ILS MARKET UPDATE

Strong Start to 2012 Sees Record First Quarter Issuance

Featuring an Interview with Nephila's Frank Majors

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Q1 2012 Cat Bond Market Issuance

The first quarter of 2012 saw record new issuance volume with over $1.3 billion of non-life capacity issued through eight transactions (2011: $1.0 billion in four deals).

Q1 2012 Non-Life Cat Bond Market Issuance Summary

($ in millions)

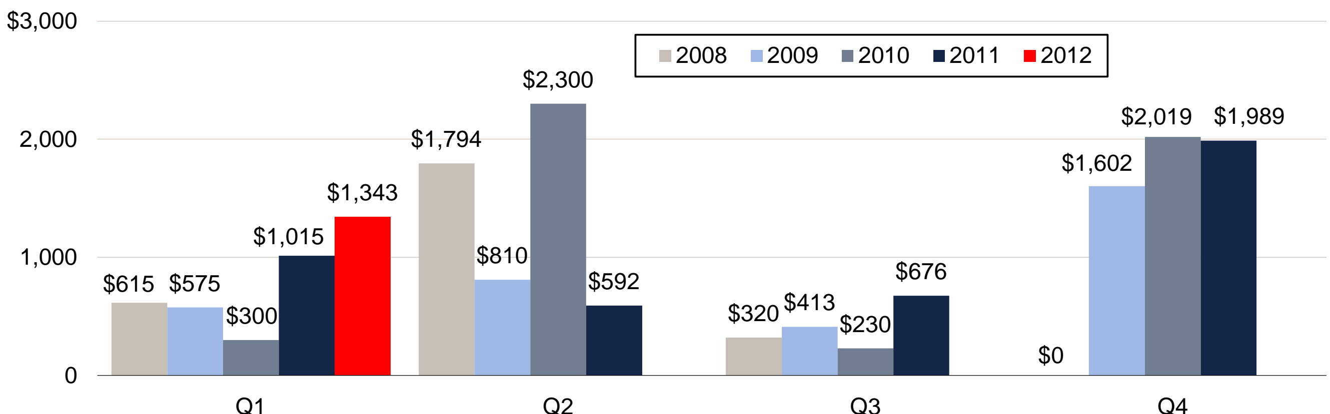
Sponsor	Issuer / Tranche	Issue Date	Term	Amount	Risk Spread	Basis	Risk
NCFB/COUNTRY	Combine Re - A	03/23/12	2.8	$100	4.50%	AGG	US Hurricane, EQ, T & W-Storm
NCFB/COUNTRY	Combine Re - B	03/23/12	2.8	50	10.00%	AGG	US Hurricane, EQ, T & W-Storm
NCFB/COUNTRY	Combine Re - C	03/23/12	2.8	50	17.75%	AGG	US Hurricane, EQ, T & W-Storm
Chubb	East Lane Re V Ltd - A	03/09/12	4.0	75	9.00%	OCC	US Hurricane
Chubb	East Lane Re V Ltd - B	03/09/12	4.0	75	10.75%	OCC	US Hurricane
Liberty Mutual	Mystic Re III Ltd - A	03/05/12	3.0	100	9.00%	OCC	US Hurricane and Earthquake
Liberty Mutual	Mystic Re III Ltd - B	03/05/12	3.0	175	12.00%	OCC	US Hurricane and Earthquake
Munich Re	Queen Street V	02/27/12	3.1	75	8.50%	OCC	US Hurricane and Euro Wind
CEA	Embarcadero Re	02/06/12	3.0	150	7.25%	AGG	California Earthquake
Zenkyoren	Kibou Ltd	02/06/12	3.0	300	5.25%	OCC	Japan Quake
Assurant	IBIS Re II Ltd 2012-1 A	01/30/12	3.0	100	8.35%	OCC	US Hurricane
Assurant	IBIS Re II Ltd 2012-1 B	01/30/12	3.0	30	13.50%	OCC	US Hurricane
Swiss Re	Successor X V-D3	01/26/12	3.0	40	11.00%	OCC	US Hurricane
Swiss Re	Successor X V-AA3	01/26/12	3.0	23	16.50%	OCC	US Hurricane and Euro Wind
			Total	**$1,343**			

Source: WCMA Transaction Database.

The first transaction of the quarter was from Swiss Re who sponsored a sixth takedown of two further tranches from their Successor X program, one of which provides $40 million of U.S. hurricane cover, the other provides $23 million of U.S. hurricane and European windstorm cover. The three year occurrence covers use an AIR-modeled PCS-based trigger for the U.S. risk exposure and PERILS for Europe. Swiss Re currently has $788 million of capacity outstanding under its various Successor programs, out of a total $2.4 billion issued since they began in 2006.

