

### Global Reinsurance – 2006 Market Review

August 13, 2007

#### Sector

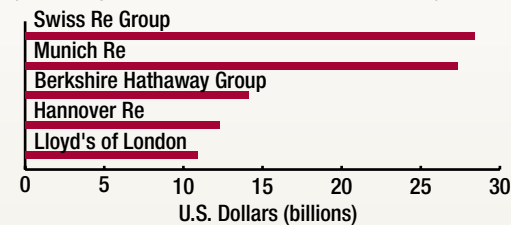
Reinsurance

#### Outlook

Stable

### 2007 Top 5 Global Reinsurers

(Ranked by Consolidated 2006 Reinsurance GPW)



Source: A.M. Best Co.

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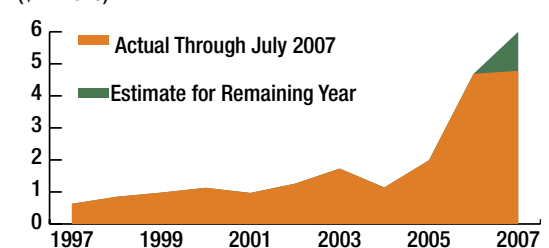
## Reinsurers Turn Cautious As Climate Shifts

While 2007 should be another good year for the global reinsurance sector, A.M. Best believes the outcome depends on how well reinsurers manage catastrophic exposures relative to capital at risk. The softening market and competition, however, are complicating prospects for beyond 2007. Also covered in this report are.

- **Top 35 Reinsurers**—Swiss Re Group edged out Munich Re for the top position in the 2007 ranking of the top 35 global reinsurers.
- **Lloyd's and the London Market**—The markets cannot ignore the need to update antiquated business processes, or the deteriorating rating environment and strengthening competition.
- **Mergers and Acquisitions**—Significant activity took place in the past two years, but future transactions are likely to be defensive.
- **Bermuda**—As competition heats up and the hurricane season matures, A.M. Best looks at reinsurers' ability to maintain pricing discipline and strong capital management.
- **Asia/Pacific**—Market is poised to enter global stage due to competition and softening rates.
- **Life Reinsurance**—Era of high profits for low-risk solutions is over. Reinsurers looking to grow will focus on lines and markets from which they have shied.
- **European Reinsurance Directive**—While creating opportunities for foreign and EU-domiciled players, it also raises questions for foreign insurers conducting reinsurance through branches.
- **Collateralization Regulation**—Competing interests of domestic and foreign reinsurers were made clear when U.S. insurance regulators proposed relaxation of collateral requirements for unauthorized reinsurers.
- **Florida Hurricane Catastrophe Fund**—Fund is another source of competition, but unforeseen opportunities have emerged to lessen the top- and bottom-line impacts.

• **Securitization**—Capital market participation in reinsurance continues to grow in volume; diversity of perils covered; geographical spread; number of new insurance company sponsors; and types of triggers employed.

### Natural Disaster Cat Bond Growth



Source: A.M. Best Co.



## Global Reinsurance Outlook is Stable, for Now

A.M. Best Co.'s 2007 outlook for the global reinsurance sector is stable, which reflects a change from the negative outlook assigned nearly two years ago. This current outlook implies that the majority of 2007 reinsurer rating actions are likely to be affirmations with stable outlooks and only a modest amount of rating or outlook changes are anticipated. However, should price deterioration and competition persist at a faster pace than expected, the outlook could be revised back to negative in 2008.

This revision follows the very strong 2006 full-year financial performance of companies operating in the global reinsurance sector, with many carriers reporting record earnings. Additionally, although mixed, the January 1 renewal season set the tone for near-term optimism, despite the increased competition primarily associated with non-catastrophe-exposed business lines. In 2006, adverse development on older casualty years slowed considerably for the majority of carriers, and the only meaningful noise of the year was adverse development relating to the 2005 hurricanes.

### Sector Poised for Profitable 2007

It is A.M. Best's expectation that the sector is poised for a profitable 2007, given the potential for favorable underwriting margins in many lines of business and reinsurers' reporting strong operating cash flow that will likely fuel investment income generation. Moreover, reinsurers are entering this softening phase of the market with replenished balance sheets due to earnings and improved loss reserving positions. While A.M. Best expects that 2007 should be another good year for the sector, the outcome, as always, will be based on how well reinsurers manage their catastrophic exposures relative to capital at risk, given that the benign catastrophe season is unlikely to be repeated in 2007.

The optimism for longer-term robust performance from the reinsurance sector is somewhat dimmed due to the resounding sentiment that market conditions will continue to deteriorate, particularly for non-catastrophic-exposed business lines.

Additionally, many cedants enjoying the strongest industry results in decades continue to retain more risk, thereby reducing the overall demand for reinsurance. With only recent history to serve as a guide, it is critical for participants to remember how quickly the good times can turn sour should the next unforeseen mega-event unleash itself on the industry.

## A.M. Best Company Special Report

August 13, 2007

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The issues with maintaining underwriting margins in light of increased competition will depend largely on how reinsurers monitor loss-cost trends in key business segments and manage risk profiles. After the calm of 2006, the majority of reinsurers improved their respective risk profiles by managing aggregate exposures while beginning to fully embrace the concept of enterprise risk management. Nevertheless, it is A.M. Best's expectation that reinsurers will have their capital management strategies tested relative to how they deploy capital while managing to garner adequate risk-adjusted returns through this next market phase. The perceived level of excess capital already has spawned an increase in share buy backs and fueled speculation about merger and acquisition strategies.

### Florida Cat Fund and Capital Markets are Wild Cards

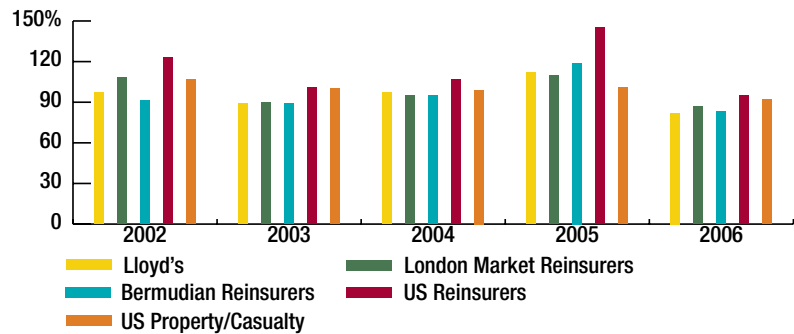
The July 1, 2007 renewal season was expected to be moderately calm for catastrophe risks, with continued casualty price softening. However, a new wrinkle was thrown into the mix by the recent legislation changes in Florida that include the near doubling of capacity provided by the Florida Hurricane Catastrophe Fund (FHCF). Although industry experts now forecast that the premium revenue impact to the sector will not be as onerous as originally predicted, there remains the potential that as catastrophe

### Swiss Re Takes Top Global Reinsurer Slot

On this 10th anniversary of A.M. Best's Global Reinsurance Report, Swiss Re Group edged out Munich Re for the top position in our 2007 ranking of the top 35 global reinsurance groups based on 2006 gross premiums written (GPW). For the fifth consecutive year, Swiss Re and Munich Re, Berkshire Hathaway Group, Hannover Re and Lloyd's of London comprised the top-five reinsurance underwriters, with each consolidated underwriting group topping the \$10 billion mark in annual reinsurance GPW.

The shift in the top two ranks was due to Swiss Re's (No. 2 last year) June 2006 acquisition of GE Insurance Solutions (GEIS was part of GE Global Insurance

### Exhibit 1 Major Markets – 2002-2006 Combined Ratios



Note: 2006 for the London Market Reinsurers is estimated. 2002-2003 figures for the Bermudian reinsurers based on reinsurance business only.  
Source: A.M. Best Co.

premiums move to the FHCF, reinsurers may be forced to shift their capacity to non-catastrophe-exposed business, further stimulating pricing competition in across the market.

Another wild card going into 2007, and beyond, is the potential effect that billions of dollars of additional and alternative forms of capital sourced from hedge funds and the capital markets will have on the competitive landscape. Since 2005, sidecar formations, catastrophe bonds and industry loss warranties (ILWs) have offered options alternatives to traditional reinsurance capacity. How this capital is deployed in the future will clearly affect underwriting margins and reinforce the importance of reinsurers holding the line on pricing and policy terms.

Holdings, No. 6 last year). Joining RGA Reinsurance Co, Everest Re and the top five reinsurers, Transatlantic Holdings Inc Group, SCOR Group and Partner Re Group moved into the top 10, replacing GE Global Insurance Holdings and overtaking XL Capital and London Reinsurance Group.

Some of the shift in rankings can be attributed to the enhanced risk management practices employed by reinsurers post 2005. For some insurers, these risk management efforts resulted in a decline in property premium writings and redeployment of capital focusing on casualty business despite price softening. However, other reinsurers took advantage of the hardened U.S. property rates, which

increased their premium writings and rankings.

Ranked by 2006 reinsurance GPW in U.S. dollars, 2007's top five groups accounted for 59% of total GPW for the aggregate top 35, up from a market share of 52% the year before. In dollars, the top five had total GPW of \$93.0 billion, up from \$82.6 billion the prior year, but the increase was accounted for by a combination of the decline in the value of the U.S. dollar against the Swiss franc, euro and pound sterling, and by Swiss Re's GEIS acquisition.

Restating the latest GPW using the prior year's currency exchange rates, the top five reinsurers' aggregated 2006 GPW would have been \$85.7 billion, just \$3.1 billion above 2005's level.

While currency volatility did not affect the ranking of the top five reinsurers, lower rankings did shift, and some reflected exchange rate changes. The currencies with the biggest changes against the U.S. dollar were: the pound sterling, up 13.8%; the euro, up 11.5%; the Australian dollar, up 8.1%; the Swiss franc, up 7.9%.

## Top 35 Global Reinsurance Groups

Ranked by consolidated gross premiums written in 2006.  
(US\$ Millions)

2007 Ranking	Group Name	Prior Rankings <sup>1</sup>					Consolidated Premiums		Total Shareholder Funds	Ratios		
		2006	2005	2004	2003	2002	Gross	Net		Loss	Expense	Combined
1	Swiss Re Group <sup>2</sup>	2	2	2	2	2	\$28,415	\$25,808	\$25,340	63.6%	31.5%	95.1%
2	Munich Re	1	1	1	1	1	\$27,337	\$25,453	\$34,894	65.5%	33.8%	99.3%
3	Berkshire Hathaway Group	3	3	4	3	3	\$14,126	\$13,474	\$108,419	N/A	N/A	74.6%
4	Hannover Re	4	4	3	4	5	\$12,265	\$9,361	\$4,629	73.7%	27.5%	101.2%
5	Lloyd's of London	5	5	5	5	6	\$10,887	\$8,726	\$26,121	50.7%	30.2%	80.9%
6	RG&A Reins Co	9	12	15	15	17	\$4,732	\$4,346	\$2,815	N/A	N/A	N/A
7	Everest Re Group	10	8	8	13	15	\$4,001	\$3,876	\$5,108	63.2%	26.5%	89.7%
8	Transatlantic Hldgs Inc Group	11	9	12	11	13	\$3,983	\$3,633	\$2,958	68.3%	27.9%	96.2%
9	SCOR Group	14	13	7	7	8	\$3,875	\$3,620	\$2,975	66.2%	33.0%	99.1%
10	Partner Re Group	12	10	13	14	14	\$3,734	\$3,689	\$3,786	55.0%	29.9%	84.8%
11	XL Capital	7	7	9	9	11	\$3,682	\$2,960	\$10,131	55.1%	28.3%	83.4%
12	Korean Reins Co <sup>3</sup>	13	16	17	18	21	\$3,413	\$2,373	\$573	N/A	N/A	N/A
13	London Reins Group	8	14	14	12	12	\$3,287	\$2,979	\$615	N/A	N/A	N/A
14	Assicurazioni Generali SpA	27	31	30	19	22	\$2,853	N/A	\$13,778	N/A	N/A	N/A
15	Odyssey Re Group (Fairfax)	15	15	16	16	24	\$2,336	\$2,161	\$2,084	66.7%	27.8%	94.5%
16	Scottish Re	16	—	—	—	—	\$2,177	\$1,842	\$1,057	N/A	N/A	N/A
17	Aegon <sup>4</sup>	17	28	25	26	18	\$2,146	\$1,203	N/A	N/A	N/A	N/A
18	Converium Group	18	11	11	10	10	\$1,981	\$1,852	\$1,846	65.1%	31.4%	96.4%
19	RenaissanceRe	21	27	27	24	35	\$1,944	\$1,530	\$3,280	29.2%	25.5%	54.7%
20	Mapfre Re	26	26	32	35	33	\$1,898	\$1,300	\$854	58.6%	34.4%	93.0%
21	ACE	20	19	23	28	31	\$1,841	\$1,824	\$14,278	50.5%	23.5%	74.1%
22	Endurance Specialty Ins Ltd	25	21	21	33	—	\$1,790	\$1,586	\$2,298	50.5%	31.0%	81.5%
23	Arch Reins Ltd	23	23	20	32	—	\$1,704	\$1,365	\$3,591	52.2%	28.5%	80.7%
24	White Mountains Re	19	18	26	29	34	\$1,625	\$1,290	\$5,059	71.3%	30.8%	102.0%
25	PARIS RE (AXA Re Group) <sup>5</sup>	24	29	10	8	9	\$1,550	N/A	\$2,091	N/A	N/A	76.0%
26	Axis Capital Holdings Limited	30	34	—	—	—	\$1,539	\$1,529	\$4,413	56.8%	20.8%	77.6%
27	Platinum Underwriters Group	22	22	31	21	—	\$1,275	\$1,177	\$1,858	56.9%	26.7%	83.6%
28	Toa Reins Group <sup>3</sup>	32	30	22	20	23	\$1,198	\$1,010	\$1,473	60.9%	27.9%	88.8%
29	Aspen Insurance	31	33	28	—	—	\$1,185	\$1,029	\$2,389	48.5%	30.0%	78.5%
30	QBE	28	24	18	23	25	\$1,159	N/A	\$5,011	N/A	N/A	N/A
31	W.R. Berkley	—	35	33	—	—	\$941	\$893	\$3,335	72.0%	27.8%	99.8%
32	American Ag	—	—	—	—	—	\$837	\$429	\$485	85.2%	17.6%	102.8%
33	Montpelier	35	—	—	—	—	\$728	\$579	\$1,493	29.6%	30.7%	60.3%
34	Harbor Point	33	32	34	—	—	\$643	\$590	\$1,462	43.7%	49.1%	92.8%
35	Allied World	—	—	—	—	—	\$573	\$572	\$2,220	55.5%	26.6%	82.1%

<sup>1</sup> Rankings based on prior year gross written premiums. Excluded are state-sponsored reinsurers.

