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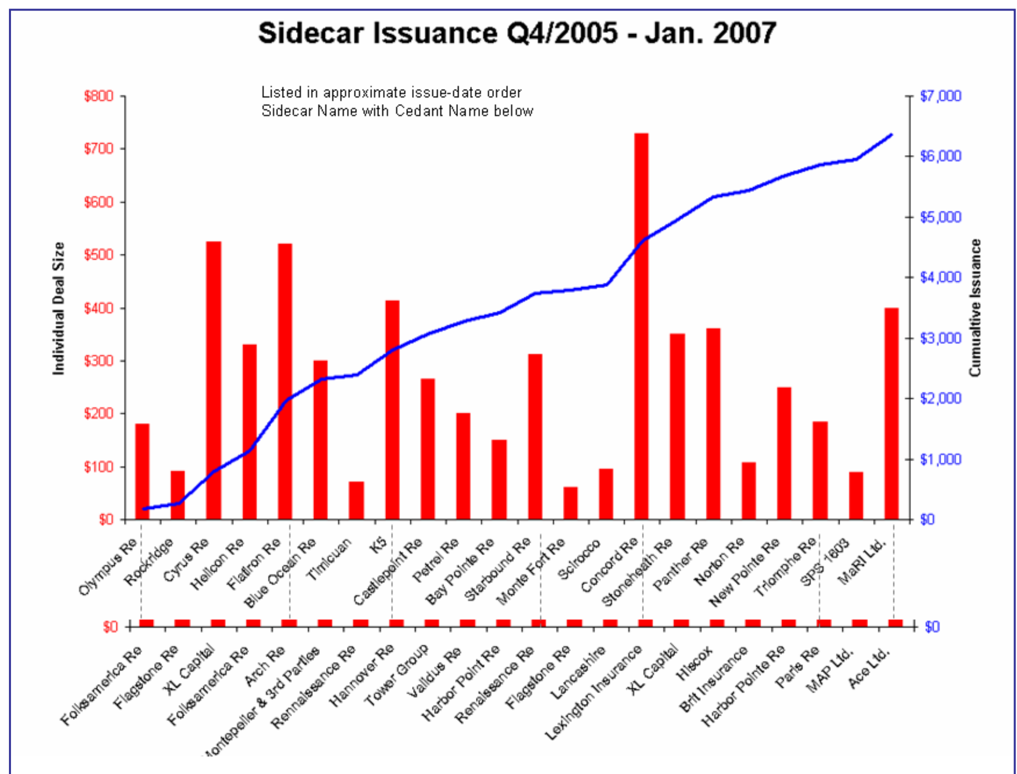
January 31, 2007

OF SIDECARS AND SUCH

By: Morton N. Lane, President

Sometimes it happens that one word so captures the zeitgeist that it is immediately adopted into the language as if it were always present. So it was with the word "sidecar" at the beginning of 2006 in the language of the reinsurance world. In the scramble to replace capital lost in the Katrina, Rita and Wilma (KRW) hurricanes of 2005[1] a variety of new mechanisms was being utilized; sidecars was one of them. It was not exactly a new mechanism; by our count in the preceding ten years between $2 and $3 billion of capital had been raised by a mechanism that would now be called a sidecar. Those forerunners were called by a variety of names, but generically could be called capped quota shares. Since re-branding, the same vehicles have raised some $6.5 billion in new capital in a period of 15 months, see Figure 1. The purpose of this note is to record that dramatic development and to lay out an "issues set" for issuers and investors in these vehicles.

Figure 1



Pre-history

The first sidecars or capped quota shares issued to the capital markets arguably occurred in the mid-1990s. Hannover Re issued a private vehicle called K1 to a handful of investors (K being a reference to the German word for

[1] This process was described in our companion article *"Recapitalizing Reinsurance – a never-ending story"* January 31, 2007.

