

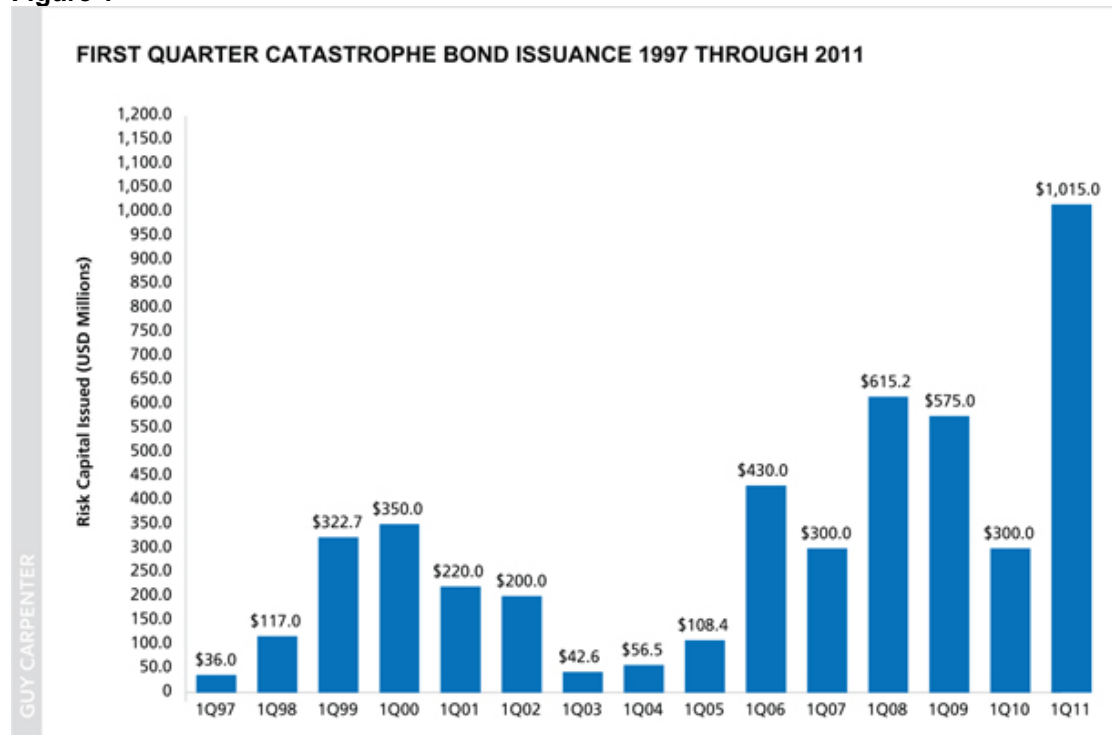
MAY 2011

## GC Securities\* Catastrophe Bond Market Update: First Quarter 2011

### The Most Active First Quarter on Record, Global Catastrophe Activity Highlights Value of Catastrophe Bond Market

The first quarter of 2011 was the most active first quarter in the history of the catastrophe bond market in terms of new issuance. All told, four transactions came to market securing USD1.02 billion of new and renewal risk transfer capacity. This is a significant increase over the USD300 million issued during the first quarter of 2010 and previous first quarter high-water mark of USD615 million posted during the first quarter of 2008. Issuance was diverse in terms of risk profile and structure, although U.S. hurricane risk was a common theme in all four transactions. All transactions marketed during the first quarter of 2011 priced within or inside of their initial spread guidance.

Figure 1



Source: GC Securities Proprietary Database, March 31, 2011

*Aside from strong issuance, the story of the first quarter in the catastrophe bond market and the world as a whole was the tragic and devastating “Great Tohoku” earthquake that occurred off the northeast coast of Japan on Friday, March 11. This earthquake registered a 9.0 magnitude according to the U.S. Geological Survey making it the largest and fourth largest earthquake in recorded history of Japan and the world, respectively. On a modeled basis (as of this writing) this event is expected to cause between USD15 billion and USD30 billion of insured loss and as much as USD300 billion of economic loss. The Tohoku earthquake had an immediate and noticeable impact not only on catastrophe bonds with exposure to Japanese earthquake risk, but also on the catastrophe bond market generally, particularly in the context of other first quarter catastrophe events including significant flooding and Cyclone Yasi in Australia, the (second) Christchurch earthquake in New Zealand and the recent RMS U.S. wind model update.*

