

# Reinsurance Market Outlook

June and July 2014 Update

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## Executive Summary - New Generation

The lowest reinsurance risk margins in a generation stimulate new growth opportunities for insurers and may allow governments to reduce their participation in catastrophe exposed regions as insurance availability and affordability improves.

New record reinsurer capital levels and continually building interest from alternative capital investors pushed risk margins lower on June 1 and July 1 reinsurance renewals. Margins in some programs today stand at levels not seen for a generation. Private reinsurance capital is now competing at a level comparable to current government roles in some areas. For example, some Florida Hurricane placements were completed at a cost of capital comparable to the cost of their Florida Hurricane Catastrophe Fund layer. Appetite for reinsuring flood risks continues to be high and the recent Florida legislation for this market is encouraging.

June and July 2014 catastrophe reinsurance program renewals include many U.S. hurricane exposed insurers, most Australia and New Zealand exposed insurers, many Asia ex-Japan exposed insurers, and a meaningful component of Latin American exposed insurers. Reinsurance demand for these renewals remained relatively flat, although some cedents chose to utilize the savings from market impact to purchase more limit.

Reinsurance capital grew to USD555 billion by the end Q1 2014, an increase of 2.7 percent over year end 2013. Use of alternative capital was robust with twelve catastrophe bonds completed during Q2 2014 and total 2014 issuance to date exceeding the first half of 2013 by 50 percent. Traditional reinsurers continued to respond to competition from alternative capacity delivering meaningful additional value for cedents. The increased capital supporting reinsurance results in a greater durability for current reinsurance rate levels. We estimate a USD100 billion or greater insured catastrophe event is required to meaningfully disrupt market pricing for any significant period of time.

## Opportunity Knocks – Reinsurance-Supported Growth

High levels of deployed capital, substantial amounts of capital waiting to be deployed, and the type of investors increasing their participation in the reinsurance market, give us confidence that current rate levels will be sustainable over time. Insurers and reinsurers are in the early stages of incorporating lower risk margin reinsurance capital into their capital management plans. We expect acceleration of these plans as more companies fully recognize the opportunities in the current and expected market conditions. Primary U.S. companies who began retreating from catastrophe exposed coastal areas in the 1990s are reassessing the potential opportunities in these fast growing regions of the U.S. Reinsurers have lost material market share to alternative capital sources and are now very actively working to incorporate alternative capital into their capital structures to leverage higher returns from far lower margin business from insurers.

Continued interest in hedge fund-backed reinsurers seeking stable underwriting risks to complement sophisticated asset strategies will offer reinsurance terms attractive to classes that are not heavily reinsured today. Auto and healthcare writers are likely to lock in profits and become more capital efficient by utilizing this class, and primary risks currently financed through captives may find greater efficiencies offered by this class of reinsurers.

*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.*

## Reinsurance Supply Increases Continue to Outpace Demand

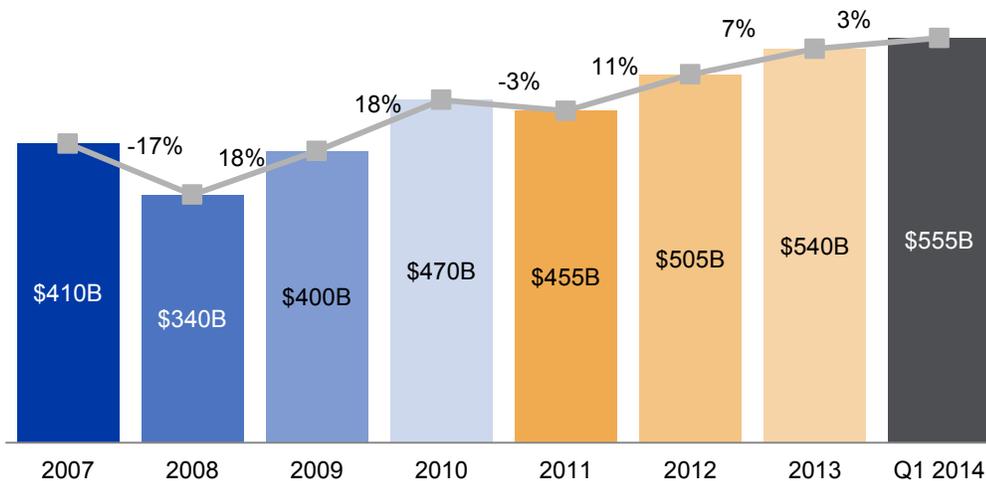
Reinsurer capital continued to increase amid low catastrophe loss activity through Q1 2014, up 3 percent since year end 2013 to USD555 billion. Combined ratios for the Aon Benfield Aggregate group of reinsurers for Q1 2014 remain largely consistent with Q1 of the prior year.