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catastrophe). It raised some $85 million and gave investors a slice of Hannover's book of business, premiums and losses alike, up to the capitalized maximum of $85 million. At about the same time Goldman Sachs packaged up part of the underwritings of the St Paul Companies into a security called Georgetown Re. Unlike many of today's insurance linked notes this vehicle did not have a fixed coupon and its payoff was intricately linked to part of St Paul's underwritings. Both were essentially quota share arrangements, but with defined limits of exposure given by the capital provided by investors. At the end of the investment, investor's funds (net of any losses/plus any profits) were returned. Any adverse development after maturity was born by the cedant (Hannover and St Paul in the above examples). Thus the transactions were not pure quota share, but capped by the capital.

Because of the capping or residual feature of the investment, the return was not the return that a pure quota share participant would get. It would be less because of the implicit cost of that cap. It would also be less because of placement and performance fees, of which more later.

Table 1

Sidecar Name	Principal Investors	Cedant	Issue Date	Amount - $ Millions	Notes
K1	Private	Hannover Re	June-94	85	Arguably the first sidecar
Georgetown Re	Private	St Paul Cos	June-95		
K2	Private	Hannover Re	November-96	110	
Top Layer Re	Private	Rennaissance Re	June-99	100	
Da Vinci	Private		October-01	500	
K3	Private	Hannover Re	April-02	200	
P-1	Private	PXRE	Apr-03		Annulled after marriage
CPP	Various, Private	Rennaissance Re	1996-2003		
Select Re	Private	PXRE	1996- 2004	200	Wound-up after 2004
Qualifying Quota Share	Private, Berkshire Hathaway	Numerous Lloyds Syndicates	2000-2004		Discontinued after 2005
Op Re	Private	Rennaissance Re			
Olympus Re	Leucadia Nat Corp	Folksamerica, Sirius	June-05	500	
C1	Private	Hannover Re			
				1695	
Other Significant Structures					
CIG Re		Citadel		500	
Newcastle Re		Citadel			
Lehman Re	Lehman			500	Much Discussed never truly took off

Also in the mid-1990's other issuers undertook similar capped quota shares. PXRE entered into an arrangement with Select Re[2] that lasted for some seven years until 2004. Renaissance Re issued various private arrangements under its CPP[3] program and at the end of the 1990's formalized arrangements under Da Vinci Re and Top Layer Re. Interestingly, in a pattern that would be repeated in 2006, while nearly all of these arrangements were done privately, only a few would be done with the benefit of an investment banker.

Perhaps the largest use of the concept prior to 2006, however, was by Berkshire Hathaway following the World Trade Center losses of 2001. Syndicates from the Lloyds of London market took large losses from 9/11. They needed to raise capital by Lloyds' "coming into line" date in November 2001. Furthermore, the market was rapidly hardening as it became apparent that the 9/11 losses were large and widespread. Syndicates quickly took capital by means of "Qualifying Quota Share" (QQS) contributions[4]. These were temporary infusions of capital with the necessary capped quality. One of the large providers of this capital was said to be Berkshire Hathaway, so much so that the trade presses gossiped unceasingly about the fact that they may constitute between 8% and 12% of Lloyds capital. Whether this was true or not, it can be said to have been a considerable contribution. Two years later when markets began to soften, Berkshire exercised its exit option and withdrew capital, syndicates having been made partially whole again by a couple of profitable years.

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[2] In the interest of full disclosure, I served as a Director of Select Re (and its predecessor Investors Re) from 1996 to 2004.

[3] Cat Portfolio Participation Program.

[4] "Baby" syndicates may be considered another variation on this form.

Table 1 lists many of the early sidecars, and while it does not contain a figure for the QQS amounts it is clearly of the order of $1 billion and is the basis for our estimation that $2-$3 billion was raised by sidecar capital prior to 2006.

Subsequent to the mid-2000's Lloyds disallowed QQS arrangements so that they were not available directly to syndicates following KRW. Whether Lloyds disallowed QQS because they left behind a tail, in lines of business where the tail could be long, or whether they were seeking to promote more permanent solutions, we do not know. Suffice it to say that it has an effect in 2006.

Some general characteristics of Sidecars

While the term sidecar covers a variety of forms, today the essential requirements are as follows. The sidecar is a registered reinsurance company, therefore capable of assuming and holding reinsurance risk. While these limited life, special purpose or single purpose companies need not be confined to Bermuda, most of the recent ones are, and are usually registered as class 3 companies. The sidecar is usually sponsored by a ceding company from which it will derive its business or quota share. Figure 1 shows the names of both the sponsoring company and the name of the sidecar, naming being apparently a fairly exotic process carefully negotiated between capital and risk providers – often with colorful and confusing results – beware the Greek Geeks?

