction. Excluding Everglades Re for both 2014 and 2015, capital raised by U.S. publicly managed entities for this period nearly doubled from \$800 million to almost \$1.6 billion.

## Publicly Managed Entity Catastrophe Bond Issuance Activity



All of this year’s six U.S. publicly managed entity sponsors have come to the ILS market before, reinforcing the trend involving veteran sponsor activity. Last year, the only catastrophe bond from a first-time sponsor was Alamo Re, indicating that this segment has identified strategic advantages for this form of risk transfer. This year, it was PennUnion Re.

For at least the past four years, nearly all sponsors in this segment have used indemnity triggers, ostensibly due to the risk profiles they have based on their specific missions (the exceptions being MetroCat Re and PennUnion Re). Interestingly, Tar Heel Re, issued in 2013, used PCS for catastrophe designation in conjunction with an indemnity trigger.

For PCS to designate an event a catastrophe, it must generate an industry insured loss of at least \$25 million and affect a significant number of insurers and insureds. The PCS team reviews 40 to 50 events in North America every year that have the potential to become catastrophes. Last year, the team designated 37 catastrophes. So far in 2015, the PCS team has designated 31 North American catastrophe events, all winter storms in the United States.

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## POST-MONTE CARLO “TO DO” LIST

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With the *Rendez-Vous de Septembre* behind us, the January 1, 2016, reinsurance renewal season has begun. The topics covered at the countless 30-minute meetings last month varied greatly, reflecting both industry trends and the specific objectives of cedents, reinsurers, and third-party capital providers. From our experiences in the annual ritual, we’ve identified five key themes of strategic importance for the renewal season. As a result, here’s how we see the industry’s “to do” list shaping up for the next three months.

**1. Keep it “lite”:** The rapid growth of cat bond lite is poised to continue. In addition to the record-breaking activity we’ve seen this year, there’s plenty of interest from potential new entrants, and the involvement of traditional reinsurers in the cat bond lite market this year suggests that 2016 could be bigger than 2015. So far, the use of cat bond lite has been complementary to the broader catastrophe bond market, a trend that’s likely to continue. The two types of securitized risk transfer address specific cedent needs (as do other forms of risk transfer, such as ILWs), demonstrating that ongoing innovation is providing a wider set of tools for better risk and capital management.

**2. Break through borders:** ILS activity is gaining more traction outside traditional market sweet spots. This year (including lites), China, Japan, Turkey, Canada, and Europe have featured in catastrophe bond issuance activity. The market clearly has an appetite for regional growth, and the benefits of ILS should help expand the catastrophe bond’s global footprint. Beyond our launch of PCS Turkey this year, we’re actively exploring new regions and lines of business to help support both reinsurance and ILS market growth.

**3. Serve the public interest:** Publicly managed entities seem like a growth market for the ILS space, with the six transactions from this sector representing a third of year-to-date catastrophe bond issuance. Cranberry Re represents a return to market for one entity, and others that have used catastrophe bonds in the past could return. Finding new sponsors in this segment will be crucial for ILS growth — both for the publicly managed entity market and the catastrophe bond space as a whole.

**4. Evaluate alternatives for new entrants:** Despite significant growth over the past decade — and even in recent years — the catastrophe bond market seems to be attracting fewer first-time cedents than in the past. Collateralized reinsurance and cat bond lite are broadening the base of cedents in this environment, but helping cedents understand the advantages of different types of structures could attract the new risk that the ILS market needs to sustain rapid growth. For more information on this topic — and the concept of “original risk” — [take a look at our recent webinar on the subject](#).

**5. Choose the right alternative:** Cedents now have many ways to access capital markets capacity, each approach having unique features that can address a specific company’s needs. As a result, it appears overall ILS market growth will not depend on the increased use of catastrophe bonds, particularly since cedents can balance the rigor of those transactions with faster and less expensive approaches, such as ILWs and cat bond lite. The maturing of the ILS market in this fashion — based on the ability to help specific companies meet their capital management objectives — bodes well for ILS market growth. Innovation for its own sake — and choosing a risk-transfer solution for its novelty — may provide short-term advantages, but it’s not a platform for sustainable growth. The ILS market, with the range of solutions it provides, is showing a growth trajectory that’s built to last.



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