AON BENFIELD

Reinsurance Market Outlook

Record Reinsurance Performance and Capital

September 2012

Empower Results™

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Executive Summary—Record Reinsurance Performance and Capital

Reinsurance works. It worked well for insurers that faced and ceded record losses in 2011 and then renewed the capacity they sought at terms and conditions that remain accretive. After assuming record losses in 2011, reinsurers rebuilt capital quickly and at the end of the first half of 2012 reinsurance capital stands at a record USD480 billion.

The growth rate of catastrophe reinsurance capacity again exceeds the growth rate of demand for catastrophe reinsurance. The demand for reinsurance for non-catastrophe perils continues to decline. The value proposition of reinsurance in most non-catastrophe lines has declined as insurers have witnessed nearly a decade of steady declines in loss frequency and manageable increases in loss severity—the need to transfer risk that seems to not be occurring has decreased.

Indeed, the reinsurance business has become an increasingly property catastrophe-centric business. U.S. hurricane risk continues to drive the capital requirements of most reinsurers. The ongoing global economic issues are impacting the capital required to write diversifying perils. The rise of the Japanese Yen and the fall of the Euro against a largely U.S. dollar denominated reinsurance market has closed a large part of the gap that used to exist between European wind and Japanese typhoon and earthquake aggregates written by reinsurers.

The more catastrophe-centric reinsurance business has increasing sources of capital. The diversifying nature of catastrophe-exposed business has attracted a much more stable group of investors than were present during the 2006 and 2007 prior-peak capacity from alternative sources. Reinsurers and insurers now are beginning to source reinsurance risks that fit the specific appetites of these investors. Low corporate and sovereign debt yields are likely to continue to produce more capacity for catastrophe and other reinsured risks.

Insurers will continue to benefit from these market conditions for the foreseeable future even if moderate levels of catastrophe losses occur. As 2011 proved, the size of individual ceded loss occurrences or the amount of ceded losses aggregating within any year that are needed to firm catastrophe reinsurance rates continues to escalate.

We are proud of the differentiated results our firm has been able to produce for our clients throughout the recent renewal cycles. Our investments in the top reinsurance professionals, unique analytical capabilities, access to all forms of underwriting capital and insight available only through our market presence have saved our clients hundreds of millions of dollars during the most recent renewals. We look forward to continuing to execute these effective client strategies in the 2013 market.

Note: This reinsurance market outlook report should be read in conjunction with our firm's views on rate on line, capacity and retention changes for each cedent's market. Our professionals are prepared to discuss variations from our market sector outlook that apply to individual programs due to established trading relationships, capacity needs, loss experience, exposure management, data quality, model fitness, expiring margins and other factors that may cause variations from our reinsurance market outlook.

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

Global Factors Influencing Reinsurance Supply	
+	Record reinsurer capital
+	Low ceded catastrophe loss activity so far
+	Growing investor interest in catastrophe bonds and similar collateralized facilities
-	Continued low market valuations of reinsurers' shares
=	**High reinsurance market supply**

Global Factors Influencing Reinsurance Demand	
-	Strong insurer capital
-	Sluggish insurance demand growth for insurance in difficult economic environment
-	Continued decline in loss frequency in casualty lines
-	Very competitive insurance landscape in nearly all markets
-	Low investment returns
+	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

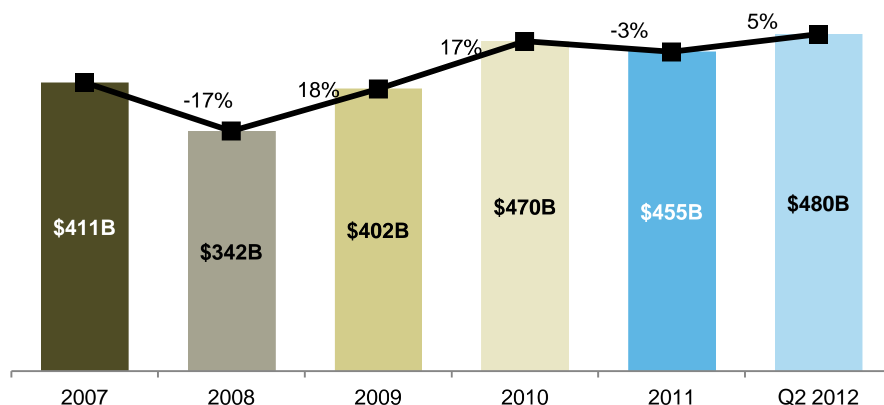
Supply Reaches New Peak Levels

Reinsurer capital has reached a new all time high of USD480 billion at the end of the first half of 2012. An increase of 2 percent over first quarter capital levels has brought the half year increase to 5 percent. Reinsurance supply remains higher than demand in all global regions. The reinsurance industry is in the position to provide desired reinsurance capacity to insurers in all global regions. Our expectation is that supply will continue to exceed the demand of insurers for upcoming January renewals in most global regions.

The supply of reinsurance capacity has risen significantly over the twenty years since Hurricane Andrew in 1992. The impact this event had on the development of the reinsurance market cannot be overstated. This is a much different industry than it was in 1992. The ability of the insurance and reinsurance industry to raise capacity to sustain multiple events the size of Hurricane Andrew today is noteworthy. At the time, many believed that central and local governments were the only entities capable of financially responding to such future events. Today it is clear that the insurance and reinsurance industry has the financial resources to handle the financial consequences of events far larger than imagined when many government insurance and reinsurance schemes were arranged around the world. There are several examples of central and local governments that now have the opportunity to realistically consider returning sponsored or subsidized catastrophe programs back into the private market. While few of these programs have undergone material reconsideration as the global economy has slowed, partially or fully returning these programs to the well-capitalized private market would decrease material government financing contingencies.

The reinsurance market is largely U.S. dollar denominated along with its peak insured risk—U.S. hurricane. U.S. hurricane therefore pays the highest reinsurance margin per unit of risk for that reason. The margins for "diversifying" perils such as European wind and Japanese typhoon and earthquake remain far lower. However, the ongoing management of economic issues yields currency movements that have important reinsurance pricing consequences. The dramatic rise of the Japanese Yen and the moderate fall of the Euro against the dollar mean that their position as the third, fourth and fifth largest reinsured perils are nearly equal. At the margin, this means that Japanese capacity is less diversifying for reinsurers than it has been in the past and the opposite is true for European capacity.

Exhibit 2: Change in Reinsurer Capital



Source: Individual company reports, Aon Benfield Analytics

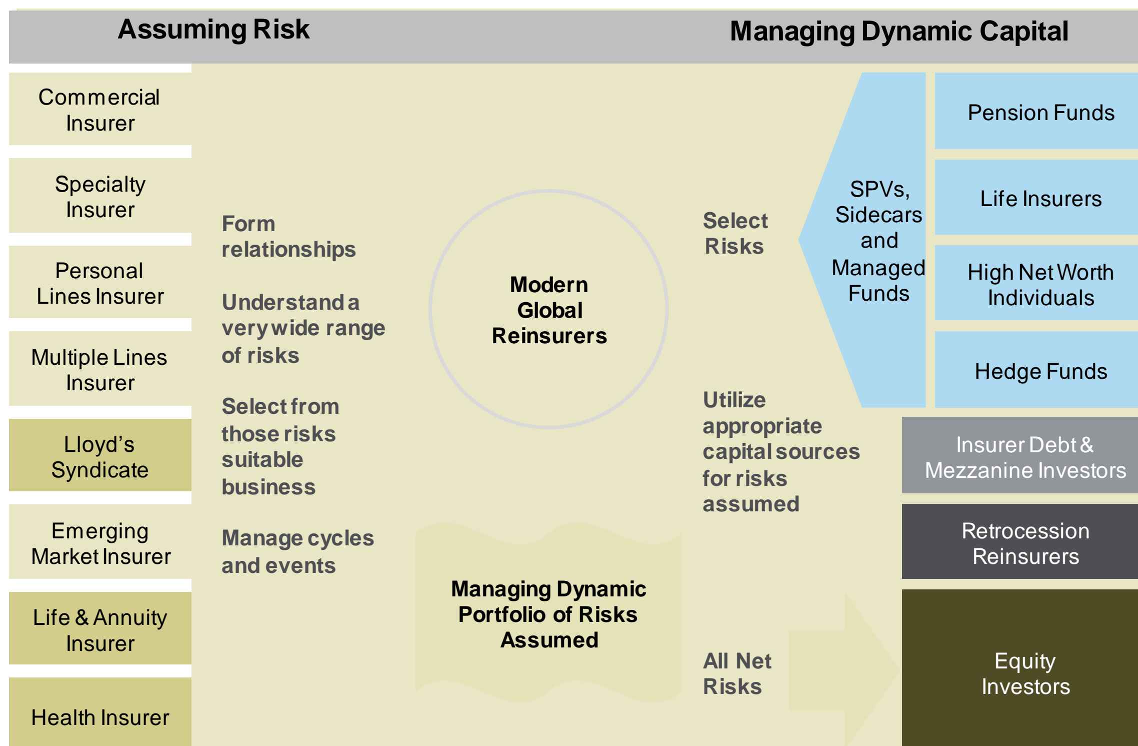
Modern Reinsurers are Managing Risk and Capital Differently

The business of being a reinsurer has become increasingly sophisticated. After nearly three years of reinsurer valuations that reflect very little franchise value (market capitalization less than book value) within the reinsurance industry, reinsurers are beginning to align with new capital partners for capacity to manage cycles and events. After reinsurers largely missed the chance to leverage the business opportunity presented by catastrophe bonds over the past 15 years, they now see catastrophe bond capacity is the most efficient source of catastrophe tail-risk management capital. Reinsurers now recognizing this beneficial aspect of catastrophe bonds are entering a market that is crowded with their clients that have in many cases more than a decade of experience in using this complementary capital.

Sidecars, while not close to the peak levels of 2006 and 2007, are now viewed as the most useful tool to manage the demand cycle. Sidecar relationships need to be formed in advance of events, especially if a reinsurer's secondary stock offering is unlikely at accretive terms. Managed funds will be a feature in most significant catastrophe reinsurers' platforms over the next decade. Some reinsurers have established managed funds platforms. Still, the most successful platforms have not been formed by reinsurers. We expect reinsurers will begin legitimate efforts to manage investment funds for a growing range of investors that find catastrophe risks sufficiently diversifying and rewarding to devote more funds to the space—through multiple managers.

The chart below provides a summary of the current position of reinsurers in this changed global landscape. It is now clear that products offered to insurers and insureds are being shaped by the growing sources of capital available to sophisticated insurers and reinsurers.

Exhibit 3: Modern Global Reinsurers

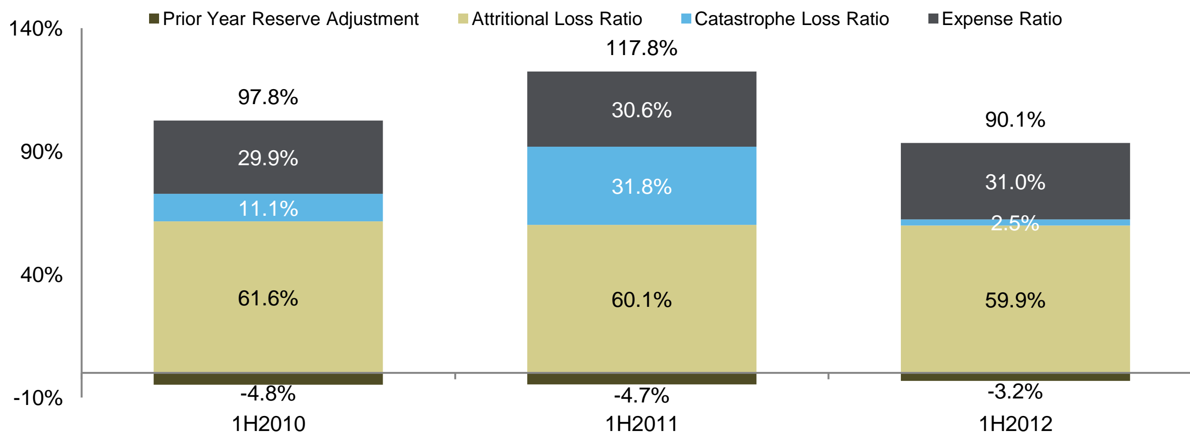


Source: Aon Benfield Analytics

Reinsurer Financial Results

Significant reduction is evident in both catastrophe loss ratios and combined ratios of the Aon Benfield Aggregate[1] group of reinsurers. With similar expense and attritional ratios and continued adjustment of prior year reserves, the group was able to achieve a 90.1 percent combined ratio for the first half of 2012 almost solely due to low catastrophe loss activity.

