

2006 Annual Global Reinsurance Report:

Reinsurers Humbled, But Most Not Broken, by Hurricane Losses

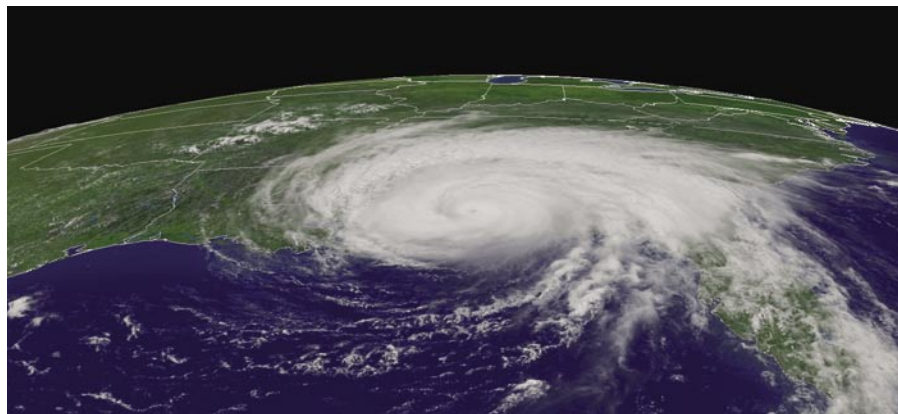
Despite the magnitude of the financial losses, the reinsurance sector, for the most part, is financially well positioned to meet its claim obligations.

Executive Summary

In 2005, property/casualty reinsurers endured the largest insurable event in history in the aggregate losses from hurricanes Katrina, Rita and Wilma. Even on an inflation-adjusted basis, the losses surpassed those of Hurricane Andrew and the U.S. terrorist attacks of 2001. The U.S. hurricane season accounted for roughly two-thirds of the record global insured property losses in the year, with global reinsurers absorbing approximately 60% of the U.S. losses.

Almost a year later, the industry still is struggling to understand the complexity of its exposure to Katrina, which has proven to be a catastrophe with a number of unique features. As a result, its ultimate cost to the industry and the reinsurance segment will not be known for some time.

In response to the extraordinary losses, the reinsurance industry is reacting decisively in anticipation of a long haul of heightened storm and catastrophic loss: Risk management techniques are becoming more sophisticated; underwriting is being tightened; catastrophe and capital models have been revised to reflect greater frequency and severity; rating agency methodologies are putting greater emphasis on capital and capital quality; and companies are looking for off-balance-sheet solutions to capital issues in catastrophe bonds and securitizations. Many companies have replenished



existing capital or have raised new capital, while simultaneously reducing risk exposure and raising prices, as much as 100% or more for property catastrophe and marine exposures. The result most likely will be that reinsurance will become an even more capital intensive business than it has been traditionally.

Top 35

For the second consecutive year, Munich Re, Swiss Re Group, Berkshire Hathaway Group, Hannover Re and Lloyd's of London held their respective top five positions in A.M. Best's ranking of the top 35 global reinsurer groups. Looking ahead, corporate changes in 2006 promise a shake-up in the rankings. If Swiss Re Group's acquisition of GE Insurance Solutions in June 2006 had taken place in 2005, it would have pushed Swiss Re to the top of the list.

Rating Changes

Since the U.S. hurricanes in 2005, 13 U.S. and Bermudian companies have been downgraded by A.M.

Best or have had their Best's Rating withdrawn after being downgraded. Hurricane losses were a factor in each of these actions. Four Bermuda-based companies have been placed in runoff.

Outlook

A. M. Best's 2006 outlook for the global reinsurance sector is negative. While there are few negative rating outlooks on specific reinsurance companies at this time, the underlying stability of the current market remains tenuous.

U.S. and Bermuda Markets

The adverse effects of the 2005 hurricanes were distributed unevenly across the globe, with U.S. and Bermudian property reinsurers carrying more of the losses than their more diversified European counterparts. Bermudian companies shouldered approximately \$11 billion¹ of the insured property losses, while

¹ All dollar references are to the U.S. dollar. Exchange rates used for currency conversions are as of December 31, 2005, unless otherwise indicated.



U.S. reinsurers' losses came in at an estimated \$7.1 billion.

In response to the lost capital and the expectation of high returns from a hardening market, approximately \$18 billion in new capital flowed into the Bermuda market. About \$8 billion was invested in nine startup companies and sidecars; the rest went into existing reinsurers. Even before the storms hit, reinsurers faced pressing issues. The emergence of adverse loss-reserve development from the soft market of 1997 to 2001 continues to depress the industry's profitability. In addition, earnings have been affected by the softening market and declining cession rates.

Lloyd's/London Market

Of note is the reduction in volatility both at Lloyd's and in the London market in 2005 as compared with 2001. Lloyd's total net estimated claims from the U.S. hurricanes in 2005 were approximately \$5.9 billion, contributing to a combined ratio of 112% for Lloyd's as a whole. A.M. Best estimates a combined ratio of approximately 119% for the major London market reinsurers.