*Valuations of cat bonds (both Japan earthquake exposed and otherwise) declined for the second half of March after the Tohoku earthquake, reflecting expected principal losses to Japan earthquake exposed cat bonds, mark to market losses (primarily with respect to certain second and/or subsequent event bonds expecting to shift to first event bonds) and also perception of potential for a general increase in the price of catastrophe risk protection. However, it is important to note that in the aftermath of one of the largest earthquakes in recorded history the catastrophe bond market continued to trade in an orderly and disciplined fashion. Additionally, investors report that their own capital providers, for example, institutions that have made or are planning to make allocations to the insurance linked securities (ILS) asset class, are responding well to the potential for principal loss associated with the event. Capital providers are prospectively focused on the implications for future issuance and investment opportunities rather than looking to reduce their exposure to the asset class.*

## **Issuance Activity**

First quarter issuance activity kicked off in February with a takedown from Swiss Re’s Successor shelf program.

- The Successor X Class IV Notes provide USD305 million of protection for U.S. hurricane and California earthquake events to Swiss Re.
- The Hartford, a veteran capital markets sponsor, also returned to the cat bond market in February with a second takedown from its Foundation Re III Ltd. shelf program. The Foundation Re III Ltd. 2011-1 notes provide The Hartford with USD135 million of four-year protection from U.S. hurricanes in a covered area spanning from Texas to Maine.

The final two transactions of the first quarter 2011 closed in March.

- East Lane IV Ltd., sponsored by Chubb, was most notable for its significant size. At USD475 million it was by far the largest transaction of the first quarter and in fact among the largest in the history of the catastrophe bond market. This transaction, which closed on March 7 and priced inside of initial spread guidance provides Chubb with USD225 million of three year protection from the Class A Notes and USD250 million of four year protection from the Class B Notes against hurricanes, severe thunderstorms and earthquakes occurring in the Northeast United States.

- The final transaction of the first quarter, USD100 million Queen Street II Capital Limited served as a modified renewal of Munich Re’s initial Queen Street Capital transaction which matured on March 21, 2011. Notably, Queen Street II Capital Limited, which provides Munich Re with three year protection for U.S. hurricanes and European windstorms, was able to successfully close within the initial spread guidance and at the announced transaction size, notwithstanding the occurrence of the Tohoku earthquake (virtually all investors continued to participate at their pre-Tohoku earthquake pricing and capacity levels) and the release of the RMS U.S. model change, both of which occurred during the Queen Street II Capital marketing period.

**Table 1**  
**2011 FIRST QUARTER TRANSACTIONS – SUMMARY OF TRANSACTION FEATURES**

Issue Date	Transaction/Tranche Name	Sponsor	Trigger	Covered Peril(s)	Transaction / Tranche Term (years)	Transaction Size (MM)	Tranche Rating (S&P / Moody’s)	ROL at Issuance <sup>(1)</sup>
18-Feb-11	Successor X 2011-1 IV-E3	Swiss Re	PCS / Parametric	U.S. HU / Cal Q	3.02	\$160.0	B	9.25%
18-Feb-11	Successor X 2011-1 IV-AL3	–	–	–	3.02	\$145.0	Unrated	13.00%
18-Feb-11	Foundation Re III 2011-1	The Hartford	PCS	U.S. HU	4.02	\$135.0	BB+	5.00%
7-Mar-11	East Lane IV 2011-A	Chubb	Indemnity	U.S. All Perils	3.01	\$225.0	BB+	5.75%
7-Mar-11	East Lane IV 2011-B	–	–	–	4.01	\$250.0	BB	6.65%
22-Mar-11	Queen Street II	Munich Re	PCS / PERILS	U.S. HU / EUWS	3.03	\$100.0	BB-	7.50%

Summary Statistics	Risk Capital	Deal Count
Total Issuance - 2011	\$1,015.0	4

Notes: (1) Expressed as a spread above the applicable benchmark rate  
 GC Securities Transactions

