

# Reinsurance Market Outlook

June and July 2012 Update

*Empower Results*



## Executive Summary

June and July 2012 catastrophe reinsurance program renewals include many U.S. hurricane catastrophe exposed insurers, most Australia / New Zealand exposed insurers, many Asia ex-Japan exposed insurers, and a meaningful component of Latin American exposed insurers. Reinsurance capacity, measured by capital, returned to its previous record high of USD470 billion at the end of the first quarter 2012. Insurers' capital too continued to grow to new records. There continues to be an excess of supply over demand for reinsurance globally.

The June and July renewals are the last substantial set of renewal dates in the year. While 2011 ranked second in insured catastrophe losses, it ranked first for reinsured catastrophe losses. Insurers in New Zealand, Japan, Thailand and Australia are and were extensive users of reinsurance and their reinsurance strategies protected their earnings and capital from very material direct losses. The renewals of these programs proved orderly. The reinsurance market continued to provide the required capacity at accretive terms and conditions for these insurers. The size of the 2011 ceded losses caused many reinsurers to fundamentally re-evaluate their risk assuming strategies in the affected regions. Some even called for global price increases.

Risk adjusted rate increases were targeted to non-U.S. catastrophe loss affected regions. Reinsurers, in the end, recognized that substantial reinsurance buyers in the U.S. and Western Europe already pay multiples of the pre-2011 reinsurance margins paid by insurers in the 2011 loss affected regions. We correctly projected that global reinsurance margins would not move materially until reinsurance margins in loss affected regions were equalized with peak region margins. Reinsurance margins paid by insurers outside the U.S. peak zones for hurricane and earthquake remain very low by comparison and reinsurance in these regions remains, even after significant compounding percentage increases, a highly efficient source of underwriting capital.

Despite record 2011 ceded catastrophe losses, new capital flows stand at one tenth of the new capital that flowed into the reinsurance market after Hurricane Katrina. New capital simply was not necessary to sustain the capacity demanded in loss affected regions. Price changes in those regions were again meaningful at June and July however reinsurance remains a very efficient source of underwriting capital for the regions' insurers. In a continuing 2012 trend, reinsurers rewarded insurers that grew catastrophe exposure with better risk adjusted pricing than they allowed insurers that reduced their catastrophe exposure. This trend weakens the value proposition of reinsurance, destroys demand and reduces the credibility of the reinsurance underwriting process.

Catastrophe bonds continue to enjoy an expanding market position and continue to influence the market by adding a meaningful alternative to traditional reinsurance. The issuance in each of the last three quarters has been very strong. Growing interest from investors has provided insurers better price visibility and multiple year commitments. Both features are important to insurers and new demand continues to flow to this market.

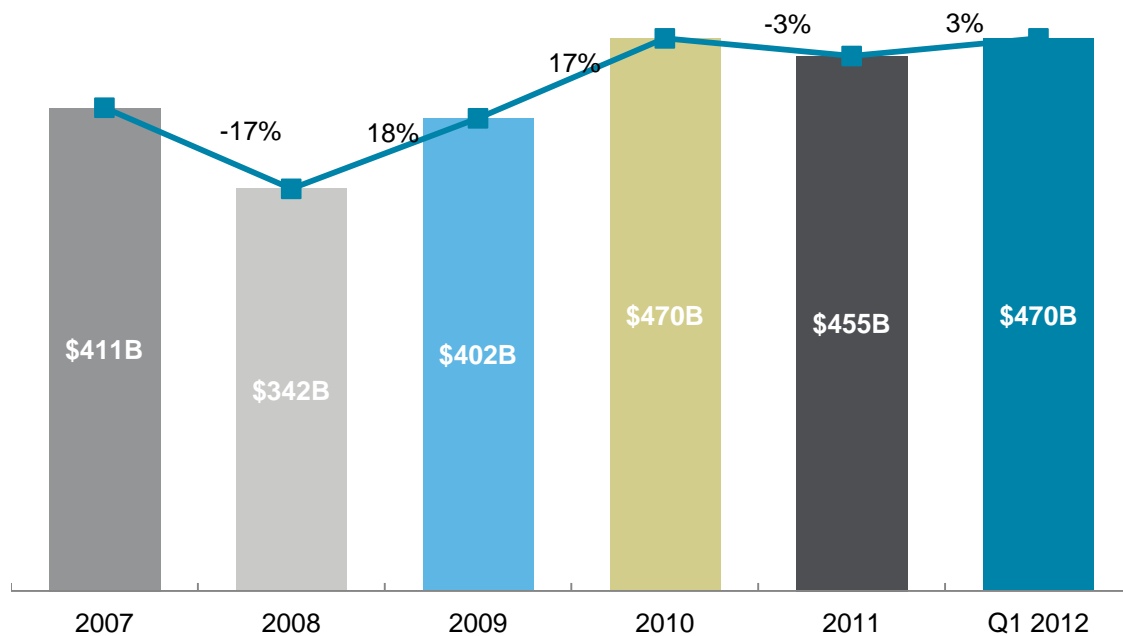
Aon Benfield is very proud to have delivered highly differentiated results to our clients in every renewing market this year. The strength of our platform has truly delivered terrific results for loss affected and non-loss affected insurers. The value of highly differentiated reinsurance execution can be measured at each renewal date and we have clearly saved our clients hundreds of millions of dollars in premiums. It is rewarding to see that significant execution benefits also accrue to our clients on the claims recovery side as well. Aon Benfield stands committed to continuing to deliver these outstanding client results.

