

Reinsurance Market Outlook

Value Creating Capital
January 2012



Contents

Executive Summary— Value Creating Capital	3
Capacity: Supply Remains Adequate Despite Catastrophes	6
Insurer Capital Stable for 2011	12
Property Catastrophe Activity Update	17
Catastrophe Bond Transaction Update	22
Rating Agency and Regulatory Perspectives	25
Solvency II: Challenges During 2012	36
Drivers of M&A Activity in 2012	38
Economic and Financial Markets Update	39
Bank Leverage	46
Contact Information	47
About Aon Benfield	47

Executive Summary— Value Creating Capital

The value proposition of reinsurance as an accretive form of underwriting capital has rarely been as tangible as exhibited in 2011. The world's reinsurance markets responded quickly to the needs of insurers in a seemingly unending series of catastrophes that drove reinsurance recoveries for events occurring in 2010 and 2011 to levels that are similar to the losses the reinsurance market sustained from U.S. hurricanes of 2004 and 2005. Global reinsurance capital remains strong and competition still exists in the reinsurance market for program participations. The capacity clients required at January 1, 2012 was achieved at accretive prices, terms and conditions.

Global insurance capital remains strong despite significant retained catastrophe losses. Insurer earnings and capital are challenged by low interest rates associated with global economic uncertainty, sovereign debt issues in Europe and similar federal and state borrowing issues in the United States (U.S.). U.S. insurers' earnings and capital also suffered from record high levels of retained tornado and hail losses. The unusual combination of catastrophic losses occurring in 2010 and 2011 has not yet driven affected insurers to seek more capital, purchase higher reinsurance limits, or raise prices/decrease exposures materially for the insurance products they sell. However, the largest of these loss-affected programs have yet to renew in 2012 and it is possible that insurers and governments affected by catastrophe losses in 2011 will increase the size of their reinsurance programs when renewed at April, June and July of 2012. It is also likely that larger global insurers will again find value in protecting large corporate catastrophe protections in regions where significant earnings events may occur. The capital available from traditional reinsurers and investors in catastrophe related products have sufficient capacity to meet this potential new demand.

New catastrophe models have not generated significantly higher demand for reinsurance. Models released in areas that were not affected by material losses in 2010 or 2011 did not find uniform adoption amongst European or U.S. insurers and that non-uniform adoption combined with reasonably strong insurer capital, muted the potential for increased demand for reinsurance limits. Additional reinsurance demand from European and U.S. insurers remains very price sensitive. New catastrophe models and talk of non-loss affected reinsurance program price increases to make up for reinsurer losses in loss-affected regions combined to temper new capacity demand for January 2012 capacity. Incremental demand for Western European and U.S. exposures was shifted to the catastrophe bond market where greater certainty over pricing appeared to exist when key decisions were required. It is possible that insurers held back additional demand for capacity at January 2012 in order to let the market uncertainty clear.

Insurer's interest in aggregate covers following significant retained losses has increased. However, insurer's interest has not resulted in a pattern of significant new buyers of this product at January 2012. Some insurers renewing aggregate programs selected increased co-participations rather than dramatically increased prices. New demand may emerge for these products if reinsurers more often take longer-term views of insurer experience.

Insurers are experiencing an improved pricing environment for many of their businesses even in non-loss affected regions where combined ratios on an accident year basis have drawn management action. However, demand growth for insurance is sluggish for a variety of reasons. Our research shows that non-life insurance losses incurred as a percentage of gross domestic product in the U.S., the world's largest insurance market, has been falling since 1986 and stands today at levels equal to the late 1960s. This continual decline potentially explains why firming rates may not portend actual growth of the insurance market. Reinsurance market growth is dependent upon insurance market growth and a continuing value proposition from the reinsurance product. The year of 2011 was a banner year for demonstrating the value proposition of reinsurance.

The reinsurance and risk transfer securities markets have the strength, capacity, creativity and credibility to support value-building insurers in 2012.

This report should be read in conjunction with the results our firm achieved for our clients at January 1, 2012 as well as our outlook for the upcoming April, June and July 2012 renewals. This information is available to clients through their Aon Benfield broker. As previously stated, we are no longer making our reinsurance market renewal results or our reinsurance market outlook public.

Exhibit 1: Key Factors Impacting Reinsurance Supply and Demand in the Global Market

Global Factors Influencing Reinsurance Supply	
+	High reinsurer capital
+	Light hurricane/typhoon season insured losses
+	Growing investor interest in catastrophe bonds or similar collateralized facilities
+	Continued favorable casualty reserve development
+	Increasing size of U.S. states' wind pools
+	Declining Florida homeowners insurance market
-	Heavily reinsured losses in New Zealand and Australia
-	Japanese non-life commercial and mutual insurer losses
-	Uncertainty related to new catastrophe models
-	Poor reinsurer reported results and low market valuations of reinsurers' shares
-	Sovereign debt related issues
=	High reinsurance market supply

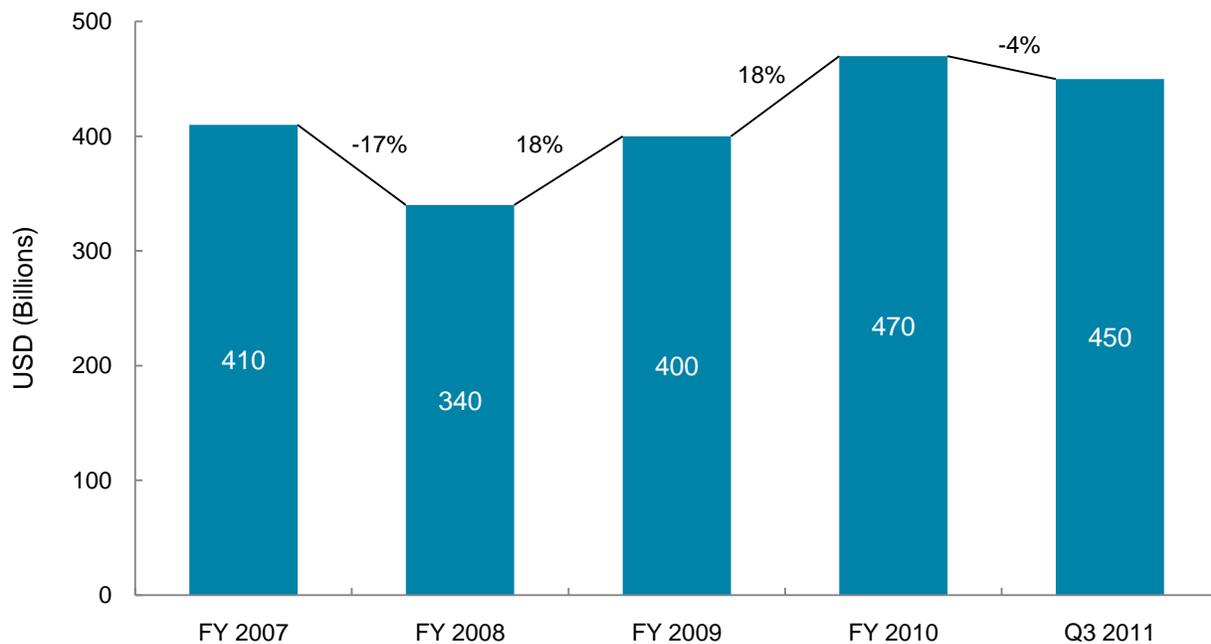
Global Factors Influencing Reinsurance Demand	
-	Strong insurer capital
-	Reinsurance pricing uncertainty in peak zones following large non-peak zone earthquakes
-	Sluggish insurance demand growth for insurance in difficult economic environment
-	Continued favorable development on casualty insurance
-	Very competitive insurance landscape in nearly all markets
-	Low investment returns
+	Significant insured earthquake losses in Japan and New Zealand
+	Significant retained tornado and hail losses in the U.S.
+	Low insurer market valuations and associated accretive share repurchase math
+	Sovereign debt related issues
=	Stable to weak growth in reinsurance demand

Source: Aon Benfield Analytics

Capacity: Supply Remains Adequate Despite Catastrophes

Reinsurer supply increased by 1 percent in Q3 2011 ending the first nine months of 2011 down 4 percent from the peak of capital at year end 2010. Despite continued loss development in global catastrophes, supply remains adequate to meet global demand for reinsurance coverage.

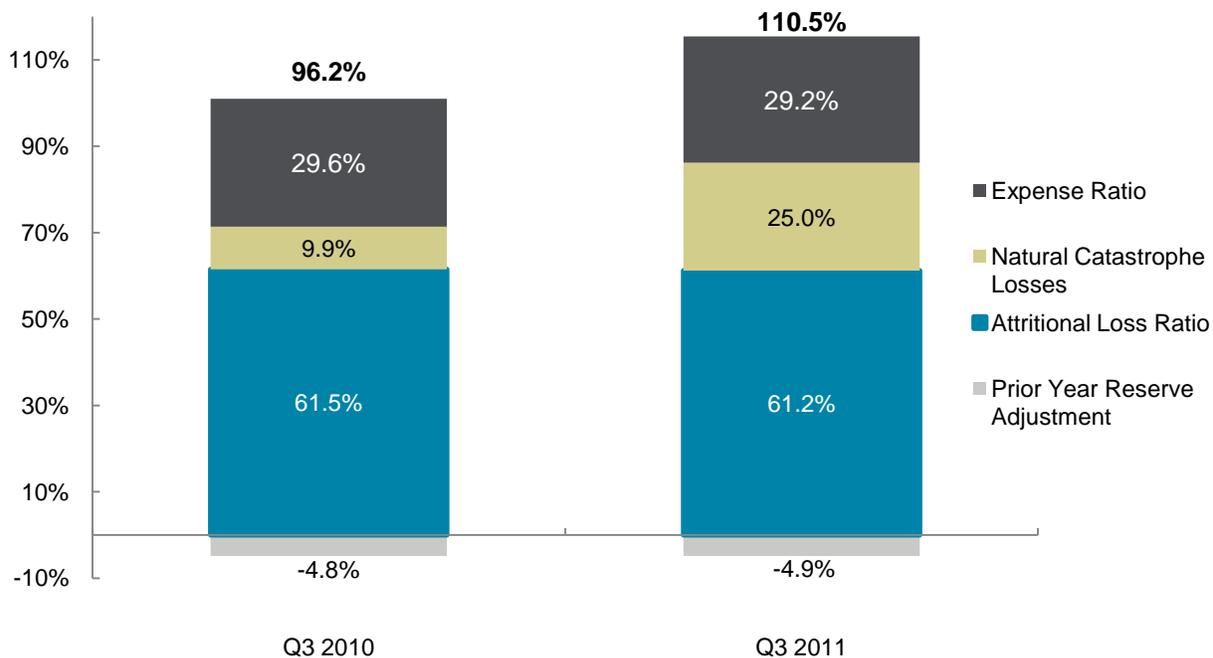
Exhibit 2: Change in Reinsurer Capital (USD Billions)



Source: Aon Benfield Analytics

Combined ratios for the Aon Benfield Aggregate subset of reinsurers closed the first nine months of 2011 up 14.3 points compared to the prior year period driven almost entirely by catastrophe loss activity largely throughout Q1 and Q2 of 2011. Disregarding the effect of prior year reserve releases, the accident year combined ratio stood at 115.4 percent.

Exhibit 3: Aon Benfield Aggregate¹ Impact of Catastrophe Losses on Combined Ratio

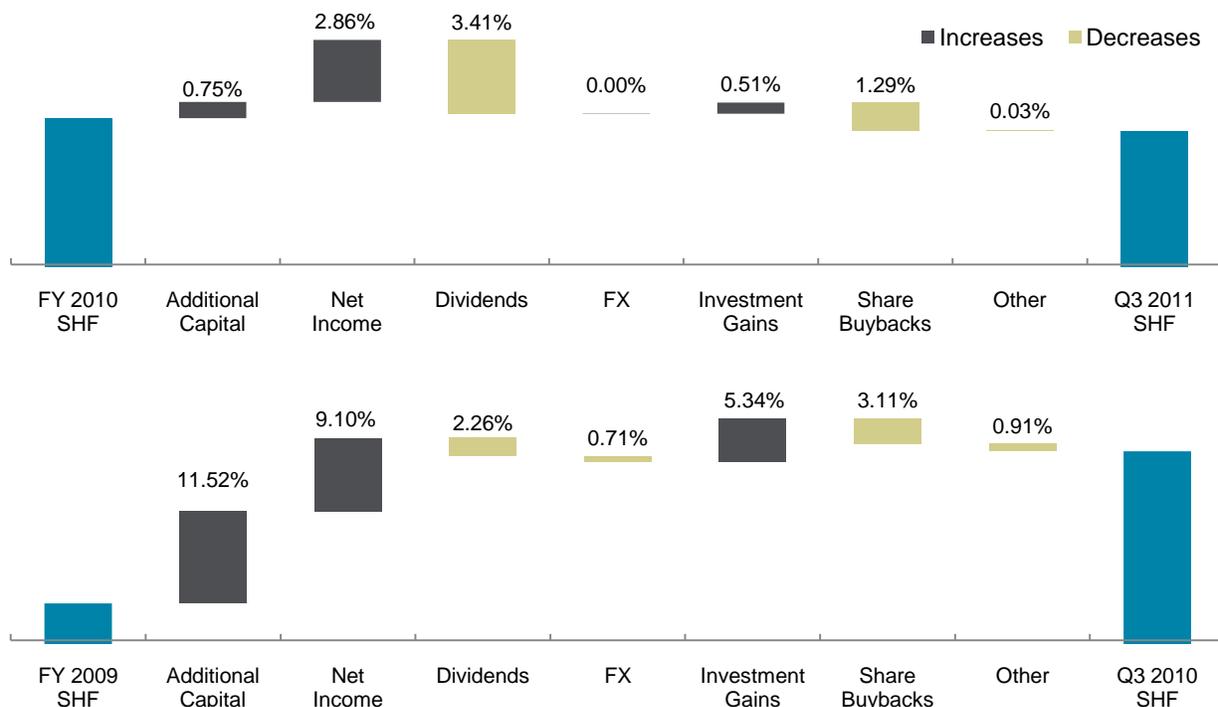


Source: Individual Company Reports, Aon Benfield Analytics

¹ The ABA is a group of 28 of the world’s leading reinsurers; latest ABA study can be found at <http://thoughtleadership.aonbenfield.com/ThoughtLeadership>

Both net income and unrealized investment gains were down significantly compared to the same time period in 2010 with the Aon Benfield Aggregate group reporting capital that is relatively flat since the end of 2010 compared to a 23 percent increase the prior year. Net income fell from 9.1 percent to below 3 percent for the first nine months of 2011. Additional capital also accounted for nearly 12 percent of the increase compared to approximately 1 percent in 2011. Dividends also accounted for a 3.4 percent reduction in shareholders' funds in 2011 compared to 2.2 percent in 2010.