Continental Europe

Several European global reinsurers suffered the largest catastrophe losses in their individual histories in 2005, amounting to approximately \$6 billion (before tax and equalization reserves), primarily the result of the U.S. hurricanes. Despite this, they posted a profit, although earnings of companies with relatively high exposure to these catastrophes dropped significantly.

European Life Reinsurance

A.M. Best expects a considerable decline in growth in the 2006 European life reinsurance premiums to an estimated 5% to 7%, from the 15% annual growth in the previous six years. The decline indicates not merely tepid demand for the product, but presages a transformation of the marketplace. Life reinsurers, now faced with declining demand and heightened competition, either are beginning to assume higher levels of risk or are moving into solutions such as securitization.

U.S. Life Reinsurance

Pricing dynamics are changing, albeit gradually, in the U.S. life reinsurance market.

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The Insurance Information Source

Prices are rising as the life reinsurance market shrinks to fewer, more disciplined suppliers due to consolidation and exits from the market. Although the competitive landscape and pricing environment generally are stable, A.M. Best believes that in the longer term, higher rates will translate into lower new business volume.

Insurance Securitization

Insurance securitizations rose sharply in

2005 to record levels, with annual issuance topping \$5 billion for the first time. Growth in the creation of new concepts of risk-linked and cash-flow instruments also has been explosive. Instruments ranging from working layer securitizations to securitizations of future profits were placed with the capital markets last year. This year promises the same, with overall activity in the first half of 2006 already topping that of 2005.

2006 Top 35 Global Reinsurers Stable, But Shake-Up Due in 2007

Top 35 Ranking

For the second consecutive year, Munich Re, Swiss Re Group, Berkshire Hathaway Group, Hannover Re and Lloyd's of London held their respective top five positions in A.M. Best's ranking of the top 35 global reinsurer groups. Among the remaining 30 groups, the rankings of 24 (80%) differed from the prior year. Notable among this year's changes in the top 10 was the addition of two life reinsurance groups, London Reinsurance Group and

RGA Reinsurance Co., which displaced Everest Re Group and Transatlantic Holdings Inc. Group.

Despite shifts in rankings, the overall market concentration remained relatively constant vs. the prior year, adjusted for currency volatility.

Looking ahead, corporate changes in 2006 already promise a shake-up in the rankings (see **Table 1**). In particular, if Swiss Re Group's acquisition of GE Insurance Solutions in June 2006 had taken

Demand for Uniform Regulation Spreads Across the Globe

Reinsurers around the globe are increasingly chafing at the regulations and capital requirements imposed in the United States, especially with the expected arrival of uniform regulations out of the European Union's Reinsurance Directive. The directive is part of the wider Financial Services Action Plan, intended to integrate the market across all 25 EU member states.

The reinsurance directive, due to come into full force at the end of 2007, establishes a regulatory structure, capital requirements and a provision for a single European passport for reinsurers. With the passport, which is expected to reduce transaction costs, reinsurers will be allowed to act through branches—as primary EU insurers now are able to.

The reinsurance directive also requires the abolition of collateralization or deposit requirements for reinsurers, which could improve liquidity. European lawmakers have hinted that Europe's elimination of collateral rules may not apply to reinsurers from countries like the United States that impose these requirements. European reinsurers have campaigned against U.S. rules that require non-U.S.-based companies to either become licensed in a state where they want to

do business or post collateral for 100% of their obligations to U.S. cedents.

Meanwhile, in June 2006, state insurance regulators in the United States voted to advance a proposal to ease collateral requirements for non-U.S. reinsurers. Regulators at a meeting of the National Association of Insurance Commissioners (NAIC) narrowed possible amendments to the U.S. reinsurance collateral requirement by voting to focus on tying collateral to a company's financial strength rating.

At the NAIC level, discussions between U.S. and alien reinsurers began more than six years ago, when Lloyd's and the International Underwriting Association asked U.S. regulators to revise the terms of collateralization.

Of note among other proposed alternatives to the current U.S. regulatory framework was a list of core principles that included creation of a single, U.S. reinsurance regulator that would be given pre-emption and enforcement authority. Recommendations also included a mechanism to assess the financial strength of reinsurers, both in the United States and abroad, and to establish a system that would preserve the ability of U.S. cedents to access reinsurance capacity by choosing to do business with either U.S. or non-U.S. reinsurers.

place in 2005, it would have pushed Swiss Re to the top of this year's list.

Ranked by 2005 gross written premium (reinsurance only) in U.S. dollars, 2006's top five groups accounted for 52% of total gross premium for the aggregate top 35, while the top 10 accounted for 74% of total gross premium. Where those concentrations vary from 56% and 72% the

year before, part of the shift was due to a strengthening U.S. dollar. Adjusted for the greenback's 16% increase against the euro, 12% rise against sterling, etc., the same concentrations in last year's report would have been 54% and 71%, respectively. The drop in aggregate gross premium to \$158 billion in the 2006 ranking from \$172 billion in the 2005 ranking also primar-

Table 1
Top 35 Global Reinsurance Groups

Ranked by Consolidated Gross Premium Written in 2005.