## Supply Rebounds to Peak Levels

Reinsurance capacity increased to USD470 billion by the end of Q1 2012—back to 2010 peak levels. Lower than average global catastrophe losses through Q1 and increased premiums at January 1 renewals assisted reinsurers in increasing capital.

Low catastrophe loss activity in Q2 is expected to result in further increases of capital for half year 2012 results and capacity for global regions renewing at June and July 2012 remained stable.

**Figure 1: Change in Reinsurer Capital**

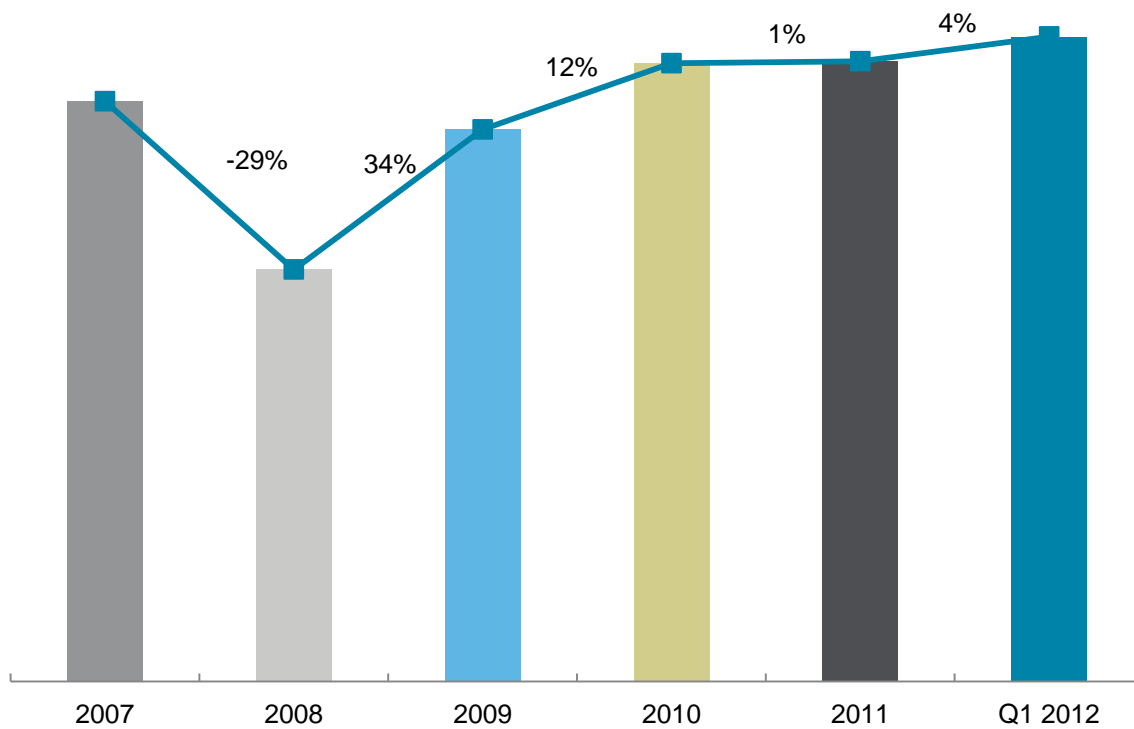


Source: Individual company reports, Aon Benfield Analytics

## Demand Stable Despite Some Insurers Increasing Net Retentions

Insurer capital increased in Q1 2012 by 4 percent over year end 2011 levels to a new peak, again as a result of the lower than average global catastrophe loss activity. New demand in peak regions at June and July 2012 renewals has been offset by the continuing trend of insurers to increase retentions or take larger co-participations. As a result of the increase in capital held by insurers and the ability to retain additional net losses, the capital benefit and budget for reinsurance protection will continue to be re-evaluated.