<sup>2</sup> Premiums are pro forma, including those of GEIS in 2006 prior to acquisition in June 2006 (GPW of \$2,325.9 million, NPW of \$1,948.5 million); ratios and shareholders' equity are per Swiss Re 2006 annual report.

<sup>3</sup> Year-end is March 31, 2007

<sup>4</sup> A.M. Best estimate based on statutory filings.

<sup>5</sup> PARIS RE closed on AXA Re Group in December 2006. Numbers shown are pro forma per PARIS RE as to what the company would have looked like for full year ended 12/31/06.

Note: Mapfre Re's ranking, based on additional information received from the company, was revised from an earlier version published in *Best's Review* magazine, August 2007. (N/A) - Information not applicable or not available at time of publication.

Source: A.M. Best Co.

## Lloyd's and London Market Face Future Challenges after Exceptional Year

Although 2006 stands out as an exceptional year for Lloyd's and the London market reinsurers, a more challenging environment lies ahead. The London market as a whole has good reason to face the future with confidence; nevertheless, the need to update antiquated business processes, as well as a deteriorating rating environment and strengthened competition from other markets, cannot be ignored.

It is interesting to observe how the recent performance of Lloyd's and the London market compares with other markets around the world. **Exhibit 1** shows how the combined ratio for Lloyd's and a group of London market reinsurance companies compares with other major markets in the period 2002 to 2006. Generally, Lloyd's and the London reinsurers compare favorably, producing underwriting results at least comparable to Bermuda's. In 2005, the U.S. hurricane losses had somewhat less impact on the two London-based markets than on Bermuda, reflecting the relatively concentrated catastrophe portfolios written by many Bermudian companies.

All the major markets had a strong year in 2006, particularly Lloyd's with a combined ratio of 82%. Further ahead, A.M. Best believes catastrophes will continue to affect the performance of Lloyd's and the London reinsurers, but the fluctuations in performance will be less than in the past. The market is likely to benefit from the introduction of the risk-adjusted capital adequacy regime (Individual Capital Adequacy Standards) by the U.K. regulator, the Financial Services Authority. Lloyd's has restructured and is now subject to more rigorous internal oversight from the Franchise Performance Directorate formed in 2002.

The United Kingdom has made a major contribution to catastrophe claims in 2007. In January, windstorm Kyrill caused widespread damage in the country and in Germany, but these losses will be eclipsed by the cost of the U.K. flooding in June and July. Although A.M. Best believes that much of the cost for the floods will be met by primary insurers, inevitably reinsurers will also be called upon.



**RIISING FLOOD WATERS** threatened homes and businesses in Oxford, U.K., and forced dozens of university students to evacuate Oxford University on July 25, as surging waters from the country's worst floods in 60 years pushed through the Thames Valley.

AP Photo/Chris Ison

### Competition

Since the formation of the "Class of 2005" Bermudian companies in the wake of the 2005 hurricane losses, speculation has heightened about the competitive position of the London market. Although start-up activity in Bermuda slowed after the immediate post-2005 catastrophe period, some significant new companies were formed in Bermuda in 2006 and the first half of 2007, including CastlePoint Reinsurance Co. Ltd., Ironshore Reinsurance Ltd. and PARIS RE Bermuda Ltd. With respect to regulation and taxation it is impossible for the market to confront Bermudian competition head on because both factors are beyond the control of reinsurers.

Over the past year, certain companies with significant Lloyd's operations have also moved to the island, with Hiscox Ltd., Omega Insurance Holdings Ltd. and Kiln Ltd. joining Catlin Group Ltd., which has been there since 2002. These moves have not led to a direct loss of business for Lloyd's. The motivation for the moves has been complex, including financial benefits as well as a desire to operate internationally.

This need not be a threat to Lloyd's. Indeed, the number of long-standing Bermudian companies that operate in the market demonstrates the continuing attractions of Lloyd's, with its access to a broad range of international business and relatively low capital requirements. More Bermudians are coming. In May, Validus Holdings Ltd. announced its planned acquisition of Talbot Holdings Ltd. Through its subsidiaries, Talbot manages and provides the capital for Lloyd's Syndicate 1183. Two months later, Ariel Holdings Limited, another of the "Class of 2005" Bermudian companies, announced its takeover offer for Atrium Underwriting plc. Atrium is the non-operating holding company of Atrium Underwriters Limited, the managing agency of Lloyd's Syndicate 570 and Lloyd's Syndicate 609. A.M. Best believes that one or two more moves of this kind are likely, with new Bermudian companies seeking wider access to business than Bermuda can provide with its emphasis on U.S.-exposed business, particularly property catastrophe business.

Several companies have also formed sidecars, principally with a view to providing dedicated reinsurance or retrocessional capacity against a backdrop of restricted supply in these markets. Partly with similar objectives, many insurers and reinsurers are looking at capital market products to provide catastrophe protection. London market operations have been active here. Late in 2006, Panther Re Bermuda Ltd. was formed as a sidecar for Lloyd's Syndicate 33 (managed by Hiscox Syndicates Ltd.), and Brit Insurance Ltd. announced in June 2007 that it would be using capital markets to provide protection for certain remote catastrophe events.

On the face of it, these moves present a challenge to traditional providers of catastrophe protection. However, the activity in capital markets has developed against a background of limited supply in the traditional market. The expansion of the Florida Hurricane Catastrophe Fund and easing market conditions in the catastrophe market

as a whole are likely to reduce the need for sidecars, which in any case are limited-life vehicles to provide temporary relief for sponsoring companies.

On the other hand, the wider area of catastrophe securitization has become a permanent feature of the market. Capital markets have co-existed for some time with conventional reinsurance as a part of the market for catastrophe protection. A.M. Best believes this is likely to continue for the foreseeable future, although the lack of standardization in the products offered in the conventional reinsurance market naturally tends to limit the penetration of capital markets.

### Market Trends

After some setbacks, London is finally making tangible improvements in its business processes. The emphasis has changed since the failure of Kinnect Ltd., the Lloyd's-sponsored company that unsuccessfully sought to develop a platform for electronic placing of risks. The objectives are less ambitious now, with Lloyd's committed to clearly delineated work streams designed to achieve the aims set out in its three year plan.

One of the leading problems with Kinnect was that a high level of consensus was required for its plans for a market solution. This time, leading market participants are driving through change, particularly the "G6" group of larger managing agencies. Commercial considerations drive the market participants' priorities. Lloyd's is focused on tackling problems with solutions that will bring practical benefits within a limited time frame. Wider scope projects can be addressed later.

An important area where progress is being made is claims handling. Lloyd's claims handling has been notoriously inefficient, and stories abound of trucks driving around the London area transporting large volumes of paper to different locations for processing. An electronic claims repository has now been created to hold claims files. Increased use is being made of the repository, and Lloyd's plans to move to processing all new claims using this vehicle by the end of the year.

A.M. Best anticipates that further progress will be made with business processes in the London market, with improvement focusing on the placement of risks, claims processing, and the accounting and settlement of financial transactions.

## Capital

Following an 11% increase in Lloyd's central solvency capital in 2006 (see **Exhibit 2**), A.M. Best anticipates a broadly stable position in 2007, with the addition of the Society of Lloyd's junior subordinated loan notes largely offset by repayment of the syndicate loans and Lloyd's GBP 90 million contribution to the transaction between Equitas and National Indemnity Co.

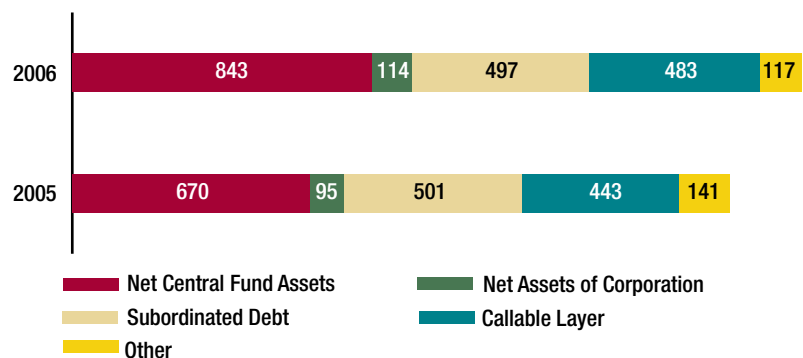
It is always difficult to predict movements in net central fund assets, dependent as the figures are on the impact of insolvent members, particularly large corporate members. However, A.M. Best believes that any future impact from current insolvent members is likely to be manageable. Lloyd's solvency position improved considerably in 2006, with deficiencies covered approximately 8.1 times by central assets (2005: 3.8 times), due to a sharp reduction in solvency deficits.

## Investment Income

The main investment focus of Lloyd's syndicates and London market companies continues to be on fixed-interest securities, despite a trend toward use of other asset classes, including equities. The currency of investments reflects the currency in which business is written, which leads to predominantly U.S. dollar and sterling portfolios. In 2006, there was a modest improvement in returns for U.S. dollar investments, as A.M. Best anticipated, but a decline in return for sterling investments.

The Society of Lloyd's manages different investment portfolios within parameters appropriate for the purpose of each portfolio. The least constrained portfolio is the surplus assets of the Central Fund, which reported a return of 9.9% in 2006, compared with a benchmark return for the portfolio of 7.2%.

## Exhibit 2 Lloyd's – 2005-2006 Central Assets for Solvency (GBP millions)



Source: Lloyd's.

Further ahead, A.M. Best anticipates relatively low investment returns to persist. Reinsurers in the London market will need to remain focused on underwriting returns, because the investment markets are unlikely to compensate for poor underwriting performance.

## Loss Development

Following several years of adverse prior year experience from U.S. casualty business written in the London Market, particularly Lloyd's, A.M. Best believes that a more stable position has been achieved. At year end 2006, Lloyd's reported a prior year surplus of GBP 270 million, incorporating an increase in reserves for the 2005 hurricanes of GBP 415 million. The surplus was related to business written at favorable terms during the period 2002-2004. Perhaps more significant is the stability in reserves achieved on long-tail business written in the soft market between 1997 and 2001. Many of the larger U.S. cases relating to this period have been settled, and it is possible to estimate the level of reserves needed for outstanding cases with greater certainty.

Another positive factor for Lloyd's was a near break-even result for runoff years at year end 2006 (GBP 3 million deficit). This area has been one of the principal sources of reserve problems for Lloyd's, and the turnaround here is another strong signal that Lloyd's is entering the current softening phase in the market cycle without major legacy issues.

## Opportunity, Not Strategy, Drives Recent M&A Activity; Future Moves Likely to be Defensive

Abundant capital and limited opportunities for organic growth, particularly in non-life, normally trigger acquisitions in the reinsurance sector. Although the segment has seen significant merger and acquisition (M&A) activity in the past two years (see **Exhibit 3**), most of the transactions apparently were opportunistic rather than driven solely by an expansion strategy.

The majority of the acquired targets were known to be for sale for a number of years, and the deals seemed to have been struck under the significant influence of the improving financial performance of both acquirers and targets, providing better financial flexibility (i.e. a better acceptance of the transaction by shareholders and capital markets) as well as a reduction in volatility, especially on the side of the acquired.

In the case of GE Insurance Solutions, the previous parent company clearly stated its wish to exit from the (re)insurance business. The same applied to AXA Re, which was sold by AXA, the French financial services group, to a group of private equity investors via a complex deal that also involved a re-branding (to PARIS RE) of the business. Rolf Gerling, the owner of German life reinsurer Revios Reinsurance A.G., had been looking for a buyer for the unit since it was spun off in the aftermath of the financial problems of Gerling Global Re. SCOR ultimately bought Revios Re in September 2006. PRXE, a Bermudian reinsurer, which stopped writing new business following significant losses from the 2005 hurricanes on the U.S. Gulf Coast, was acquired recently by Argonaut group.

