MANAGING EXTREMES

Q1 2012 ILW update

On the up…

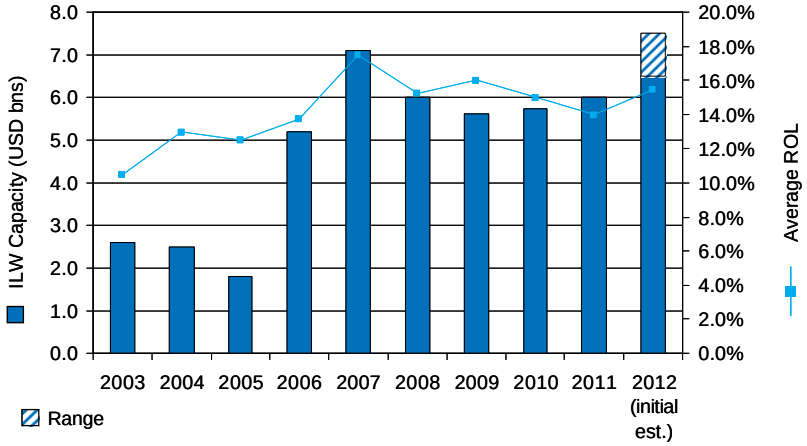
2011 activity will drive 25% growth in ILW volume for 2012

In 2012, the industry loss warranty (ILW) market is expected to be back at peaks in trading volume and pricing last seen in the hard market of 2006-2007, post-Katrina Rita and Wilma.

Based on our trading volume, we estimate the ILW market traded between $2.75bn and $3.25bn at the crucial 1 January ILW trading season and we predict that the market as a whole will trade between $6.5bn and $7.5bn of notional limit in 2012.

The market reached trading volumes of $6bn last year (based off Willis Re estimates), resulting in an estimated 10 percent to 25 percent increase in trading.

And average Rate on Line (RoL) – or pricing – of the contracts is expected to be around 20 percent up on 2011 levels this year. Although the average RoL of 15.5 percent predicted for 2012 falls short of the average 17.5 percent reached in 2007, the trend is for a strong year for the ILW market.



ILWs are private reinsurance or derivative transactions, triggered by an index of the total industry loss arising from a natural catastrophe.

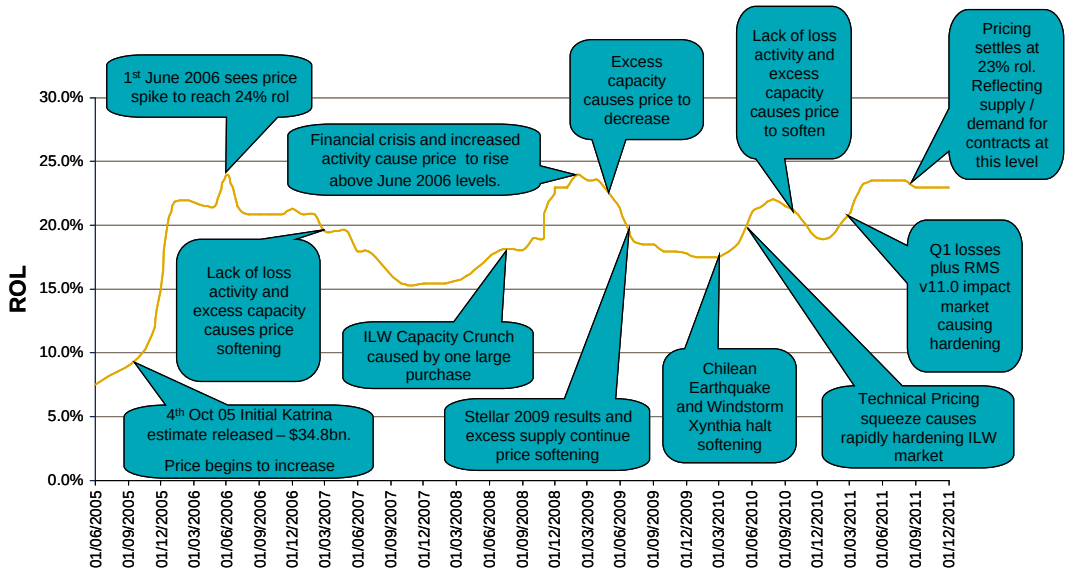
However, it is important to note that as a semi-commoditised product, pricing and capacity in the ILW market tends to react more swiftly than in the traditional markets, where contracts are renewed typically once a year. Year on Year (YOY) RoL comparison provides an interesting perspective on pricing trends however we feel it is often hard to track pure renewal pricing trends as there are many external factors that can influence a deal, including size, security and relationships. The recent vendor model changes have also made it harder to use a pure "expected loss load" for comparison purposes.

However we observe generally that loss-affected contracts experienced a 30-50 percent price increase in January and non loss-affected contracts were 10-20 percent up on a year-on-year basis.