**Figure 2: Change in Insurer Capital**

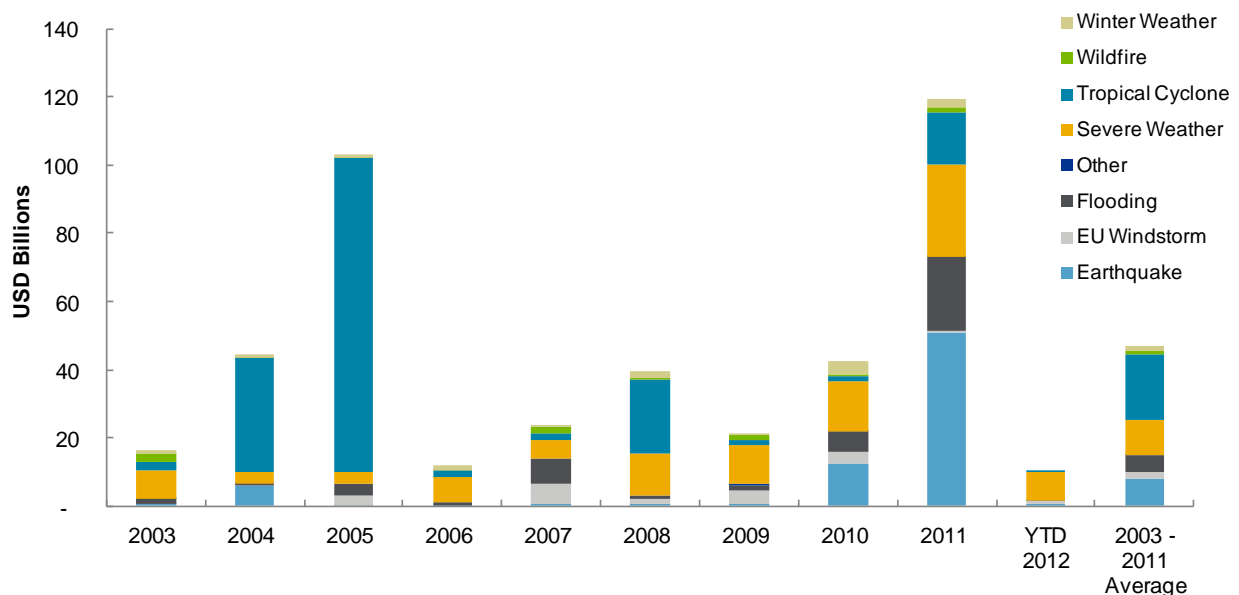


Source: Individual company reports, Aon Benfield Analytics

## Insured Catastrophe Losses Lower than Average Through Q2

Following catastrophe loss activity in 2011 that was more than double the average in recent years, the Q1 and Q2 2012 results imply that 2012 is on pace to produce lower than average annual insured catastrophe loss. Q1 and Q2 global insured loss experience for 2012 is currently half of the average of recent years Q1 and Q2 loss activity. Severe weather, predominantly in the U.S., dominated global losses for Q1 and Q2 as it comprises 83 percent of the overall insured loss. That said, severe weather losses are in line with the 2003 – 2011 average activity to date, and remain significantly lower than the experience of 2011.