Exhibit 4: Shareholders' Funds Development – Q3YTD 2011 versus Q3YTD 2010

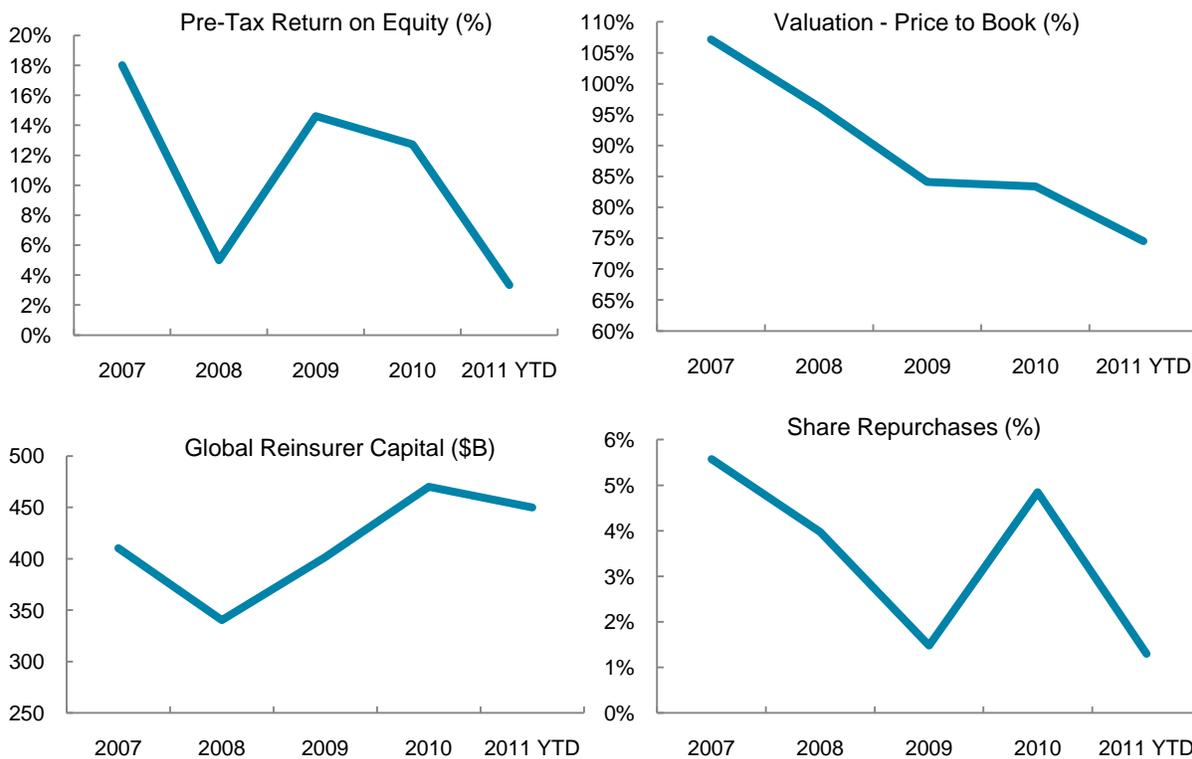


Source: Individual Company Reports, Aon Benfield Analytics

Reinsurer capital remains strong enough to supply the global demand for reinsurance despite a reduction of 4 percent in shareholders' funds from the peak position at year end 2010. At various times following the release of revised catastrophe models in 2011, it was prognosticated that these models may fully utilize any "excess" capital in the reinsurance industry. Some prognostications went further and considered the compound affect of additional model-based demand from insurers that might result in the need for the reinsurance industry to raise new capital or even spawn new reinsurers. Reinsurers (and insurers too) spent the time to understand what portions of the new releases made sense to adopt for capital management and pricing purposes. The significant changes in frequency estimates for severe U.S. hurricanes were muted by reinsurers (and insurers too) researching and adopting their own considered frequency opinions. In Western Europe the changes in modeled catastrophe loss estimates were wide ranging and not always in a uniform direction or consistent with insurer's experience. In many ways, the reduced use of the off-the-shelf models meant that reinsurers offered more diverse opinions on pricing and capacity.

Pre-tax return on equity dropped from 12.7 percent in 2010 to approximately 3.3 percent through 9M 2011. Catastrophe events in early 2011 and low returns on invested funds led to a sharp decrease in share repurchases in 2011 following a sharp increase in 2010. Price to book valuations of reinsurers ended 2010 relatively flat compared to 2009, but declined again through 9M 2011 to 75 percent. On the margin, should these low valuations persist and profitability return to higher historical levels, reinsurers will be strongly incented to repurchase shares rather than increase capacity. Analyst consensus estimates for reinsurer returns on equity for 2012 are approximately 10 percent.

Exhibit 5: Reinsurer Capital, ROE, Share Repurchases, and Valuation

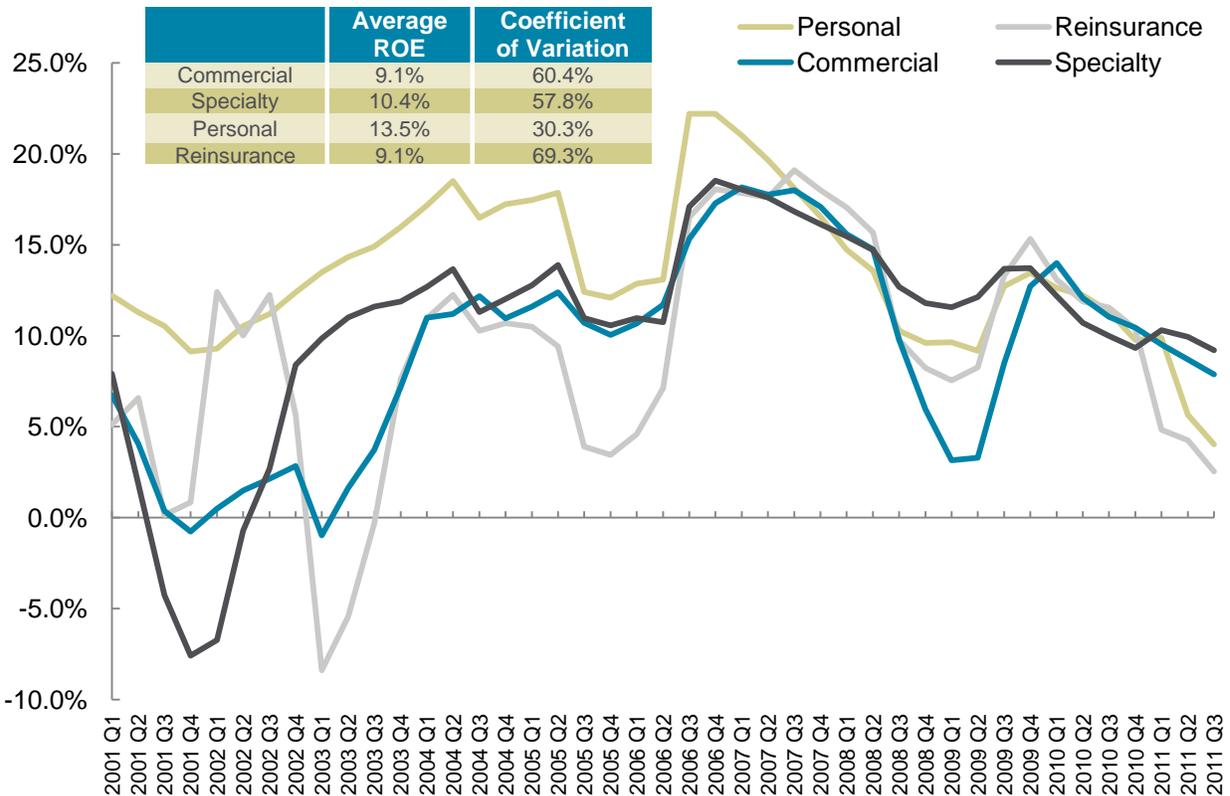


Source: Aon Benfield Analytics

Historical Returns and Volatility of Reinsurers and Insurers

Based upon our analysis of the historical results of public insurers and reinsurers, the rolling 4-quarter weighted average returns for reinsurers have now fallen below the returns of most insurers. The coefficient of variation reinsurers' ROE is, as expected, higher than insurers.

Exhibit 6: Weighted-Average After-Tax Return on Equity by Sector
(2001 – present; Rolling 4-Quarters)



Note: Analysis excludes Berkshire Hathaway and AIG
Source: Aon Benfield Analytics

Reinsurance Margins for Peak versus Non-Peak Regions

Reinsurance capital has been built to its current levels in order to serve the consistent demand of insurers that operate in peak insured property regions. The global insured aggregates as we have covered in prior editions stack-up in this order: 1. U.S. Hurricane (highest by far), 2. U.S. Earthquake (#2 only because Freddie Mac, Fannie Mae and FHA do not require earthquake insurance on mortgaged properties), 3. European Windstorm, 4. Japanese Typhoon and 5. Japanese Earthquake (#5 only because Japanese banks do not require earthquake insurance on mortgaged properties). All zones beyond these top-five are viewed as “diversifying” by the global reinsurance market.

Until the Chilean earthquake in 2010 and the New Zealand earthquakes in 2011 these zones had not produced losses that challenged the notion that these diversifying perils could be written at margins that were a small fraction of the margins that are charged in the aforementioned peak zones. These losses, along with the Japanese earthquake, have changed the views of the reinsurance market about margins and minimum rates-on-line. Many reinsurers have established new and higher minimum rates on line for new programs and programs with loss experience. Mathematically, if reinsurers are successful over the long-term at sustaining higher margins and minimum rates on line for diversifying regions, lesser margins should be required for reinsurance in peak regions.

New Opportunities for Reinsurance to Add Value – U.S. Tornado and Hail Risk

While U.S. insurers enjoyed a light hurricane season, the first half of the year was dominated by earnings and capital volatility stemming from tornado and hail losses. The reinsured portion of the larger losses in Tuscaloosa, Alabama and Joplin, Missouri was equal to the proportion expected to be ceded in mild hurricanes. However, insurers largely retained losses from a seemingly never ending group of less severe catastrophe events. After a year of such unusual experience insurers were interested in reinsurers' thoughts on pricing occurrence, aggregate and proportional covers for 2012.

This potential area of new demand was met with reasonable levels of interest from reinsurers. Reinsurers that tended toward a long-term view (greater than three years) were able to lead insurers to successful transactions. Many reinsurers either did not quote or provided pricing that reflected wariness toward U.S. tornado hail risk. Insurer interest was price sensitive and many hoped for transactions went unfulfilled.

New Demand from Loss-Affected Regions

Past hardenings of reinsurance markets have generally included significant new demands for limits from loss-affected insurers. The insurers and government programs that were most affected by the events of 2011 do not renew in the January renewal cycle. With the substantial losses and subsequent development on the losses, it is possible that new demand for higher limits or lower retentions could emerge as we move toward April, June and July renewal dates.

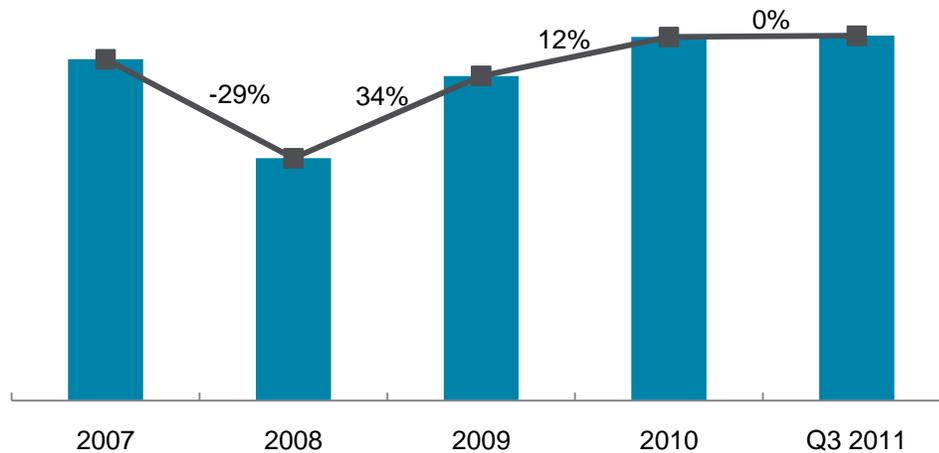
New Demand for Retrocessional Covers

Reinsurer earnings have been heavily impacted by the non-peak catastrophe losses that occurred in 2011. At midyear, reinsurers added material industry loss warranty protections of their portfolios as the heart of the U.S. hurricane season drew near. At January 2012 the market for retrocessions is the one market where there appears to be less supply than there is, albeit price sensitive, demand. We expect additional retrocession capacity to form through existing market suppliers and the catastrophe bond market to meet the current excess demand in the market during the early part of 2012.

Insurer Capital Stable for 2011

Insurer capital is relatively flat year over year despite significant loss activity in 2011. Demand for reinsurance was flat to slightly down in peak zones with some insurers retaining more risk in order to manage reinsurance costs.

Exhibit 7: Change in Insurer Capital



Source: Aon Benfield Analytics

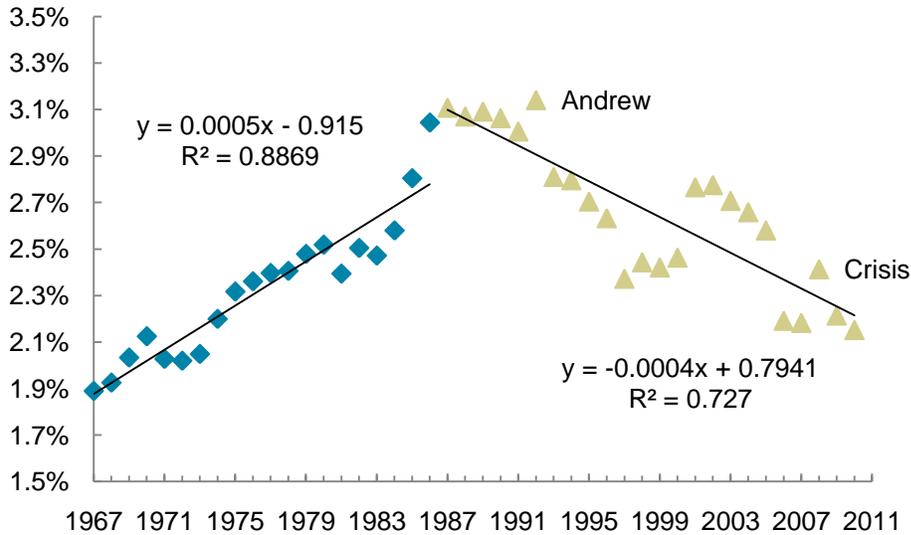
U.S. Soft Market Cycle Could be Unlike Others as Insurance Loses GDP Traction

Following the significant losses that arose from the liability crisis and the emergence of asbestos and environmental claims in the 1980s, U.S. insurers began covering liability claims on a claims-made basis and to exclude coverage for latent exposures. Corporate insured's began to retain substantially more risk through self-insured retentions or simply higher deductibles. Over time, the U.S. insurance market has become much more focused on compulsory lines than discretionary lines. The industry has not provided sufficient innovation or product value to sustain its place in the broader U.S. economy.

U.S. Non-life insurance had grown to a level where the industry losses accounted for 3.11 percent of Gross Domestic Product (GDP) in 1986, but the declining trend since 1987 undermined the industry's ability to sustain growth. It is a simple fact that it is hard for reinsurers to grow when the insurers that rely on their products to control underwriting volatility and capital relief are not growing in real terms or are losing their place in the underlying economy. Despite insurers' current ability to increase rates, real growth for insurers and reinsurers is unlikely to occur without some change that will increase the rate of their participation in the economy. We suspect this will require great industry introspection and innovation to put forward a much more compelling value proposition to insurance buyers.

Thankfully, for the global insurance industry, the declining economic participation by insurance witnessed in the U.S. is not being observed in Western Europe. Insurance in Western European countries, however, never reached the peak penetration levels achieved in the U.S. Of course, insurance is still growing at a predictable pace as a percentage of GDP in emerging markets.

