



# **ILS MARKET UPDATE**

New Non-Hurricane Issues, as 2011 Hurricane Threat Recedes

**WILLIS CAPITAL MARKETS & ADVISORY**

November 2011

**Willis**  
Capital Markets & Advisory

## Q3 2011 Cat Bond Market Issuance

The third quarter of 2011 saw four cat bond issuances in five tranches, with a total of \$676 million of new risk capital. This was a \$196 million increase over Q3 2010 (\$480 million issued in three deals). Q3 is traditionally a period of lighter issuance as the market waits out the hurricane season. Year-to-date, the market has seen a total of \$2.28 billion in new issuance in 2011, compared with a total of \$2.98 billion during the first three quarters of 2010. This decrease in issuance can be largely attributed to H1 catastrophe losses and model changes. The Q3 issues are summarized in the table below. Some non-renewals or placements accelerated into late 2010.

### Q3 2011 NON-LIFE CAT BOND MARKET ISSUANCE

(\$ in millions)

Sponsor	Issuer / Tranche	Issue Date	Term (Yrs)	Amount (\$M)	Amount (€M)	Risk Premium	Risk
Tokio M&F	Kizuna Re	08/30/11	3.0	\$160	-	5.50%	Japan Typhoon
ERDF	Pylon II Capital - A	08/01/11	5.0	93	€ 65	5.50%	France Windstorm
ERDF	Pylon II Capital - B	08/01/11	5.0	122	85	9.00%	France Windstorm
CEA	Embarcadero Re 2011	08/01/11	3.0	150	-	6.60%	California Earthquake
Munich Re	Queen Street III	07/28/11	3.0	150	-	4.75%	European Windstorm

Source: WCMA Transaction Database.

**Total \$675.6**

Munich Re sponsored a third takedown from their Queen Street shelf facility. A single, \$150 million tranche was placed providing three year wind coverage against European wind events. The notes use a parametric trigger and a treasury money market fund collateral structure.

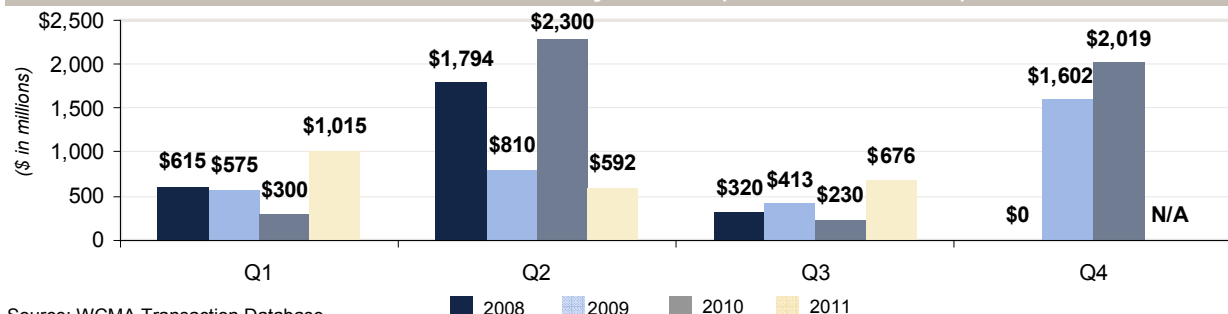
The California Earthquake Authority completed its first catastrophe bond as a direct sponsor, with a \$150 million transaction exclusively exposed to California earthquakes (shake only). This single tranche issuance provides three year annual aggregate coverage with a unique drop-down feature utilizing a reset trigger at each loss occurrence period. Strong demand allowed Embarcadero to price near the bottom of its guidance range. Following the announcement of this deal, senior management at the CEA openly applauded the transaction. CEO Glenn Pomeroy called it a “game-changer” and “less costly than traditional reinsurance”, with the potential to make residential earthquake reinsurance more affordable and more widely used. CFO Tim Richison stated that the CEA plans to return to the market every four to six months.

French energy giant EDF sponsored Pylon II Capital, a €150M, two-tranche transaction. Pylon II is exposed to French windstorms and covers five full wind seasons, although it has a term of less than four years and nine months. The deal is structured to trigger with the occurrence of storms with similar magnitude of 87J (1987), Lothar (1999) and Martin (1999). Combined with Queen Street II / III and the Loma deals, 2011 has seen nearly \$600 million of issuance exposed to Euro wind. Pylon II is also a unique transaction as it marks just the seventh time a corporate entity has sponsored a cat bond and the first repeat issuance.