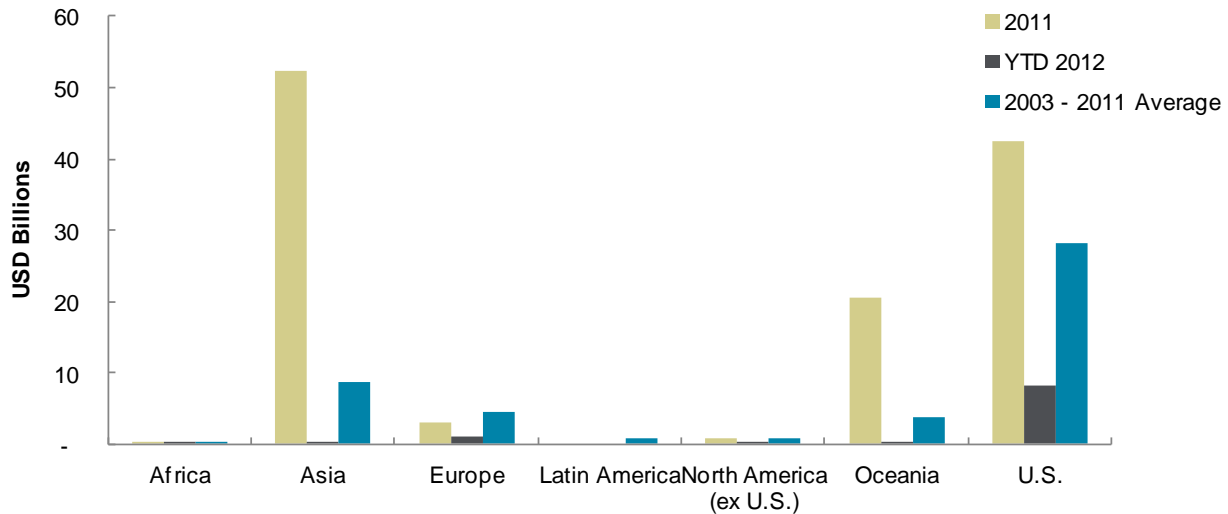
**Figure 3: Annual Insured Losses By Event Type (USD Billions)**



Source: Aon Benfield Analytics

To date, catastrophe loss activity in all regions remain well below 2011 results and annual averages in recent years. The U.S. is the only region with significant insured catastrophe loss activity in 2012 incurring approximately 30 percent of the average losses in recent years. Final experience in the region for 2012 will depend significantly upon the outcome of the Atlantic Hurricane Season which began just a month ago.

**Figure 4: Annual Insured Losses By Region (USD Billions)**



Source: Aon Benfield Analytics

## Christchurch Update

Following an extended period of seismic activity, reconstruction in the Canterbury region has started. The insurance industry has been responding strongly in a complex claims settlement and underwriting environment and is now turning its attention to understanding the long-term implications of these events.

Since September 2010, 41 earthquakes of magnitude 5.0 or greater have impacted the Canterbury region. The rate of these larger magnitude events has been slowing and the epicenters have been migrating offshore, away from the Christchurch central business district. No events greater than magnitude 6.0 have been recorded since December 23, 2011.

**Figure 5: Earthquakes in Canterbury since September 2010**

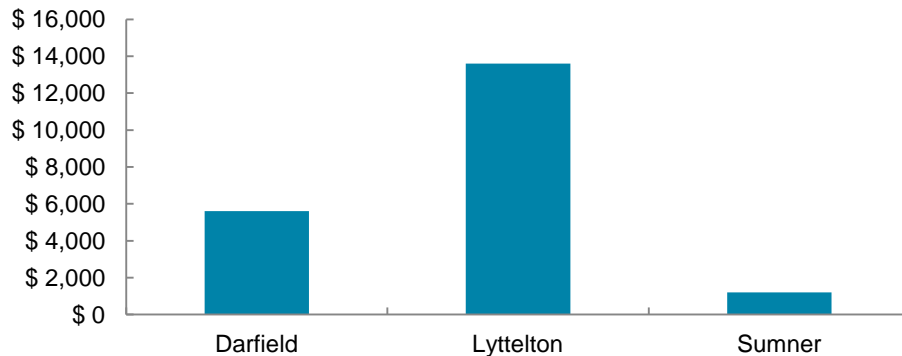
Magnitude	Quantity
5.0-5.4	30
5.5-5.9	7
6.0-7.0	3
>7.0	1

Source: GNS 27/6/2012

It is estimated that over 80 percent of the population of Canterbury have been directly affected by these earthquakes. In total, the cost of these events is estimated at approximately 15 percent of New Zealand's 2011 GDP.