We saw significant pricing volatility on contracts at 1 January. This was caused by a record tally of natural catastrophe losses in 2011 (see box out below), vendor model changes and shifts in capacity caused by supply and demand fluctuations.

It is difficult to distinguish between the impact of risk modeller RMS' Version 11 US wind model and the wider impact of 2011 losses on ILW buying demand and capacity supply. Our view is that the new model had more impact at year-end than at mid-year as both buyers and sellers have become more acclimatised to the new model..

As you can see from the line graph below, an indicative $30bn US wind contract is now priced at 23 percent RoL – a 20 percent increase on the 19 percent RoL it carried last January.



In the second half of 2011, there was heightened speculation on availability and pricing of retro capacity for the 2012 season, which – conversely to the late renewal in the traditional market – pushed ILW protection buyers into the market early to seek cover.

Indeed, we even saw some contracts bound in Monte Carlo in September for 1 January.

However, once the ultimate net loss (UNL) renewal season began with gusto, the ILW market slowed slightly as clients and markets concentrated on renewing their traditional book of business.

Despite the hiatus, at time of going to press the majority of 1 Jan UNL renewals had been put to bed and we have seen a significant uptick in ILW trading.

A maturing palate

Another interesting observation from this season was buyer interest in locking-in pricing and capacity over multi-year contracts as an efficient way to provide a long-term hedge to their portfolios.

With the uncertainty around the supply of retro capacity, multi-year ILWs also help to soften spikes in retro pricing.

Buyer appetite also continued to drive innovation in contract design, with heightened interest in purchasing ILWs with aggregate trigger levels – rather than the standard one-shot single event trigger – and multi-peril triggers.

More buyers also sought to tailor their protection for 2012, in structured deals that drilled cover down to state, county or Cresta level.

We are increasingly seeing demand for structured deals that aim to minimise basis risk and are tailored to suit a buyer's portfolio. This is matched by sellers looking to offer capacity that suits the buyer's needs, but that still triggers on an industry loss estimate rather than the buyer's own loss experience.

The term “private cat bond” is often used when discussing the ILW market and we have continued to see cedants looking to a private placement as opposed to a public security.

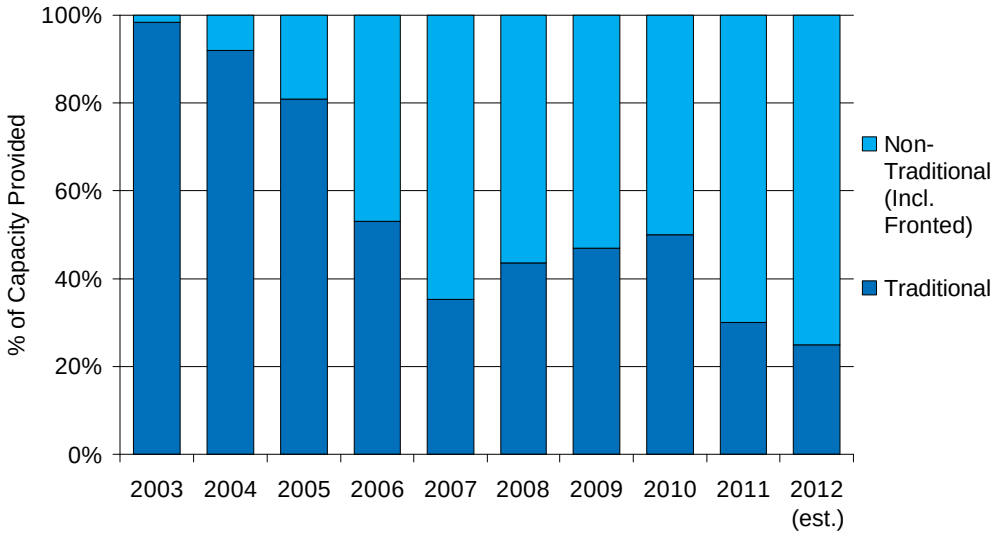
At one extreme of the spectrum we may negotiate a highly structured, multi-year, $50m+ collateralised reinsurance deal as an ILW, while at the other end the smaller spot trade in a peril and territory that is very transparent – like a US Wind $50bn industry loss trigger – is still a standard trade.

Balance of power

As we have mentioned in previous reports, the ILW continues to cement itself as an integral part of a buyers exposure hedging strategy.

The ILW market continues to be controlled by a handful of large participants with whom many ILW protection buyers share a multi-faceted relationship. The capacity provider may increasingly offer cat bond protection or collateralised reinsurance capacity on the buyer’s main programme as well as selling ILWs.

And, following a theme that we have tracked over the past year(s), the ILW market continues to shift towards the capital markets as the dominant protection providers. For 2012, around 75 percent of the estimated $6.5-7.5bn of ILW capacity traded will come from capital markets players – including those that use a fronting reinsurer to support a collateralised cover (see bar chart).



The large cat funds have been highly successful in raising money during 2011 and we have certainly felt this translate into growth in the ILW market.