Exhibit 4: Aon Benfield Aggregate Combined Ratios

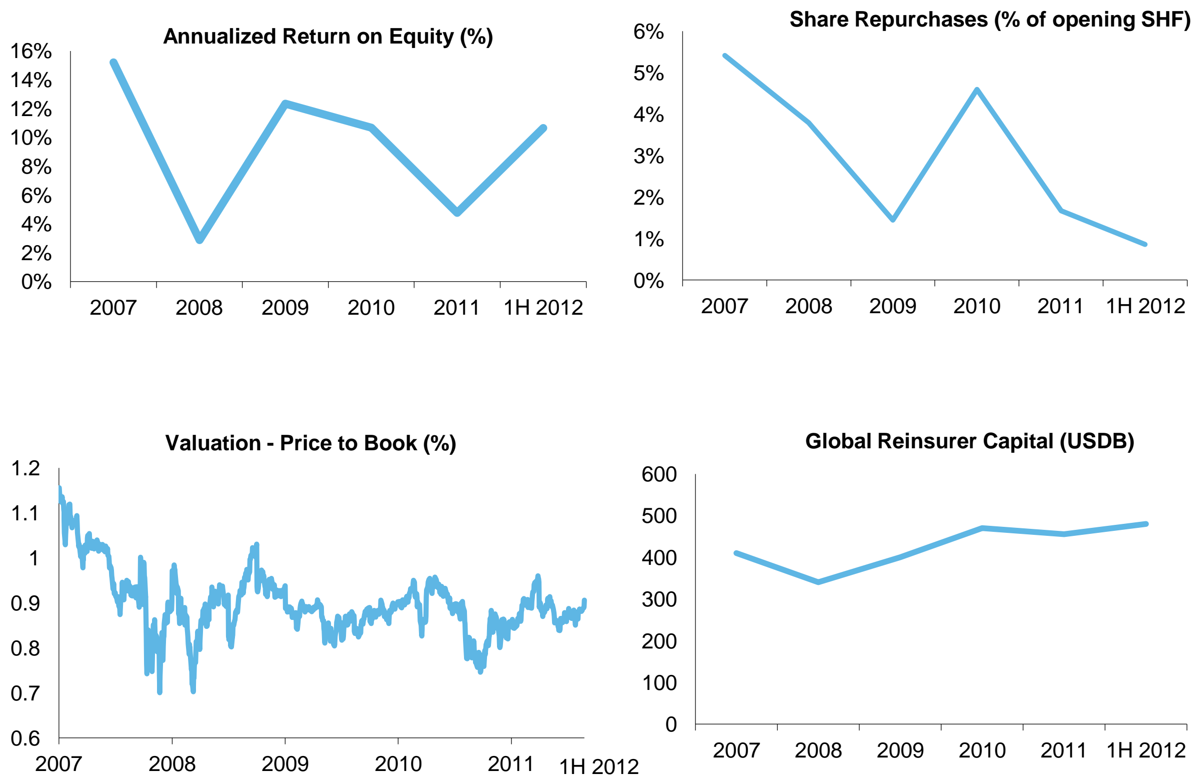


Source: Individual company reports, Aon Benfield Analytics

[1] The Aon Benfield Aggregate is a group of 31 of the world's leading reinsurers; latest ABA study can be found at http://thoughtleadership.aonbenfield.com

For the Aon Benfield Aggregate set of reinsurers, annualized ROE came in at 10.7 percent for the six months ending June 30, 2012 despite less than optimal investment returns, capital deployment opportunities and the existence of excess capital levels.

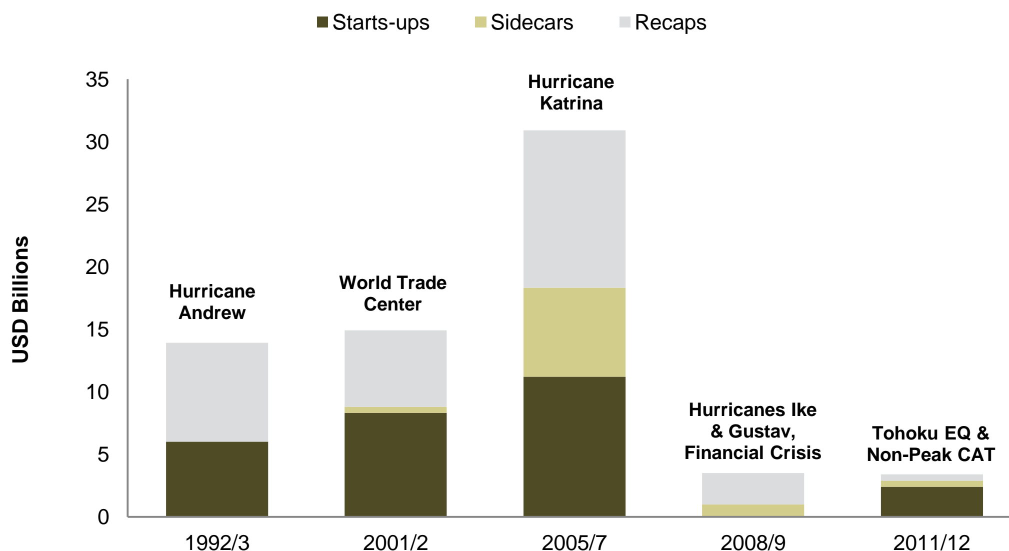
Exhibit 5: Aon Benfield Aggregate Reinsurer Capital, ROE, Share Repurchase and Valuation



Source: Individual company Reports, Aon Benfield Analytics

Given the excess supply in the market, post-event capital raising following the catastrophe losses of 2010 and 2011 was relatively low. While the proportion of losses paid by reinsurers was higher than for the series of hurricane losses in 2005, the market has seen approximately one-tenth of the capital that was raised following Hurricane Katrina.

Exhibit 6: Post-Event Capital Raising



Source: Aon Benfield Securities, Inc.

Opportunities Continue for Reinsurers to Offer Tornado/Hail Coverage

Following another year of above average tornado/hail activity, insurers may again look to the market to evaluate purchasing tornado/hail coverage on an occurrence, aggregate or proportional basis. Often still within the retentions of insurers' property catastrophe coverage, this exposure has resulted in significant losses to insurers in 2010, 2011 and again in 2012. Although a number of covers went unfulfilled, a light global catastrophe loss season may result in new dynamics for this protection for insurers and reinsurers during upcoming renewals.

Credit Risk for Property Catastrophe Coverage is Low

Catastrophe reinsurance provides very high credit quality protection to insurers: simply put, reinsurers pay their catastrophe claims. Since 2000 the reinsurance industry has paid more than USD150 billion in catastrophe claims. Based on a study conducted by Aon Benfield Analytics over the same time horizon only eight reinsurers have gone insolvent due to catastrophe losses, and those eight represented less than 1 percent of global reinsurer capital. Further, the insolvent companies have settled more than 99 percent of their claims. As a result, realized credit losses have been less than 10 basis points, a rate consistent with ‘AA’ corporate bond default rates.

The last twelve years have tested reinsurance capacity. Most recently, 2011 was a record year for natural catastrophe losses with economic losses of USD435 billion and insured losses of USD107 billion generated by 253 separate events. The reinsured portion of losses in 2011 was far higher than in 2005, the other record year. Despite the losses, reinsurance capital ended 2011 essentially unchanged from 2010, at USD455 billion. The majority of reinsurers incurred catastrophe losses less than 25 percent of shareholder funds.

Aon Benfield Analytics conducted a study on a number of catastrophe reinsurers in the following two catastrophe prone years:

- 2005: Significant catastrophe losses were driven by Hurricanes Katrina, Rita and Wilma (KRW)
- 2011: Significant catastrophe losses were driven by Australian floods, New Zealand earthquakes, the Tōhoku (Japanese) earthquake and tsunami, U.S. tornadoes, and Thai floods

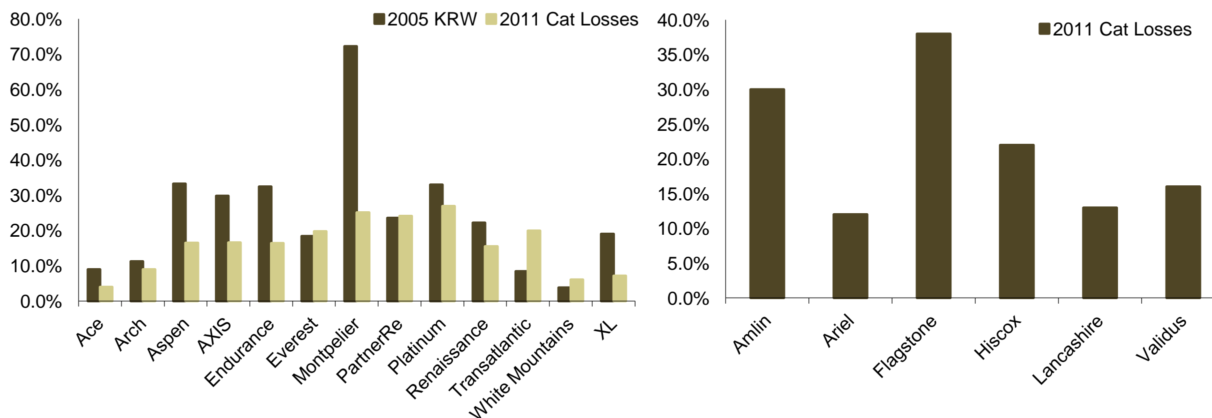
The purpose of the study was to determine any pattern in the amount of capital that was consumed by catastrophe events in two elevated catastrophe years. Exhibit 7 shows the percentage of catastrophe losses for both KRW and the 2011 catastrophes as a percentage of prior-year equity.

Of the 13 reinsurers included in the study, only four (Everest, Partner Re, Transatlantic, and White Mountains) had larger losses as a percentage of prior year surplus that were higher in 2011 than 2005.

Also it is notable that in 2005, five reinsurers had losses at or greater than 30 percent of their prior-year capital and none of the reinsurers included in the study experienced losses in excess of 30 percent of their prior year capital in 2011.

Exhibit 7 also shows the same chart for the class of 2005 reinsurers, noting only Flagstone had a loss greater than 30 percent of capital.

Exhibit 7: Reinsurers' Catastrophe Losses as Percent of Prior Year-end Capital



Source: Individual company reports, Aon Benfield Analytics

The 2011 catastrophes led A.M. Best and Standard & Poor's (S&P) to assign a negative outlook to a small number of reinsurers; however, only four reinsurers were downgraded by S&P and no reinsurers were downgraded by A.M. Best. Further, three of the four downgraded companies continue to have ratings in the 'A' range. The limited rating actions reflect reinsurers' effective catastrophe risk management as well as a significant cushion for catastrophe losses built into rating agency capital requirements.

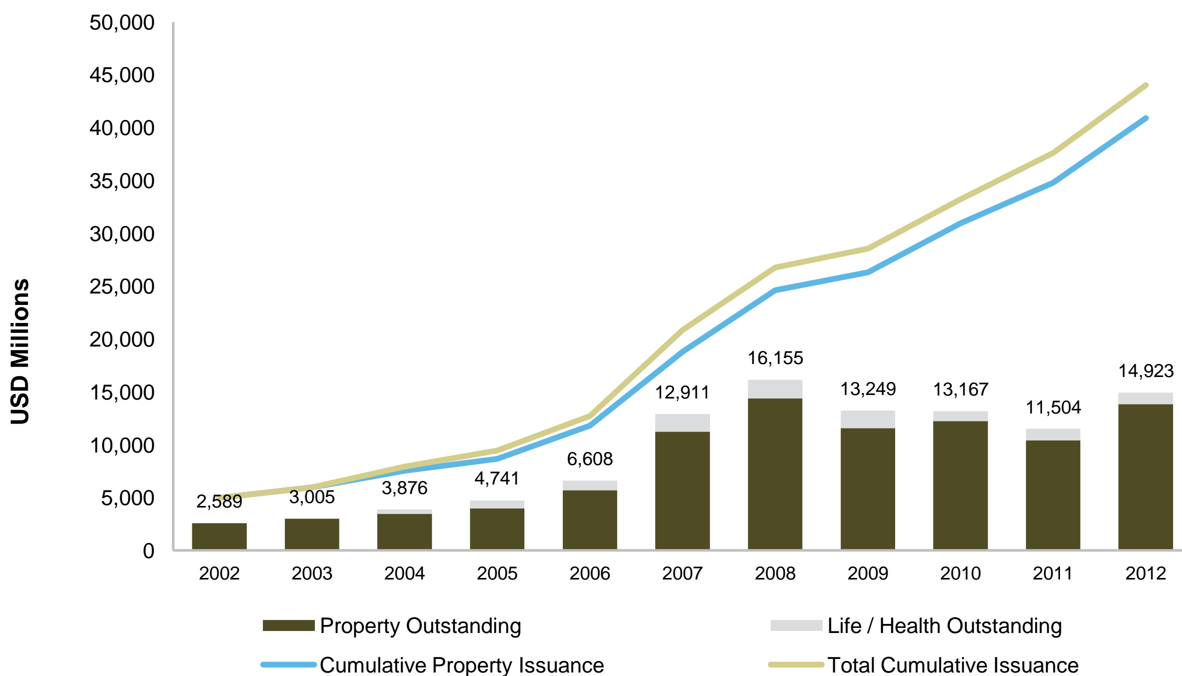
Aon Benfield Securities Annual Review of the Catastrophe Bond Market

For the 12 months ended June 30, 2012, the Insurance-Linked Securities (ILS) market continued to be an attractive source of capacity for both new sponsors and repeat sponsors. The ILS market has clearly demonstrated its resilience following the global financial crisis. The market reached its highest levels for both new issuance and outstanding volumes in four years.