With reinsurance rate reductions beginning to earn through on prior high margin catastrophe portfolios, 2014 ROE expectations are for mid-to-high single digits, a concern also highlighted by AM Best. Lower catastrophe reinsurance prices will continue to impact earnings with a lagging effect and any significant reinsured catastrophe loss will have a material impact on earnings.

Terms and conditions for June and July renewals also improved, continuing a trend from the beginning of the year. Property catastrophe renewals saw movement in traditional reinstatements, occurrence definitions, and terrorism language. While the movement was not uniform for all insurers, this further highlights traditional reinsurers' desire to directly compete with the capacity provided by alternative markets.

While demand for reinsurance remained relatively stable in peak zones for January renewals, summer renewals saw pockets of increases largely driven by Florida insurers. Alternative market capacity increased USD2 billion, or 4 percent in Q1 2014.

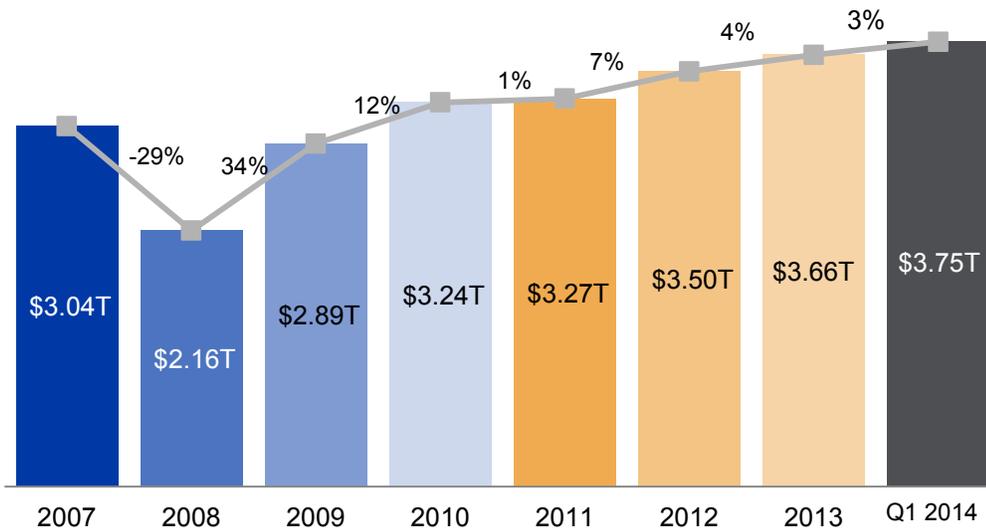
**Exhibit 1: Change in Reinsurer Capital**



Source: Individual company reports, Aon Benfield Analytics

Lower catastrophe losses and primary premium increases continued to drive growth in insurer capital in Q1 2014, increasing 3 percent from year end 2013.

**Exhibit 2: Change in Insurer Capital**



Source: Individual company reports, Aon Benfield Analytics

### Florida Market Dynamics

Placements for Florida insurance companies make up a significant portion of renewals at June and July 1 largely as a result of the coinciding renewals for the Florida Hurricane Catastrophe Fund (FHCF). Reinsurance renewals saw increased demand from private market insurers and Florida Citizens for 2014. Continuing its annual increase in total reinsurance coverage, Florida Citizens purchased approximately USD1.5 billion in reinsurance from the traditional market with a mix of aggregate and occurrence protection, a portion of which is provided on a multi-year basis. In addition, the company secured an additional USD1.5 billion through a catastrophe bond issuance, increasing the total outstanding capital markets coverage provided through Everglades Re to USD1.75 billion. In total, this brings Citizens reinsurance coverage to more than USD3.019 billion for the 2014 hurricane season.