Exhibit 8: Calendar Year U.S. Incurred Loss as Percent of GDP

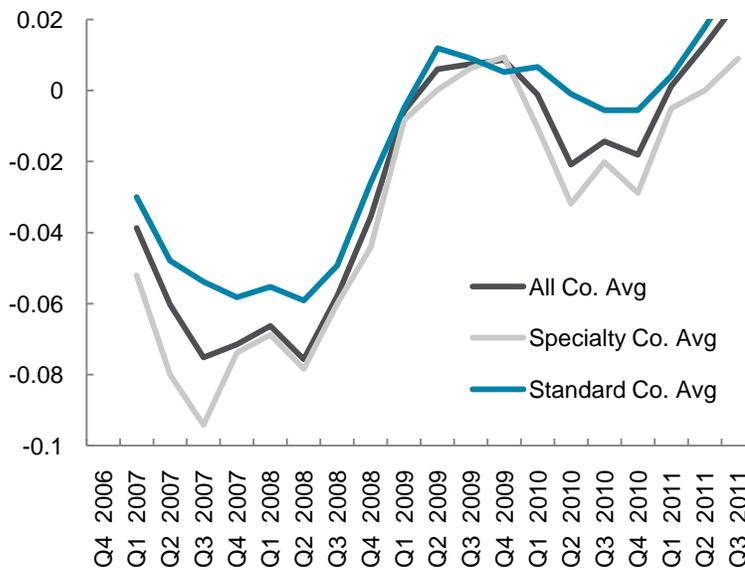


Source: Aon Benfield Analytics

Rate Increases continue for Primary Insurance

Primary lines continue to show stability as rates increased again from Q2 2011. Aon Benfield’s summary of rate change shows an all company average of 2.5 percent, with standard lines achieving rate increases of 3.3 percent on average, and specialty lines achieving a 0.9 percent increase for the quarter.

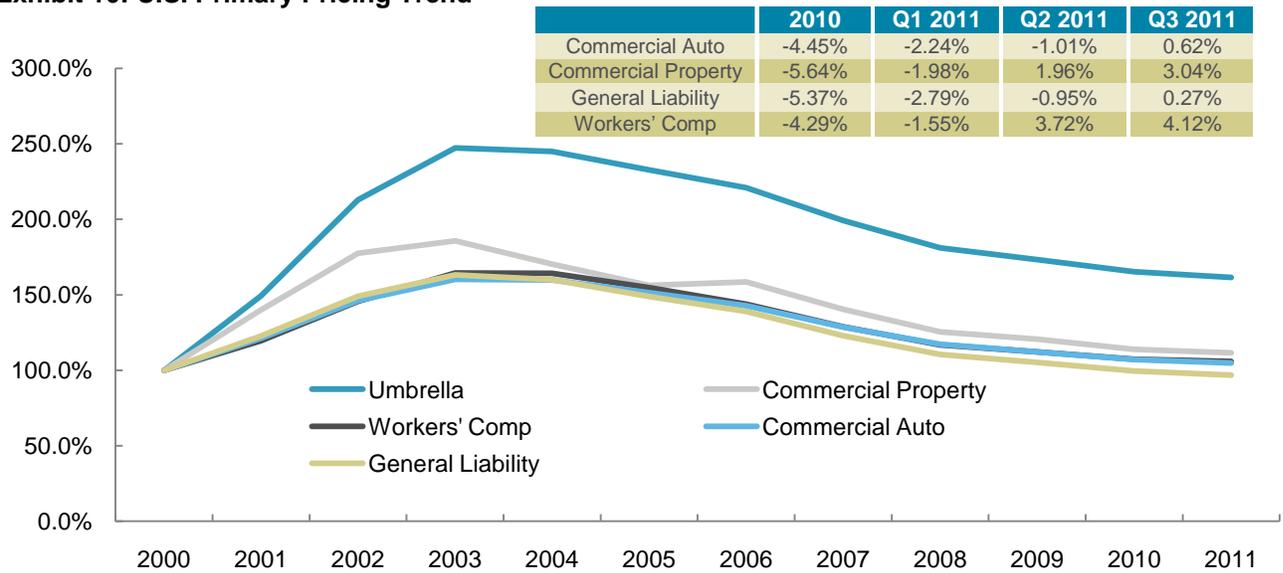
Exhibit 9: U.S. Primary Pricing Trend



Source: Aon Benfield Analytics

Exhibit 10 shows CIAB results that indicate that commercial auto and general liability may have turned as both saw slight increases in rates in Q3 2011. Commercial property and workers' compensation continued the trend shown at Q2 2011 by again increasing rates in Q3 2011.

Exhibit 10: U.S. Primary Pricing Trend

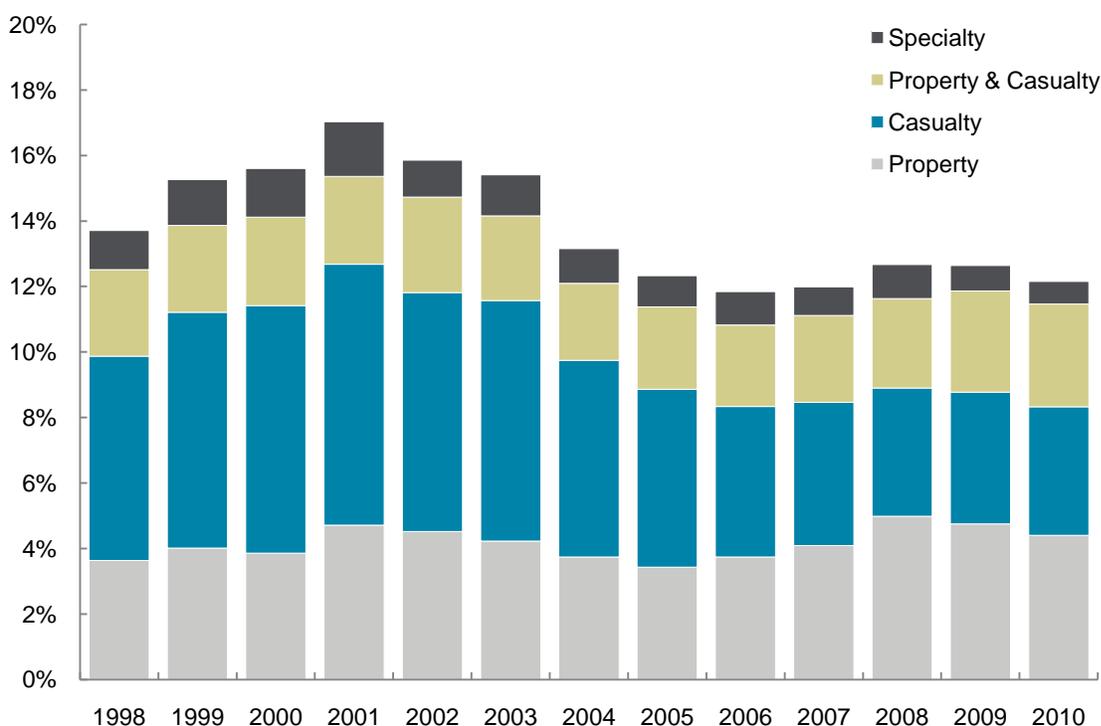


Source: Council of Insurance Agents & Brokers

Demand for Reinsurance from U.S. Insurers Continues to Decline

U.S. insurers have, for the last decade, decreased their reliance on reinsurance. Reinsurance for casualty business shows the largest decrease as U.S. insurers have continued to raise retentions. Reinsurers provided real value to insurers of casualty business over the long-term; however, during the last decade, reinsurers missed what turned out to be a very profitable opportunity by not aligning with insurers on key assumptions about declining frequency and reasonable severity. The lack of alignment destroyed material demand for treaty casualty business. The value proposition of property reinsurance remains strong globally and insurers and reinsurers are well positioned to grow this relationship.

Exhibit 11: U.S. Ceded to Gross Written Premiums



Source: Aon Benfield Analytics

Changes in Florida may Impact Demand

Because the U.S. State of Florida contributes materially to the global insured catastrophe peak zone of U.S. hurricane, it is important to understand changes in the dominating government sponsored reinsurance-like (“reimbursement”) programs in the state. Insurers in the state rely upon reimbursements from the State’s Catastrophe Fund to pay their own losses from hurricanes. The State’s Catastrophe Fund, in turn, relies substantially on its ability to sell bonds based upon assessments of all the State’s insurance policyholders for 30 years. The uncertainty associated with the State’s ability to sell these bonds has led the Catastrophe Fund to ask the State’s legislature to reduce its potential reimbursements to insurers. These measures, if they become law will decrease the supply of the Catastrophe Fund’s reimbursements and this may increase the private reinsurance needs of Florida’s residential insurers.

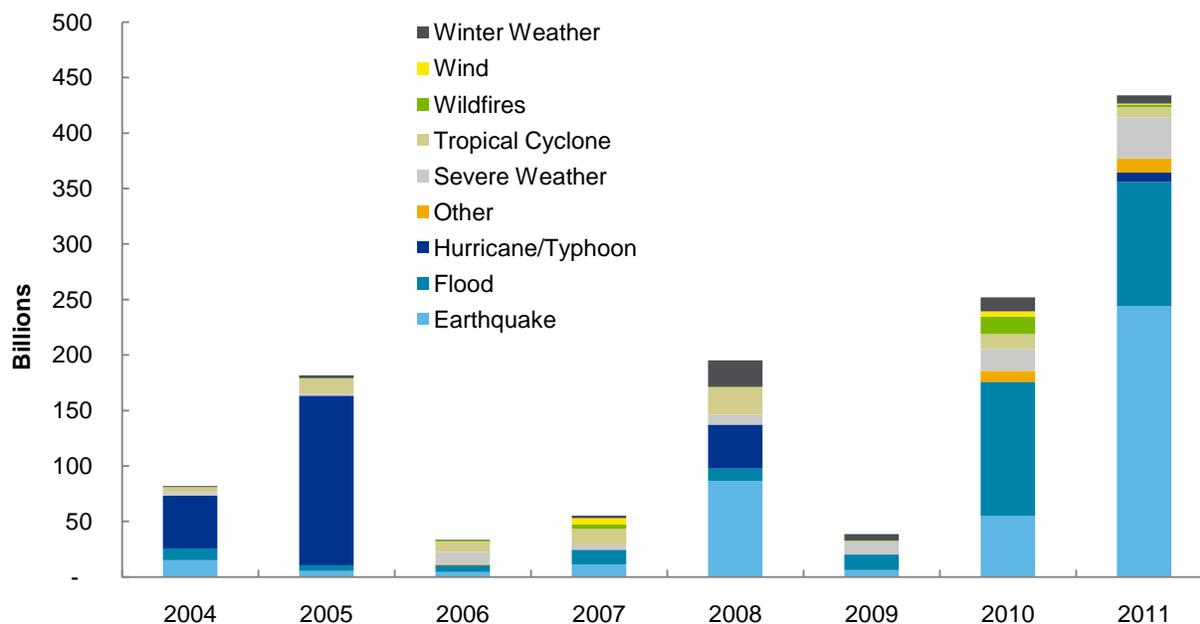
Florida's residential insurers though, have struggled with a variety of issues including insufficient rates, competition from an underpriced State-owned insurer (now the largest insurer in the State), sinkhole losses, catastrophe model changes, increased reinsurance and capital requirements from the only rating agency that still rates the majority of these insurers and changes to their MGA-based business models. Several of these insurers have failed, merged at the direction of the regulator or struggle to continue independently. Reinsurers derive a significant portion of their global catastrophe profits from Florida's residential insurers. The failures of some of these insurers have decreased the demand for private market reinsurance and more failures are expected in 2012. The remaining insurers, with some exceptions, are in a delicate condition and reinsurers are motivated to assist them through what needs to be a multiple-year process of coordinated moves to transition the Florida residential insurance market into a sustainable private market. It is not clear that the State of Florida wishes to make such a transition but its current leadership appears to understand the issues and seems genuinely interested in restoring a sustainable private insurance market.

In what is perhaps one of the first steps in the long market transition, Florida's State-owned insurer Citizens responded to the Governor's request for a comprehensive risk reduction strategy in December. The strategy Citizens presented included an increase in the 2012 budget for private market reinsurance limit of USD175 million, up from the USD575 million of limit placed for the 2011 season to USD750 million for the 2012 season. In addition, Citizens also mentioned they would seek to use catastrophe bonds for the first time. The budget includes USD250 million limit of catastrophe bond protection for 2012. The remainder of Citizens' risk reduction strategy mainly included the reduction of coverage included in its insurance policy offerings. At the margin, these reductions should make Citizens less attractive to homeowners in the state. However, substantially greater changes that will require the cooperation of the historically resistant legislature will be required to raise Citizens rates from their heavily subsidized existing levels. Agents and policyholders believe that Citizens is too big to fail and therefore take advantage of its low rates and comprehensive coverage.

Property Catastrophe Activity Update

Increased estimates on prior loss activity and additional events that occurred following our September *Reinsurance Market Outlook* have resulted in USD30 billion of additional insured losses from catastrophes in 2011. Global losses for 2011 are currently estimated at USD434 billion on an economic basis.

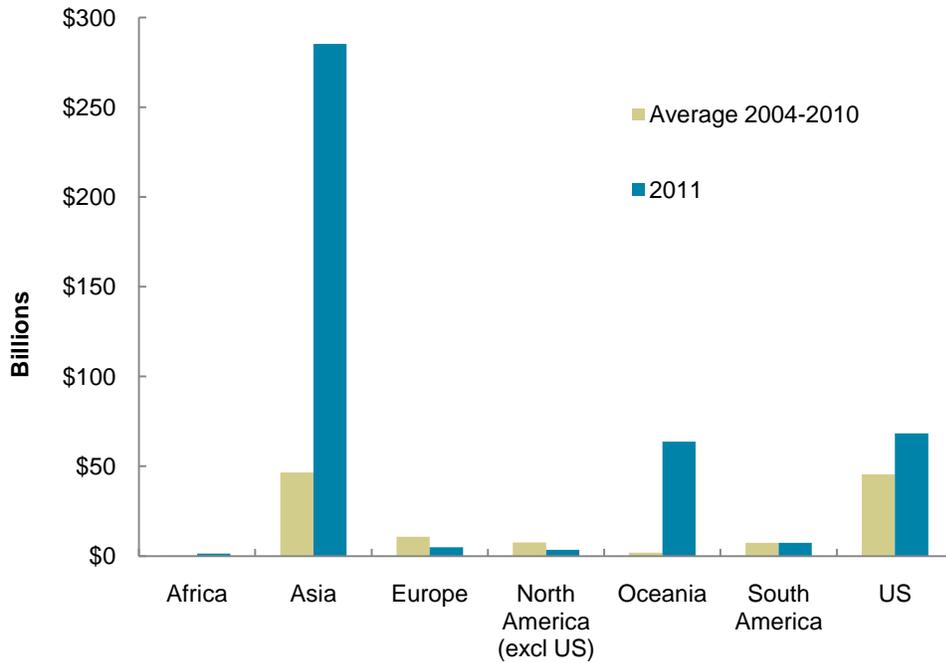
Exhibit 12: Economic Losses from Catastrophe Events by Year by Type



Source: Impact Forecasting

Losses in Asia alone accounted for 65 percent of total losses for 2011, more than six times the average annual economic loss in that region in recent years.

Exhibit 13: 2011 Economic Loss versus Recent Years' Average



Source: Impact Forecasting

Higher insurance penetration in the regions with loss in 2011 increased total loss covered by insurance to approximately 25 percent (USD106 billion), up from 15 percent in 2010.

Insured Loss Movement from September Reinsurance Market Outlook

Losses increased by almost USD30 billion since Aon Benfield released the September *Reinsurance Market Outlook*. Approximately USD11 billion emanated from the floods in Thailand in recent months, with an additional USD4.3 billion from Hurricane Irene and adverse loss development in a number of events throughout 2011.

Exhibit 14: Losses since September Reinsurance Market Outlook Report

Region	Event	September Estimates	December Estimates	Difference
Asia	Thailand Flood		10.78	10.78
U.S.	Hurricane Irene		4.30	4.30
Asia	Japan Earthquake & Tsunami	31.90	35.5	3.60
New Zealand	February Earthquake	15.40	13.50	(1.90)
New Zealand	June Earthquake		1.80	1.80
U.S.	Severe Weather - Joplin	5.00	6.50	1.50
Asia	Typhoon Roke		1.15	1.15
Europe	Floods		1.09	1.09
U.S.	Northeast Winter Weather		0.89	0.89
U.S.	Severe Weather - Tuscaloosa	6.50	7.30	0.80
All Other				5.69
Total				29.70

Source: Impact Forecasting

2010/2011 vs. 2004/2005

The insured losses in 2004 and 2005, including but not limited to seven major land-falling hurricanes in the U.S. continue to exceed the insured losses from 2010 and 2011. However, because reinsurance was substantially less expensive in the regions affected by the 2010 and 2011 catastrophes, insurers utilized far more reinsurance to protect their earnings and capital. Reinsurers assumed losses from large events in 2010 and 2011 that are now likely to exceed their assumed losses from the large events of 2004 and 2005.

