Swiss Re

Insurance-linked securities market update

In this issue:

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Market commentary

The first half of 2010 continued the trend of strong returns for the ILS sector after the financial crisis. The Swiss Re Global Cat Bond Index returned 3.3% in the first half of 2010, with recent price declines at the start of wind season offsetting a very strong first quarter. New issue volume for 2010 YTD is $2.5 billion, 40% higher than the same period in 2009, and 73% of all 2009 issuance. As we anticipate a robust pipeline of transactions for non-US perils in the rest of the year, it seems likely that 2010 new issue totals will meet or exceed 2009 levels.

Nearly 85% of the new issuance in this period was exposed to US Wind risk. This heavy concentration contributed to capacity constraints for investors and led spreads for this peak peril to widen in May and June. Meanwhile, spreads for bonds with non-US risk began trading at tighter levels in the secondary market as investors looked to balance their portfolios. This dislocation occurred as a result of a couple of dynamics. Firstly, many dedicated investors reached their aggregate limits for US Wind risk and were unable to purchase more US Wind bonds despite having the cash to do so. Secondly, the forecasts for the 2010 hurricane season have suggested a very strong storm season ahead for 2010. This caused investors to be more cautious with purchasing new positions.

It is our view that this dislocation is temporary. As we enter into the wind season and there is more visibility around the level of hurricane activity, investors are returning to the market. Additionally, as outstanding bonds mature and bonds with non-US Wind risk arrive in the market, we expect constraints to ease for those investors who have reached their maximum aggregate US Wind limit.

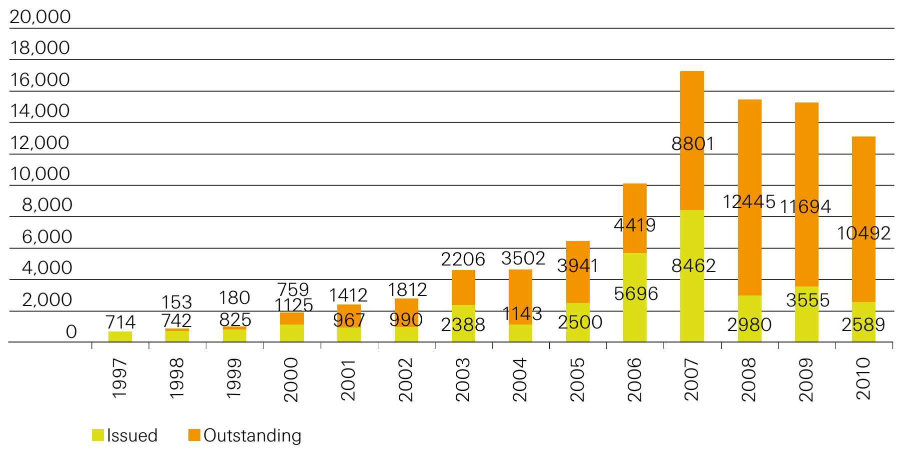
Figure 1:
New issue 1 January 2010 – 31 July 2010

Deal Name	Settlement Date	Size (mm)	Peril
Foundation Re III	1/27/10	$180.00	US Wind
Successor X Class II-CN3	3/26/10	$45.00	Multiperil
Successor X Class II-CL3	3/26/10	$35.00	Multiperil
Successor X Class II-BY3	3/26/10	$40.00	Multiperil
Merna Re II	4/1/10	$350.00	US EQ
Ibis Re 2010 Class A	4/27/10	$90.00	US Wind
Ibis Re 2010 Class B	4/27/10	$60.00	US Wind
Johnston Re A	5/6/10	$200.00	US Wind
Johnston Re B	5/6/10	$105.00	US Wind
Lodestone Re A	5/12/10	$175.00	USWD/USEQ
Lodestone Re B	5/12/10	$250.00	USWD/USEQ
EOS Wind A	5/19/10	$50.00	US Wind
EOS Wind B	5/19/10	$30.00	USWD/EUWD
Caelus Re II	5/21/10	$185.00	USWD/USEQ
Blue Fin 3 A	5/25/10	$90.00	USWD/USEQ
Blue Fin 3 B	5/25/10	$60.00	USWD/USEQ
Residential Re 2010 1	5/28/10	$162.50	Multiperil
Residential Re 2010 2	5/28/10	$72.50	Multiperil
Residential Re 2010 3	5/28/10	$52.50	Multiperil
Residential Re 2010 4	5/28/10	$117.50	Multiperil
Vita Capital II Class E	5/28/10	$50.00	Extreme Mortality
Shore Re Class A	7/8/10	$96.00	US Wind
		$2,496.00	