Of course, the spawning of a sidecar is the result of a happy meeting of issuers who want capital, and investors who judge the risk to be a worthwhile investment in a hard market. One might think that the more eager party, the capital raiser, might be the one who pays the larger price. However, the reinsurance market is not a perfectly competitive market with easy entry and exit. To get a direct slice of an underwriting book, the investor ends up paying both a management fee and a performance fee to the underwriting ceding company. And, with the popularity of sidecars and the participation of investment bankers as promoters, there has been a tendency for fees to replicate those of hedge funds – the famous 2 and 20 formula. The 2% is a management fee, imposed over and above any reimbursement of brokerage costs to the cedant; the 20% is the percentage retained by the underwriter when the business is profitable. Just as in the hedge fund world, there is an infinite list of variations on the 2 and 20 formula. Some companies will have low management fees or "over-riders" and others might have high performance fees. The over-riders can range from 1 to 3% and the performance fees we have seen as low as 10% and as high as 40%. Obviously, however, to command a 40% performance fee, you had better be perceived to be an exceptional underwriter.

The other general characteristic of sidecars is that they are typically for a fixed term, most commonly two years. There is the thinking that following a disaster such as KRW the market will be hard and stay hard for maybe three years. Investors will not want to tarry beyond two years in case the market softens earlier, or at least will want the chance to re-evaluate their continued investment at that point.

One final general characteristic of the recent sidecars is that they often have debt as well as equity components in the capital structure of the special purpose reinsurer. The debt can be seen as the senior part of the exposure and the equity becomes the junior part. Frankly, we are puzzled why the evaluation of debt and equity should be much different, allowing for the risks, etc., but that is what the market appears to do.

We have already suggested one reason why sidecars took off in 2007, namely that Lloyds disallowed QQS thereby encouraging private versions of the same. The second reason is perhaps more appealing to economists, and that is that there was a labor shortage as well as a capital shortage. One usual response to a reinsurer crisis is to start a new company, but that requires talented people who can attract capital. That is a small pool, and AM Best among others early on suggested that they would not rate new reinsurers that did not have experienced personnel on board. Investors, therefore, who wanted to invest directly in the risks of the hardened market were left with no choice but to come up with another solution. The sidecar perfectly fits the bill. Their capital is exposed to the direct risk, but their underwriting is done by the experienced personnel of the ceding company.

Table 2

Sidecar Name	Principal Investors	Cedant	Capital Structure	Issue Date	Term	Amount - $ Millions	Additional Drawdowns	Jan-07	
Olympus Re	Private, White Mtn Grp	Folksamerica Re		May-05		*$180*		$180	$180
Rockridge	West End Capital	Flagstone Re		September-05		$91		$91	$271
Cyrus Re	Highfields Management	XL Capital	$365 Equity, $160 Loan	November-05		$525		$525	$796
Helicon Re	Private, White Mtn Grp	Folksamerica Re		December-05		*$330*		$330	$1,126
Flatiron Re	Goldman Sachs	Arch Re	$256 Loan $264 Equity	December-05		$520	320	$840	$1,966
Blue Ocean Re	Montpelier Re and others Wibur Ross	Montepelier & 3rd Parties	$133 Montepelier (40%)	December-05		$300	55	$355	$2,321
Timicuan		Rennaissance Re		January-06		$70		$70	$2,391
K5		Hannover Re		February-06		$414	106	$520	$2,911
Castlepoint Re	Tower Principals, $15 Tower	Tower Group		March-06		$265		$265	$3,176
Petrel Re	First Reserve Company	Validus Re		May-06		$200		$200	$3,376
Bay Pointe Re	Golden Tree Asset Management	Harbor Point Re		June-06		$150		$150	$3,526
Starbound Re		Renaissance Re	$184 Loan, $126.5 Equity	June-06	1 year	$311		$311	$3,837
Monte Fort Re	Lehman Bros	Flagstone Re		June-06		$60		$60	$3,897
Scirocco		Lancashire		August-06		$95		$95	$3,992
Concord Re		Lexington Insurance		September-06		$730		$730	$4,722
Stoneheath Re		XL Capital		November-06		$350		$350	$5,072
Panther Re	Wilbur Ross	Hiscox	$216 Loan, $144 Equity	December-06		$360		$360	$5,432
Norton Re		Brit Insurance		December-06		$108		$108	$5,540
New Pointe Re		Harbor Pointe Re		December-06		$250		$250	$5,790
Triomphe Re		Paris Re	$64 Loan, $$121 Equity	December-06		$185		$185	$5,975
SPS 1603		MAP Ltd.		January-07		$90		$90	$6,065
MaRI Ltd.		Ace Ltd.		January-07		400		400	$6,465
					$0	$5,984	$481	$6,465	

