

# Insurance-Linked Securities

Second Quarter 2013 Update

## Second Quarter 2013 Catastrophe Bond Transaction Review

New catastrophe bond issuance for the first half of 2013 was USD4.0 billion, the highest level since 2007. USD17.5 billion of total limit was outstanding as of June 30, 2013. Thirteen cat bonds closed during the second quarter, with several additional transactions expected to close in the coming weeks. Strong demand has continued since the first quarter such that transactions continue to be marketed into the start of hurricane season.

Market pricing conditions for insurance-linked securities continued the downward shift from earlier in the year, stabilizing by the end of the second quarter at a level more than 40% lower than the fourth quarter of 2012. The catastrophe bond market consistently continued to offer more aggressive pricing than the traditional reinsurance market. Although new issuance in the second quarter included predominantly repeat sponsors, including United Services Automobile Association (“USAA”), The Travelers Indemnity Company (“Travelers”) and Assurant, we expect new sponsors will continue to enter the ILS sector. A broad array of coverage was offered during the quarter including regional earthquake and hurricane, Turkey earthquake and Australia cyclone, as well as U.S. nationwide multi-peril.

The table below summarizes the terms of the deals that closed during the second quarter:

### Second Quarter 2013 Catastrophe Bond Issuance

Beneficiary	Issuer	Series	Class	Size (USD millions)	Covered Perils	Trigger	Rating	Expected Loss <sup>1</sup>	Interest Spread
State Farm Fire and Casualty Company	Merna Re IV Ltd.			300	New Madrid EQ	Indemnity	Not Rated	0.40%	2.50%
Nationwide Mutual Insurance Company	Caelus Re 2013 Limited	Series 2013-2	Class A	320	U.S. HU, EQ	Indemnity	Not Rated	1.98%	6.85%
North Carolina JUA/IUA	Tar Heel Re Ltd.	Series 2013-1	Class A	500	NC HU	Indemnity	B+	2.77%	8.50%
Turkish Catastrophe Insurance Pool	Bosphorus 1 Re Ltd.	Series 2013-1	Class A	400	Turkey EQ	Parametric Index	BB+	1.01%	2.50%
Allstate	Sanders Re Ltd.	Series 2013-1	Class A	200	U.S. HU, EQ	Industry Index	BB+	0.95%	3.50%
			Class B	150			BB	1.22%	4.00%
Louisiana Citizens Property Insurance Company	Pelican Re Ltd.	Series 2013-1	Class A	140	LA HU	Indemnity	Not Rated	2.05%	6.00%
American Coastal	Armor Re Ltd.	Series 2013-1	Class A	183	FL HU	Indemnity	BB+	0.40%	4.25%
Travelers	Long Point Re III Ltd.	Series 2013-1	Class A	300	Northeast HU	Indemnity	BB	1.24%	4.00%
Allianz Argos 14 GmbH	Blue Danube II Ltd.	Series 2013-1	Class A	175	U.S., CB, MX HU & U.S., CAN EQ	Industry Index	BB+	0.96%	4.25%
USAA	Residential Reinsurance 2013 Limited	Series 2013-1	Class 3	95	U.S. HU, EQ, ST, WS, CAL WF	Indemnity	B-	3.68%	9.25%
			Class 11	205		Indemnity	Not Rated	2.60%	8.00%
Munich Re	Queen Street VIII Re Limited			75	U.S. HU, AUS CY	Industry Index, Modeled Loss	Not Rated	2.90%	6.50%
Assurant Inc.	Ibis Re II Ltd.	Series 2013-1	Class A	110	U.S. HU	Industry Index	BB+	0.85%	4.00%
			Class B	35			BB-	1.53%	4.50%
			Class C	40			B	3.36%	8.00%
Amlin AG	Tramline Re II Ltd.	Series 2013-1	Class A	75	U.S. & CAN EQ	Industry Index	Not Rated	1.21%	3.25%
Total Marketed During Q2				3,303					

Source: Aon Benfield Securities, Inc.