Private market renewals increased demand and purchased to higher return period levels as a result of the lower margins for reinsurance and also secured multi-year protection for portions of their reinsurance coverage. In addition, insurers were able to secure more customized reinsurance protections during 2014 renewals including cascading layer coverage where upper layers of a program inure to lower layers and drop down to provide protection once lower layers have been exhausted as a result of smaller events.

The FHCF is also in its strongest cash position with a year end 2014 estimated fund balance of approximately USD11 billion, or almost 65 percent of its mandatory layer potential liabilities funded for the first season.

## Second Quarter 2014 Catastrophe Bond Transaction Review

In response to the advantageous market conditions witnessed in the first quarter, twelve transactions closed during the second quarter of 2014 – setting a market record with USD4.5 billion of issuance, the most of any quarter in the catastrophe bond market to date.

This record quarter follows the second most active first quarter issuance to date and combines for the highest total issuance for the first half of any year reflecting the continued strong demand for catastrophe bonds from both sponsors and investors. Issuance to date in 2014 exceeds the first half of 2013 by more than 50 percent and appears poised to rival the annual market peak set in 2007. Total outstanding bonds also remain at a record high of USD22.4 billion, reflecting the deployment of additional investor capital into catastrophe bonds. Further, rates remain at historic lows, as investor demand has kept pace with increased supply allowing sponsors to expand coverage at competitive rates.

New sponsors, Heritage Property & Casualty Insurance Company (“Heritage”), Assicurazioni Generali S.p.A (“Generali”), Everest Reinsurance Company (“Everest”), Sompo Japan Nipponkoa Insurance Inc. (“SJNK”) and Texas Windstorm Insurance Association (“TWIA”) joined first quarter new comers American Strategic Insurance Group and Great American Insurance Company. This brings the new sponsor total to seven for the year to date matching the entrance of new sponsors for the full year 2013 as the most to enter over a single year period post-2007.

Repeat sponsors, Allstate Insurance Company (“Allstate”) and Citizens Property Reinsurance Company (“Florida Citizens”) saw the favorable market environment as an opportunity to expand the share of ILS in their risk transfer programs. Through Sanders Re Ltd, Allstate’s 2014 total issuance has grown to USD950 million. Florida Citizens doubled its previous largest issuance from 2012 with Everglades Re Ltd. 2014-1, which provides the sponsor with USD1.5 billion in indemnity coverage.

Investors were presented with a variety of risks in the second quarter with particular emphasis on Florida hurricane. A total of USD2.1 billion was secured across five transactions which covered Florida only. Also of note, meteorite impact and volcanic eruption are two new perils that have been included in United Services Automobile Association’s multi-peril catastrophe bond Residential Reinsurance 2014 Limited. The table below summarizes the terms of the deals that closed during the second quarter:

