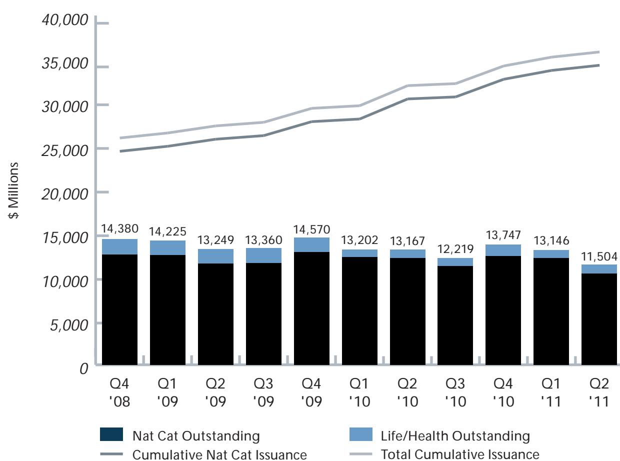
reDEFINING Capital

Aon Benfield Securities again presents a quarterly review of Insurance-Linked Securities (ILS), providing insight into this active market.

Quarterly Catastrophe Bond Transaction Review

Five catastrophe bond issuances closed in the second quarter of 2011, as compared to nine issuances in the same period in 2010. Four of these five issuances were from repeat-issuers, including one from the life/health sector. In total, the second quarter of 2011 experienced $741 million in issuance, versus $2,300 million in the same period in 2010.

Outstanding Catastrophe Bond Volume By Quarter



Source: Aon Benfield Securities

Foremost among these transactions, USAA returned to the market with Residential Reinsurance 2011 Limited in three tranches: Series 2011-1 Class 1, Class 2, and Class 5, for $57 million, $33 million, and $160 million respectively. Despite having $350 million in maturing ILS, USAA sponsored only a total of $250 million. Like earlier iterations, the transaction covered five U.S. perils: hurricane, earthquake, winter storm, severe thunderstorm, and wildfire. Spreads were in line with 2010 pricing, demonstrating consistency in year-over-year pricing. The bonds paid investors an interest spread of 9.00 percent, 12.00 percent, and 8.75 percent, respectively, and collateral was invested in U.S. Government Money Market Funds. The expected losses on each tranche were 1.88 percent, 3.77 percent, and 1.06 percent, respectively.

Allianz returned to the market with its Blue Fin Ltd. Series 4 Class B transaction for $40 million. Like earlier Blue Fin transactions, this iteration covers U.S. hurricane and earthquake perils and uses a modeled loss trigger structure. The transaction paid an 8.50 percent risk premium, had an expected loss of 1.40 percent, and was not rated. Collateral in the transaction was invested in U.S. Government Money Market Funds.

Subsequently, The North Carolina Wind Pool returned to the market for a third time with Johnston Re Ltd. 2011-1, Class A and Class B for $70 million and $131.80 million, respectively. The transaction covered North Carolina hurricane risk for the North Carolina Insurance Underwriting Association and North Carolina Joint Underwriting Association. The tranches paid investors a 7.60 percent and 6.90 percent risk premium, and had an expected loss of 1.93 percent and 1.60 percent for Class A and Class B, respectively. Both classes were rated "BB-"and invested collateral in U.S. Government Money Market Funds.

From the life/health sector, Aetna Life sponsored its second transaction in two tranches: Vitality Re II Ltd., Class A and Class B. Sized at $110 million and $40 million, respectively. The transaction used a tri-party repurchase agreement collateral structure, and was rated BBB and BB+ each. The tranches paid a risk premium of 4.40 percent and 6.25 percent and had expected losses of 0.01 percent and 0.20 percent, respectively.