Still the largest occurrence in 2011 is half the size of Hurricane Katrina after adjusting for the impact of Japanese Earthquake Reinsurance (JER) facility that keeps a substantial portion of earthquake losses from impacting the private reinsurance market. While the Japanese earthquake and tsunami is often reported as a USD35 billion insured loss event, the JER absorbs a substantial share of these losses.

Lessons Learned from 2011 Catastrophe Events

The loss events of 2011 brought interesting tests of coverage, deductibles, policyholder co-participations and government/private insurer partnerships. Our teams visited affected regions and found many interesting coverage issues that may be useful for insurers wondering what would happen to them if the events of 2011 occurred in their regions. The table below sets out just a few of our thoughts. Aon Benfield professionals that gained insight from these extensive losses are available for client major loss response planning sessions.

Exhibit 15: Lessons Learned from Observed Events

Event	Issue Observed	Event Coverage	Issues to Consider
Japan Earthquake and Tsunami	Overwhelming debris created by tsunami	No coverage for debris removal by Japanese insurers	Large scale debris removal operations in many nations will require a coordination of the insurance policy coverage for debris with the need for extensive government involvement in the debris removal process.
	Minority of homes and businesses purchased earthquake insurance	Banks do not require earthquake insurance in Japan	The impact on communities that did not have sufficient insurance was clear in New Orleans after Hurricane Katrina and it is clearly going to be an issue in Japan. Insurers and reinsurers have capacity to provide more coverage should governments recognize the inadequacy of banking policies. These policies place undue catastrophe burdens on financial systems and consequently destroy communities when the known catastrophic risks eventually occur.
	50% co-participations for all homeowners	Coverage for earthquake in Japan is viewed as financial assistance after an event rather than indemnity coverage	While a 50% co-participation is substantially larger than the deductibles in place in most other nations there appear to be no signs of policyholder unrest with this form of coverage. Would co-participations be more useful to policyholders than large deductibles? Would insurance take-up rates improve if co-participations were used rather than deductibles?
New Zealand Earthquake and Liquefaction	Severe liquefaction combined with low levels of shake related damage to homes and businesses	Government underlying and private insurer excess coverage combine to insure homes and businesses	Liquefaction can affect very large areas and the decisions about relocating homes and businesses are made by governments, not private insurers. Insurers may need to reconsider whether excess coverage can include coverage for government requirements to relocate homes.
United States Tornado and Hail Missouri and Alabama	Nature's most powerful winds affecting high concentrations of insured values	Tornado and hail losses are covered under substantially all property policies	Very high level of damage can occur as a percentage of total insured values. Some of the highest levels of insured damage to insured values ever observed in tornado and hail losses occurred in these events. Concentration risk is real everywhere. Some of the debris removal coordination issues mentioned above were also revealed in these events.
United States Hurricane Irene	Non-uniform deductibles required or allowed in multiple states affected by the same event	Varying deductibles state to state and coastal versus inland in the same state	Consistency of deductibles may be more important than previously considered and the pressure from individual state insurance regulators for extra contractual allowances to policyholders may have been underappreciated.

Source: Aon Benfield Analytics

Severe Liquefaction

One of the notable features of the earthquakes in Japan and New Zealand was the extremity of the observed liquefaction. The process of liquefaction occurs when soil temporarily changes from a solid to liquid state as heavy sand and rock sink, while water and lighter sand lift to the surface. Pressure created by this action forces liquefied soil to bubble to the surface and cover roads and landscaped surfaces, as well as destabilize structures and subsurface infrastructure.

In the case of the main magnitude-9.0 Japan event, liquefaction was sporadic but widespread as would be expected from an event of such magnitude. Geologists believe that the long duration of the earthquake shaking (up to five minutes in length) probably coupled with the extreme magnitude to exacerbate the severity of the liquefaction.

In Christchurch, liquefaction and lateral spread has occurred in each of the 4 main events which have occurred, and this is largely related to the geomorphology of the region. For the February Lyttelton event this was likely exacerbated by the significant vertical motions. All of these earthquakes have generated a significant increase in understanding liquefaction, and its occurrence during events with extreme shaking.

Government Participation in Earthquake Insurance

The New Zealand Earthquake Commission (EQC) and the JER were both tested by the recent earthquakes. The EQC assured earthquake and land restoration to all that purchased fire insurance at very low compulsory rates (\$50 for \$100,000 of building coverage). The EQC was the government instrument used to ready the country for the potential of a 7.5 magnitude event in Wellington. While the location of the recent events was Christchurch, there can be no doubt that the EQC did an excellent job of preparing the country for the financial consequences of the severe financial outcomes from the recent series of events. While New Zealand considers the appropriate financial structure for future events, reinsurers continue to deploy extensive capacity to the system at very favorable terms.

The JER's mission was quite different from EQC's. JER primarily ensured that non-life insurers could offer a financial assistance (non-indemnity) product to those homeowners that opted to acquire such coverage. The proportion of Japanese homeowners in the affected region that opted to acquire the financial assistance product from non-life insurers is estimated in the mid 20 percent level. JER is the exclusive reinsurer of non-life insurers in Japan for residential earthquake risks and it does not make use of any private reinsurance to back its significant (USD64 billion) earthquake capacity. The partnership between insurers, JER and the Japanese government was clearly well thought out prior to the March 11 events. The financial consequences to insurers and their policyholders are substantially less devastating than they would have been without the forethought of the program. The substantial uninsured population and the 50 percent co-participation level on all underlying policies makes it likely that some elements of the program may need to be reconsidered if greater homeowner assistance is considered desirable following the next significant earthquake. As proven in New Zealand, reinsurers have substantial capacity to provide government programs and can be relied upon to act quickly to fulfill their commitments following major losses.

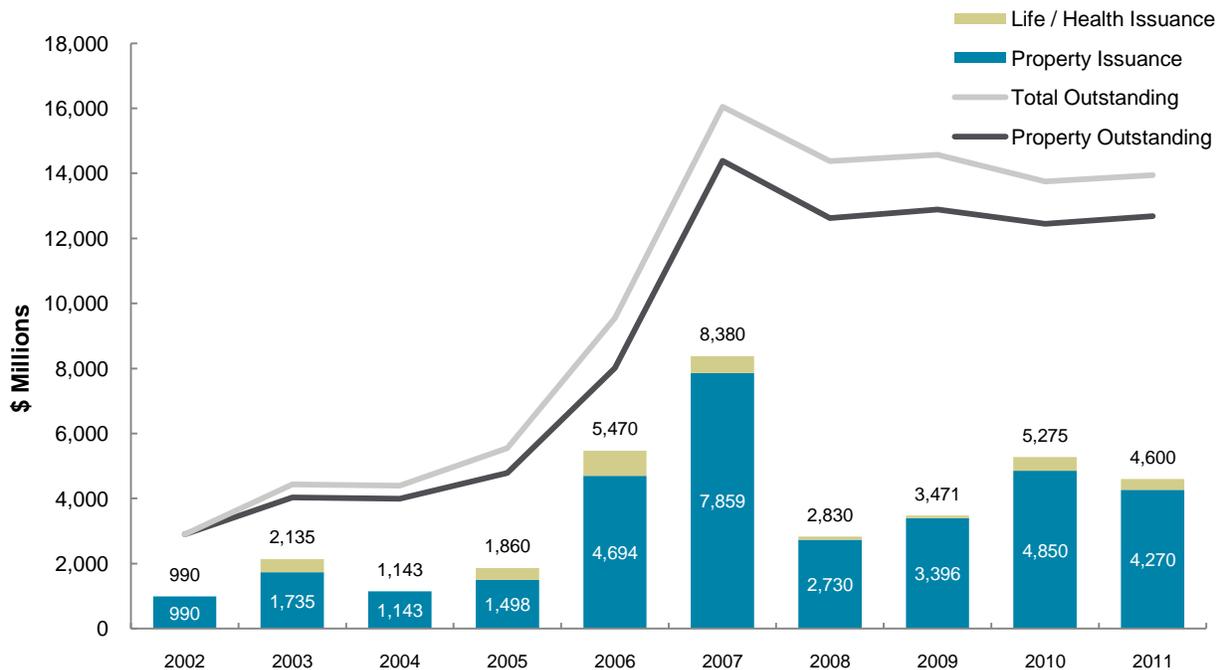
Government participation in catastrophe insurance plans continues to grow worldwide. In the U.S. for example, state sponsored wind pools that provide insurance for hurricanes and other wind related losses cover 2.25 times more risk than they did in 2005.

Catastrophe Bond Transaction Update

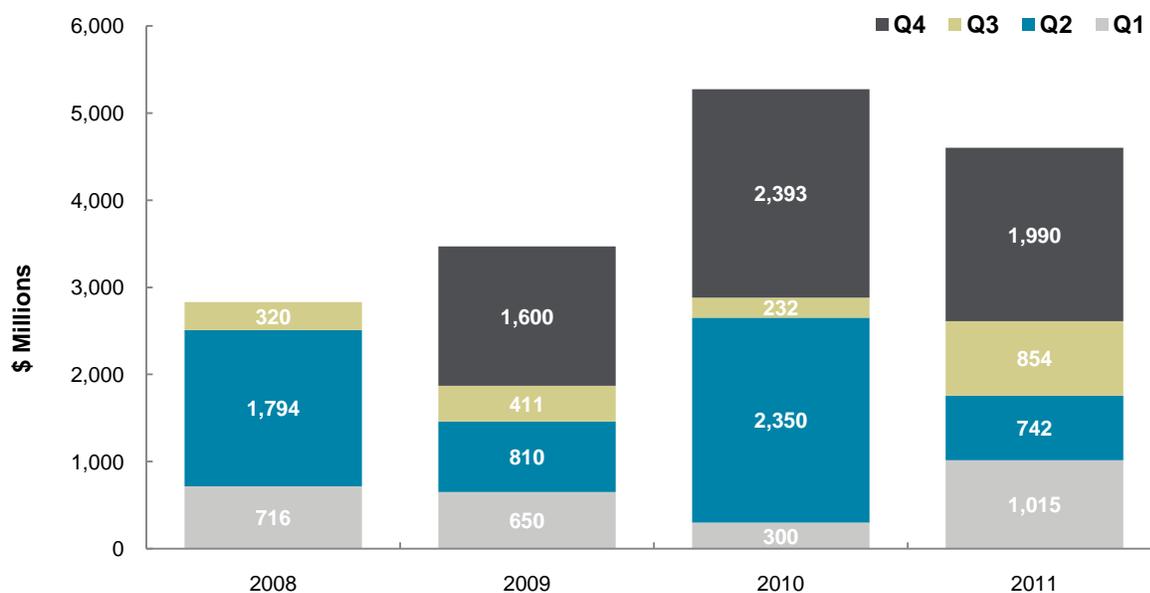
Although the ILS market started strong in Q1 and ended with a flurry of issuances in Q3 and Q4, impacts from record levels of global catastrophic losses, as well as reverberations from the release of the updated RMS U.S. hurricane model, caused the issuance levels for 2011 to be below initial expectations. Total issuance in 2011 was USD4.6 billion, a 13 percent decline from 2010 and certainly lower than the initial estimates of USD5 to USD6 billion. Still, the issuance level in 2011 was sufficient to cause the outstanding catastrophe bonds to post a small amount of growth, only the second time in the past four years in which new issuances outstripped maturing bonds.

The chart below highlights annual issuance over the past ten years and total catastrophe bonds outstanding:

Exhibit 16: Outstanding Catastrophe Bond Issuance



Source: Aon Benfield Securities, Inc.

Exhibit 17: Catastrophe Bond Issuance by Quarter

Source: Aon Benfield Securities, Inc.

Quarterly Summary 2011

2011 was clearly a year with stories – a weaker than expected first half of the year and a more active than expected second half of the year. After a strong start with more than USD1 billion of issuances in Q1, the traditionally active Q2 brought only USD742 million of catastrophe bonds, a 68% decline from USD2.3 billion in the same quarter a year earlier. Overall results for H1 2011 were USD1.76 billion, a 34 percent decline from H1 2010. The lower than expected primary issuance, however, led to more than a 3 fold increase in secondary market trading, as investors looked to utilize excess capital.

Catastrophe bond issuance rebounded in Q3, with more than USD800 million of new issuances in the quarter. The rebound was fueled by issuances of diversifying perils, satisfying the demand from investors for risks other than U.S. hurricane and caused the results to significantly increase from the USD232 million recorded in the same year ago period.

Q4 continued the resurgence in issuances, as investors continued to deploy capital that had been largely on the sidelines since the end of the first quarter. Nearly USD2 billion of new deals closed for nine sponsors, two of which were first time entrants. Strong investor demand was met with additional supply as evidenced by several deals being upsized (some significantly) from their original targeted offerings. The nearly USD2 billion of issuances that closed during Q4 represented an increase of almost USD800 million over original offering amounts. Also noteworthy was the fact that USD1 billion utilized aggregate trigger structures. Overall results for H2 2011 were USD 2.84 billion, an 8 percent increase from H2 2010.

By the close of 2011, both sponsors and investors had successfully navigated formidable obstacles to finish the year on a high note. This bodes well for the continued growth of the market. The forward calendar for Q1 2012 is expected to be active with a strong pipeline of new deals. Additionally, we expect the secondary markets to continue to demonstrate resiliency at or above 2011 trading levels.

The following chart summarizes the terms of the deals that closed during H2 2011:

Exhibit 18: Catastrophe Bond Transactions Closed During Second Half of 2011

Beneficiary	Issuer	Series	Class	Size (MM)	Covered Peril(s)	Trigger	S&P Rating	Expected Loss	Interest Spread
Munich Re	Queen Street III Capital Ltd.			\$150	EU W	Industry Index	B+	1.91%	4.75%
California Earthquake Authority	Embarcadero Reinsurance Ltd.	Series 2011-1	Class A	\$150	US EQ	Indemnity	BB-	2.09%	6.60%
Electricité Réseau Distribution France ¹	Pylon II Capital Ltd.		Class A	€65	EU W	Parametric Index	B+	2.59%	5.50%
Electricité Réseau Distribution France ¹	Pylon II Capital Ltd.		Class B	€85	EU W	Parametric Index	B-	4.52%	9.00%
SwissRe	Vita Capital IV Ltd.	Series 5	Class D	\$100	Extreme Mortality	Index	BBB-	0.24%	2.90%
SwissRe	Vita Capital IV Ltd.	Series 6	Class E	\$80	Extreme Mortality	Index	BB+	0.68%	3.85%
Tokio Marine & Nichido Fire Insurance Co., Ltd.	Kizuna Re Ltd.	Series 2011-1		\$160	JP TY	Indemnity	Not Rated	1.81%	5.50%
AXA Global P&C ²	Calypso Capital Ltd.	Series 2011-1	Class A	€180	EU W	Industry Index	BB-	1.70%	4.10%
MunichRe	Queen Street IV Capital Ltd.			\$100	US HU, EU W	Industry Index	BB-	1.94%	7.50%
SwissRe	Successor X Ltd.	Series 2011-3	Class V-F4	\$80	US HU	Industry Index	Not Rated	6.70%	16.25%
SwissRe	Successor X Ltd.	Series 2011-3	Class V-X4	\$50	US HU, EU W	Industry Index	B-	3.14%	11.25%
United Services Automobile Association	Residential Reinsurance 2011 Ltd.	Series 2011-II	Class 1	\$100	US HU, EQ, ST, WS, WF	Indemnity	Not Rated	1.65%	8.90%
United Services Automobile Association	Residential Reinsurance 2011 Ltd.	Series 2011-II	Class 2	\$50	US HU, EQ, ST, WS, WF	Indemnity	Not Rated	3.33%	13.25%
California State Compensation Ins. Fund	Golden State Re Ltd.	Series 2011-1	Class A	\$200	US EQ	Modeled Loss	BB+	0.36%	3.75%
National Union Fire Insurance Co. of Pittsburgh	Compass Re Ltd	Series 2011-1	Class 1	\$75	US HU, EQ	Industry Index	BB-	1.76%	9.00%
National Union Fire Insurance Co. of Pittsburgh	Compass Re Ltd	Series 2011-1	Class 2	\$250	US HU, EQ	Industry Index	BB-	1.87%	10.25%
National Union Fire Insurance Co. of Pittsburgh	Compass Re Ltd	Series 2011-1	Class 3	\$250	US HU, EQ	Industry Index	B+	2.26%	11.25%
SCOR Global P&C SE	Atlas VI Capital Ltd.	Series 2011-1	Class A	\$125	US HU, EQ	Industry Index	B	3.95%	15.25%
SCOR Global P&C SE	Atlas VI Capital Ltd.	Series 2011-1	Class B	\$145	US HU, EQ	Industry Index	B+	2.83%	12.50%
SCOR Global P&C SE	Atlas VI Capital Ltd.	Series 2011-2	Class A	€50	EU W	Industry Index	B	3.30%	8.00%
Amlin AG	Tramline Re Ltd.	Series 2011-1	Class A	\$150	US HU, EQ, EU W	Industry Index	B-	3.98%	17.00%
Argo Re Ltd.	Loma Reinsurance Ltd.	Series 2011-2	Class A	\$100	US HU, EQ	Industry Index	Not Rated	5.12%	18.00%
\$2,843									

Source: Aon Benfield Securities, Inc.

