ILS MARKET UPDATE

No Surprises

WILLIS CAPITAL MARKETS & ADVISORY

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The Insurance Industry Experts

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Capital Markets & Advisory

Q3 2014 Market Outlook

Q4 2014 will reveal the answers to several questions. Some of the answers will shape the market for 2015 and years to come.

Will Records Fall?

First, will 2014 break 2007's record for nonlife ILS issuance? Since it would only take about $1.2 billion more issuance, it seems quite likely. In fact, we still predict a final tally of between $8 and $9 billion. The actual number is not really as important as the broader participation of investors in sidecars, cat bonds, and collateralized re, which continues to grow at a rate consistent with this estimate.

"Positioning ILS capacity in an existing reinsurance structure is more like executing a corner kick than shopping for the best price for a bestselling book"

Will Investors Chase Higher Yields in Traditional Fixed Income?

Many have said that ILS capital will flee when bond yields rise to long-term levels. This raises a second question for Q4: will the modest high yield spread rebound draw away investor capital from ILS? Undoubtedly, some opportunistic managers will chase higher yields, but we expect this to be the exception rather than the rule for yield swings outside a crisis. This is because the relative importance of long term ILS commitments by pensions should mute the impact of any decline in relative value.

What Is the Sweet Spot?

Positioning ILS capacity in an existing reinsurance structure is more like executing a corner kick than shopping for the best price for a bestselling book. For the corner, the team might consider the probability of executing according to plan based on the field and game conditions and the team's own capabilities. Then, before executing, it needs to consider who is defending and how might they react.

At WCMA we see a steadily growing pool of clients willing to work with us and their brokers to execute "better corners." This means thinking about market conditions and the other available options in a direct comparison of obvious points (cost, collateralization benefit etc.) but then going beyond this to tailor the analysis to the client's own objectives. Where, considering all the moving parts, will it create the most overall benefit now and in the future?

"ILS has broader potential application than many have thought, which portends well for further market growth"

An individualized approach means we are seeing companies make different choices. While the average expected loss (and peril mix) of deals has remained relatively stable, the deals have become more varied. Perhaps we may see a new consensus around riskier deals in Q4 2014 and 1H 2015, as investors seek higher absolute returns. If the trend continues and the deal mix remains diverse, it suggests ILS has broader potential application than many have thought and portends well for further market growth.