**Exhibit 3: Second Quarter 2014 Catastrophe Bond Issuance**

Beneficiary	Issuer	Series	Class	Size (USD millions)	Covered Perils	Trigger	Rating	Expected Loss <sup>1</sup>	Interest Spread
Heritage Property & Casualty Insurance Company	Citrus Re Ltd.	2014-1	Class A	150	FL HU	Indemnity	NR	1.53% <sup>2</sup>	4.25%
		2014-2	Class 1	50			NR	1.21% <sup>2</sup>	3.75%
Assicurazioni Generali S.p.A	Lion Re I Limited			263	EU W	Indemnity	B+	1.01%	2.25%
Everest Reinsurance Company	Kilimanjaro Re Limited	2014-1	Class A	250	SE HU	Industry Index	BB-	1.79%	4.75%
			Class B	200	NA HU, EQ		BB-	1.62%	4.50%
American Coastal Insurance Company	Armor Re Ltd.	2014-1	Class A	200	FL HU	Indemnity	NR	0.62% <sup>2</sup>	4.00%
Citizens Property Insurance Corporation	Everglades Re Ltd.	2014-1	Class A	1,500	FL HU	Indemnity	B	2.68%	7.50%
Castle Key Insurance Company / Castle Key Indemnity Company	Sanders Re Ltd.	2014-1	Class B	330	US HU, EQ	Industry Index	BB+	0.79%	3.00%
			Class C	115			BB	0.97%	3.25%
			Class D	305			BB	1.28%	3.90%
		2014-2	Class A	200	FL HU	Indemnity	NR	0.88%	3.90%
National Mutual Insurance Federation of Agricultural Cooperatives ("Zenkyoren")	Nakama Re Ltd.	2014-1	Class 1	150	JP EQ	Indemnity	NR	0.75%	2.25%
			Class 2	150			NR	0.75%	2.50%
United Services Automobile Association	Residential Reinsurance 2014 Limited	2014-1	Class 10	80	US HU, EQ, ST, WS, WF, Others	Indemnity	NR	11.31%	15.00%
			Class 13	50			NR	0.63%	3.50%
Sompo Japan and Nipponkoa Insurance Company	Aozora Re Ltd.	2014-1	Class B	100 <sup>3</sup>	JP TY	Indemnity	BB	0.52%	2.00%
Texas Windstorm Insurance Association	Alamo Re Ltd.	2014-1	Class A	400	TX HU	Indemnity	[B]	[3.09%]	[•]
<b>Total Closing During Q2</b>				<b>4,492</b>					

Source: Aon Benfield Securities, Inc.

EU – Europe  
FL – Florida  
US – United States  
NA – North America  
SE – Southeast  
JP – Japan  
TX – Texas  
EQ – Earthquake  
HU – Hurricane  
ST – Severe Thunderstorm  
TY – Typhoon  
WF – Wildfire  
W – Windstorm  
WS – Winter Storm

<sup>1</sup> Annualized modeled expected losses, with warm sea surface temperature results for hurricane risks

<sup>2</sup> Losses projected by applying loss modification factors

<sup>3</sup> JPY10.125 billion converted at 1¥ = 0.009825\$ as of May 30, 2014

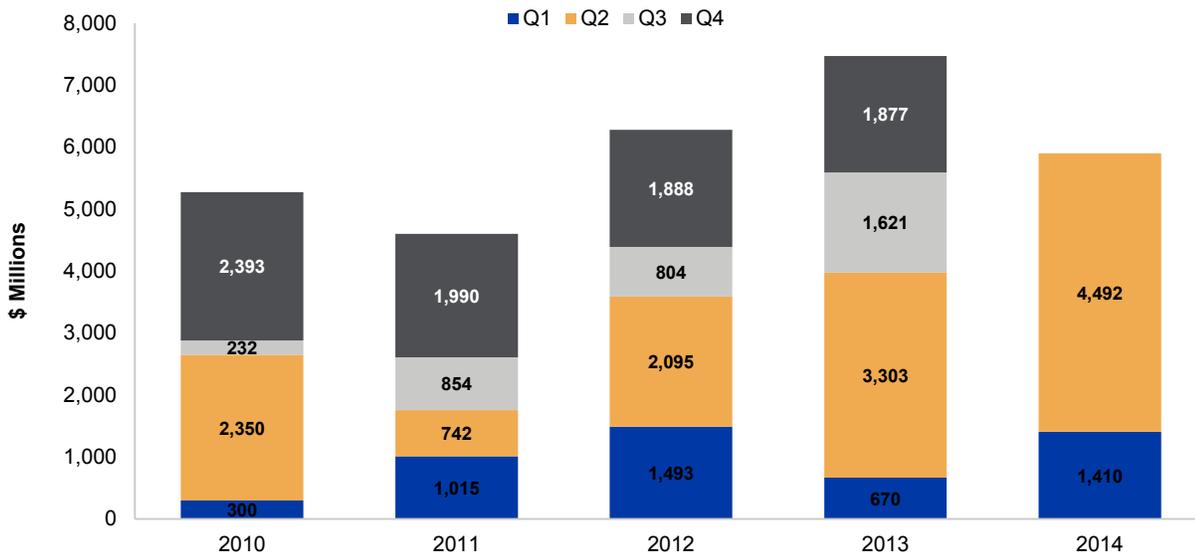
Lion Re I Limited marks the entrance of Generali, the third largest European insurance group<sup>4</sup>, into the cat bond market with coverage for Europe windstorm. Everest also entered the market for the first time through Kilimanjaro Re Limited which gives the insurer North American index protection against hurricane and earthquake risks. The transaction was well received by investors which allowed Everest to upsize its issuance by 80 percent to USD450 million while the interest spreads for each class of notes closed 50 basis points below the low end of initial price guidance.

