Q4: Rounding Off a Year of Plenty

Including an exclusive interview with Peter Nakada of RMS

WILLIS CAPITAL MARKETS & ADVISORY

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Market Outlook

2014 may prove to be a pivotal year for the cat bond and sidecar markets. On the one hand, 2013 was a banner year for cat bonds, sidecars, and collateralized re with $7.1 billion in non-life cat bond issuance and considerable sidecar activity despite the softening market conditions. On the other hand, traditional reinsurers are reacting aggressively to maintain market share by launching preemptive quotes to defend previously unassailable positions on the programs of favored clients. These quotes have included not only aggressive pricing but also terms and conditions better tailored to ceding companies' needs. Some investors seeing the narrowing spreads in the cat bond market are taking equally aggressive steps by attempting to negotiate sole-placed collateralized re contracts at "off-market" prices. These are "off market" in the sense that they offer pricing and terms and conditions at generally less favorable terms for the ceding company (but more favorable for the investor) than would be available in a syndication.

The question remains whether changing terms and conditions in the traditional market will act more like sandbags or a levee in resisting the flood of capital that has arrived at the banks of the reinsurance industry. Alternatively will the levee simply break? Willis estimates that cat bond, collateralized re, ILW and sidecar capital totaled $50 billion by the end of 2013. Some of the more optimistic reinsurance CEOs believe that the flood will recede from the current high water mark with the inevitable return of catastrophe losses and better opportunities outside reinsurance for investors. They also believe that the relatively efficient capital structure of reinsurers as well as the speed and ease of traditional reinsurance will protect them from competition in lines of business (e.g., casualty) and coverages (e.g., reinstatable covers based on a promise to pay) not presently addressed directly by investors.

To breach these barriers investors will need to act more like water than ice (without going over any waterfalls in the river). To the extent transactions can become faster and marginally less expensive whether through private deals or through less burdensome Rule 144A deals, a trend in evidence in 2013, investors will have a higher probability of expanding market share. The key for investors is to sell products that solve real problems for ceding companies.

One bridge between investors and their impact on the market is the growing competition of sidecars, reinsurer-sponsored ILS funds and more traditional independent ILS managers. While both traditional investors and reinsurers have important roles in providing investors with access to risk, reinsurers themselves bring tools that many independent ILS managers lack such as relationships with brokers and ceding companies, expertise in claims and understanding of treaty wording of specific risks that can prove more challenging to underwrite. By piggybacking on this expertise, pensions, endowments, life insurers and other institutional investors can diversify and expand their access to risk either as a complement to direct investment, by investing through independent managers or, in some cases, as their first entry to the space.

With so many moving parts (not the least of which is the softening market), a precise estimate for cat bond and sidecar activity is particularly hard to make and we will reassess our outlook with more confidence at the end of the quarter. Falling rates should increase the overall demand for coverage and create a "bigger pie" for all protection sellers. This would, for example, help cover the tragic gap between economic losses and insured losses from major catastrophes (e.g., for earthquakes in California or Asia or typhoons in less developed countries in Asia).

We echo the comments of some that claim that spreads for cat bonds and sidecar returns will eventually face some floors. Just because ILS funds have slow money backers does not mean that the investors will naively pursue uneconomic returns. At some point as returns fall and new allocations to managers will become more limited even if prior allocations remain sticky. How these floors will compare to the potential floors on pricing for traditional reinsurers is less clear.

Regulation (and deregulation) will also play a role in governing activity. Government activity that will have an impact ranges from the Citizens Property depopulation efforts, the partial NFIP rate freeze and potential changes in TRIPRA in the US to further clarity regarding Solvency II in Europe. Dodd Frank also continues to cast a shadow of uncertainty over the reinsurance and ILS markets although the light seems now to be peaking through.

So what is our outlook for 2014? At this point, we would estimate that 2014 non-life non-investment grade cat bond issuance would exceed 2013 modestly with issuance between $7 billion and $8 billion along with similar modest growth in collateralized re. Sidecars outstanding at year end should (in the absence of an event catalyst) remain static but the total footprint of sidecars and reinsurer-sponsored ILS funds should continue to grow. Regardless of the tug-of-war between investors and reinsurers, the one certainty for 2014 (if loss-free) is that ceding companies will benefit from more choice, more pricing tension and savings by seeking capacity from a variety of products and sources. 2014 is the year of the ceding company!