¹ 1 EUR = 1.42 USD as of Aug 11, 2011

² 1 EUR = 1.38 USD as of Oct 20, 2011

³ 1 EUR = 1.32 USD as of Dec 12, 2011

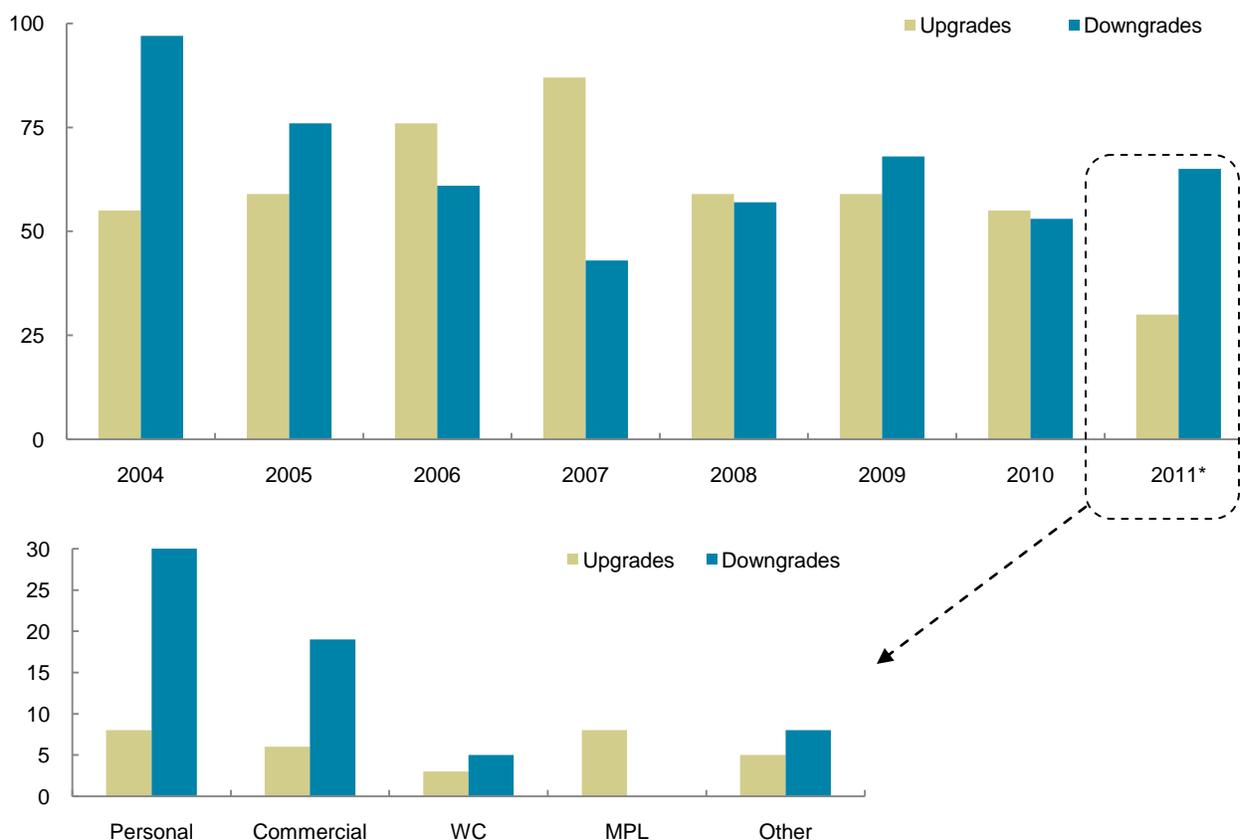
Legend: HU – Hurricane; WF - Wild Fire; EQ – Earthquake; EU – Europe; WS - Winter Storm; US - United States; ST - Severe Thunderstorm

Rating Agency and Regulatory Perspectives

Downgrade Environment

2011 was a challenging year for many global non-life insurers due to elevated catastrophe losses, heightened stock market volatility, and continued decline in investment yields. These conditions weakened capital adequacy for many companies and led to a number of rating downgrades. As shown below measured by A.M. Best rating changes, the U.S. market endured a downgrade environment in 2011 with downgrades outpacing upgrades by a ratio of 2:1. Further analysis shows that the underlying trend is even more tilted toward downgrades when evaluating rating actions by industry composite. Specifically, the medical professional liability (MPL) sector has been a contrarian with eight upgrades and zero downgrades in 2011, whereas excluding MPL companies from the analysis the downgrade to upgrade ratio approaches 3:1.

Exhibit 19: A.M. Best Rating Changes (U.S. Non-Life Industry)



*as of December 20, 2011
Source: Aon Benfield Analytics

Looking back a year ago, there were approximately 110 companies with a negative outlook from A.M. Best. Of those ratings that were updated in 2011, 47 percent were downgraded, with some experiencing multiple notch downgrades. In contrast, for companies that entered 2010 with a negative outlook from A.M. Best, only around 25 percent had their ratings downgraded in 2010.

Similarly, Standard & Poor's (S&P) rating changes for U.S. P&C companies have been mostly downgrades, with seven companies downgraded in 2011 and only two companies upgraded.

Outside the U.S., we saw significant market players impacted by negative rating actions, mostly related to Eurozone debt exposure. Below is a table of key non-U.S. companies downgraded or currently on Credit Watch Negative from S&P and A.M. Best.

Exhibit 20: Rating Agency Actions on Non-U.S. Companies

Company / Group	Standard & Poor's			A.M. Best		
	Current Rating	Prior Rating	Action	Current Rating	Prior Rating	Action
Allianz Group	AA	AA	Credit Watch Negative	A+	A+	Under Review Negative
Aviva Group	AA-	AA-	Credit Watch Negative	A	A	Under Review Negative
AXA Financial	AA-	AA-	Credit Watch Negative	NR	NR	
Caisse Centrale de Reassurance	AAA	AAA	Credit Watch Negative	A++	A++	Under Review Negative
Generali	AA-	AA-	Credit Watch Negative	A	A+	Downgrade; Under Review Negative
Groupama	BBB-	A-	Downgrade; Credit Watch Negative	NR	NR	
Mapfre	AA-	AA	Downgrade; Credit Watch Negative	A	A+	Downgrade; Under Review Negative

Source: Aon Benfield Analytics

In total, A.M. Best downgraded 14 European groups while S&P downgraded or placed on Credit Watch Negative 29 companies.

S&P also took multiple rating actions on a number of Japanese groups as well as Thai Re, primarily driven by regional catastrophe losses.

Exhibit 21: Rating Agency Actions on Non-U.S. Companies

Company / Group	Standard & Poor's			A.M. Best		
	Current Rating	Prior Rating	Action	Current Rating	Prior Rating	Action
Asia Capital Re	A-	A-	Credit Watch Negative	A-	A-	No Rating Action
MS&AD	AA-	AA-	Credit Watch Negative	A+/A	A+/A	No Rating Action
NKSJ	AA-	AA-	Credit Watch Negative	A+/A	A+/A	No Rating Action
Thai Re	BBB+	A-	Credit Watch Negative	NR		
Toa Re	A+	A+	Credit Watch Negative	A+	A+	Under Review - Negative
Tokio Marine Group	AA-	AA-	Downgraded	A++	A++	No Rating Action

Source: Aon Benfield Analytics

Catastrophe Losses and Model Change

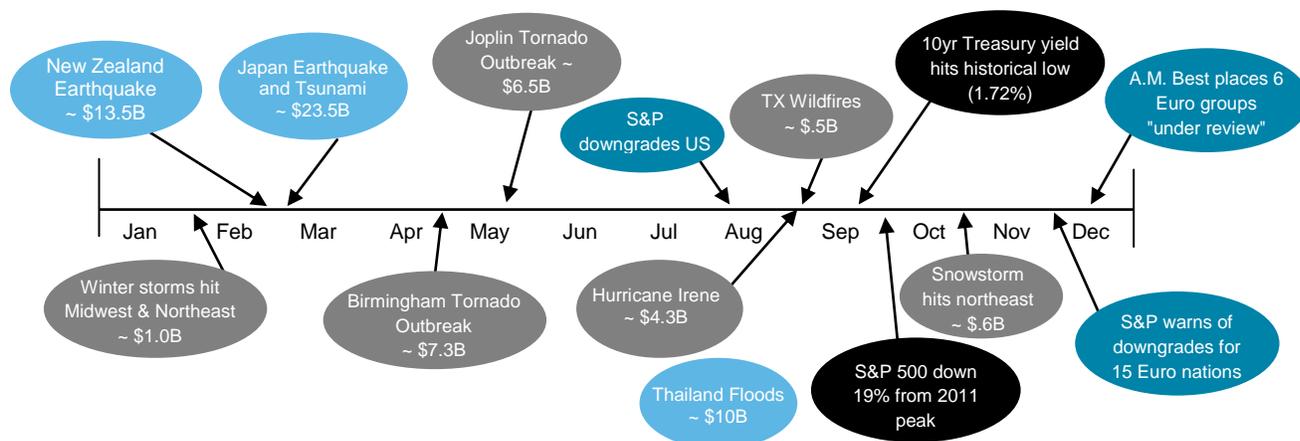
In 2011, catastrophe loss activity and catastrophe model changes have been at the forefront of rating agency discussions in the U.S. Property Claims Services (PCS) measured U.S. catastrophe losses at USD30.9 billion for the year through November 2011. This is 170 percent higher than the trended historical losses and makes 2011 the fourth worst catastrophe year over a 61 year period trailing only 2005, 1992 and 2004. Interestingly, the top three years were all driven by noteworthy hurricane activity, while 2011 has been primarily impacted by significant tornado and hail loss activity. In March, Risk Management Solutions released an update to their hurricane catastrophe model (RMS v11) which led to significant increases in the average annual loss (AAL) and probable maximum loss (PML) estimates at the 100-yr and 250-yr return periods. Most notably, some companies in the Gulf Coast, Mid-Atlantic, and Northeast regions had their PMLs increase by over 100 percent due to the model change. As such, RMS v11 results have been subject to much scrutiny and rating agencies have allowed companies time to analyze and understand the changes to their portfolio. Further, many companies have more explicitly adopted a customized approach that they believe better reflects the exposures of their individual portfolios and mitigates the potential volatility of relying on a single catastrophe model. While the impact of RMS v11 varies by company and some challenge its results, the process of doing an additional analysis to understand exposure has enhanced the catastrophe risk management process for many companies (even if they do not agree with RMS v11 findings).

Outside the U.S. model change has not garnered the same level of interest for rating agencies as within the U.S. despite significant changes to the Euro Wind model. Nonetheless, non-U.S. companies are considering the impact of the model change, as well as a shift to blending of modeled losses, in the context of both Solvency II and the rating agencies. Needless to say, the combination of global catastrophe losses and model change has impacted both ratings and companies' views of catastrophe risk.

Financial Trends

As depicted in the following timeline, 2011 was an eventful year with elevated catastrophe loss activity, volatile stock market conditions, record low investment yields, downgrade of U.S. debt and the European sovereign debt crisis.

Exhibit 22: Timeline of 2011 Industry Events

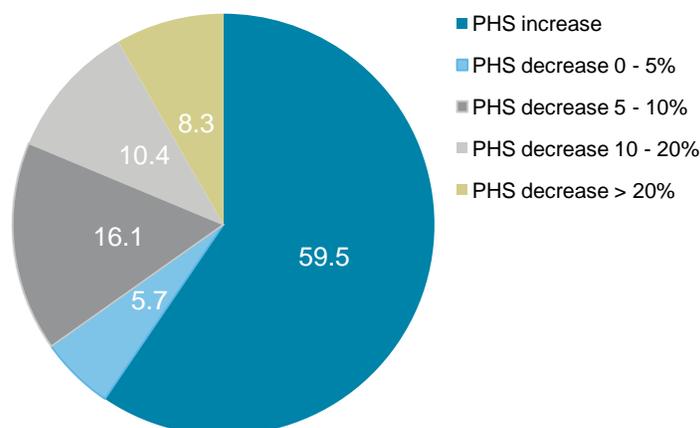


Source: Aon Benfield Analytics

These events significantly impacted the earnings and capital position of many U.S., Japanese and European primary companies and reinsurers. Per A.M. Best, the U.S. non-life industry combined ratio through Q3 2011 is 108.3 percent, which is 8.5 points higher than a year ago. While many companies generally expect favorable underwriting results during the last quarter of a year, there is not enough profit in Q4 results to save 2011. Further, 2011 results have also shown signs of loss development erosion and there is the possibility that some companies will be increasing losses following a year-end review of reserves. In all, the industry is poised to record its highest combined ratio in more than a decade.

As of September 2011, the overall U.S. P&C industry surplus is down 3.1 percent from year-end 2010. However, 34.8 percent of companies have experienced a decline in surplus greater than 5 percent with 18.7 percent reporting a decline of more than 10 percent. While reinsurers have not been unscathed to the challenges 2011 has presented, due to the nature of many of the events highlighted above and coupled with a steady trend toward higher retentions in recent years, primary company financials have taken a larger hit to capital.

By comparison, total equity declined only 1 percent based on our analysis of 28 companies comprising the Aon Benfield Aggregate (ABA) for the reinsurance industry, which includes primarily U.S., Bermudian and European carriers. Three of the 28 companies reported a decline of more than 10 percent, but their beginning equity only represented 1.3 percent of the total equity for the ABA composite. Global reinsurer capital declined 4 percent year to date, as this estimate incorporates much of the capital lost from the Asia Pacific catastrophes within companies not part of the ABA.