Also in the second quarter, Sanders Re Ltd. allowed Allstate to upsize its alternative market capacity by USD950 million with two separate issuances utilizing different triggers. The second issuance, Sanders Re Ltd. 2014-2 provides Castle Key Insurance Company and Castle Key Indemnity Company, Allstate’s affiliated and dedicated Florida property insurance companies, hurricane coverage on an indemnity basis. Sanders Re Ltd. 2014-1 provides nationwide multi-peril coverage on an index basis.

Zenkyoren’s Nakama Re Ltd. 2014-1 utilizes two classes of notes which each provide USD150 million in Japan earthquake coverage on an indemnity basis, utilizing per occurrence and annual aggregate recovery mechanisms.

The chart below shows historical catastrophe bond issuance by quarter:

**Exhibit 4: Catastrophe Bonds Issued by Quarter**



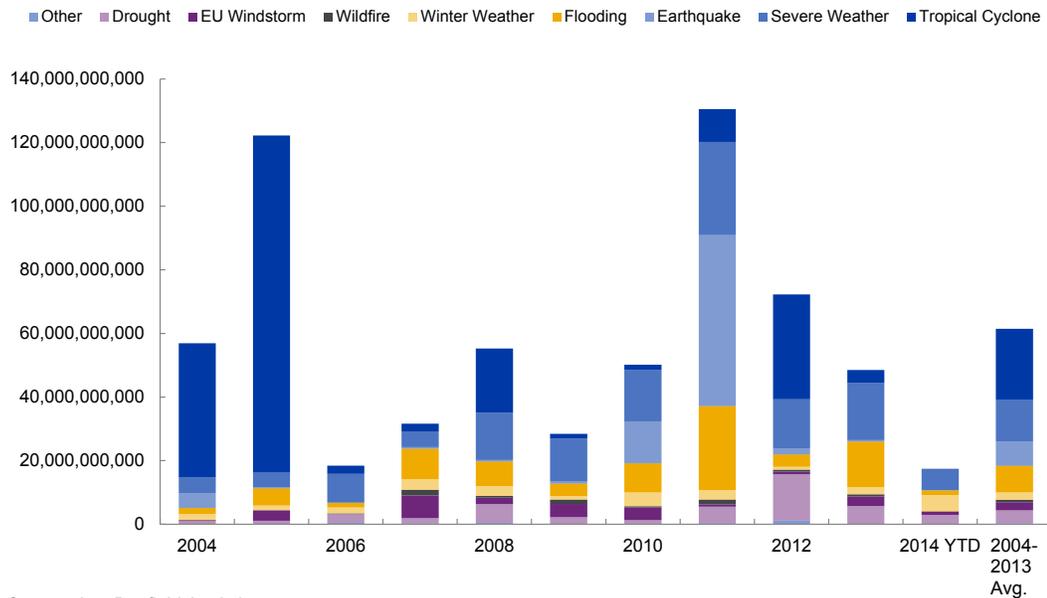
Source: Aon Benfield Securities, Inc.

<sup>4</sup> Based on total gross written premium

## First-Half 2014 Insured Natural Disaster Losses Below Average

Despite a number of newsworthy events during the first six months of the year, overall first-half natural disaster losses in 2014 were below normal from the recent 10-year average (2004-2013). As of July 1, roughly USD18 billion in insured losses were 37 percent less than the recent first-half average of USD27 billion. Global losses were below average for all major peril types with the exception of winter weather, given an active season in the United States and Japan. The costliest event during the first two quarters of the year was an extended period of very heavy snowfall in Japan that has caused insurance payouts of at least USD2.5 billion. This becomes one of the costliest insured loss events in the country's history. Drought losses in the U.S. and Brazil are also expected to prove expensive.