Although investment banks always are keen to explore potential new deals (such as a

sale of Munich Re's primary insurance business to Talanx in exchange for Hannover Re), A.M. Best expects that larger transactions are unlikely to be announced during the remainder of 2007. The most significant bid so far this year has been SCOR's offer, launched in February 2007, to acquire Converium. Despite the initial rejection by Converium's management, the hostile offer has been converted into a friendly takeover bid. The acquisition has been successful and SCOR has secured a 96.32% stake in Converium by the end of the additional acceptance period. However, in A.M. Best's view, this mainly non-life deal comes at a time when there is ample capacity in the market that has precipitated softening of rates in most lines of business. It is not yet clear whether the combined group, over time, can achieve the business plan it has communicated to investors.

Some recent acquisitions were driven either by protecting the value of the company (as in the case of Scottish Re, which was acquired by a consortium of Mass Mutual and Cerberus) or by the realization that a certain size is necessary to be able to expand significantly outside the domestic market. The latter applies to Mutuelle Centrale de Reassurance (MCR), a smaller French mutual reinsurer and part of the Monceau group, which recently sold its renewal rights for its international portfolio to Partner Re.

Some other transactions clearly are driven by a need to diversify portfolios, either geographically or by business line. The recently closed acquisition of Talbot Holdings, a Lloyd's managing agency, by Validus Re is evidence of this. A.M. Best believes further acquisitions are likely to be initiated by companies looking to secure their defensive positions in the softening market.

There also appears to be some room for consolidation in the life reinsurance sector. Hannover Re only recently has reiterated its aspiration to acquire another player in the market. It's not clear yet how Hannover Re would finance such a transaction, given its dependence on capital support from its parent company, Talanx AG.

### Exhibit 3 Recent M&A Transactions

Target	Acquirer
GE Insurance Solutions	Swiss Re (closed in 2006)
Revios Re	Scor (closed 2006)
AXA Re	Stone Point Capital et al. (closed 2006)
Scottish Re	Mass Mutual/Cerberus
Mutuelle Centrale de Reassurance	Partner Re (June 2007-purchased MCR's renewal rights for international business)
Validus Re	Talbot Holdings, Lloyd's managing agency.
PRXE	Argonaut (to be closed 3rd Quarter 2007)
Converium	Scor (closed August 2007)

Source: A.M. Best Co.

## Light 2006 Storm Activity Benefits Bermuda Market

The extraordinary results achieved by the Bermuda market in 2006 (see **Exhibit 4**)—primarily the result of low catastrophe losses for the year—while impressive, may prove to be only a short reprieve if the meteorologists' predictions for a hyperactive hurricane season prove correct. The consensus is that the peak of the cycle is now clearly in the rearview mirror.

While the market for the most part has remained rational, the capital that flowed into the industry during 2005 and 2006 is putting pressure on rates and conditions in 2007. As competition heats up and the hurricane season matures, A.M. Best will be looking at companies' ability to maintain pricing discipline and strong capital management.

### Analysis

As 2006 insured losses relating to catastrophes were only a fraction of 2005's losses, the Bermuda market reported a very healthy 2006 combined ratio of 83.7 (see **Exhibit 5**), compared with a catastrophic combined ratio of 119.4 for 2005. The property-catastrophe-oriented Bermuda companies posted the lowest combined ratios in the sector, indicating higher underwriting margins for the year. For property-oriented companies, how-

ever, one year's underwriting gain can be a shortsighted view of success, as gains can be wiped out overnight.

Underpinning the dramatic improvement was the robust level of price improvement attained in 2006 for U.S. catastrophe-exposed business. **Exhibit 6** shows that leading the Bermuda pack for 2006 in net premium written

### What's on Reinsurers' Minds

As Bermuda-based reinsurers began to roll out second-quarter results in late July, several themes reoccurred, including:

- Nature threw the industry a change-up this year, with catastrophes striking in unexpected areas, including U.K. and Australian floods and an earthquake in Japan.
- Ambivalence was the mood regarding the key Florida property market as June and July renewals came and went. Some said it was bad, others not as bad as feared.
- Exchange-rate volatility and shaky debt markets were causing angst among reinsurers' investment managers.
- Consensus emerged that pricing was softening across the board. "Renewal increases were essentially zero" for July 1 renewals, according to PartnerRe Ltd. Chief Executive Patrick Thiele, who saw no change in current trends, while acknowledging that profitable opportunities were few and far between. Joseph V. Taranto, chairman and CEO of Everest Re, was less optimistic about U.S. casualty, an area that reinsurers were counting on as a profitable alternative to the property market. In Tartanto's opinion, as casualty rates continued to decline, ceding companies were keeping more of their net and seeking more favorable terms and rates on their treaties. Ace Ltd. CEO Evan Greenberg noted that Ace's second-quarter reinsurance revenue fell 20% (insurance rose 3%), as the environment for reinsurance, particularly for casualty and non-catastrophe-related property, continued to grow more competitive.

For full article, see [www.ambest.com](http://www.ambest.com), for "The Word from Bermuda," BestWeek Europe, 30 July 2007.

### Exhibit 4

## Bermuda Market – 2004-2006 Key Figure Changes

(\$ Thousands)

	YE2004	YE2005 <sup>1</sup>	% Change	YE2006 <sup>2</sup>	% Change
Total Equity <sup>1,2</sup>	\$44,872,798	\$47,376,590	5.6%	\$66,970,049	24.3%
Net Premiums Written	40,464,550	42,667,076	5.4%	43,837,288	2.7%
Net Premiums Earned	40,146,190	42,027,323	4.7%	42,483,100	1.1%
Net Investment Income	3,538,827	4,467,843	26.3%	6,985,983	56.4%
Net Realized Gains (Losses)	920,122	573,051	-37.7%	-87,510	-115.3%
Losses & LAE	27,671,406	39,013,157	41.0%	23,635,359	-39.4%
Operating Expenses	10,518,618	11,319,445	7.6%	11,934,218	5.4%
Net Income	5,596,173	-3,262,603	-158.3%	11,645,772	n.a.
Loss & LAE Ratio	68.9%	92.8%		55.6%	
Expense Ratio	26.0%	26.5%		28.1%	
Combined Ratio	94.9%	119.4%		83.7%	
Return on Equity	13.9%	-7.0%		19.3%	

(1) - YE 2005 total equity excludes Class of 2005.

(2) - Class of 2005 included in Dec. 31, 2006 total equity and annual change.

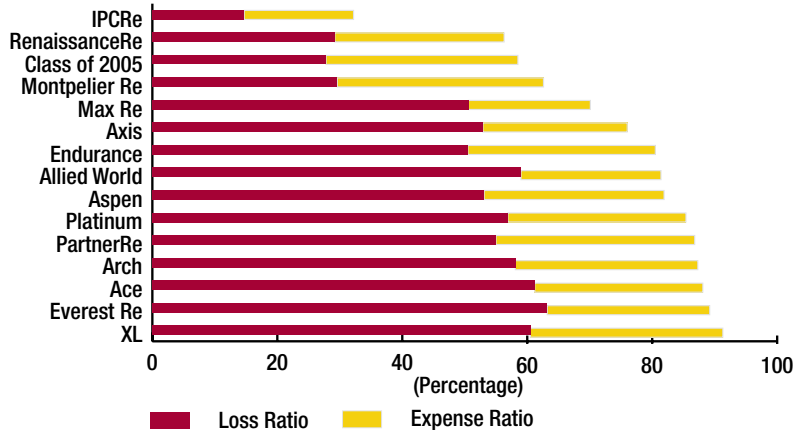
Source: A.M. Best Co.

# Bermuda Non-Life Market 2006

(Exhibits 5-7)

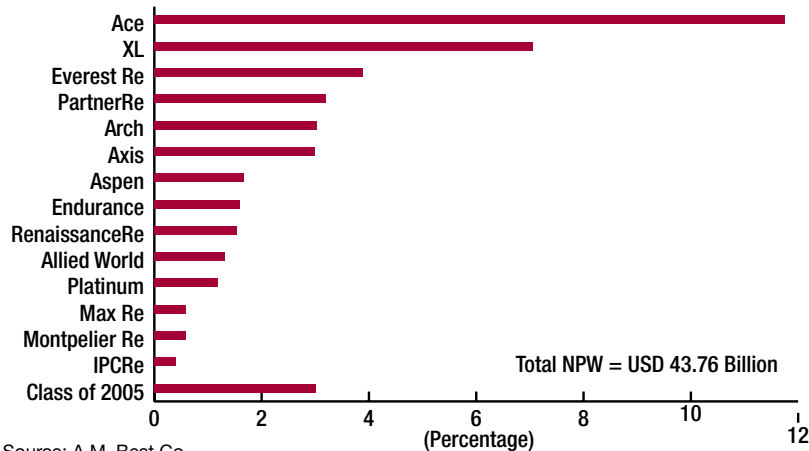
## Exhibit 5 Combined Ratios

2006 (GAAP Basis)



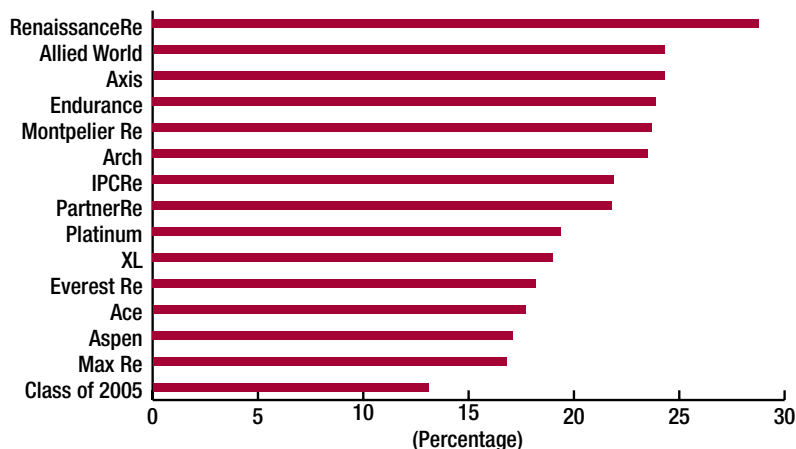
Source: A.M. Best Co.

## Exhibit 6 Net Premiums Written



Source: A.M. Best Co.

## Exhibit 7 Return on Equity



Source: A.M. Best Co.

was Ace, followed by XL Capital, Everest Re and Partner Re.

Firmer prices, combined with the absence of major catastrophe losses and favorable loss-reserve development emerging from the 2003 and 2004 underwriting years, set the stage for one of the most favorable earnings years on record. Underwriting activities alone generated \$6.9 billion of earnings. Combine these with net investment income of \$7.0 billion, and the sector produced a composite return on equity of 19.3% (see Exhibit 7). After taxes and other miscellaneous expenses, net income totaled \$11.6 billion, which net of \$1.4 billion in shareholders dividends was added to the coffers of Bermuda's leading reinsurance and insurance organizations.

The bad news clearly is that the strong performance in 2006 has set the stage for increased pressure on rates as a whole. Property rates in regions exposed to severe catastrophic events likely will continue to fare better. Casualty classes, however, most likely will continue to decline, ideally at a gradual pace. Longer-tailed classes should demonstrate greater strength where expertise with products and superior financial strength keep the bar high and limit the threat from naïve capital.

By the end of 2005, \$7.0 billion of new capacity was deployed for the formation of new reinsurance and insurance companies on the island. In addition, 20 sidecars were formed throughout 2006 with \$4.5 billion of total capital, while elsewhere in the world, catastrophe bond issuances topped \$4.6 billion. All of this capital was poised to reap the benefits of the hardest property catastrophe market since just after Hurricane Andrew in 1992.

Given the increased competitive pressures, A. M. Best believes that the 2005 start-ups will seek alternative business opportunities to fully utilize the capital raised. Strategies that go beyond the constraints of an organization's capital cushion or are not rational from a competitive, operational or intellectual perspective will result in increased execution risk. As such, existing ratings will come under downward pressure. From A.M. Best's perspective the key to successful navigation in 2007 will be a clear focus on capital management and underwriting discipline.

## Asian Market Poised to Enter Global Stage

The Asian reinsurance market, as measured by gross premium written, is comprised of four large markets, each above USD 3 billion—Japan, Australia, Korea, and China; two mid-sized markets (between USD 1 billion and USD 3 billion)—Taiwan and India; with the remaining countries being small markets of under USD 1 billion.

In general, the growth in the overall Asian reinsurance market over the past five years (see **Exhibit 8**) has been supported by robust growth in the non-life market, although pricing is on a downward trend. The Chinese and Indian reinsurance markets have had an additional boost to their high growth from the increased demand from newly licensed primary insurers. Other Asian reinsurance markets that showed high growth, and should continue doing so, are retakaful (a form of reinsurance for takaful) and life and casualty reinsurance. However a different trend can be observed in the Japanese reinsurance market. The size of the Japanese reinsurance market—Asia’s largest at more than USD 10 billion—has not changed in the last five years due to a stagnating non-life market and higher retention rates by direct companies.

**Exhibit 9** also shows the strong growth in net income that the Asian reinsurance companies experienced from 2002 to 2006. However, due to increased competition and capacity in the Asian reinsurance market, A.M. Best expects underwriting income to slow down in 2007. If investment market continues to be favorable, overall profitability will continue to increase at the current pace.