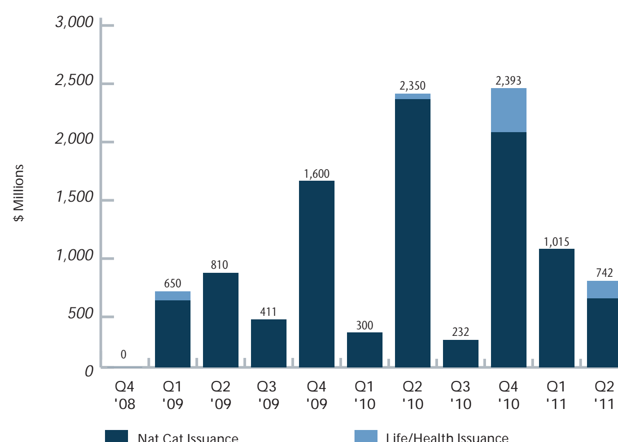
Finally, a new sponsor, Argo Re, Ltd., brought Loma Reinsurance Ltd. Series 2011-1. The $100 million issue covered four perils: U.S. hurricane and earthquake, Europe Windstorm, and Japan Earthquake. This transaction also used a tri-party repurchase agreement collateral structure, and was rated BB-. The transaction paid a risk premium of 9.50 percent, and had an expected loss of 2.35 percent.

As compared to the same period in 2010, the second quarter provided less volume for several reasons. First, sponsors and

investors alike continued to evaluate the substantial model change from RMS (see our review of this change on page 4). A number of issuances were delayed pending further review of the change by sponsors. In addition, evaluating the natural events in Japan and New Zealand continued to occupy the market. As hurricane season begins, it remains unclear what effect these events will have on traditional reinsurance rates and, consequently, risk premiums for catastrophe bonds.

Aon Benfield Securities forecasts substantial issuance in the latter half of 2011, based on sponsors' desire to discuss and evaluate potential transactions for the fourth quarter.

Catastrophe Bond Issuance By Quarter



Source: Aon Benfield Securities

Aon Benfield ILS Indices

Index Title	Index Value				Return for Quarterly Period Ended June 30		YTD Return for Period Ending June 30	
Aon Benfield ILS Indices	**6/30/11**	**3/31/11**	**6/30/10**	**3/31/10**	**2011**	**2010**	**2011**	**2010**
All Bond	234.08	231.17	220.88	219.96	1.26%	0.42%	5.97%	12.85%
BB-rated Bond	221.48	218.24	211.90	211.05	1.49%	0.41%	4.52%	12.95%
U.S. Hurricane Bond	231.13	231.35	213.00	214.71	-0.09%	-0.80%	8.51%	15.18%
U.S. Earthquake Bond	202.08	197.73	188.48	185.27	2.20%	1.73%	7.21%	7.04%
Benchmarks								
3-5 Year U.S. Treasury Notes	310.87	302.45	300.26	289.94	2.78%	3.56%	3.53%	6.61%
3-Year U.S. Corporate BB+	383.45	375.72	353.25	348.93	2.06%	1.24%	8.55%	14.34%
S&P 500	1320.64	1325.83	1030.71	1169.43	-0.39%	-11.86%	28.13%	12.12%
ABS 3-5 Year, Fixed Rate	337.20	329.35	317.00	305.82	2.38%	3.66%	6.37%	19.54%
CMBS Fixed Rate 3-5 Year	256.63	252.42	235.72	226.29	1.67%	4.17%	8.87%	26.85%

The Aon Benfield ILS Indices are calculated by Thomson Reuters using month-end price data provided by Aon Benfield Securities. The ILS indices posted increases for the second quarter of 2011, with the exception of the U.S. Hurricane index which was essentially flat to the prior quarter.

For the U.S. Hurricane bonds, coupon returns were essentially negated by seasonal adjustments heading into the U.S. Hurricane season. For the quarterly period ending June 30, 2011, the Aon Benfield All Bond, BB-rated Bond, and U.S. Earthquake Bond indices posted quarterly returns of 1.26 percent, 1.49 percent, and 2.20 percent, respectively, and all exceeded comparable returns for the quarter ended June 30, 2010. Such performance was driven by price increases across bonds covering non-U.S. perils. Market participants continue to seek bonds with diversifying perils, as well as price recovery from Japan Earthquake-exposed bonds.

