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More acceleration ... or slamming on the brakes?

Is the industry's two-year love affair with the sidecar over? Jeremy Golden explains the structure behind them and the opportunities they continue to afford

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The enormous catastrophe losses of 2004 and 2005 continue to generate shockwaves through the property reinsurance market, concentrated mainly on underwriting commercial and residential property risks.

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One clear outcome for reinsurers is to draw sustenance from the capital markets for alternative, creative and fully transparent solutions to underwrite catastrophe risks. This applies not only to Florida but the whole southeast US wind exposure and how that correlates to the Caribbean.

Sidecars, can best be defined as temporary reinsurers, mostly Bermuda-based, and backed by investors such as private equity firms and hedge funds. There has been a proliferation of sidecars established in the past two years.

The sidecar vehicle quota share mechanism that creates a structure using the capital market and relying on underwriting expertise goes back to the early days of Lloyd's and it is not a new concept in itself. Where the sidecars differ from earlier models is in the construction of setting up a new company, a capitalised entity, not controlled by sponsoring company, used multiple times in 2006 and 2007.

Currently, sidecars are mainly used for property catastrophe reinsurance, which are easier to model and to define aggregates for, but such vehicles also exist for direct property insurance such as Concord, the AIG supporting sidecar, the second largest in the market. Participants can also identify other potentially efficient applications for sidecars beyond catastrophe, although such vehicles are not yet in place.

While you could argue that just as it makes sense to judge whether a new catamaran is really seaworthy after staying upright during a torrid storm and not from its sparkling exterior when sitting in the marina, so the viability of sidecars is still under some scrutiny.

Structuring sidecar deals

Guy Carpenter's investment banking specialty practice has been involved in structuring sidecar deals. The practise offer mergers and acquisitions advisory services, private debt and equity capital raising and structured finance transactions.

Christopher McGhee, managing director, based in New York, is cautious about judging the success or not of the vehicles: "We cannot say definitely if sidecars are successful, as it depends on what people thought their returns would be. Returns in sidecars are driven by two main factors: losses and premium income. If losses are lower and/or premiums are higher than expected, investors' returns will be happy. If, however, premiums are lower and/or losses are higher than expected, they are likely to be unhappy. As such, you need to know what return expectations were set for each vehicle/deal. Generally, this information is not readily available.

"Sidecars were seen as a good way for the reinsurers to offload excess catastrophe risk, at a time when rating agencies were putting tight restriction on them. The agencies were instructing reinsurers to hold more capital against a given level of Cat risk. Sidecars essentially freed up capital. At the same time, sidecars can also be a source of fee generation."

In short, sidecars could fulfil two purposes: if the reinsurer felt compelled to move risk off balance sheet; or as a means to generate fee income, but not looking to add more risk. This is the way the capital structure works.

Christopher McGhee neatly describes the process as 'accordion capital', because it allows you to expand and contract underwriting capital when opportune to do so.

John Nichols, Jr, president of RenaissanceReVentures outlines a parallel motivation for sidecars: "To my mind there are three main motivations for sidecars. Firstly, they enable reinsurers to have a larger market share than they otherwise could using their own balance sheets. The second motivation is demand driven, where demand exceeds supply in relation to a certain attachment point within a class of business or region.

Finally, some sidecars are purely retrocession vehicles, in short, looking to apply retro protections. A trend I see evolving is for US direct insurers with catastrophe exposure increasing their use of sidecars as a structure for their business - or at least seriously considering it as an option."

In summary, the upside is that investors get access to business that they otherwise could not access. However, Equity interest in a sidecar is not publicly traded, like a Cat bond, which could be seen as a downside.

Renaissance Re recently launched a sidecar, Starbound II, dedicated to providing reinsurance capacity for the Florida homeowners market, creating approximately $375m in reinsurance capacity.

"I believe that sidecars are here to stay, as it is perceived as a more efficient way to get capital in and out of the market, compared to the start-up IPO model. Depending on the interest of investors, the sidecar has less operational risk and liquidity risk. It will be interesting to see how it interplays with the start-up IPO model. There will always be investors who see more value in the start-up IPO model than a sidecar.

"Sidecars should look at other ways to optimise the portfolio of risk for the capital structure, and they will continue to evolve in bringing stability to the market when capital withdrawal has taken place," summarises Mr Nichols.

Adequate testing?

Have sidecars been adequately tested? Mr McGhee states: "The new classes of sidecars in 2006 and 2007 have not been properly tested post-2005, having only experienced very limited losses so far. However, plenty can still happen in this wind season as shown by Hurricane Andrew, one of the most destructive hurricanes on record, which struck in late August in 1992."

Mr Nichols says: "Cat losses in 2004 and 2005 did not adversely affect investors' willingness to put capital to work in sidecars. People understood what they should and should not do. Similarly, Cat bonds had difficulties with Hurricane Katrina, but have also continued. Reinsurers have learnt to stay focused on the lines that they are writing, with a full view of the risk."

"Starbound II was different from Starbound I. We were approached by a single client to explore the possibility of establishing a sidecar. We agreed with that client and the broker that if we could raise the capital, the client would provide the product to the entity. So Starbound II was established to serve that client, who wanted a higher degree of certainly that their program would be fully placed but had very strict criterion. They were happy to work with us and the vehicle required significant effort and collaboration.

"In this transaction, we worked intensively with Merrill Lynch and Benfield to achieve our aims. An important component of sidecars is the creation of a team that brings different capabilities, such as debt placement skills, risk validation skills, access to market, and so on. Sidecars are reliant on collaborative skills to bring the vehicle to market.

"In the end, the outcome was very successful in the sense that we got the capacity to market. We brought attractive business to the capital markets and will continue to do so."

