ILS MARKET UPDATE

Declining Spreads & Flexibility in Structuring

WILLIS CAPITAL MARKETS & ADVISORY

April 2014

The Insurance Industry Experts

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Capital Markets & Advisory

Market Outlook

"With accelerating savvy sponsors and brokers, increasing speed to market, a favorable spread environment, and more flexible terms, the next quarter could well break the previous Q2 record for non-life cat bond issuance"

The second quarter of 2014 is on course for strong levels of issuance. Indeed, the deal pipeline has been developing nicely on the back of the successful executions in the first quarter. As is typical of any second quarter, the bulk of the deals will likely include U.S. hurricane exposure with some opportunistic tranches thrown in to satisfy investors' ongoing craving for diversifiers.

But what specifically is driving the uptick in deals? First, new issuance risk spreads have continued to trend downwards falling from 12.0% in Q3 2012 to 6.4% in Q1 2014. Second, terms have become more flexible to allow for deals tailored to a sponsor's needs. This flexibility can sometimes increase risk spreads but sponsors at least have increased options. Third, speed to market is improving, reducing lead times between decisions to proceed and execution. Finally, sponsors and their brokers are getting better at resisting the siren call of overpriced private placements.

An important trend to look out for is the increased participation from money managers and mutual funds investing in the space. Indeed, money managers, mutual funds, and ILS specialist investors still see significant value for their investors despite the fall in market clearing spreads. Note that a modest tick upwards in spreads would bring in a significant amount of capacity. As a consequence the risk of running out of capacity seems limited.

ILS specialist investors try to increase their participation in syndicated collateralized reinsurance and, more importantly, in private placements of collateralized reinsurance to avoid the competition for investments in syndicated cat bonds. An advantage of private placements (for these investors) is that they can sometimes preempt cat bond placements, that would otherwise have occurred at a syndicated and lower spread.

However, lately preemption is on the decline. Sponsors now understand that a private placement will usually occur at a higher spread than the syndicated spread even after taking into account the relative frictional costs of both placements. The private placement concentrates market power to the detriment of the sponsor as opposed to a syndication which increases its number of relationships. In truth, now that cat bonds have more flexible terms and conditions, the justification for private placements has become increasingly difficult.

With increasingly savvy sponsors and brokers, accelerating speed to market, a favorable spread environment, and more flexible terms, the next quarter could well break the previous Q2 record for non-life cat bond issuance ($3.5 billion in 2007).

Q1 2014 Cat Bond Market Issuance Overview

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Two first-time sponsors, American Strategic Insurance and Great American Insurance, accessed capital markets capacity in the first quarter. The remaining sponsors included capital markets veterans Munich Re, Tokio Marine & Nichido Fire Insurance, State Farm and Chubb.

Q1's first issuance was Munich Re's Queen Street IX. The bond provides Munich Re with three years of fully collateralized retrocessional coverage against the perils of U.S. Hurricane and Australia Cyclone. Coverage for events is provided on a per-occurrence basis and the bond incorporated a county and line of business-weighted PCS trigger for hurricane events and a postcode and line of business-weighted modeled loss index for Australia Cyclone events. It is interesting to note that the first Queen Street, issued in March 2008, was domiciled in the Cayman Islands. Queen Street II, III and IV were domiciled in Ireland. Subsequently, the Queen Street franchise saw its domicile move to Bermuda for four cat bonds (Queen Street V, VI, VII and VIII). And now, with the latest issuance under the franchise, Queen Street IX, will return to Ireland for its SPV domicile.

The notes had an expected loss of 2.92% and were issued at a spread of 5.50%.

Q1 2014: Non-Life Cat Bond Issuance Summary [(b)]

($ in millions)

Sponsor	Issuer / Tranche	Issue Date	Maturity	Amount	EL	Risk Spread	Basis	Risk	Trigger
Great American	Riverfront Re Ltd.	31-Mar-14	6-Jan-17	$95	1.24%	4.00%	Occ	Named Storms, EQ, Severe T-Storm, Winter Storm	Indemnity
State Farm	Merna Re V Ltd.	31-Mar-14	7-Apr-17	300	0.41%	2.00%	Occ	US Quake	Indemnity
Tokio M&F	Kizuna Re II Ltd. (Class A)	14-Mar-14	6-Apr-18	200	0.21%	2.25%	Occ	Japan Quake	Indemnity
Tokio M&F	Kizuna Re II Ltd. (Class B)	14-Mar-14	6-Apr-18	45	0.57%	2.50%	Occ	Japan Quake	Indemnity
American Strategic	Gator Re Ltd.	10-Mar-14	9-Jan-17	200	1.76%	6.50%	Occ / Agg	Named Storms & Severe T-Storm	Indemnity
Chubb	East Lane Re VI Ltd.	7-Mar-14	14-Mar-18	270	0.89%	2.75%	Occ	Named Storms, EQ, Severe T-Storm, Winter Storm	Indemnity
Munich Re	Queen Street Re IX Ltd.	26-Feb-14	8-Jun-17	100	2.92%	5.50%	Occ	US Wind & Australia Cyclone	Index
			Total:	$1,210					