The ongoing seismic activity, complications surrounding the distribution of insured loss between the EQC (the New Zealand residential insurance scheme for geophysical perils) and private insurers, the assessment of claims within the cordoned central business district (CBD), the issuance of new building codes and the apportionment of loss between events have all complicated the establishment of robust loss estimates. As each of these obstacles is addressed the ability to refine loss estimates increases. Figure 6 shows the total estimated losses for the three most costly earthquakes as at the time of writing (Darfield - September 4, 2010, Lyttelton - February 23, 2011 and Sumner - June 13, 2011).

**Figure 6: Insured Losses from Major Christchurch Quakes (NZD Millions)**



Source: Aon Benfield Analytics

One of the unique features of these earthquakes is the significant and extensive land damage. The initial recovery period post-event was slowed as Central Government undertook an extensive program of land zonation and a review of the engineering remedies available for reconstruction—the result of which was a decision to retire areas that were deemed uneconomical to rebuild.

Reinsurers have been very supportive in their response to this complex situation. Most reinsurers have recognized that clarity regarding these losses is evolving and that prompt funding for these losses is paramount to the recovery.

The New Zealand insurance market has responded very strongly with underwriting changes post-event. Primary premiums have increased significantly, with fire premium rates increasing approximately 20 percent for small commercial risks and 40 percent for large commercial risks. Natural peril premiums have increased approximately 100 percent for small commercial risks and in the order of 150 percent to 200 percent for some large commercial risks. These rates do vary based on geography and perceived natural peril risk. For homeowners’ policies, private insurer premiums have risen between 25 percent to 50 percent from February and the EQC premium rate has increased threefold. Combined with these price increases, insurers have implemented significant changes in cover, including increased deductibles and sub-limiting some coverages.

One outcome of these events is a proposed review of the EQC scheme. The scope of this review is currently under development, however it is believed the inquiry will be broad ranging. Prior to the September 2010 earthquake, the EQC had accumulated a fund in excess of NZD5 billion (USD3.9 billion), which is now almost exhausted.

While the underwriting changes have been positively received by reinsurers, reinsurance rates on New Zealand earthquake risk have understandably risen. These increases are driven by a combination of sustained losses, uncertainty and opportunism. Mitigating these price increases is that overall capacity has not diminished and the rate increases are attracting some new entrants.

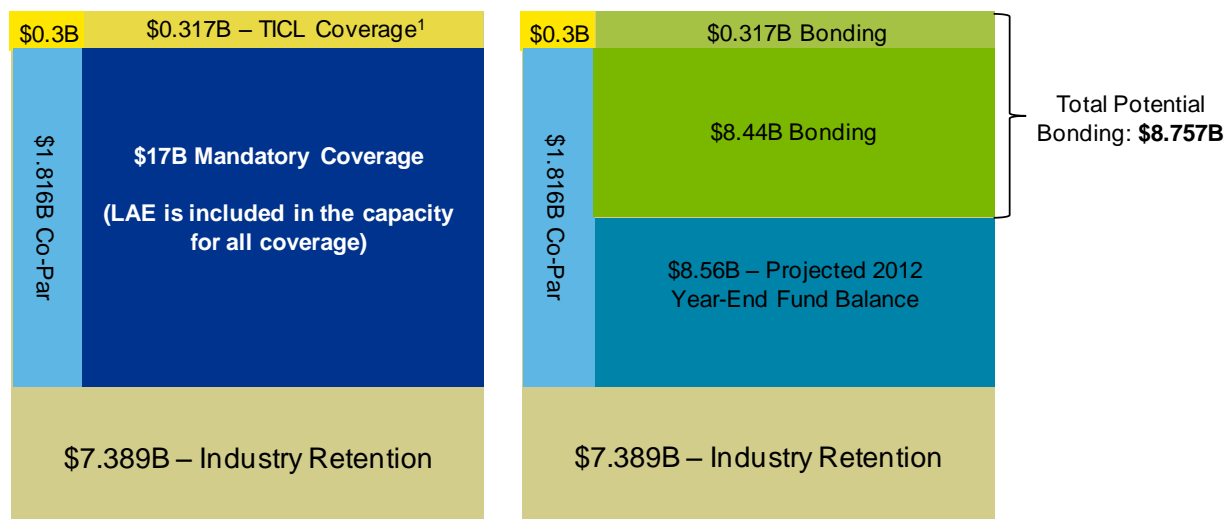
For many years the New Zealand Government, often under the guise of the EQC, has invested heavily in natural hazard research through various government, academic and private institutions. These efforts have been redoubled post these events as New Zealand recognizes that the experiences of Canterbury hold crucial lessons for the industry going forward.