Source: GC Securities Proprietary Database, March 31, 2011

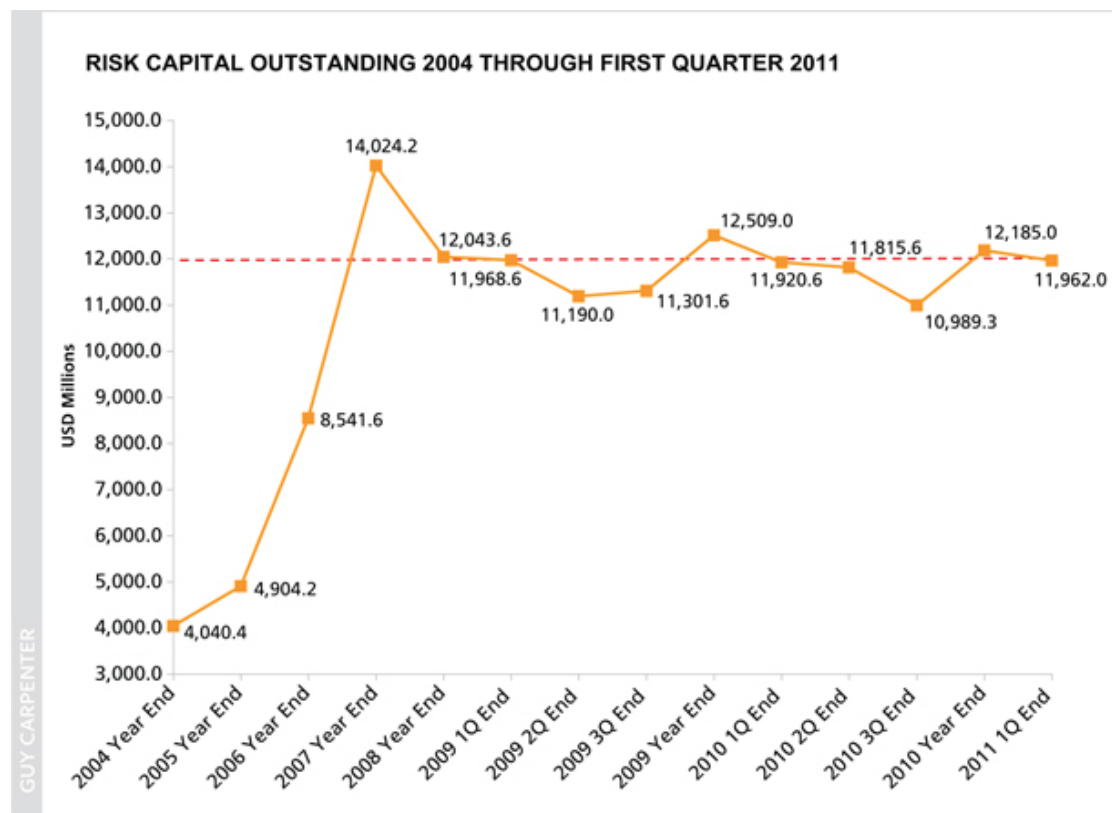
## Catastrophe Bond Redemptions

In the first quarter of 2011, USD1.24 billion of catastrophe bond risk capital matured. USD553 million of this amount was exposed exclusively to European windstorm. Of the remaining USD685 million, two separate transactions of USD150 million each were exposed to California earthquake and U.S. hurricane respectively. The remaining USD385 million, comprised of two transactions, was exposed to multiple worldwide perils including U.S. hurricane and earthquake, European windstorm and Japan earthquake. Notably, the one maturing transaction with exposure to Japan earthquake, USD235 million Atlas Reinsurance IV Ltd., matured in January, well before the Tohoku earthquake struck in mid-March.

## Risk Capital Outstanding

Total risk capital outstanding declined by USD223 million (1.8 percent relative to year-end 2010) during the first quarter despite USD1.02 billion of new issuance. Over the past two quarters, approximately USD3.03 billion of risk capital has been issued. This is the second highest sequential two quarter issuance total in the history of the catastrophe bond market.