(a) Includes certain transactions marketed in Q1 and closed at the beginning of Q2. $520 million of bonds were issued in Q1, prior to April 1st.

(b) All issuance amounts reported in or converted to USD. Expected loss for hurricane deals is based on WSST conditioned catalog for AIR and medium-term catalog for RMS.

Note: All issuance and par outstanding metrics presented are based on the following methodology for catastrophe bonds: Only broadly distributed natural catastrophe bonds are included in the graphs and charts. Our total par outstanding calculations do not include extreme mortality, longevity risk and contingent capital transactions. Calculations exclude private transactions such as 4(2) deals. Total par outstanding metrics exclude sidecars and other alternative risk transfer transactions.

Source: WCMA Transaction Database as of 3/31/2014.

Q1 2014 Cat Bond Market Issuance Overview (continued)

"In many ways, Gator Re broke new ground incorporating several unique features. Overall coverage is provided via two sections that together share the $200 million limit"

The second deal to settle in the quarter was East Lane Re VI, issued by repeat sponsor, Chubb. East Lane Re VI secured $270 million of fully collateralized coverage against the perils of named storms, earthquake, severe thunderstorm and winter storm in the Northeast U.S. East Lane VI was comparable to East Lane IV in scope and covered perils. However, the East Lane Re VI, with an expected loss of 0.89% priced at 2.75% compared to the Class B notes of East Lane Re IV (expected loss of 0.92%) which priced at 5.75%. Also of note was the change in modeler from AIR in East Lane Re IV to RMS in the current transaction.

Coverage was provided on an indemnity, per-occurrence basis and secured coverage for a four year term. The bond had an expected loss of 0.89% and was initially marketed at a spread of 3.00% - 3.75%. The deal was significantly oversubscribed and was upsized from an initially proposed $225 million. Strong investor demand led to the bond pricing below initial guidance at 2.75%.

First time sponsor American Strategic Insurance accessed the cat bond market through the $200 million Gator Re Ltd. deal. Gator Re provides just under three years of fully collateralized coverage against the perils of named storms and severe thunderstorm. In many ways, Gator Re broke new ground incorporating several unique features. Overall coverage is provided via two sections that together share the $200 million limit. Section A provides indemnity, per-occurence coverage against named storms and severe thunderstorms. Section B provides indemnity, annual aggregate coverage against severe thunderstorms only.

The fourth deal to settle in the quarter was Tokio Marine & Nichido Fire Insurance's Kizuna Re II Ltd. Kizuna Re II was issued over two tranches and provides four years of fully collateralized indemnity-based coverage against earthquakes in Japan. The Class A notes secured $200 million of coverage and the Class B notes $45 million, for an aggregate limit of $245 million. The Class A notes had an expected loss of 0.21% and were issued at a spread of 2.25%, while the Class B notes had an expected loss of 0.57% and were issued at a spread of 2.50%.

There was strong demand for the issue and the offering was upsized from the initially marketed $125 million. The bond had projected an expected loss of 1.76% and was initially marketed at a spread of 7.00% - 7.75%. The transaction adjusts the premium to account for changes in exposures within each year as well as from year-to-year.

Q1 2014 Cat Bond Market Issuance Overview (continued)

State Farm sponsored Merna Re V, which secured three years of fully collateralized indemnity-based coverage against the peril of U.S. earthquakes in the New Madrid region. Coverage is provided on a per-occurrence basis. The bond had an expected loss of 0.41% and eventually priced at 2.00%. Merna Re IV, providing similar coverage to the current issue (expected loss of 0.40%) priced at 2.50%. Both transactions were modeled by RMS.

The final broadly distributed non-life issue of the quarter was Riverfront Re Ltd., brought to market by first time sponsor Great American Insurance Group, a subsidiary of American Financial Group. Riverfront Re secured $95 million of fully collateralized cover against the perils of named storm, earthquake, severe thunderstorm and winter storm in the U.S. and Canada. Coverage is provided on an indemnity, per-occurrence basis. The bond has an expected loss of 1.24% and priced at 4.00%.