Q4 2013 Cat Bond Market Issuance Overview

The fourth quarter of 2013 saw $1.8 billion of non-life catastrophe bond capacity issued in 7 deals (Q4 2012 saw $1.9 billion issued in 7 deals). The quarter's overall issuance brought annual capacity issued within a hair of the 2007 record of $7.2 billion, with non-investment grade and unrated issuance recording a new high. Through the course of 2013, a record 29 deals came to market, representing the most deals ever (even without counting the handful of private cat bond deals). Overall outstanding capacity at year-end reached $19 billion and has now grown at a compounded growth rate of ~18% since 2000.

All but one of the fourth quarter issuances were sponsored by repeat sponsors. Queen City Re sponsored American Modern Insurance was the sole exception.

Q4 2013: Non-Life Cat Bond Issuance Summary

($ in millions)

Sponsor	Issuer / Tranche	Issue Date	Maturity	Amount [a]	Risk Spread	Basis	Risk	Trigger
QBE	VenTerra Re 2013-1	30-Dec-13	9-Jan-17	$250	3.75%	Occ	US Quake, Australia Cyclone & Quake	Indemnity
Argo	Loma Re 2013-1 A	30-Dec-13	8-Jan-18	32	9.75%	Agg	T. Cyclone, US Quake & S. Thunderstorm	Multiple
Argo	Loma Re 2013-1 B	30-Dec-13	8-Jan-18	75	12.00%	Agg	T. Cyclone, US Quake & S. Thunderstorm	Multiple
Argo	Loma Re 2013-1 C	30-Dec-13	8-Jan-18	65	17.00%	Agg	T. Cyclone, US Quake & S. Thunderstorm	Multiple
Am. Modern	Queen City Re 2013-1	23-Dec-13	6-Jan-17	75	3.50%	Occ	Named Storms	Indemnity
AIG	Tradewynd Re 2013-2 - Class 1A	18-Dec-13	8-Jan-15	100	6.25%	Occ	US, CB & Gulf Named Storms, US / CAN EQ	Indemnity
AIG	Tradewynd Re 2013-2 - Class 3A	18-Dec-13	9-Jan-17	160	6.25%	Occ	US, CB & Gulf Named Storms, US / CAN EQ	Indemnity
AIG	Tradewynd Re 2013-2 - Class 3B	18-Dec-13	9-Jan-17	140	7.00%	Occ	US, CB & Gulf Named Storms, US / CAN EQ	Indemnity
USAA	Residential Re 2013-2 - Class 1	2-Dec-13	6-Dec-17	80	20.00%	Occ	US Wind & Quake, S. Thunderstorm, Winter Storm and California Wildfire	Indemnity
USAA	Residential Re 2013-2 - Class 4	2-Dec-13	6-Dec-17	70	5.25%	Occ	US Wind & Quake, S. Thunderstorm, Winter Storm and California Wildfire	Indemnity
Catlin	Galileo Re 2013-1	30-Oct-13	9-Jan-17	300	7.40%	Agg	US Wind & Quake, Can. EQ, EU Wind	PCS / PERILS
AXA	Calypso Capital II - Class A	14-Oct-13	9-Jan-17	250	2.60%	Occ	European Wind	PERILS
AXA	Calypso Capital II - Class B	14-Oct-13	8-Jan-18	223	2.90%	Occ	European Wind	PERILS
			Total:	$1,820				

The first issuance of the quarter was AXA's Calypso Capital II Ltd. The bond secured multi-year (three years for the Class A notes and four years for the Class B notes) fully collateralized protection against the peril of European windstorm. The notes provide coverage on a per-occurrence basis and utilize a CRESTA zone and line of business weighted PERILS index trigger. The Class A notes, with an expected loss of 0.96%, priced at 2.60%. The Class B notes, with an expected loss of 1.18%, priced at 2.90%.