#### Legend

AUS – Australia  
CAL – California  
CAN – Canada

CB – Caribbean  
FL – Florida  
LA – Louisiana

MX – Mexico  
NC – North Carolina  
U.S. – United States

CY – Cyclone  
EQ – Earthquake  
HU – Hurricane

WF – Wildfire  
WS – Winter storm

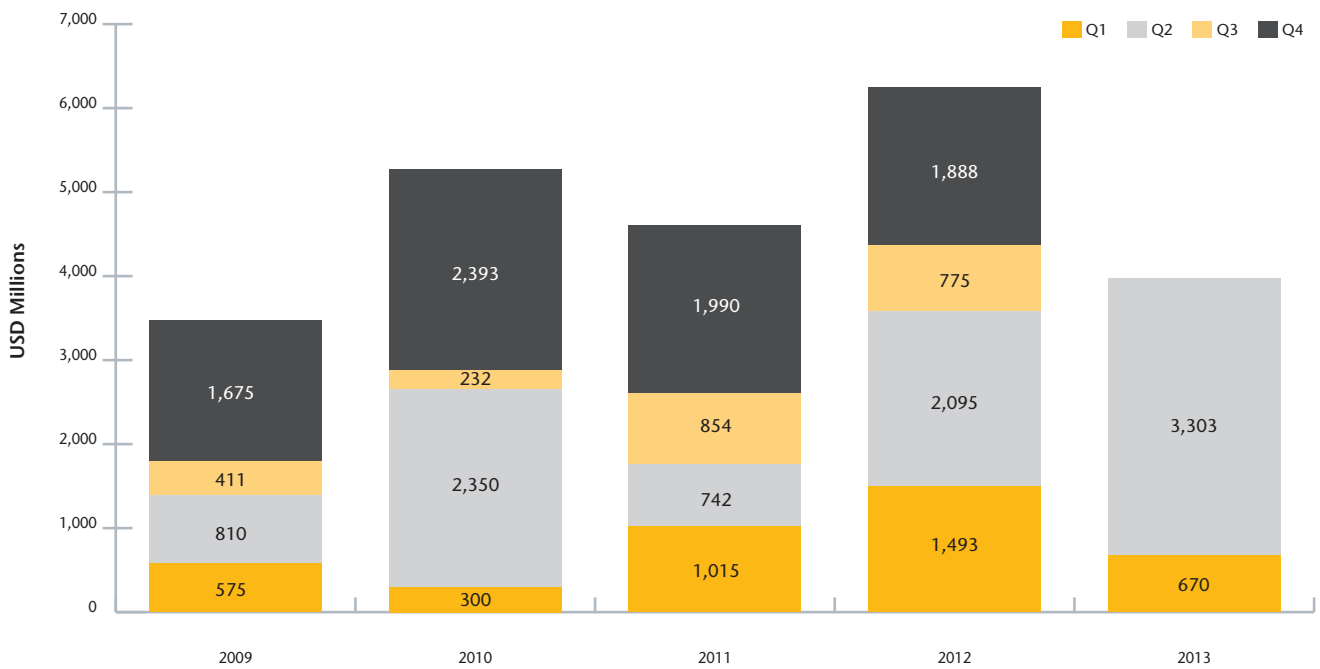
<sup>1</sup> Modeled expected losses for the first annual risk period, with warm sea surface temperature results for hurricane risks

American Coastal Insurance Company (“American Coastal”) entered the market for the first time and secured USD183 million in Florida hurricane capacity via Armor Re Ltd.

Strong issuance volumes are expected to continue for the second half of the year, with an estimated total USD7–8 billion in new issuance expected for 2013.

In April, Allstate Insurance Company (“Allstate”) returned to the market for the first time since 2008 with Sanders Re Ltd. Allstate successfully secured USD350 million in industry index coverage against hurricanes and earthquakes across two classes. The Class A notes closed with a spread of 3.50%, the lowest spread seen in five years for U.S. hurricane risk.