Exhibit 23: Distribution of U.S. Surplus change from YE 2010 to 9/30 2011

Source: Aon Benfield Analytics

Given the number of companies that have experienced a decline in surplus, we have seen capital adequacy measures erode as well. For the first time since 2008 when the industry absorbed the financial markets crisis, we expect median U.S. BCAR scores to drop across the board even after reflecting rating downgrades. Likewise, we expect average U.S. S&P capital adequacy to diminish given the drop in surplus as well as the shrinking investment yields. Companies with meaningful reserve leverage will see their S&P Total Adjusted Capital (TAC) impacted by a lower investment rate applied to reserves and unearned premium as the 10-year Treasury yield has fallen from 3.30 percent in December 2010 to currently hovering around 2.00 percent. Since September 30 the S&P 500 has rebounded by 11.6 percent which will help offset the surplus erosion for some companies. In addition, unrealized bond gains have grown for many companies providing a needed lift to BCAR capital.

Outside the U.S. we expect capital adequacy ratios to decline likewise due to the aforementioned catastrophe losses but as well as market value write downs on European sovereign debt and possibly on fixed income investments of certain European banks. Further, European government yields are in line with current U.S. yields (see Exhibit 30) while Japanese yields continue to lag behind both, which will hinder investment income opportunities to offset losses, further impacting capital adequacy levels.

Exhibit 24: Minimum and median U.S. BCAR scores by rating level

A.M. Best's Capital Adequacy Scale				
Rating	Minimum	2010 Median	2011 Est. Median	Change
A++	175	293	279	-14
A+	160	316	292	-25
A	145	298	286	-11
A-	130	264	245	-18
B++	115	232	215	-17
B+	100	178	164	-14

Source: Aon Benfield Analytics

Loss Reserve Adequacy

The consensus view of the rating agencies is that the reserve cushion accumulated during the last hard market (2002-2006) is diminished and that the most recent accident years (2008-2010) will see an uptick in the ultimate loss and LAE ratios. Rating agencies expect continued decreases in P&C reserve releases through 2012 with average industry earning enhancements approaching zero in the long-term.

Rating agencies will continue their vigilance in monitoring reserve positions and advise that unforeseen charges from adverse loss development will result in downward pressure on a company's rating. Pricing, inflation, regulation and reserve risk controls are seen as the primary drivers of non-life reserve adequacy across agencies. Below is a chart of each rating agency's view of U.S. reserve positions as of 2010.

Exhibit 25: Rating Agency Views of Industry Reserves

	Rating Agency	Estimate
(1)	A.M. Best	\$19.3B Deficiency (Excludes Statutory discount)
(2)	Fitch	\$18.2B Redundancy to \$8.7B Deficiency
(3)	Moody's	\$1.6B Redundancy to \$1.4B Deficiency
(4)	Standard & Poor's	Adequate but Deteriorating

- (1) A.M. Best presentation at 2011 Aon Benfield Analytics July Conference
 (2) Fitch's P/C Industry Loss Reserve Adequacy Special Report, August 22, 2011
 (3) Moody's P&C Reserves Special Comment, December 19, 2011
 2010 estimated redundancy of \$11-13B less 2011 reserve releases of \$11.4B
 (4) Standard & Poor's Reserve Adequacy for the Long Tail Commercial Lines, June 7, 2011

Rating Agency Impact on Reinsurance Supply and Demand

Rating Agency actions and concerns are not creating a widespread impact on either reinsurance supply or demand. Reinsurers are still operating at near record capital levels, as evidenced by only a 1 percent decline in ABA capital and 4 percent decline in global reinsurer capital despite 2011 catastrophe losses after reaching record levels of capital in 2010. Reinsurers with significant U.S. hurricane exposure saw their PMLs increase materially due to the recent model changes, but given excess capital positions and reinsurers' use of blending models and other analytical tools such as custom loss curves, they did not need to buy more retro or significantly reduce catastrophe exposures in order to maintain their ratings. As such, their capital adequacy levels remained relatively flat, thus not driving a change in capacity purely from a rating agency perspective. Certain reinsurers with outsized catastrophe losses likely had to rethink their catastrophe accumulations from a rating agency perspective in order to maintain ratings, but this did not materially impact overall reinsurance supply.

In certain isolated cases, U.S. companies that lost a substantial amount of their capital base due to 2011 losses or an accumulation of losses over the past few years have purchased quota share reinsurance or additional catastrophe excess of loss reinsurance as a means to bolster rating agency capital adequacy in order to avoid or minimize the number of downgrades. However, despite significantly higher PMLs emanating from the updated catastrophe models, as well as primary company catastrophe losses, rating agency capital adequacy for the U.S., as defined by A.M. Best BCAR, remains robust, though down slightly from 2010 levels (see Exhibit 24). A small number of companies purchased additional catastrophe excess of loss limit to respond to the model change and help keep their capital adequacy levels consistent, but this was not as extensive as initially expected. Similar to reinsurers, companies looked to a blended view of the models as well as other analytical tools to help manage the capital adequacy impact from model change. Also, given reinsurance pricing, companies opted to increase retentions or take a small co-participation, and only in some cases used the savings to purchase additional limit on top.

The majority of U.S. rating actions were a result of poor profitability rather than a significant decline in capital. Companies are trying to manage their desire to improve volatility and profitability against the cost of reinsurance that would enable them to do this. A number of companies that did not previously purchase aggregate covers considered this form of reinsurance to manage their ratings, particularly those on negative outlook resulting from a number of consecutive years of material catastrophe losses. However, the price for aggregate reinsurance proved to be too costly for many. Similarly, a number of companies explored quota share reinsurance as a means to manage volatility and share more losses with the reinsurers, but again the cost outweighed the benefit in the eyes of most potential cedents. Instead, companies are trying to manage their ratings by improving profitability from a pricing perspective rather than reinsurance. Next year will tell though if the rating agencies accept this or pressure companies to manage better their recent volatility via third party reinsurance.

As such, demand in the U.S. driven by rating agency requirements was up slightly due to model change and downgrade pressure from profitability strain, but was not a material driver behind any increased demand.

Outside the U.S., and particularly in Japan, companies lost a significant amount of capital due to catastrophe losses. Japanese and other Asia Pacific companies are still assessing the impact of the Earthquake losses as well as the Thai flood losses. Those companies will be under pressure to rebuild their capital in the near-term, and reinsurance would be an efficient means to do this. However, as most of these companies' reinsurance programs renew at April 1, it is too soon to determine how rating agencies will drive reinsurance demand in the region. As noted above though, a number of Japanese non-life companies are on Credit Watch Negative status from S&P, so there is significant rating agency pressure to improve both capitalization and profitability.

In Europe, rating agency actions and pressure are a result of the sovereign debt crisis, much of which is evolving daily. Given the underlying uncertainty, European companies are taking a 'wait and see' approach to managing this. Although reinsurance would be an effective way to help manage capital adequacy, even when caused by asset write downs, we do not see this driving a significant change in demand in the near-term.

Enterprise Risk Management

Enterprise risk management processes were tested industry-wide in 2011. Elevated natural catastrophes, particularly in parts of Asia-Pacific earlier this year, set the tone on the liability side of reinsurance balance sheets. This continues on the asset side during the later-half of the year with credit losses and financial market contagion associated with the sovereign debt crisis in Europe. Some carriers were hit harder than others by these extreme scenarios. However, other than a handful of outliers, the industry has proven to be resilient during these stressful financial times, a sign that the fundamentals of ERM are being followed. The question is which companies are better positioned for the risk challenges that will surface in 2012: emerging or fully known, asset or liability driven, or even the regulatory demands that are on the horizon such as solvency II in Europe or the solvency modernization initiative in the U.S.

Most financial, risk and strategic leaders alike would agree that the ERM concept has had positive influences on the industry as a whole. Some firms have had their ERM scores upgraded by S&P in 2011, and S&P noted in an ERM report on May 3, 2011 a positive correlation between higher ERM scores and better stock price performance of their rated U.S. and Bermudian public insurers and reinsurers.

However, even the most advanced ERM constructs have limitations. Examples of global ERM score changes in recent years showed exactly that, as certain firms previously viewed to have “excellent” or “strong” ERM as measured by S&P’s ratings reviews were downgraded as a result of excess unexpected losses or misapplication of risk management processes, after the financial crisis of 2008 and the more recent extreme events in 2011. Understanding multiple risk interaction and diversification under a portfolio context, a staple of ERM, can provide a misleading perspective if done naively. That is, simply adding risks to a portfolio will not enhance risk-adjusted returns on a continuum.

Some companies with outsized catastrophe risk exposures in regions viewed to have diversification benefits to existing portfolios realized losses and correlations that were above expectations. These were due to ERM framework weaknesses including misapplication of risk bearing capacity (e.g., faulty application of risk models or results), or misunderstood risk tolerances where balance sheets were unknowingly exposed to loss scenarios that were beyond comfort. Indeed, the RMS catastrophe model changes introduced in 2011 highlight the risk capacity and risk tolerance issues at hand. 2012 will likely see a re-focus on what risk tolerance will mean for certain companies, as well as how organizations will use risk tools such as catastrophe models. Even rating agencies welcome the idea of a move towards multiple model views for catastrophe risk (or any risk) for a more enriched understanding of the risk identification / measurement aspect of ERM.

Since 2006 S&P has led the charge on embedding the evaluation of insurers’ and reinsurers’ risk management within financial strength ratings. New for 2011 was S&P’s focus on economic capital modeling (ECM) for a selected group of firms already viewed to have strong or excellent ERM. The market still awaits the findings of these reviews with expectations that if S&P deems the ECM process of firms to be credible, then these organizations may get capital relief within S&P’s capital model framework.

A.M. Best expanded its risk management review process as well. New for 2011 was a series of questions specific to ERM within their supplemental rating questionnaire (SRQ). These questions cover topics such as risk governance practices, risk tolerance and the use of economic capital modeling. Per an A.M. Best special report that summarized the ERM SRQ responses, the majority of U.S. companies has a Chief Risk Officer and makes strategic decisions based on combined risk-reward measures, although less than 30 percent in the U.S. use economic capital models. Also, larger and higher rated firms seem to have relatively more advanced ERM processes in the U.S., and these trends align with Aon Benfield’s published data for global S&P ratings and ERM scores.

Ratings actions are often driven by a combination of factors such as capital, earnings performance, and strategy. In addition the role of and focus on risk management by rating agencies will establish fundamental practices that will be expected of the industry going forward. Entering 2012 those firms that fail to demonstrate sound ERM fundamentals will face additional scrutiny by rating agencies, may need to hold more capital than peers, and risk a strong likelihood of downward pressure on their ratings.

Risk management understanding and application is a fundamental and essential component of the overall management of any insurance and reinsurance company. However, simply claiming to have an ERM construct is not enough. Stakeholders will continue their push to gain more insight on ERM including capital modeling. Companies must first ensure that adequate processes exist to identify, understand and respond to the risks that they entertain, while articulating to their constituencies why those processes are adequate. Otherwise these firms face the risk that their pricing power, ratings and valuations will trail their peers in what will continue to be a complex financial market underscored by global political uncertainties in 2012.

On The Horizon for the U.S....

The NAIC has been active with its Solvency Modernization Initiatives (SMI). During the NAIC Fall National Meeting, the NAIC adopted two key reforms:

1. The reintroduction of a catastrophe risk charge in the NAIC's Risk Based Capital (RBC) formula
2. Own Risk Solvency Assessment (ORSA) Guidance Manual

The NAIC has been considering the inclusion of a catastrophe risk charge in the RBC for a number of years now. The U.S. RBC is the only solvency capital calculation in a developed insurance market to exclude a specific catastrophe risk charge.

At the fall meeting, the NAIC discussed a number of its initial conclusions regarding the use of one or more of the three commercially available models (RMS, AIR and EQECAT) that will be approved to model companies' exposure to hurricane and earthquake events. The modeled loss exposure from only these models would become the basis for companies' catastrophe RBC charge. Based on the discussion at this meeting, it appears that the NAIC has tentatively decided upon the following:

- Any one or a combination of two or three of the commercial models can be used.
- Model choices and key modeling parameters will be determined by the companies provided they are the same as the insurer uses in its own internal catastrophe management risk process.
- The risk charge will be net of reinsurance.
- The charge will be based on separate 1-in-100 year modeled loss for both hurricane and earthquake events.
- A contingent credit risk charge for the risk of uncollectible reinsurance will be assessed. The current charge is 10 percent, though this is still being debated both within and outside the NAIC.
- The NAIC will continue to discuss whether models should use Tail Value At Risk rather than Value At Risk.
- There would be a covariance adjustment applied to the separate hurricane and earthquake events. The hurricane catastrophe risk charge plus the hurricane contingent credit risk charge will be added together and then squared. The earthquake catastrophe risk charge plus the earthquake contingent credit risk charge will be added together and then squared. These two values would be added to the sum of the squares of all the other RBC risk elements before the square root of the new total is taken.

Interestingly enough, the NAIC previously intentionally excluded Other Wind from its assessment of a catastrophe charge. Many of the discussions regarding the catastrophe risk charge predate the recurring severe storm losses over the recent years that have negatively impacted capital, earnings and ratings for a number of companies geographically focused in Other Wind exposed states. Despite these losses, there are no indications that the NAIC wishes to include Other Wind in its catastrophe risk charge.

The ORSA is another important component of the NAIC's SMI. Many in the industry view this as the most significant U.S. regulatory requirement since the adoption of the RBC. The two primary goals of ORSA, per the NAIC are:

1. To foster an effective level of enterprise risk management at all insurers, through which each insurer identifies and quantifies its material and relevant risks, using techniques that are appropriate to the nature, scale and complexity of the insurer's risks, in a manner that is adequate to support risk and capital decisions.
2. To provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view.

The ORSA reporting requirement will only apply to individual companies with annual direct and assumed premiums greater than USD500 million or groups with annual direct and assumed premiums greater than USD1 billion.

The NAIC views ORSA as just one element of an insurer's overall Enterprise Risk Management (ERM) framework. It links the insurer's risk identification, measurement and prioritization processes with capital management and strategic planning. The NAIC believes that an effective ERM framework should include, at a minimum, the following key principles:

- Risk culture and governance
- Risk identification and prioritization
- Risk appetite, tolerances, and limits
- Risk management and controls
- Risk reporting and communication

These key principles are very similar to those presented by the rating agencies.

Companies are expected to document the quantitative measurement of risk exposure in both normal and stressed environments of each material risk category. Quantitative measurement should be relevant to the category and can include the following categories: credit, market, liquidity, underwriting, and operational risks.

Generally, insurers should consider the likelihood and impact that each material and relevant risk will have on the firm's balance sheet, income statement and future cash flows. Also, the analysis should be conducted in a manner that is consistent with the way in which the business is managed, be it on a group, legal entity, or some other orientation. Furthermore, companies should consider the impact of stresses on capital adequacy. This may include consideration of risk capital requirements, as well as available capital, and may include regulatory, economic, rating agency or other views of capital adequacy.

Finally, any risk tolerance statements should include material quantitative and qualitative risk tolerance limits, how the tolerance statements and limits are determined, taking into account relevant and material categories of risk and risk relationships that are identified.

The NAIC also presented a Group Capital Assessment, which is intended to document how the company combines the qualitative elements of its risk management policy and the quantitative measures of risk exposure in determining the level of financial resources necessary to manage current business and longer-term business cycle, such as the next 2-5 years. The goal is to determine that a given level of capital is sufficient to withstand the various risks, individually and collectively, up to a defined risk appetite.

Companies need to provide a two to five year business plan and assess its ability to meet the capital requirements of these future plans. Companies need to consider the following:

- Current risk capital requirements (internal and regulatory)
- Quality of capital
- Risk management policy
- Risk exposure (on both a normal and stressed basis)

Notwithstanding potential rating agency changes resulting from current economic conditions or pressures, U.S. companies need to stay abreast of the rapidly developing regulatory framework within the U.S. Needless to say non-U.S. companies are feeling similar pain, emanating from Solvency II and other regulatory initiatives globally resulting from a heightened regulatory focus.