Q3 2014 Cat Bond Market Issuance Overview

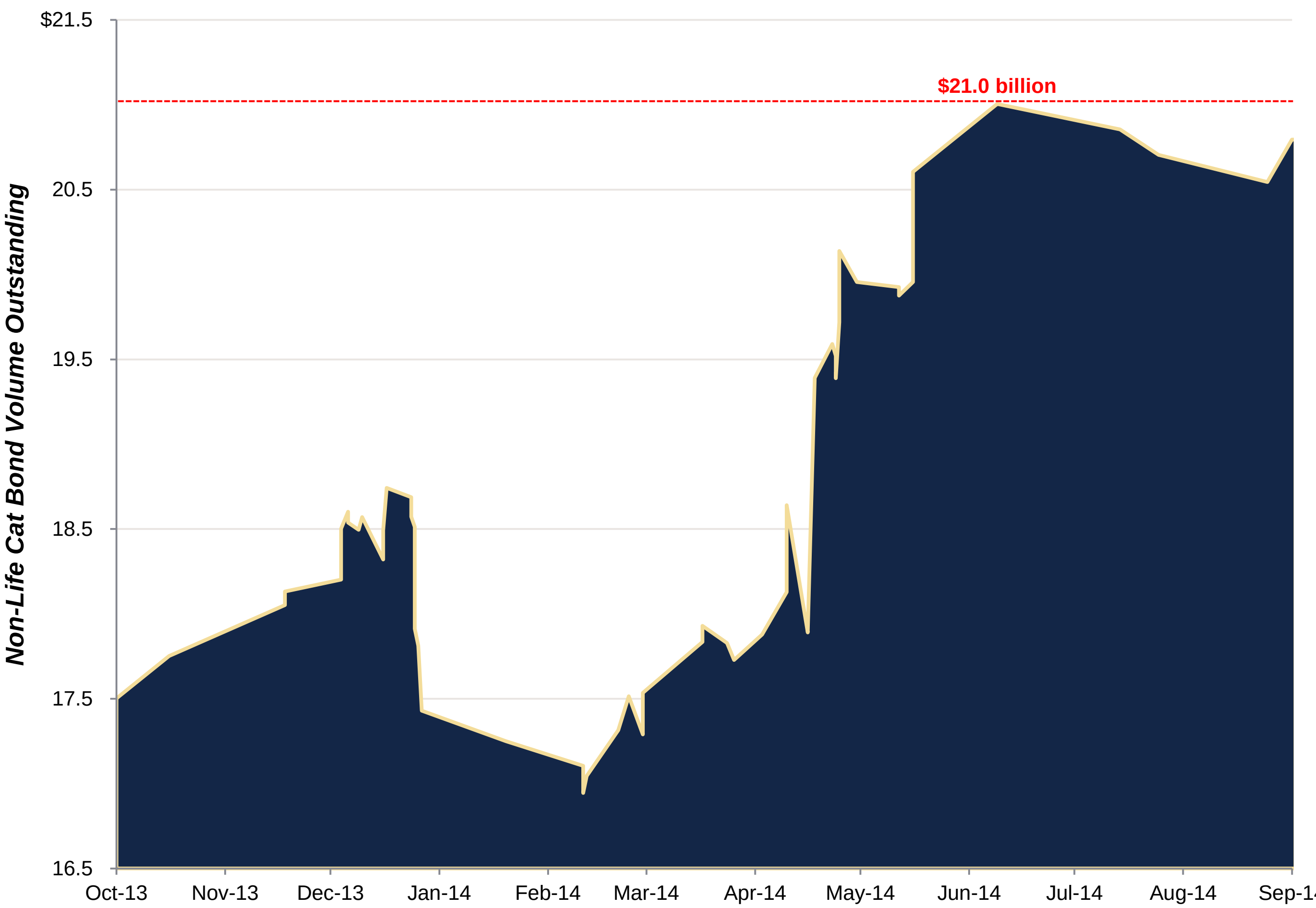
"Just one transaction came to market, State Fund's Golden State Re II"

Q3 issuance was comparatively slow relative to the record-breaking second quarter, with quarterly issuance volume the lowest since 2010. Just one transaction came to market, State Fund's Golden State Re II.

Golden State Re II, sponsored by State Compensation Insurance Fund, was brought to market to replace the maturing $200 million Golden State Re 2011 transaction. Golden State Re II covers workers' compensation risk against earthquake. The bond replaces and expands the $200 million of coverage secured via Golden State Re in 2011 and uses a modelled loss trigger. The transaction was initially marketed with a size of $150 million and a spread range of 2.20% - 2.70%. State Fund chose to upsize the transaction to $250 million. It had a final issuance spread of 2.20%, at the bottom of the initial guidance range. The successful placement confirmed the market's appetite for diversifying workers' compensation risk using a well-structured trigger.

($ in billions)

Non-Life Cat Bond Volume Outstanding Over the Past Year



Source: WCMA Transaction Database as of 9/30/2014.

Evolution of Catastrophe Bond Terms

Catastrophe bond terms and conditions have evolved considerably over the last 3 years as ILS investors respond selectively to sponsor needs. Instead of ILS capacity providers being the last dollars a sponsor would seek to access as part of its risk transfer program, “alternative capacity” is now becoming an integral component of sponsors’ risk transfer strategy. ILS capacity is being fully integrated into the reinsurance purchase decision.

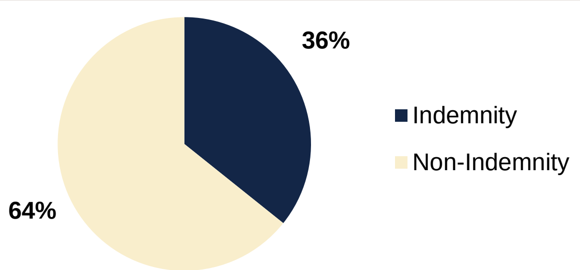
We examined a number of trends of Rule 144A catastrophe bond initial issuance from the LTM period ending 9/30/2011 and compared them to the most recent LTM of issuance ending 9/30/2014.