* First "Insurance" sidecar

2006/07 Sidecars

Figure 1 and Table 2 list the sidecars of the post KRW period. It is worth highlighting certain characteristics of some of these before proceeding to our investor checklist. The Table lists 22 different sidecars, the average size of which was $300 million, for a total capital of $6.5 million raised since KRW.

The first of these listed is Olympus Re, sponsored by Folksamerica, which strictly preceded KRW. However, its story is related to the period and is quite revealing. Started in 2001, Olympus Re took some large hits from KRW. Accordingly, at the start of 2006 Olympus raised more funds (that is the number shown in the post KRW table). Investors expected to be on risk in 2006 and for risks going forward but adverse development of the KRW losses exploded the loss attributable to Olympus Re to more than its initial capital plus its new capital. This was quite an unexpected bath for new investors. To avoid reputational risk White Mountains, owner of Folksamerica, was said to have decided to arrange for reimbursement of investors, to rewrite the original quota share from 1/1/2006 on. In the new arrangement it ceded 56% of the original 35% quota share to Olympus and 44% to another new sidecar called Helicon Re. It remains to be seen if this arrangement will be acceptable to regulators[5], or if outsiders have the right picture of what really happened. However, the episode serves as a salutary but important investor caution and more banally a record setter. Helicon Re became the first sidecar of a sidecar.

Other cedants have had to address the issue of adverse development of prior losses but some investors in sidecars may have participated in sidecars without fully appreciating the nature of that risk. Hannover Re launched K5 in 2006 and raised some $415 million. At year end they then allowed initial investors an exit option as well as admitting new investors for the 2007 risks. They raised an additional $105 million from this process. The new investors for 2007 did acquire

[5] See *The Royal Gazette*, January 29, 2007.

some legacy risks from business written during 2006, but did so with open eyes. Fortunately, 2006 was one year where new investors carried little development risk because there were so few losses in 2006.

The largest sidecar issued during 2006 was Concord Re, being sponsored by AIG's Lexington Insurance vehicle. Thus an insurer has set up its own sidecar. So did Brit Insurance, so that it is not just reinsurers who are setting up sidecars. Also, cedants are not confining themselves to just one sidecar. Why should they as they may wish to access different sets of investors, some of whom may want their own dedicated vehicles. Four companies, Flagstone Re, XL Re, Renaissance Re and Harbor Pointe, sponsored two sidecars each. Furthermore, Lancashire, one of the class of 2005, has issued its own sidecar within months of its own formation and initial public offering.

Most sidecars involve property catastrophe business, because that is where the shortage is, and nearly all involve short tail business since the sidecars are usually not only special purpose but for limited life. Perhaps the most interesting peril encapsulated in a sidecar was in Petrel Re. It dwelt exclusively on marine risk, addressing specifically the shortages in the Gulf of Mexico. The cedant was Validus Re who ceded some 75% of its marine and energy book.

Investor Checklist

During 2006 investors who were interested in sharing in the risks and rewards of the hard reinsurance market were confronted with an abundance of choices, from legacy companies, new reinsurers, cat bonds and sidecars. Of these we can separate cat bonds as being different from the others. Cat bonds offer a known risk at a fixed price. Neither is there uncertainty about what risks can be acquired by the underwriter, nor is there uncertainty about the rewards that the investor will be paid. In all the others, legacy companies, new companies or sidecars, it is not known *a priori* what risk will be underwritten nor the eventual prices that will be paid. Plans will be presented, but the plan is not the reality. Of course, legacy companies will have more credibility about their business plans than will new companies and by correspondence, sidecars to legacy companies are more likely to deliver than sidecars to new companies. But that is by no means a certainty. Investors in Blue Ocean, sponsored by Montepelier Re, might have been forgiven for wondering if Montepelier might not eventually suffer the same fate as PXRE with whom it shared a similar 2005 underwriting record.