Continued Pressure on Ratings

The culmination of the recent catastrophe losses, local and global economic pressures and looming regulatory changes continue to put downward pressure on ratings both within the U.S. and on the global scale. In the U.S. we are seeing downgrades driven by continual poor profitability, while in Europe most rating actions are resulting from the sovereign debt crisis (more on this in the section entitled “European Economic and Financial Markets Update”). Japanese rating actions are driven by reported Earthquake losses, but as well as concern over potential further loss development from this event (USD1 billion of development was reported from August through December) and unknown losses emanating from the Thailand floods (USD10 billion of losses thus far reported globally). Companies are facing strong headwinds to improve their profitability given current economic trends including continued pricing pressure, catastrophe losses, shrinking investment income, diminishing reserve releases and potential market devaluations of asset portfolios driven by the European debt crisis.

Solvency II: Challenges During 2012

The Solvency II project was conceived as a consequence of the recommendation by the European Commission in the Financial Services Action Plan (1999) of a “fundamental and wider-ranging review of the overall financial position of an insurance undertaking, including investment risk”.

The original goals of Solvency II were focused on harmonization of insurance regulation across Europe, movement to a risk based capital framework and provision of better warning signals for regulators to protect policyholders in the event of a failing insurer. Some of the key principles set out in the Action Plan to underpin the design of Solvency II included:

- To avoid undue complexity
- To establish principles and not be excessively prescriptive
- Where possible, to be based on common accounting policies so as to produce expenditure savings and avoid the duplication (and even multiplication) of financial reporting systems
- To avoid unnecessary capital costs harming the global competitiveness of European insurance

However, the development of Solvency II has not been a simple process due to the diversity of the insurance industry across Europe and hence the difficulty of developing a “one size fits all” approach to insurance regulation. In addition, the convergence of accounting standards under IFRS has not been as closely coordinated with Solvency II as might have been expected.

Rolling the clock forward to 2012 and many tens of thousands of pages later, we are finally reaching the closing stages of the Solvency II project with a soft start in 2013 and the capital rules are expected to become binding from 2014. The fundamental change for the insurance industry driven by Solvency II is the movement to an economic view of the balance sheet and the setting of regulatory capital that reflects the overall level of risk inherent in the business. Perhaps surprisingly, given the long period of development for Solvency II, the industry still has many challenges to meet in aligning business practices with the new view of the world.

Maintaining capital efficiency and attractive returns on equity under Solvency II is demanding and requires collaboration between different insurance business functions and disciplines. Capital requirements under Solvency II arise through both asset and liability risks and the interactions between them. Historically non-life insurance companies have tended to manage underwriting risk and investment risk as silo activities under the Chief Underwriting Officer and the Chief Investment Officer respectively without joined up measurement of risk and capital for the purposes of setting strategy. Solvency II changes the way insurers think about risk, capital, volatility and value generation through unified risk management processes. Many companies are introducing the role of Chief Risk Officer who is responsible for managing the overall level of risk and capital utilization in the organization across both sides of the balance sheet.

During 2012 firms will need to prepare their business to meet the requirements of Solvency II, from both the capital perspective under Pillar 1 and the more qualitative requirements of Pillars 2 and 3. The regulator will be expecting firms to be well prepared and to demonstrate that their plans are well tested in the business, rather than “pushing a switch” on day 1. From a capital planning perspective, it is important for firms to identify a target Solvency II ratio that provides a sufficient safety buffer above the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). Falling below the SCR level will invoke the regulator’s intervention ladder, under which soft or hard measures will be imposed on the firm, depending on the severity of the shortfall. The Solvency II ratio is calculated as the ratio of available to required capital – that is, the free assets above the technical provisions, divided by the SCR.

We expect that overall the demand for reinsurance will increase, driven by the need to seek capital relief under the more onerous regulatory requirements. We observe already there may be a greater demand for aggregate covers and more specialized reinsurance products in order to reduce the regulatory capital charge. This trend is expected to continue into 2012 as companies aim to optimize the use of capital through reinsurance that provides optimal capital relief under Solvency II.

Reinsurers are well placed for the transition into Solvency II. Their businesses are diverse and the majority already utilize internal models for setting economic capital. We do not expect Solvency II to have a material impact on the supply of reinsurance.

Drivers of M&A Activity in 2012

Mergers and Acquisitions (M&A) activity in the insurance and reinsurance market will be robust in 2012, driven by several interesting trends and cross currents. Below is a summary of the more important and, in some cases, perhaps less obvious trends.

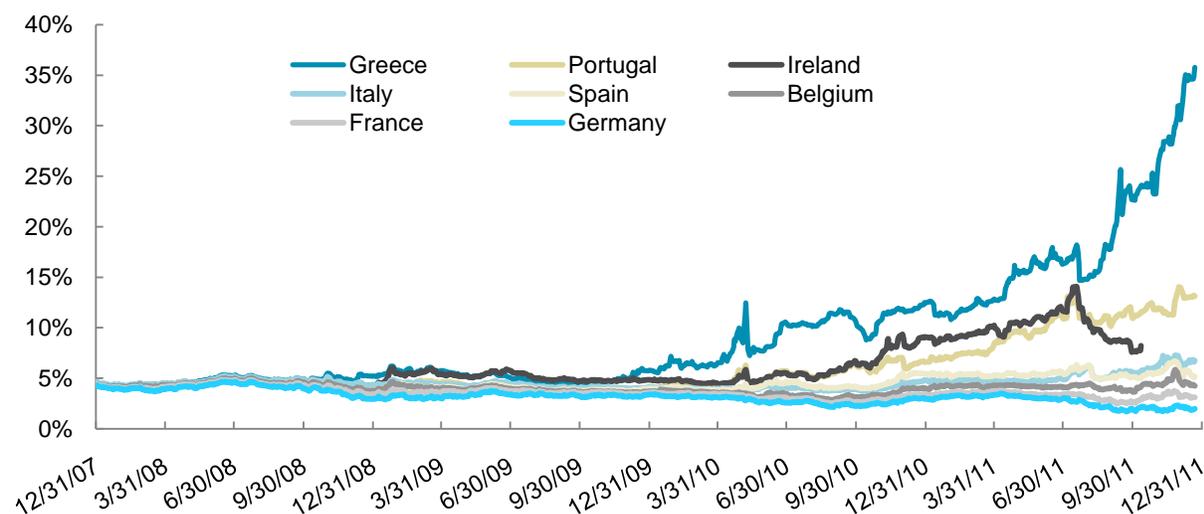
1. **Company Valuations Have Hit Bottom** – When run-off specialists can competitively bid for relatively healthy companies with stable credit ratings, market valuations are at or close to bottom. Historically, only damaged companies whose credit ratings fell below competitive levels were bought by run-off specialists. With the average valuation of insurance and reinsurance companies in most geographies and sectors well below tangible book value, however, run-off specialty companies can buy healthy companies at 25%+ premiums and still generate acceptable returns by selling off the renewal rights of the most attractive premium and running off the old liabilities. Run off specialists have not won many competitive bidding situations but they will continue to help push companies to seek a sale transaction.
2. **Continued Consolidation of Mono-line Business Model** – While mono-lines might have greater focus and expertise than their multi-line competitors, they are challenged by vulnerability to pricing cycles and risk concentration. For example, there are only a handful of catastrophe reinsurance, workers compensation and medical malpractice mono-lines left due to consolidation within mono-line segments and the purchase of mono-lines by larger multi-line companies.
3. **Hedge Funds Seeking Permanent Capital** – An increasing number of hedge funds are interested in forming or acquiring insurance and reinsurance companies and managing assets under long-term investment management contracts. This interest is being driven by three factors:
 - a. Hedge funds suffered unprecedented redemptions in 2008 and 2009 and those that survived place high value on more permanent Assets Under Management (AUM);
 - b. The typical investment portfolio of insurance and reinsurance companies, medium duration fixed income instruments, will generate below 3 percent in 2012; and
 - c. Insurance market conditions remain difficult and risk adjusted returns from underwriting are often lower than those that are available from hedge fund investment strategies.
4. **Private Equity Investors** – Attracted by historically low valuations and improving conditions in some sectors, private equity investors may become more active buyers of insurance and reinsurance enterprises.

Economic and Financial Markets Update

The EU Debt Crisis

During the second half of 2011, the global economy has been overshadowed by the crisis in the Eurozone. Initial worries about the sustainability of the sovereign debt of Greece, Ireland and Portugal have widened to the much larger economies of Italy, Spain and more recently even France. Resultant austerity measures, coupled with bank deleveraging, are crimping economic growth, heightening the concerns of the bond markets and pushing up the costs of new issuance. In an attempt to break this vicious circle, the European Central Bank (ECB) has stepped up its intervention in the secondary market, buying sovereign bonds ostensibly to prevent Italian and Spanish interest rates rising to unsustainable levels (generally considered to be in excess of 7 percent).

Exhibit 26: Eurozone 10-year Government Bond Yields



Source: Bloomberg (data as of Dec 21, 2011)

The markets have already priced-in a Greek default and, given the substantial amount of sovereign debt requiring refinancing in 2012 (almost EUR500 billion or USD 650 billion in the case of Italy and Spain alone), fears linger over an eventual break-up of the Eurozone. Measures adopted at the summit of EU leaders on December 7-9, 2011 left most commentators unconvinced, The Economist stating that they “fell short of what is required to save the euro, though they may be enough to support the zone’s stricken banks and sovereigns for a while.”² The major rating agencies also appear skeptical. On December 5, 2011, Standard & Poor’s placed its sovereign ratings on 15 members of the Eurozone, including France and Germany, on CreditWatch with negative implications. Fitch Ratings took similar action on six Eurozone sovereigns, including Italy and Spain, on December 16, 2011, having “concluded that a ‘comprehensive solution’ to the Eurozone crisis is technically and politically beyond reach.”³

² The Economist, December 17, 2011, Damned with faint plans

³ Fitch Ratings, press release, December 6, 2011

Moody's Investors Service announced on December 12, 2011 that it would revisit the ratings of all EU sovereigns during the first quarter of 2012.

Exhibit 27: Sovereign Debt Ratings

	Moody's			Standard & Poor's			Fitch		
	Sovereign	Outlook	Downgrade notches since Jan 2011	Sovereign	Outlook	Downgrade notches since Jan 2011	Sovereign	Outlook	Downgrade notches since Jan 2011
Belgium	Aa3	Negative	2	AA	Watch Negative	1	AA+	Watch Negative	-
France	Aaa	Stable	-	AAA	Watch Negative	-	AAA	Negative	-
Germany	Aaa	Stable	-	AAA	Watch Negative	-	AAA	Stable	-
Greece	Ca	Developing	9	CC	Negative	9	CCC		8
Ireland	Ba1	Negative	3	BBB+	Watch Negative	2	BBB+	Watch Negative	-
Italy	A2	Negative	3	A	Watch Negative	1	A+	Watch Negative	1
Netherlands	Aaa	Stable	-	AAA	Watch Negative	-	AAA	Stable	-
Portugal	Ba2	Negative	7	BBB-	Watch Negative	3	BB+	Negative	6
Spain	A1	Negative	3	AA-	Watch Negative	1	AA-	Watch Negative	2
UK	Aaa	Stable	-	AAA	Stable	-	AAA	Stable	-
USA	Aaa	Negative	-	AA+	Negative	1	AAA	Negative	-
Japan	Aa3	Stable	1	AA-	Negative	1	AA	Negative	1

Source: Moody's, S&P, Fitch (ratings as of Dec 21, 2011)

The effects of the EU sovereign debt crisis are beginning to be felt in the financial strength ratings assigned to Europe's primary insurers, particularly those domiciled in the member states most affected, or with significant life operations based in those countries. On December 9, 2011, for example, Standard & Poor's placed the ratings of 15 organizations on CreditWatch with negative implications, including those of major groups such as Allianz, AXA, Generali and Mapfre.

On a more positive note, enhanced credit support measures announced by the ECB on December 8, 2011 to support bank lending and liquidity appear to be having a beneficial impact, in terms of bringing down the short-term interest rates paid by Italy and Spain. On December 21, 2011, it was disclosed that over 500 European banks had taken a higher than expected EUR489 billion (USD 633 million) of three year loans, offered at 1 percent, from the ECB's longer-term refinancing operations. A second offering will be made at the end of February 2012. Such measures are required because European lenders have around EUR720 billion of bonds due to mature in 2012 and many, particularly in the periphery of the Eurozone, have been shut out of public funding markets.

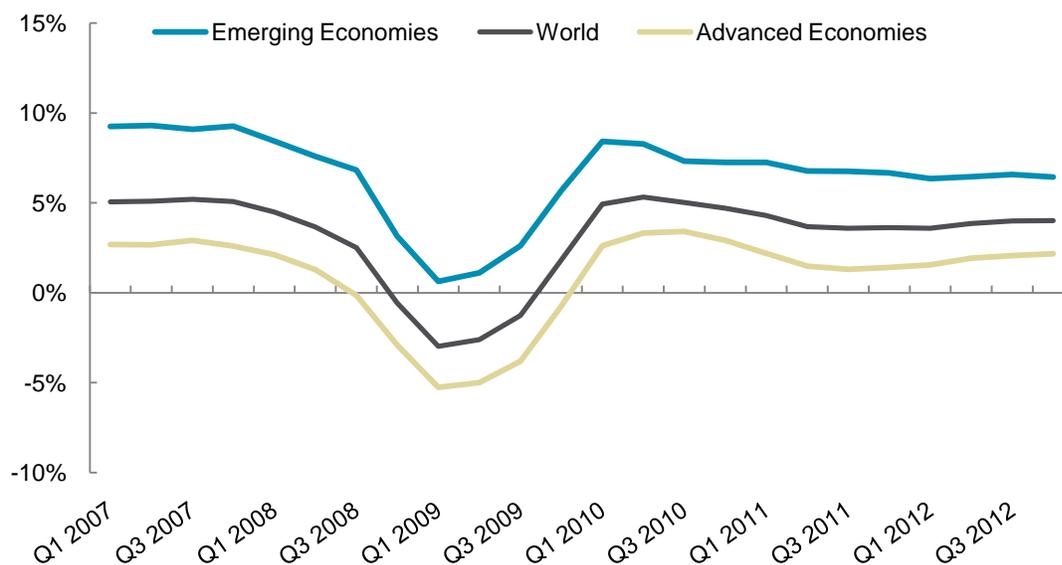
Economists fear the Eurozone's uncertain future will continue to cast a huge shadow over the global economy in 2012, even when considered beside other concerns such as pre-electoral paralysis in the U.S., and the massive overhang of global public and private debt which will likely hinder any robust recovery in the advanced economies.^[1] An unmanaged default by a major European state would have serious ramifications for the world's financial markets, as evidenced by the turmoil during the second half of the year, and economies such as Japan and the U.S., each with their own problems, would feel the chill.

The Global Economy

In its most recent bi-annual World Economic Outlook dated September 17, 2011, the International Monetary Fund (IMF) noted a significant weakening of economic activity, pointing to a longer than anticipated transfer from public to private demand in advanced economies such as the United States and sovereign debt and banking sector problems in the euro area. The Tohoku earthquake and tsunami in Japan and related surge in the oil price were also cited as negative features. On the positive side, the IMF noted robust activity in emerging and developing economies, in part propelled by buoyant commodity prices.

Mid-year concerns about developments in the Eurozone and weakening global economic activity sparked a resurgence of financial market volatility. Against this backdrop, the IMF pared back its growth forecasts, observing that the evidence pointed to continued but uneven economic growth, driven by strong performance in emerging and developing markets and an accommodative monetary policy in many advanced economies, but commenting that "risks are mainly on the downside over the near term."