Overview

Annual issuance accelerated in the last year sparked by strong sponsor interest to issue new bonds and strong investor inflows into the market. The annual issuance volume of USD6.4 billion for the year ending June 30, 2012 was up more than USD2.0 billion compared to the same period in 2011. The total bonds on risk as of June 30, 2012 finished at USD14.9 billion, up USD3.4 billion from the previous June 30. Over the three prior years commencing 2009, the total outstanding volume experienced decreases due to both high amounts of maturities and lower new issuance numbers following the global financial crisis. The substantial overall increase marks an important period of growth for the market. In all, the catastrophe bond market has seen USD44.0 billion of cumulative issuance since 1996, demonstrating its importance as a strategic and efficient risk management tool.

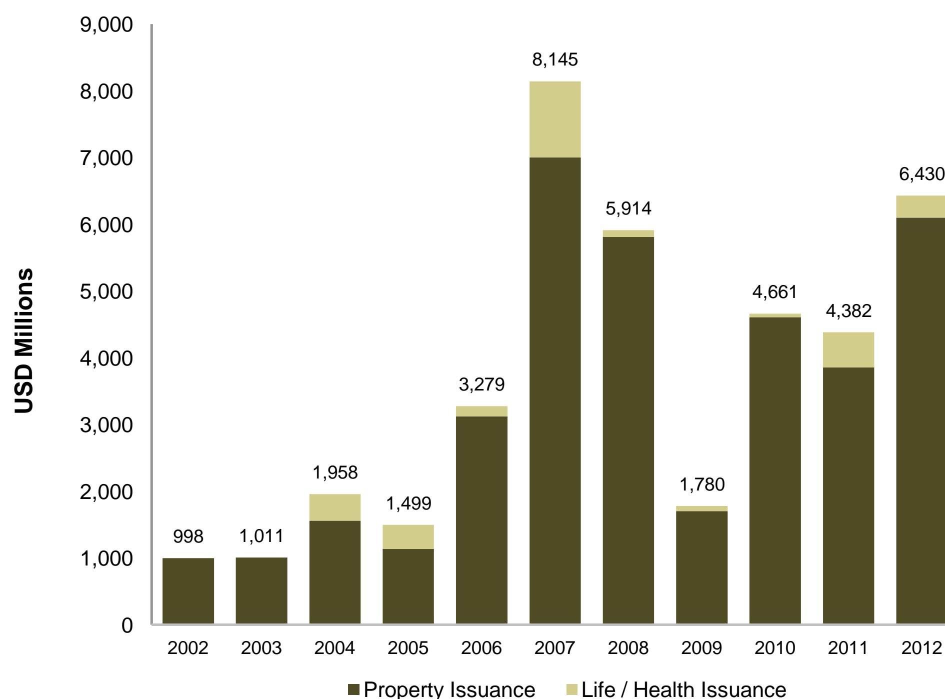
Exhibit 8: Outstanding and Cumulative Catastrophe Bond Volume, 2002–2012 (Years ending June 30)



Source: Aon Benfield Securities, Inc.

Thirty transactions (including two deals from the life and health sector) closed during the 12-month period ending June 30, 2012, compared to 24 transactions over the same period in the prior year. As expected, U.S. hurricane risk continued to dominate the market, comprising over 50 percent of natural catastrophe issuance. The proportion of catastrophe bonds covering U.S. earthquake risk increased slightly from 17 percent for the year ending June 30, 2011 to 20 percent for the same period in 2012. By comparison, Europe windstorm transactions decreased slightly from 21 percent of issuance in the 12-month period ending June 30, 2011 to 17 percent for the same period in 2012. Life and health issuance activity contributed to USD330 million of issuance.

Exhibit 9: Catastrophe Bond Issuance by Year (Years ending June 30)

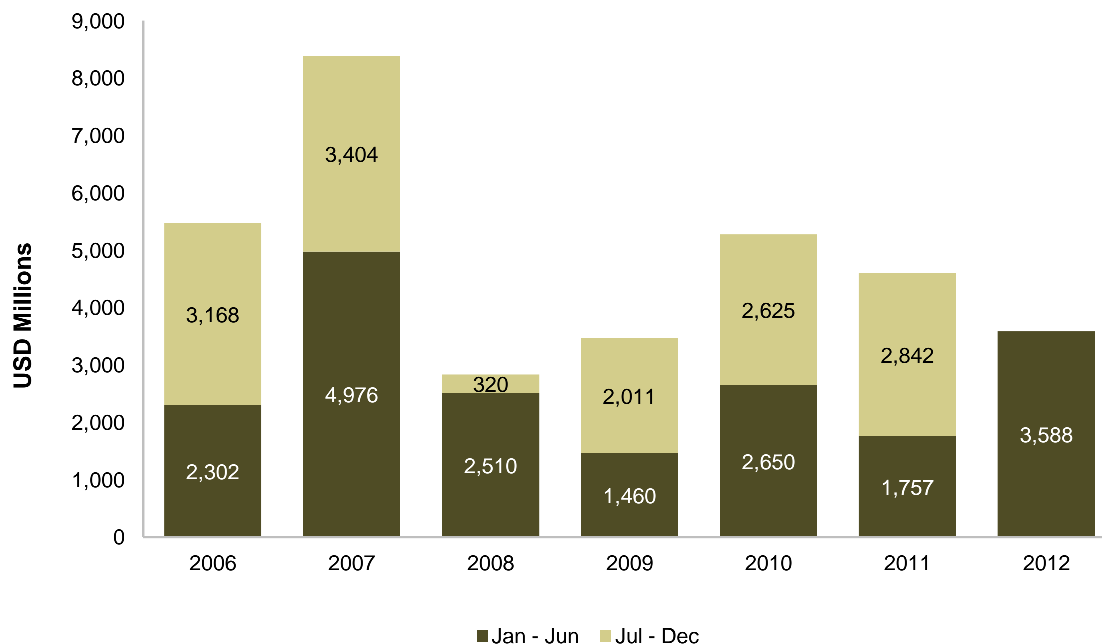


Source: Aon Benfield Securities, Inc.

Traditionally, the third quarter of each calendar year is characterized by light issuance activity as the market readies for U.S. hurricane season. In 2011, however, five issuances closed totaling USD853 million, compared to just USD232 million for the third quarter of 2011. This kicked off a very active fourth quarter 2011 where nine transactions closed totaling almost USD2 billion. Despite losses to the Mariah Re transactions that covered severe thunderstorm, the market remained resilient. Strong issuance continued into the first quarter with USD1.5 billion across nine transactions and accelerated into the second quarter, which closed with USD2.1 billion in issuance. This capped off the busiest first half since 2007, where issuance was just under USD5.0 billion.

Issuance Date	Issue	Series	Class	Perils	Issue Size (Millions)	Trigger	Collateral
Jul-11	Queen Street III Capital Limited			EU Wind	$150.0	Industry Index	MMF
Aug-11	Embarcadero Reinsurance Ltd.	Series 2011-I	Class A	CAL EQ	$150.0	Indemnity	MMF
Aug-11	Vita Capital IV Ltd.	Series V Series VI	Class D Class E	CA DE Mortality CA DE UK US Mortality	$100.0 $80.0	Industry Index	IBRD Notes
Aug-11	Pylon II Capital Limited		Class A Class B	FR Wind	€65.0 €85.0	Parametric Index	Tri-Party Repo
Aug-11	Kizuna Re Ltd.	Series 2011-1		JP TY	$160.0	Indemnity	IBRD Notes
Oct-11	Calypso Capital Limited	Series 2011-1	Class A	EU Wind	€180.0	Industry Index	EBRD Notes
Oct-11	Queen Street IV Capital Limited			US HU, EU Wind	$100.0	Industry Index	MMF
Nov-11	Successor X Ltd.	Series 2011-3	Class V-F4 Class V-X4	US HU US HU, EU Wind	$80.0 $50.0	Industry Index	MMF
Nov-11	Residential Reinsurance 2011 Limited	Series 2011-II	Class 1 Class 2	US HU, EQ, ST, WS, WF	$100.0 $50.0	Indemnity	MMF
Dec-11	Compass Re Ltd.	Series 2011-1	Class 1 Class 2 Class 3	US HU, EQ	$75.0 $250.0 $250.0	Industry Index	MMF
Dec-11	Golden State Re Ltd.	Series 2011-1		US EQ	$200.0	Modeled Loss	MMF
Dec-11	Atlas VI Capital Limited	Series 2011-1 Series 2011-2	Class A Class B Class A	US HU, EQ EU Wind	$125.0 $145.0 €50.0	Industry Index	EBRD Notes
Dec-11	Tramline Re Ltd.	Series 2011-1	Class A	US HU, EQ, EU Wind	$150.0	Industry Index	MMF
Dec-11	Loma Reinsurance Ltd.	Series 2011-2	Class A	US HU, EQ	$100.0	Industry Index	MMF
Jan-12	Vitality Re III Limited	Series 2012-1	Class A Class B	US Medical Benefit Ratio	$105.0 $45.0	Industry Index	MMF
Jan-12	Ibis Re II Ltd.	Series 2012-1	Class A Class B	US HU	$100.0 $30.0	Industry Index	MMF
Feb-12	Embarcadero Reinsurance Ltd.	Series 2012-I	Class A	CAL EQ	$150.0	Indemnity	MMF
Feb-12	Kibou Ltd.	Series 2012-1	Class A	JP EQ	$300.0	Parametric Index	MMF
Feb-12	Successor X Ltd.	Series 2012-1	Class V-AA3 Class V-D3	US HU, EU Wind US HU	$23.0 $40.0	Industry Index	MMF
Feb-12	Queen Street V Re Limited			US HU, EU Wind	$75.0	Industry Index	MMF
Mar-12	Mystic Re III Ltd.	Series 2012-1	Class A Class B	US HU, EQ (ex Calif.) US HU, EQ	$100.0 $175.0	Indemnity	MMF
Mar-12	East Lane Re V Ltd.	Series 2012	Class A Class B	Southeast HU, ST	$75.0 $75.0	Indemnity	MMF
Mar-12	Combine Re Ltd.		Class A Class B Class C	US HU, EQ, ST, WS	$100.0 $50.0 $50.0	Indemnity	MMF
Apr-12	Blue Danube Ltd.	Series 2012-1	Class A Class B	US, CB, MX HU, US, CAN EQ	$120.0 $120.0	Industry Index	IBRD Notes
Apr-12	Pelican Re Ltd.	Series 2012-1	Class A	Louisiana HU	$125.0	Indemnity	MMF
Apr-12	Akibare II Ltd.	Series 2012-1	Class A	JP TY	$130.0	Modeled Loss	MMF
Apr-12	Everglades Re Ltd.	Series 2012-1	Class A	FL HU	$750.0	Indemnity	MMF
May-12	Mythen Ltd.	Series 2012-1	Class A Class E Class H	US HU US HU US HU, EU Wind	$50.0 $100.0 $250.0	Industry Index	IBRD Notes
May-12	Residential Reinsurance 2012 Limited	Series 2012-I	Class 3 Class 5 Class 7	US HU, EQ, ST, WS, Calif. WF	$50.0 $110.0 $40.0	Indemnity	MMF
Jun-12	Long Point Re III Ltd.	Series 2012-1	Class A	Northeast HU	$250.0	Indemnity	MMF
Total					**$6,429.7**		

Exhibit 10: Catastrophe Bond Issuance by Half-Year



Source: Aon Benfield Securities, Inc.

Market Drivers

Supply and Demand

In the twelve months ending June 30, 2012, investors kept pace with the very active issuance calendar. In the fourth quarter of 2011, a flurry of high expected loss transactions were issued, which somewhat limited investors' appetite for this level of risk in the first quarter of 2012. Despite this, investors remained keen to put capital to work, as many successfully continued to receive inflows from their own investors. As the second quarter came to a close, a slower primary issuance market created a very active secondary market as investors looked to put their funds to work.