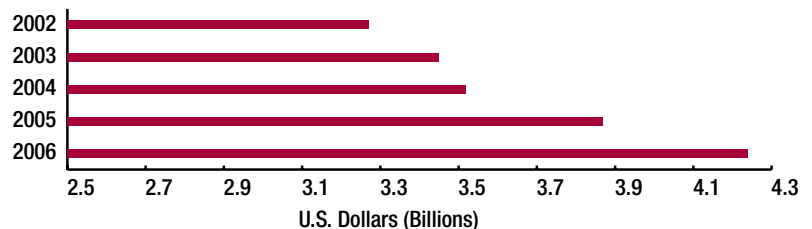
### Profitability Remains Stable

Most Asian countries have a local reinsurer that dominates the proportional business, while foreign reinsurers generally take the lead in non-proportional business. Markets that fall into this category are Japan, Korea, China, India, Taiwan, Hong Kong, Malaysia, Thailand, and Singapore.

Although compulsory cessions to local reinsurers have disappeared in most markets, A.M. Best believes that the dominance of local reinsurers in the proportional market will continue. Market shares of these companies in Asia that are rated by A.M. Best have not

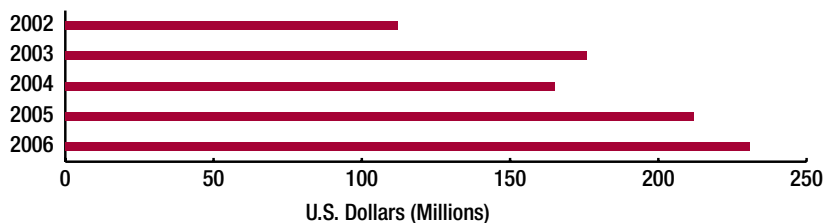
## Asian Reinsurers – 2002-2006 Fiscal Year (Exhibits 8-11)

### Exhibit 8 Net Premiums Written<sup>1</sup>



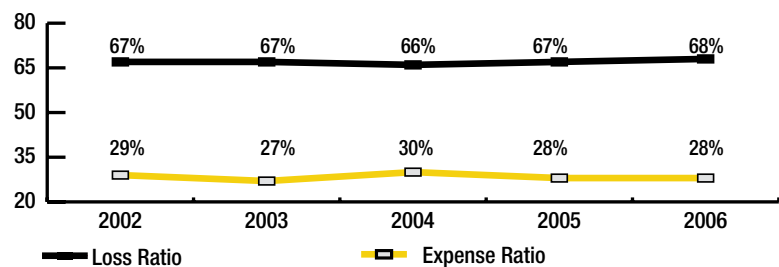
Source: A.M. Best Co.

### Exhibit 9 Net Income<sup>1</sup>



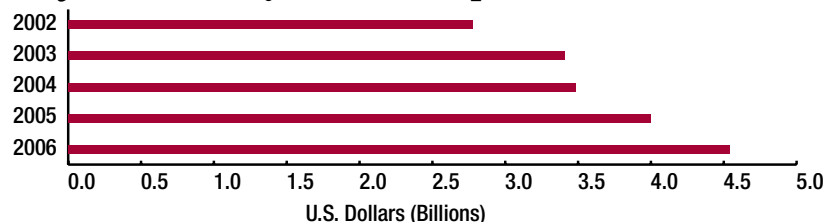
Source: A.M. Best Co.

### Exhibit 10 Combined Ratio<sup>2</sup>



Source: A.M. Best Co.

### Exhibit 11 Adjusted Policyholder Surplus<sup>1</sup>



Source: A.M. Best Co.

<sup>1</sup> All AMBAP-rated reinsurers, excluding General Insurance Corporation of India due to unavailability of 2006 data.

<sup>2</sup> All AMBAP-rated reinsurers, excluding Toa Re (as it is exposed to U.S. and European risk) and General Insurance Corporation of India, as it is obligated to write motor business, which has a very high loss ratio.

eroded over past few years, nor have their business structures changed.

Due to the focus on proportional business, underwriting performance of Asian reinsurers has been as relatively stable compared with reinsurers in other markets (see **Exhibit 10**). Asian reinsurers that were exposed to the U.S. and European markets, however, showed more volatile results.

### **Capitalization Gradually Improves**

Overall, capitalization has gradually improved in recent years (see **Exhibit 11**). There also has been an increasing influx of capacity from outside Asia, which has resulted in a highly competitive reinsurance environment in the region.

As most Asian countries have adopted or are planning to adopt a risk-based solvency regime, risk awareness is increasing in the region. Consolidation is in progress in some markets, and this has increased the ability of direct insurers to retain more business. Asset risk also has reduced significantly in recent years.

As the Asian reinsurers face challenges coming from overseas capacity, as well as from the direct market which is retaining more business, they are forced to expand overseas. Another reason for overseas expansion is the need for risk diversification, as their risk has

been concentrated in one market.

Due to their non-diversified portfolios, Asian reinsurers normally are not exposed to natural catastrophes. A large portion of this risk is retroceded out to foreign reinsurers.

### **Outlook**

Although the growth perspective for the Asian reinsurance market is positive, capacity has increased at a higher pace. As such, A.M. Best expects the market to remain soft in 2007. This softening trend also has been supported by the absence of major catastrophe events in Asia.

Continuation of the soft market is expected to put pressure on operating performance of the Asian reinsurers as they pursue increased profitability through overseas expansion, introduction of new products and take on higher risk in the investment markets.

Companies in the region will put effort into strengthening ties with local insurers in order to maintain their current market presence, which will become increasingly challenging in coming years.

In addition, as the retrocession market is tightening, Asian reinsurers are striving for a greater degree of risk quantification in catastrophe and accumulation risk.

## **For Life Re, Easy Times of High Profits for Low Risk Are Over**

The global life reinsurance market has been growing strongly over the past five years—an impressive trend, considering that the non-life cycle was hardening during this period. Increasing demand from primary insurers under financial strain, due to either the collapsing equity markets or dramatic growth, has helped reinsurers grow their life portfolios faster than their non-life business.

But the market has changed. Strong financial performance of the primary insurers, combined with the “de-risking” of their balance sheets and strong retained earnings, means that the period of high profits for low-risk solutions is over. As such, reinsurers look-

ing to grow will focus on lines and markets that they have shied away from until recently. That is exactly what the largest global composite reinsurers are likely to do given the softening of the non-life rates. (A.M. Best will publish a special report on the U.S. life reinsurance market in near future.)

However, macroeconomic indicators are against them, with increasing interest rates and moderate growth of the gross domestic product in more developed economies. Emerging markets still are a small proportion of reinsurers’ overall portfolio; and the focus in the U.S. protection market, together with a

reappearance of financing treaties in Europe, are likely to be the short-term growth areas. With capital gains—the mainstay for life reinsurers' profitability over the past few years—in decline, A.M. Best expects financial performance to be good but more volatile than in recent years.

Still, not everything is doom and gloom: capitalization is at its highest, and financial flexibility is good. The main question is whether the strong capitalization will lead to reinvestment for growth or to increased acquisition activity. Only the lack of creditable targets diminishes the latter possibility.

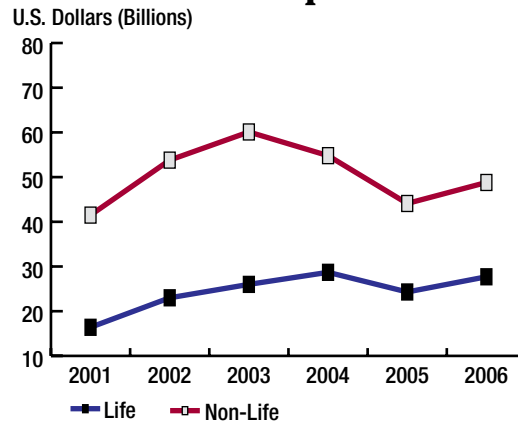
### This is Life...but Not as We Know It

Life reinsurance will continue the strong growth experienced over the past five years; however, the main drivers are changing significantly. A.M. Best estimates that life premium income grew approximately 7% annually during the period 2001 to 2006, with the largest companies benefiting the most (11% for the top six composite insurers). This trend continued through 2006, when life premiums for the top reinsurers grew by a strong 14% after the previous year's decline. The decline in 2005 is attributable mainly to the implementation of International Financial Reporting Standards and the reallocation of some business as non-insurance contracts (see **Exhibit 12**). The increasing focus that composite insurers have been showing on life business is reflected in the growing proportion of such business in their consolidated premiums. As a result, during a period of generally strengthening non-life rates, the proportion of life business in reinsurers' consolidated portfolios increased by five percentage points to 36% in 2006.

This increased focus on life business is likely to continue and indeed accelerate in the near future, especially as moderate but stable returns for the sector become more appealing in the light of softening non-life rates.

The main drivers for the growth, however, are changing dramatically, resulting in a significant change in the risk profile assumed by the reinsurers. The developed European markets have driven most of the recent growth. The significant financial

## Exhibit 12 Top 6 Composite Reinsurers – 2002-2006 Premium Development



Source: A.M. Best Co.

problems faced by the European life insurers resulted in increased demand in the early years of the decade, while significant regulatory changes in several markets helped to reinvigorate demand recently. This is unlikely to be repeated in the near future, as growth in the primary markets has been generated by unit-linked products that traditionally have had limited need for reinsurance.

Indeed, overall cession rates in most reinsurance markets are likely to continue declining due to the combination of improving financial performance at primary insurers, the lower strain of the new products being sold and the continuing consolidation in the primary market. Further, the recent implementation of the European Reinsurance Directive is creating opportunities for smaller reinsurers, as primary insurers are trying to reduce their counterparty risk by increasing the number of reinsurers in their programs.

One of the main growth areas over the next two years is likely to be the U.S. protection market, where consolidation in the reinsurance market is driving rates upward, making them a feasible growth proposition for the more cost-efficient reinsurers.

This probably is the least risky of the strategies for short term growth. In the other developed markets, growth likely will be driven by increased cession of rider business, especially those that up until recently had

not been in part of the reinsurers focus.

Finally, primary insurers' focus on the annuity business is being felt only slowly in the reinsurance market. Typical reinsurers lack the scale necessary to handle this business. In addition, their investment portfolios are far more conservative than those of the primary insurers, thus purely centering reinsurance of annuities on the risk element rather than whole solutions. These risk solutions, therefore, are more sensitive to mortality improvements. That being said, immediate annuities, impaired annuities or, indeed, the mortality element of variable U.S. annuities have been attracting increased attention from reinsurers.

The opportunities arising in emerging markets are likely to have a much longer-term impact, with the only exceptions being some Eastern European markets. Over the longer term, India and China as well as the re-emergence of demand for financing reinsurance are likely to be the main opportunities for growth. Still, whichever strategy life reinsurers choose, either in the short term or over the long run, the risks assumed will increase, especially compared with earlier in the decade when the demand for traditional reinsurance covers was much higher.

### Profits Decline, But No Panic Yet

As market needs have shifted, life reinsurers have been consolidating and restructuring operations to achieve competitive advantage through cost efficiency. Overall administration expenses for the leading reinsurers in A.M. Best's analysis have remained stable at around 5% (see **Exhibit 13**). This ratio has

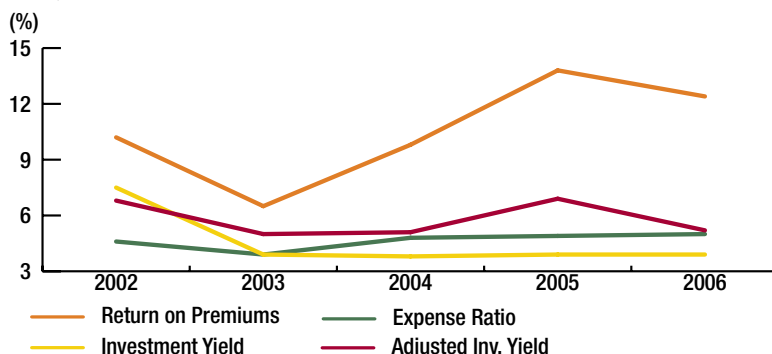
been inflated by the increased integration and one-off restructuring costs, as well as the impact of high growth in treaties with financing elements experienced after 2002. Over the next three years, however, this ratio is likely to fall closer to 4.5%.

The return on premiums ratio remains historically high despite the decline observed in 2006, which was driven by a decline in capital gains. Reinsurers' investment portfolios remain conservative, especially when compared with those of primary insurers, with the majority of assets being bonds. Indeed, cash and bonds account for almost 80% of the investment portfolio of the sample of companies in this report. Major movements over the years are attributable to increased value of shares rather than a strategic reallocation of investments. This, combined with the stability or decline of interest rates over the early part of the decade, has resulted in a strong dependence on capital gains. A.M. Best estimates that almost 6% of a life reinsurer's revenue in 2006 was due to revaluation of invested assets. This has been declining from a high point of more than 10% in 2005, and with the increasing interest rates in most of the developed markets, it is likely to be depressed further.

Marginal profitability of life business, therefore, is likely to come under pressure. On the other hand, absolute profitability is likely to continue growing, considering the increased investment portfolio, with assets having grown by 15% annually over the past five years. In the longer term, rising interest rates and moderate growth of GDP in the developed markets are likely to accelerate reinsurers' focus on higher-risk products as they try to improve financial performance without significant changes in asset allocations. At the same time, these conditions are ideal for financing reinsurance, making it likely that in the next couple of years, this line of business will make a strong return. However, profitability of financing business is typically low, and significant deals tend to distort the accounts of the companies transacting them. Before things get better, A.M. Best expects greater top-line volatility with depression of the bottom line.