On a year-to-date basis, through June 30, 2011, all indices posted gains. The Aon Benfield All Bond and BB-rated Bond indices posted returns of 5.97 percent and 4.52 percent, respectively, while the U.S. Hurricane and U.S. Earthquake Bond indices posted returns of 8.51 percent and 7.21 percent, respectively. The 2011 year-to-date returns fell below comparable returns for the prior year period, with the exception of the U.S. Earthquake Bond index which performed marginally better. This was primarily due to the effects of global catastrophes which led to mark-to-market decreases in 2011 versus the twelve-month period ending June 30, 2010.

In the absence of a severe catastrophic event, we would expect strong seasonal price increases in U.S. Hurricane bonds as the hurricane season progresses. Given strong demand, we would also expect price increases for those bonds covering diversifying perils. However, the magnitude of change will not be drastic due to existing low spreads.

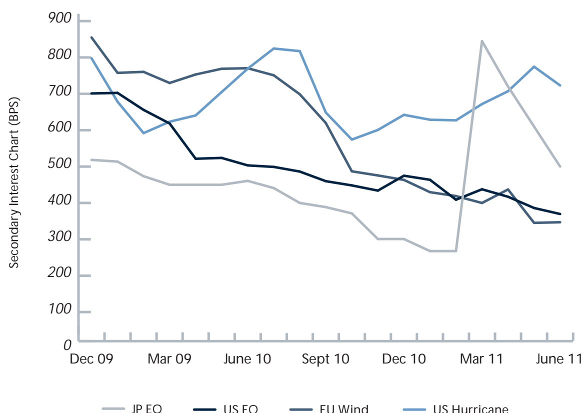
ILS Sales and Distribution

Investors began the second quarter of 2011 gaining an understanding of the effects of the Japan earthquake on the ILS market. Although the earthquake led to reinsurance losses, the coverage provided risk transfer which sponsors expected under such extreme events. Most of the trading in Japan-based bonds occurred in the first quarter of 2011 when investors were able to liquidate their positions in a fairly organized market.

Investors then shifted their focus to the upcoming U.S. hurricane season. The relatively small pipeline was a disappointment to investors, forcing many to look to the secondary market to acquire positions. Luckily for pure ILS investors, the dislocation in the retro and ILW markets convinced many collateralized players to liquidate cat bond positions, giving pure ILS investors an opportunity purchase cat bonds despite the lack of a heavy primary pipeline. Demand for diversifiers continued throughout the second quarter, although this does not lead to high trading volumes as investors are reluctant to sell diversifiers without having a replacement security.

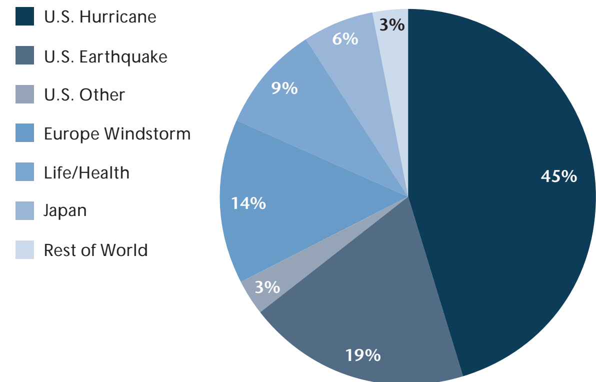
With the major update to the RMS U.S. Hurricane model in late February, investors anxiously awaited the release of remodeled statistics for Miu. Given the large increase in modeled statistics, S&P placed 16 of RMS-modeled catastrophe bonds on negative credit watch in mid-April. Although the potential downgrade did not have negative effects on pricing, investors remained cautious with those bonds. RMS then released its Miu update to investors in mid-May. The update provided Miu subscribers with new modeling statistics for all bonds in the market. Although investors anticipated higher modeling statistics, the magnitude of change was a shock to most. RMS reported that on average the expected losses of existing bonds increased by 90 percent under the new model. On the secondary market, buyers instantly lowered their bids by one to two percent on bonds originally modeled by RMS to account for this new change, although the bonds began to recover toward the end of the quarter.