Responding to trends

Panther Re is unusual as it was set up by Hiscox for the London market, not the Bermuda market. Hiscox's Charles Dupplin explains: "Essentially we were responding to the same trends in the reinsurance market, a tremendous hardening of the rates and a marvellous opportunity presented itself to get the vehicle in place - Panther, New Point, Cyrus and other similar vehicles, whether supporting London-based or Bermuda-based insurers all came together in response to the same observation. There was a confluence of factors: the whiff of profit in the nostrils of the sidecar equity investors; a bond market hungry for the debt; capital hungry insurers; and the promise of fees for the investment banks - and deals were done."

Panther Re was set up very quickly, the decision taken in July 2006 and the structure in place within just 12 weeks. Four main people were involved on the Hiscox side but calling on around 40 people in total working including various Lloyd's departments and a strong team from Goldman Sachs.

According to Dupplin, one of the main challenges was to reconcile the vehicle with Lloyd's traditional structure, and he is very grateful to Lloyd's for responding to the tight timetable in a pragmatic, constructive way, leveraging their expertise as 'masters of quota share rules'. The original rules were, of course, drawn up for when sidecars did not exist.

"Panther is a Bermuda-based vehicle trading with a Lloyd's syndicate. The way Lloyd's reports is so utterly different from how a Bermudian reinsurance company reports that there were many challenges in simply getting the parties involved in the transaction to understand each other's numbers.

In order for the Panther transaction to work, all parties needed the reinsurance to be deemed a qualifying quota share, a special category of reinsurance contract in the Lloyd's market. From a capital point of view, it is very efficient, all parties being very focused on return on capital. Now there is precedent established to allow similar vehicles to come into Lloyd's - a structure that works."

From the Hiscox point of view, it is very attractive to have our team of dedicated underwriters able to write more business where rates in the cycle are very strong. We are paid a salary and profit commission to source the business. The interests of the sidecar investors and Hiscox are completely aligned," says Mr Dupplin.

How challenging was it to raise debt for sidecars? The Panther Re vehicle shows 40% equity and 60% debt, with both debt and equity apparently heavily oversubscribed.

Mr Dupplin does not know if sidecar debt in general will remain a class with a deep market, given the current turmoil in the credit markets, but believes this might happen providing future sidecar propositions are sensible and well structured.

He believes, however, that at least in the short term the spreads over US treasuries may widen, which in turn would reduce returns for equity investors in sidecars. Analysis of debt in something like the Panther vehicle is incredibly complex however and investors and rating agencies are still to some extent on a learning curve.

Panther Re Structure

- Panther Re participates via a quota share agreement in the reinsurance underwriting of Syndicate 33, a leading Lloyd's syndicate managed by Hiscox;

- Under the terms of the Quota Share, Syndicate 33 cedes 40% of its new and renewal property catastrophe reinsurance business, from certain territories to Panther Re;

- Capitalisation was funded with the following mix of debt and equity: 60%: $216m of secured term loans - two tranches; 40%: $144m of equity.

The future of sidecars

All of these sidecars are going to reach maturity and start to unwind, if participants had a good experience then they will be keen to continue but if there is tremendous event, it will undoubtedly affect future of sidecars. Catastrophe bonds by contrast are much easier to understand.

The principle difficulty in sidecar structuring is to achieve an elegant solution to the wind up. If no losses occur it is easy to do so, and simple losses are also relatively straight forward but if a major hurricane event happened it can become quite complex to wind up. Each deal has bought a little improvement in the clarity of the wind up.

Mr McGhee believes: "Investors are sophisticated and if the vehicles are properly structured and competent lawyers have written the documents correctly, which we can assume is the case, how losses get settled and winding up the vehicle, should not be difficult. It should be relatively easy to wind up, but that does not mean that there cannot be misunderstandings."

Likewise, Mr Nichols asserts: "The market has spent a lot of time on contractual provisions of wind up - balancing the interests of investors who want clear liquidity and the way that the vehicles have evolved indicates that unwinding will not be that difficult., It will be very efficient, which is important. It is critical for investors to get in and out of the market efficiently and sidecars are structured to respond to the needs of the investor to withdrawal from the market based on risk appetite."

Will sidecars continue? Mr Dupplin's strong view is that they will: "It is a highly efficient way of raising short-term capital for an insurer and from the sidecar investor's perspective they get access to an existing management team and renewal book of business, which is also very attractive. Enough sidecars have been done now so that there is a 'balance of economics'. Interests are aligned between the parties and there is accepted precedent as the profit is shared between the insurer and the sidecar."

"The next time around we will not be alone. The London market is mighty, by merely having a stall in the London market we have access to enormous amounts of business that is not accessible to Bermuda and vice versa.

"Each sidecar has a defined life - Panther in due course will wind itself up. We would love to do Panther 2 and 3 if we can identify a great opportunity in catastrophe reinsurance or insurance, and if conditions were right."

SIDECARS: APRIL 2005 UNTIL JULY 2007Sidecar Name Client Insurer Total financing sizeFlatiron Arch $840mConcord AIG $730mCyrus XL $525mKaith Hannover $414mMaRI Ace $400mStarbound II Renassance $375mPanther Re Hiscox $360mBlue Ocean Montpelier $355mHelicon White Mountains $330mStarbound Renaissance $315mCastlepoint Tower $265mNew Point Harbor Point $250mPetrel Validius $200mTriomphe Paris Re $185mMaxwell Ace $175mBay Point Harbor Point $150mNorton Re Brit $108mByrus XL $100mBlue Ocean Montpelier $100mScirocco Lancashire $95mRockridge Montpelier $90mTimicuan Renaissance $70mMonte Fort Flagstone $60mSource: Hiscox

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