Figure 1: Initial Issuance by Trigger Type
Indemnity triggers have grown significantly over the last 3 years and now make up the predominant trigger type for new issuance. Investors have continued to become more sophisticated and are now able to evaluate and take on more complex forms of risk transfer, including indemnity-triggered structures. However, even as the use of indemnity triggers was growing in the years leading up to Q3’11 (LTM period shown below), specific terms being offered by catastrophe bond investors were still not as flexible as what cedants could achieve in the traditional market. Figures 2 and 3 highlight two of the key changes to the trigger flexibility that fueled the growth of indemnity triggered issuance.

Figure 2: Initial Issuance of Indemnity Triggered Transactions by Co-Participation Type
Traditionally, indemnity triggered cat bond transactions required the sponsor to warrant they would retain at least 10% of the layer being covered and not otherwise reinsure that risk. In contrast, the traditional markets had long since done away with this requirement. As catastrophe bond investors relaxed and then eventually removed the co-participation requirement, sponsors who were not comfortable with retaining additional losses in excess of their program’s retention were now able to use catastrophe bonds alongside their traditional reinsurance purchase.

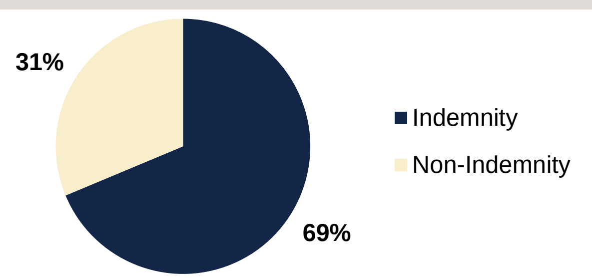
Figure 1: Initial Issuance by Trigger Type

Q3’11 LTM Issues



Total: $4.3 billion

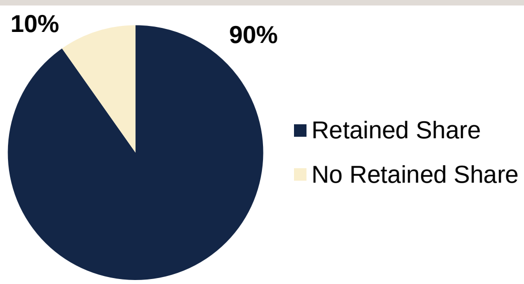
Q3’14 LTM Issues



Total: $8.0 billion

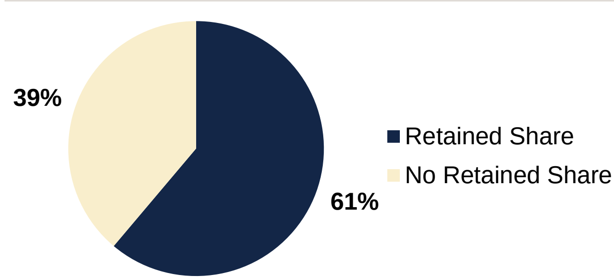
Figure 2: Initial Issuance of Indemnity Triggered Transactions by Co-Participation Type

Q3’11 LTM Issues



Total: $1.5 billion

Q3’14 LTM Issues



Total: $5.5 billion

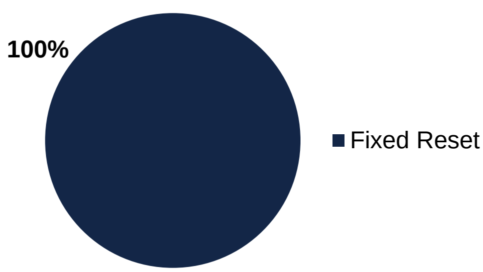
Evolution of Catastrophe Bond Terms (Continued)

Figure 3: Initial Issuance of Indemnity Triggered Transactions by Reset Type

Because of the multi-year nature of catastrophe bond transactions, an annual reset is required to keep the risk consistent as the underlying exposure of the portfolio changes. Historically this would create gaps in coverage and would require complex placements with traditional markets. The variable reset allows the sponsor to keep the layer 100% insured and eliminate any potential gaps that could be created through the normal process. This is achieved through changes in the risk profile of the layer within a defined range and a corresponding change in the premium required for the cover.