Historical Bond Spreads



Source: Aon Benfield Securities

Catastrophe Bonds On Risk By Peril



Source: Aon Benfield Securities

An extremely active stretch of severe weather occurred across areas east of the Rocky Mountains during the period between early April and June. Five severe storms proved to be billion-dollar outbreaks. In fact, based on preliminary data, April 2011 set an all-time monthly record with 875 tornadoes. The previous monthly record was 542 tornadoes, set in May 2003, as compared to the 30-year average number of tornadoes for April at 135. The record year for U.S. tornado losses continued to push the Mariah Re bond down in price. The Mariah bonds are structured with an aggregate trigger and protect the sponsor, American Family, against a spate of tornado losses. In any normal year, one would expect to see multiple tornadoes eroding the retention. However, the 2011 season has been especially brutal. As the U.S. tornado season comes to a close at the end of July, we expect downward pricing pressure to ease on tornado-exposed bonds.

U.S. Hurricane capacity began to rebound in earnest towards the end of the quarter as several investors began to distribute ILS bids across the secondary market. Investor inflows were positive as a number of new indirect investors came into the market through existing cat funds. These investors sought to acquire bonds across multiple regions and perils. This demand began to push spreads down throughout the month of June. The weighted average spread for U.S. Hurricane bonds began the quarter at 652 basis points and peaked on May 31 at 755 basis points, only to decline to 703 basis points by the end of the quarter. At the same time, U.S. Earthquake, Europe Windstorm and Japan Earthquake pricing continued to decline to 350 basis points, 327 basis points, and 480 basis points, respectively.

A Review of RMS Model Changes

Despite the passage of nearly four months since RMS released version 11.0 of the U.S. Hurricane Model, sponsors and investors alike are still working to thoroughly understand the changes. RMS implemented changes to both the Industry Exposure Database (IED) and to the model itself. Although the model changes primarily drove the increase to the model loss curves, the total industry property exposure increased by 12 percent across hurricane-exposed states. Commercial lines experienced a larger increase at 18 percent compared to an increase to residential lines at eight percent. It should be noted that the 2010 U.S. hurricane IED has a 2008 vintage.

Both the wind and storm surge hazard modules in version 11.0 have been pushed farther inland. The wind vulnerability module has been updated to include claims data from Hurricane Ike, where previous data was sparse, as well as a reevaluation of data from the 2004-2005 seasons.

The tables below show the increase in average annual losses and select return periods for the hurricane industry loss curves (ILCs) for wind including storm surge. These show both the changes due to the IED update and between model versions 10.0 and 11.0 for residential and commercial lines.

Residential

	IED			ILC		
Region	**AAL**	**1 in 100**	**1 in 250**	**AAL**	**1 in 100**	**1 in 250**
All hurricane states	-4%	-3%	-	51%	46%	41%
Texas	-8%	-6%	-5%	93%	98%	100%
Gulf	-15%	-14%	-14%	55%	68%	83%
Florida	-3%	-4%	-2%	37%	34%	29%
Southeast	8%	5%	5%	74%	97%	101%
Mid-Atlantic	13%	12%	14%	201%	194%	175%
Northeast	5%	4%	4%	44%	38%	40%
Hawaii	-11%	-8%	-12%	-12%	-8%	-12%

Source: RMS 2011 Industry Exposure Database and Industry Loss Curves Scope and Description of Changes

Commercial

	IED			ILC		
Region	**AAL**	**1 in 100**	**1 in 250**	**AAL**	**1 in 100**	**1 in 250**
All hurricane states	20%	24%	26%	77%	61%	49%
Texas	16%	13%	13%	168%	177%	154%
Gulf	-	2%	-	71%	72%	77%
Florida	29%	31%	31%	63%	53%	34%
Southeast	-1%	-	2%	46%	68%	80%
Mid-Atlantic	19%	20%	19%	201%	210%	194%
Northeast	24%	20%	24%	85%	73%	84%
Hawaii	28%	25%	30%	24%	24%	29%

Source: RMS 2011 Industry Exposure Database and Industry Loss Curves Scope and Description of Change

The commercial lines average annual losses and select return periods are generally higher, both from the IED and ILCs. The Texas and the mid-Atlantic region have the greatest increase for the ILCs mostly due to the updates increasing inland hazard but reducing the coastal hazard.