The second transaction of the quarter was Galileo Re Ltd. sponsored by Catlin. Galileo Re provides Catlin with $300 million of fully collateralized protection on an annual aggregate basis against U.S. named storms, U.S. & Canada earthquake and European windstorm for a three-year risk period. The structure features an index trigger determined by PCS and PERILS based industry losses. Investors welcomed the transaction, which was oversubscribed, leading to the deal being upsized from $175 million to $300 million. The notes will pay a risk spread of 7.40%, well below the bottom of the initial pricing guidance of 7.75% - 8.50%.

The third transaction of the quarter was another issuance under USAA's Residential Re franchise. USAA sponsored two tranches of fully collateralized notes providing coverage against the perils of U.S. wind and earthquake, severe thunderstorm, winter storm and California wildfire. The Class 1 notes had a high expected loss of 14.23% and were issued at a spread of 20.00%. The notes upsized from $50 million to $80 million. The Class 4 notes, had a more traditional expected loss of 1.80% and eventually priced at 5.25%.

(a) All issuance amounts reported in or converted to USD. Expected loss for hurricane deals is based on WSST conditioned catalog for AIR and RMS medium-term catalog for RMS.

Note: All issuance and par outstanding metrics presented are based on the following methodology for catastrophe bonds: Only natural catastrophe bonds are included in the graphs and charts. Our total par outstanding calculations do not include extreme mortality, longevity risk and contingent capital transactions. Calculations exclude private transactions such as 4(2) deals. Total par outstanding metrics exclude sidecars and other alternative risk transfer transactions.

Source: WCMA Transaction Database as of 12/31/2013.

Q4 2013 Cat Bond Market Issuance Overview (Continued)

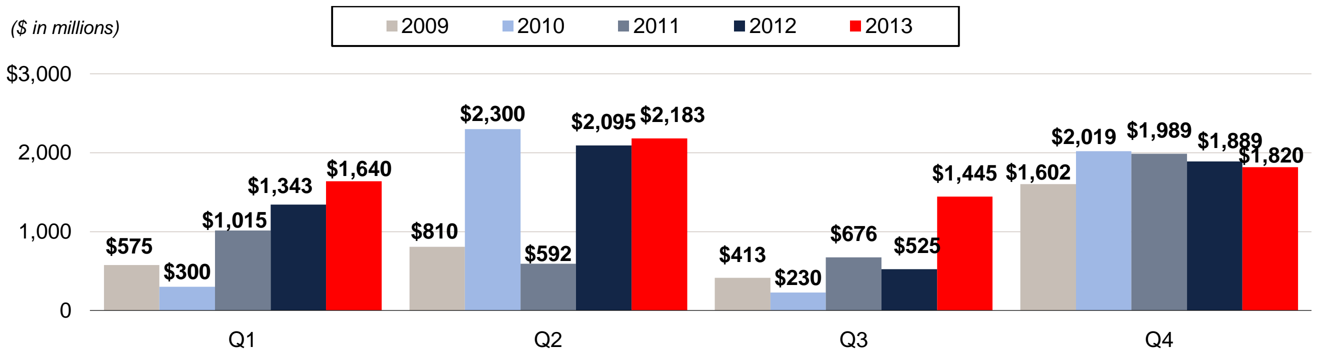
AIG returned to the market with another issuance of Tradewynd Re, issuing three tranches of notes to cover the perils of named storms in the U.S., Caribbean, Gulf of Mexico and earthquakes in the U.S. and Canada. The Class 1A notes provide one year of fully-collateralized protection, while the Class 3A and 3B notes are on-risk for three years. The Class 1A notes were marketed at an initial spread of 6.00% - 6.75% (expected loss of 1.28%) and eventually priced at 6.25%. The Class 3A notes provided coverage against the same layer as the 1A notes, eventually also pricing at 6.25%. The Class 3B notes, with an expected loss of 1.62% priced at 7.00%. Initially, a fourth tranche of notes (Class 1B) was also offered, but this tranche was eventually withdrawn. Unlike the prior Tradewynd deal, this one used RMS as the modelling firm but also made data available to other modelers.