(US\$ Millions)

2006 Ranking ¹	Group Name	Prior Rankings ¹				Consolidated Premiums		Total Shareholder Funds	Ratios		
		2005	2004	2003	2002	Gross	Net		Loss	Expense	Combined
1	Munich Re	1	1	1	1	\$26,482	\$22,606	\$28,652	83.6%	33.2%	116.8%
2	Swiss Re Group	2	2	2	2	\$23,151	\$21,229	\$17,430	82.1%	30.9%	113.0%
3	Berkshire Hathaway Group	3	4	3	3	\$12,486	\$11,646	\$68,484	87.1%	23.4%	110.5%
4	Hannover Re	4	3	4	5	\$11,452	N/A	\$3,740	85.6%	26.8%	112.5%
5	Lloyd's of London	5	5	5	6	\$9,053	\$6,568	\$18,915	103.6%	31.5%	135.1%
6	GE Global Ins Hldgs ²	6	6	6	4	\$8,565	\$6,697	\$8,251	164.5%	32.3%	196.8%
7	XL Capital	7	9	9	11	\$5,686	\$5,013	\$8,472	99.7%	27.3%	127.0%
8	London Reins Group	14	14	12	12	\$4,243	\$3,730	\$554	N/A	N/A	N/A
9	RGA Reins Co	12	15	15	17	\$4,222	\$3,867	\$2,528	N/A	N/A	N/A
10	Everest Re Group	8	8	13	15	\$4,109	\$3,972	\$4,140	94.0%	26.2%	120.2%
11	Transatlantic Hldgs Inc Group	9	12	11	13	\$3,888	\$3,466	\$2,544	85.0%	27.7%	112.7%
12	Partner Re Group	10	13	14	14	\$3,665	\$3,616	\$3,093	87.3%	29.2%	116.5%
13	Korean Reins Co ³	16	17	18	21	\$2,975	\$2,068	\$515	67.9%	27.2%	96.9%
14	Scor Group	13	7	7	8	\$2,851	\$2,692	\$2,036	74.7%	21.9%	96.7%
15	Odyssey Re Group (Fairfax)	15	16	16	24	\$2,627	\$2,302	\$1,623	90.5%	27.1%	117.6%
16	Scottish Re ⁴	---	---	---	---	\$2,553	N/A	\$1,506	N/A	N/A	N/A
17	Aegon ⁵	28	25	26	18	\$2,112	\$1,156	N/A	N/A	N/A	N/A
18	Converium Group	11	11	10	10	\$1,994	\$1,816	\$1,653	77.4%	28.2%	105.6%
19	White Mountains Re	18	26	29	34	\$1,981	\$1,304	\$3,833	90.3%	28.2%	118.4%
20	ACE	19	23	28	31	\$1,847	\$1,794	\$11,812	91.6%	24.0%	115.5%
21	RenaissanceRe	27	27	24	35	\$1,809	\$1,543	\$2,254	116.6%	23.1%	139.7%
22	Platinum Underwriters Group	22	31	21	---	\$1,765	\$1,717	\$1,540	87.8%	27.6%	115.4%
23	Arch Reins Ltd	23	20	32	---	\$1,751	\$1,657	\$2,481	66.3%	31.2%	97.5%
24	Axa Re Group ⁶	29	10	8	9	\$1,729	\$1,719	\$40,090	88.3%	32.9%	121.2%
25	Endurance Specialty Ins Ltd	21	21	33	---	\$1,669	\$1,619	\$1,873	95.8%	27.7%	123.5%
26	Mapfre	26	32	35	33	\$1,584	\$1,082	\$737	67.6%	32.0%	99.6%
27	Assicurazioni Generali SpA	31	30	19	22	\$1,575	N/A	\$20,792	N/A	N/A	N/A
28	QBE	24	18	23	25	\$1,546	\$1,191	\$3,767	71.8%	30.1%	101.9%
29	Caisse Centrale de Reassur	20	24	27	30	\$1,537	\$1,476	\$1,973	75.8%	11.4%	87.2%
30	Axis Capital Holdings Limited	34	---	---	---	\$1,519	\$1,491	\$3,512	86.4%	19.7%	106.1%
31	Aspen Insurance	33	28	---	---	\$1,443	\$1,129	\$2,040	100.8%	27.2%	128.0%
32	Toa Reins Group ³	30	22	20	23	\$1,346	\$1,299	\$1,584	86.7%	28.4%	115.1%
33	Chubb/Harbor Point ⁷	32	34	---	---	\$1,018	\$904	\$12,407	61.6%	33.5%	95.1%
34	Alea Group ⁸	25	29	30	---	\$998	\$1,087	\$490	84.6%	41.5%	126.1%
35	Montpelier	---	---	---	---	\$979	\$757	\$1,222	178.0%	22.7%	200.7%

(1) - Rankings based on prior year gross written premium. Deutsche Rueckversicherung reports gross written premium at year-end 2004 of € 894 million, which would have qualified it for the top 35 last year, and for this year, if the numbers held. Given the year's information lag and exchange rate issues, the company is not included in the current ranking.