**Catastrophe Bond Issuance by Quarter**



Source: Aon Benfield Securities, Inc.

## Aon Benfield ILS Indices

The Aon Benfield ILS Indices are calculated by Thomson Reuters using month-end price data provided by Aon Benfield Securities. Each ILS index posted increases for the second quarter of 2013. The All Bond and BB-rated Bond Indices reported returns of 2.20% and 1.33% respectively, while returns for the U.S. Hurricane Bond and U.S. Earthquake Bond Indices were 2.34% and 1.91%, respectively. Each index outperformed comparable fixed income benchmarks for the quarter; however, they did not exceed equities for the period.

For the trailing 12 months all indices posted gains, outperforming gains for the prior year's trailing 12-month period. The Aon Benfield All Bond and BB-rated Bond Indices

posted returns of 12.14% and 8.16% respectively, while the U.S. Hurricane and U.S. Earthquake Bond Indices posted returns of 13.19% and 6.89%, respectively. Each bond index benefitted from strong mark-to-market gains, especially throughout the first half of 2013 as investor demand drove down spreads to historical levels. On an annual basis, each index outperformed comparable fixed income benchmarks; however, they did not outperform the S&P 500 index.

In the absence of severe catastrophic events, we would expect 2013 to be another positive year of returns for the ILS market. However, given recent spread compression, we do not foresee a repeat of the strong performance witnessed over the past year.

### Aon Benfield ILS Indices<sup>1</sup>

Index Title	Return for Quarterly Period Ending June 30		Return for Annual Period Ending June 30		5 yr Avg Annual Return	10 yr Avg Annual Return
	2013	2012	2013	2012	2008-2013	2003-2013
<b>Aon Benfield ILS Indices</b>						
All Bond Bloomberg Ticker (AONCILS)	2.20%	2.80%	12.14%	7.36%	8.41%	8.23%
BB-rated Bond Bloomberg Ticker (AONCBB)	1.33%	2.67%	8.16%	7.90%	7.17%	7.04%
U.S. Hurricane Bond Bloomberg Ticker (AONCUSHU)	2.34%	2.39%	13.19%	7.60%	9.10%	9.27%
U.S. Earthquake Bond Bloomberg Ticker (AONCUSEQ)	1.91%	2.33%	6.89%	4.37%	5.48%	6.59%
<b>Benchmarks</b>						
3-5 Year U.S. Treasury Notes	-1.57%	1.20%	-0.61%	4.61%	4.22%	3.88%
3-Year U.S. Corporate BB	-0.91%	0.99%	4.06%	6.27%	8.21%	6.83%
S&P 500	2.36%	-3.29%	17.92%	3.14%	4.64%	5.12%
ABS 3-5 Year, Fixed Rate	-1.77%	1.75%	1.55%	5.90%	5.91%	3.72%
CMBS 3-5 Year, Fixed Rate	-1.03%	1.41%	4.73%	8.41%	9.28%	6.29%

Source: Aon Benfield Securities Inc., Bloomberg

<sup>1</sup> The 3-5 Year U.S. Treasury Note Index is calculated by Bloomberg and simulates the performance of U.S. Treasury notes with maturities ranging from three to five years.

The 3-Year U.S. Corporate BB+ Index is calculated by Bloomberg and simulates the performance of corporate bonds rated BB+ on a zero coupon basis. Zero coupon yields are derived by stripping the par coupon curve. The maturities of the BB+ rated bonds in this index are three years.

The S&P 500 is Standard & Poor's broad-based equity index representing the performance of a broad sample of 500 leading companies in leading industries. The S&P 500 Index represents price performance only, and does not include dividend reinvestments or advisory and trading costs.