The final issuance of the quarter was a private deal sponsored by Tokio Marine & Nichido Fire providing \$160M in coverage against Japanese typhoons.

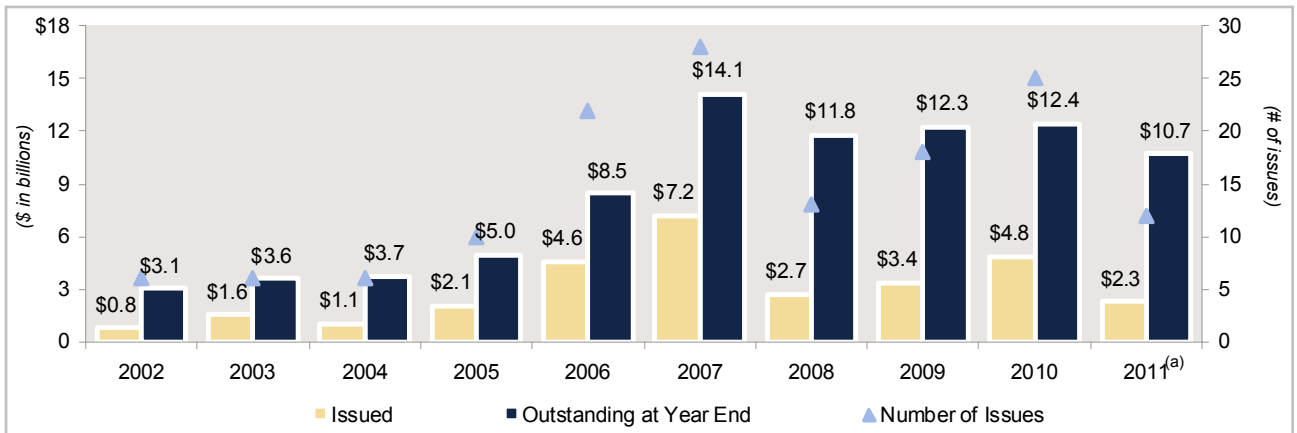
All five tranches issued in the quarter were exposed to non-U.S. wind risk. Despite this diversification, the market remains heavily weighted towards U.S. wind risk, with 67% of capital covering such events, down from ~71% last quarter. With \$1.24B of Euro wind exposure scheduled to mature in the first six months of 2012, this trend of non-U.S. wind issuance will likely continue.

### Cat Bond Issuance by Quarter (Q1 2008 – Q3 2011)



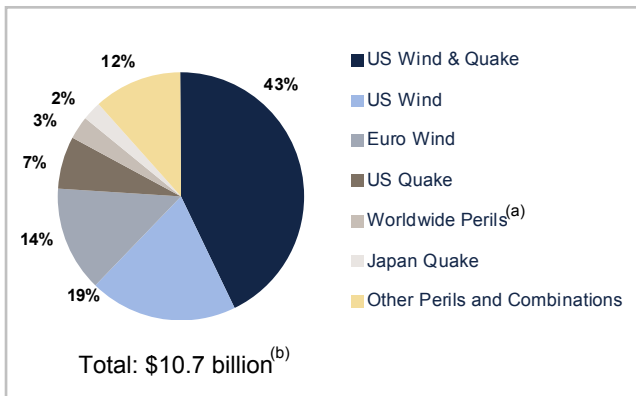
Source: WCMA Transaction Database.

## CAPACITY ISSUED AND OUTSTANDING BY YEAR



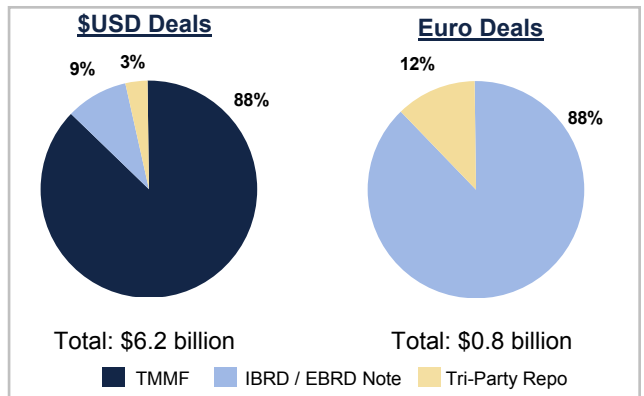
Source: WCMA Transaction Database.  
 (a) As of 9/30/11.