**Exhibit 5: Full Year Insured Losses by Year by Type (2004-2014)**



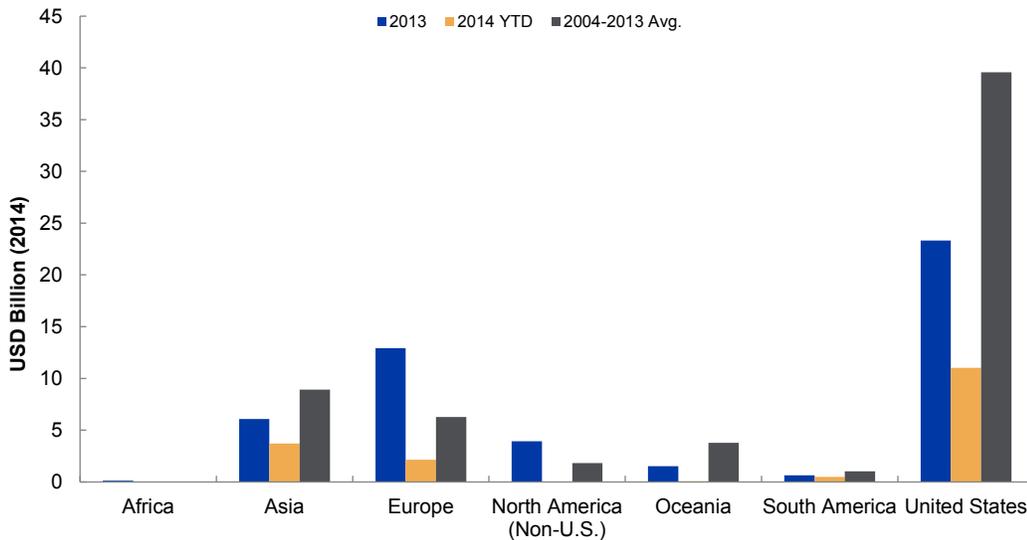
Source: Aon Benfield Analytics

The USD18 billion in global insured losses were primarily led by two perils: severe weather (convective thunderstorm) and winter weather. The two combined to comprise approximately 68 percent of the total, with each causing more than USD5.0 billion. The U.S. sustained the highest level of insured losses (USD11 billion), which represented nearly 63 percent of the globally incurred total. It should be noted that U.S. insured losses in 2014 were 32 percent less than what was sustained in 1H 2013 (USD16.3 billion) and 41 percent less than what was registered in 1H 2012 (USD18.6 billion).

For the most up-to-date global catastrophe loss data for 2014, and other historical loss information, please visit Aon Benfield's Catastrophe Insight website:

[www.aonbenfield.com/catastropheinsight](http://www.aonbenfield.com/catastropheinsight)

**Exhibit 6: 2014 YTD Insured Losses Compared to Recent Annual Averages by Region**



Source: Aon Benfield Analytics

Should current trends from the first half of the year continue, there are currently no regions of the world on pace to surpass their 10-year average in 2014. The pending arrival of a moderately strong El Niño phase of ENSO (El Niño-Southern Oscillation) should have a modest impact on losses through the rest of the calendar year into early next year as well.

It is worth noting that despite the fact that the U.S. is currently below recent loss averages, with the Atlantic Hurricane Season officially underway, it would take just one significant landfalling hurricane event could quickly reverse the trend. As a reminder, the U.S. remains in the midst of a record-setting stretch without a major hurricane landfall (Category 3+). 2005’s Hurricane Wilma was the last such event.

**Costly Northern Hemisphere Winter Season**

The first quarter of 2014 was marked by a rather active winter season throughout much of the Northern Hemisphere, where record cold and snow was recorded in several countries. Overall insured losses attributed to ice, snow and sub-zero temperatures were roughly USD5.2 billion – the highest such total in at least ten years and already 117 percent above the 2004 to 2013 average for the current year.