Source: Swiss Re Capital Markets

There are currently $13.5 billion bonds outstanding in the cat bond market. The overall outstanding amount may decrease from the previous two years due to the lag in new issue in 2008. However, the market only needs to see another $1 billion in new issues to surpass last year's level. Stronger new issuance would signal a rebound in the growth of the market after the financial crisis.

Figure 2:
Cat bonds outstanding (as of 31 July 2010)



Source: Swiss Re Capital Markets

The second half of 2010 is expected to see $2 billion of maturities, adding more capital back into the sector. Around $1 billion of this is the Merna Reinsurance transaction which was investment grade paper and generally appealed to a different investor base. The maturity of US Wind bonds and issuance of non-US wind perils should hopefully allow investors to take on more US Wind risk.

Figure 3:
Cat bond maturities 30 June 2010 – 31 December 2010

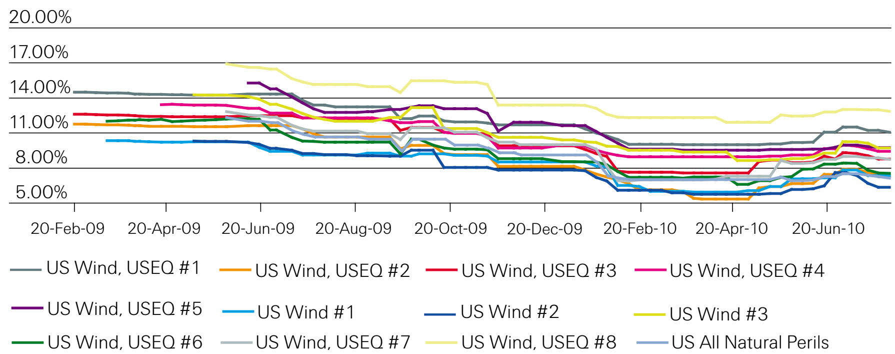
Issuer	Maturity	Size (mm)	Peril
Merna Reinsurance Series A	7/7/10	$256.00	US All Natural Perils
Merna Reinsurance Series B	7/7/10	$647.60	US All Natural Perils
Merna Reinsurance Series C	7/7/10	$155.00	US All Natural Perils
Foundation Re II Class A	11/26/10	$180.00	US Wind
Blue Coast Class A	12/8/10	$70.00	US Wind
Blue Coast Class B	12/8/10	$30.00	US Wind
Blue Coast Class C	12/8/10	$20.00	US Wind
Successor X Class I-S1	12/9/10	$50.00	US Wind, CAEQ, Euro Wind
Successor X Class I-U1	12/9/10	$50.00	US Wind, CAEQ
Successor X Class I-X1	12/9/10	$50.00	US Wind, CAEQ
Newton Re 2007 Class A	12/24/10	$87.50	US EQ
Newton Re 2007 Class B	12/24/10	$137.50	US Wind
Atlas Re IV	12/31/10	€ 160.00	Euro Wind, JP EQ
	Total	**$1,969.50**[1]	

Source: Swiss Re Capital Markets

[1] Euro denomations converted to USD per exchange rate at settlement date.

By April 2010, spreads tightened on average around 40-50% from the wide levels of bond new issues in 2009. But, as the hurricane season approached, new issue activity heightened, investors' US wind capacity began to fill and spreads began to widen again for bonds containing US Wind risk. Despite this widening, spreads for the early 2009 new issue class are still approximately 40% tighter than their initial issuance.