The ABS 3-5 Year, Fixed Rate Index is calculated by Bank of America Merrill Lynch (BAML) and tracks the performance of U.S. dollar denominated investment grade fixed rate asset backed securities publicly issued in the U.S. domestic market with terms ranging from three to five years. Qualifying securities must have an investment grade rating, a fixed rate coupon, at least one year remaining term to final stated maturity, a fixed coupon schedule, and an original deal size for the collateral group of at least \$250 million.

The CMBS 3-5 Year, Fixed Rate Index is calculated by BAML and tracks the performance of U.S. dollar denominated investment grade fixed rate commercial mortgage backed securities publicly issued in the U.S. domestic market with terms ranging from three to five years. Qualifying securities must have an investment grade rating, at least one year remaining term to final maturity, a fixed coupon schedule, and an original deal size for the collateral group of at least \$250 million. The performance of an index will vary based on the characteristics of, and risks inherent in, each of the various securities which comprise the index. As such, the relative performance of an index is likely to vary, often substantially, over time. Investors cannot invest directly in indices.

Past performance is no guarantee of future results.

Note: Subsequent to publication of the Insurance-Linked Securities First Quarter 2013 Update, Aon Benfield Securities, Inc. was notified by its third-party calculation agent that certain portions of the Aon Cat Bond Index calculations provided by the calculation agent, which were reflected in the Aon Benfield ILS Indices in the First Quarter 2013 Update, contained an error. Upon this discovery, the calculation agent provided corrected index values and the Aon Benfield ILS Indices table provided in this Insurance-Linked Securities Second Quarter 2013 Update reflects those corrected values. Prior versions of this publication, including the First Quarter 2013 Update, remain unaltered in this respect.



## ILS Sales and Distribution

Unprecedented demand for catastrophe bonds continued into the second quarter of 2013, bringing the total new issuance for the first half of 2013 to USD4.0 billion. This is the largest issuance figure since the record-breaking issuance in the first half of 2007, where almost USD5.0 billion of catastrophe bonds closed. Despite such an active quarter, investor capital kept pace with primary market issuance. Many transactions upsized as oversubscription levels allowed a number of transactions to close at the low end or below marketed price guidance.

Throughout the second quarter, investors continued to find catastrophe bonds attractive despite the ongoing decrease in interest spread levels relative to 2012. The ILS market continued to offer collateralized, multi-year protection at more aggressive levels than traditional markets. The demand for ILS had a ripple effect across the traditional markets, allowing sponsors to benefit from the competition between reinsurers and alternative forms of capital, such as catastrophe bonds and collateralized reinsurance.

Interest spreads remained competitive throughout the quarter with some stabilization seen towards the end of the period. Over 75% of the catastrophe bond limit placed in the period was exposed to U.S. hurricanes. New transactions with this exposure continued to come to market, despite the onset of the U.S. hurricane season.

Three non-U.S. hurricane-exposed bonds came to the market in the second quarter. These were also the lowest yielding bonds in the period. Minimum pricing was tested with State Farm's Merna Re IV Ltd., covering New Madrid earthquake, and the Turkish Catastrophe Insurance Pool's Bosphorus 1 Re Ltd., covering Turkey earthquake. Both transactions priced at 2.50%, the lowest absolute spread in five years. Additionally, Amlin's Tramline Re II Ltd., covering U.S. and Canada earthquake, secured USD75 million at 3.25%.

As minimum interest spreads decreased, many sponsors found it attractive to issue catastrophe bonds for the more remote layers of their risk transfer programs. No transaction brought to market during the second quarter had a double digit coupon. This is leading to stronger investor demand for higher yielding bonds, with demand for lower yielding bonds beginning to decrease.

In the secondary market, several investors began to take profits by selling recently issued bonds at premium levels in a very short period. Many bonds issued in the quarter were almost instantly trading at premium levels in the secondary market. As the quarter closed, sellers entered the secondary market to free up capacity for new issuances and rebalance portfolios after an active period for ILS and the collateralized markets.