"The market for non-natural catastrophe bonds and private placements remained active and saw compelling pricing for many deals."

The market for non-natural catastrophe bonds and private placements remained active and saw compelling pricing for many deals. Aetna returned to market a fifth time with a Vitality Re deal. Vitality Re V secured $200 million of fully collateralized coverage against extreme increases in the medical benefits ratio (MBR) paid out by Aetna's subsidiary, Aetna Life Insurance Company (ALIC). Vitality Re V replaces coverage that has matured from the Vitality Re I and II bonds.

The bond was issued over two tranches: the Class A tranche priced at 1.75% and the Class B tranche priced at 2.50%. The deal was oversubscribed, highlighting investor comfort with the type of risk and the associated modeling.

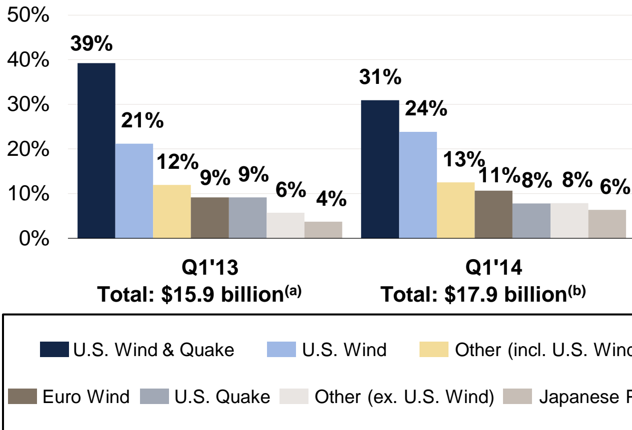
Private cat bond activity continued to gather momentum in Q1 2014. Dodeka I was the first private catastrophe bond of the quarter and allowed Twelve Capital to transform a PCS-based Industry Loss Warranty (ILW) into a more liquid structure which could be included in its liquid investment strategies and funds. The notes covered multiple U.S. perils. Twelve Capital had a subsequent $25 million issuance, Dodeka II, securing approximately 6 months of coverage against U.S. wind and earthquake.

Omamori was a $25 million private catastrophe bond placed via Tokio Solution Management's Tokio Tensai platform for sponsor Tokio Millennium Re AG. The ultimate issuer was Shima Reinsurance Ltd. on behalf of Segregated Account Omamori. The bond provides fully collateralized second event coverage against U.S. earthquakes and named storms.

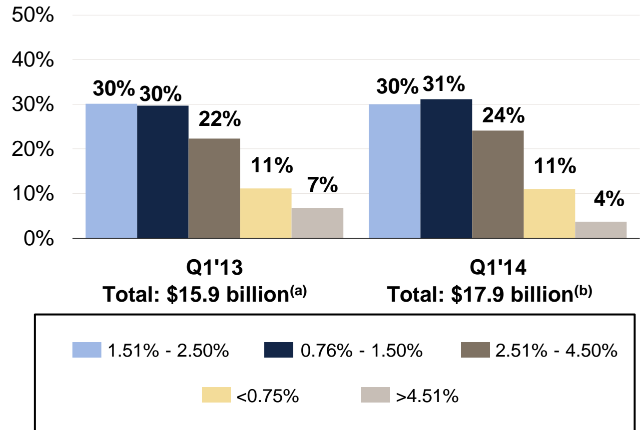
Cincinnati Insurance returned to the capital markets with Skyline Re 2014-1. Their first issuance was Skyline Re 2013, which provided $72 million of coverage against New Madrid quake on a per-occurrence basis and severe convective storm on an aggregate basis. Skyline Re 2014-1 secured $100 million of indemnity-based, multi-year coverage against earthquake (on a per-occurrence basis) and severe convective storm risk (on an aggregate basis).