In general, individual portfolios are likely to vary significantly from the industry results. It will take sponsors a number of months before this process is complete and rate changes are implemented.

European Reinsurance, PERILS, and Politics

The European catastrophe bond market experienced a benign quarter with a solitary bond issued. Allianz continued to support the market with the issuance of a fourth series from their Blue Fin program. They accessed a further $40 million of capacity to protect against both U.S. Hurricane and Earthquake on an aggregate basis. It is structured to mature at the same time as last year's series and notes.

PERILS continues to gain traction for Europe Windstorm issuances with its inclusion in the Loma Re catastrophe bond sponsored by Argo Re. Loma Re is the fifth catastrophe bond to utilize the industry loss trigger. PERILS also continues to be widely used in the ILW market.

The traditional UNL market continues to offer competitive pricing for European perils, making the capital markets a less compelling proposition. However, there are signs that this may be about to change with the growing economic instability that is being experienced in Europe. These events and the accumulation of global catastrophe losses could lead to a greater degree of convergence between the capital markets and traditional reinsurance markets within Europe.

The European economic crisis poses significant systematic risk across Europe. This could cause widespread investment losses across the market including those assets held by the insurance industry.

Although the proportion of European peripheral sovereign debt held by the insurance industry is believed to be low, combining this with the natural catastrophe losses already suffered this year could lead to a further write down of claims paying resources and could further impact traditional market pricing.

The eroding of capital also raises the potential for a "failure to pay" event, reinforcing the argument for insurance participants to utilize fully collateralized cover providing peace of mind for risk managers and mitigating any doubts on the recovery following a large event. This could result in the incremental use of catastrophe bonds in the future, especially with the upcoming introduction of Solvency II bringing with it the heightened focus on counterparty risk.

Sidecar Market Review

Sidecars, a subject which has not received much press prior to the second quarter, have had resurgence in the wake of natural catastrophes this year. Most sidecars with which the market has broad knowledge are all focused on exploiting higher (re)insurance rates, particularly in the retro market, either now or in the future. As sidecars are usually private transactions, market participants cannot know the actual number of transactions thus far this year, and the structural details can be scarce. But the media has published enough accounts of transactions to give the impression that equity investors have interest in capitalizing on reinsurance market dislocation where it exists.

Those that have been publicized include[1]:

- AlphaCat Re 2011 (sponsor: Validus)
- Accordion Re (sponsor: Lancashire Re)
- New Point IV (sponsor: Alterra)
- DaVinci (sponsor: RenaissanceRe, capacity added to existing vehicle)

Interestingly, and in contrast to some of the 2005 sidecars, it is believed that little to no debt is being used to capitalize this new class of sidecar. Rather, equity is presumed to be the primary source of capital. And, one can expect that retrocessional reinsurance will dominate the business plans of these new sidecars, since rate hardening has been more apparent in this market.

Finally, with the market still evaluating the RMS model change, reacting to past catastrophic events, and anticipating the current hurricane season, one can also expect that the new sidecar sponsors will either hold capital aside for future opportunities or actually allow investors to keep their capital until it is called by the sponsor for investment in the sidecar.

Aon Benfield Securities expects further growth in the sidecar market should hurricane activity materialize in the current season.

[1] "Sidecar bogue bemuses key investor," *The Insurance Insider*, 13 June 2011.

Impact of Tohoku Earthquake for the Japanese Insurance Industry

On March 11, a mega-earthquake and tsunami struck the northeastern coast of Japan, killing at least 12,300 people, injuring nearly 3,000 more and causing damage to at least 203,000 homes and other structures. The magnitude-9.0 earthquake struck with an epicenter 130 kilometers (80 miles) east of Sendai, Japan and 373 kilometers (231 miles) northeast of Tokyo at a depth of 24 kilometers (15 miles). Following the main tremor, more than 830 aftershocks rattled the region with at least 57 shocks registering above magnitude-6.0.