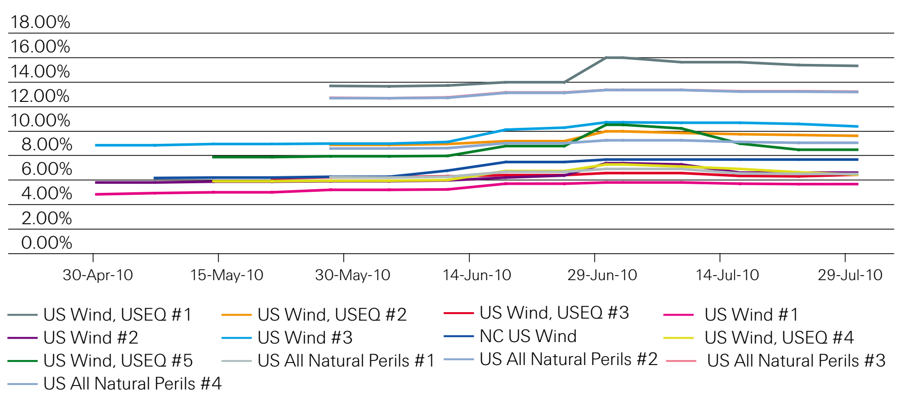
Figure 4:
Spreads[1] for selected 2009 transactions (as of 31 July 2010)



Source: Swiss Re Capital Markets

As illustrated in figure 5, spreads have widened around 10-20% for bonds including US wind risk that were issued in 2010. Contrary to the trend of widening US Wind bonds, bonds without US Wind risk have been tightening. As discussed, there is very strong demand for non-US Wind risk as certain investors seek to balance their portfolio exposures.

Figure 5:
Spreads[1] for selected 2010 transactions (as of 31 July 2010)



Source: Swiss Re Capital Markets

[1] Spreads without seasonality adjustment, spreads are indicative only.

Secondary Trading

As previously outlined, after steady spread tightening in the first quarter of 2010 new issuance of US peril exposed bonds ramped up very quickly in the second quarter, driving up spreads as capacity and appetite for US Wind started to dry out.

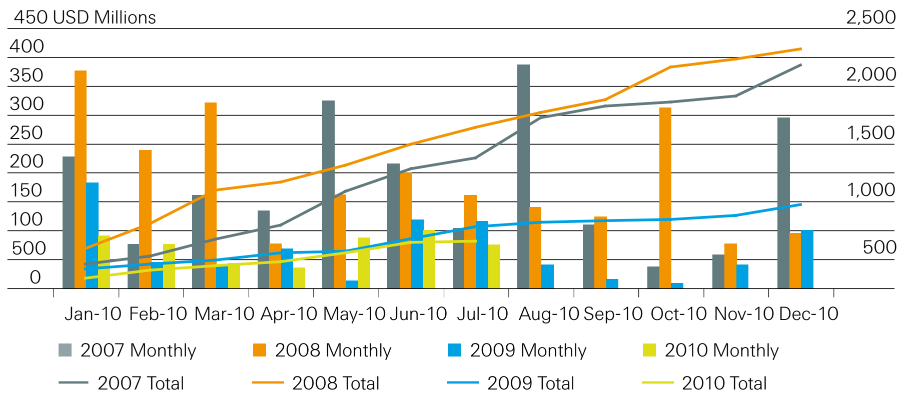
The scarce supply of non-peak bonds coupled with the heavy influx of new issuance bonds primarily exposed to US wind led to the erosion of US wind aggregates in many portfolios. This dynamic has contributed to the spread widening of US Wind and multiperil bonds to near peak 2009 levels and to the spread tightening of non-peak bonds to 2007 levels.

Risk appetite for US Wind was further dampened by the May release of the NOAA hurricane forecast, which in general consensus with other forecasters, expect an extremely active 2010 season.

Notwithstanding the above, a few investors with US Wind capacity have tried to capitalize on the current bipolar market dislocation, taking the opportunity to buy bonds at levels almost as wide as the peak of the market in 2009. Similarly, a few holders of non-peak bonds saw an opportunity to crystallize attractive returns in the wake of the significant spread tightening.

Swiss Re's secondary trading volume surpassed $511mm as of July 31, 2010. June represented the most active trading month and July volume continued the active trading environment which suggests volume may continue to pick up throughout the hurricane season.

Figure 6:
Secondary trading volume (as of 31 July 2010)



Source: Swiss Re Capital Markets

Beginning mid-May, demand for US Wind capacity in the ILW market sharply increased, pushing prices up significantly across all trigger levels ranging from 15% to 60%. Demand came from both cat bond investors as well as traditional ILW buyers.

Absent a significant erosion of capital, from an active season or otherwise, we anticipate spreads re-tightening to April levels as US peril bonds continue to mature and the pool of investors able to capitalize on the wider levels increases.