## FHCF Cash Increases as Potential Liabilities Declines

The Florida Hurricane Catastrophe Fund potential liabilities are expected to decrease by more than USD1 billion since the prior contract year as a result of legislative changes in 2012 and the expected decrease in selections for the TICL capacity. 2012 legislation eliminated the underlying coverage previously provided to limited apportionment companies and those that participated in the capital build-up program resulting in a reduction in liabilities of approximately USD411 million. In addition, expected take-up for TICL according to the FHCF is expected to drop from USD1.14 billion to USD0.317 billion.

In addition, the projected fund balance is expected to increase by USD1.31 billion compared to a year ago as a result of premiums to be paid for the 2012 contract period. The lack of storm activity has allowed the FHCF to build cash to USD8.56 billion (the highest in the fund's history).

**Figure 7: FHCF Anticipated Coverage and Claims Paying Ability**



<sup>1</sup>Available TICL capacity is USD 4 billion for the contract year. FHCF estimates for selections for the 2012/2013 contract year are USD 0.317 billion. Source: Aon Benfield Analytics

As a result of the decline in potential liabilities and increase in fund balance, the total potential bonding required has decreased by more than USD2.5 billion (from USD11.3 billion to USD8.757 billion) from the prior contract year. Available bonding estimates provided by the FHCF senior managers in May ranged significantly, yet 3 of the 4 senior managers expected the market would have capacity for the required bonding by the FHCF through a combination of tax-exempt and taxable bonding. Goldman Sachs estimates remained low, at USD3 billion to USD8 billion.

**Figure 8: FHCF Potential Bonding Estimates**

	Citi	Goldman Sachs	JP Morgan	Barclays	Average
<b>Tax-exempt:</b>					
0-12 Months	3	1-3	3-4	3.5-4.5	3
12-24 Months	2	1-3	2-3	3-4	2
Total tax-exempt	5	2-6	5-7	6.5-8.5	6
<b>Taxable:</b>					
0-12 Months	5-6	1-2	3-4	5.5-6.5	4
12-24 Months	2-3	1-2	2-3	5-6	3
Total taxable	7-9	2-4	5-7	10.5-12.5	7
0-12 Months Total	8-9	1.5-4	6-8	9-11	7
12-14 Months Total	4-5	1.5-4	4-6	8-10	5
<b>0-24 Months Total</b>	<b>12-14</b>	<b>3-8</b>	<b>10-14</b>	<b>17-21</b>	<b>12</b>

Source: Aon Benfield Analytics

## Florida Citizens: More Reinsurance / Less Assessments

Florida Citizens secured USD1.5 billion in private market protection through a combination of USD750 million in traditional reinsurance and USD750 million in catastrophe bond capacity for the 2012 hurricane season—an all time high for the corporation. As a result of the small increase in demand for private market capacity (up USD175 million from the purchase for the 2011 hurricane season), increases in rates secured at January 1 renewals, and light catastrophe activity in Q1, reinsurers were able to provide the coverage to Citizens without further disruption to private insurers also looking to renew their reinsurance placements.

2012 legislation also significantly reduces the burden on Florida insurers. Prior legislation had clarified that assessments were considered advancement of funds reducing insurers concern over the ability to recoup regular assessments from Citizens. Yet, the legislature took another step to significantly diminish the potential liability of insurers through elimination of regular assessments for both the personal lines and commercial lines accounts (down from 6 percent for each account) and a reduction in the coastal account from 6 percent to 2 percent.



## National Flood Insurance Program Reauthorized

Following a series of short extensions, a five-year reauthorization of the U.S. National Flood Insurance Program (NFIP) was signed into law by President Barack Obama July 6. New provisions result in the following changes to the NFIP:

- Eliminates the federal subsidy on premiums for new or lapsed policies on second homes
- Reforms how NFIP rates are determined, eliminates subsidies under certain circumstances and establishes a commission to recommend standards and guidelines for federal flood maps
- Incorporates premium adjustments to reflect current risk of flood, allowing the maximum annual premium increases to go from 10 to 20 percent
- Requires Federal agency lenders to accept private flood insurance as satisfaction of the flood insurance coverage requirement
- Reiterates FEMA's authority to buy private reinsurance to back the program
- Requires a reinsurance assessment report to congress that includes capacity of private reinsurance, capital, and financial markets
- Conducts an assessment on claims paying ability, including the role of the private reinsurance sector
- Adds a provision for FEMA to build a reserve fund to assist in losses for above average years. The fund balance shall maintain 1 percent of the total sum of potential loss exposure on outstanding policies
- Development of new methodology by FEMA to determine expense reimbursement for Write Your Own program participants