(2) - GE Insurance Solutions acquired by Swiss Re in June 2006.

(3) - Year end is March 31, 2006.

(4) - Acquired ING life reinsurance.

(5) - A.M. Best estimate based on statutory filings.

(6) - Axa includes expenses for both life and non-life segments.

(7) - Harbor Point acquired Chubb Re book of business in December 2005.

(8) - Operations materially curtailed in 2005.

(N/A) - Information not applicable or not available at time of publication.

Note: A.M. Best's Top 35 Ranking may differ from other published rankings in that: (1) The ranked entities are global in scope, not just U.S. based. (2) The ranked entities are insurance groups or unaffiliated single insurance companies. (3) The ranking is based on 2005's consolidated gross premiums written (GAAP accounting or non-U.S. equivalent) for reinsurance only.

Source: A.M. Best Co.

ily was a currency translation issue. Net of last year's dollar gains, the prior ranking's aggregate gross premiums would have been \$160 billion on a comparable basis. Foreign exchange volatility, did not affect the rankings of the top five.

Reinsurer Rating Changes, Post 2005 U.S. Hurricane Season

Rating Trends

Since Hurricane Katrina zeroed in on the U.S. Gulf Coast, there have been 17 net changes in Best's Ratings of reinsurers as of July 31, 2006 (see Table 2). Thirteen companies have been downgraded or had their ratings withdrawn after a downgrade, and hurricane losses were a factor in each of those actions. There were no upgrades, and there are seven companies with their ratings currently under review. Three of the companies under review are tied to the Securities and Exchange Commission's (SEC) Wells Notice that led to the resignation of RenaissanceRe's chief executive officer in late 2005. RenaissanceRe also suffered heavy hurricane losses. The under review actions for Glacier Re and Folksamerica were tied directly to 2005 hurricane loss development. There were only two under review actions that were independent of hurricane losses, and they were related to

Swiss Re's acquisition activity. In total, 15 of the 17 net rating changes were influenced by hurricane catastrophe losses.

Despite a perceived level of excess capital in the market before the storms, a number of companies did not hold a sufficient level of capital for their stated rating. As the accumulation of losses from the hurricanes was larger than expected, a material decline in risk-adjusted capitalization resulted for many companies. This was due, in large part, to over reliance on catastrophe models and failure to properly assess the impact of correlating risk exposure.

Hurricane Katrina exposed the inadequacy of the cat models, as well as the data and risk assumptions on which the models relied, therefore impeding the reliable quantification of expected loss. A. M. Best believes that some companies either did not recognize or did not

Table 2
Best's Ratings
Reinsurance Net Rating Changes Post 2005 U.S. Hurricanes

Company	Ratings on 8/28/2005		Ratings on 7/31/2006		Current Status	Reason for Under Review
	FSR	ICR	FSR	ICR		
Endurance Specialty	A	a	A-	a-		
IPCRe	A+	aa-	A	a		
Montpelier Re	A	a	A-	a-		
Allied World	A+	aa-	A	a		
Folksamerica	A	a	A- u	a- u	Under Review	2005 Hurricane Loss Development
DaVinci Re	A	a+	A u	a u	Under Review	Renaissance Re Wells Notice
Renaissance Reinsurance Ltd.	A+	aa-	A u	a u	Under Review	Wells Notice
Glencoe Group	A	a	A- u	a- u	Under Review	Renaissance Re Wells Notice
Swiss Re	A+	aa	A+ u	aa u	Under Review	Acquisition of GE Insurance Solutions
Employers Re Corp Group	A	a	A u	a u	Under Review	Acquisition by Swiss Re
Glacier Re	A-	a-	A- u	a- u	Under Review	2005 Hurricane Loss Development
Rosemont Re	A-	a-	NR-4		Withdrawn ¹	
PXRE	A	a	NR-4		Withdrawn ²	
Quanta	A-	a-	NR-4		Withdrawn ³	
Olympus Re	A-	a-	NR-4		Withdrawn ⁴	
Alea	A- u	a- u	NR-4		Withdrawn ⁵	
Western General ⁶	A	a	NR-4		Withdrawn ⁶	

1 - Rating was downgraded to B FSR, bb ICR on 10/18/2005.

2 - Rating was d

3 - Rating was downgraded to B++ FSR, bbb ICR on 3/2/2006; B FSR, bb ICR on 6/7/2006.

4 - Rating was downgraded to B+ FSR, bbb- ICR on 9/15/2005; B- FSR, bb- ICR on 3/24/2006.

5 - Rating was downgraded to B++ FSR, bbb ICR on 9/22/2005; B FSR, bb ICR on 1/30/2006.

6 - Rating was downgraded to B++ FSR, bbb ICR on 11/23/2005; B+ FSR and bbb- ICR on 3/2/06 and affirmed 7/11/06.

Source: A.M. Best Co.

consider the limitations of the models and may have placed too much emphasis on them for purposes of managing their exposure to natural perils.