Assurant returned to the catastrophe bond market for a third time with the IBIS Re II transaction. The three year deal was split into two tranches of $100 million and $30 million, both covering U.S. hurricane risk on an occurrence basis. This transaction features a county-weighted industry loss index trigger for personal lines losses reported by the Verisk Catastrophe Index. The Verisk index utilizes data from ISO's Property Claims Services (PCS) and risk modeller AIR Worldwide to allocate industry losses by state and business line to individual counties. IBIS is the first deal to use the Verisk index directly although other bonds such as SCOR's December 2011 Atlas VI transaction have used similar trigger technology.

Non-Life Cat Bond Issuance by Quarter (2008 – 2012 YTD)



Source: WCMA Transaction Database.

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Q1 2012 Cat Bond Market Issuance (cont'd)

Zenkyoren sponsored the largest issue of the quarter, a single $300 million tranche from their new Kibou Ltd. vehicle. The transaction provides three years of occurrence coverage against Japanese earthquakes and uses a parametric index trigger. The deal also features a potential drop-down of the coverage after certain qualifying events. This transaction demonstrates that in the right circumstances sponsors can renew catastrophe bond protection after an event has caused a total loss to an earlier deal (the $300 million Muteki cat bond, which was triggered by the March 2011 Tohoku earthquake event).

In early February, the California Earthquake Authority (CEA) returned to the market following their $150 million issuance in August 2011, with a further $150 million issuance through the Embarcadero Re program. The deal provides annual aggregate coverage for Californian earthquakes on an indemnity basis for a three year period.

Munich Re sponsored an issuance from Queen Street V, which provides $75 million of occurrence coverage against U.S. hurricanes and European windstorms for just over three years. The transaction utilizes a state-weighted PCS index trigger for the U.S. and a country-weighted PERILS index for Europe.

In March, Liberty Mutual returned to the cat bond market with the $275 million Mystic Re III transaction. Willis Capital Markets & Advisory (WCMA) acted as a Co-Manager on this deal. This was the first time that Liberty Mutual had sponsored a cat bond that featured an indemnity trigger; all previous cat bond deals, totaling $900 million of capacity since 2006, had used index triggers. The deal, structured in two tranches of $100 and $175 million, provides Liberty Mutual with three years of occurrence protection against U.S. hurricane and earthquake exposures. Demand for the transaction was strong enough for it to be upsized from an initial $150 million to $275 million.

March also saw the $150 million East Lane Re V transaction sponsored by Chubb. This was Chubb's fifth cat bond and provides four years of indemnity protection on a per occurrence basis against personal lines losses from hurricanes and severe thunderstorms in eight states from Texas to North Carolina.

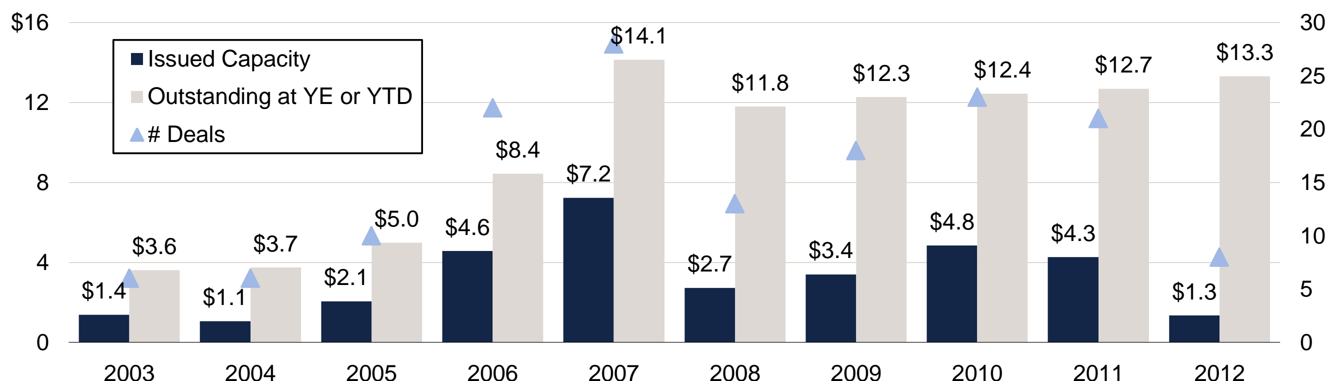
The final new issue of the quarter was brought by Swiss Re, acting as a conduit for two new sponsors, North Carolina Farm Bureau Mutual Insurance Company and COUNTRY Mutual Insurance Company. Combine Re provides $200 million of three year annual aggregate indemnity protection against the perils of hurricane (including tropical storm), earthquake, severe thunderstorm and winter storm in the U.S., excluding California and Florida. The transaction is structured such that Swiss Re has entered into two separate $100 million reinsurance agreements with each reinsured. Swiss Re has simultaneously entered into two separate retrocession agreements with Combine Re to receive payments following the aggregation of losses of the two reinsured parties. Combine Re has then sold catastrophe bond notes to transfer the risk to investors.

