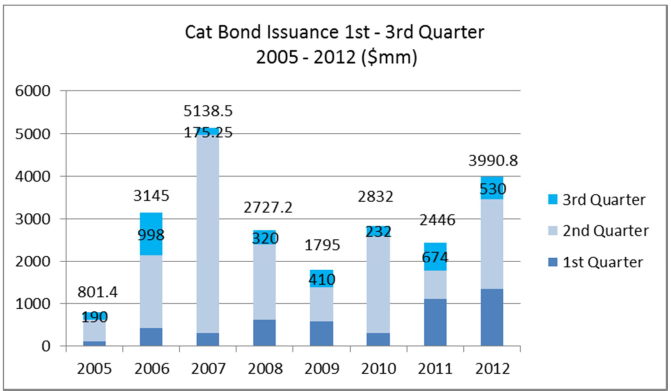
ILS Market | Quarterly Review & Outlook | 3rd Quarter 2012

Welcome to our quarterly review of developments in the market for insurance linked investing. While we try to comment on developments in our regular monthly and bi-weekly reports, space and time does not allow for a deeper investigation and commentary on the specific developments or longer term trends within the ILS Space. This quarterly review is our attempt to help bring into context for investors what is happening in our sector as well as to provide them with an outlook for what they can expect in the near future - to the extent possible! - as obviously we cannot give you any clear predictions on the timing of specific events.

## Issuance Activity

The third quarter historically has been the quietest issuance period in the Cat Bond market, largely due to the fact that this period is also the most active portion of the North Atlantic Hurricane season. In the 3rd Quarter of 2012 we saw $530 mm in Cat Bonds plus a further $275 mm in Extreme Mortality bonds issued leading to a total issuance of $805 mm in ILS for the quarter, making it the third strongest quarter in the market's history. On a year-to-date basis just under $4 bn in Cat Bond principal was issued making 2012 the second strongest year of issuance since inception of the market.

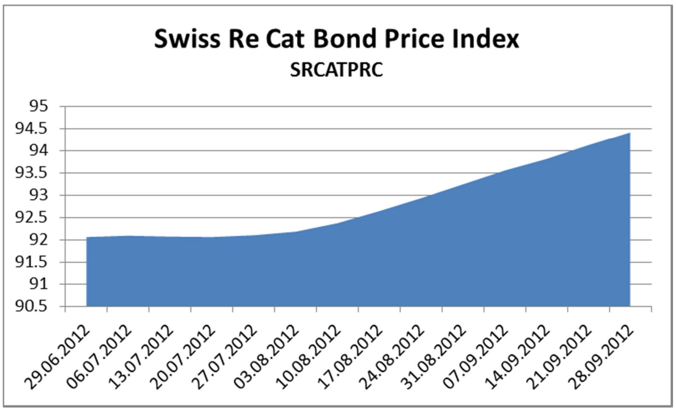



This period's activity was limited to four transactions, three of which were placed in July and commented on in our Second Quarter Outlook. The fourth transaction, launched in late August, was focused on European Wind Storm on an indexed basis. This was a follow-on transaction to Eurus II that matured last Spring (the end of the European Winter Storm season). Market reception for the non-US peril was quite favorable, resulting in a modest upsizing from initial €75 mm to €100 mm and final pricing coming inside of the initial price guidance.

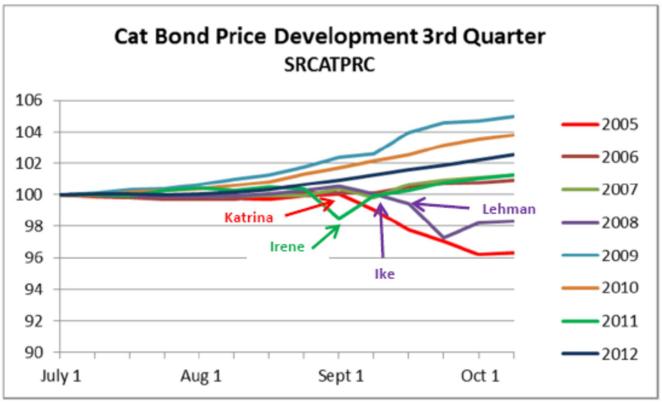
## Price Development and Performance

Cat bond prices were relatively stable during the month of July and began to improve as the hurricane season progressed. With each week where no landfall occurred, the market prices for bonds strengthened. Interestingly, we did not observe any "blip" in prices towards the end of August as Hurricane Isaac made landfall in Louisiana. Although Isaac was a large storm in diameter, it only reached Category 1 strength shortly before making landfall, so that only one Bond, Pelican Re, was ever seriously considered to be potentially at risk. This bond did experience a decline from a pre-storm level of 102 to 98 at the time of landfall and quickly moved back to a 102 level a few days after landfall.