As a result, A.M. Best will continue to take a more rigorous approach in its due diligence in regard to the evaluation of a company's capitalization and risk management controls. A.M. Best considers catastrophe models to be a valuable tool and resource for the quantification of risk, but it expects management to demonstrate confidence

in the data and parameters employed throughout the modeling exercise. Further, management needs to demonstrate that underwriting and risk controls are adequate to ensure there is a clear understanding of, and controlled correlation with, unmodeled exposures. To that end, A.M. Best is requiring more detailed information through its supplementary rating questionnaire and in company meetings (see sidebar on A.M. Best's Catastrophe Rating Methodology).

Outlook for Global Reinsurance Industry

A.M. Best's 2006 outlook for the global reinsurance sector is negative. While there are few negative rating outlooks on specific reinsurance companies at this time, the underlying stability of the current market remains tenuous. As a result, the likelihood for assignment of positive rating outlooks or upgrades over the mid-term appears remote.

In A.M. Best's view, the global reinsurance sector remains susceptible to competition from both established players and new entrants, as investor expectations run high. A considerable portion of the capital that flowed into the market since the 2005 U.S. hurricanes is short-term in nature, deployed through

special purpose vehicles such as sidecars or catastrophe bonds. Capital requirements for catastrophe-exposed classes are significantly higher, post Katrina, and companies have been constrained in deploying their capacity. The market has demonstrated that while property rate increases attained during the January and July 2006 renewal seasons were favorable, they were narrowly focused and limited to those covers affected by recent losses—primarily property catastrophe, marine and energy reinsurance. Casualty business in the United States and Europe has seen little, if any, benefit in terms of price hardening thus far.

Should an active 2006 storm season materialize as predicted, it may help to prolong

Catastrophe Analysis in A.M. Best's Ratings

A.M. Best Co. considers catastrophic loss, both natural and man-made, to be the greatest threat to the financial strength and credit quality of property and casualty insurers due to the significant, rapid and unexpected impact that can occur. While many other exposures can affect solvency, no single event can affect policyholder and debt-holder security more instantaneously than catastrophes. Moreover, immediately following a significant event, the company retains its exposure base, and subsequent events can occur prior to the implementation of any risk-mitigation strategies. Indeed, as catastrophic losses continue to rise, insurers and reinsurers are being challenged to further improve their risk-management systems and provide capitalization to support the risk.

A.M. Best's response has been to continue to refine its methodology for evaluating insurers' financial strength to reflect the ability to manage catastrophic potential losses. For many years, A.M. Best has been including Probable Maximum Loss (PML) from severe events (1-in-100-year hurricane/windstorm and a 1-in-250 year earthquake) in its calculation of a company's risk-adjusted capitalization as measured by Best's Capital Adequacy Ratio (BCAR). BCAR is A.M. Best's main tool

for evaluating a company's operating capitalization.

As indicated in A.M. Best's methodology "Catastrophe Analysis in A.M. Best's Ratings," April 2006, A.M. Best performs an additional "stress test" for a second event to determine the potential financial condition of an entity after two successive catastrophes. The stress test for the second event considers the nature of the exposures (hurricane/wind/earthquake) and whether the second event is likely to be more or less severe than the first.

Recent modifications to the stress test also recognize the trend toward increased conservatism of a number of the catastrophe modeling tools now being used by insurers. In addressing the level of capital, the test also gives greater consideration to the financial flexibility of a company—its ability to replenish capital after a catastrophic event—and the greater differential between companies in their employment of strong or weak risk management. The bottom line is that insurers must be able to demonstrate the financial wherewithal to absorb the potential losses in order to maintain their ratings.

The full text of the methodology is available at www.ambest.com.

the hard property market, but at additional cost to earnings and capital. The financial flexibility of some established companies already is stretched, with debt-to-capital ratios near all-time highs. Although common equity has previously flowed into the reinsurance sector with relatively little resistance, the recent rise in special purpose vehicles may prove to be a strong diversion for some investors previously willing to take longer-term bets on traditional

reinsurance companies.

When the current market opportunity in property, marine and energy business begins to diminish, the new capital that flowed into the market through special purpose vehicles will seek alternative investment strategies. The remaining traditional players will be left to deal with the downward slope in the underwriting cycle typified by declining margins on property and casualty business. Currently, restrained

Impact of Catastrophe Losses on Strength of U.S. Industry

In the past 100 years, 80% of the catastrophes that rattled the insurance markets have been hurricanes. A.M. Best has tracked property/casualty (P/C) impairments and their causes formally since 1969. The common denominator found among insurer failures was a diminished operating environment, with peaks in impairments often being triggered by external factors affecting the industry's underwriting or investment results. Negative underwriting surprises in the form of catastrophes often have stressed already vulnerable companies to the breaking point.

A company's Best's Rating, or lack of same, was a reasonable predictor of whether an insurer might succumb to the impact of a catastrophe. Of the 45 companies identified as having failed primarily due to catastrophic losses in the 1969-2006 period, most had either a Vulnerable Best's Rating or no Best's Rating. In the year of impairment, 71% were not rated, 27% were Vulnerable and only 2% were Secure. Further, 80% of insurers impaired by catastrophe losses appear to have been liquidated.