Perhaps more important than the ability to write business is the underwriting record of the sponsoring or ceding company. The single most important aspect about sidecar investments is that the investor is entering into a limited partnership with the ceding underwriter. The investor is "giving the pen" to the ceding underwriter, so question one is how good is the

Sidecar Partial Check List for Investors

Table 3

Underwriting Record/History

Alignment of Interest
- Quota Share of whole book?
- QS of "selected" book?
- First Loss?
- Discretionary Cession
- Fixed cession
- Minimum retention
- Minimum cession

Term
- Extendible or callable

Incepting Date
- Subject to adverse development

Exit
- First exit
- Fixed or Optional
- Mandatory extention
- Extention by investor election
- Cedant's put or Investor call
- Minimum gate

Risk Disclosure
- Curves

Fees
- Brokerage caps
- Arranger fees

Override
- Independent of performance?

Other Management fees

Performance Fess
- Fixed or scale

Payout Schedule

Clawbacks Highwater Marks

Caps, Tails and runoffs

Rated or Collateralised

Debt in structure

Board positions

Audit, oversight or surveillance provisions

Mark-to Market possibilities

underwriter. It seems that in the rush to get into the hard market this question is sometimes overlooked. And while we agree that pricing can override underwriting in a hard enough market, it is a question that should always be asked, if only because a sidecar investment can survive beyond the immediate market.

Having satisfied itself that the cedant (a) is able to write the business, and (b) has a decent underwriting record, the investor might next want to satisfy itself that there is a good alignment of interest. If the alignment is strong, then the investor can become comfortable that the underwriter is working on his own behalf as well as the investor's. A 50% quota share of the whole book of business is the most perfectly aligned of partnerships. Anything short of that, which most sidecars are, is less than perfectly aligned. None of the sidecars cede a share of the whole book. Nearly all of them cede only a share of part of the book, and nearly all cede only their peak exposures. Of course, that may not be a problem since part of the reason for investing may be to acquire peak risk. However, to the extent that it is used as a measure of alignment, the narrower the cession the less the alignment. Similarly, the smaller the percentage that is ceded from that part of the book, the less is the alignment. In most sidecars the cession was seldom less than 10% and seldom greater than 50% of the designated fraction of the book. Thirty percent seems to be the usual cession percentage.

Table 3 contains a list of other considerations that the investor will want to review. It is not an exhaustive list but it is nevertheless comprehensive. Of great interest to investors are the sidecar's entry and exit provisions. We have already mentioned being aware of whether the investor is exposed to past losses, but just as important is the length of the investment. Typically, these have been set up for a two year term, but often they have the ability to be extended. A few have provisions to exit earlier, but there may be a cost for this. When a deal is extended at whose option and under whose conditions will such extension take place? If there has been a loss investors may or may not want the rights of first refusal to any new sidecars that the cedant offers to other investors. On the other hand, if the investment is only partially successful most investors will want to get their remaining money out as soon as possible. They need to remember that that they have entered the indemnity world of insurance and repatriation of investor funds can take time. Some sidecars offer exit at book value, some at the calculated valuation of an independent reserving actuary. There are pluses and minuses to all of these; the point is to be aware of them.

Fees will, of course, be heavily scrutinized and comparisons made with other forms of investing. In one sense that is an error. A ceding reinsurer underwriting in a hard-to-access market is not the same as a portfolio manager trading in deep and liquid markets. Each market has costs peculiar to it. Fees and terms are more like private equity investments than hedge funds. Notwithstanding, of course the fees should be competitive. Further, the investor will want to know when intra-term dividends will be paid out and whether the profit commission is to be charged on annual performance or term performance.