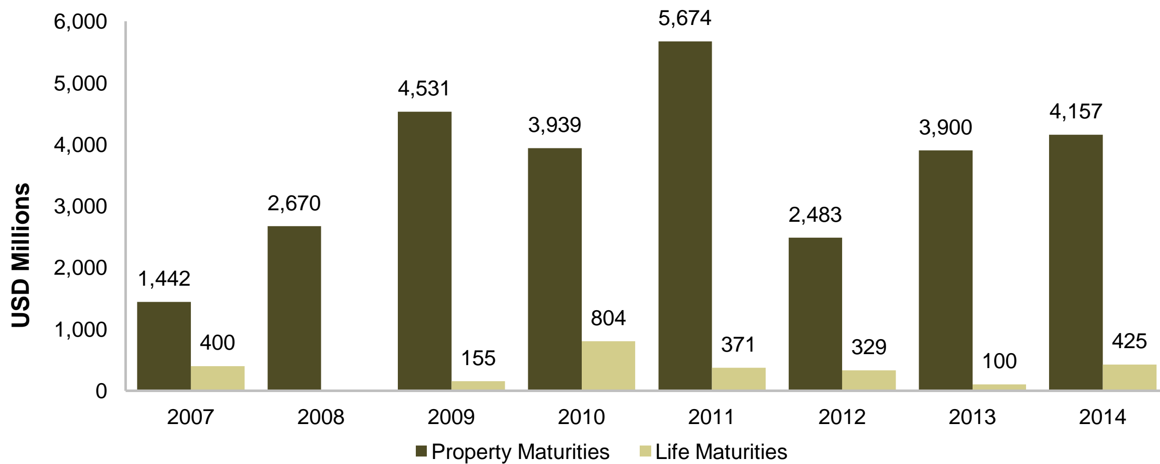
Enhanced Coverage

Indemnity issuances became more prominent in the twelve months ending June 30, 2012. Several repeat sponsors, including Liberty Mutual Insurance Company, The Travelers Indemnity Company, Tokio Marine & Nichido Fire, and the California Earthquake Authority, successfully moved from index triggers to indemnity. In addition, a number of new sponsors entered the market and also secured indemnity coverage. These included Louisiana Citizens Property Insurance Company, Citizens Property Insurance Company, and the dual-sponsors North Carolina Farm Bureau and COUNTRY Mutual.

Natural Events

One of the most active severe weather seasons in the U.S. led to full recoveries for the indexed transactions Mariah Re Ltd. totaling USD200 million. The market remained strong and sponsors that desired the coverage have successfully continued to receive coverage for the peril as part of their issuances.

Exhibit 11: Catastrophe Bonds Maturing by Year *(Years ending June 30)*



Source: Aon Benfield Securities, Inc.

Outlook

Supply and Demand

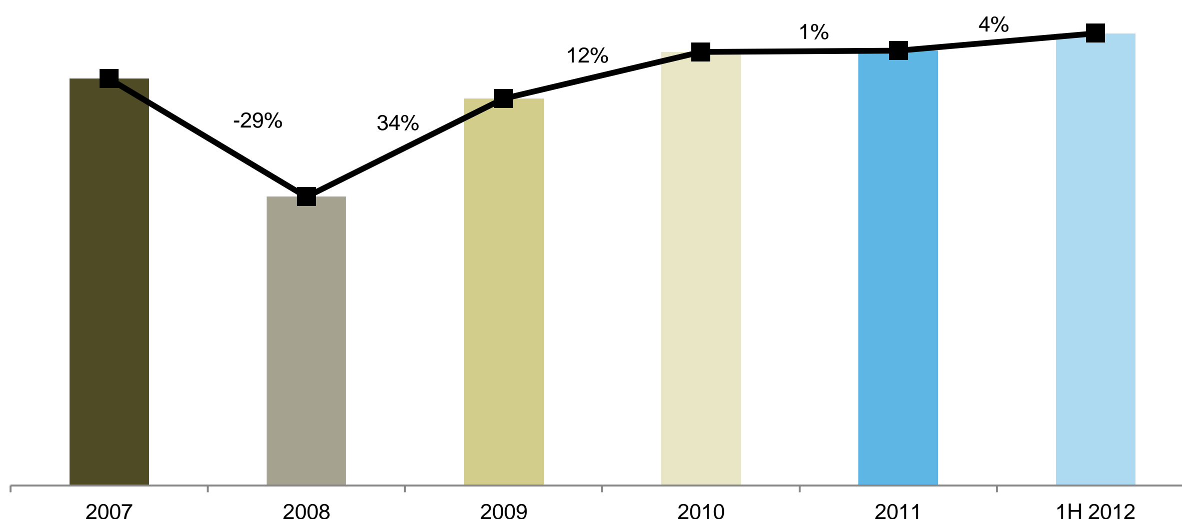
Conditions remain positive for catastrophe bond issuance for the remainder of the 2012 calendar year. Investors have strong demand for bonds as they look to put new capital inflows to work. Both repeat and new sponsors are expected to issue into the ILS market for diversification and to complement overall reinsurance purchases. With a solid pipeline for the second half of the year, annual issuance is likely to reach USD6.0 billion.

Despite the losses from the severe weather, ILS returns for the 12-month period ended June 30, 2012 were 7.40 percent, up from 6.43 percent for the prior 12-month period, according to the Aon Benfield All-Bond Index. The ILS markets have consistently provided competitive returns versus similarly rated corporate securities. As a result, new investors continue to show interest in the space while a number of existing investors are looking to dedicate more capital to the market.

Insurer Demand for Reinsurance

Following 2011 with minimal growth and significantly less loss activity, insurer capital has increased by 4 percent in the first six months of 2012 compared to a 3 percent increase for the same period in the prior year, and 1 percent for the whole of 2011. Increases in capital in many regions have mitigated some increase in reinsurance demand, but in regions where there has been higher growth in the primary market, reinsurance demand has benefitted. Unlike prior years following significant catastrophe events, demand in those regions has also not materially increased.

Exhibit 12: Change in Insurer Capital

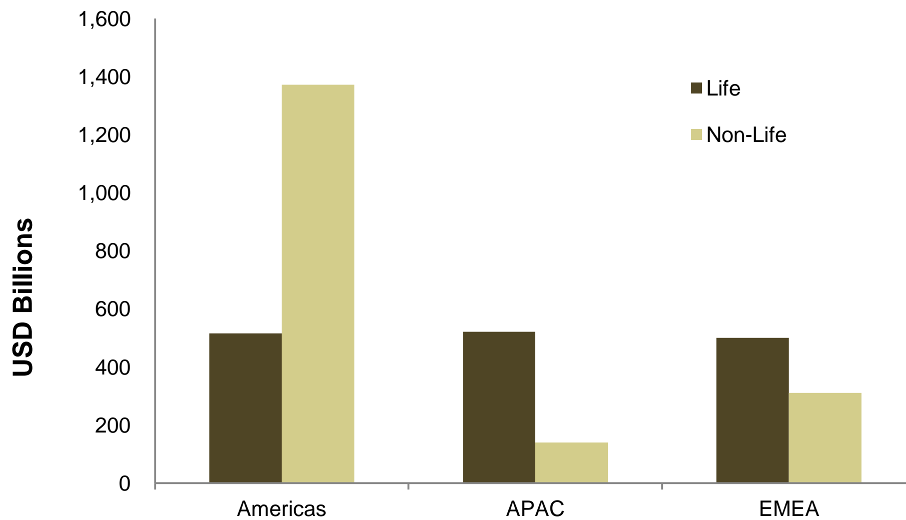


Source: Individual company reports, Aon Benfield Analytics

Global Insurer Capital

Aon Benfield's analysis of global premiums and estimated leverage ratios shows insurance capital at approximately USD3.4 trillion at the end of 2011. Estimates for the Americas include approximately 56 percent of the total insurance capital, with the non-life segment alone accounting for more than 40 percent.

Exhibit 13: Global Insurer Capital

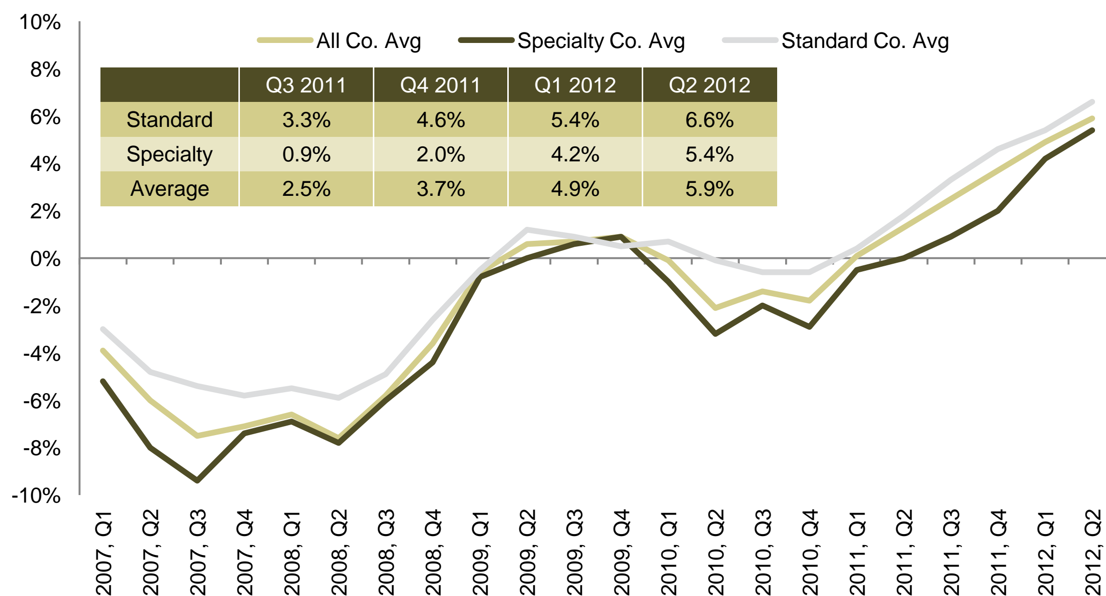


Source: Aon Benfield Analytics

U.S. Primary Casualty Rates Continue Positive Trend

Aon Benfield's summary of casualty rate changes shows an all company average rate increase of 5.9 percent, with standard commercial continuing to outpace specialty commercial with rate increases of 6.6 percent and 5.4 percent, respectively. Where budget constraints previously pushed reductions in demand, the insurance industry may look to purchase additional reinsurance if the turn in the market continues to hold.

Exhibit 14: Primary Casualty Pricing Trend

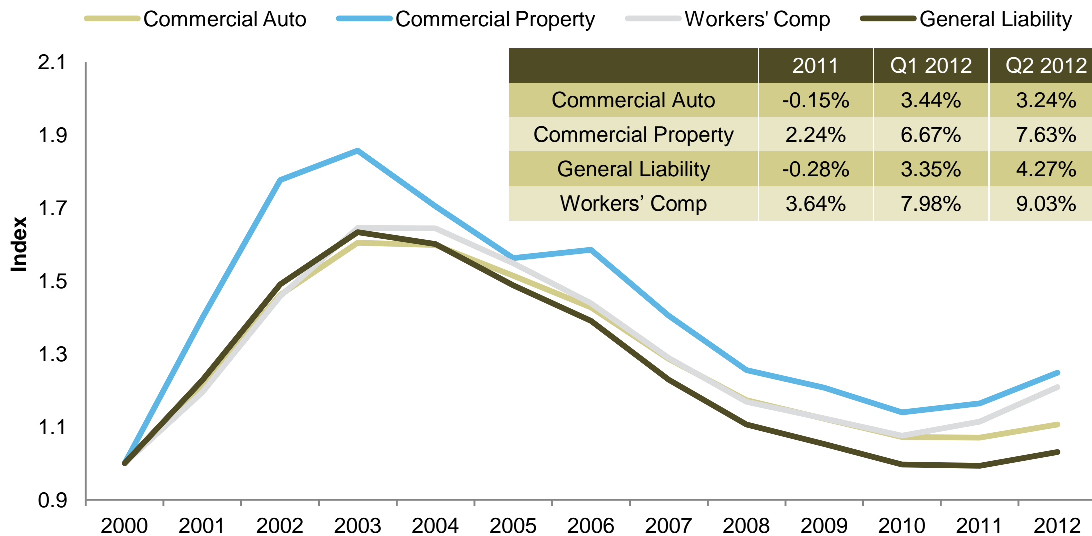


	Q3 2011	Q4 2011	Q1 2012	Q2 2012
Standard	3.3%	4.6%	5.4%	6.6%
Specialty	0.9%	2.0%	4.2%	5.4%
Average	2.5%	3.7%	4.9%	5.9%

Source: Aon Benfield Quarterly Rate Monitor Report

For the second quarter since 2003, all lines referenced experienced rate increases in the U.S. according to the CIAB. Workers' compensation continues to increase at the fastest pace with a second quarter increase of 9.03 percent. While the events of September 11, 2001 were a catalyst to rate increases across the industry, it remains to be seen what the pace of future rate increases will be without a significant catastrophe event.