The 2004-2005 Experience

Despite six of the 10 costliest hurricanes in U.S. history having occurred within 14 months between 2004 and 2005, most P/C insurers have been able to ride out the storms. Overall P/C impairments dropped to a 25-year low of 11 companies in 2005 from 17 in 2004 for an impairment rate of 0.32%, or 1-in-313 companies.

At the time of publication of A.M. Best's annual hurricane special report titled "Shake, Rattle and Roar," on June 1, 2006, four Florida insurer failures were tied directly to the one-two punch of the 2004-2005 storms: American Superior Insurance Co. and the three insurers from the Poe Financial Group—Southern Family Insurance Co., Florida Preferred Insurance Co. and Atlantic Preferred Insurance Co. Poe had been under confidential supervision prior to the public announcement of regulatory action.

The Poe Group was the third-largest homeowners insurer in Florida in 2004, with a 6.5% market share, based on direct premiums written, according to A.M. Best Co. State/Line product information. In total, more than 280,000 policyholders were affected by Poe's failure. Many of these policyholders inevitably

will end up with Citizens Property Insurance Corp., the state-run homeowners insurer of last resort. Citizens, the second-largest homeowners insurer in Florida, may be facing a \$1.7 billion deficit stemming from the 2005 hurricane season.

Despite the resiliency demonstrated by the insurance industry over the past two hurricane seasons, a number of insurers have been scrambling to minimize their exposure in high-value coastal areas. The 2004-2005 storms hit all lines, with reinsurers and personal property insurers taking the brunt.

Industry Financial Strength Helps '04-'05 Buck Trend

In 2004, the U.S. P/C industry sustained \$20.5 billion in insured losses, yet recorded its first underwriting profit since 1978. The industry's combined ratio—a barometer of profitability with a high correlation to impairments—improved by 2.1 points to 98.1.

In 2005, even with insured losses from the hurricanes reaching 14.1% of policyholders' surplus, the industry reported an overall operating profit. Underwriting results deteriorated, but only marginally, as the combined ratio climbed to 100.7—the result not only of the hurricane losses, but also of softening market conditions.

Beyond the rapid growth in PHS, several factors present in the three years leading up to 2004-2005 contributed to the industry's stability:

- Stable financial markets and economy.
- Transference of risk to the growing global reinsurance market.
- Greater use of capital-market solutions (for capital raising), such as trust-preferred securities, hedge funds and securitization.

Also helping stability were major improvements in building codes, insurers' risk-management techniques and the catastrophe modeling adopted after Hurricane Andrew and ensuing catastrophes. In recognition of these improvements, A.M. Best has modified its catastrophe analysis to allow more flexibility in calculating capital requirements for insurers with catastrophe exposures.

This material is an excerpt from A.M. Best's annual hurricane study, "Shake Rattle and Roar," June 2006. For a full copy of the study, see www.ambest.com.

underwriting discipline is being tested as companies seek to take advantage of the near-term

property opportunity while maintaining a prudently diversified risk portfolio.

U.S. Market: Divided and Under Pressure

Overview of P/C Reinsurance Markets

Insured losses from Hurricane Katrina and the other U.S. hurricanes pounded the 2005 results of the U.S. and Bermudian reinsurance segments more heavily than U.S. primary writers and most other reinsurers globally, as the Americans and the Bermudians carried more of the hurricane risks. U.S. reinsurers had an estimated \$7.1 billion in catastrophic losses for 2005, while the Bermudian companies were hit even harder with approximate-

ly \$11 billion. The two domiciles absorbed approximately half the losses worldwide.

Compounding the negative effects on U.S. reinsurers' performance were existing pressures from legacy reserve issues and loss of premium due to a softening market and competition from alien reinsurers. Losses for the professional reinsurers in the United States pushed their combined ratio in 2005 to 144.8%, from 106.7% in 2004.

Renewals

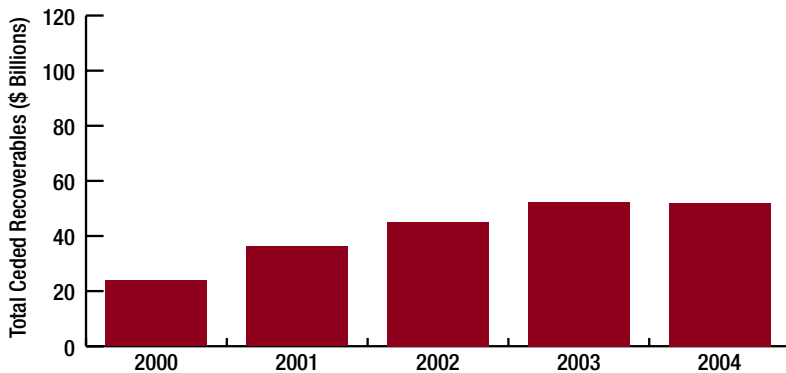
Reinsurance renewals so far in 2006 have firmed anywhere from 50% to 100% for U.S. property and marine reinsurance in catastrophe prone areas. But the increases were not across the board, as some cedents with healthy balance sheets have resisted pricing changes by retaining higher levels of risk. Rates have not hardened across all lines either, as casualty pricing has softened or at least remained stagnant.