Several transactions were wrapping up their marketing at the end of the quarter. We expect capital to continue to flow into the market as investors prepare for a busy second half of the year. Many sponsors continue to look at the market for coverage, and we expect to see new entrants seek to utilize the catastrophe bond market.

## An Interview with James Illingworth, Chief Risk Officer, Amlin plc

### **1. Can you outline your role at Amlin and how ILS fits within the broader business strategy, both in terms of risk management and from a pure risk transfer perspective?**

My role as Chief Risk Officer is to ensure that the risks that we accept as an insurance company, as well as accompanying risks such as credit, financial and operational, are managed within acceptable tolerances and that no adverse risks pose a material threat to the continuity of our business and to our reputation as a leading insurance provider within both the Lloyd's, London, and international markets. Insurance linked securities provide a hugely attractive means of risk transfer as the fully collateralized nature of the contract eliminates traditional reinsurer credit concerns and alleviates the potential burden of liquidity on our capital base. These advantages, coupled with attractive pricing, make the ILS market a good opportunity for Amlin to transfer risks, provided that the basis risk is acceptable. As stated following the conclusion of Tramline II, it is a long-term strategic objective to continue to blend the output of this market with traditional reinsurance risk transfer methods.

### **2. Amlin decided to seed capital to the London investment manager, Leadenhall Capital Partners. How does this strategy complement Amlin's objectives, and why did Amlin choose to engage with Leadenhall?**

The motivations for our investment in LCP were threefold:

- a) To understand the developments of the ILS and capital markets so that influence of these markets on Amlin could be fully taken into account in our strategy.
- b) We believed we would be able to establish a successful asset management business in this market through our expertise and knowledge of catastrophe risks, and potentially through facilitation of other solutions through an introduction to LCP. In turn this has led to a good return on the assets invested and significant growth in LCP managed funds.
- c) We wanted to ensure that we were at the forefront of developments of the ILS market so that we could make use of any options to transfer our own risk into the capital markets.

### **3. Do you see the flood of new capital into the reinsurance/ILS space as an opportunity or threat going forward for Amlin?**

The answer is both. There has been a well-publicised impact on reinsurance supply and reduction in rates in some areas. However, following the establishment of Leadenhall Capital to write and invest in the ILS space and the continued use of the capital markets to complement our outwards reinsurance, it is clear that we also perceive the flood of new capital as an opportunity, taking advantage of it from both the investor and sponsor angles. As the Tramline transactions have shown, we expect to continue to use the capital markets for our own risk transfer needs.

**4. *With your recent Tramline Re II transaction, what was the main motivation for coming back to the capital markets?***

Having already established contacts on both the legal and structuring side through the issue of Tramline I, we felt that our second issuance would be easier. Certainly we were pleased with the collateralized nature of the coverage available and intended to utilize the capacity within the capital markets again. The attractive price compared to traditional coverage (albeit with the additional basis risk), coupled with the ability to sustain that price over a four year period, was also an obvious advantage.

**5. *Now that Amlin is a repeat issuer of cat bonds, and an experienced investor in the market, has this benefitted its broader underwriting expertise and capability? Are there any synergies that have developed between the way Amlin approaches both markets?***

We anticipate that the benefits we described above will continue to be realised in the coming months and years. There are real benefits of having expertise on both the traditional underwriting and capital markets side.

**6. *Finally, are there any hurdles to entry that you think may deter new sponsors accessing the ILS market?***

The process is radically different to a traditional retrocession or reinsurance, and is a more complicated path to tread; this is exacerbated, or perhaps caused, by the minefield of legislation which sponsors have to navigate. These structures can appear complex, expensive and impenetrable to the uninitiated. We hoped our second bond would be a simpler exercise, and in many ways it was, but we still had to employ six separate law firms as well as our in-house legal team to get through the process. Therefore, the associated costs of such transactions can only be justified by larger bond issues likely to come from larger sponsors.

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