# Forecasters Predict Near Normal U.S. Hurricane Activity

Forecasts are for near normal hurricane activity for the 2012 hurricane season. TSR, CSU and NOAA all expect the level of named storms to be at or slightly above average levels while the expectation for hurricanes and major hurricanes remains at or below average.

**Figure 9: U.S. Hurricane Season Forecasts—TSR, CSU and NOAA**

	Named Storms	Hurricanes	Major Hurricanes
<b>TSR (June 2012)</b>			
Average	10.7	6.2	2.7
2012	13.8	5.8	2.7
Difference	+3.1	-0.4	0
<b>CSU (June 2012)</b>			
Average	9.6	5.9	2.3
2012	13.0	5.0	2.0
Difference	+3.4	-0.9	-0.3
<b>NOAA (May 2012)</b>			
Average	12	6	3
2012	9-15	4-8	1-3
Difference	0.0	0.0	-1.0

Source: TSR, CSU and NOAA

## Capital Markets Reaches New Levels

The Insurance-Linked Securities (ILS) market began the second quarter with strong momentum following the record USD1.5 billion issued in the previous quarter. Seven catastrophe bonds successfully closed, providing USD2.1 billion of new capital to both repeat and new sponsors. The ILS market continues to see growth and as of June 30, 2012 there was USD14.9 billion of catastrophe bonds on risk, up USD3.4 billion compared to the same period in 2011.

The trend of cedents favoring indemnity coverage continued from the first quarter when Liberty Mutual Insurance Company successfully moved to indemnity coverage from industry index. In the second quarter, The Travelers Indemnity Company sponsored their first indemnity transaction and successfully upsized Long Point Re III Ltd. to \$250 million.

**Figure 10: Q2 Catastrophe Bond Issuance**

Beneficiary	Issuer	Series	Class	Size (MM)	Covered Peril(s)	Trigger	Rating	Expected Loss	Interest Spread
Louisiana Citizens Property Insurance Corporation	Pelican Re Ltd.	Series 2012-1	Class A	\$125	LA HU	Indemnity	Not Rated	3.54%	13.75%
Allianz Argos 14 GmbH	Blue Danube Ltd.	Series 2012-1	Class A	\$120	US HU, EQ; MX HU; CAN EQ	Industry Index	BB+ (S&P)	0.59%	6.00%
			Class B	\$120	US HU, EQ; MX HU; CAN EQ	Industry Index	BB- (S&P)	1.77%	10.75%
Mitsui Sumitomo Insurance Co	Akibare II Ltd.	Series 2012-1	Class A	\$130	JP TY	Modeled Loss	BB (S&P)	1.04%	3.75%
Citizens Property Insurance Corporation	Everglades Re Ltd.	Series 2012-1	Class A	\$750	FL HU	Indemnity	B+ (S&P)	2.89%	17.75%
Swiss Reinsurance Company	Mythen Ltd.	Series 2012-1	Class A	\$50	US HU	Industry	Ba3 (Moody's)	1.23%	8.50%
			Class E	\$100	US HU	Industry	Ba3 (Moody's)	0.99%	8.00%
			Class H	\$250	US HU, EU W	Industry	B2 (Moody's)	2.44%	11.00%
United Services Automobile Association	Residential Reinsurance 2012 Limited	Series 2012-1	Class 3	\$50	US HU, EQ, ST, WS, WF	Indemnity	BB- (S&P)	1.82%	10.00%
			Class 5	\$110	US HU, EQ, ST, WS, WF	Indemnity	BB (S&P)	0.58%	8.00%
			Class 7	\$40	US HU, EQ, ST, WS, WF	Indemnity	Not Rated	6.94%	22.00%
The Travelers Indemnity Company	Long Point Re III Ltd.	Series 2012-1	Class A	\$250	NE HU	Indemnity	BB+ (S&P)	0.88%	6.00%
<b>Total Closed During Q2</b>				<b>\$2,095</b>					