In the first quarter 2006, net premiums written declined 5.9%, continuing a two-year trend. While net premiums written (NPW) declined, gross premiums increased, driven by significant hardening in property rates, particularly in catastrophe prone areas. Influencing the upward pressure on property catastrophe rates is the recalibration of catastrophe and capital models to reflect the expectation of increased frequency and severity of risk.

As 2006 progresses, demand for property cover is expected to grow, especially with predictions for another hyperactive hurricane season. Market share and premiums for U.S. property reinsurers, however, are not expected to increase, as reinsurers limit their capacity in catastrophe prone areas of the United States and prospective cedents retain high levels of risk or turn to non-U.S. reinsurers (see Exhibits 1 and 2) or the capital markets to lay off risk.

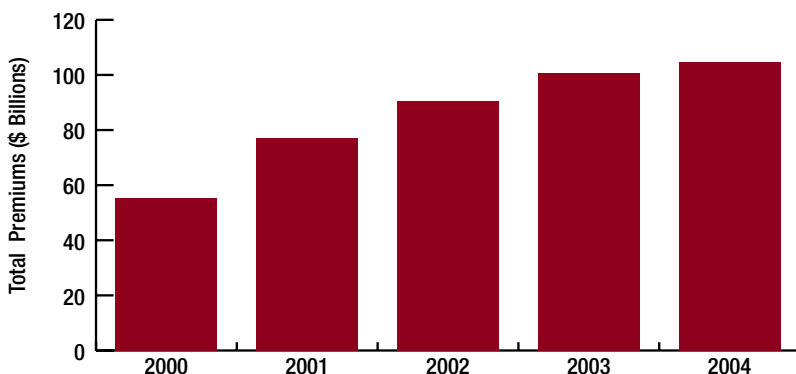
Swiss Re's 2006 acquisition of GE Insurance Solutions, making it the largest reinsurer in the world, is an unknown factor in the direction of market. Swiss Re's behavior could encourage more discipline in terms of underwriting, pricing and conditions; otherwise it

Exhibit 1
Premiums Ceded to Affiliated and Unaffiliated Alien Reinsurers



Source: Reinsurance Association of America

Exhibit 2
Recoverables from Affiliated and Unaffiliated Alien Reinsurers



Source: Reinsurance Association of America

could expedite softening.

Supply, however, will be contingent on the market's ability to allocate capital to catastrophe prone regions, along with the availability of alternative forms of capital provided by the ever-growing presence of hedge funds (see **Exhibit 3**).

Financial Results

Full-year 2005 underwriting results for the U.S. reinsurance sector were significantly affected not only by the frequency and severity of the hurricane season, but by a number of one-time transactions that skewed the sector's performance measurements (see **Table 3** on financial performance indicators and **Exhibits 4** and **5** on underwriting leverage trends and adverse reserve development by accident year).

The most significant U.S. transaction was the loss portfolio transfer (LPT) of approximately \$6 billion between American Re, a U.S.-domiciled reinsurer, and its German parent, Munich Re. The income statement impact directly hit net premiums written, ceded premiums and net premiums earned, which in turn affected the loss and LAE ratio, expense ratio and combined ratio for the U.S. reinsurance segment. In addition, American Re reported adverse development of approximately \$1.4 billion in the second quarter of 2005, which had an impact on the segment's reported underwriting loss, as did the \$1.7 billion of adverse development taken by GE Insurance Solutions in the fourth quarter. Further affecting the year's underwriting results was an LPT reported in the first quarter by the Berkshire Hathaway companies. It was booked gross of discount; resulting in approximately \$1.3 billion of prior-year development. A fourth item was the monetization of an asset by another Berkshire Hathaway affiliate, which increased net investment income by approximately \$2.3 billion.

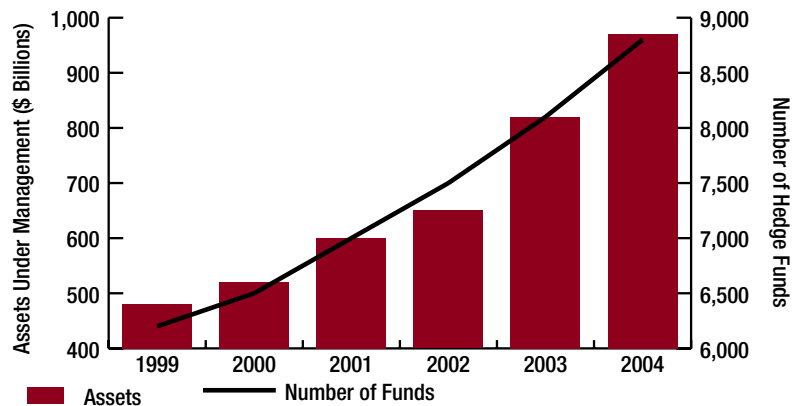
The most significant impact on earnings of the overall reinsurance sector were the catastrophe losses tied to the 2005 hurricane season. On a net basis (after significant cessions to offshore affiliates), catastrophe losses totaled approximately \$7.1 billion and underwriting losses were \$9.1 billion, including approximately \$470 million of asbestos and environment (A&E) development. The combined ratio for 2005 was 144.8%. The impact of catastrophe losses was about 35 points, up from 8.3 points in 2004. Adjusting for prior

year development, the year's combined ratio improved to 134.6%.