## ON-RISK CAPACITY BY PERIL (Sept 30, 2011)



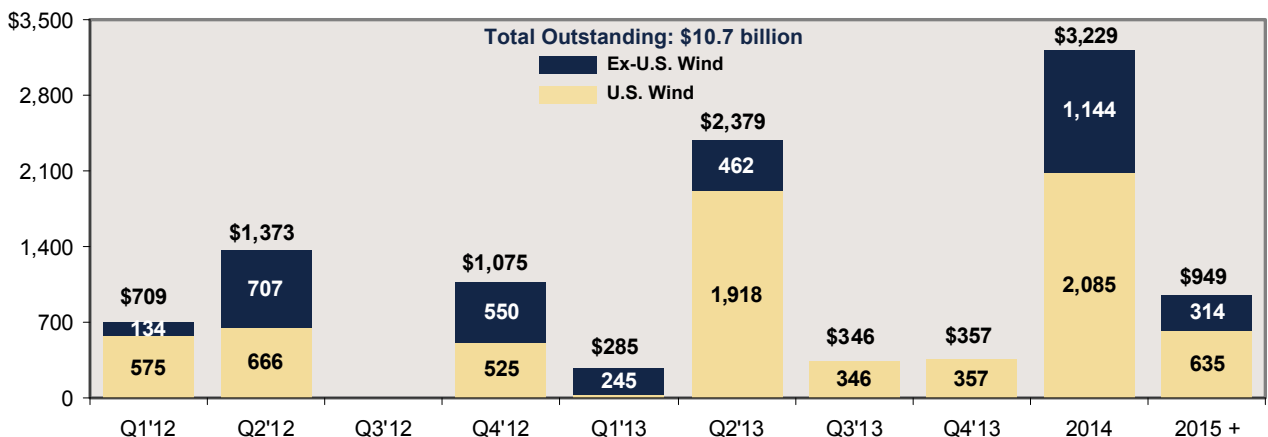
(a) Worldwide includes all bonds with coverage in more than 2 continents.  
 (b) In aggregate, 67% of all capacity outstanding exposed to U.S. Wind.  
 Source: WCMA Transaction Database.

## 2010 & 2011 Issuance by Collateral Type



Source: WCMA Transaction Database.  
 Note: Excludes Kizuna Re, collateral type unknown.

## ON-RISK CAPACITY BY MATURITY DATE (\$ in millions)



Source: WCMA Transaction Database.

## Legal Perspective: Michael Madigan Interview



*Michael Madigan, a familiar face to many market participants, is a partner with Sidley Austin LLP in New York. He advises principally on insurance securitizations, such as catastrophe bond transactions, having represented either issuers or their financial advisors in more than 90 such transactions since 1997. He has degrees from both Harvard Law School and the University of Stockholm Law School.*

### **How did you get involved in the cat bond / ILS area?**

I became involved with insurance-linked securities in 1995, when a number of investment banks began exploring the possibility of transferring insurance risk to the capital markets. Around this time, capacity for catastrophe cover in the reinsurance market became a concern in the wake of Hurricane Andrew and the Northridge Earthquake. The threshold legal question at this time was whether or not insurance-linked bonds would be viewed as insurance contracts by regulators. I had the fortune to be involved in the first 144A transaction back in 1997, so I am truly specialized in this area.

### **Recently, accompanying the increase in collateralized reinsurance, we have seen a move to 4(2) “private” transactions. The argument is that these transactions save time and money in comparison to Rule 144A deals. The tradeoff is that Reg 4(2) transactions lack the price discovery available with a full syndication and often have transferability restrictions. What is your perspective on this trend?**

I am very skeptical about the reasons given for this trend away from traditional 144A transactions. First, anyone who has been involved in executing a 4(2) placement knows that it is not as easy as it sounds. This is because you are negotiating the structure *and* the documentation directly with all the investors and in many cases the investors will have their own law firms involved. This may not be so bad if you have a small number of experienced 144A cat bond investors. However, if you increase the number of investors or have investors who are unfamiliar with the ILS space, a 4(2) can be very challenging from an execution point of view.

The current trend with 4(2) placements is to have them trade in book entry form just like a 144A offering. If the bonds trade, you need to think about whether you are comfortable that new investors buying the bonds really understand the structure. Investors in the secondary market were not involved in the original negotiation and this may pose potential execution risk for the ceding company if the bonds get triggered. Lots of efforts over the years have gone into making sure that we have sound structures and good disclosure. In a 144A offering the expected loss on the bonds is vetted by two independent sources: the modeling firm and the rating agency. The rating agency also is the only third party that will review in detail that the transaction is documented correctly. In a 4(2) placement, there are typically no third parties ensuring the transaction integrity.

