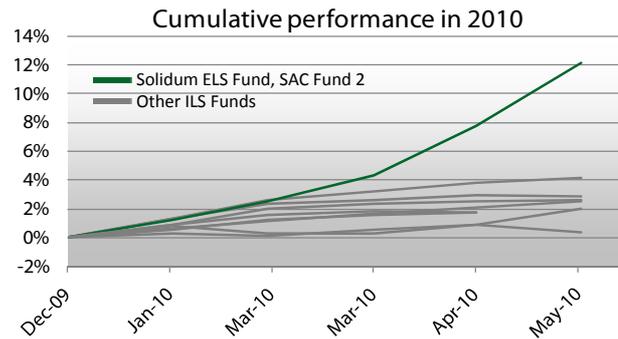


The Avalon Re Story

Attentive observers of the Solidum Event Linked Securities Fund will have noticed that the SAC Fund 2 was able to outperform significantly the market during the first half of 2010. The reason for the brilliant performance was a consequence of Solidum Partners' activities in the workout process of a distressed catastrophe bond, Avalon Re. The story of this bond can serve as a lucid example of how Solidum Partners' profound knowledge about the reinsurance market place and its functioning enables the team to generate profits for the investors in the Fund that clearly outperform the already good risk adjusted returns of the ILS asset class as such.

Avalon Re was the first ever issued cat bond to cover liability risk arising from industrial catastrophes. It came in three tranches of USD 135 mio each; the junior one (Class C) to reinsure the third loss, the mezzanine (Class B) to reinsure the fourth, and the senior tranche (Class A) to reinsure the fifth liability loss that a Bermudian industrial liability insurer were to incur over the three years from June 2005 to June 2008. The numbering of 3, 4, or 5 losses refers here to sizable and full layer losses. Events with a loss amount below 50 mio were not considered at all, and if the sponsor's share of any loss was less than 150 mio (they always kept 10% of any potential loss ceded to the cat bond, hence bringing the recovery down to the 135 mio of each layer), then only that amount would be deducted from the principal of the respective layer.

During the risk period of the bond, several losses occurred of which, in the sponsor's judgement, three qualified in scope and size under the definitions of the cover. Two of those were obvious cases (one had already been fully paid), but the third loss was less obvious to market participants and investors, both in scope and loss amount (or more exactly reserve amount, as close to nothing had been paid in losses so far). It consequently took the market by surprise when shortly before the scheduled maturity in 2008 the sponsor of the bond announced that its reserve to this Con Ed Lexington Avenue Steam Pipe explosion that occurred in July 2007 would allow it to trigger an extension to both the Class B and the Class C notes. Late reporting is not unusual, but it was difficult to imagine that a truck size hole in a street can cause



Comparison of the performance of the Solidum ELS Fund and selected comparable ILS funds in 2010

more than USD 385mio of damage, the attachment point of the policy in question. The extension allowed for a maximum of two years to wait for the further development of old claims in order to assess more correctly the ultimate loss amounts, with the bonds being off risk for any new claims. As prescribed in the offering memorandum, this happened despite the fact that even if the Con Ed loss was a total loss to the sponsor, it would only generate a partial loss to the Class C notes and nothing to the Class B notes. The Class B notes still had no loss and were only exposed to a potential adverse development. They were expected to be paid back in full at the legal final maturity in June 2010 (at the latest), however at the end of April 2008, following the announcement of the extension, the indicative bids for the Class B's came down heavily to around 80c, a price that did not at all reflect the inner value of the Class B notes.