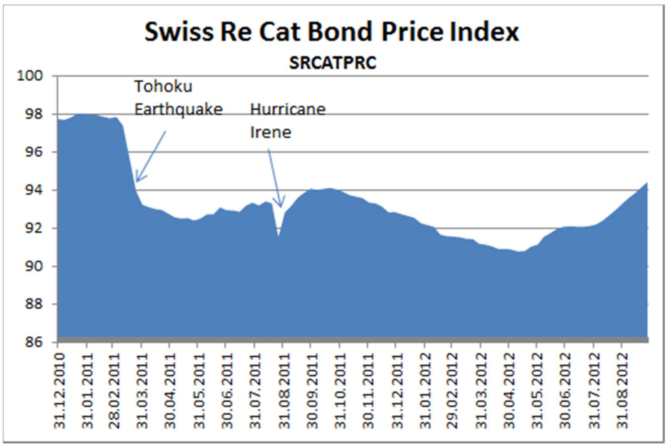
The price behavior observed during this quarter was very much in line with what has historically been observed over the last several years. Barring any major event, prices generally are flat during July and then begin to gradually move up as the hurricane season advances. Exceptions are when large events occur. This happened in 2005 with Hurricane Katrina,




again in 2008 with Hurricane Ike which was followed by the collapse of Lehman Brothers which had an impact on four bonds where Lehman Brothers was the total return swap counterparty (a structural defect in earlier bonds which has since been addressed) and again in 2011 when Hurricane Irene made landfall along the eastern U.S. seaboard.



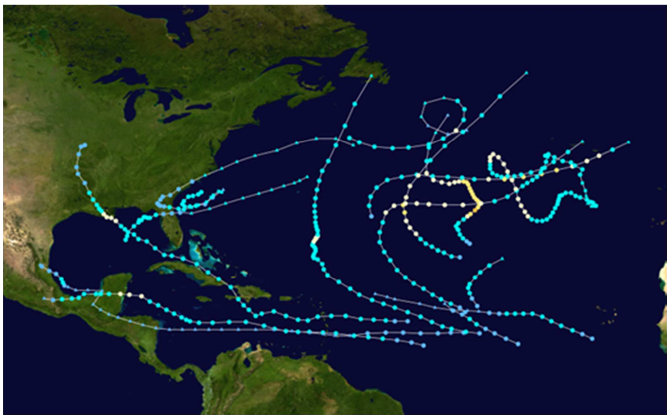

The 3rd Quarter of 2012 was the third strongest quarter in terms of price improvement over the period in question. In total price improvement added 2.55% to the overall performance in the ILS Cat Bond sector when using the Swiss Re Cat Bond Price Index as the basis for measuring sector performance. Part of this is a continuation of the recovery in secondary prices which has been an ongoing phenomenon after reinsurance and bond price corrections following the major catastrophe events of 2011. By September 28, 2012 the Swiss Re Price Cat Bond Price Index had reached a level of 94.41, a level last seen in March 2011 immediately after the Tohoku Earthquake.




The strong recovery in prices is very much in line with our forecast from earlier this year and is also a reflective of the growing demand for ILS alternative investments.

## Claims Activity

The 3rd Quarter of 2012 was relatively benign in terms of insured loss events globally. There were numerous weather related incidents across the globe which resulted in significant economic loss, but much of this was uninsured (specifically relating to flood losses). Tropical storm activity in the North Atlantic basin exhibited unusual behavior in that four named storms formed prior to July 1 (the first time this has happened since records have been maintained from 1851) after which not a single named storm formed during the month of July. August saw the formation of 8 named storms, tying a record for the most named storms in a month set in 2004. In total, the season thus far has seen 15 named storms and 8 hurricanes, which lies well above the level initially forecast (pre-season average estimate was 12 named storms and 6 hurricanes). As can be seen in the map tracking the 2012 North Atlantic Hurricane activity, most of the activity



took place far from the U.S. Coastline which may have given many investors the impression that the season was quiet.

Reality was actually quite different, but luck and favorable atmospheric conditions kept most storms away from the U.S. mainland. Hopefully these conditions will prevail up through the end of the current hurricane season which ends on November 30th.