The most significant losses were registered in Japan following a series of February storm systems that struck the country in rapid succession (including the Tokyo metropolitan region) and prompted the heaviest snow totals in decades. Insurers noted that at least 278,000 filed claims led to more than USD2.5 billion in payouts. Similar winter storm losses occurred in the United States following multiple periods of extreme cold and snow between January and March. U.S. winter storm-related insured losses were up to USD2.4 billion. In Europe, a busy winter season saw the arrival of a number of windstorms, most notably Windstorm Christina, Windstorm Tini and Windstorm Ulla.

## El Niño's Arrival: What are the Potential U.S. Industry Impacts?

Heading into the second half of 2014, the expectation of a developing phase of El Niño continues to become more prevalent. In its June ENSO (El Niño-Southern Oscillation) discussion, the National Oceanic and Atmospheric Administration (NOAA) increased the likelihood of a developing El Niño phase to 70 percent for the summer and 80 percent by the fall. The general consensus from the latest forecast computer model projections suggests that this will be a moderate El Niño event.<sup>5</sup> While not expected to rival the intensity of the El Niño of 1997/98, this could be one of the strongest phases since that time.

With the pending arrival of El Niño, the question is raised as to what – if any – impacts this may have on the insurance industry throughout the rest of 2014 into early 2015.

### El Niño and the Atlantic Hurricane Season

Outside of the always present possibility of a significant earthquake event, a large portion of the major economic and insured losses from natural disasters during the third and fourth quarters are generally concentrated around the tropical cyclone peril. During an El Niño phase, suppressed tropical cyclone activity is typically expected in the Atlantic Basin; while enhanced tropical cyclone activity occurs in the Eastern Pacific Basin. The decreased level of activity in the Atlantic Basin is due to increased vertical wind shear and reduced sea surface temperatures in the main development region. In the Western Pacific Basin, the number of tropical cyclones does not significantly vary. However, there is usually a shift in storm development location with a higher frequency of storms developing further eastward in the basin.

Given the much higher percentage of insurance penetration in the United States, there always remains a heightened level of interest in the Atlantic Hurricane Season. Since 1990, there have been eight separate hurricane seasons which have endured El Niño conditions either throughout an entire season or just partially for select number of months. Despite an expected reduced level of activity in 2014, the ultimate factor of a busy season for the insurance industry depends on how many storms actually make landfall. Looking at El Niño seasons since 1990, the 2004 Atlantic Hurricane Season was anomalous in terms of the number of U.S. landfalls and how much it cost private insurers and the National Flood Insurance Program (NFIP).

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<sup>5</sup> El Niño events are defined as having five consecutive months with sea surface temperature (SST) anomalies equal or greater than +0.5°C above normal. Phases are defined as: Weak (+0.5°C to +0.9°C); Moderate (+1.0°C to +1.4°C); Strong ( $\geq$ +1.5°C)

Notable El Niño (or transitioning to/from an El Niño) U.S. landfalling hurricanes since 1990 include:

Name (Year)	Affected U.S. States	Insured Loss (Actual)	Insured Loss (2014 USD)
HU Andrew (1992)	FL, LA	15.7 billion	26.3 billion
HU Charley (2004)	FL, NC, SC	7.5 billion	9.3 billion
HU Frances (2004)	FL, GA, NC, NY, SC	4.8 billion	5.9 billion
HU Jeanne (2004)	DE, FL, GA, MD, NC, NJ, NY, PA, SC, VA	3.8 billion	4.7 billion
HU Ivan (2004)	AL, DE, FL, GA, LA, MD, MS, NC, NJ, NY, OH, PA, TN, VA, WV	8.7 billion	10.8 billion

Source: Aon Benfield Analytics

## Forecasters: El Niño Expected to Cause Below Average Atlantic Storm Activity

The three main hurricane season prognosticators (National Oceanic and Atmospheric Administration (NOAA), Colorado State University (CSU) and Tropical Storm Risk (TSR)) have all forecast below normal hurricane activity for the 2014 Atlantic Hurricane Season. Each agency cites several factors as to why a quieter season is anticipated, most notably due to the development of El Niño in the Eastern Pacific Ocean which will in turn lead to cooler sea surface temperatures in the main development region of the Atlantic Ocean and above-average wind shear in the upper levels of the atmosphere. The prognosticators cite that the forecast computer models currently expect a moderate El Niño to develop by late summer and linger through the upcoming fall and winter months.