Q1 2014 Cat Bond Market Issuance Overview (continued)

Par Outstanding by Risk Peril

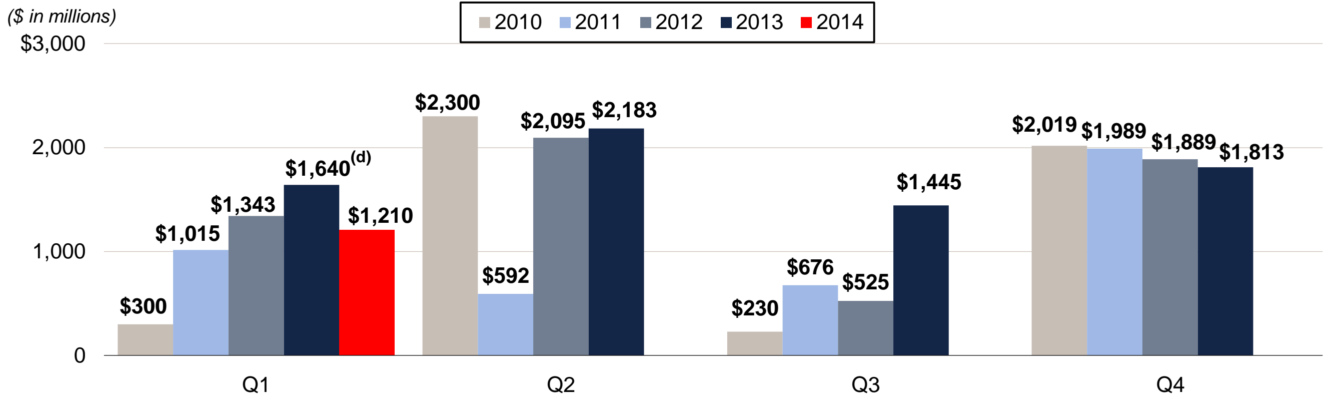


Par Outstanding by Expected Loss

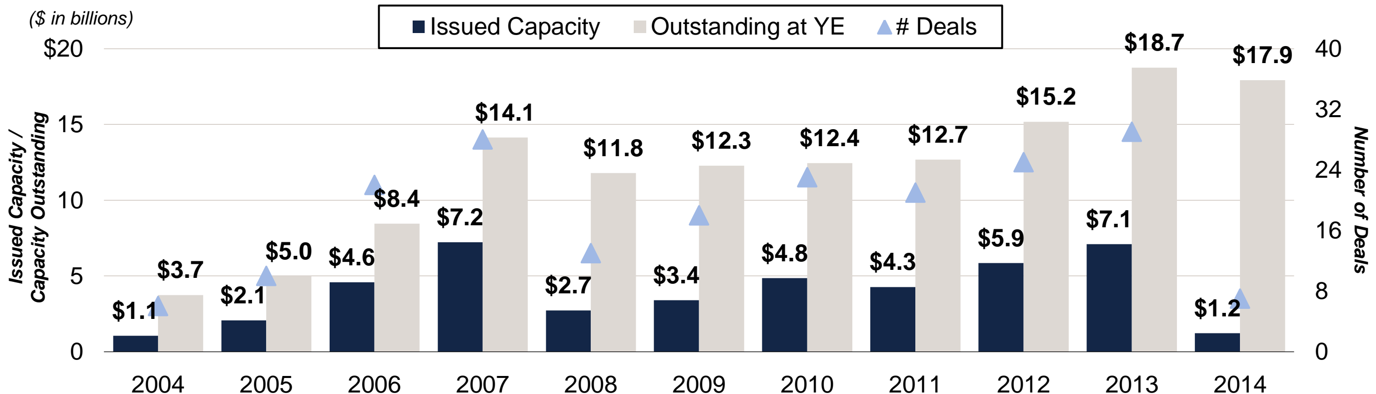


Source: WCMA Transaction Database as of 3/31/2014.
(a) In aggregate, 72% of all capacity outstanding exposed to U.S. Wind.
(b) In aggregate, 67% of all capacity outstanding exposed to U.S. Wind.

Non-Life Cat Bond Issuance by Quarter (2009 – 2014) [c]