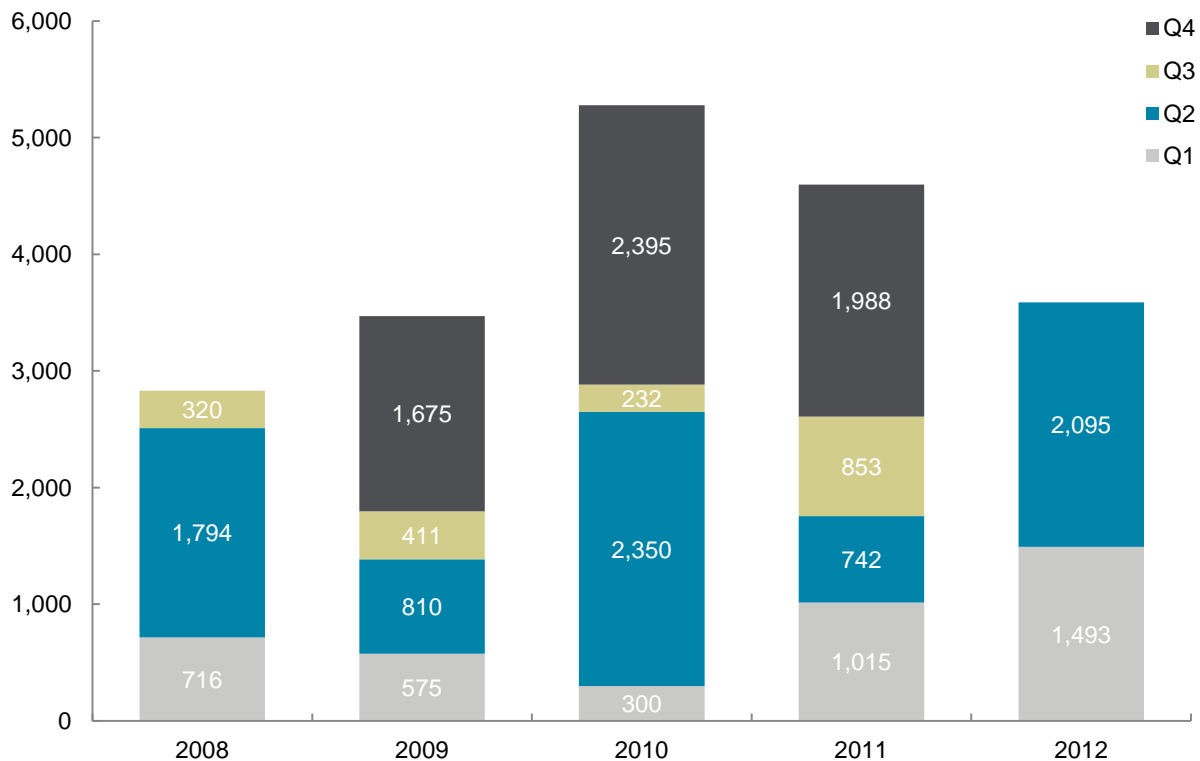
Source: Aon Benfield Securities, Inc.

Legend: CA – Canada; EU – Europe; FL – Florida; JP – Japan; LA – Louisiana; MX – Mexico; NE – Northeast; US – United States; EQ – Earthquake; HU – Hurricane; TY – Typhoon; ST – Severe Thunderstorm; W – Windstorm; WF – Wildfire; WS – Winter Storm;

Total issuance of almost USD3.6 billion in the first half of 2012 proved to be the most active since 2007, in which USD3.8 billion of new issuance came to market.

We continue to see spreads tighten in the secondary market which is likely to produce a more competitive cat bond market in the second half of 2012. Following such strong activity in the first half of the year, annual issuance for 2012 is likely to reach USD6 billion, as both seasoned and new investors remain keen to put capital to work.

**Exhibit 11: Catastrophe Bond Issuance by Quarter (USD Millions)**



Source: Aon Benfield Securities, Inc.

Sidecar issuance also continued to gain momentum in the second quarter of 2012. This year New Point Re V, AlphaCat Re 2012, Upsilon Re and Timicuan Re III have successfully raised capital. Existing facilities, such as Accordion Re, have also raised additional capital.

Further, the industry loss warranty (ILW) market continues to see increased capacity. The U.S. continues to be the dominant region for the ILW market; however, the development of PERILS has increased interest in Europe windstorm transactions.

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