Exhibit 28: Real GDP Growth and Forecasts
(Quarter over Quarter, Annualized)

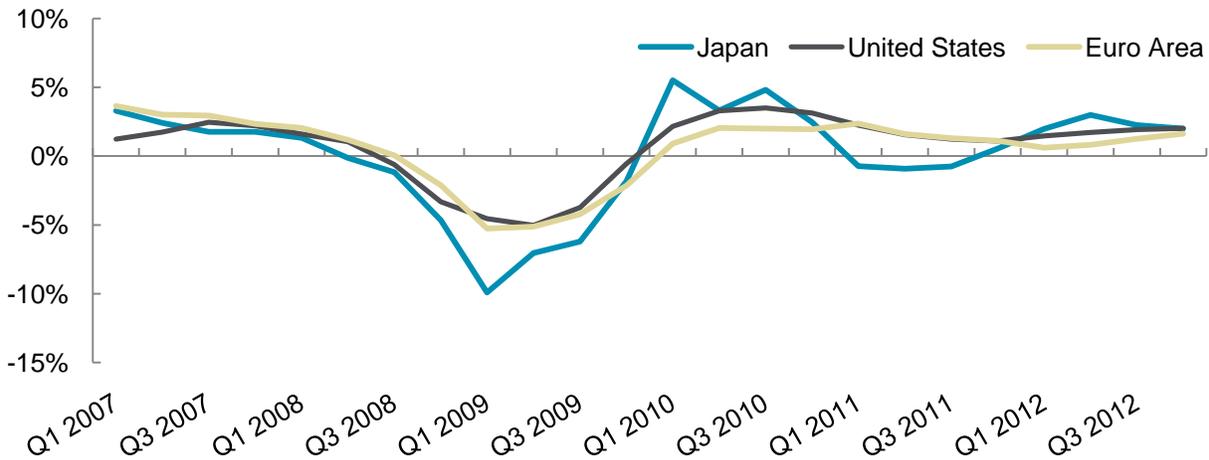


Source: IMF World Economic Outlook Update, September 2011

^[1] Financial Times, December 21, 2011

Exhibit 29: Real GDP Growth and Forecasts, Developed Economies

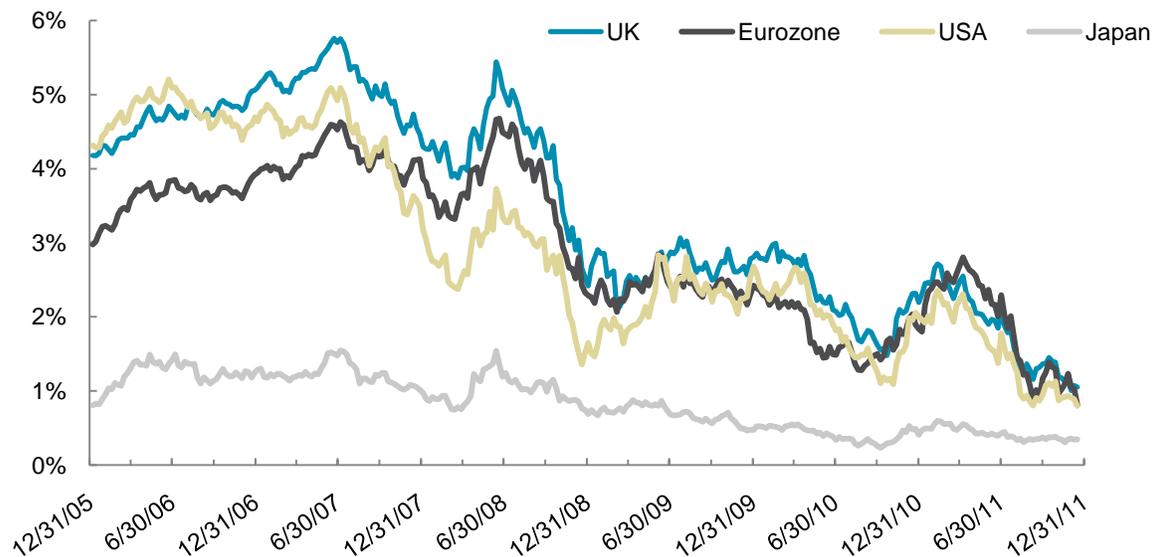
(Quarter over Quarter, Annualized)



Source: IMF World Economic Outlook Update, September 2011

Governments around the world have continued to target low interest rates as a key policy measure to promote economic recovery. The key U.S. Federal Funds Rate has been kept at a record low of 0.25 percent since December 2008 and the UK Bank Rate has been at 0.5 percent since March 2009. In an effort to provide a stimulus, on December 8, 2011, the European Central Bank lowered its benchmark Main Financing Rate by 0.25 percentage point to 1.0 percent, the second such cut in as many months.

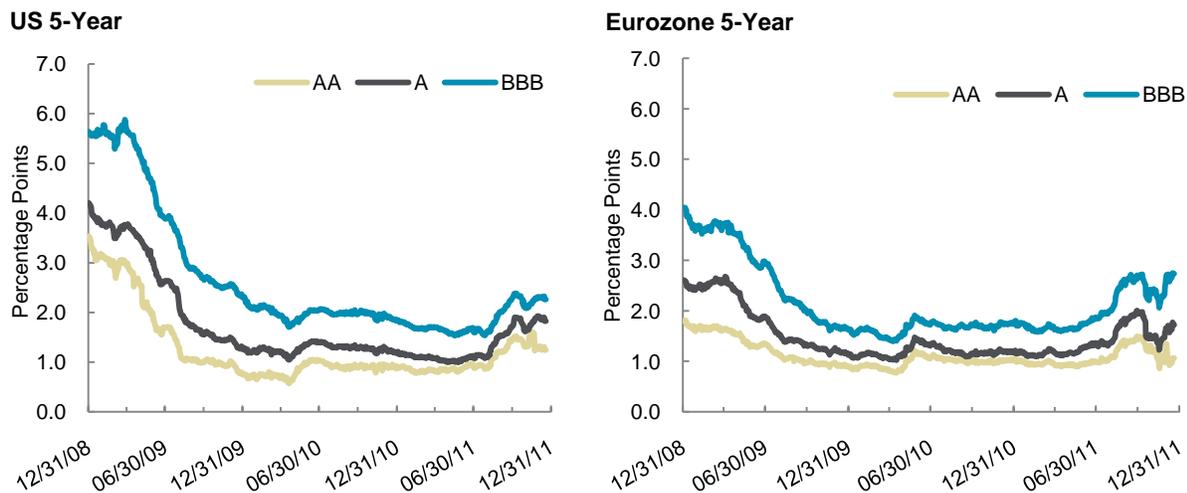
Exhibit 30: Five-year Government Bond Yields



Source: Aon Benfield Analytics, Bloomberg

With growing economic confidence in the early months of 2011, bond yields continued on an upward trajectory, maintaining a trend started in the fourth quarter of 2010, with yields on U.S. bonds peaking at 2.3 percent in mid-April. At the same time, yields on UK and Eurozone debt reached highs of 2.6 percent and 2.8 percent, respectively. The yield on Japanese bonds topped out in February, to reach 0.6 percent. However, early confidence proved misplaced and, as worries resurfaced about the state of the global economy, yields fell again and dropped sharply from late July, maintaining a broadly downward trend for the remainder of the year. Yields in the Eurozone and the U.S. had dropped to around 0.8 percent at mid-December while in Japan the yield leveled off at around 0.35 percent.

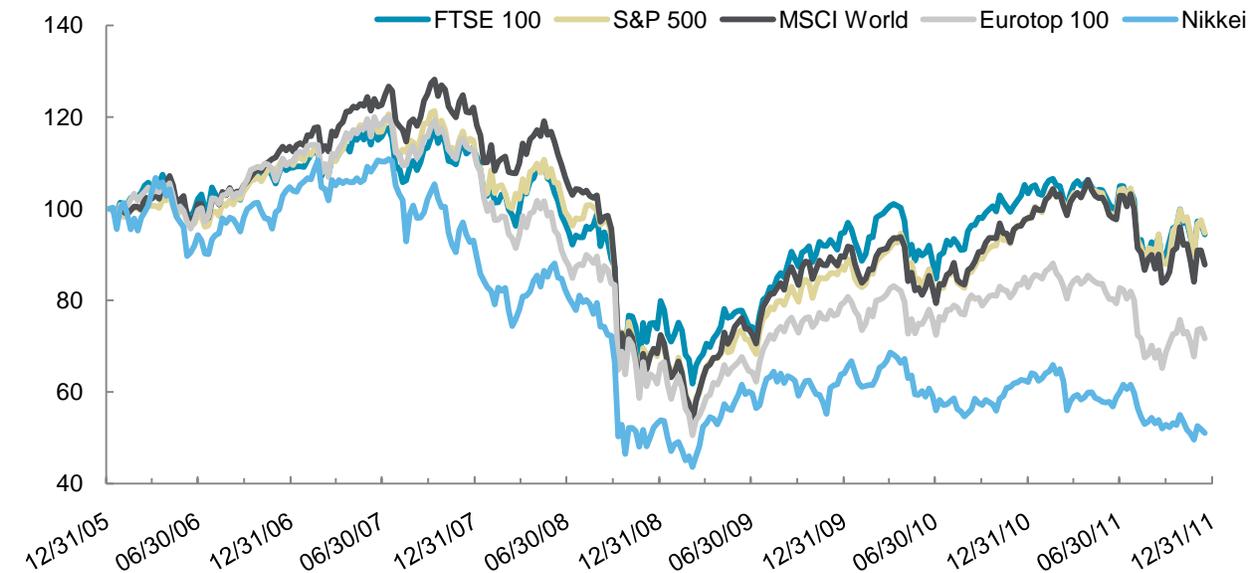
Exhibit 31: Five-year Corporate Bond Spreads over Government Debt



Source: Aon Benfield Analytics, Bloomberg

The spreads of corporate bonds over Treasuries/government bonds was relatively stable for the first half of the year, but with renewed credit concerns on the back of the ills of the Eurozone sovereign debt market and the banking sector, spreads rose sharply during the third quarter. Unsurprisingly, this was more evident in Europe, where the spread on BBB rated issues widened by around one percentage point.

Exhibit 32: Equity Markets Index (January 2006=100)

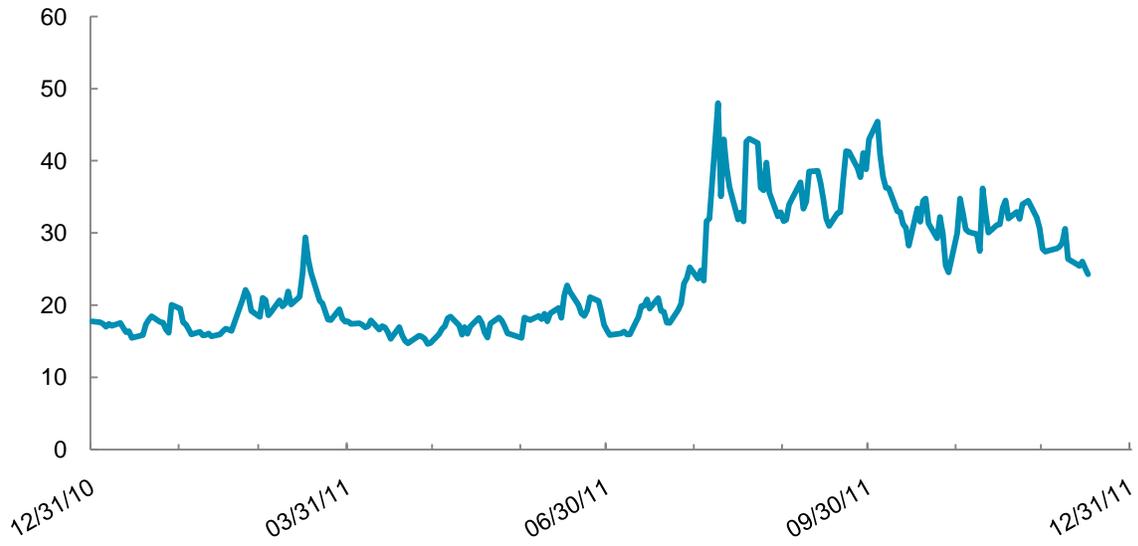


Source: Aon Benfield Analytics, Bloomberg

Equity markets made a positive start to 2011 and stabilized in the second quarter, before taking a nosedive from late August with the onset of worries associated with the US federal debt ceiling, the stresses in the Eurozone and the weak outlook for economic growth. The S&P 500 index rose 6 percent during the first quarter to 1330, but at mid-December the index was down 3 percent since the start of the year. Stock markets in Europe (Eurotop 100) and the UK (FTSE 100) both rose 2 percent in the first quarter but were down 14 percent and 9 percent respectively at mid-December. Japan's Nikkei index was down 18 percent over the period.

Markets remain weak and volatile, as evidenced by the CBOE S&P 500 volatility index which rose sharply during August. Although it has fallen back, the index remains at a higher level than at the start of the year.

Exhibit 33: CBOE S&P 500 Volatility Index



Source: Aon Benfield Analytics, Bloomberg

Bank Leverage

Our analysis of the 20 largest banks globally reveals that total asset leverage, as measured by total assets to shareholders' equity, has been steadily declining since the financial crisis high of over 36x in the third quarter of 2008. At the end of Q3 2011 it stood at less than two-thirds of this amount, at just under 23x. As a further measure of progress, this is also below the pre-crisis level of 29x.

Excessively leveraged bank balance sheets heightened the risk of bank insolvencies and the natural response of regulators is to increase the required capital. The Basel Committee formulates broad supervisory standards and recommends statements of best practice in banking supervision in the expectation that they will be implemented by domestic regulators. Based upon the Basel II accords, the FDIC currently requires a maximum asset leverage ratio of 25x for a bank to be "adequately capitalized". For a bank to be "well capitalized" the maximum asset leverage ratio is 20x. From January 1, 2013 the more onerous Basel III will become effective and the required asset leverage ratio is expected to become stricter and change to 16.7x.

Although progress has been made in the reduction of asset leverage, for the portfolio of banks in our analysis only 45 percent of these meet the current criteria for being "well capitalized" at the end of Q3 2011. Further, the introduction of Basel III will require additional capitalization to meet the new criteria as only 5 of the 20 banks in the portfolio met this updated criteria at the end of Q3 2011.

Exhibit 34: Top 20 Largest Banks Total Leverage

	06-30-2007	09-30-2008	12-31-2008	12-31-2009	12-31-2010	09-30-2011
BNP Paribas SA	36.4	45.2	48.6	33.5	30.0	28.3
HSBC Holdings PLC	18.0	23.0	27.0	18.8	16.9	17.1
Deutsche Bank AG	53.4	59.2	71.7	40.9	39.0	44.0
Mitsubishi UFJ Financial Group Inc	25.1	24.4	25.6	32.2	23.5	23.4
Barclays PLC	55.2	58.4	56.1	29.2	29.3	28.9
Royal Bank of Scotland Group PLC	24.3	34.7	40.8	21.8	19.3	20.8
Bank of America Corp	11.5	13.4	13.0	11.5	10.7	10.5
JPMorgan Chase & Co	12.2	16.4	16.1	12.9	12.6	13.1
Credit Agricole SA	33.2	35.7	42.4	36.4	37.2	32.9
Industrial & Comm. Bank of China	16.7	16.6	16.2	17.5	16.4	16.8
Citigroup Inc	17.5	20.8	27.3	12.2	11.7	10.9
Mizuho Financial Group Inc	44.4	43.7	52.9	128.7	52.4	35.3
Banco Santander SA	19.8	19.0	18.3	16.3	16.2	17.2
China Construction Bank Corp	18.8	15.3	16.2	17.3	15.5	15.2
Bank of China Ltd	14.8	14.7	15.0	17.0	16.2	16.6
Societe Generale SA	39.1	36.0	37.7	28.7	28.4	25.9
Agricultural Bank of China Ltd		136.3	24.2	25.9	19.1	18.7
Sumitomo Mitsui Financial Group Inc	34.1	31.7	31.3	55.4	26.0	26.8
Lloyds Banking Group PLC	31.0	38.9	46.4	23.7	21.5	21.5
UBS AG	49.5	43.0	61.9	32.7	28.1	27.9
Average	29.2	36.3	34.4	30.6	23.5	22.6

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