Following the initial jolt, a tsunami with waves reaching heights in excess of 10 meters (32 feet) swept away thousands of homes, boats, cars and buildings, leaving excessive amounts of debris.

The General Insurance Association of Japan has released an update to its loss development associated with the Tohoku Earthquake, reporting that the amount of claims paid for "Earthquake Insurance on Dwelling Risks" totaled ¥974 billion as of June 15th. This level of claims is already 13 times larger than that for the Great Hanshin Earthquake in 1995.

The insurance companies' exposures for the dwelling earthquake risks are covered by the government sponsored reinsurance pool. The net retention by the private sector insurers under the pool is ¥503.80 billion for the losses between ¥115 billion and ¥1.12 trillion. So, the losses of the current level are fully absorbed in the ample risk reserves of the private sector insurers.

The reinsurance programs that the Japanese insurers purchase for commercial earthquake risks are typically renewed at April 1st. Several insurers have extended the programs beyond April 1st to enable them to fully assess the impact from the Tohoku Earthquake. Some are still in negotiations. For the programs renewed at April 1st, most saw a price increase of 25 to 50 percent from the previous year while the typhoon programs showed a moderate increase of five to 10 percent.

Japanese insurers have observed that the Muteki catastrophe bond provided the expected protection (and alternative to traditional reinsurance) for Zenkyoren. As a result, insurers have demonstrated a heightened interested in ILS. Any rate hardening in the Japanese market will also increase the demand for securing earthquake coverage through the capital markets, as insurers seek to lock-in rates for an extended time.

Catastrophic Events in the Second Quarter

An extremely active stretch of severe weather occurred across areas east of the Rocky Mountains during April. The largest tornado outbreak in world history (334 separate tornado touchdowns) led to catastrophic damage throughout the Southeast and the Tennessee Valley. The city of Tuscaloosa, Alabama took a direct hit from a high-end EF-4 tornado that caused widespread devastation. At least three EF-5 tornadoes touched down during this outbreak.

An outbreak in late May spawned an EF-5 tornado that destroyed a large section of Joplin, Missouri. This massive tornado had at least a 0.75 mile (1.2 kilometer) width over a 22.1 mile (35.6 kilometer) path. NWS meteorologists confirmed that the tornado contained winds at one point up to 250 mph (405 kph). This marked the fourth EF-5 tornado of the year in the U.S. According to local law enforcement officials, up to 25 percent of Joplin was completely destroyed by the tornado after it touched down at approximately 5:35 pm local time (22:35 UTC). City managers noted that as much as 75 percent of the city had suffered various degrees of damage. The tornado caused 154 fatalities in the city, becoming the deadliest singular tornadic event since the National Weather Service officially began keeping records in 1950. A second EF-5 tornado during May was recorded in central Oklahoma.

In June, Super Typhoon Songda became the first Category 5 cyclone of 2011 prior to weakening and skirting parts of the Philippines and Japan, killing at least 17 people. The storm brought periods of torrential rains and gusty winds to each location.

Later that month, the greater Christchurch, New Zealand region was struck by two aftershocks, leaving at least one person dead and 46 more injured and causing widespread damage. In addition to the two shocks, several smaller tremors (ranging from magnitudes-3.4 to 4.9) also rattled the region in the following days. According to the USGS, at least 487,000 residents in New Zealand felt various levels of shaking during the magnitude-6.0 aftershock.

An Interview With John DeCaro, Co-Founder, Elementum Advisors

As someone who has worked on the sell side and now the buy side for years what perspective has it given you?

The most important benefit is probably having the ability to appreciate the objectives of the transaction sponsor in addition to our own when evaluating a new transaction. The sell-side experience enables us to provide valuable feedback to bankers on transaction structure and pricing matters during premarketing with the goal of helping facilitate a transaction that meets the objectives of both sponsor and investor. Once a deal is in the market, we offer immediate and direct feedback on the transaction which assists the bankers in running an orderly book. As an investment manager, we have a fiduciary duty to our clients when investing capital which includes an obligation to maximize both the allocation we receive and pricing of deals while also being highly selective on what we buy. The reputation that we have developed with both bankers and sponsors given our unique perspective enables our investors to benefit with strong allocations of appropriately-priced, well-structured bonds.