The SAC Fund 2 had invested in the Class B a year before these events at a weighted average purchase price of 70c. Shortly before the call of the extension, the bond traded close to par and the SAC Fund 2 incurred a mark to market loss of 1% of its NAV, leading to the first negative return since its inception in December 2006. The management team immediately looked into the sparse details available with regards the Con Ed claim. From the information they had, it appeared that Asbestos had been in some way involved in the claim. This was supported by archived news articles surrounding the very public explosion in New York City. From the offering circular it was clear that losses arising from or in connection with asbestos were excluded from the reinsurance.¹⁾ next page With the management team's knowledge of reinsurance they surmised that much of the financial cost of the loss was due to so-called business interruption – the loss of

profits due to the inability to access business premises – and decontamination (as opposed to merely clean-up), both a direct result of the involvement of asbestos. Lesser loss costs would be due to physical damage arising from the explosion – from photographs on the internet one could see that the damage was predominantly a ‘truck-sized’ hole in the road intersection with surrounding buildings and windows seemingly unscathed – and to the severe injuries sustained by thankfully only five individuals.

Further the management team could not understand how Milliman, the independent actuary with the role under the offering circular of the bond of verifying and reserving for the claim, could value the claim at a figure in excess of USD 750m – more than the loss cost of American Airlines Flight 587, an Airbus A300 which crashed into Queens, NY, on 12 Nov 2001 with the loss of 265 lives. This made no sense.

The management team immediately wrote a letter to the directors of Avalon Re expressing doubts as to the validity of the claim and the reserved amount. This was responded to several months later by the sponsor of the transaction, the contractual counterparty of Avalon Re, stating unsurprisingly that they did not subscribe to Solidum’s opinion.

Solidum then requested all possible underlying documentation, however much of the pertinent documentation was subject to confidentiality and not able to be released to investors. Solidum further sent a written request to Milliman requiring that they reduce their reserves due to the excluded asbestos component. This would have had the effect of immediately releasing the Class B notes, those held by the SAC Fund 2, at par.

The management team spoke unofficially to specialist reinsurance counsel who confirmed that the claim appeared to be subject of the exclusion and that the case of the noteholders was strong. However as merely a holder of the Class B notes, and ultimately only a small investor, it was not economically viable for Solidum to engage counsel.

1) Interestingly, it became apparent later that the sponsor itself first tried to reject the incoming claim on the basis of an asbestos exclusion in the contract between the sponsor and its originally insured. However, that exclusion had a write-back clause which subjected asbestos claims to the cover when arising from an explosion. The asbestos exclusion in the reinsurance contract that covered the liabilities of the Avalon cat bond, in contrast, was absolute. This is a typical example of a so-called difference-in-condition situation in reinsurance.

On a regular basis during that time, investor conference calls were held where the sponsor read a declaration with regards to the status of the claims and the extension. The Solidum management team were very vocal regarding the inclusion of asbestos, however the sponsor held its opinion. This was despite an article in the ILS publication “Trading Risk”, following input from Solidum, which suggested to the market that asbestos was being wrongfully included in the Con Ed claim. This was denied by the sponsor at that time.

In August 2009 the sponsor of the Avalon Re notes issue made a Tender Offer to repurchase the Class B notes at 85c. In the documentation they made reference to the fact that certain claims for asbestos did exist and that they were not being segregated from the other claims and would likely be paid. This written public admission enabled Solidum to approach other investors. Solidum set up a password-protected discussion forum and ftp site for investors, putting forward its views and its argumentation surrounding the Con Ed claim and other possible potential claims that it was aware of, together with the documents that it had been able to procure. Solidum approached investors it knew owned the notes, including two large US multi-strategy hedge funds. Both these large investors were very interested in Solidum’s analysis and thoughts. The three funds’ holdings together made the majority of both the Class B and Class C notes, with one of the investors holding by far the largest participation. Lending further weight, at this time “Trading Risk” published a further long article with input and direction from Solidum which outlined the issues and confirmed that “A growing group of investors – led by Swiss Investment firm Solidum Partners” were questioning the validity of the Con Ed claim (copies available upon request).