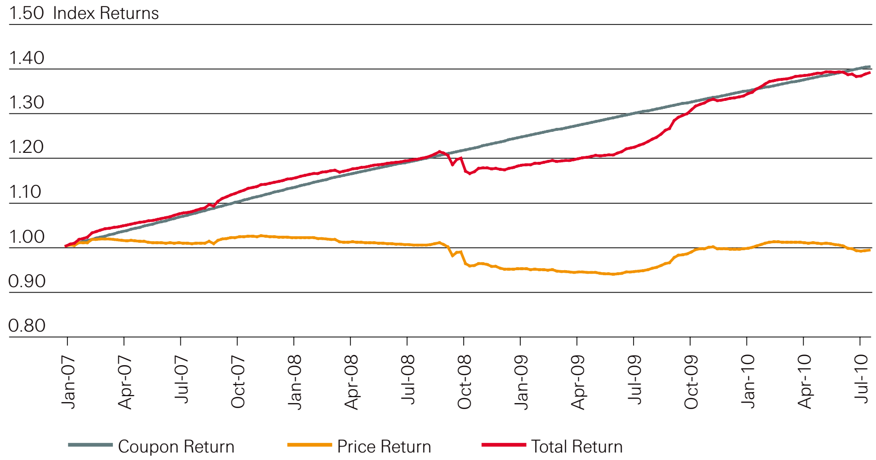
In fact, we have already begun to see this market stabilization as the last two weeks have seen a flurry of trading at spreads more than 5% tighter than the lows of recent weeks. It appears spreads have hit the current ceiling and are now on their way back down.

Swiss Re Cat Bond Indices

The Swiss Re Global Cat Bond Index (SRGLTRR) returned 3.3% in the first half of 2010, with recent price declines at the start of wind season offsetting a very strong first quarter.

Figure 7:
Swiss Re Global Cat Bond Index (1 January 2007 – 31 July 2010)

Swiss Re Global Cat Bond Index



Source: Swiss Re Capital Markets

The SRGLTRR continued its strong 2009 finish into 2010, returning 3.4% in the first quarter and peaking with a 4.1% year-to-date return on June 4. The start of US wind season coincided with a flurry of US wind issuance in May, however, causing many investors to reach their limits of US wind capacity. As a result, prices for wind-exposed bonds fell and the index had a -0.8% return for the month of June. Nearly 70% of the index is exposed to US wind, giving the seasonality of US wind pricing in the secondary market a notable impact on the price return. The total return of the index in the second quarter was -0.1%. The year-to-date return as of July 31 is 4.2%.

While the level of risk in the index did not change materially since the start of the year, it changed in early July with the maturity of the Merna bonds. The three Merna tranches are all investment grade and with a combined notional of over $1.1bn, created 9.9% of the index. The expiration of the Merna bonds bumps the average expected loss of the index from 1.60% to 1.78% and correspondingly pushes the average stated spread from 7.28% to 7.90%.

Deal focus: Blue Fin Ltd Series 3

In May 2010, Swiss Re Capital Markets successfully placed $150mm of the Blue Fin Series 3 transaction covering US hurricane and earthquake risk for Allianz. This marked Allianz's fourth sponsored transaction in the sector, demonstrating their commitment to accessing complimentary capacity through the capital markets.

The placement was done in two tranches, summarized in Figure 8. The split of tranches by expected loss allowed the transaction to attract a broad investor base and achieve the cover desired by Allianz. The Class B Notes used a term aggregate trigger to provide protection against combinations of medium-sized and large events.

Figure 8:
Blue Fin Ltd Series 3 Transaction Summary

	Class A	Class B
Amount	$90mm	$60mm
Coupon	14.00%	9.25%
Risk Period	3 Years	3 Years
Modelling Agency	AIR	AIR
Trigger	Modeled Loss per occurrence	Modeled Loss term aggregate
Expected Loss	4.97%	1.59%
Rating	B-	BB
Collateral	TMMF	TMMF