Financial performance, therefore, seems to have peaked and is likely to be more volatile in the near future. Top-line growth is likely

Exhibit 13  
**Top 6 Composite Reinsurers – 2002-2006**  
**Key Performance Indicators**



Source: A.M. Best Co.

to become more volatile under the impact of financing agreements, while the bottom-line performance is likely to be depressed by the continuing decline in capital gains.

### Yet Capitalization Is Strong

Strong capital position is shaping the industry. On the one hand the strengthened capitalization of primary insurers results in lower reinsurance demand while on the other hand the improved capital position of reinsurers is motivating their expansion drive. Capital and surplus has grown by a combined 15% over the past five years among the largest composite reinsurers, due to the benign pricing and investment conditions (see **Exhibit 14**).

At the same time, the issuance of hybrid debt has provided additional capital for growth. Even accounting for the increased risk of the lines of business written, the industry has moved significantly from the earlier years of the 21st century, with overall underwriting leverage (consolidated premiums/capital and surplus plus hybrid capital) declining to 1.0 in 2006. Companies, therefore, face increasing pressure to return capital to shareholders or find profitable areas of expansion.

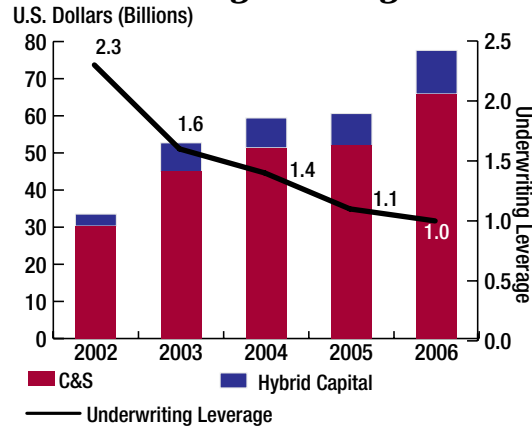
With softening non-life rates and declining ROEs for many non-life lines of business, the reallocation of capital to growth in life

## EU Reinsurance Directive Ties Fragmented Regulations Together

In most European Union (EU) member states, the Reinsurance Directive, finalized in 2005, has made the transition into national law. The directive's main objective is to apply rules similar to those in place for primary insurers. This "freedom of services" principle in the directive allows insurers (and now reinsurers) to do business through a single license from the "home" regulator.

This accomplishment required harmonization of the various supervisory rules across the EU. For example, there was a huge disparity between the regulation of reinsurers in the United Kingdom and Germany, where there were no minimum solvency requirements and only minimal reporting standards. On the other hand, Germany forces life reinsurers to deposit back reinsurers' share of mathematical reserves to

### Exhibit 14 Top 6 Composite Reinsurers – 2002-2006 Capital Structure & Underwriting Leverage



Source: A.M. Best Co.

seems a credible strategy. The question is whether there is enough organic growth to satisfy shareholders. While the answer seems to be negative, at least in the short term, credible acquisition targets are too few to satisfy the growth needs of an entire industry. This limits the strategic options to the organic growth of higher-risk products. In any case, capitalization may be high but will not remain so for too long.

the cedants, creating some liquidity issues for them (see **Exhibits 15** and **16**).

The reinsurance directive also allows member states to draft specific rules regarding the treatment of finite reinsurance and special purpose vehicles (SPVs). When the reinsurance directive was drafted, the treatment of finite reinsurance was an important issue because of the accounting irregularities discovered during the investigations by then-New York State Attorney General, now Governor, Eliot Spitzer. While this topic is no longer in the spotlight, it remains an important consideration for all stakeholders, including regulators and rating agencies.

In respect of SPVs, two issues need to be resolved: Currently, there are no clear

rules about the recognition of transactions through SPVs for regulatory solvency purposes. In addition, with the increasing popularity of capital market transactions, in particular for catastrophe risks, some EU members are keen to attract such entities, rather than see them set up in tax-efficient locations such as the Cayman Islands.

The reinsurance directive has raised some questions for foreign insurers that

### Exhibit 15 Regulation of Reinsurers: Germany vs U.K.

Supervision	Germany*	UK
License Required	No	Yes
Management must be fit and proper	No	Yes
Changes in management rules must be reported	No	Yes
Assets are examined	No	Yes
Solvency margin requirement exists	No	Yes

\*Germany prior to amendment of insurance supervision act.  
Source: A.M. Best Co.

### Exhibit 16 Life Reinsurer – 2004 Balance Sheet

Revios 2004	
Assets	2004
Investments	
Real Estate	0.1
Securities available for sale	353.9
Deposits with banks	266.1
Deposits retained on assumed reinsurance business (cedants' deposits)	3,428.40
Total investments	4,048.50
Other Assets	
Reinsurers' share of underwriting provisions	490.1
Accounts receivable	149.6
Deferred acquisition costs	541.5
Deferred tax assets	35.7
Misc Assets	35.4
Total other assets	1,252.30
Intangible Assets	
Goodwill and others	5.7
<b>Total Assets</b>	<b>5,306.50</b>

Source: A.M. Best Co.

conduct reinsurance business through branches. On the other hand, it has opened some opportunities for both foreign and EU-domiciled players. As for branches of reinsurers based outside the EU, there is some uncertainty about their prospective treatment. The directive stipulates that branches of non-EU reinsurers cannot be treated better than EU reinsurers. Although the directive allows for recognition of similar regulatory standards, the recognition procedures and standards have not been finalized.

Notwithstanding this, EU reinsurers and non-EU reinsurers alike increasingly see the "passport" system as an opportunity to streamline their operations within the EU. So far, reinsurers are conducting business through numerous subsidiaries across Europe with separate solvency and reporting requirements. In the future, and similar to what already is in place for primary insurers, reinsurers can write business through a single entity throughout the EU via one license.

This allows reinsurers to better manage their capital, which can be held in one entity for a very large market. In addition, in most member states, life reinsurance and non-life reinsurance can be written in one entity (which is not possible for primary insurance). Zurich-based Swiss Re, the world's largest reinsurer, announced recently that it would set up a single reinsurance carrier in Luxembourg. The aim is to transfer all portfolios currently written in a number of subsidiaries (Germany, Ireland, Denmark and the United Kingdom) to this new carrier. While the location of underwriting teams remains unchanged, assets and liabilities (and capital) will be moved to Luxembourg.

The abolishment of collateral requirements, in particular in Germany relating to life business, should improve reinsurers' management of liquidity. So far, reinsurers that write life business in Germany must deposit back mathematical reserves to their cedants, which means that the largest block of assets within a life reinsurer's balance sheet normally is cedants' deposits,

as shown in **Exhibit 16**. This makes it more difficult to write new financing business for pure life reinsurers because of limited liquidity.

There also is a lot of talk about future collateral requirements in the United States once the EU reinsurance directive is fully in place. The National Association of Insurance Commissioners (NAIC) is looking into this issue. However, it appears there is no intention to fully abolish these requirements in the near future, but instead to introduce a system based on the financial strength of a reinsurer.

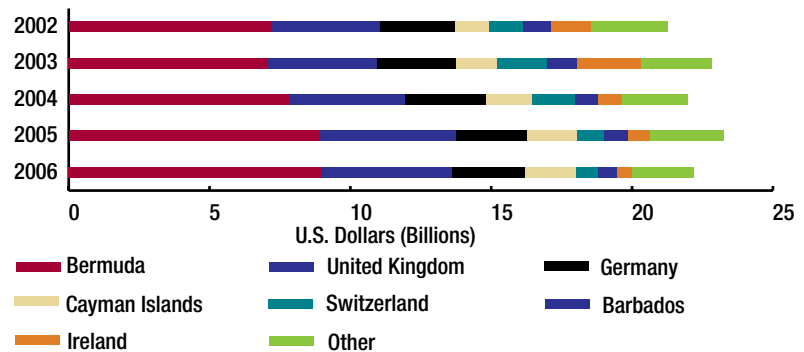
## Fate of NAIC's Collateral Proposal Spells Uncertainty for U.S. and Foreign Reinsurers

More than \$22.2 billion in reinsurance premium was ceded by U.S. (re)insurers to unaffiliated companies in some 95 foreign jurisdictions in 2006 and another \$44 billion was recoverable from alien companies (see **Exhibits 17** and **18**), according to the Reinsurance Association of America (RAA). As such, whatever U.S. regulators decide relative to unauthorized reinsurers is bound to have a ripple effect around the world.

The competing interests of the domestic and foreign reinsurers was made perfectly clear, however, when the Reinsurance Task Force of the National Association of Insurance Commissioners' (NAIC) proposed relaxation of collateral requirements for unauthorized reinsurers. Certain domestic, U.S.-licensed carriers and industry trade groups adamantly oppose such measures, while the international carriers welcome the increased flexibility in the proposal. The NAIC is attempting to correlate the amount of collateral required for alien reinsurers with their financial strength, thereby recognizing the differences between financially sound and weaker carriers.

Under current NAIC regulations, unauthorized reinsurers are required to post collateral equal to 100% of all reinsurance obligations assumed. Alien reinsurers can avoid the collateral requirements by maintaining licensure in the states where cedants are domiciled. Given the nature

### Exhibit 17 U.S. Reinsurers – 2002-2006 Premiums Ceded To Unaffiliated Offshore Reinsurers



Source: Reinsurance Association of America (RAA).

of the reinsurance business, however, it would be necessary to maintain licensing in each of the 50 U.S. states, which would require additional time and expense and would lead to higher reinsurance costs. Currently, cedants require collateral so that secured reinsurance recoverables are accounted for as assets, because unsecured unauthorized recoverables lead to a reduction of surplus.

The rules requiring foreign carriers to post collateral stem from the consequences for both cedants and policyholders should a global reinsurer face solvency issues. Moreover, with several of the largest insured loss events having occurred in the past five years, liquidity concerns following a mega-catastrophe fuel the arguments of opponents of the provision. Reinsurance disputes and slow payments create cash flow and liquidity concerns, depending on the magnitude of uncollectible recoverables. Without collateral, cedants often settle for considerably less than 100% of their outstanding balances through commutations. This happened after the ratings downgrades of reinsurers such as PXRE, Converium and Gerling.

The heart of this issue is the cedant's great disadvantage in seeking legal recourse in a foreign jurisdiction if a reinsurer is not subject to U.S. regulation. Additionally, unauthorized reinsurers are governed under different accounting standards, which could affect the actual balance of any reinsurance recoverables should a dispute occur.

In response to concerns, the NAIC has proposed establishing a Reinsurance Evaluation Office (REO) to rate the financial strength of reinsurers conducting business in the United States, regardless of the company's domicile. Some regulators within the NAIC feared the collateral requirements could create barriers to entry for alien reinsurance carriers writing in the United States. Additionally, large, international reinsurance organizations requested that the NAIC establish a process that recognizes the differences between stronger reinsurers and those with weaker financial positions. The amount of collateral required would depend on the rating each carrier received from the REO. The REO rating categories would range from REO-1 (highest) through REO-6 (lowest). The rating criteria would be developed with the starting point being an assessment of a reinsurer's ratings from National Recognized Statistical Ratings Organizations (NRSOs), as well as the organization's plans to expand its analytic criteria and staff. Key areas of focus also encompass financial regulation within a reinsurer's domicile, including regulatory and accounting standards. For those carriers not rated by an NRSRO, the REO would establish the rating.

Opponents of the revision argue that not only can collateral minimize credit risk it mitigates the question of the willingness of a reinsurer to pay and other factors, such as political risk and dispute risk. Under the new rating bands established by the REO, there would be the potential risk that a higher REO-rated reinsurer could face a

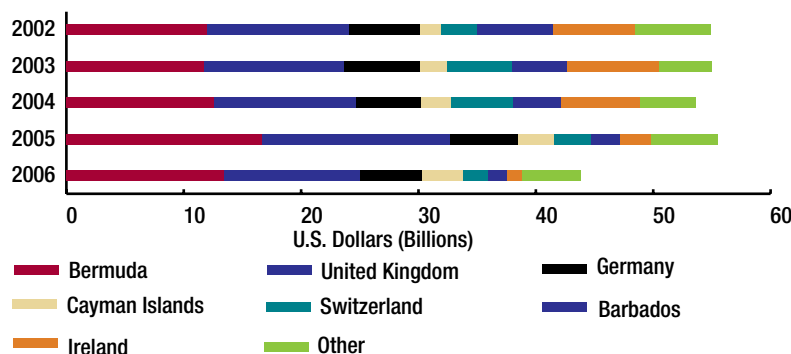
rating downgrade, with little incentive to establish higher collateral on par with the revised REO rating. A question for the NAIC is how it would handle a situation in which a reinsurer's REO rating is reduced and the reinsurer does not increase collateral accordingly.

International reinsurers support the provision, given that U.S.-licensed reinsurers are not required to put up collateral in countries such as the United Kingdom, Germany (non-life), Switzerland, Bermuda and Japan, which collectively represent the overwhelming majority of the global reinsurance markets. They also argue that by establishing collateral, a reinsurer faces burdensome opportunity costs associated with holding assets of such high credit quality, versus deploying an investment philosophy focused on higher returns. Additionally, the current NAIC collateral requirements do not take into account the amount of retrocessional coverage that reinsurers purchase. A key difference between U.S. regulation and international regulation is that a U.S. reinsurer, operating in a foreign jurisdiction, is required to maintain a localized presence with capital on the ground and is subject to the regulatory oversight of that country. By easing collateral requirements without factoring in the potential issues of oversight, the NAIC provision potentially could be a disadvantage to U.S.-domiciled reinsurers and could leave little incentive for reinsurers to maintain a U.S. presence or to attract new capital.