The fifth issuance of the quarter was Queen City Re, sponsored by first-time sponsor American Modern. American Modern secured three years of fully collateralized indemnity, per occurrence coverage against named storms in the U.S. The deal had an expected loss of 0.57% and was initially marketed at a spread of 4.00% - 4.75%, eventually pricing below this spread at 3.50%.

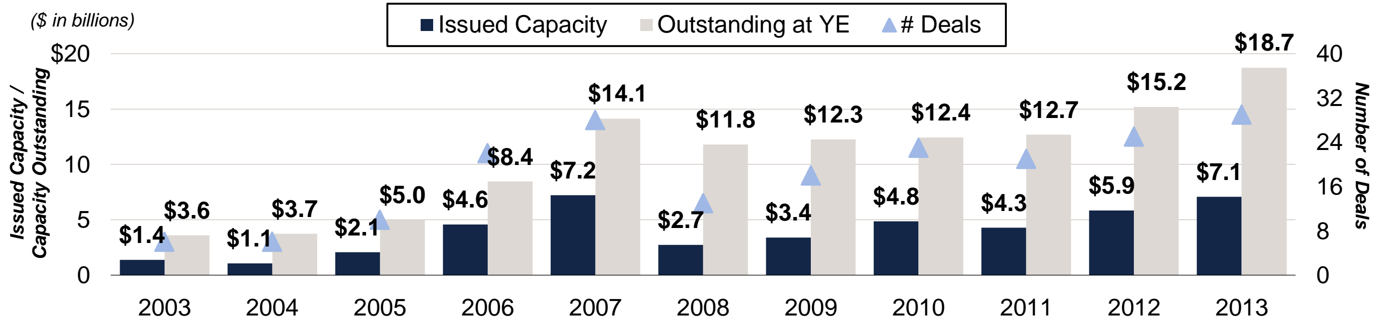
The penultimate issuance of the quarter was Loma Re, sponsored by Argo. Loma Re provides four years of fully collateralized annual aggregate cover against the perils of tropical cyclone, U.S. earthquake and severe thunderstorm. The bond initially sought to raise a $100 million across three tranches, eventually raising $172 million The Class A notes, with an expected loss of 4.16%, priced at 9.75%. The Class B notes (expected loss of 5.62%) and Class C notes (expected loss of 8.99%) were then priced at 12.00% and 17.00% respectively.

The final issue of the quarter was sponsored by QBE and provides three years of fully collateralized indemnity, per occurrence coverage against the perils of U.S. earthquake, Australia cyclone and Australia earthquake. The deal had an expected loss of 1.35% and issued at a spread at 3.75%.

Non-Life Cat Bond Issuance by Quarter (2009 – 2013) (a)



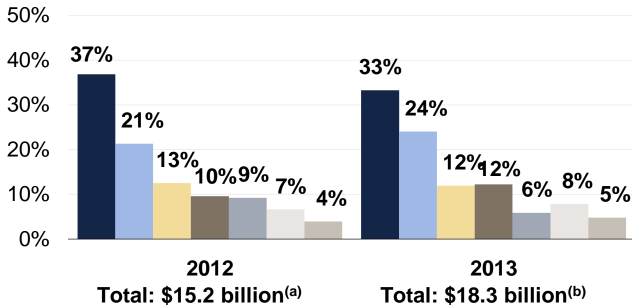
Capacity Issued and Outstanding by Year



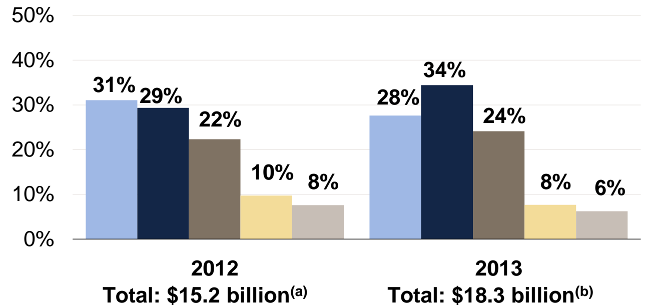
(a) All issuance amounts reported in or converted to USD.
Source: WCMA Transaction Database as of 12/31/2013.