Figure 2



Source: GC Securities Proprietary Database, March 31, 2011

## Issuance Composition

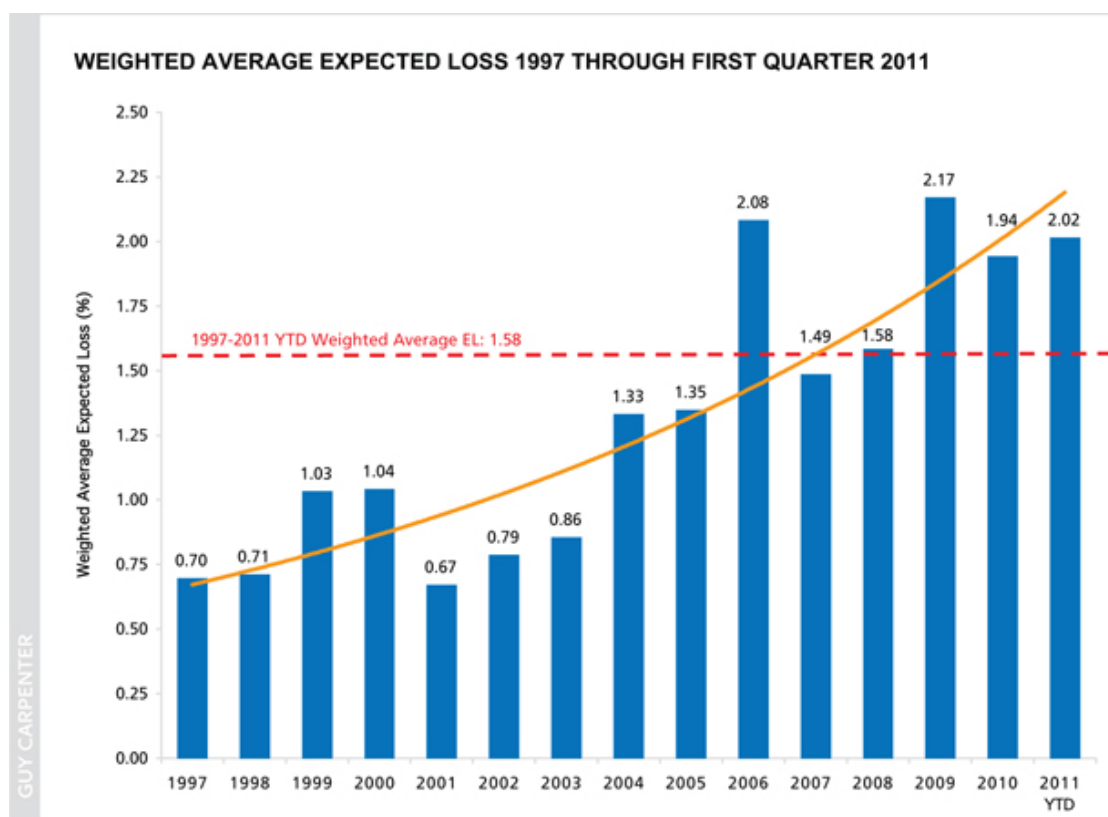
All of the USD1.02 billion issued in the first quarter of 2011 had exposure to the peril of U.S. hurricane. USD135 million was exposed to U.S. hurricane exclusively, USD100 million was exposed to U.S. hurricane and European wind on a joint basis and USD475 million was exposed to Northeast U.S. hurricane, earthquake, thunderstorm and windstorm perils.

## Expected Loss Characteristics

The risk profile of new offerings increased relative to 2010, to a weighted average expected loss of 2.02 percent. While additional new issuance during the balance of the year could reduce the new offerings' expected loss for 2011, we note that the weighted average expected loss from 1997 through the first quarter of 2011 is 1.58 percent and there has only been one year in the last six years where the weighted average expected loss of primary issuance in a calendar year has been less than this long-run mean. This increase in risk profile can be explained by an increasingly

sophisticated and informed investor base, a reduction in the broad based availability of affordable leverage for catastrophe bonds and prevailing reinsurance market conditions. In relatively scarce capacity environments, such as 2006 and the first half of 2009, where minimum clearing spreads tend to increase, protection buyers are inclined to increase the expected loss of each transaction in order to improve price efficiency. In relatively plentiful capacity environments, such as the second half of 2009 and 2010, where minimum clearing spreads tend to decrease, protection sellers (with an improved ability to understand more “in the money” covers) are inclined to prefer riskier transactions in order to achieve target portfolio returns. The fact remains that, relative to the early 2000s, financial leverage for catastrophe bonds is less available, which tends to augment the tendency for higher risk catastrophe bond structures.

Figure 3



Source: GC Securities Proprietary Database, March 31, 2011

It is important to note that the increase in the expected loss of deals brought to the catastrophe bond market and the inclination of catastrophe bond investors to accept riskier transactions in declining premium environments does not imply an easing of the market’s analytical discipline. Nor does it imply a focus reduction on terms and conditions by catastrophe bond market participants. Rather, it signifies an improvement of the catastrophe bond market’s ability to evaluate, understand and, where modeling and disclosure are sufficient, competitively price a more diverse range of perils, risk profiles, structures and triggers. Going forward, this increased sophistication and measured expansion of investor appetite for risk should be a catalyst for productive and healthy long-term growth for the catastrophe bond market.

## **Industry Loss Warranties**

The industry loss warranty (ILW) market hardened significantly during the final weeks of the first quarter. Catastrophes in New Zealand, Australia and Japan have increased demand for additional protections for the remainder of 2011, while the output from RMS RiskLink v11 appears more pronounced than anticipated in all the major hurricane zones of the United States. A period of intense trading immediately following the Tohoku earthquake saw pricing for U.S. wind risk increase by 20 percent (largely due to model concerns) and U.S. earthquake risk increase by 15 percent (largely due to concerns about earthquakes creeping eastward from the Pacific Rim). More recently, however, the market is in a more reflective mood where new capacity is entering the space in an attempt to take advantage of rate increases. This new capacity and an abatement of protection buyer interest have moderated any further price increases and, in the short term, the ILW market pricing is showing signs of remaining stable at current levels.