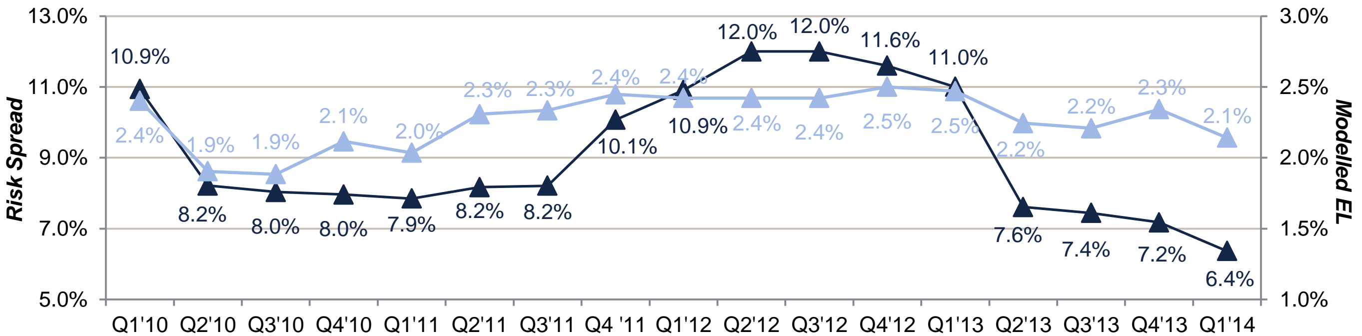
Capacity Issued and Outstanding by Year



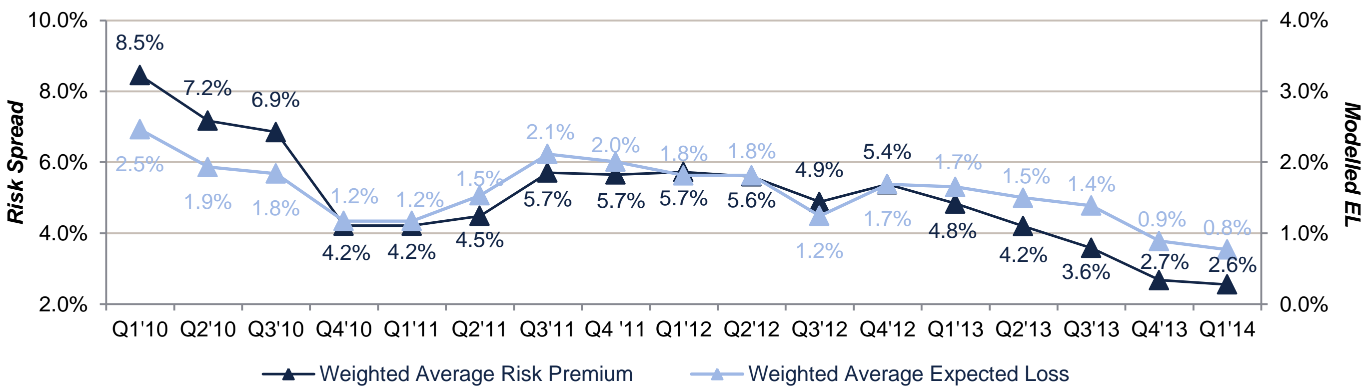
(c) All issuance amounts reported in or converted to USD.
(d) Includes certain transactions marketed in Q1 and closed at the beginning of Q2. $520 million of bonds were issued in Q1, prior to April 1st.
Source: WCMA Transaction Database as of 3/31/2014.

Q1 2014 Cat Bond Market Issuance Overview (continued)

Quarterly LTM U.S. Wind Exposed Weighted Average Risk Premium & Expected Loss



Quarterly LTM Non-U.S. Wind Exposed Weighted Average Risk Premium & Expected Loss



Source: WCMA Transaction Database as of 3/31/2014.
LTM = Last twelve months. Data is for primary issuance and does not reflect secondary trading.

Secondary Market Trading Overview

"Going forward, investors will be on the hunt for higher yielding bonds which will help maintain return targets. With so little in the secondary market, there is increased longing for private placements…"

Q1 was a quarter of discovery and wonder. With each new primary issuance, investors discovered the bottom of guidance pricing challenged and broken; and wondered if these phenomena would continue throughout the quarter. As it turned out, it did; however consensus is that disciplined picking will return to the market long before the wind season is upon us. This buy-and-hold market had little to offer in such a sparse issuance season, and consequently the imbalance of demand, cash inflows from new money and maturing bonds pushed up secondary pricing on very little volume. As rates fell below 3 percent on many issues, some investors chose to lighten up, reducing their portfolios.

Going forward, investors will be on the hunt for higher yielding bonds which will help maintain return targets. With so little in the secondary market, there is increased longing for private placements by the investors, simply put, a quest for risk access and better yields.

There is still meaningful pent up demand for non-US wind exposed bonds.

WCMA Leadership

Antonio (Tony) Ursano Jr.
Chief Executive Officer
Willis Capital Markets & Advisory

+1 (212) 915-7986

tony.ursano@willis.com

William Dubinsky
Managing Director & Head of ILS
Willis Capital Markets & Advisory

+1 (212) 915-7770

william.dubinsky@willis.com

Howard Bruch
Managing Director & Head of S&T
Willis Capital Markets & Advisory

+1 (212) 915-8407

howard.bruch@willis.com

The Insurance Industry Experts
New York | London | Hong Kong

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