Q4 2013 Cat Bond Market Issuance Overview (Continued)

Par Outstanding by Risk Peril

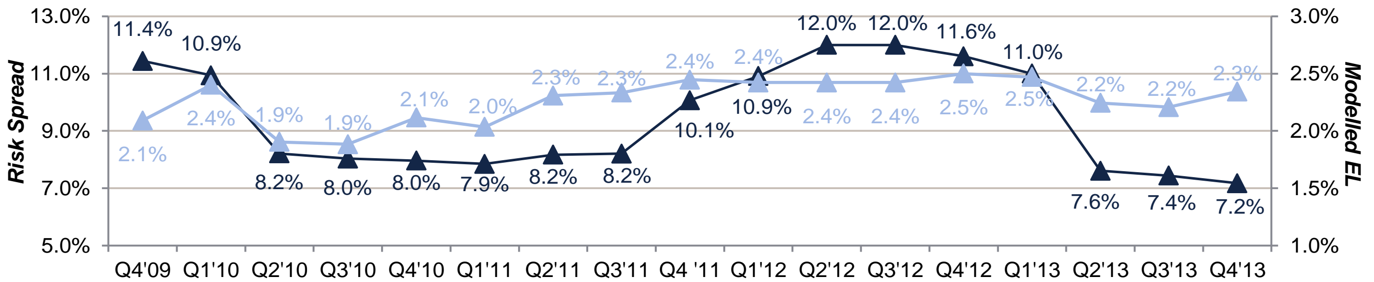


Par Outstanding by Expected Loss

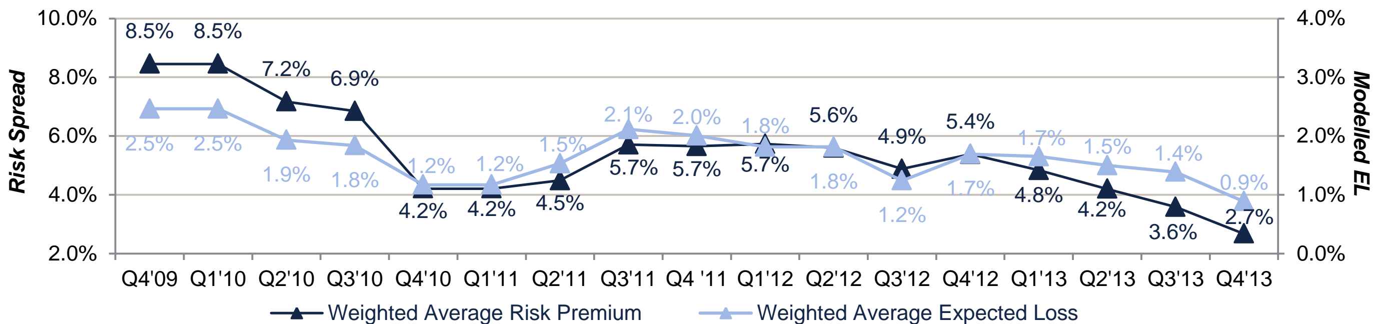


(a) In aggregate, 71% of all capacity outstanding exposed to U.S. Wind. (b) In aggregate, 69% of all capacity outstanding exposed to U.S. Wind
Source: WCMA Transaction Database as of 12/31/2013.

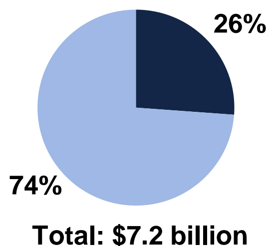
Quarterly LTM U.S. Wind Exposed Weighted Average Risk Premium & Expected Loss



Quarterly LTM Non-U.S. Wind Exposed Weighted Average Risk Premium & Expected Loss

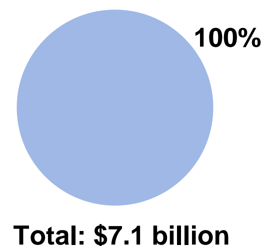


2007 Investment vs. Non-Investment Grade (a)



Total: $7.2 billion

2013 Investment vs. Non-Investment Grade (a)



Total: $7.1 billion

Investment Grade
Non-Investment Grade

Source: WCMA Transaction Database as of 12/31/2013. LTM = Last twelve months. Data is for primary issuance and does not reflect secondary trading.
(a) Non investment grade includes unrated bonds.