All of the first quarter transactions were denominated in U.S. dollars and all invested the collateral from the bond proceeds in U.S. Treasury Money Market Funds. Another structural constant was that AIR continues to be the dominant model of choice for catastrophe bonds into 2012, performing the risk analysis for all the non-life cat bonds issued during the quarter.

During the first quarter, four catastrophe bonds matured totaling just over $700 million, meaning outstanding on risk-capacity increased by a little over $600 million. Two-thirds of capacity issued was exposed to the peril of U.S. hurricane, which continues to dominate the non-life market; 67% of outstanding cat bond limit is exposed to U.S. hurricane risk of some form.

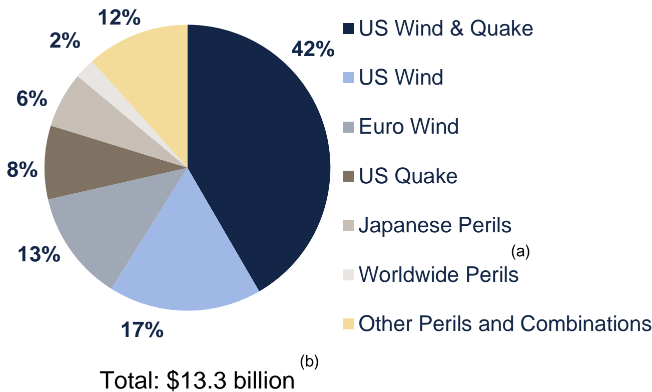
Capacity Issued and Outstanding by Year

($ in millions)



Source: WCMA Transaction Database as of March 31, 2012.

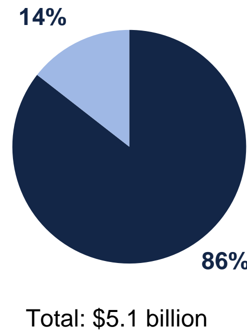
On-Risk Capacity by Peril (March 31, 2012)



Source: WCMA Transaction Database.
(a) Worldwide includes all bonds with coverage in more than 2 continents.
(b) In aggregate, 67% of all capacity outstanding exposed to U.S. Wind.

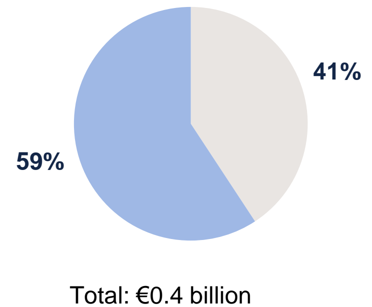
2011 & Q1 2012 Issuance By Collateral Type