Ideally the 4(2) placement should be a buy / hold placement with transfer restrictions. However, if you make the bonds non-transferable you may have an insurance regulatory problem. Most regulators emphasize that one of the reasons ILS would not be viewed as insurance contracts is because they are issued in the form of a security which has the characteristic that it is freely tradable – which an insurance contract is not. The Rule 144A process is already fairly streamlined with established documentation.

### **What do you think can be done to reduce legal costs?**

The most important way to control legal costs is to use service providers that have extensive experience with these types of transactions. This will allow the parties to focus on deal specifics instead of renegotiating legal documents. Also, transaction counsel plays a large role in keeping the transaction running smoothly which lowers the overall expenses.

### **What is your favorite / least favorite part of working in the ILS space?**

I most like to be involved in the structuring phase of the transaction. That phase can be intellectually challenging and individual transactions are very unique from each other. Furthermore, most participants in this market have longstanding relationships, so from a social standpoint it is very enjoyable. What I like least is negotiating legal fees.

Note: Michael Madigan is a partner at the law firm of Sidley Austin LLP and is not affiliated with Willis Capital Markets & Advisory or its affiliates. The views expressed herein by Mr. Madigan are his personally and do not reflect the views of the law firm or Willis Capital Markets & Advisory and its affiliates.

## Market Outlook

We anticipate the potential for robust 144A issuance in Q4 2011 continuing into Q1 2012. This represents the confluence of a number of factors: (1) pent up demand from prior quarters where model and price uncertainty ruled, (2) tightening spreads, especially for perils other than U.S. Hurricane, (3) substantial H1 2012 maturities, and (4) some degree of regulatory uncertainty beyond Q1 2012 pushing deals forward (see separate article on pending regulatory initiatives).

H2 2011 has seen continued interest in “private deals”. The term “private deals” is really a catch all for transactions on the spectrum between collateralized reinsurance and Rule 144A cat bonds. In return for giving up the ability to achieve a full syndication and the accompanying potential spread savings, private deals can save transaction costs but as Michael Madigan points out in his interview in this newsletter, this is not always the case. Investors may have the added benefit of obtaining some additional disclosure relative to a Rule 144A deal. Additional disclosure typically comes at the price of reduced secondary liquidity.

The approach to private deals continues to evolve as market participants try to settle on how and when to use this approach. At present private deals co-exist with collateralized reinsurance and Rule 144A transactions. We think this is likely to continue into 2012.

## Pending Regulatory Initiatives

Two pending regulatory initiatives in the US pose some theoretical threats to cat bond structures. One of these, the proposed “no conflicts” regulation (Rule 127B) under Section 621 of the Dodd-Frank law, addresses the issues raised in the infamous Abacus CDO trade. In Abacus, it is alleged that an investment bank structured and sold a deal primarily to allow their “client” to benefit from a loss of principal on the bonds.

Cat bonds have the same basic design: a reinsurance recovery occurs in tandem with a principal reduction. Taken literally, Rule 127B bans conflicts of interest between arrangers, sponsors and investors in ABS deals. A common sense version of Rule 127B would allow cat bond risk factors and other disclosure to justify an exemption from the new rules for sales to institutional investors. The fear is that the exemption will not prevail and that satisfying the new regulations will create inefficiencies and added costs for cat bonds.

A second initiative: proposed changes under Regulation AB, addresses a broader range of alignment of interest and disclosure issues arising from the Financial Crisis. Without an exemption, this second initiative would also appear to have some potential to complicate cat bonds as it might require, among other things, risk co-participation as well as different disclosure both for new and ongoing deals. The bottom line for both regulatory initiatives is that at this point they pose not insurmountable threats but instead a threat of increased cost and complexity for Q2 2012 and beyond.

## Cat Bonds for Corporates

Pylon II represented the return of the corporate cat bond, the first since 2007. Why are corporate cat bonds so rare relative to cat bonds for insurers and reinsurers? We believe there are two key reasons; corporate risk managers are less aware of the cat bond option than their ceded reinsurance peers and cat bond pricing and coverage tends to make more sense for an insurer or a reinsurer.