From a market prospective, the legislation clearly would benefit international carriers while weakening the relative competitive position of U.S.-licensed carriers, which already are at a disadvantage from a corporate tax position. International carriers that historically have maintained onshore operating subsidiaries to facilitate transactions now may find it easier to transact business against an offshore balance sheet.

It is important to note that the provision, in most cases, would not allow for a complete elimination of collateral, and that the REO provision clearly would allow companies to maintain collateral at their own discretion within their reinsurance programs. Under the new

**Exhibit 18**  
**U.S. Reinsurers – 2002-2006 Recoverables From Unaffiliated Offshore Reinsurers**



Source: Reinsurance Association of America (RAA).

provision, larger carriers with greater scale and diversification in their reinsurance programs would have more influence over terms and conditions when purchasing reinsurance and establishing credit protection. Conversely, small to midsize carriers likely would have less flexibility in negotiating reinsurance coverage and, therefore, would have a harder time garnering security.

This proposal comes at a time when the global reinsurance industry has withstood mega-catastrophes, including the World Trade Center attacks and hurricane Katrina. After record earnings in 2006, capital infusions and industry investments, global reinsurance capacity is at an all-time high. It is important to remember, however, that as easily as capital has flown into the global reinsurance market, it can dissipate.

## Florida Legislation's Impact Defies Expectations

Immediately after the passage of legislation that nearly doubled the capacity of the Florida Hurricane Catastrophe Fund (FHCF), predictions wheeled throughout the reinsurance market of a devastating loss of both premium revenue and earnings.

Concerns about the privatization of one of the world's largest peak zones were compounded by the consensus that widespread price softening in the property/casualty markets was well under way and likely to worsen. As it turned out, to this point at least, those predictions were as accurate as a typical weather forecast. The FHCF indeed has proven to be an additional source of competition for reinsurers, but not to the extent predicted. Unforeseen opportunities have emerged in Florida to lessen both the top- and bottom-line impacts of the legislation. However, the long-term effects of the legislation can be assessed only by letting market forces play out with regard to reinsurance capacity, demand for reinsurance and their respective impacts on pricing.

Florida-only and national companies operating in Florida, both beneficiaries of the cost savings afforded by the FHCF, have spent a portion of those savings on additional, third-party reinsurance. Reinsurers have experienced increased demand for coverage above, below and alongside the FHCF, while demand for second-event covers also has spiked.

From the onset of this issue, A.M. Best had believed the legislative reforms enacted in Florida would not directly impact the financial strength ratings of any particular reinsurer. Moreover, A.M. Best maintains that these measures, direct-

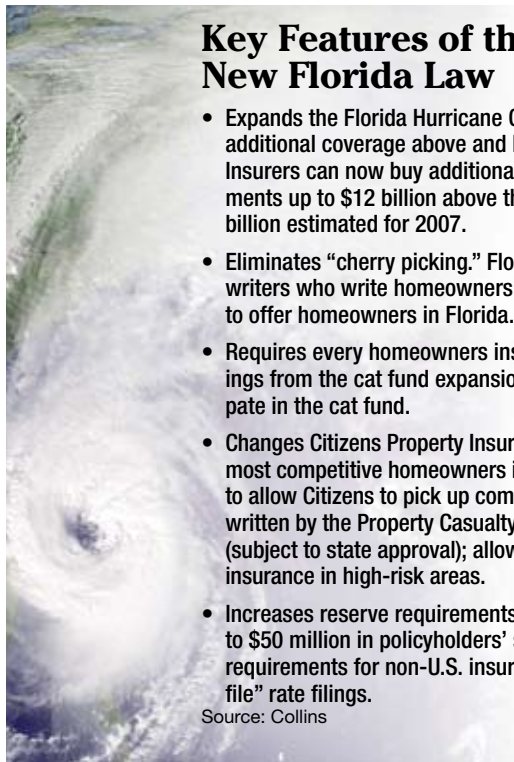
ed at lowering the state's homeowners' rates, have had a bearing on the competitive landscape for Florida reinsurance and a more subtle effect on the broader domestic and global reinsurance markets.

While the reforms did not totally eliminate \$3.0 billion of reinsurance premium or free up \$8.0 billion of reinsurance capacity as originally forecasted, they did make some additional capacity available for redeployment. The ramifications of this appear to be a broader softening in rates than originally anticipated. This has been observed in the neighboring, catastrophe-exposed Gulf and Southeastern states; in the accelerated rate softening in non coastal property regions; and in further competition in casualty lines.

### Key Features of the New Florida Law

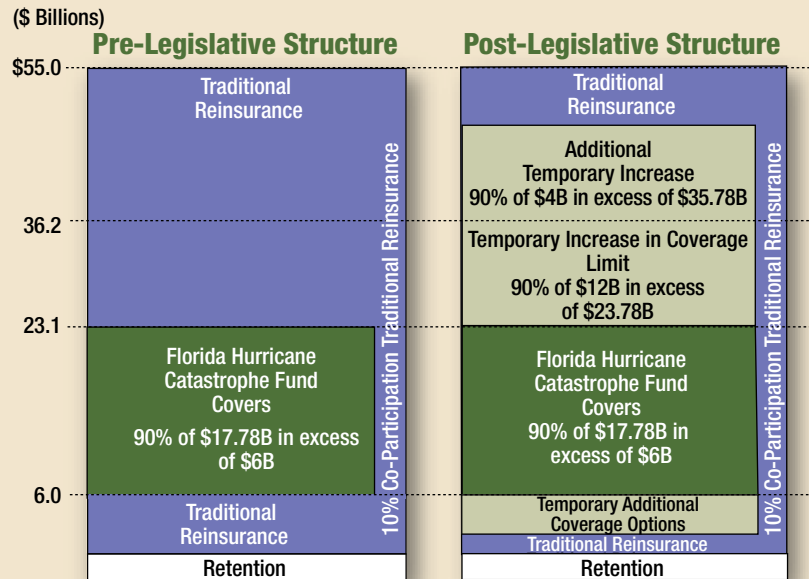
- Expands the Florida Hurricane Catastrophe Fund to provide additional coverage above and below the original program. Insurers can now buy additional reinsurance in \$1 billion increments up to \$12 billion above the FHCF industry-limit of \$16 billion estimated for 2007.
- Eliminates "cherry picking." Florida private-passenger auto writers who write homeowners in other states will be required to offer homeowners in Florida.
- Requires every homeowners insurer to file rates reflecting savings from the cat fund expansion—even if they do not participate in the cat fund.
- Changes Citizens Property Insurance Corp.'s rates to make it the most competitive homeowners insurer in Florida; opens door to allow Citizens to pick up commercial coverages currently written by the Property Casualty Joint Underwriting Association (subject to state approval); allows Citizens to write multiperil insurance in high-risk areas.
- Increases reserve requirements for Florida-only subsidiaries to \$50 million in policyholders' surplus; eliminates collateral requirements for non-U.S. insurers, suspends the "use-and-file" rate filings.

Source: Collins



## How the Florida Hurricane Catastrophe Fund Expanded

The Florida Legislature expanded the state-run cat fund to provide additional coverage above and below the original program. The maximum industry losses that could be covered have been increased to 90% of \$37 billion in excess of \$3 billion, compared to the previous maximum of 90% of \$18 billion in excess of \$6 billion.



Source: Collins.

In terms of Florida exposures, many carriers re-established risk tolerances in 2006 and were well on their way to reducing Florida exposures. Additionally, carriers with global diversification have increased their writings outside the United States, which also has reduced overall catastrophe exposures. This has forced reinsurers that were expecting a smooth July 2007 catastrophe renewal to once again reassess capital-management strategies. Management, in some cases, has found it prudent to return excess capital to shareholders rather than deploy it for under-priced business.

Given the size of the Florida catastrophe market, these changes continue to affect reinsurers' premium generation and operating margins, but not to the extent anticipated. Reinsurers that derive a majority of revenue from property/catastrophe writings in Florida will be the most affected on both the top and bottom lines. However, reinsurers that maintain a rational approach to allocating capacity under difficult circumstances potentially could strengthen their risk-adjusted capitalization while sustaining reasonable returns on capital.

## Surplus Lines and Reinsurance House Bill Would Ease Regulations on Reinsurers

In what reinsurers hope is a first step to regulatory uniformity, the U.S. House of Representatives on June 25 passed the Non-admitted and Reinsurance Reform Act (H.R. 1065), which would bring regulatory clarity to the surplus lines market and end the extraterritorial regulation of reinsurers. Fourteen states currently permit regulators to operate extraterritorially—in other words, to apply their state's regulations to all reinsurers operating in their state, both licensed and domiciled.

The bill also would dictate that the solvency of reinsurers be solely the jurisdiction of the regulators in the reinsurer's domicile and would prohibit states from requiring reinsurers to furnish financial information not required by their home state regulators.

The determination of whether to grant a reinsurance credit would be left to home state regulators of primary insurers. All other states would be bound by these determinations.

A similar bill was introduced in the Senate (S.929) earlier this year but remains in the Senate Banking Committee. (For the full article, see "Reinsurers See House Victory as First Step to Uniformity," BestWire, July 3, 2007, [www.ambest.com/news](http://www.ambest.com/news).)

With the absence of hurricane activity in 2006 and the benefit of considerable rate increases, the majority of carriers with Florida property exposures reported record earnings and benefited from elevated catastrophe premiums. Conversely, these same reinsurers could have lost billions of dollars had catastrophe activity mirrored that of 2004 and 2005, which highlights the risk-reward dynamics of the Florida catastrophe risks. This applies to established operations as well as recent market entrants, including start-up reinsurers and sidecar structures.

Many established multiline and property/catastrophe reinsurers enhanced their risk management capabilities and portfolios through 2006, particularly in terms of establishing more reasonable risk profiles. However, other carriers aggressively took advantage of the soaring property rates and favorable policy terms in areas such as Florida, where insurers have paid more than \$30 billion of catastrophe losses

since 2004. A.M. Best believes that continued focus on underwriting discipline and enterprise risk management are the keys for reinsurers to ease the potential impacts from what is occurring in Florida and in the general market.

A.M. Best expects that as easily as capital poured into the Florida markets to address serious capacity shortages, there will be continuing pressure to either return capital to shareholders or redeploy capital in other markets outside of Florida. Moreover, the demand for alternative sources of capacity, such as the sidecar formations, Industry Loss Warranties (ILW's) and start-up operations that took

the region by storm in 2005 and 2006, likely will decline because of the unexpected increase in reinsurance capacity.

As the industry braces for what is expected to be an active hurricane season in terms of the frequency and severity of large storms, the Florida legislation will continue to be a leading industry topic. Now that the near-term impacts have settled, many in the industry wonder how the financial position of the FHCF will hold up should a storm of great magnitude cause Katrina-like losses in Florida. Ultimately, a reinsurer's market profile and business mix will drive the long-term impacts of the Florida legislation.

## P/C-Linked Securitizations are Robust and Creative, Despite Softening Prices

Convergence of the capital markets and traditional property/casualty reinsurance accelerated rapidly after the disastrous losses from the 2004 and 2005 U.S. hurricane seasons—a string of catastrophes that dramatically shrunk available retrocessional coverage. In 2006, a surge of alternative reinsurance capacity from the capital markets, particularly in the form of catastrophe bonds and sidecars, supplemented and/or replaced traditional reinsurance coverage. Catastrophe bond issuance totaled \$4.7 billion—a record at that time—representing a 136% increase over 2005's activity. In 2007, catastrophe bond issuance was \$4.8 billion through late July and could reach \$6 billion at year-end, depending on reinsurance capacity and prices. Sidecar capital (debt and equity) was about \$4.5 billion in 2006. Through July 2007, however, new capital in this nascent market was only about \$1.5 billion. This decrease was due partially to the expansion of the Florida Hurricane Catastrophe Fund (FHCF) and the general softening of the property/casualty reinsurance market. Sidecars are playing the role expected—providing capital when markets are hard and returning capital to investors when prices decline.

2007 is shaping up to be a robust year for property/casualty activities in insurance-linked securities (see **Exhibit 19**), despite reinsurance prices that have somewhat softened compared with last year. The

capital market's participation in this sector continues to grow in volume; diversity of perils covered; geographical spread; number of new insurance company sponsors; and types of triggers employed to indicate whether losses have occurred.

With the assistance of investment bankers, brokers and peril modelers, capital market solutions with highly structured platforms have been developed that have helped both reinsurers and direct writers to address their capital efficiency and risk-return profile. These solutions address multiple issues such as alternative sources of reinsurance, capital relief from rating agencies and the efficient use of capital (for example, by monetizing premiums).

With insurance-linked securitizations continuing to expand at a robust pace, several notable trends and transactions have emerged, including:

- **Direct Writers**—While traditional reinsurers continue to access the capital markets to help mitigate risk and provide additional capacity, direct writers are actively becoming direct sponsors of insurance-linked securitizations. Dislocation of reinsurance capacity, restrictions in terms and conditions, and the desire to have a stable, multiyear reinsurance program have driven direct writers to access the capital markets—for example, Willow Re Ltd., spon-

sored by Allstate Insurance Co., and Akibare Ltd., sponsored by Mitsui Sumitomo Insurance Co. Ltd.

