Lazy Days of Summer

Commentary

Third-quarter catastrophe bond issuance activity is usually light, and this year was no different. Only two catastrophe bonds came to market last quarter: a $225 million transaction using the PCS® Catastrophe Loss Index and the latest indemnity-triggered transaction covering risks in Japan. They brought the total only to nearly $3.7 billion for the year. Because of the quiet second quarter, year-to-date catastrophe bond issuance was down more than 15 percent year-over-year.

9M 2016 Catastrophe Bond Issuance

According to data from the Artemis.bm Deal Directory, insurers and reinsurers issued just over $3.7 billion[1] in catastrophe bonds in the first nine months of 2016, down 15 percent from the same period last year. This follows a 22 percent decline from the first nine months of 2014 to the first nine months of 2015. One transaction completed in third-quarter 2016, Blue Halo Re 2016-2, came quickly on the heels of the first Blue Halo Re transaction, which came to market in the second quarter. The other came late in the quarter and covers Japan only. Average year-to-date transaction was generally flat at around $230 million, following a 19.5 percent drop from the first nine months of 2014 to the first nine months of 2015.

9M 2016 Issuance Activity

	9M 2016	9M 2015
PCS trigger use ($ billions)	1.9	1.3
PCS trigger use (# of transactions)	9	6
North American issuance ($ billions)[2]	2.9	3.9
North American issuance (# of transactions)	13	15
Total issuance ($ billions)	3.7	4.4
Total issuance (# of transactions)	16	19

Sources: PCS, Artemis Deal Directory

The year-over-year decline in issuance activity reveals some interesting dynamics in the catastrophe bond market.

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.

First, the drop isn't uniform. Use of PCS (Property Claim Services®) data in catastrophe bonds is up significantly from the first nine months of 2015. Of the $1.9 billion in limit raised with triggers involving PCS, 63 percent uses the PCS Catastrophe Loss Index. The remaining $700 million uses PCS for independent catastrophe designation in indemnity-triggered catastrophe bonds. Seventy-two percent of limit raised (exclusive of transactions not covering any North American risk) uses PCS data, and 46 percent uses PCS in index triggers. PCS use is close to the level reached for the first nine months of 2014. Given the decline in issuance activity, though, the share of transactions using PCS is up sharply from both 2015 and 2014. Sponsors using PCS, particularly in index triggers, appear to have integrated catastrophe bonds into their strategic risk and capital management activities, which implies this will likely continue.

Other sectors of the catastrophe bond sponsor community acted differently. Publicly managed entities didn't return to the market this year, despite heavy use of catastrophe bonds in 2015. Last year, six sponsors in this category raised nearly $2 billion in fresh capital, $1.7 billion of it coming in the first nine months of the year.

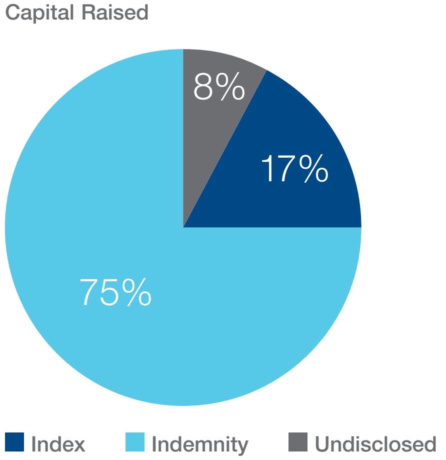
Further, few first-time sponsors came to market this year. In fact, the only two debut catastrophe bonds—First Coast Re and Laerte Re—represented only $175 million in new limit (raised in the second quarter). In 2015, three first-time sponsors raised $375 million in the first nine months of the year, with one more raising $275 million at the beginning of the fourth quarter. In 2014, eight first-time sponsors came to market (one of them, Citrus Re, with two issuances) and raised $1.9 billion.

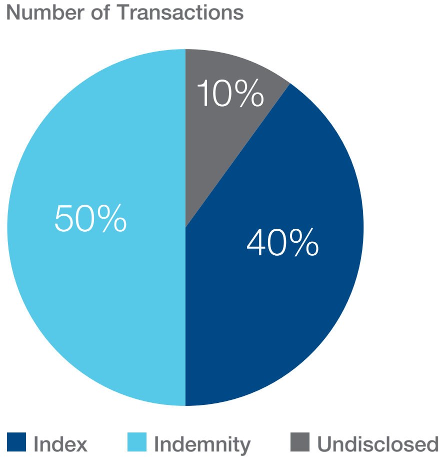
It's not surprising that the third quarter was quiet—third quarters usually are. Last year, third-quarter catastrophe bond issuance rose to only $400 million from three transactions—two covering risks outside the United States and one covering California earthquake. They ranged in size from $50 million to $200 million. Of course, the same period in 2012 and 2013 was more active, but what looked like a trend at the time failed to gain momentum. Some third-quarter issuance in those years was just carryover activity from the second quarter.