## **First Quarter Market Dynamics and Outlook for the Balance of 2011**

First quarter market dynamics were altered by the Tohoku earthquake on March 11 particularly in combination with other first quarter losses emanating from flooding and Cyclone Yasi in Australia and the (second) Christchurch which occurred on February 21. Additionally, though to a lesser but still relevant degree, RMS' release of its latest North American hurricane model, RiskLink v11, on February 28, also influenced market opinion on general valuation levels.

During January and February market conditions were generally in line with 2010 year-end expectations and, as mentioned, issuance was exceptionally strong, particularly on the heels of such a strong fourth quarter in 2010. The market's focus very much remained on the size of the issuance pipeline and managing through the more than USD2.0 billion of scheduled maturities set to occur prior to June 30, 2011. From a secondary trading perspective, activity was light, with trading interest driven by some small to medium size accounts seeking to generate liquidity in order to participate/support new transactions from long-standing sponsors. The East Lane IV Ltd. transaction in particular, due to the market's perception of pricing, regional risk profile and Chubb as a high quality sponsor for an indemnity triggered transaction, was particularly well received. Once expectations of the potential for upsize began to firm, some investors did look to exit existing positions in order to support larger East Lane IV orders. Deal specific trading aside, however, activity was light as catastrophe bond buyers continued to outstrip sellers, particularly for diversifying perils, non-U.S. Texas to Maine wind exposed catastrophe bonds and for the (relatively few) transactions carrying higher coupons.

In the aftermath of the Tohoku earthquake the market's focus shifted to evaluating the probable impact of the event on existing catastrophe bonds and, to a lesser extent, on the implications for future issuance. Approximately USD1.43 billion of catastrophe bonds, consisting of fifteen individual classes from ten separate transactions associated with six sponsors, have exposure to Japan earthquake risk. In terms of risk capital, the USD1.43 billion of catastrophe bonds represented approximately a 12 percent share of the USD11.97 billion of natural peril exposed catastrophe bonds outstanding at March 31, 2011. Due to differing trigger designs and other structural features, the principal at risk in each of these bonds from the Tohoku earthquake differs significantly.

**Table 2A**

JAPANESE EARTHQUAKE EXPOSED CATASTROPHE BONDS, AS OF MARCH 31, 2011  
 Total Return Comparison (ILS vs. BB Corporates vs. S&P 500)

Bond Name (Issue Month/Year)	Sponsor	Modeling Firm	Notional Amount (USD, M)	Maturity	Structure	Trigger Type
<b>Japan Earthquake Only</b>						
Midori (10/07)	East Japan Railway	EQECAT	\$260.00	Oct 2012		Parametric
Muteki (5/08)	Zenkyoren	AIR	\$300.00	May 2011	Drop down feature	Parametric
<b>Multi Peril (Including Japan Earthquake)</b>						
Atlas VI (12/09) (Euro 75m)	SCOR	RMS	\$107.50	Apr 2013	Second event	Parametric
Atlas VI (12/10) (Euro 75m)	SCOR	RMS	\$99.40	Apr 2014		Paradex (modeled industry loss)
Montana Re 2010-E (12/10)	Flagstone	RMS	\$60.00	Jan 2014		Paradex (modeled industry loss)
Successor X 2010 BY3 (3/10)	Swiss Re	EQECAT	\$40.00	2013		Parametric
Topiary Capital (8/08)	Platinum	RMS	\$200.00	2011	Second event	Parametric
Valais Re Class A (5/08)	Flagstone	RMS	\$64.00	Jun 2011	Aggregate events	Indemnity
Valais Re Class C (5/08)			\$40.00			
Vega Capital Ltd. 2008-I Class A (6/08)	Swiss Re	EQECAT	\$21.00	2011	Aggregate events	Modeled loss
Vega Capital Ltd. 2008-I Class B (6/08)			\$22.50			
Vega Capital Ltd. 2008-I Class C (6/08)			\$63.90			
Vega Capital Ltd. 2008-I Class D (6/08)			\$42.60			
Vega Capital Ltd. 2010-1 Class C (12/10)	Swiss Re	EQECAT	\$63.90	2011	Aggregate events	Parametric
Vega Capital Ltd. 2010-1 Class D (12/10)			\$42.60			
<b>Total</b>			<b>\$1,427.40</b>			