• **New First-Time Issuers**—A majority of the recent catastrophe bonds have come from first-time issuers and sponsors, several of which are direct writers, including Longpoint Re Ltd., sponsored by Travelers Indemnity Co.; East Lane Re Ltd., sponsored by Chubb Group of Insurance Cos.; Willow Re Ltd., sponsored by Allstate Insurance Co.; and Merna Re Ltd., sponsored by State Farm Mutual. First-timers, in total, issued catastrophe bonds in excess of \$2.1 billion through July 2007.

• **Non-Insurance Entities**—Entities other than traditional reinsurers and direct writers are entering the marketplace as either direct issuers or sponsors. The Caribbean Catastrophe Risk Insurance Facility (CCRIF), sponsored by the World Bank, provides 16 countries in the Caribbean with coverage against hurricanes and earthquakes. A portion of the coverage was collateralized by the issuance of a catastrophe bond.

• **Shelf Programs**—More than 70% of the recently issued catastrophe bonds originated from “shelf programs.” A shelf program provides ready and efficient access

## Exhibit 19

**Catastrophe Bonds and Sidecar Transactions Closed in 2007**

Issue Date	Vehicle	Sponsor	Capital <sup>1</sup> (USD mil)	Description
<b>Catastrophe Bonds</b>				
Jul-07	Merna Re Ltd.	State Farm	1,181	Multiple perils; indemnity catastrophe bond
Jun-07	Residential Re 2007 Ltd	USAA	600	U.S. hurricane and earthquake
Jun-07	Fusion 2007 Ltd	Swiss Re	140	Japan typhoon and Mexico earthquake
Jun-07	Willow Re Ltd	Allstate	250	Northeast U.S. hurricane
Jun-07	Nelson Re Ltd	Glacier Re	75	U.S. wind and earthquake, and Europe wind
Jun-07	Mystic Re II Ltd	Liberty Mutual	150	U.S. hurricane
Jun-07	Fremantle Ltd	Brit Insurance	200	Multiple perils (CDO-Type Structure)
Jun-07	CCRIF <sup>3</sup>	World Bank	20	Hurricane and earthquake; will benefit 16 Caribbean countries
May-07	MedQuake Ltd	Swiss Re	100	Mediterranean earthquake
May-07	Gamut Re Ltd	Nephila	310 <sup>2</sup>	Facility that will invest in various reinsurance contracts (CDO-Type Structure)
May-07	Akibare Ltd	Mitsui Sumitomo	120	Japan typhoon
May-07	Carillon Ltd	Munich Re	150	U.S. hurricane
May-07	Longpoint Re Ltd	Travelers	500	Northeast U.S. hurricane
Apr-07	East Lane Re Ltd	Chubb	250	Northeast U.S. hurricane; indemnity cat bond
Apr-07	Ajax Re Limited	Aspen	100	California earthquake
Apr-07	Blue Wings Ltd	Allianz	150	Great Britain flood, and Canada and U.S. earthquake (excl California)
Mar-07	Puma Capital/Bridge Re	Various	183	Hybrid cat bond/sidecar transaction (CDO-Type Structure)
Mar-07	Australis Ltd	Swiss Re	50	Australia earthquake and cyclone
Jan-07	Calabash Re II Ltd	ACE America	250	U.S. hurricane
			<b>4,779</b>	
<b>Sidecars</b>				
Jan-07	Kaith Re Limited	Hannover Re	106	Multiple perils
Jan-07	MaRI Ltd	Marsh Inc/ACE	400	U.S. commercial property
Mar-07	Kepler Holdings Limited	Hannover Re	200	Worldwide natural perils; a segregated cell sidecar
May-07	Starbound Re II Ltd	Renaissance Re	342	Florida wind
Jun-07	Emerson Re Ltd	CIG Re & New Castle Re	500	Multiple perils
			<b>1,548</b>	

<sup>1</sup> Capital amounts for sidecars include both debt and equity.

<sup>2</sup> Includes an equity tranche and an unrated debt tranche with a combined capital amount of \$70 million.

<sup>3</sup> Caribbean Catastrophe Risk Insurance Facility.

Source: A.M. Best Co.

to the capital markets by providing the flexibility to issue periodic tranches of debt. Shelf programs tend to standardize the capital-market borrowing and legal requirement processes and, therefore, reduce overall legal and capitalization expenses as well as reduce the execution period required for subsequent borrowing issuances.

• **U.S. Northeast Exposure**—With the FHCF now providing significant retrocessional hurricane coverage in Florida, territorial coverage has been redeployed to other sectors of the United States. Recently issued wind-related catastrophe bonds, including those by Willow Re Ltd., Mystic Re II Ltd. (sponsored by Liberty Mutual), Longpoint Re Ltd. and East Lane Re Ltd., provided extended coverage to the Northeast, among the largest hurricane peak zones in terms of insured values.

• **Investment-Grade Ratings**—Recently issued catastrophe bonds such as Merna Re Ltd. and Bridge Re Ltd. (sponsored by Puma Capital Ltd.) have been given investment-grade ratings. These transactions have tranches of debt at a much higher attachment point, which makes the probability of first-dollar loss much more remote.

• **Credit Cliff Mitigation**—Recent catastrophe bond transactions, including catastrophe-linked securities with collateralized debt obligation(CDO) features and multiple event triggers, provide for the orderly initial and subsequent rating evaluation of specific debt tranches. These features provide the ability to address the “credit cliff” issue associated with traditional catastrophe bonds; for example, Fremantle Ltd. combined the use of a swap agreement, a reinsurance agreement and CDO features to provide coverage to Brit Insurance Ltd.

• **Indemnity Triggers**—The increased usage of indemnity triggers (i.e. reimbursements that are based upon actual incurred losses) in several sizable catastrophe bonds has been noted. Direct writers that recently issued securities have incorporated indemnity triggers in their transactions—for example, East Lane Re Ltd. and Merna Re Ltd. These insurers appear to be more sensitive to basis risk than traditional reinsurers, which predominantly incorporate parametric/index triggers in their transactions.

• **Contingent Capital**—Farmers Insurance Group recently finalized a committed capital facility that provides \$500 million of regulatory capital should it suffer windstorm-related losses in certain Southern states.

• **Nonstandard Triggers**—A recent catastrophe bond issued by Fusion 2007 Ltd., partly sponsored by Kyoei Fire and Marine Insurance Co. and covering typhoons in Japan, employed a quake event in Mexico as a trigger. This was the first catastrophe bond to reference an existing catastrophe bond as a trigger.

• **Reinsurance Recoverables**—Merlin CDO I B.V., sponsored by Hannover Re, was a unique transaction that provided a synthetic solution to transfer the credit risk in reinsurance recoverables to the capital markets. For such transactions, the ability to transfer or mitigate some or all of the present and future credit risk associated with the recoverables, if properly structured, could: 1) improve the sponsor’s capital position by providing capital relief and liquidity at the time of the prescribed event and 2) reduce concentration risk of reinsurance counterparties.

• **Automobile Policy Premium**—The FCC SPARC Europe (senior) transaction, which closed in 2007, was the second motor vehicle policy securitization to be sponsored by the AXA Group. The first transaction closed in 2005. The transaction covered a defined motor policy book of business in Belgium, Germany, Italy and Spain underwritten by five subsidiaries of the AXA Group.

• **New Peril Models**—Increased activity in the catastrophe bond market has led to the introduction of new models by the peril modelers. Blue Wings Ltd., sponsored by Allianz, was a first in the catastrophe bond market to utilize a newly developed model to provide flood coverage in Great Britain.

• **Sidecar Activity**—The use of sidecars, although at a significantly reduced level from the prior year, continues to be an alternative risk transfer vehicle for reinsurers that want to take advantage of the relatively hard market in specific hurricane peak zones, for example, Starbound Re II Ltd., sponsored by Renaissance Re Ltd. The increase in reinsurance capacity by the FHCF did not eliminate the use of sidecars.

## A.M. Best's View on Insurance-Linked Securitizations

In the past few years, a steady rollout of insurance-linked securitizations, especially by large insurance and reinsurance companies, is paving the way for the insurance industry to regularly tap alternative sources of funds through the capital markets.

A.M. Best expects the convergence of the capital markets and insurance to continue, but the pace will depend on the occurrence of significant catastrophes that expose an insufficiency of capital in the global reinsurance market. Such events tend to cause reinsurance prices to spike and attract new capital, however temporary, from the capital markets.

In addition, A.M. Best expects more capital market participation in the insurance industry as institutional investors and hedge funds gain understanding of insurance risks and the “novelty risk premiums” shrink on the returns required on insurance-linked securities.

The growth of the insurance-linked securities market also depends on whether rating agencies fully recognize the transactions in the financial strength ratings (FSRs) of the sponsoring insurers. Overall, A.M. Best believes the insurance-linked securities market will continue to grow, despite occasional peaks and troughs, and this growth will tend to moderate cyclical and amplitude in global reinsurance pricing.

### Categories of Transactions

Insurance-linked securitizations span a wide spectrum of transactions in both the property/casualty and life/health sectors. A.M. Best groups them into broad categories of transactions designed to:

- Transfer catastrophic as well as high-frequency/low-severity risks (such as with catastrophe bonds associated with natural-catastrophe/mortality risks and with transactions that transfer risks associated with near working layers of a cedant's business);
- Provide contingent capital in the event of a catastrophe;
- Increase equity capital (as with securitization of trust-preferred securities and surplus notes);
- Provide capital relief (as with efforts to hedge reinsurance recoverables);
- Aid in the redeployment of capital (as in closed-block/value-in-force/embedded-value transactions);
- Augment statutory reserves (as in Regulation XXX and Regulation AXXX transactions); and
- Hedge mortality or longevity risk (as provided by bonds backed by structured settlements or life settlements).

### Advantages

- 1) Avoidance of cyclical pricing due to the relative long-term nature of the transactions compared with annual reinsurance contracts;
- 2) Avoidance of credit risk because many of the transactions are fully collateralized;
- 3) Access to a deeper capital base from entities outside the insurance industry that often compete with the industry; and
- 4) Availability of retrocessional capacity that may not be available in the traditional markets at reasonable prices.

### Disadvantages

- 1) Frictional costs of structuring and underwriting insurance-linked securities can be high compared with traditional reinsurance contracts;
- 2) Reinsurance can cover ancillary damages (such as floods caused by hurricanes, damage from sprinklers, ice storms, frost, etc.), while insurance-linked securities generally cover specific perils that can be modeled by the major peril models;
- 3) Reinsurance contracts can be put together in a relatively short time compared with the two to three months it can take to consummate most natural-catastrophe insurance-linked transactions (and a year or so for some life-related transactions);
- 4) Capital market investors only invest in securities backed by short-tail risks, unlike reinsurance, which covers both short-tail and long-tail risks;
- 5) There is no option for a prearranged reinstatement of limits; and
- 6) A.M. Best must consider significant risks, such as basis risk, tail risk and enterprise risk, in analyzing the efficacy of the hedge provided by insurance-linked securitizations.

Transactions in these categories, with the exception of natural-catastrophe bonds, often are not easily repeatable and thus require a steep learning curve to consummate.

The chart on the previous page shows the advantages and disadvantages of insurance-linked securitizations.

### **Basis Risk and Tail Risk**

With regard to the hedging of property/casualty catastrophic risks, the main issues facing sponsors of securitizations are basis risk and tail risk. Basis risk in catastrophe bonds generally reflects the possibility that a non-indemnity catastrophe bond may not be partially or fully triggered even when the sponsor of the catastrophe bond has suffered a loss for covered perils. Even if there is little basis risk at the inception of a catastrophe bond transaction, basis risk can increase as the business composition of the transaction's sponsor or beneficiary changes. This is the case even if the attachment point of the catastrophic event being reinsured is adjusted periodically. For this reason, A.M. Best believes it is important to evaluate the basis risk of catastrophe bonds at the beginning as well as during the life of the transaction. A.M. Best's methodologies, *Rating Catastrophe Bonds* and *Gauging the Basis Risk of Catastrophe Bonds*, will guide sponsors of catastrophe bonds on how A.M. Best rates these instruments and determines how much reinsurance credit will accrue to their sponsors.

A.M. Best is seeing more catastrophe bonds—including catastrophe CDOs that hedge multiple catastrophic risks—with investment-grade ratings. Presumably, such high ratings will attract a broader spectrum of investors. There is, however, an inverse relationship between the ratings of catastrophe bonds and the amount of reinsurance credit that will accrue to the sponsor. In addition, regardless of whether multiple catastrophes are covered by the catastrophe bonds, *Best's Capital Adequacy Ratio (BCAR)* methodology still focuses on the most dominant catastrophic risk faced by the sponsors of these bonds—earthquake or hurricane. Therefore, in determin-

ing how much reinsurance credit will be recognized in the BCAR, A.M. Best will require that the basis risk be evaluated based on the dominant catastrophic risk.