Exhibit 15: U.S. Primary Pricing Trend



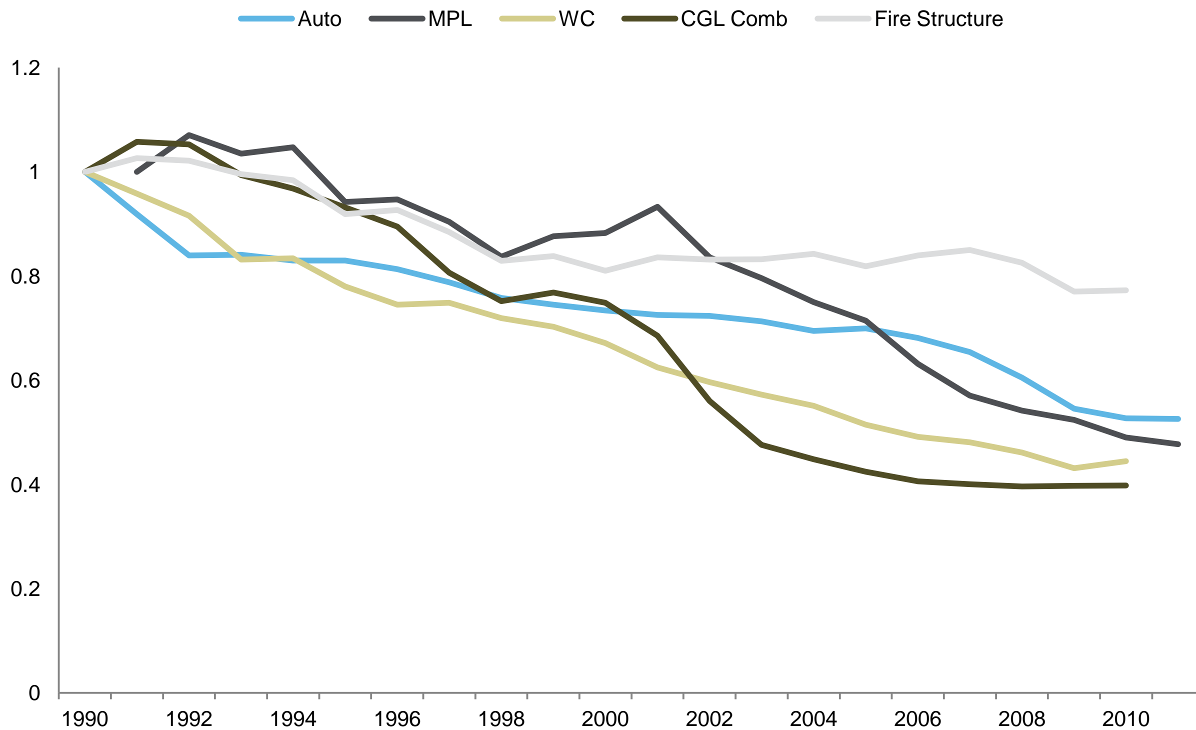
	2011	Q1 2012	Q2 2012
Commercial Auto	-0.15%	3.44%	3.24%
Commercial Property	2.24%	6.67%	7.63%
General Liability	-0.28%	3.35%	4.27%
Workers' Comp	3.64%	7.98%	9.03%

Source: Council of Insurance Agents & Brokers

Non-Catastrophe Retentions Continue to Increase

Casualty retentions and property per risk retentions continue to increase amid a decade of declining frequency. Workers' compensation, general liability, property and auto lines of business have all seen dramatic declines in frequency and retentions for these segments of reinsurance have continued to increase. Facultative reinsurance also remains under pressure as a result and the market for reinsurance continues to become more catastrophe centric.

Exhibit 16: Loss Frequency

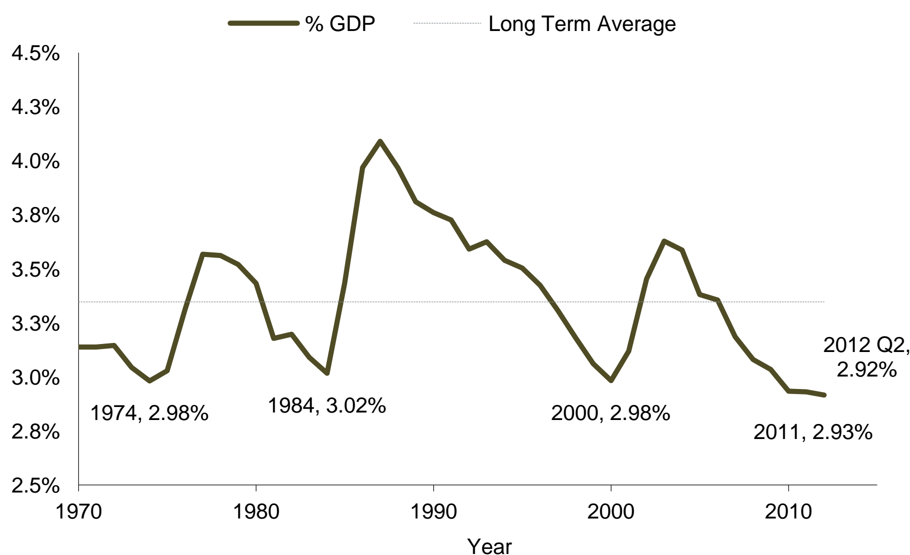


Source: A.M. Best, Insurance Services Office (ISO), National Council on Compensation Insurance, Inc. (NCCI), National Fire Protection Association (NFPA), National Highway Traffic Safety Association (NHTSA), National Practitioner DataBank, U.S. Bureau of Economic Analysis

NWP to U.S. GDP Expected to Increase Following Recent Rate Increases

Results for year end 2011 showed a NWP to U.S. GDP of 2.93 percent and a slight decline through mid-year of 2012 shows the market at 2.92 percent. Although there was not an immediate increase once the industry fell below 3 percent in 2010 as with soft markets, recent rate increases in the industry seem to suggest that the cyclical relationship dating back to 1973 has largely continued.

Exhibit 17: NWP to U.S. GDP

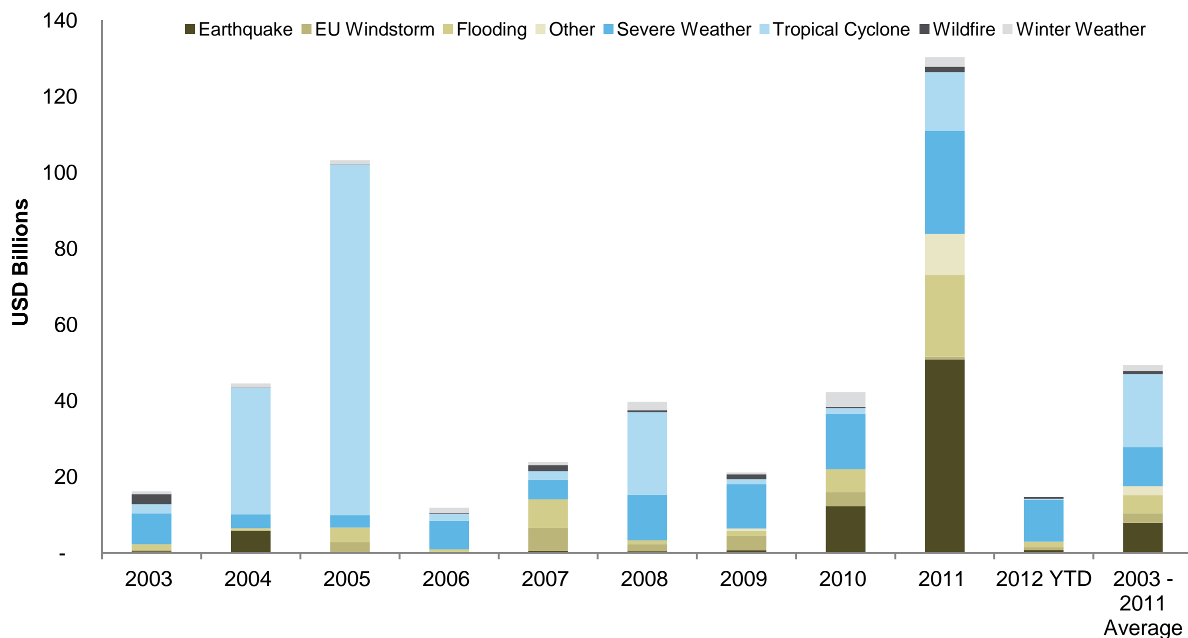


Source: U.S. Department of Commerce and SNL

Global Catastrophe Losses on Pace to be Less than Average

The first half of 2012 experienced significantly lower catastrophe loss activity in all regions with the exception of the U.S. where severe weather continued to drive higher results for the first and second quarters of 2012.

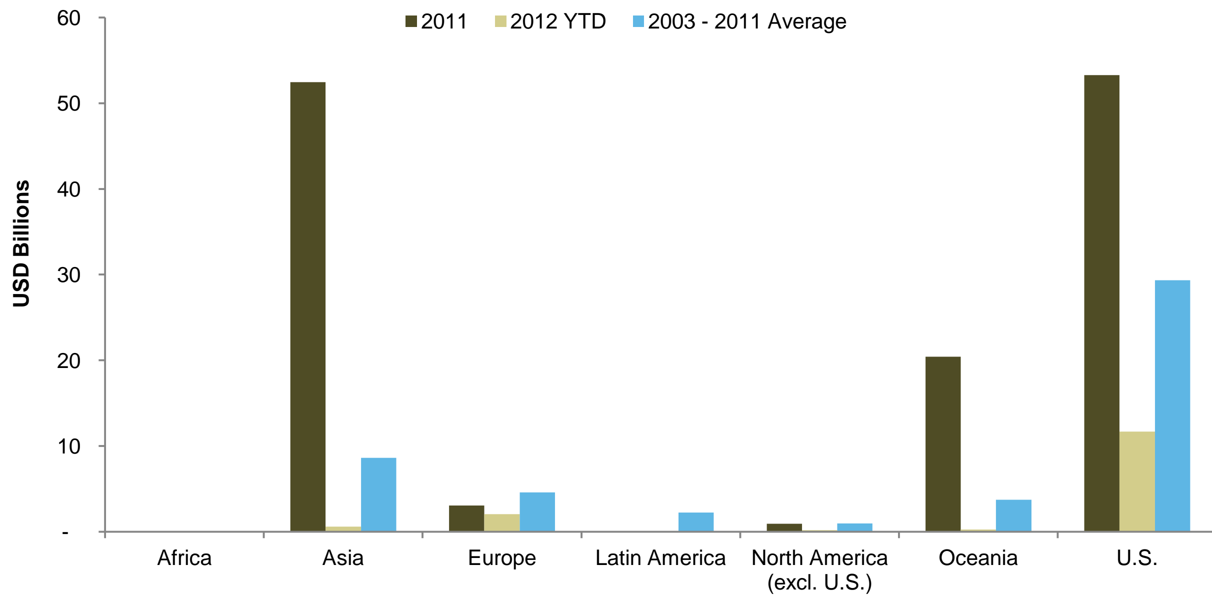
Exhibit 18: Insured Losses by Year by Type



Source: Aon Benfield Analytics

Total catastrophe losses through the second quarter were approximately USD14.7 billion. This compares favorably to 2011 where the majority of loss occurred in the first half of the year with a total annual loss of USD130.2 billion. In addition, losses remain well within the average annual range from 2003 to 2011 of USD49.4 billion. If insured catastrophe activity remains low for the remainder of the year, 2012 would be the second lowest year for catastrophe losses incurred in the 10 year span.