Source: Transaction Documents, Public Disclosures

Table 2B

JAPANESE EARTHQUAKE EXPOSED CATASTROPHE BONDS, AS OF MARCH 31, 2011 (continued)  
Total Return Comparison (ILS vs. BB Corporates vs. S&P 500)

Bond Name (Issue Month/Year)	Main JPEQ Parameter	Period for Loss Determination <sup>(1)</sup>	Trigger Assessment	Rating Action (if any)
<b>Japan Earthquake Only</b>				
Midori (10/07)	JMA magnitude	5BD after JMA Monthly Report issuance (20th of the following month)	JMA magnitude figure is available for index calculation. Unlikely triggered since its covered area is within 70 kilometers from Tokyo.	
Muteki (5/08)	K-net PGA	Notice: 35CD after EQ Report: 30CD after Notice	K-net site was inaccessible and resumed on March 15. Missing data were added on March 30.	Moody's downgrade Ba2 to C
<b>Multi Peril (Including Japan Earthquake)</b>				
Atlas VI (12/09) (Euro 75m)	K-net PGA	Notice: 25BD after EQ Report: 40BD after Notice	K-net site was inaccessible and resumed on March 15. Missing data were added on March 30.	
Atlas VI (12/10) (Euro 75m)	Spectral acceleration	Notice: 25BD after EQ Report: 45BD after Notice	RMS will calculate the Paradex figures, subject to an event notice from SCOR	
Montana Re 2010-E (12/10)	Spectral acceleration	5 BD prior to first payment day following Paradex publication within 40BD	RMS will calculate the Paradex figures to judge if the first event is hit. Flagstone delivered an activation notice to RMS.	S&P Negative watch
Successor X 2010 BY3 (3/10)	JMA Shindo (seismic intensity)	Notice: 35CD after EQ Report: 90CD after Notice	JMA Shindo figures are available for index calculation.	
Topiary Capital (8/08)	K-net PGA	40CD after Event Notice	K-net site was inaccessible and resumed on March 15. Missing data were added on March 30. Platinum delivered an activation notice to RMS.	S&P Negative watch
Valais Re Class A (5/08) Valais Re Class C (5/08)			Losses subject to franchise deductible. It will take some time to assess the ultimate net loss. New Zealand EQ in Feb may also be counted for the aggregate calculation for Class A.	
Vega Capital Ltd. 2008-I Class A (6/08) Vega Capital Ltd. 2008-I Class B (6/08) Vega Capital Ltd. 2008-I Class C (6/08) Vega Capital Ltd. 2008-I Class D (6/08)	JMA Shindo, JMA magnitude, maximum wind speed		EQECAT will calculate the modeled loss figures, subject to an event notice from Swiss Re	
Vega Capital Ltd. 2010-1 Class C (12/10) Vega Capital Ltd. 2010-1 Class D (12/10)	JMA Shindo	Notice: 35CD after EQ Report: 90CD after Notice	JMA Shindo figures are available for index calculation.	Moody's Negative watch