The figure below shows the latest TSR, CSU and NOAA forecasts. The table shows a comparison of each group's climatological average to their forecast for 2014.

	Named Storms	Hurricanes	Major Hurricanes
<b>TSR (June 2014)</b>			
1950-2013 Average	11	6	3
2014	12	5	2
Difference	+1.0	-1.0	-1.0
<b>CSU (June 2014)</b>			
1981-2010 Median	12.0	6.5	2.0
2014	10	4	1
Difference	-2.0	-2.5	-1.0
<b>NOAA (May 2014)</b>			
1981-2010 Average	12	6	3
2014	8-13	3-6	1-2
Difference	-1.5	-1.5	-1.5

Sources: Tropical Storm Risk (TSR), Colorado State University (CSU), NOAA

## Rating Agency Update

While the use of economic capital modeling in the industry is on the rise, many participants find rating agency capital requirements a higher capital constraint and therefore a leading determinate in strategic decisions. As rating agencies and regulators continue to evolve, how insurers manage capital and make reinsurance decisions must evolve as well.

Earlier this year, Standard & Poor's (S&P) changed its outlook for the global reinsurance sector from stable to negative. This change follows S&P holding a stable outlook on the sector for the last 8 years and noted it was driven by an oversupply of reinsurance capital and competition, in line with our experience in the market over the last few major renewal dates. S&P said the competitive market that they have witnessed is expected to weaken profitability in 2014 and 2015 and these competition related risks are now the most prominent threat to the reinsurance sector, outweighing the macroeconomic risks it highlighted in September 2013. A negative outlook implies that S&P expects more downward rating action than upward over the near term.

Both A.M. Best and S&P have been focused on the expiration of TRIPRA and have released various reports on the topic. A.M. Best utilizes a terror stress test to measure the balance sheet impact of terrorism losses to companies. The terror stress test specifically looks at a 5-ton truck bomb deterministic loss scenario – net of reinsurance but gross of TRIPRA recoveries to analyze companies in determining whether they were over-reliant on TRIPRA. Concurrently, A.M. Best continues to make progress in finalizing the Stochastic BCAR model and expects to release a draft methodology later this year.

For Florida Homeowners specialists, Demotech is the rating agency which drives reinsurance buying decisions for most. In addition to standard annual and quarterly financial reviews, Demotech conducts a specific review related to a company's reinsurance program through analysis of their "Exhibit A" filing, which was due June 1, 2014 and requires companies to disclose gross and net catastrophe losses at various return periods and under three different modeling assumptions. Demotech requires companies to purchase reinsurance protection up to at least the 100 year long-term basis including demand surge / loss amplification and expects the reinsurance program to support a 1 in 50 year second event. Demotech indicated that they will begin asking companies in other catastrophe exposed states (LA, TX, OK) to submit PML data in the form of Exhibit A.

From a regulatory perspective, the NAIC continues to push ahead with its Solvency Modernization Initiative resulting in a potential new catastrophe risk charge within the RBC model. In the most recent draft, the NAIC included two additional required capital categories for hurricane risk and earthquake risk respectively. Interestingly, the NAIC's draft methodology utilized the gross and net aggregate loss perspective. Currently the FHCF provides occurrence based protection and most cedants purchase third party catastrophe reinsurance on a per occurrence basis. As such, the use of aggregate PMLs and aggregate based reinsurance will be an interesting topic to watch if the NAIC does adopt the current proposed view of catastrophe risk in their RBC calculation.

Additionally, the current draft calculation includes a 10 percent credit risk charge for the "ceded" PML. This is high relative to historical default rates and also does not account for the credit quality of the reinsurer or the benefit of a diversified panel of reinsurers.

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