It was decided between the three investors that it would be worth hiring counsel, and the largest investor, on behalf of Solidum and the other investor, sought representation from a reputable New York securities law firm. After several conference calls, predominantly led by Solidum, the counsel sent a letter to Milliman. This was finally rebuffed by Milliman stating that it was not their role to decline the claim. The discussions with the counsel following Milliman’s response highlighted to Solidum that those lawyers involved did not understand the peculiarities of reinsurance law. Solidum strongly suggested to the inves-

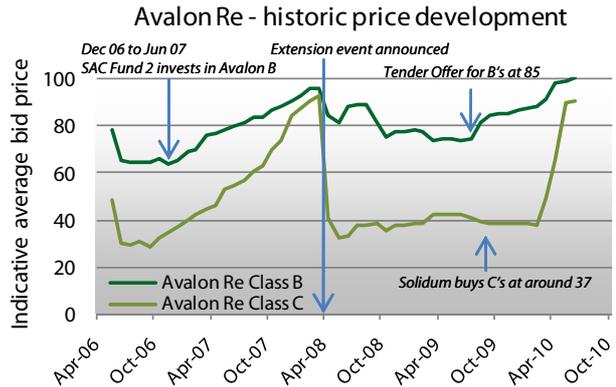
tors that they should move counsel to Jenner & Block where there was specialist reinsurance litigation experience. The group followed this advice.

In order to exploit this very promising opportunity, Solidum decided in August 2009 to purchase Class C notes. It purchased a significant amount of face value of Class C's at a combined price of 36.74c with the knowledge that the notes would be redeemed in 9 to 10 months at 68.67c based upon the sponsor's own expectation of recovering the maximum amount possible for the Con Ed claim. Any deviation downwards from that redemption price could only come from the development of two monitored claims, which either from a loss amount or because of coverage considerations had negligible chance to occur, absent tricks played by the sponsor. Because of the group's financial power to set things straight through litigation, if needed, this risk was minimal. Despite further notes being available on the market, SAC Fund 2 could not purchase additional notes whilst clearly remaining within the fund's investment guidelines for a maximum single investment.

After hiring Jenner as counsel, Solidum provided all the information it had gathered and what it believed was the case. The counsel immediately saw the issues and in close collaboration with Solidum several letters were sent stating the case. Under this pressure, together with direct pressure from Solidum on the CEO of HSBC management services when he visited the Solidum offices in Zurich, Avalon Re / administrator HSBC hired separate claims counsel to review the validity of the claim. The claims counsel performed their analysis which also suggested that at least large portions of the claim were questionable.

In late March 2010 it became definite that apart from the Con Ed claim, no further claims would be subject of the notes. This meant that in June the Class B notes would be redeemed at par and the Class C notes at the anticipated 68.67c, and caused an increase in the price of both tranches as price providers became aware of the news. With this, the base case scenario, which at least to achieve was always highly likely, had materialised. However, the story improved beyond that, and the work put in by Solidum earned further rewards.

With the opinion of Avalon Re's claims counsel, Milliman stated that they could not arrive at a reserve



Price movement of Avalon Re Classes C and B over time

for the Con Ed claim. This was strongly in the favour of the noteholders, however Ernst & Young as a final umpire would now be asked their opinion. At this time the sponsor agreed to have a discussion with the noteholders. On 28 April 2010 investors and the sponsor hammered out an agreement whereby, to avoid lengthy and costly legal disputes, thereby tying up funds for potentially years, the investors would agree to pay a settlement of 30% of the \$50mm reinsurance layer exposed to the Con Ed claim to the sponsor, allowing the C's to mature at 90.6c on the \$ on June 7, 2010.

The information was available in the public domain on 24 May 2010 and the SAC Fund 2 was able to purchase further C's at 79.5c later that week.

As a testament to Solidum's drive and expertise, the following is quotes an email sent by the largest of the investors to the group:

"This is a good opportunity to thank everyone: I wanted to thank all of you for your work on this. The collaboration between the three funds and the different people in the funds were a true pleasure. It had the value of reducing costs for all of us, but more importantly, allowed us to reach conclusions and take actions which reflect a wider experience and views - and I think it led to better decisions and end results.

I wanted to especially thank two of us:

Cedric [Edmonds, Solidum Partners], who was relentless on the subject for many years now. Your persistence, knowledge, attention to details and involvements were superb and were vital in making all of this happen.

David [Greenwald, Jenner & Block], your professional knowledge, understanding of the case and the way you stirred all of us in the right direction were really impressive."