Note: <sup>(1)</sup>CD = Calendar Days, BD = Business Days

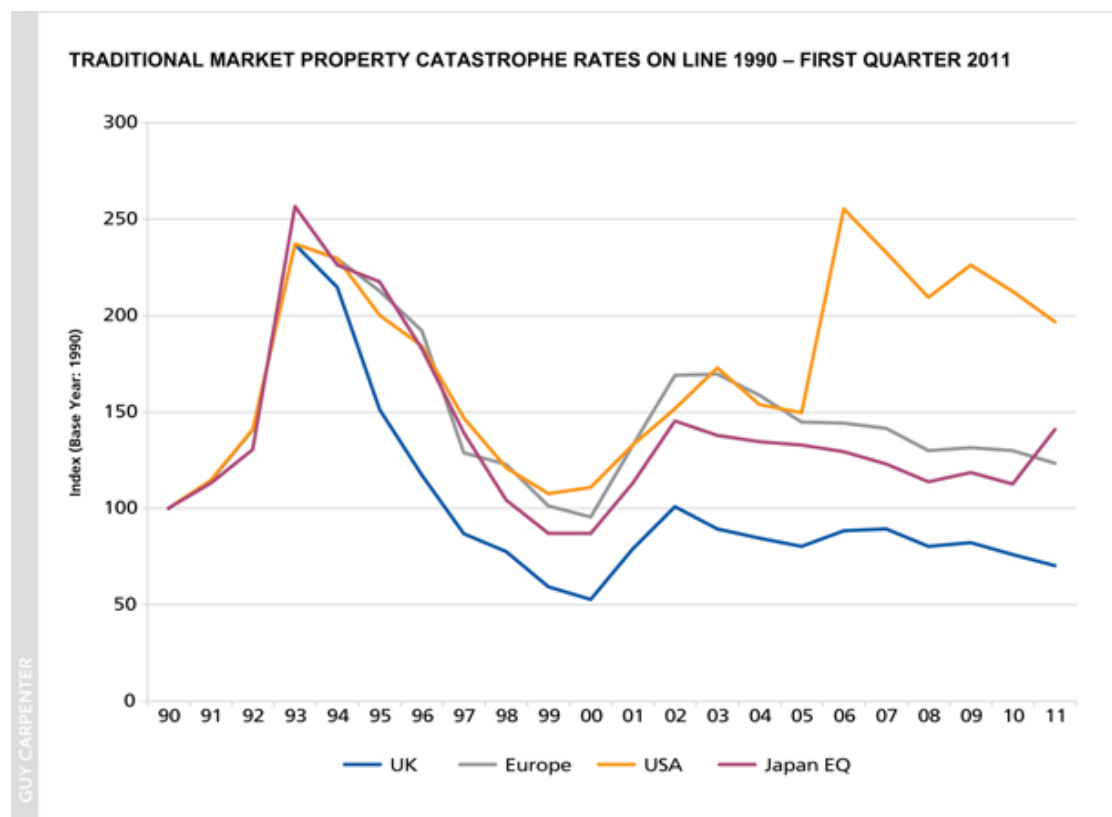
Source: Transaction Documents, Public Disclosures

In the immediate aftermath of the Tohoku earthquake the secondary market was able to maintain good order as the loss implications and expectations were digested and priced into the most likely exposed bonds. Muteki Ltd., a USD300 million catastrophe bond

(ultimately benefitting Zenkyoren) which utilizes a parametric trigger based on ground motion measurements via K-Net, quickly arose as investors' primary bond of interest. During the days following the earthquake event until additional information concerning the stations' readings became available (and confidence increased about the likelihood of a partial or total loss), the Muteki bond did continue to trade. Importantly, throughout the discovery process, there remained a consistent bid in the market, and while in many cases these bids were put forth at distressed levels by non-core cat bond investors; the continuous presence of liquidity throughout a period of significant uncertainty is further evidence of the maturation of the cat bond market.

Multi-peril bonds with exposure to Japan earthquake risk also traded down during March, reflecting mark to market losses on aggregate transactions and formerly second event bonds that are now "activated" and exposed to first event losses going forward. Marks on non-Japan earthquake exposed catastrophe bonds were affected as well due to concerns about reinsurance rates globally in light of the first quarter 2011 loss activity and impact of the RMS RiskLink v11 release. The loss activity of 2011 thus far, while not expected to be a "capital" event for the industry, has, in many cases, exhausted reinsurers' annual catastrophe risk budgets – even prior to the onset of U.S. wind season. Renewals at June 1 and July 1 will demonstrate how reinsurers are reacting to the first quarter 2011 headwinds.

Figure 4



Source: Guy Carpenter & Company LLC, March 31, 2011

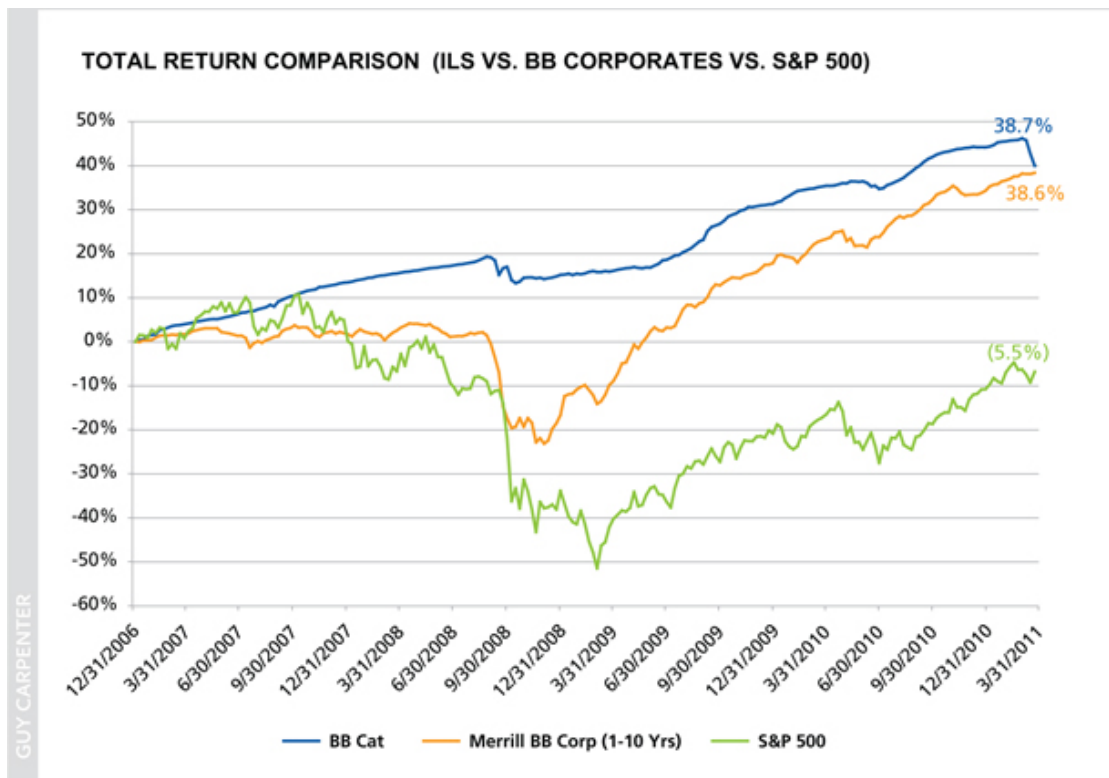
We note that while capacity sellers have sustained significant losses during the first quarter, Guy Carpenter estimates that going into 2011 the industry was carrying