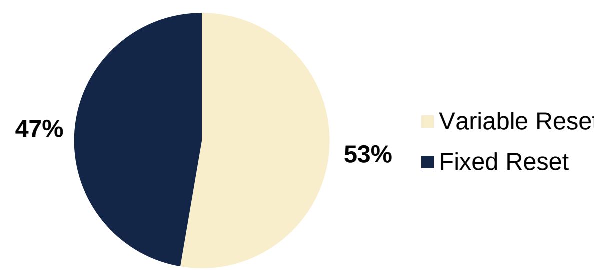
Figure 3: Initial Issuance of Indemnity Triggered Transactions by Reset Type

Q3'11 LTM Issues



Total: $1.5 billion

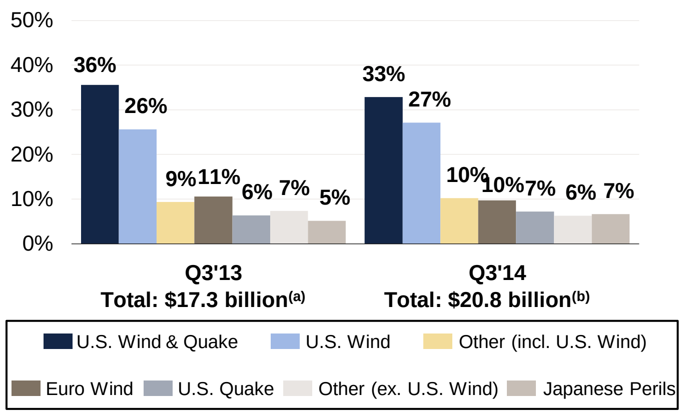
Q3'14 LTM Issues



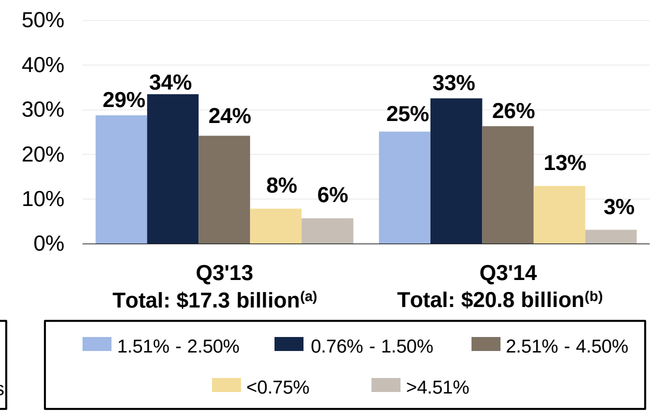
Total: $5.5 billion

Q3 2014 Cat Bond Market Statistics

Par Outstanding by Risk Peril

