TRADING Risk

INSIDE
ISSUE NUMBER: 34

- Sidecars
- US renewals
- Ratings storm
- Cat models
- Private market
- ILW stasis

Insight and Intelligence on (Re)insurance Convergence with the Capital Markets May 2011

Cat bonds slow but no panic

Cat bond structurers say the market is still on track to grow in 2011 despite a sluggish start to the wind season build-up.

Trading Risk surveyed a handful of major structurers for their ILS sales predictions at the start of this year and did the rounds again for this issue. The consensus remains at around $5bn-$6bn of new issuance for the full year.

Most structurers kept their sales forecasts unchanged but Goldman Sachs partner Michael Millette took a more optimistic view, upping his predictions by $1bn.

"We have a good shot at this being a record issuance year," he said, noting that significant hurricane losses would bump sales up further still.

But others were more muted. Aon Benfield Securities president Paul Schultz said he would focus his forecast on the lower end of his original $5bn-$6bn range.

"We believe that there could still be a very active second half of the year," he said. But as the firm's first quarter ILS market report pointed out, the Q2 pipeline is looking lighter than the same period last year.

With pent-up demand from investors, this is likely to push pricing down, the broker predicted. However, it said the slow quarter would not push annual sales below last year.

"We're still quite bullish on the activity, in part just due to the capacity on the investor side," Schultz said.

Broker GC Securities could not be reached for comment by publication deadlines, but its quarterly ILS market report said there was an increasingly murky outlook for the rest of the year.

It said some sponsors were taking a wait-and-see approach, putting pre-wind season bond offers on hold until they had more clarity on traditional reinsurance pricing at the 1 June renewals.

Renewals of the Japan-exposed bonds maturing this year – Tokio Marine's $200mn Fhu Jin and Zenkyoren's $300mn Muteki – are on hold due to disruption from the Tohoku disaster, *Trading Risk* understands. Meanwhile, potential US sponsors are also still reviewing the latest RMS hurricane model, as Aon Benfield Securities' report noted.

However, certain renewals are expected before the official 1 June start to the wind season, including the perennial USAA Residential Re offering and a return of the Massachusetts state wind pool to the market, according to sources.

With more than $1bn of issuance under its belt, the market still has a good chance of reaching "at least" the low end of $5bn-$7bn sales forecasts, GC Securities said in its report.

Its chances would depend on relative pricing between traditional and capital markets, as well as further catastrophe losses.

Munich Re's Rupert Flatscher also cited an influx of pension *... continued on page 2*

Nephila launch races off to $1.7bn start

Guy Carpenter's CWIL product picks up on bullish private market

Leading convergence investment manager Nephila Capital has sold $1.67bn of a new hybrid indemnity and parametric contract, *Trading Risk* can reveal.

The technology, developed and brokered by Guy Carpenter, uses industry loss data calculated from Property Claims Services (PCS) and breaks it down to a county-weighted level for (re)insurance buyers. The resulting index can be used as a trigger mechanism for risk transfer contracts, including catastrophe bonds, swaps and private reinsurance transactions.

Nephila Capital – which manages $4bn of insurance-linked assets for institutional investors – sourced new, dedicated funds from pension investors specifically to generate capital for the initiative.

Managing principal Frank Majors described it as "the most exciting product I have seen in many years".

The firm wrote $100mn of product based on the county weighted industry loss (CWIL) trigger in 2009, $465mn in 2010 and a stellar $1.1bn to date in 2011. The firm is continuing to write high volumes of business in the run-up to the US wind season.

Private reinsurance contracts using CWIL contracts offer collateralised, cover to protection buyers with minimal basis risk. The product is offered over-the-counter (OTC) and can be executed within days, adding to its appeal among buyers of insurance-linked capital markets protection.

And the use of PCS loss estimates shortens the final settlement date after a loss, thus appealing to sellers of the product.

Although more than $6bn of cat bond capacity has been secured since the beginning of 2010, an increasing number of would-be ILS sponsors are also considering private county-weighted transactions, taking volumes to more than $1.5bn in the same period.

The product will also compete with other insurance-linked instruments such as industry loss warranties (ILWs), swaps and options.

It is unlike 144A cat bond products, which can take months to complete and require detailed disclosure from the sponsor and costly structuring, legal and rating agency input.

In contrast, private CWIL-based products can be analysed within hours by Guy Carpenter's in-house experts and quoted and completed within days by the seller.

Despite being relatively small, CWIL's success in recent months offers another example of the growing predominance of the private or OTC *... continued on page 10*

ISSN: 1756-784X

... Nephila sets new convergence product off to $1.7bn start *continued from page 1*

sector in the insurance-linked capital markets.

Goldman Sachs partner Michael Millette recently noted that for him the "signature event" of 2010 was the amount of collateralised reinsurance written outstripping outstanding cat bond volume for the first time. He estimated outstanding volume of cat bond capacity at about $13bn and collateralised reinsurance capacity to be about $15bn for the year (see page11).

The success of new instruments such as CWIL reflects the protection-buying market's appetite for a variety of products and capital sources.

Allianz Re president Amer Ahmed has expressed his desire for diversification: "By using the capital markets, we want to diversify our sources of capital, give ourselves the ability to get different structures, different constructs," he said last year.