WCMA Interview: Peter Nakada

Mr. Peter Nakada, serves as Managing Director of Risk Markets at Risk Management Solutions, Inc.

How did you come into your current role at RMS? How have your responsibilities changed as the ILS market has developed?

I joined RMS in 2005 – the week after Hurricane Katrina. I was hired to start up a group called RMS Consulting, and risk analysis for ILS was just one of the activities I managed. By 2008, capital markets activities had grown so much that we created a separate group, RMS Capital Markets, and made it my sole focus. At the same time, RMS launched its flagship portfolio management tool, Miu. In addition to managing this product and group, I also took over the oversight of excess mortality and longevity transactions. So in essence, through the course of my career I went from running a consulting business to running a group focusing on providing products and services to markets adjacent to RMS's core P&C insurance and reinsurance markets. My two focuses now are developing the market for longevity transactions, and helping to make the ILS market more efficient and easier for sponsors to enter into.

To what extent has the importance and role of risk modeling and expertized results in cat bond issuance evolved in the past five years? Many deals no longer have ratings but most still have third party modeling. What are your thoughts on this development?

While RMS's role as an expert modeler on transactions continues to be integral to deal success, over the past five years RMS's role within the industry has evolved from an EL (Expected Loss) calculation agent to something more like a fixed income analyst. Similar to research reports for bonds and equities, we provide commentary on ILS deals. RMS' First Look Notes provide investors with commentary and analysis around the structure of a deal, issues around the transaction and other points of note. Our services include calculating the cash flows on deals and providing investors with a view on cat-adjusted spreads (similar to option-adjusted spreads). Prior to the development of First Look Notes, RMS would receive offering documents from investors and would subject them to review by their most experienced "deal leads." These deal leads would then analyze and critique the deal for structure, riskiness and other nuances that are pertinent to investors. We would then make these deal critiques available to clients within 24 hours of receiving the offering materials. Even as this product has developed into its current form, emphasis has always been on providing investors with an alternate and unbiased view of risk. In terms of other services, we also provide investors with third party marks on their private transactions for purposes of Net Asset Value calculations. With regards to ratings, there is now enough capital in the market that a rating isn't always necessary to ensure a successful syndication.

What is the biggest change you have seen in investor demands? Has the growing involvement of investors in collateralized reinsurance and similar risks outside the Rule 144A market changed investors' needs?

I think the most significant change is the investor-driven need for detailed loss modeling. In the past, when ILS investors received loss data for a transaction, it would be aggregate data without much granularity. For instance, for an industry index deal we would receive PCS market-share data by county – not very detailed information. Sponsors didn't feel comfortable sharing detailed exposure data with investors or modeling agencies providing alternate views on the deal. Recently, however, more and more cedents have shown a willingness to share detailed exposure data on indemnity transactions. I believe this is a trend that will continue and investors will have access to much more detailed modeling to support their investment decisions. This need for more detailed loss modeling is prevalent amongst non-144A deals as well (e.g. 4(2) placements).

What new non-life perils does RMS expect to model? Are there any solutions being developed to model flood or terrorism? Do you see further development in surge modeling following the Metrocat Re deal?

Our latest initiative has been the creation and development of a fully-probabilistic U.S. flood model which we hope to release in the near-to-medium-term. This model will contemplate the genesis and movement of inland floods caused through high precipitation and will include rain linked to hurricanes as well as rain not linked to other wind events. The model will be a significant advance over the current FEMA maps. Concurrently, we are also working on an Asian flood model. This will be especially meaningful given the rapid growth of industrial complexes in Asia, which for the sake of convenience often develop on the banks of rivers (the same convenience can quickly become a huge natural hazard). This Asian flood model will be deterministic and is currently on a rapid development and deployment trajectory. We will continue to develop and refine our surge model and imagine that the Metrocat transaction will soon be replicated by others.