Exhibit 19: 2012 Insured Losses to Date Compared to Recent Years Annual Average

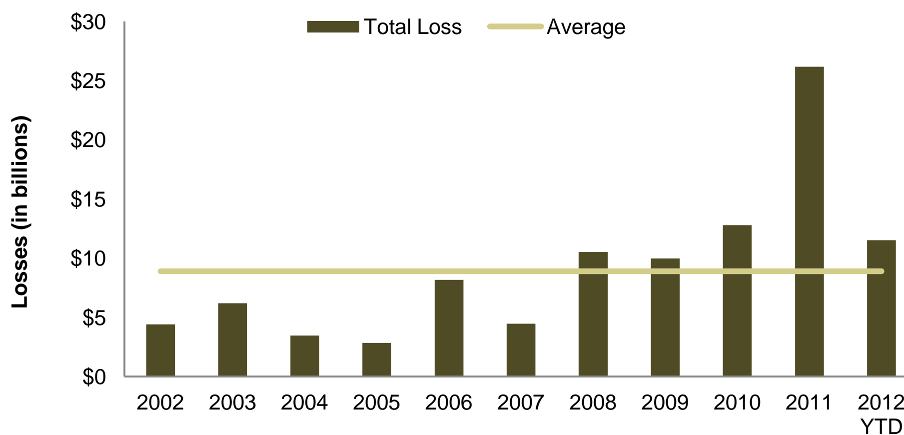


Source: Aon Benfield Analytics

Severe Weather Activity in the U.S. Again Surpasses Recent Years Average

Despite the record loss activity experienced in 2011, U.S. severe weather losses are, again, above the 10-year prior average of USD8.9 billion with second quarter 2012 total losses of approximately USD11.5 billion. In addition, losses from 2010 to 2012 have comprised more than 50 percent of the loss activity experienced since 2001.

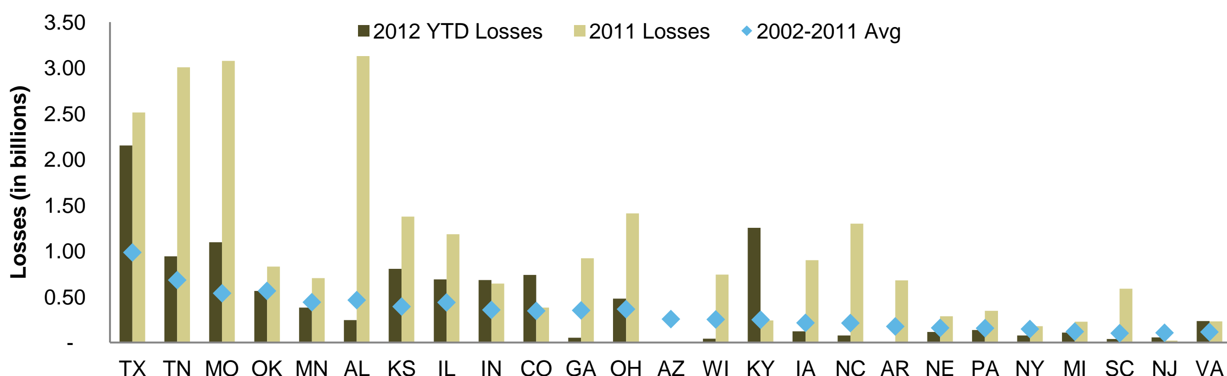
Exhibit 20: Severe Weather Loss Activity By Year



Source: PCS

While loss activity in Texas surpassed all other states, Kentucky and Colorado loss experience in 2012 has been well above both the average experience for the state and that experienced in 2011. Other states, including Alabama, Georgia, Iowa, North Carolina, South Carolina, and Wisconsin, experienced lower than average loss activity following significant losses in 2011.

Exhibit 21: Annual Mean Loss Activity By State Compared to 2011 and 2012 (2002 – 2011)



Source: SNL, PCS

While the prior year averages are now impacted by loss activity that was 2 to 5 times the normal average, southeast states experienced loss activity that was less than the 10-year average in 2012. Ten states have experienced loss activity that was 2 to 5 times the historical average, but that compares favorably to 2011 where 10 states were over 5 times the average.

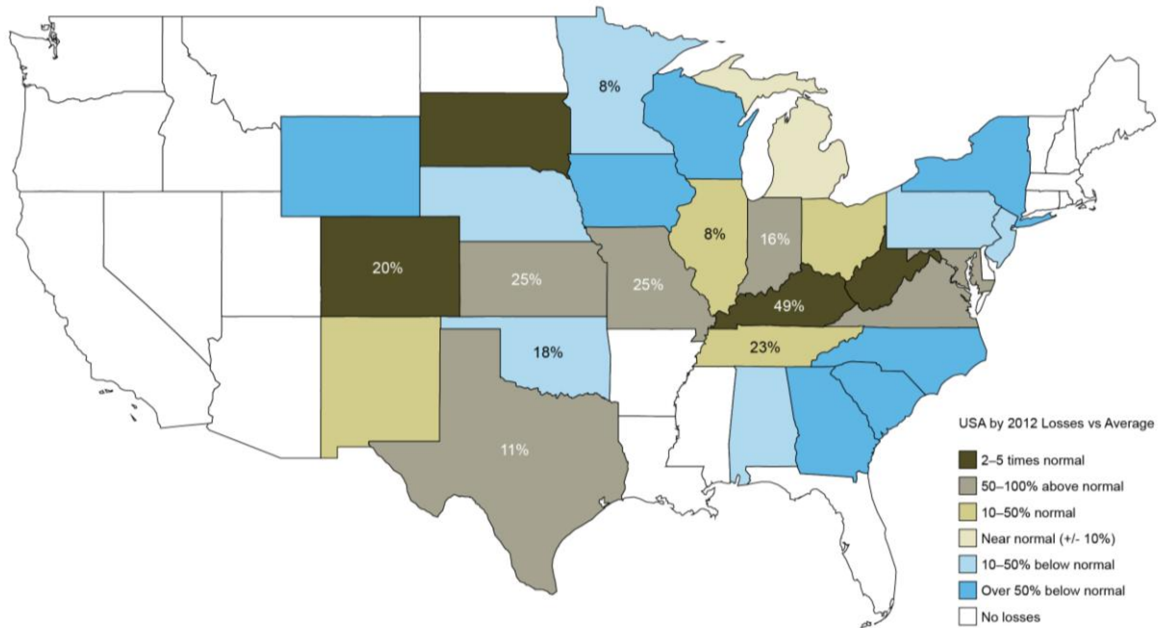
Exhibit 22: 2012 Activity Compared to Historical Average Losses (2002-2011)

USA by 2012 Losses vs Average
2–5 times normal
50–100% above normal
10–50% normal
Near normal (+/- 10%)
10–50% below normal
Over 50% below normal
No losses

Source: PCS

Assuming similar premiums to 2011, Exhibit 23 highlights loss ratio impacts by state. While last year three states had over 50 percent loss ratios for tornado/hail losses alone, this year Kentucky is the top state with a 49 percent loss ratio for catastrophe losses. That said, Colorado, South Dakota and West Virginia all experienced loss ratio impacts that were 2 to 5 times the average impact for the prior 10 years.

Exhibit 23: January through July 2012 Loss Ratio Impact versus Historical Means

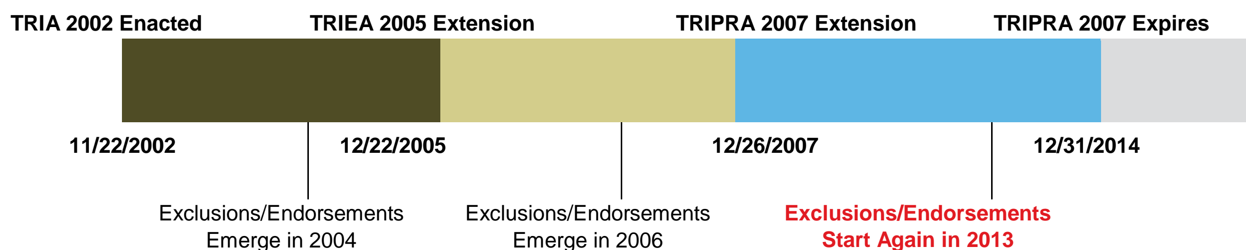


Source: SNL, PCS

Private Reinsurance Opportunity at TRIA Sunset

Following the terrorist attacks of September 11, 2001, the Terrorism Risk Insurance Association (TRIA) was enacted in 2002 in order to provide a federal reinsurance backstop to the insurance industry for terrorism protection. TRIA has been a very important source of capacity for insurers that provide capacity to U.S. industries; without its existence, insurers would have to exclude material terrorism risk from the policies they issue. That said, the existence of TRIA has greatly reduced the opportunity for private reinsurers to offer capacity for terrorism risk and the latest extension is set to sunset on December 31, 2014.

Exhibit 24: History of the Terrorism Risk Insurance Act and Extensions



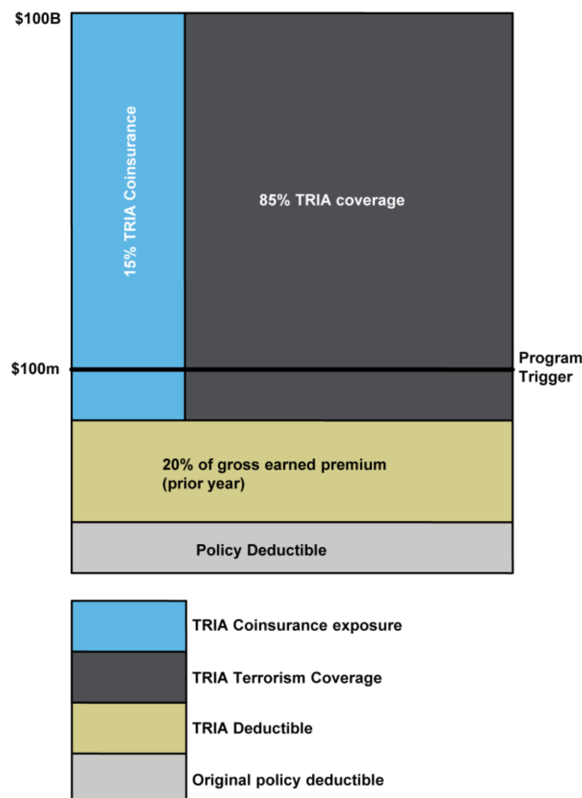
As part of the most recent extension in 2007, a few key changes were made:

1. Includes “domestic” terrorist acts in the definition of a certified TRIA event
2. Provides for a seven year term with no changes to TRIA 2005 deductibles, coinsurance or loss trigger thresholds
3. No change in covered property and casualty lines
4. Clarifies that insurers are “capped” at their respective retention levels for deductibles and coinsurance exposures

With take-up rates in the primary market in excess of 60 percent, a significant opportunity to provide protection could be absorbed in the private reinsurance market.

If TRIA is not renewed, expectations are for material exclusions to be introduced to insurers’ policies that could in fact begin as part of renewals in 2013 and an honest dialogue between insurers and insurance commissioners throughout the U.S. about why, despite state statutes, terrorism was never an intended coverage in workers' compensation and fire insurance policies.

It is expected that there will be sufficient capacity from reinsurers to meet the expected demand from insurers that cover specific terrorism risks they insure.



Atlantic Hurricane Season Forecast Update

Colorado State University (CSU), Tropical Storm Risk (TSR) and National Oceanic and Atmospheric Administration (NOAA) have all increased their original named storm and hurricane forecasts from their earlier predictions in May/June. All except CSU have also increased their prediction of major hurricanes for the 2012 Atlantic hurricane season. The general consensus is that 2012 will be an above normal season for named storms potentially due to the uncertainty surrounding El Niño. To date, there have been 12 named storms, including five hurricanes and no major hurricanes.

Exhibit 25: U.S. Hurricane Season Forecasts—TSR, CSU and NOAA

	Named Storms	Hurricanes	Major Hurricanes
TSR (August 2012)			
Average	10.7	6.2	2.7
2012	14.2	6	2.9
Difference	+3.5	-0.2	+0.2
CSU (August 2012)			
Average	9.6	5.9	2.3
2012	14	6	2
Difference	+4.4	+0.1	-0.3
NOAA (August 2012)			
Average	12	6	3
2012	12-17	5-8	2-3
Difference	+3.0	+0.5	-0.5

Source: TSR, CSU and NOAA

M&A Activity Update

Mergers and acquisition (M&A) activity in the insurance and reinsurance market has been significantly depressed through the first half of 2012. According to Dealogic, global insurance sector M&A deal volume through the first seven months of 2012 totaled USD17.5 billion, compared to USD47.3 billion for the same period of 2011, a drop of 63 percent. Below is a summary of the current trends affecting capital raising and M&A activity in the insurance sector.