Cat Bond Lite

While the traditional catastrophe bond market was fairly quiet in the third quarter, cat bond lite continued to push forward. Four transactions led to approximately $122.4 million in new limits. The fourth Market Re transaction of the year brought $75 million in fresh capacity. It was the second Market Re cat bond lite of the year to top $70 million (in addition to a Resilience Re transaction that exceeded $80 million). The other three third-quarter cat bond lites came from the Dodeka platform. Together, Dodeka V, IX, and X amounted to $47.4 million and used the PCS Catastrophe Loss Index.

9M 2016 Cat Bond Lite Issuance by Trigger Type





Source: PCS, Artemis Deal Directory

The flurry of July activity has brought the year-to-date publicly revealed total to $423 million across 11 transactions. While that's down from $490 million and 16 transactions at the end of the third quarter of 2015, it still far exceeds the 2014 full-year result of $242 million. While the composition of the cat bond lite market continues to evolve—particularly with larger transactions—the market itself remains robust.

Year-to-date publicly revealed activity totals $423 million across 11 transactions.

By capital raised, indemnity triggers were most common in the first three quarters of 2016, due largely to the size of the transactions that used them. Year-to-date, $318 million of the cat bond lite limit raised used indemnity triggers. Index triggers accounted for $71.4 million. Five "lites" used indemnity triggers, four used the PCS Catastrophe Loss Index, and one trigger was undisclosed.

The continued strong use of cat bond lite 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 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.

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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Post–Monte Carlo "To Do" List

So, what was hot in Monte Carlo this year? As usual, more than the brutal sun! The global reinsurance industry is in a unique position right now. Abundant capital continues to put pressure on reinsurance rates. The ILS sector—now certainly converged with the traditional market—has shown a shift to more efficient vehicles such as cat bond lite and collateralized reinsurance, with catastrophe bond issuance down 25 percent year-over-year at the end of the first nine months of 2016. Capital wants access to more original risk, but the latter is coming slowly. And while the industry continues to excel at improving what it already does well, efforts to access new markets require the time and patience difficult to summon in a soft market.

Every sign points to an acute need for the global reinsurance industry to adapt to a fundamentally different market. Waiting for a big event to help absorb capital and push rates higher—if that could even happen in today's market—simply can't compete with market-changing innovation focused on current conditions and needs. With this in mind, let's take a look at this year's hot topics for the *Reinsurance Rendez-Vous de Septembre*.

Catastrophe activity

It's been a long time since catastrophe activity featured in a Monte Carlo discussion, with nothing significant since Superstorm Sandy struck in 2012. And while 2016 hasn't had a market-changing event, there's been enough to make the market talk. Between the Fort McMurray wildfire in Alberta and the second-quarter hailstorms in Texas, the global reinsurance industry has felt the results. Neither event is sufficient to change the market, but both have revived discussions about such topics as unmodeled risks and loosening terms and conditions in treaties and ILWs.

Global terror

Growing terror event frequency over the past 12 months has made many in the market take a second look at that risk, particularly since accumulations may be higher for some than they expect. Little in the way of physical damage has occurred, as the prevailing trend tends toward active shooter scenarios focused on causing fatalities. However, this may not last forever. There's always the risk that a terrorist organization could attack a "trophy target" after having achieved results through fatalities. Additionally, the recent events indicate a need in the market for a broader set of cover that would help original insureds transfer active shooter risk more effectively, which provides an original risk opportunity for the global insurance and reinsurance market.

New lines of business

Property catastrophe isn't enough for the ILS market. The investor community needs access to new forms of risk for this space to grow. In addition to new regions with loss indices (such as Turkey, for which a historical PCS loss database is now available), new lines of business will also be crucial. Energy and marine has long been discussed as a candidate for alternative risk transfer, especially with the availability of a credible, independent industry loss index. Global terror and cyber also make sense for the sector.

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