Note: Mr. Peter Nakada, serves as Managing Director of Risk Markets of Risk Management Solutions, Inc and is not affiliated with Willis Capital Markets & Advisory or its affiliates. The views expressed herein by Mr. Nakada are his personally and do not reflect the views of RMS or Willis Capital Markets & Advisory or its affiliates.

WCMA Interview: Peter Nakada (Continued)

How would you compare the evolution of modeling for longevity and extreme mortality to what we see with natural catastrophes?

We have been surprised to see the low growth in appetite for excess mortality risks relative to nat cat risk. Interestingly however, there has been considerable demand for longevity risk in the capital markets as many sponsors have wanted to move this risk off-balance sheet (essentially a capital management play). RMS came to the market with a longevity catastrophe model which allowed investors to better understand the types of risks being packaged and thereby helped facilitate increased demand for the product. Our longevity risk model, RMS Liferisks, has been in development for 4 years and the last commercial release was approximately a year and a half ago.

We recently worked with Societe Generale and Aegon to transfer €200 million of longevity risk using a modeled loss approach. The transaction had an initial term of 20 years with a commutation at the end of the term that effectively incorporates an additional 50 years of longevity risk. This innovative transaction essentially hedges 70 years of longevity risk with a 20 year instrument. SCOR was a key investor in this transaction.

The Tradewynd Re transaction offered access to modeling input files, not only to RMS as the expert modeler but also other modeling firms. Do you see this as a useful development and would you anticipate modeling transactions if you are "on the outside looking in"?

Absolutely. If RMS receives detailed exposure information on any cat bond in the market (even if RMS is not the modeler on the transaction), we will model it for our Miu clients – with no charge to the sponsor. Investors are essentially paying for the modeling – we see this business model as a very healthy evolution of the market. Think about credit ratings – they are an issuer-paid model and as such there is moral hazard and potential for "shopping" for the firm that provides the lowest view of risk. Conversely, an investor-paid model for risk modeling eliminates this potential moral hazard ("model shopping"). Tradewynd was the first step in the move towards this business model. Over time, rating agencies have also moved in that direction. Think about the bond rating processes and the use of a 17g-5 site to post rating agency questions. Other rating agencies (aside from the one selected) can access this information and provide alternative ratings. This is the regulator's attempt to address the same issue in the corporate credit rating process.

Has the number of non-144A private deals (such as 4(2) deals) increased in the past few years? What has caused this shift and what solutions does RMS offer to assist with such transactions?

The number of private deals in the past year has definitely increased. Part of the reason for this is the tremendous investment of time and money associated with a broadly syndicated Rule 144A deal. If the execution risk associated with a narrower syndication can be mitigated with proper pre-marketing, much of the documentation and regulatory process associated with a public deal can be avoided. Today there is enough capital amongst a handful of large investors to achieve comparable execution on a 4(2) deal. RMS has been actively involved in characterizing these deals for investors.

What are three things you would like to change about the ILS market if you could wave a magic wand and change them overnight?

We would love to see less complexity around the issuance of cat bonds, which really limits the size and scope of the market. Some steps towards this would be: 1) A complete move to an investor-paid model. We see this as the logical end-point to risk-analysis within this market. 2) We would also like to see a streamlined and controlled sharing of exposure data with significant granularity. 3) Standardizing legal documents would increase transaction efficiency. 4) We believe that service providers must sacrifice some amount of short-term profits to achieve a bigger, more efficient market for everyone. An example of this latter point is how RMS produces characterizations for deals, while taking the potential risk that investors may not purchase the report.

How do you see RMS(one) fitting in with all of this?

RMS(one) is scheduled to be released in April. It is a cloud-based cat modeling platform and represents RMS's entry into the cloud computing business. We will host competitors models within this cloud infrastructure, alongside our own. This reaffirms an important RMS(one) operating methodology – "one view of exposure, multiple views of risk." The current process of managing exposure data is a headache for clients and RMS wants to eliminate this issue. We will handle all the physical requirements of data storage and management.