- **Company valuations remain near historic lows.** The composite of publicly traded insurers and reinsurers that Aon Benfield Securities tracks currently trades below book value. Depressed public valuations of insurers has inhibited deal activity as potential sellers are not motivated at current valuations; while potential buyers own equity valuations limit what they can reasonably pay given dilution constraints.
- **Incentive for companies to continue/increase share buy backs.** For insurers and reinsurers trading below book value with excess capital, buying back shares and generating immediate risk-free gains continues to be more compelling than considering an acquisition or deploying capital to support organic growth in the current market.
- **Private equity returning to specialty insurance sector.** With valuations depressed and debt financing available, private equity buyers have been increasing activity in the small to mid-cap specialty insurance sector, specifically targeting distribution platforms and specialty insurers focused on niche lines of business.
- **Continued interest in specialty managing general underwriters (MGUs), wholesalers and fee for service providers.** Both strategic and private equity investors have recently demonstrated increased interest in acquiring distribution sources, although strategic investors have ultimately been more successful primarily due to potential synergies and a lower cost of capital.
- **Hedge funds seeking permanent capital vehicles.** Several well-known hedge funds have recently announced the formation of reinsurance companies with investment portfolios to be managed by the sponsoring hedge fund. These vehicles provide the sponsor funds with a permanent asset base and current fund investors with a more tax efficient investment vehicle along with the potential for greater liquidity when shares are ultimately listed on a public exchange.

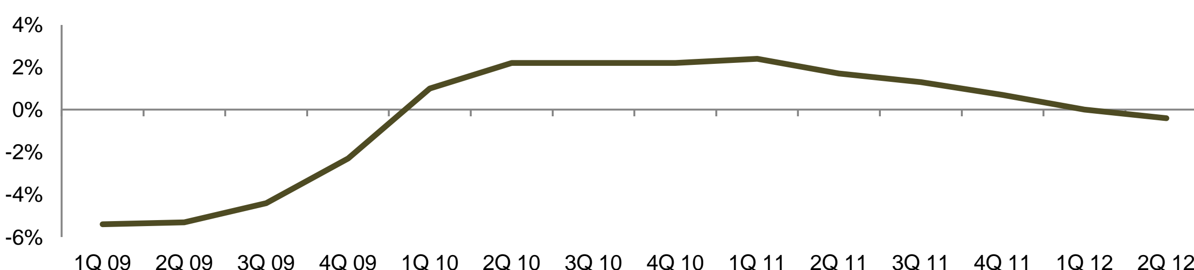
Over the near term, Aon Benfield Securities expects strategic investors to pursue consolidation and focused “bolt-on” acquisitions more actively as organic growth continues to be constrained by fragile global economic undercurrents of low growth, high unemployment and volatile capital markets.

Economic and Financial Market Update

The EU Debt Crisis

Uncertainty around developments in the euro area continued to overshadow the global economy through 2012 to date and has acted as a brake on recovery. Preliminary figures show that the Eurozone edged closer back towards recession with gross domestic product falling 0.2 percent in the three months ended June 30 and flat in the first quarter of the year. Compared with the 2011 quarter, GDP fell 0.4 percent in the second quarter and was flat in the first quarter.

Exhibit 26: GDP Quarterly Percent Change Year-on-Year



Source: Eurostat

Economic growth in Germany slowed to 0.3 percent in the second quarter compared with the first quarter, while the French economy has been flat for three successive quarters. The U.K. economy contracted by 0.7 percent in the second quarter—the third (and largest) successive quarterly fall.

Exhibit 27: GDP Percentage Change Compared with Previous Quarter

	3Q 2011	4Q 2011	1Q 2012	2Q 2012
Eurozone	0.2	-0.3	0.0	-0.2
Germany	0.4	-0.1	0.5	0.3
France	0.3	0.0	0.0	0.0
UK	0.6	-0.4	-0.3	-0.7

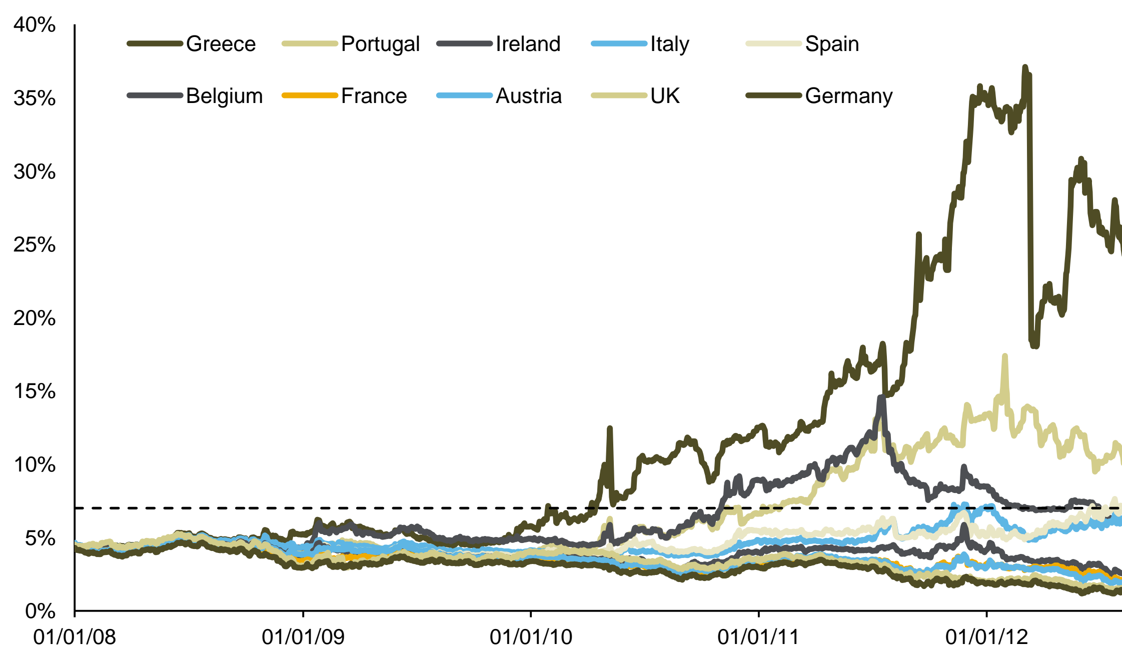
At their summit on June 28 and 29, European Union finance ministers announced some positive policy measures, including ways to increase the flexibility of providing financial support to member states, which provided some comfort to financial markets. The European Central Bank lowered interest rates in July and the Bank of England recently added another GBP50 billion to its Quantitative Easing program. Despite these actions, investors and market commentators are still concerned that the combined measures will be insufficient to delay the prospect of recession and some observers have raised the possibility of the euro area entering a prolonged period of stagnation.[2]

[2] The Economist, August 4, 2012, The global crash – Japanese lessons

Worries about Greece persist, even if the near-tem risk of the country's exit from the euro has receded following the victory of New Democracy in the recent parliamentary elections. Nevertheless, the possibility of a so-called Grexit does now appear to be being contemplated by Eurozone finance ministers, with such a possibility now being described as manageable if undesirable.[3] The political and social consequences of such a move would be profound.

Financial market worries appear to have shifted and Spain has become the focus of recent attention. The Spanish economy remains constrained by the increasing cost of bank recapitalization, deeper recession, upward revisions of fiscal deficits and targets, rising projections of the public debt ratio, and tightening funding conditions. Problems in the banking sector have led to up to EUR100 billion of support being made available from the European Financial Stability Facility and the European Stability Mechanism. The government has adopted a series of policies aimed at reducing its deficit, including tax rises and public spending cuts. Despite these and other measures, the yield on 10-year government debt has recently been around the 7 percent level which has prompted previous intervention (Greece and Ireland).

Exhibit 28: Eurozone 10-year Government Bond Yields



Source: Bloomberg (data as at August 15, 2012)

[3] Jean-Claude Juncker, Prime minister of Luxembourg

The major rating agencies have also highlighted weak economic prospects as a negative factor for the credit outlook—particularly for Europe and European institutions. Commenting on the global slowdown, Fitch noted that "risks are skewed to the downside."[4] The agencies maintain a predominantly negative outlook on most of their European sovereign debt ratings. At the end of April, Standard & Poor's lowered its long-term sovereign credit rating of the Kingdom of Spain to BBB+. The rating was affirmed on August 1, 2012, although the agency maintained a negative outlook.

Exhibit 29: Sovereign Debt Ratings

	Moody's			Standard & Poor's			Fitch		
	Sovereign rating	Outlook	Downgrade notches since Jan 2011	Sovereign rating	Outlook	Downgrade notches since Jan 2011	Sovereign rating	Outlook	Downgrade notches since Jan 2011
Belgium	Aa3	Negative	2	AA	Negative	1	AA	Negative	1
France	Aaa	Negative	-	AA+	Negative	1	AAA	Negative	-
Germany	Aaa	Negative	-	AAA	Stable	-	AAA	Stable	-
Greece	C	-	10	CCC	Negative	9	CCC	-	6
Ireland	Ba1	Negative	3	BBB+	Negative	2	BBB+	Negative	-
Italy	Baa2	Negative	6	BBB+	Negative	3	A-	Negative	3
Netherlands	Aaa	Negative	-	AAA	Negative	-	AAA	Stable	-
Portugal	Ba3	Negative	8	BB	Negative	5	BB+	Negative	6
Spain	A3	Negative	5	BBB+	Negative	5	BBB	Negative	7
UK	Aaa	Negative	-	AAA	Stable	-	AAA	Negative	-
USA	Aaa	Negative	-	AA+	Negative	1	AAA	Negative	-
Japan	Aa3	Stable	1	AA-	Negative	1	A+	Negative	3

Source: Moody's, S&P, Fitch (ratings as at August 16, 2012)

Recent negative rating action at the sovereign level has had implications for a number of insurance and European reinsurance groups, including Generali and Mapfre. Following its two notch downgrade of the Kingdom of Spain to BBB+, Standard & Poor's lowered its rating on Mapfre group and Mapfre Re to A-, introducing, for the first time, a one notch differential in its rating of Mapfre over that of Spain.

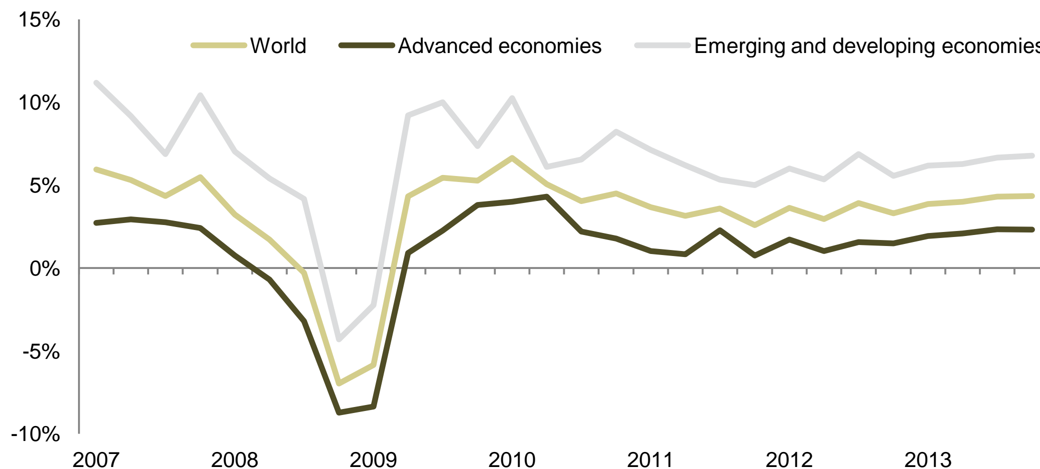
The Global Economy

The IMF has pared back its forecast for global growth to 3.5 percent in 2012 and 3.9 percent in 2013, down 0.1 and 0.2 percentage points, respectively, noting that "more worrisome than these revisions to the baseline forecast is the increase in downside risks." These forecasts were predicated on the following assumptions:

- There will be enough policy action for financial conditions in the so-called euro area periphery, which includes Greece and Spain, to ease gradually through 2013
- U.S. fiscal policy does not tighten sharply in 2013
- Steps by some major emerging markets to stimulate growth gain traction

[4] Fitch Ratings, Negative Outlooks Rise as Eurozone Troubles Weigh on Global Growth, July 23, 2012

Exhibit 30: Global GDP Growth and Forecasts (Quarter over quarter, annualized)



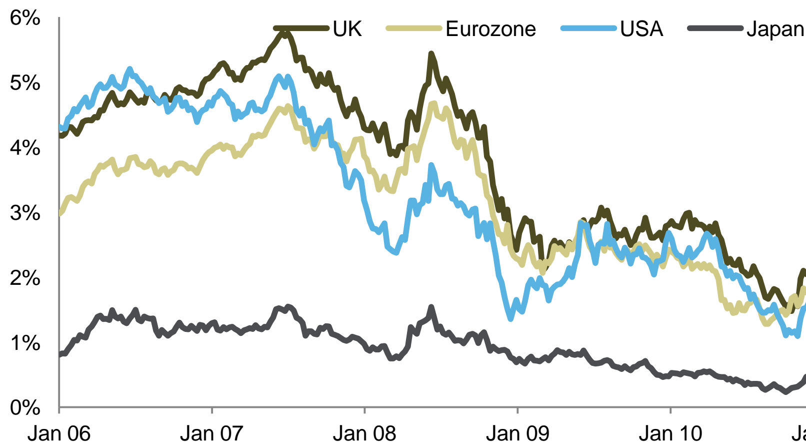
Source: IMF World Economic Outlook Update, July 2012

The IMF noted a weakening of underlying growth in the U.S. and from emerging market economies, notably Brazil, China and India. Slowing in emerging markets reflects both a weaker external environment, and a sharp decline in domestic demand in response to capacity constraints and policy tightening over the past year. Falls in equity markets, currency depreciation and capital outflows have followed a heightened risk aversion by foreign investors as money has been diverted into perceived safe havens.