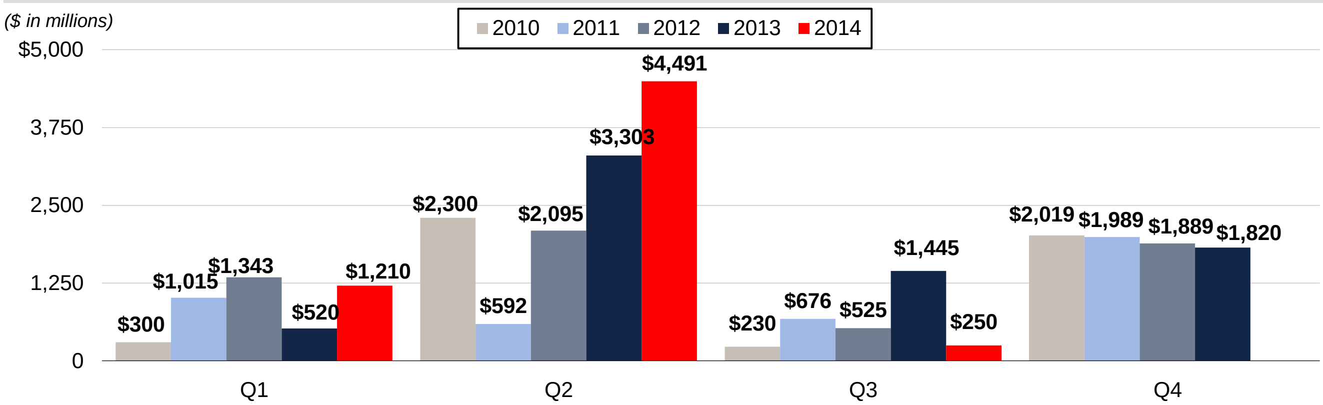


Par Outstanding by Expected Loss at Issuance

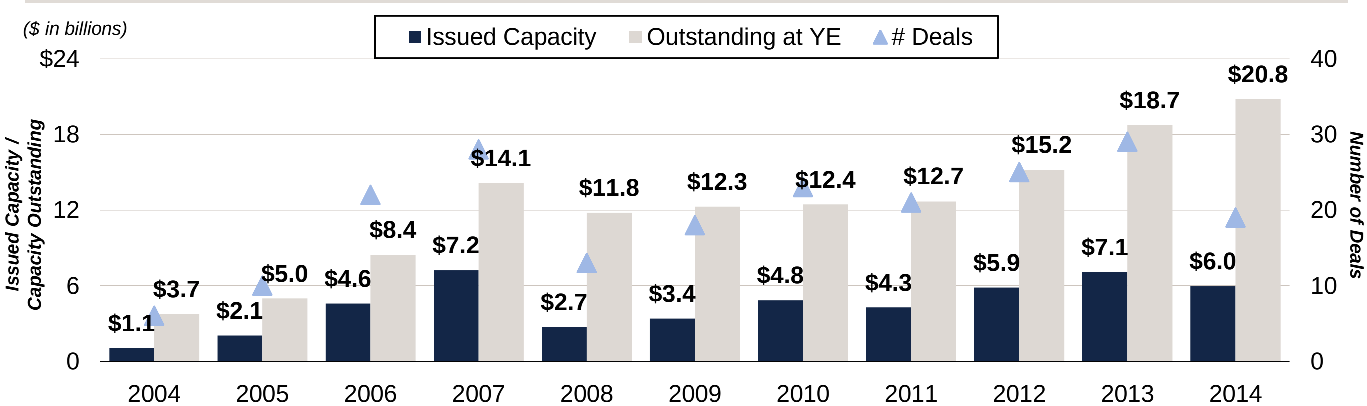


Source: WCMA Transaction Database as of 9/30/2014.
(a) In aggregate, 71% of all capacity outstanding exposed to U.S. Wind.
(b) In aggregate, 70% of all capacity outstanding exposed to U.S. Wind.

Non-Life Cat Bond Issuance by Quarter (2010 – 2014) (c)