There are a number of ways in how this platform will impact the capital markets. 1) It will be easier for investors to access detailed modeling. 2) RMS(one) will help facilitate the sharing of exposure data between various parties in a controlled and efficient way. 3) We are also embracing an open eco-system for developers to create reports and other useful outputs.

Update to Standard & Poor's Natural Peril Catastrophe Bond Rating Criteria

In December, S&P published an update to its previously released article "Methodology and Assumptions for Rating Natural Catastrophe Bonds" dated May 12, 2009. In addition to providing clarification on the methodology used to assign a rating to a catastrophe bond and the stresses applied to the model results, the article also discusses four key updates to existing criteria:

1) Unrated Sponsor

The updated criteria address how an unrated sponsor can still issue a rated transaction and insulate the credit risk. The article mentions that this has typically been achieved by prepaying insurance premiums due to the noteholders. Alternatively, if a third party rated by S&P were to write a guarantee on the periodic payment that meets S&P's criteria for a rating substitution, S&P would give credit for the guarantee based on the guarantor's rating.

2) Partial-year Risk Periods

For transactions with partial-year risk periods where the peril is not seasonal, S&P will interpolate a partial-year default factor assuming a linear distribution of the default factor (e.g. for a 9-month risk factor S&P would use 75% of the equivalent nat-cat risk factor).

For perils that have known seasons, such as U.S. Hurricane or European Windstorm, the seasonality of the peril is considered. For example, if a bond covering U.S. hurricane has a risk period from June 1 through November 30, S&P would use the one-year nat-cat risk factor.

3) Named Storms vs Hurricanes

S&P addresses the recent trend in the market which has seen a broadening of the event definition from Hurricanes to Named Storms. S&P now expects the modeling agency and sponsor for a particular transaction to disclose whether they are aware of any named storms that, while never reaching hurricane status during their lives, would still have resulted in loss amounts that would have been qualified events.

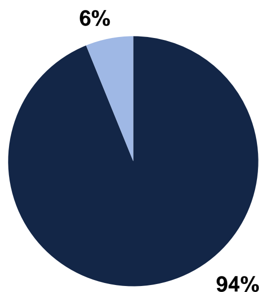
4) Coupon Stepdowns

A rating can be impacted by a coupon stepdown even if the likelihood of principal reduction is not known. If a coupon steps down (for example, as a result of a reduced interest event) but S&P expects it to be fully reinstated and all accumulated arrears repaid within 12 months, S&P would not lower the rating solely for that reason.

The ratings on any outstanding transactions will not be impacted as a result of this update. Furthermore, the default probability tables used for ratings have not changed.

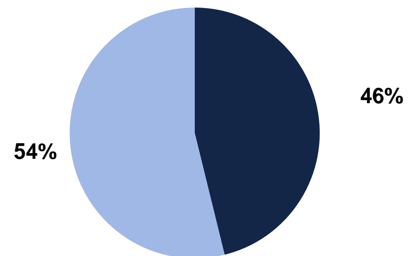
2007 vs. 2013 Ratings Analysis

2007 Rated vs. Non-Rated



Total: $7.2 billion

2013 Rated vs. Non-Rated



Total: $7.1 billion

Source: WCMA Transaction Database as of 12/31/2013.

Cat Bond Secondary Market Trading

A busy primary issuance calendar in the year's final quarter, gave cat bond investors ripe-and-ready opportunities for portfolio adjustment in the secondary market.

One clear trend, saw some investors extend the duration of their portfolios by lightening up on their almost "dead" cat bonds with minimal or no remaining exposure to cat risk.

In an effort to meet return objectives, many investors also reached for the higher yielding bonds, and when selling preferred to sell lower yielding bonds to investors with mandates across the risk spectrum. Diversifiers continued to be popular. With a widespread search for risk investors reached out to other ILS products such as collateralized cover as well as sidecars.

As we look to 2014, the market continues to focus on the new issuance calendar in the hopes of reinvesting maturing investments and putting new capital to work. The arrival of bonds in the first quarter will be welcomed and will surely help satiate the unfulfilled demand for liquid paper.

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