Financial Markets

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 U.K. Bank Rate has been at 0.5 percent since March 2009. In an effort to provide a stimulus, the European Central Bank lowered its benchmark Main Financing Rate by 0.25 percentage point to 0.75 percent on July 5, 2012.

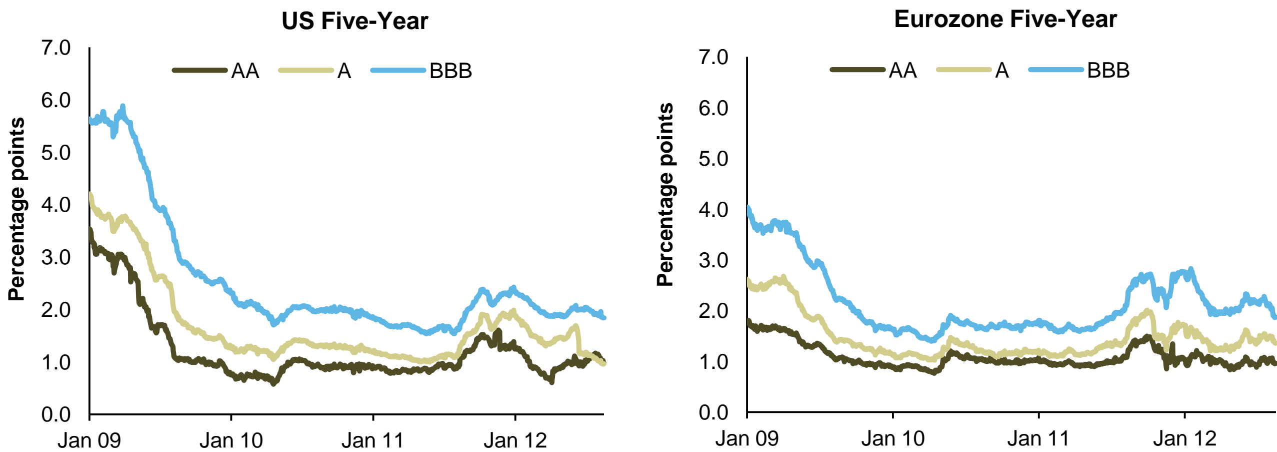
Exhibit 31: Five-year Government Bond Yields



Source: Aon Benfield Analytics, Bloomberg

Weak economic conditions and measures to attempt to kick start the global economy have kept government bond yields at historical lows throughout 2012. Starting the year at 0.83 percent, the yield on five-year U.S. Treasuries had fallen to 0.66 percent by mid-August. At the same time, the yield on U.K. bonds fell from 1.05 percent to 0.54 percent, while that of Eurozone debt was down from 0.76 percent to 0.43 percent. The yield on Japanese bonds continued to slide, falling from 0.35 percent to 0.18 percent.

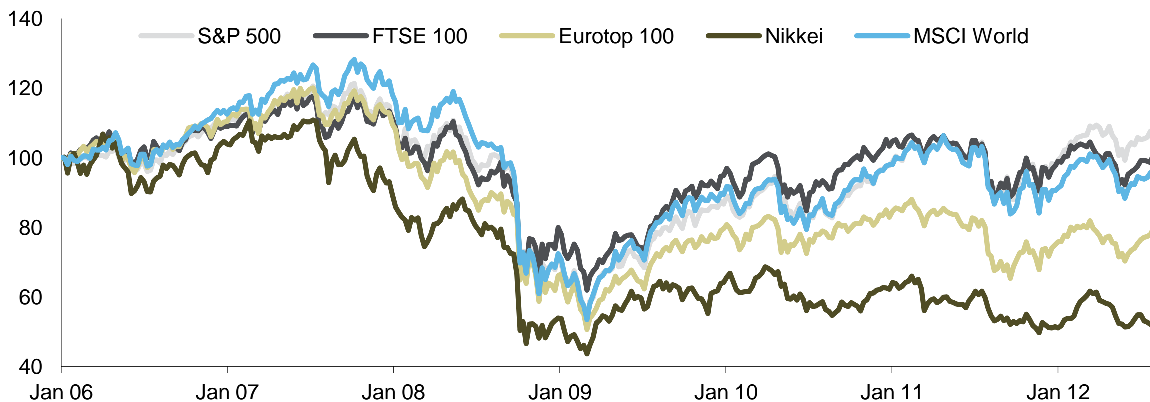
Exhibit 32: Five-year Corporate Bond Spreads over Government Debt



Source: Aon Benfield Analytics, Bloomberg

Despite wider financial market concerns, there is evidence that investors' credit risk appetite has increased through the year as they again turned their attention to the corporate bond market. A number of insurers and reinsurers made notable net investments in the sector in the first half of the year. This increased demand was reflected in the spreads of corporate bonds over Treasuries/government bonds, which was relatively stable for the year to date, and even fell by around 0.9 percentage points for BBB rated European issues.

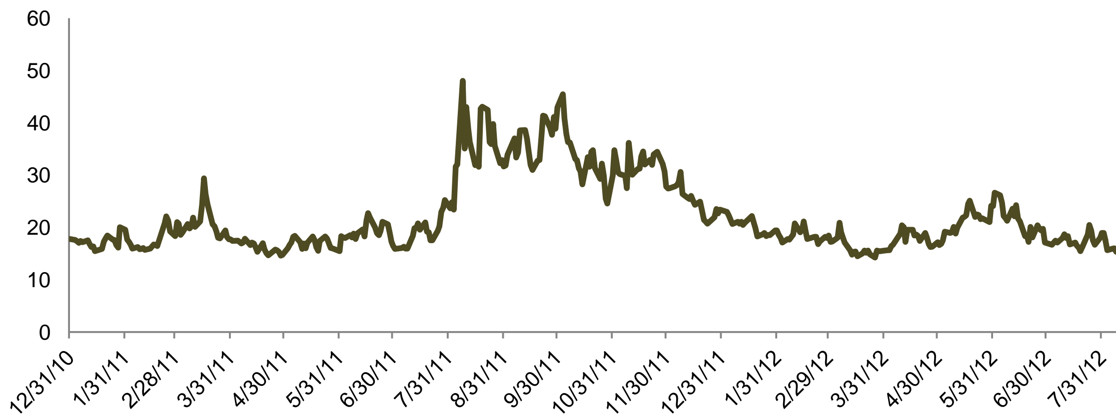
Exhibit 33: Equity Markets Index (January 2006 = 100)



Source: Aon Benfield Analytics, Bloomberg

Equity markets made a positive start to 2012 but weakened in the second quarter, before recovering again through July and August. At mid-August, the S&P 500 index was up 12 percent since the start of the year. Stock markets in Europe (Eurotop 100) and the U.K. (FTSE 100) both rose, by 8 percent and 5 percent, respectively, while Japan's Nikkei index was up 5 percent over the period. The MSCI World index rose 8 percent.

Exhibit 34: CBOE S&P 500 Volatility Index



Source: Aon Benfield Analytics, Bloomberg

Market volatility fell through the first quarter and increased again through the second quarter, reflecting the concerns about the global economy and the Eurozone problems. With some relief provided with the (at least temporary) resolution to some of the more pressing problems in Europe, the index fell to around its lowest level since the start of 2011.

Bank Leverage

Analysis of the 20 largest banks globally shows that total asset leverage, measured by total assets to shareholders' equity has continued to decline only slightly since a year ago. Last year's second quarter average of 22.9x only decreased one-tenth of a point to 22.8x in 2012 as there were a number of increases since a year ago.

To be considered "adequately capitalized", the FDIC requires a maximum asset leverage ratio of 25x based upon the Basel II accords. At the end of second quarter 2012, two of the twenty were considered adequately capitalized. Currently, "well capitalized" banks have a maximum asset leverage ratio of 20x, of which only eight banks met the ratio. As of January 1, 2013, banks will have an even stricter leverage ratio of 16.7x in order to be considered "well capitalized" when Basel III goes into effect. Only six of the eight "well capitalized" banks would be termed as such under the new requirements at January 1.

Exhibit 35: Top 20 Largest Banks Total Leverage

Leverage Name	06/30/07	12/31/07	06/30/08	12/31/08	06/30/09	12/31/09	06/30/10	12/31/10	06/30/11	12/31/11	06/30/12
Deutsche Bank AG	53.4	54.5	62.4	71.7	50.5	40.9	46.4	39.0	37.0	40.5	40.2
Mitsubishi UFJ Financial Group Inc	25.1	22.9	22.3	25.6	27.5	32.2	28.0	23.5	23.6	24.1	23.4
HSBC Holdings PLC	18.0	18.7	20.1	27.0	20.5	18.8	17.8	16.9	16.8	16.4	16.0
Barclays PLC	55.2	52.7	61.3	56.1	41.0	29.2	32.0	29.3	28.9	28.1	30.1
BNP Paribas SA	36.4	36.0	42.1	48.6	46.8	33.5	34.6	30.0	28.3	28.9	26.3
JPMorgan Chase & Co	12.2	12.7	14.0	16.1	13.8	12.9	12.4	12.6	12.8	12.9	12.5
Royal Bank of Scotland Group PLC	24.3	34.7	30.5	40.8	32.7	21.8	20.6	19.3	19.3	20.1	19.1
Bank of America Corp	11.5	12.0	12.4	13.0	11.5	11.5	11.0	10.7	11.0	10.1	9.9
Mizuho Financial Group Inc	44.4	38.1	41.4	52.9	64.9	128.7	58.6	52.4	40.8	41.5	38.9
Citigroup Inc	17.5	19.3	19.3	27.3	23.7	12.2	12.5	11.7	11.1	10.6	10.4
Sumitomo Mitsui Financial Group Inc	34.1	28.3	33.9	34.8	35.4	55.4	32.2	26.0	26.5	28.2	26.8
Banco Santander SA	19.3	16.5	18.5	18.2	18.1	16.2	16.9	16.2	16.8	16.4	17.6
Societe Generale SA	39.1	39.3	34.5	37.7	33.7	28.7	29.6	28.4	28.0	28.2	28.8
Lloyds Banking Group PLC	31.0	29.1	34.1	46.4	31.8	23.7	22.0	21.5	21.8	21.1	20.9
UBS AG	49.5	61.7	46.9	61.9	47.7	32.7	31.7	28.1	26.2	26.6	25.8
Wells Fargo & Co	11.6	12.2	12.9	19.3	15.4	12.0	11.1	10.7	10.1	10.2	9.8
UniCredit SpA	21.9	17.7	19.0	19.0	17.0	15.6	14.8	14.5	14.2	18.0	15.6
Credit Suisse Group AG	32.3	31.5	33.4	36.2	30.1	27.5	31.9	31.0	31.3	31.2	30.0
Nordea Bank AB	24.2	22.8	25.2	26.7	22.6	22.7	25.0	23.8	24.0	27.5	26.6
Commerzbank AG	40.0	40.7	43.2	63.6	80.3	95.6	90.0	70.5	29.8	30.9	28.1
Average	**30.1**	**30.1**	**31.4**	**37.2**	**33.3**	**33.6**	**29.0**	**25.8**	**22.9**	**23.6**	**22.8**

Source: Aon Benfield Analytics

Contact Information

Bryon Ehrhart
Chairman of Aon Benfield Analytics
Chairman of Aon Benfield Securities
+1 312 381 5350
bryon.ehrhart@aonbenfield.com

Stephen Mildenhall
Chief Executive Officer
Aon Benfield Analytics
+1 312 381 5880
stephen.mildenhall@aonbenfield.com

John Moore
Head of Analytics, International
Aon Benfield Analytics
+44 (0)20 7522 3973
john.moore@aonbenfield.com

Tracy Hatlestad
Managing Director
Aon Benfield Analytics
+1 952 886 8069
tracy.hatlestad@aonbenfield.com

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Aon Benfield
200 E. Randolph Street
Chicago, Illinois 60601
t +1.312.381.5300
f +1.312.381.0160
aonbenfield.com

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