And the CWIL product appears to fill a niche in the market, according to Guy Carpenter managing director Erik Manning. "Many clients that chose to buy CWIL in the traditional market rather than issue a cat bond have renewed their covers, some of those clients more than once by this time."

"The fact that clients tend to renew says that the product has struck a chord with the market," Manning told *Trading Risk*.

Manning, who joined Guy Carpenter in September last year, pioneered the county-weighted concept in 2008 as a cat bond trigger. The LAZR trigger was used on the $120mn ILS transaction Blue Coast – sponsored by Allianz Risk Transfer and managed by Deutsche Bank.

French reinsurer Scor also used the trigger on its 2009 Atlas V transaction, when AIR Worldwide modelled the PCS industry loss to county level.

Protection buyers from global (re)insurers, regional and national US (re)insurers, state wind pools, Bermudian and European reinsurers and Lloyd's syndicates have snapped up the product, which has been sold exclusively by Nephila Capital via Guy Carpenter's distribution network. Nephila has used the contract both to assume risk and to hedge risk for its investor portfolios.

CWIL reduces basis risk – the risk that a buyer's own (indemnity) losses will not match the pay-out from a parametric or industry loss estimate when a natural catastrophe hits – as it aims to refine the PCS industry loss breakdown to provide the closest match to the buyer's own exposure map in the US.

Several non-insurance corporations are also considering buying CWIL as a complement to their traditional insurance programmes, *Trading Risk* believes.

The product aims to bridge the gap between buyers of catastrophe protection seeking more, or higher credit quality, coverage, and investors seeking a zero beta positive expected return, Nephila principal Adolfo Peña told *Trading Risk*.

"CWIL cover is less expensive than pure indemnity coverage, as the protection seller is insulated from company-specific issues such as loss adjustment, growth, and data quality, that should require some additional technical price.

"Yet for a company with a good understanding of their underlying exposures, the risk of mismatch between a loss and recovery is far lower than that for a more blunt form of hedging instrument such as a state, regional, or national ILW or parametric contract," Peña said.

The success of the county-weighted product has been demonstrated by the introduction of similar structures by broker Aon Benfield – with its INCA contract – and ISO subsidiary Verisk, which uses AIR Worldwide expertise to break down PCS industry loss numbers. Both are more recent initiatives than CWIL but are gaining traction in the market, and both are supported by Nephila.

What price certainty? A case study

How CWIL stacks up against traditional indemnity cover

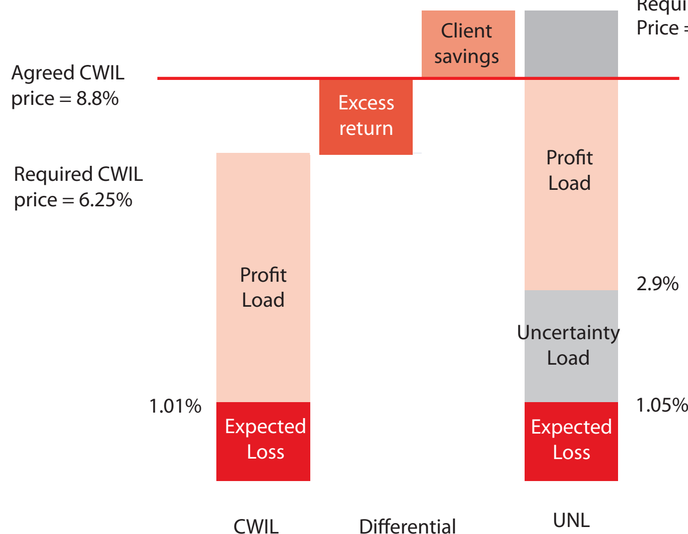
Company X was seeking large amounts of well-rated capacity, and Nephila funds already wrote a significant amount on the traditional indemnity programme.

However, additional growth beyond this participation was limited by its concern with respect to data issues. It believed traditional reinsurers were not charging high enough premium for uncertainty about the data quality from the cedent.

Given the amount of coverage the insurer was looking to purchase, Company X explored alternative methods of securing additional coverage, including issuing catastrophe bonds and buying industry loss warranties.

As part of this effort, it approached Nephila to ask how it could secure maximum capacity.

Nephila explained its pricing mechanism, and, having made clear that Company X would be paying a significant additional premium to remove operating risk as well as market penetration basis risk, was able to convince it to invest the time to understand CWIL as a possible solution.



Company X worked with Guy Carpenter to determine the weights (which can be thought of as market share) for each county, and asked for a quote on the basis of the stipulated county weights.

Nephila calculated an expected loss of 1 percent – virtually the same as the indemnity layer if the uncertainty in data/operations was stripped out – and a required price for $150mn of 7 percent.

A gap existed between the price Company X was paying in the traditional reinsurance market (10 percent) compared to the cost of ceding on a county-weighted basis (7 percent).

Nephila chose to rebate a significant proportion of this difference, in recognition of the value of sharing this saving in "cost of goods sold" with the buyer, and quoted a price of 8.5 percent. Such gaps are consistent with technological innovation, and must be shared in order that first movers accrue the advantages.