USD Denominated Deals



Total: $5.1 billion

Euro Denominated Deals

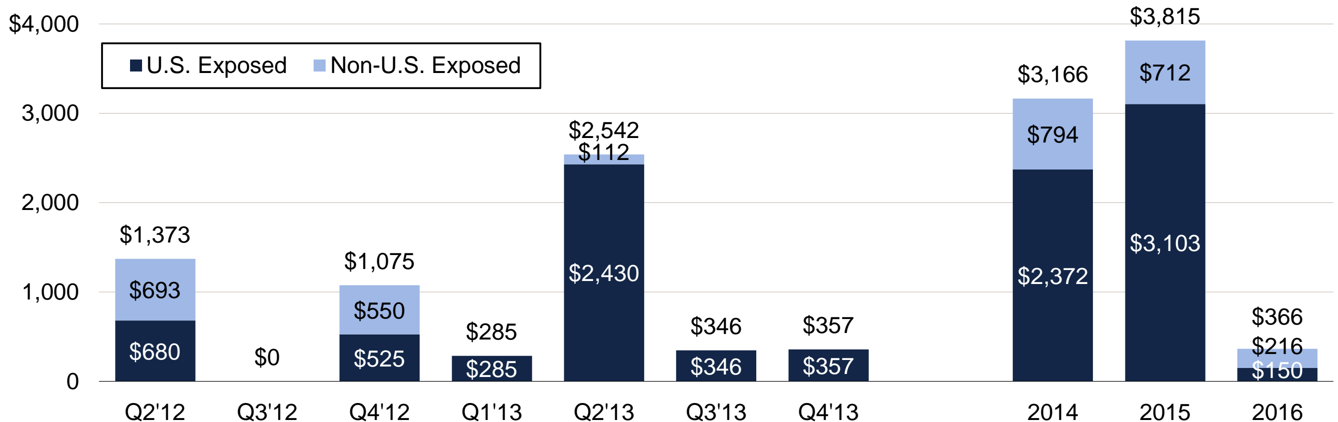


Total: €0.4 billion

TMMF IBRD / EBRD Note Tri-Party Repo

On-Risk Capacity by Maturity Date

($ in millions)



Source: WCMA Transaction Database.

Secondary Market

Faced with significant new issuance in the first quarter, investors took the opportunity to do some portfolio rebalancing to make room for the new offerings coming to market. Some were anxious to lighten up on U.S. wind and as the quarter progressed, the U.S. wind bonds increasingly began to reflect the widening spreads seen in the primary issuance market.

Although we believe investors remain keen to see diversifying risk, recent deals have demonstrated pricing discipline which has impacted the secondary market. Existing Japanese peril bonds widened a touch and the CEA's 2011 Embarcadero issuance traded down from its recent highs, as the new Embarcadero deal came to market.

We saw some trading in Johnston Re bonds, as the Combine Re deal (which is also North Carolina exposed) was marketed. The recent new issuance has caused investors to weigh their preferences for regions and perils, risk adjusted returns and particularly tested their underwriting mettle.

Although new capital has come into the market, it does not seem to be aggressively chasing cat bonds. There has been an increased interest in private collateralized covers from ILS investors who can participate in such trades.

By the quarter end, secondary market pricing was starting to offer an attractive value proposition and several new money players have been looking to develop positions.

WCMA Interview: Frank Majors

Frank Majors is a Managing Principal and Co-founder of Nephila, a leading dedicated reinsurance risk investment manager. Frank is also a Willis alumnus and we are pleased that he agreed to be interviewed for our newsletter.

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How developed is the recognition of the attraction of insurance risk as an asset class among mainstream asset managers such as pension funds?

The attractiveness of the asset class is much more appreciated now than it was fifteen years ago when we started, but the real awareness is still mostly with the larger pension funds. We are seeing much broader acceptance starting to emerge, with several of the more progressive investment consultants being enormously helpful in spreading the appeal to a broader audience, particularly in the past couple of years. We think this is great news for these investors, since the asset class really is a remarkable instrument for improving portfolios – investors are compensated attractively for the risk and effectively receive diversification for free. Consultants understand this dynamic, and how truly rare it is, and are therefore educating their clients on the asset class.

Is the market starting to mature or still at an early stage in terms of ultimate amount of AUM for this sector?

We think the market is just starting to mature, though the maturation process could take many forms and we do not think extrapolating to assume that the future looks like a bigger version of the present will provide a very accurate forecast. For the current trend of allocations to external managers to continue, managers will need to demonstrate that they add value above what the pension fund could do in-house and that they have good uses for capital, among other requirements. We believe the most likely trend is for AUM to grow significantly and for the broader catastrophe markets to continue to evolve, with significant implications for reinsurers, ILS managers and, ultimately, insurers. Underpinning our assumptions are our beliefs that a significant and sizeable opportunity exists for investors and that the incumbent business model may not be the most efficient method for financing all forms of insurance risk.

Does the track record and size of established managers such as Nephila create a powerful barrier to entry for new funds?

We don't think our size provides a barrier to entry per se: Nephila has grown over the past fifteen years and every year there are more competing managers in the space. I think our size allows us to invest in a lot of resources which provide significant and demonstrable value to our investors, ranging from analytics supporting performance to operations to compliance. We have also found that as we have grown our access to deal flow has improved even more, which is contrary to most asset classes and a difficult case to make to investors. I assume that smaller managers would differentiate themselves by emphasizing that their smaller size provides an advantage – we don't agree with this view at all, and think we make a pretty compelling case to investors why our size is a benefit, but we do realize that most investors' starting point is that size is a negative for performance. To the extent that the viewpoint is held by investors, our size provides new funds an opportunity to differentiate, which is healthy and pushes us to try continually to improve performance. I think this also comes back to the question of how the market will mature – as an industry we have to provide real value to our investors or they will not allocate to insurance risk or will manage the risk in-house. Investors benefit from economies of scale, as we can apply resources to questions and challenges that a pension fund would find uneconomic to research based on an allocation of less than $1B, and which a smaller fund would not be in a position to undertake. But it's an exciting time in the evolution of the market, and it's really a marketplace of ideas and viewpoints, and we are sure that there are many others besides ours that have merit.