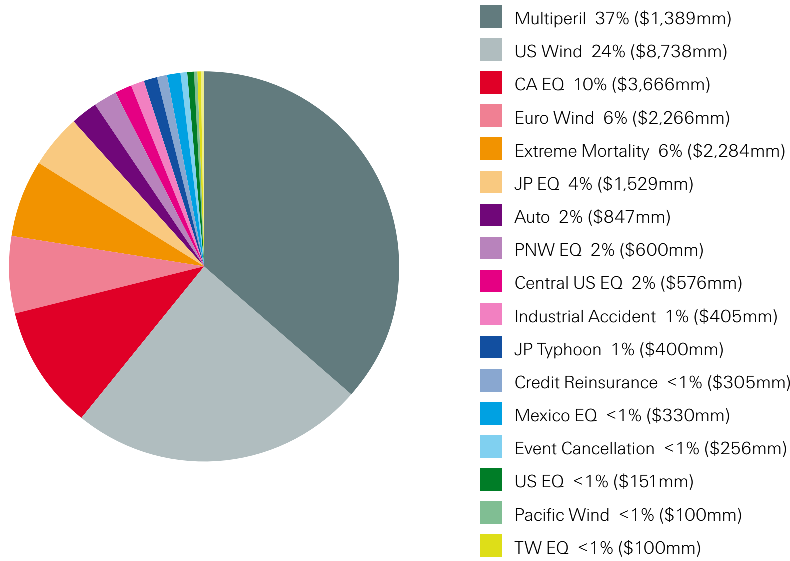
Source: Swiss Re Capital Markets

While the Blue Fin Series 3 Notes were placed at comparable rates to traditional reinsurance, Allianz received a key benefit in that this transaction provides fully collateralized, multi-year protection from a diversifying source to their traditional reinsurance program.

The transaction was well received by investors and one of the only deals during that period that was executed with the original price guidance provided to the market and for the full notional amount desired.

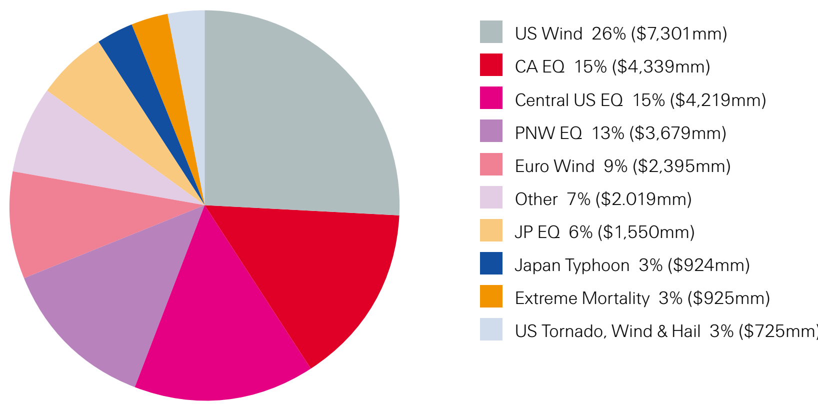
Sector data

Figure 9:
Risks securitized since 1997 (as of 31 July 2010)



Source: Swiss Re Capital Markets

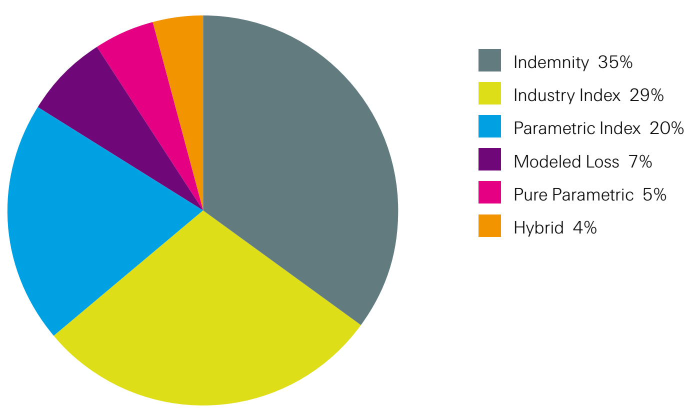
Figure 10:
Current capacity provided by the capital markets (as of 31 July 2010)



(1) Others include Mexico EQ, Greece/Turkey EQ, Portugal EQ, Israel EQ, Cyprus EQ and Mexico Wind

Source: Swiss Re Capital Markets

Figure 11:
Triggers used by catastrophe bond transactions (as of 31 July 2010)



Source: Swiss Re Capital Markets

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