For transactions that rely on the credit risk of multiple insurers or reinsurers, the biggest issue to address is how credit risk is derived. The capital market is accustomed to defining a credit event as having occurred when a company misses interest and principal payments on a financial obligation such as a bond. However, due to the regulatory environment in which insurance companies operate and the fact that relatively few insurance companies issue debt, data are scarce on such a measurement of credit events. As a result, substantial basis risk will exist with any transaction designed to hedge the credit risk of insurers or reinsurers unless the data used to gauge such credit risks are specific to the insurance industry. For example, a sizeable basis risk would result if general corporate bond default data are used to determine the hedge ratio for a pool of reinsurance recoverables. For the past four years, A.M. Best has published statistical studies on insurance industry impairment rates, which are proxies for the credit risk of insurance companies. The latest of these is *Best's Impairment Rate and Rating Transition Study, 1977 to 2006*, which is the basis of the analysis of transactions associated with insurer credit risk. It contains the most comprehensive data available on the credit risk of insurance companies, and it covers more than 5,000 insurers over 29 one-year periods.

Catastrophe-linked transactions that have derivative features may be problematic, depending on the ease with which insurance companies using these instruments can reverse hedges that A.M. Best assumes will be in place to cover catastrophic risks. If the transaction can be cancelled easily, A.M. Best probably will not recognize the hedge in the first place.

Reinsurance of property/casualty risks through sidecars also provides the unique challenge of tail risk that sponsors or beneficiaries must address. Tail risk anticipates that under-capitalization of a sidecar may result in its sponsor

absorbing the risk that originally was assumed to be fully hedged by that sidecar. Nearly all sponsors of sidecars tell A.M. Best that their sidecars are fully collateralized. However, A.M. Best's analysis has shown that only one or two sidecars initiated in 2006 were capitalized up to or very near their full aggregate limits.

For transactions that are not fully collateralized, A.M. Best determines how much capitalization is necessary to avoid tail risk. This capitalization level is based on data derived from *Best's Impairment Rate and Rating Transition Study*. Best's rating methodologies *Rating Sidecars*, *Assessing the Tail Risk of Sidecars* and *Tail Risk and the BCAR* will guide sponsors of sidecars on how A.M. Best rates sidecars and determines how much tail risk will be charged to the sponsors.

### Enterprise Risk

As sizeable players in the insurance industry undertake more securitizations, insurers and reinsurers increasingly will become originators of risk as opposed to warehouseers of risk. This raises issues about how the enterprise risk emerging from this change in the insurance business model will affect the FSR of insurance companies. Some of the questions A.M. Best will ask regarding insurance-linked securitizations are, as follows:

- What is the level of granularity employed by actuarial or catastrophe modeling agencies in modeling the risks covered by the transactions?
- Are policyholders subject to the risk of anti-selection if the better risks are transferred to investors?
- Will becoming a risk originator mean lower underwriting standards in order to maintain product flow? Specifically, if books of business are being acquired for the sole purpose of monetizing cash flows, will market forces press companies to exercise less due diligence and thus, be forced to retain less profitable portfolios if the monetization market unexpectedly evaporates? And, will the fact that risks in acquired blocks of business may not be as transparent as risk in "home-grown" portfolios mean more risk for policyholders (even for a short period

until the monetization occurs)?

- What risks can be put back to the originating insurance companies under scenarios of extreme adverse developments in mortality, lapse rates, expense ratios, loss ratios and interest rates?
- For Regulation XXX and Regulation AXXX transactions, to what extent are reserves truly redundant and to what extent is the debt raised recourse or non-recourse?
- For risk transfers involving working-layer risks (as opposed to catastrophic risks), how much empirical data exist to support data on loss ratios and recoveries for any specific business line being reinsured or hedged?
- For transactions based on parametric triggers (such as cat bonds), how is the probability of an event occurring tied to the probability of a trigger being activated?

With some of the insurance-linked securitizations (particularly those in the life insurance sphere), there is some level of recourse to the ceding companies. In this sense, "true sale" (i.e. de-linkage from the ceding companies) is not completely achieved, unlike with the traditional non-insurance transactions in the asset-backed securities market. This is especially true of closed-block/value-in-force and risk-transfer transactions. In these transactions, it is critical to understand specifically which risks are being transferred and what type of agreements are in place to shield investors from risks associated with pandemics, catastrophes and terrorism. These agreements to shield investors from certain risks mean, of course, that the insurance company will have to absorb those risks. Thus, in the rating process, A.M. Best has to know what risks insurers retain. In addition, these transactions may have special servicing and systems requirements that may tax the capacity of the originating insurance/reinsurance companies. This, too, has to be revealed in the financial strength rating process.

### Full Disclosure, Impact on FSRs

A.M. Best is looking more critically at how insurance-linked securitizations in general can affect the FSRs of insurance

companies it evaluates. To consider the insurance-linked securitizations in the FSR of a sponsor of these transactions, A.M. Best must have the associated legal documents, reinsurance agreements and rating agency presentations. The opinions on the transactions' effect on the FSRs are given in conjunction with the rating of the securities in the insurance-linked transactions.

This rating requirement is particularly important because many of these insurance-linked transactions are designed to be reinsurance substitutes; therefore they need to be vetted thoroughly because they can contain features that make them not directly comparable to reinsurance contracts. Within these analyses, A.M. Best considers the structural integrity of the transactions and the analytical rigor applied by various experts and advisers, such as actuaries, modelers and investment banks. The factors A.M. Best considers in evaluating the transactions ultimately help in determining whether the transactions' stated objectives will strengthen, weaken or have no effect on the FSRs of the participating insurers and reinsurers.

Regardless of the size of the insurance-linked securitizations, A.M. Best believes full disclosure of such transactions before they are announced publicly is integral to the rating process. Such disclosures should be made to A.M. Best in the context of how the transaction affects the company's general reinsurance program and/or how the transaction helps the company in managing its capital more efficiently. The timely disclosure of insurance-linked securitizations also gives A.M. Best: 1) the opportunity to evaluate the effect of the transaction on a timely basis; 2) the confidence that the company is freely sharing information about the

extent of its enterprise risk management; and 3) confidence in the integrity of the sponsor's management team.

For most transactions, A.M. Best's securities rating process focuses on the probability of first dollar of loss (i.e. the attachment probability). Given an attachment probability and barring any other issues such as the binary nature of catastrophe losses and the uncertainties surrounding the modeling of catastrophes, Best's Idealized Default Matrix provides the rating that should apply to insurance-linked securities for each term. Significant methodologies related to the rating of insurance-linked securities include the following (see [www.ambest.com/methodology](http://www.ambest.com/methodology)):

- *A. M. Best's Idealized Default Matrix*
- *Rating Sidecars* (Quick Reference)
- *Assessing the "Tail Risk" of Sidecars*
- *Tail Risk and the BCAR* (Quick Reference)
- *Rating Natural Catastrophe Bonds* (Quick Reference)
- *Gauging the Basis Risk of Catastrophe Bonds*
- *Best's Impairment Rate and Rating Transition Study – 1977 to 2006*
- *Catastrophe Analysis in A. M. Best Ratings*
- *Rating Surplus Note and Insurance Trust-Preferred CDOs*
- *Life Settlement Securitization*
- *Catastrophe Risk Management Incorporated Within the Rating Analysis*
- Also soon to be published: *Securitization of Reinsurance Recoverables*

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## GUIDE TO BEST'S FINANCIAL STRENGTH RATINGS

A Best's Financial Strength Rating is an independent opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. Best's Financial Strength Ratings are not a warranty of a company's financial strength and ability to meet its ongoing obligations to policyholders.

### Financial Strength Ratings

A **Best's Financial Strength Rating (FSR)** is an opinion as to an insurer's financial strength and ability to meet its ongoing obligations to policyholders.

	Rating	Descriptor	Definition
<b>Secure</b>	A++, A+	Superior	Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders.
	A, A-	Excellent	Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders.
	B++, B+	Good	Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.
<b>Vulnerable</b>	B, B-	Fair	Assigned to companies that have, in our opinion, a fair ability to meet their ongoing obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.
	C++, C+	Marginal	Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing obligations to policyholders and are financially vulnerable to adverse changes in underwriting and economic conditions.
	C, C-	Weak	Assigned to companies that have, in our opinion, a weak ability to meet their ongoing obligations to policyholders and are financially very vulnerable to adverse changes in underwriting and economic conditions.
	D	Poor	Assigned to companies that have, in our opinion, a poor ability to meet their ongoing obligations to policyholders and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.
	E	Under Regulatory Supervision	Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control or restraint whereby they are no longer allowed to conduct normal ongoing insurance operations. This would include conservatorship or rehabilitation, but does not include liquidation. It may also be assigned to companies issued cease and desist orders by regulators outside their home state or country.
	F	In Liquidation	Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.
	S	Suspended	Assigned to companies that have experienced sudden and significant events affecting their balance sheet strength or operating performance whereby the rating implications cannot be evaluated due to a lack of timely or adequate information.

### Rating Modifiers and Affiliation Codes

A rating modifier can be assigned to indicate that a Best's Financial Strength Rating may be subject to near term change (under review), that a company did not subscribe to Best's interactive rating process (public data) or that the rating is assigned to a syndicate operating at Lloyd's. Affiliation codes (g, p, and r) are added to Best's Financial Strength Ratings to identify companies whose assigned ratings are based on group, pooling or reinsurance affiliation with other insurers.

	Modifier	Descriptor	Definition			
<b>Rating Modifiers</b>	u	Under Review	A modifier that generally is event-driven (positive, negative or developing) and is assigned to a company whose Best's Rating opinion is under review and may be subject to change in the near term, generally defined as six months.			
	pd	Public Data	Assigned to insurers that do not subscribe to Best's interactive rating process. Best's "pd" Ratings reflect qualitative and quantitative analyses using public data and information.			
	s	Syndicate	Assigned to syndicates operating at Lloyd's.			
<b>Affiliation Codes</b>						
	g	Group	p	Pooled	r	Reinsured

### Not Rated Categories (NR)

Assigned to companies reported on by A.M. Best, but not assigned a Best's Rating. The five categories are as follows:

NR-1: Insufficient Data.	NR-2: Insufficient Size and/or Operating Experience.	NR-3: Rating Procedure Inapplicable.
NR-4: Company Request.	NR-5: Not Formally Followed.	

### Rating Outlook

Best's Financial Strength Ratings (A++ to D) are assigned a Rating Outlook that indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Public Data Ratings are not assigned an Outlook. Rating Outlooks, which appear in the rating rationale section of the company's *Best's Company Report*, are as follows:

Positive	Indicates a company's financial/market trends are favorable, relative to its current rating level and, if continued, the company has a good possibility of having its rating upgraded.
Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level and, if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and there is a low likelihood that its rating will change in the near term.

Best's Financial Strength Ratings are distributed via press release and/or the A.M. Best Web site at [www.ambest.com](http://www.ambest.com), and are published in the *Rating Monitor* section of *BestWeek*®. Best's Financial Strength Ratings are proprietary and may not be reproduced without permission. Copyright © 2007 by A.M. Best Company, Inc.

**Version 060807**

# GUIDE TO BEST'S CREDIT RATINGS

A Best's Credit Rating is an independent opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Best's Credit Ratings are not a warranty of a company's ability to meet its ongoing financial obligations.

## Financial Strength Ratings

A **Best's Financial Strength Rating (FSR)** is an opinion as to an insurer's financial strength and ability to meet its ongoing obligations to policyholders.

	Rating	Descriptor
<b>Secure</b>	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Good
<b>Vulnerable</b>	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the issuer to meet its ongoing senior financial obligations. A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Good; (bb) - Fair; (b) - Marginal; (ccc and cc) - Weak; (c) - Poor; (rs) - Regulatory Supervision/Liquidation. The (nr) designation may be assigned to insurers that were previously rated.

A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

Rating Modifiers		Affiliation Codes	
"u"	Under Review	"g"	Group
"pd"	Public Data	"p"	Pooled
"s"	Syndicate	"r"	Reinsured

## Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

## Long-Term Issuer Credit, Bank Deposit and Debt Ratings

A.M. Best uses its long-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due);
- **Issuer Credit Ratings** (an opinion as to the ability of the issuer to meet its ongoing senior financial obligations) and
- **Bank Deposit Ratings** (an opinion as to a bank's ability to meet its ongoing obligations to depositors).

	Rating	Descriptor
<b>Investment Grade</b>	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
<b>Non-Investment Grade</b>	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a ("u") modifier for Under Review.

Ratings prefixed with an ("i") denote indicative ratings. Issuer Credit Ratings may also be assigned a ("pd") modifier, which indicates that a company does not subscribe to A.M. Best's interactive rating process. A.M. Best may also assign the ("rs") designation, which indicates that a company is under regulatory supervision or liquidation.

## Short-Term Issuer Credit and Debt Ratings

A.M. Best uses its short-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the issuer to meet its senior financial commitments on obligations maturing in generally less than one year).

	Rating	Descriptor
Investment Grade	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
Non-Investment Grade	AMB-4	Speculative
	d	In Default

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

## Not Rated (nr)

The (nr) designation may be assigned to issuers or issues that were previously rated.

## Rating Outlook

Best's Credit Ratings (A++ to D, aaa to c) are assigned a Rating Outlook that indicates the potential direction of a company's/issue's rating for an intermediate period, generally defined as the next 12 to 36 months. A.M. Best does not assign Public Data Ratings to Bank Deposit or Debt Ratings. Financial Strength and Issuer Credit Public Data Ratings are not assigned an Outlook. Rating Outlooks are as follows:

Positive	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.





Founded in 1899, A.M. Best Company is a full-service credit rating organization dedicated to serving the financial services industries, including the banking and insurance sectors. For more information, visit [www.ambest.com](http://www.ambest.com) or contact one of our offices.

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