Do you think it's desirable for the cat bond market to expand into new perils and geographies or remain focused on peak exposures?

Our view is that capital should flow to where it is needed in order for it to be rewarded. We don't see a great need for significant capital to flow to so-called diversifying perils. We are aware that our investors will not be rewarded if we try impose our business plan on a market, rather than developing a business plan around the market's needs. Would we prefer to have 20 discrete, equally-weighted risks? Sure, but that is not how the world is. We advise investors not to become too enamored with diversification, as we believe diversification works more to the manager's advantage, by reducing business risk, than to investors, who often end up "buying" more diversification than is needed.

Note: Frank Majors is a Managing Partner of Nephila Capital Limited and is not affiliated with Willis Capital Markets & Advisory or its affiliates. The views expressed herein by Mr. Majors are his personally and do not reflect the views of Willis Capital Markets & Advisory and its affiliates.

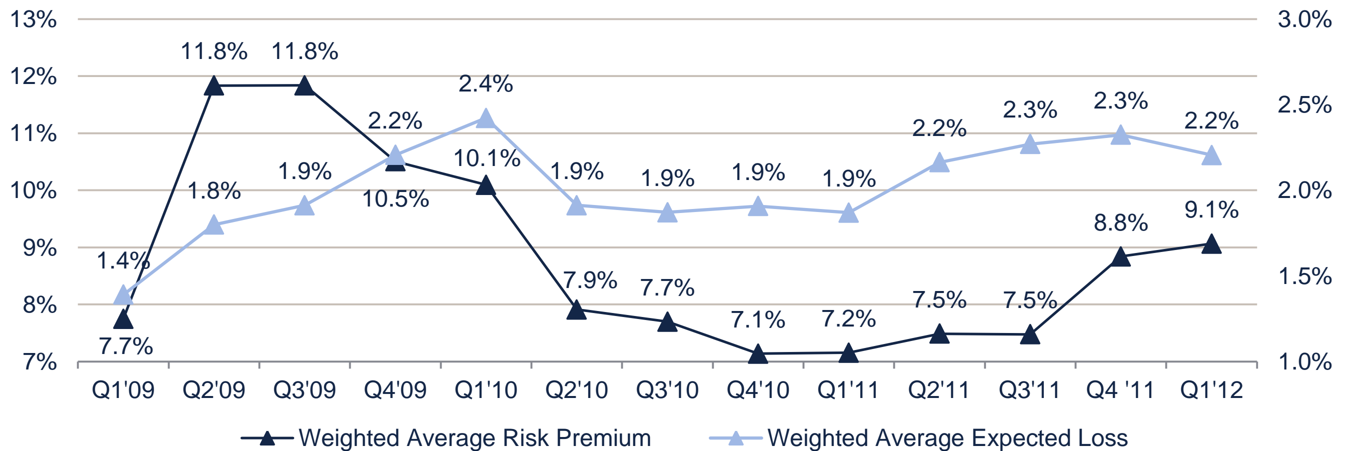
Market Outlook

We posed the question in our previous quarterly newsletter as to whether risk spread increases observed at the end of 2011 would persist into 2012. As the chart below demonstrates, market spreads have continued to widen in the first quarter. The weighted average risk premium has increased to 9.1% from 8.8% in the fourth quarter of last year, itself an increase on the risk spreads earlier in 2011.

Despite this, we have seen a record quarter for new issuance. The market's strong momentum has continued into April, including the recent announcement of a record $750 million in capacity for a single tranche for the Florida Citizen's cat bond.

In our view current spread levels will inevitably dampen demand for new issuance from potential sponsors in the short-term. We believe the medium term outlook for the market remains encouraging. Investor inflows to the catastrophe risk asset class remain strong. Capital markets participants will likely want to support the catastrophe bond product alongside the other investment forms available to them such as private collateralized reinsurance contracts and index based products. Growth in peak insured exposures should continue creating more demand in the future for protection from natural catastrophes. These peak risks will likely drive further capital markets involvement in the market in coming years.

Quarterly Weighted Average Risk Premium and Expected Loss For Trailing Twelve Months Issuance



Source: WCMA Transaction Database.

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