Corporate Sponsored Cat Bonds				
Deal Name	Year Issued	Notional (\$ M)	Peril	Sponsor
Concentric	1999	\$100	Japan EQ	Oriental Land Co (Tokyo Disney)
Studio Re	2002	175	CA EQ	Vivendi (Universal Studios)
Golden Goal Finance	2003	256	Event Cancellation	FIFA
Pylon	2003	234	Euro Wind	EDF
DREWCAT Capital	2006	50	Offshore U.S. Wind	Dominion Resources
Midori Ltd.	2007	260	Japan EQ	East Japan Railway Co.
Pylon II	2011	215	Euro Wind	ERDF
Total (\$ M)		\$1,290		

Note: Notional amounts for non-U.S. dollar transactions converted to dollars at historic exchange rates. Sources include Bloomberg and rating agency publications.

## Cat Bonds for Corporates (cont'd)

Deals like Pylon II can make sense when one or more of the following apply: large limit, peak zone exposure, or significant business interruption exposure. Perhaps the combination of recent loss activity, the success of Pylon II, and the increasing use of the private deal format could make these transactions more common in the future.

## Secondary Trading

In Q3 2011, traders focused on several items. Hurricane Irene in August triggered some portfolio adjustment by investors as it first approached the Mid-Atlantic and the Northeast U.S. as a major hurricane and then weakened before landfall. Some investors looked at both live cat ILWs and cat bond trades as options for this portfolio realignment. While the storm caused devastating loss of life and extensive flooding damage, it did not cause enough property damage to trigger any bonds. Another focus during the quarter was the continued loss development of the Mariah Re bonds. These bonds were sponsored by American Family and provide annual aggregate protection against severe Thunderstorm and Tornado events. Both the unrated Mariah Re Series 2010-2 bond and the rated Mariah Re Series 2010-1 traded down as losses continued to emerge. Series 2010-1 now carries a CC(sf) rating from S&P down from B(sf) at issuance. As in Q3 2011, Q4 will likely see continued trading around new issuance activity. As hurricane season ends, we would also anticipate modest trading around seasonality.

## CONTACTS

<b>Bill Dubinsky</b> <i>Head of ILS</i>	+1 212 915 7770 william.dubinsky@willis.com	<b>Adam Beatty</b> <i>Executive Vice President</i>	+1 212 915 7905 adam.beatty@willis.com
--------------------------------------------	------------------------------------------------	-------------------------------------------------------	-------------------------------------------

<b>Howard Bruch</b> <i>Executive Vice President</i>	+1 212 915 8407 howard.bruch@willis.com
--------------------------------------------------------	--------------------------------------------

## DISCLAIMER

Willis Capital Markets and Advisory ("WCMA") is a marketing name used by Willis Securities, Inc., a licensed broker dealer authorized and regulated by FINRA and a member of SIPC ("WSI"), and Willis Structured Financial Solutions Limited, an investment business authorized and regulated by the UK Financial Services Authority ("WSFSL"). Both WSI and WSFSL are Willis Group companies. Securities products are offered through WSI and WSFSL. Reinsurance products are placed through Willis Re Inc. in the United States and through Willis Limited in the UK, both also Willis Group companies. These materials have been prepared by WCMA based upon information from public or other sources. WCMA assumes no responsibility for independent investigation or verification of such information and has relied on such information being complete and accurate in all material respects. To the extent such information includes estimates and forecasts of future financial performance, WCMA has assumed that such estimates and forecasts have been reasonably prepared on bases reflecting the best currently available estimates. No representation or warranty, express or implied, is made as to the accuracy or completeness of such information and nothing contained herein is, or shall be relied upon as, a representation, whether as to the past, the present or the future. Readers should not place any reliance on any forward-looking statements, noted by such words as "should", "may", "expect" and "believe" contained herein. The information contained herein is not intended to provide the sole basis for evaluating, and should not be considered a recommendation with respect to, any transaction or other matter. Nothing in this communication constitutes an offer or solicitation to sell or purchase any securities and is not a commitment by WCMA (or any affiliate) to provide or arrange any financing for any transaction or to purchase any security in connection therewith. WCMA assumes no obligation to update or otherwise revise these materials. This communication has not been prepared with a view towards public disclosure under any securities laws and may not be reproduced, disseminated, quoted or referred to, in whole or in part, without the prior written consent of WCMA. Information contained within this communication may not reflect information known to other employees in any other business areas of Willis Group and its affiliates. WCMA and / or its affiliates may have business relationships with, and may have been, or in the future may be compensated for services provided to, companies mentioned herein.