Only Hurricane Isaac, which made landfall in Louisiana as a Category 1 strength storm on August 29th (ironically the same day that Hurricane Katrina made landfall 7 years earlier), posed any real threat to the insurance industry and capital markets. Interestingly, the last three hurricanes to make landfall in the United States have all had a name beginning with the letter "I". These were Ike in 2008 (September 13), Irene in 2011 (August 27) and now Isaac (August 29).

The Pacific saw much more intense tropical storm activity both in the western Pacific along the Mexican Coast where the 3rd Quarter saw 11 named storms form, 7 of which became hurricanes. In the eastern Pacific experienced 14 named storms during the 3rd Quarter, 9 of which became typhoons including two, Sanba and Jelawat, reached Super typhoon status (Category 5) within two weeks of each other. Only one storm, Jelawat, posed a potential threat to Japan where two bonds provide cover for typhoon exposures. At the end of the day, the storm weakened to a Category 1 level prior to making landfall on Honshu.

## Outlook

The 4th Quarter is traditionally the most active issuance period, particularly as most sponsors seek to align their capital market protections with their traditional reinsurance programs many of which are purchased to match their fiscal calendar. During the last three years the average issuance volume during the 4th Quarter has been in the range of \$1.9 bn and the general consensus amongst many market participants is that aggregate issuance for the full year 2012 will exceed \$6 bn.

The 4th Quarter issuance season began with the announcement of the MultiCat Mexico 2012 transaction, a follow-on to the MultiCat Mexico 2009 transaction that is set to expire in mid-October. The issuer is a special purpose vehicle established by the World Bank to promote capital market solutions for disaster relief. Ultimate sponsor is FONDEN, a Mexican federal administrative trust created in 1999 to aid the general population affected by natural catastrophes. The program offers investors parametric index instruments protecting against Earthquake, as well as Atlantic and Pacific Hurricane risk within pre-defined geographic zones. The timing of this new launch was very favorable for the sponsor as many managers have experienced strong in-flows at a time when supply of new product is scarce. In addition, as these perils are largely diversifying to existing the peak perils they were heavily oversubscribed, resulting in final pricing coming in well inside the initial price guidance.

While some market observers may express concern that a supply overhang will lead to depressed pricing, our view is more sanguine. Pricing for peak risk exposures, which is what is principally transferred to the capital markets, remains robust. What is clearly observable is that the global reinsurance industry is today in a less stressed position than it was twelve months ago. The first three quarters of 2012 have had a far lower level of catastrophe claims activity, allowing industry participants to recharge their balance sheets following the horrendous loss activity experienced in 2011. That having been said, there is still quite a bit of pressure on reinsurers to maintain, and wherever possible, improve the pricing of their business. AON Benfield, one of the reinsurance industry's leading brokers recently reported that the overall return on equity for the 31 leading global reinsurers (referred to as the AON Benfield Aggregate or ABA[1] ) for the first half of 2012 rebounded from 4.8% for the fiscal year 2011 to 10.7% for the first half of 2012. While impressive, it is still a far cry from the pre-crisis ROE levels of 15.7% in 2007 and it is solely due to the fact that catastrophe losses in the first half of 2012 plummeted to 2.5 percentage points of the ABA's combined ratio compared with 30.6% during the first half of 2011. Much as one swallow does not make a summer, the absence of catastrophe losses for 6 or 9 months does not mean that prices will collapse. This message was clearly broadcast by leading industry figures during the Monte Carlo Rendez-Vous in early September where market participants meet annually to discuss market developments and set the stage for the important January 1 renewal season. Here it was pointed out that the very low interest rates and weak capital markets will require continued pricing discipline.

Interestingly another leading reinsurance broker, Guy Carpenter, made the point in a recently published report "Cold Spots Heating Up: The Impact of Insured Catastrophe Losses in New Growth Markets" that reinsurers in their push to seek improved geographic diversification in new emerging insurance markets have been confronted with new and poorly understood catastrophe exposures that have been inadequately assessed and priced. What these recent events also highlighted was the interconnectedness of the global supply chain in manufacturing which resulted in some of the more expensive "Cold Spot" event losses actually emerging in reinsurance agreements outside of the region. As we reported in our 2nd Quarter update, one of the larger "events" reported in many reinsurer's 2nd quarter financial results was actually the deterioration of the Thai flood losses from the 4th quarter 2011. Many of these losses actually came from insurers outside the region who provided overseas coverage to multinational corporates head-quartered in their region. We believe that efforts will be made to more strictly limit coverage offered under existing reinsurance arrangements with a push towards requiring additional separate protections for these risks.

So overall, we remain positive on the outlook for the reinsurance market and the prospects for capital market participants.

[1] For more details on the ABA refer to http://thoughtleadership.aonbenfield.com

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