approximately USD19 billion of excess capital. However, the prospective rate environment is less certain than it was at January 1.

The range of opinions associated with the prospective rate environment in the traditional market is contributing to increased uncertainty with respect to catastrophe bond issuance for the second quarter and balance of 2011. While on the one hand, significant catastrophe activity should serve to increase the perceived value of multi-year collateralized protection in the eyes of protection buyers, concerns about cat bond market pricing and capacity still remain. Some sponsors have elected to take a wait and see approach (putting planned pre-U.S. wind season transactions on hold) while paying close attention to the pricing environment in the traditional market leading up to the June 1 renewals.

On balance, it is apparent that protection buyers do continue to recognize the value of the catastrophe bond market and the features of catastrophe bond protection. Features such as full collateralization and multi-year protection are recognized in an increasingly explicit sense during the transaction evaluation process. Relative "all-in" pricing is critical, as it reflects the additional benefits of catastrophe bond protection as well as transaction costs, when comparing the traditional and catastrophe bond markets. To the extent the catastrophe bond market, in this particular environment, can demonstrate coordination and a reasonable level of consistency with the traditional market, it would provide a measure of assurance to protection buyers currently contemplating new transactions. It is also worth noting that while the returns on outstanding catastrophe bonds did have a negative month (due to mark-to-market effects reflecting potential losses, etc.) during March, the long-term cumulative return profile does still compare favorably to alternative asset classes.

Figure 5



Source: Bloomberg

With respect to activity in the third and fourth quarters, it seems reasonable to expect that Asia-Pacific issuers will have an increased need for protection and potentially could be more appreciative of the value of multi-year fixed spread protections. The Tohoku event has also provided an opportunity for market participants to identify structural improvements for future transactions that should improve transparency, reduce basis risk and improve post event loss determination processes going forward. With respect to other perils (particularly European windstorm), the prevailing rate environment, the continued expansion of the PERILS database and other trigger enhancements should still present value to both protection buyers and sellers and therefore additional issuance from these regions would not be surprising. Finally, while in recent years the catastrophe bond market has been predominantly utilized by primary companies, it is possible that rating agency and capital concerns, scarcity with respect to traditional retrocession covers and a desire to structure more certain multi-year capacity, could prompt reinsurers (as a group) to return to the market during the balance of the year.

At the beginning of 2011 consensus estimates pegged expected issuance for the year at between USD5 billion and USD7 billion. By and large those estimates were re-confirmed at the recent SIFMA Insurance-Linked Securities conference, which is widely attended by industry participants. With over USD1 billion of issuance already and positive underlying market fundamentals, the chances of reaching at least the low end of these issuance totals is still feasible. Relative pricing between traditional and capital markets will be important as will the occurrence or non-occurrence of additional catastrophe events.

Finally, it is important to highlight that the sympathies and thoughts of GC Securities and Guy Carpenter (and market participants, generally) are foremost with those personally affected by the Tohoku earthquake, Cyclone Yasi and the Christchurch earthquakes. We note that the catastrophe bond market, by providing consistent and effective protection for these types of events, has an important humanitarian and socially beneficial role in the reconstruction efforts.

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