Advantages and Disadvantages of Sidecars vs. Cat Bonds

Advantages	Disadvantages
Established/Experienced Underwriting Team	Higher Fees - performance
Able to respond to Circumstances	Risks unknown exactly
Alignment of interest	Inability to lock in high premiums
Access to larger market	Legacy risks?
Access to diversifying risks	Only peak exposures
Piggy-backing a good Balance Sheet	Not full transparency
Ability to negotiate collateral arrangements	No secondary market

Table 4

Finally, it is apparent that many of the sidecars are the vehicles of just a few investors. Often these are large chunks of money from

Table 5

Repetitive Issuers

Sidecars				Cat Bonds			
Renaissance Re		Hannover Re		USAA		Swiss Re	
CPP	Various			Res Re 1996	163		
Top Layer Re	100	K1	85	Res Re 1997	313		
Da Vinci	500	K2	110	Res Re 1998	450		
Op Re		K3	200	Res Re 1999	200		
Starbound	311	C1		Res Re 2000	200		
Timicuan	70	K5	370	Res Re 2001	150		
				Res Re 2002	125	Australis	100
				Res Re 2003	160	Pioneer	150
				Res Re 2004	227.5	Arbor	500
				Res Re 2005	176	Successor	1191
				Res Re 2006	112.5		
Current Totals Recoverable (Approx)	$1,000		$500		$500		$1,250

multi-strategy hedge funds. Such investors will want representation on the boards of the sidecar companies.[6]

Sidecar Debt

Many of the sidecars are heavily geared. Lenders have accepted the arguments that debt in a sidecar is a remote risk that will be attached only after equity is exhausted. Indeed that is the case. However, at the time of the loan neither the book to be ceded, nor the premiums to be obtained, nor the probabilities of attachment are known to the lender. They are either planned or estimated and one may give greater or lesser confidence to the estimate depending on cedent, rating, etc. However, whatever the statistics, sidecar debt is by and large non-recourse debt. There is seldom access to other assets to defray any outstanding balances. In this regard, sidecar debt is like a cat bond - fixed coupon, fixed term - but without the certainties about the risk embedded in the note. As such, in our opinion it should properly price at "cat bond plus" rates. While we are not privy to all such prices it would appear to have been priced at lesser rates. This is good for the equity holders - they get cheap leverage - it is, however, risky for the lenders. Cedants will be indifferent as long as the security, usually full collateralization, covers their ceded risk.

Sidecar Advantages and Disadvantages

The investor checklist discussion hopefully reveals much about the advantages and disadvantages of investing in a sidecar versus, say, a cat bond investment. It is nevertheless worth putting out some other advantages, as is done in Table 4. Two additional features stand out. On the plus side, it becomes obvious that the sidecar is a beneficiary of a strong cedant company Balance Sheet. Without that Balance Sheet it is unlikely that the sidecar investor would be able to access quality business.

On the negative side, investors who wish to accumulate several risks and develop their own portfolio of exposures may not be able to manage them precisely because of a lack of transparency. Not all sidecar presentations will contain precise peril exposure information, let alone risk curves. It may be possible to acquire such information after the start of the underwriting year, but not all cedants will want to reveal their book to potential competitors.

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[6] A good example is Wilbur Ross, an investor in and director of Blue Ocean and principal investor in Panther Re, (see WSJ January 20, 2007).

Concluding Remarks

The capital raising activities of the reinsurance industry are evolving, that much is clear. As part of that evolution sidecars have found a place on the menu of alternatives that reinsurers will use in the future, much as insurance linked notes have found their place. Reinsurance is a cyclical business and reinsurers have long sought to acquire temporary capital which is not a burden through the whole cycle. Sidecars and cat bonds fit exactly into that framework and certain issuers have been thinking that way for some time. Table 5 shows a list of repetitive issuers[7] in both sidecars and cat bonds. Renaissance Re and Hannover Re have put down the road map for sidecars, just as USAA and Swiss Re have put down the markers for cat bonds. Each has now raised incrementally enough capital so that they now have approximately $1-$1.25 billion in coverage recoverable from these mechanisms. As more and more of the big guys take note, we expect these numbers to begin to grow exponentially.

[7] Table 6 does not list all repetitive issuers, merely the ones who have been at the practice for some time.