Elementum is one of the larger secondary traders in the market, do you feel that secondary trading enhances your returns, or do you trade for other reasons?

We definitely believe that our secondary trading provides benefits to our investors. During 2010 we traded almost $750 million of catastrophe bonds, or roughly 40% of our estimate of the market's total non-life trading volume. We generally attempt to speak with every dealer multiple times per day and track every trade indication that occurs. This enables us to have our finger on the pulse of the cat bond market and provides two significant benefits. First, we benefit from price discovery and are usually able to identify numerous chances to buy cheap assets and sell rich ones to dynamically maximize our risk-adjusted returns. Second, we believe we are able to see buy and sell opportunities before they are sent to the broader market—this enables us to invest capital inflows more easily and facilitates liquidity when needed.

Are there any areas of the market that you find relatively more attractive at the moment?

Yes. We find the market for non-U.S. wind diversifiers to be unattractive due to the scarcity of supply and high demand from new investors for the seasoned bonds.

A lot has taken place in the ILS market since you became part of it back in 1997. What aspects do you believe the market needs to consider for continual development? Where do you see the market in the next five years?

The ILS market has finally developed into a legitimate source of alternative natural catastrophe reinsurance capacity since inception in the early 1990s. With the exception of collateralized reinsurance investments, which by definition take the form of reinsurance, the ILS market has failed to adopt a number of the features of traditional reinsurance. I'm specifically talking about the disparity in exposure data provided in a cat bond offering document compared with the reinsurance underwriting submission, as well as the lack of a guaranteed annual risk premium for most ILS. Further, the amount of cat bonds outstanding has fallen from $13B to just over $10B since peaking in 2007/2008 while the number of dedicated ILS investors has significantly grown. While I understand the appeal to sponsors of transferring U.S. hurricane risk via cat bonds, and do not want to sound like a cat bond indexer, the lack of diversification opportunities for investors will hinder the market's growth. Specifically, a lack of diversification can result in higher cash balances or a reach for yield, and when combined with cat losses can lead to poor performance which could have the perverse impact of lessening the long-term appeal of the asset class to end investors. Thus, in order for the ILS market to resume growth and exceed previous peak levels it is imperative that sponsors issue non-U.S. wind diversifiers to facilitate continued growth in U.S. wind capacity. Outstanding supply in five years time will likely surpass $13B.

Would you give us some of your thought process that goes into evaluating a new cat bond?

We take a top-down, bottom-up approach that thins out our investment universe rather quickly. We look at several characteristics of each bond (e.g., covered peril, type of coverage, trigger, modeling, price guidance) to determine if additional diligence is warranted. If so, we then perform more detailed work on the risk exposure, modeling, transaction structure and relative pricing to determine our level of interest. We believe that this approach enables us to give direct and immediate feedback to the bankers, maximizes productivity by eliminating from detailed review transactions which don't meet our investment criteria, and enables us to perform robust due diligence on the most interesting investments.

What is it about the ILS market that excites new investor capital?

The realization that in a world awash in liquidity, investment returns on traditional asset classes are likely to be lower for an indeterminate period of time. The ILS market offers investors an uncorrelated source of investment return, proven over more than a decade, which can consistently range from the mid to high single digits annually (or more, depending on the chosen level of risk).

Where would you like to see Elementum in 5 years?

Our vision upon launching Elementum was to build an institutional quality alternative investment manager focusing on collateralized natural event reinsurance, with an emphasis on providing strong investment performance and a high level of client service and transparency. We are proud of what we have accomplished since inception but understand that the realization of that vision is more about the journey and not the destination. In 2016 I would like us to have furthered our reputation in this regard and be managing an amount of capital commensurate with the level of attractive investment opportunities inside the universe of cat bonds, reinsurance, ILWs and derivatives.

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