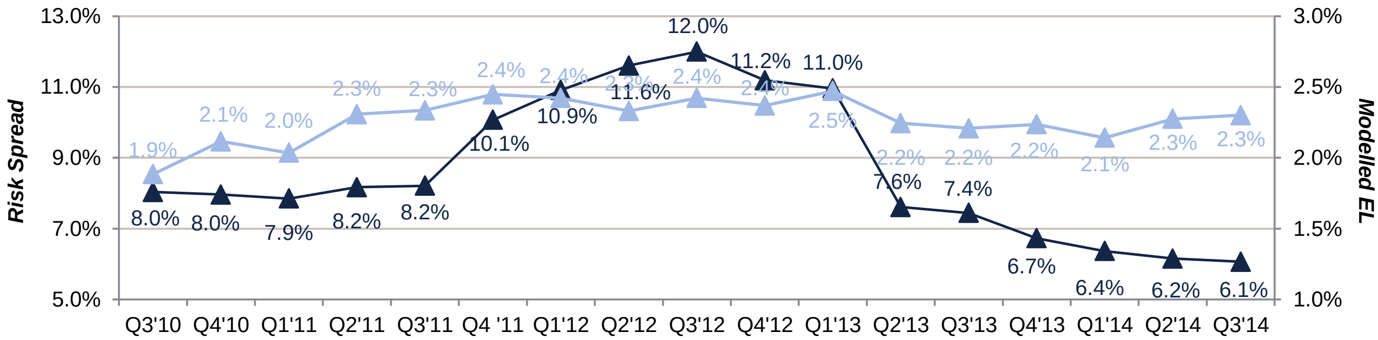
Capacity Issued and Outstanding by Year



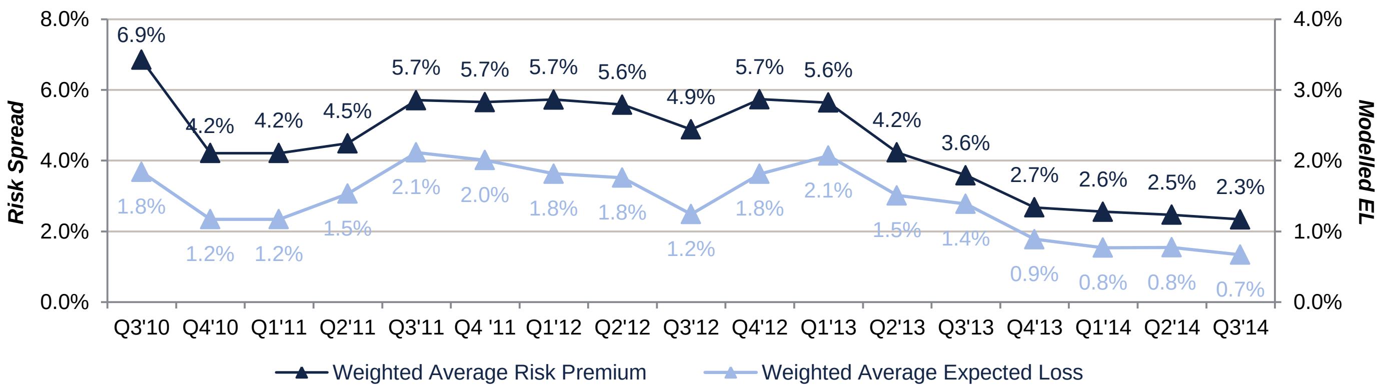
(c) All issuance amounts reported in or converted to USD on date of issuance.
Source: WCMA Transaction Database as of 9/30/2014.
Note: Data excludes private ILS deals which, in some cases, have the potential for some of the liquidity present in more traditional Rule 144A cat bonds.

Q3 2014 Cat Bond Market Statistics (Continued)

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



Source: WCMA Transaction Database as of 9/30/2014.
LTM = Last twelve months. Data is for primary issuance and does not reflect secondary trading.

Secondary Market Trading Overview

"Investors are approaching Q4 with a hint of optimism… good things may arrive soon in the cat bond space"

Q3 followed a robust issuance season with new capital having already been deployed and portfolio managers choosing to lightly rebalance portfolios for the U.S. wind season. The environment was characterized by calm seas and smooth sailing with many participants sitting on the sidelines, electing to collect coupons, squeezing in a vacation, marking their portfolios for the summer's end seasonal spread tightening and anxiously awaiting primary issuance.

Hurricane Odile's Baja California landfall caused MultiCat Mexico Series 2012 Class C to take an approximately 50% markdown in the secondary market. Portfolio managers are convinced of the impending value reduction, but await confirmation from post event procedures. Hurricane Odile follows the South Napa quake which had spared cat bond investors from losses.

Investors appear to be approaching Q4 with a hint of optimism. They look at the heavy bond maturities in January with the hope that good things may arrive soon in the cat bond space.

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