However, we have also seen the arrival of a couple of large new entrants into the market at 1/1/12. The ILW product is viewed as an efficient way to invest in a catastrophe related derivative product. There is no information exchange and contract wordings are becoming increasingly standard.

Proving their worth…

ILWs pay out on 2011 cats

The record natural catastrophe loss year of 2011 has been well documented for the ultimate net loss (UNL) market – but less comprehensively for the ILW sector, where a succession of substantial individual events caused a number of pay-outs on contracts.

Thus the instruments have proved their worth in a testing year – and the response appears to have triggered a swift uptick in trading interest for 2012.

As discussed in previous ILW reviews, territorial contracts outside the peak perils of US hurricane and quake, European windstorm and Japanese wind and quake historically carried lower trigger levels.

The threshold for non-peak zones such as Australia, Canada, Chile and New Zealand – so-called "cold spot" ILWs – typically attached around $5-10bn last year, but could be as low as $3bn.

As shown in the table below, a total of four non-peak events exceeded an industry loss estimate of $3bn. September's Hurricane Irene and Japan's Tohoku earthquake were the only peak peril catastrophes to exceed $3bn.

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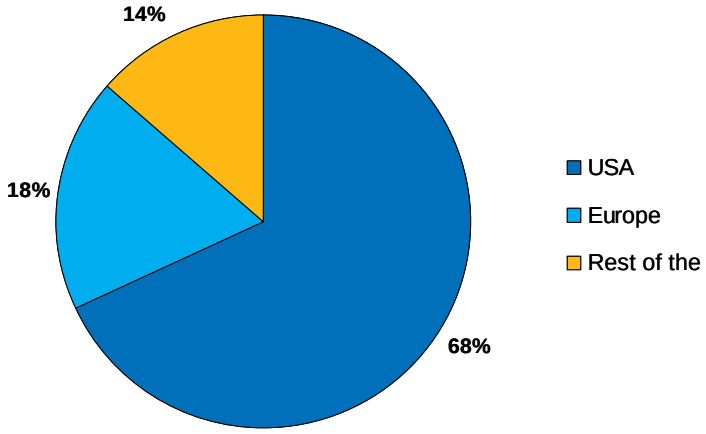
However, it is important to note (see pie chart) that the majority of ILW exposure is to the peak territory of the USA.

Approximately 70 percent of (outstanding) contracts have US exposure, while only 14 percent cover the Rest of the World zones (based on Willis Re estimates).



A total of 17 events – totalling industry losses of more than $96bn – exceeded $1bn of losses each.

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2011 insured losses > $1bn

Event	date	est. $bn	source	xs $3bn
Australia, Queensland Floods	January	2,400	ICA	0
US winter freeze	Jan/Feb	1,425	PCS 35-6	0
Canada, Alberta Horizon fire	6 Jan	1,300	Willis Re	0
Australia, Cyclone Yasi	2-7 Feb	1,300	ICA	0
New Zealand EQ 2	22 Feb	12,750	M/S avg.	12,750
Japan, Tohoku EQ/Tsun	11 Mar	37,500	M ($35-40bn)	37,500
US Tornadoes Kansas/Missouri et al	3-5 April	2,000	PCS 42	0
US Tornadoes N & S Carolinas et al	8-11 April	1,510	PCS 43	0
US Tornadoes N Carolina/Texas et al	14-16 April	1,400	PCS 44	0
US Tornadoes Alabama/Tennesse et al	22-28 April	7,300	PCS 46	7,300
US Tornadoes Missouri/Ohio et al	20-27 May	6,900	PCS 48	6,900
US Tornadoes Texas/Oklahoma et al	16-22 June	1,200	PCS 53	0
New Zealand EQ 3	13 June	3,000	(various 2-4)	0
Denmark, cloudburst	2 July	1,000	Willis Re	0
US, Hurricane Irene	26-28 Aug	4,300	PCS 59	4,300
Thailand, flooding	Oct-Nov	10,000	M/S avge.	10,000
France, floods	Nov	1,100	CCR	0
Worldwide		96,385		78,750

Speed is of the essence

The trigger on an ILW is invariably linked to a loss reporting index – either Property Claims Services (PCS) in the US, Perils AG in Europe and Swiss Re's Sigma or Munich Re's NatCatService for the rest of the world.

Most loss indices were not designed to service the traded reinsurance sector and therefore have faced criticism from the ILW market regarding late reporting dragging payment on contracts.

Indeed, Swiss Re and Munich Re may only report loss data once – and this could be up to a year after the event has occurred.

However, with multi-billions of ILW dollars exposed to the events of 2011, the ILW market responded swiftly and pragmatically.

In Willis Re' experience, loss estimates were released in a timely fashion in 2011 and contracts that were affected by Japan and New Zealand actually paid out in advance of the anticipated annual loss reports.

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MANAGING EXTREMES Willis Re ILWs

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