

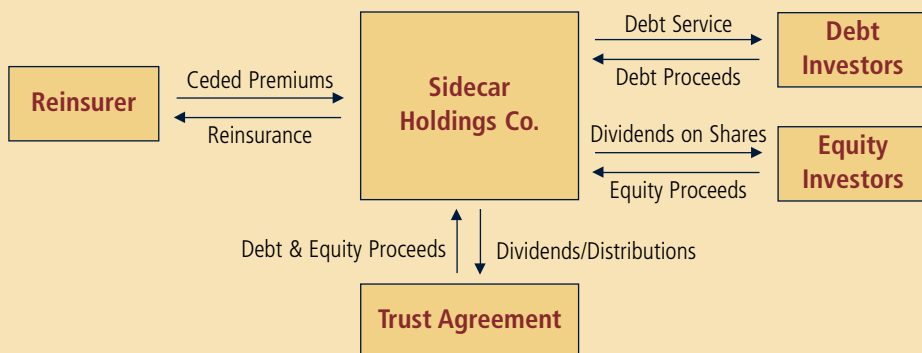
# Perspectives – Insurance Sidecars

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## What Is a Sidecar?

Sidecars are financial entities created to allow investors to take the risk and return of a small and limited category of insurance policies – generally short-tailed property catastrophe policies written by a (re)insurer – without taking on the long-term investment risk associated with a (re)insurer’s entire book of business or legacy loss reserves. A.M. Best defines sidecars as “limited-life special purpose entities that generally provide property catastrophe quota-share reinsurance exclusively to its sponsor.” Others refer to them as “disposable reinsurers.”

A.M. Best has provided the following diagram of a simplified sidecar structure.



In 2006, approximately \$5 billion was raised to fund reinsurance sidecars. Industry experts project that this number will increase several fold by 2008, making sidecars an increasingly significant element in the reinsurance world. Below is a list of recent sidecar activity.

| 2005           |                |                      |
|----------------|----------------|----------------------|
| Sidecar Entity | Capital Raised | Reinsurer Sponsor    |
| Blue Ocean     | \$355M         | Montpelier Re        |
| Cyrus          | \$550M         | XL Capital           |
| Flatiron       | \$840M         | Arch Capital         |
| 2006           |                |                      |
| Sidecar Entity | Capital Raised | Reinsurer Sponsor    |
| BayPoint       | \$150M         | Harbor Point         |
| CastlePoint    | \$265M         | Tower Group          |
| Concord        | \$730M         | AIG (Lexington)      |
| Helicon        | \$330M         | White Mountains Re   |
| Kaith/K5       | \$370M         | Hannover Re          |
| Monte Forte    | \$60M          | Flagstone Re         |
| Petrel         | \$200M         | Validus Re           |
| Sirocco        | \$95M          | Lancashire Re        |
| Starbound      | \$315M         | Renaissance Re       |
| Timicuan       | \$70M          | Renaissance Re       |
| Panther        | \$360M         | Hiscox               |
| Triomphe       | \$185M         | Paris Re             |
| Syncro         | Unknown        | Chaucer Holdings PLC |

*Perspectives* is a periodic publication of the Willis Property Resource Group, addressing timely and pertinent property risk and protection issues for the risk management professional.



## Why Sidecars? The (Re)insurer Perspective

While sidecars emerged after 9/11, it was the capital-depleting 2005 hurricane season that prompted A.M. Best and other credit agencies to raise the bar substantially in terms of minimally acceptable capital levels for reinsurers and insurers. In essence, (re)insurers were forced to either decrease the amount of Property Catastrophe insurance they could write or increase capital reserves enough to ensure that losses could be paid based upon the new catastrophe loss landscape shaped by the 2005 hurricane season. (Re)insurers embraced sidecars because they improve their balance sheets, allowing them to write more business than their own base of capital would normally allow, while still maintaining acceptable financial credit ratings. It is worth mentioning that sidecars are generally fully collateralized and also provide their sponsors with ceding and profit commissions.

## Why Sidecars? The Investor Perspective

On the other side of the equation, investors primarily made up of private equity and hedge funds have viewed sidecars as worthwhile investments for a number of reasons. On a macro level, an abundance of private equity and hedge fund capital has been available for deployment. This capital is seeking extraordinary returns on investment not easily obtained in the traditional financial markets. Reinsurance sidecars allow these investor groups to deploy capital in today's reinsurance capacity-constrained hard market and generate a high ROE (said to be as high as 20 percent):

- (i) Without taking on any legacy risks associated with the 2005 hurricane season or before
- (ii) Without taking on the long-tailed liabilities that reinsurers use to diversify their books of business (diversity lowers volatility and therefore the potential for extraordinary returns)
- (iii) Without being tied to financial market risks associated with traditional capital markets and public securities
- (iv) Without having to hire their own underwriting staff

Put simply, sidecar investors are seeking high-yield and unencumbered short-tailed investments that are driven by event-based risk and that allow for easy entrance and exit. It is the relative ease of entry and exit associated with sidecars that captures investors' attention and dissuades them from investing in either well-established reinsurance companies or start-ups.

We stress the point that sidecars are designed to be opportunistic investments that can be terminated very quickly. Given that most sidecar arrangements have a term of one-to-three years, investors will shift their focus toward opportunities with greater rates of return once pricing softens or losses persuade sidecar investors to exit. In some cases, sidecar investors have mid-term exit mechanisms in place if rates soften beyond investor appetites. Therefore, stability of this capital is ensured only to the extent that hard market pricing prevails, and investors are not in significant loss positions. Interestingly enough, some postulate that the departure of sidecar capacity would in and of itself cause a firming of the market due to near-term capacity shortfalls, thereby creating opportunity for others to take advantage of hardening rates – a kind of Catch-22 for those who want to stay one step ahead of the market.



## The Impact of Sidecars

Recent sidecar activity has allowed (re)insurers to increase their deployable limits for US Property Catastrophe business. Policyholders should benefit from a greater amount of available capacity in the currently constrained environment. Even though rates remain high, sidecars are enabling companies to fully subscribe their programs, which would be difficult at best to do in today's environment without this surge of additional capital.