Net premiums written totaled \$20.4 billion. Adjusted for the American Re LPT, they were \$26.3 billion, down from \$28.3 billion in 2004. Likewise, net premiums earned decreased 7.4% year-over-year on an adjusted basis, to \$26.2 billion from \$28.3 billion. A softening marketplace and higher retention rates by cedents put a drag on premium growth. Still, although underwriting concessions were observed in the market in the form of lower rates and less stringent terms and conditions, the changes, for the most part, appeared reasonable.

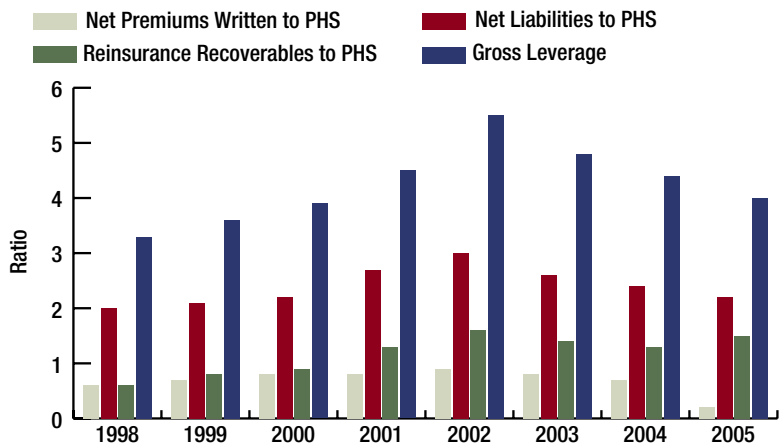
Underwriting losses for 2005 year were

**Exhibit 3
Growth in Hedge Funds**



Source: International Monetary Fund

**Exhibit 4
Underwriting Leverage Trends, U.S. Reinsurers**



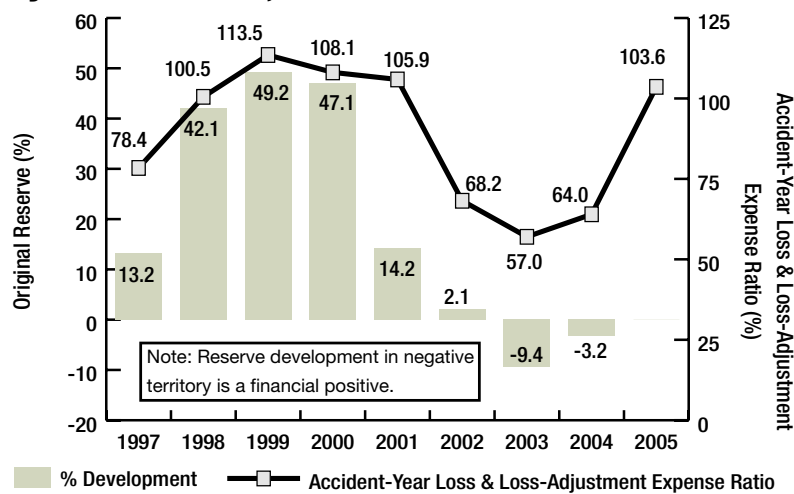
Note: Excludes National Indemnity
Source: A.M. Best Co.

Table 3
Segment Underwriting Details—U.S. Reinsurance

Category	2004 %	2005 %	2005(N) %
Net Premiums Written Growth	-3.1	-28.0	-6.9
Pure Loss Ratio	72.0	99.8	98.7
Loss Adjustment Expense Ratio	8.3	12.3	10.6
Underwriting Expense Ratio	26.5	32.7	25.3
Policyholder Dividend Ratio	0.0	0.0	0.0
Combined Ratio (Reported)	106.7	144.8	134.6
Less : Catastrophe Losses	8.3	34.6	26.8
Less : A&E Losses	2.2	-1.0	3.3
CY Combined Ratio (Normalized)	96.2	111.2	104.5
Less : Core Loss Reserve Dev.	7.9	1.2	17.4
AY Combined Ratio (Normalized)	88.3	110.0	87.1

(N) Normalized for American Re loss portfolio transfer.
Source: A.M. Best Co.

Exhibit 5
Adverse Reserve Development
By Accident Year, U.S. Reinsurers



Source: A.M. Best Co.

partially offset by net investment income and realized capital gains of \$9.3 billion and \$5.6 billion, respectively, resulting in an overall net income of \$5.8 billion, which was 55.3% higher than for the same period in 2004. However, when normalized for the American Re LPT, net income deteriorated 5.1% due to the substantial realized gains taken by a Berkshire Hathaway affiliate. Notwithstanding the underwriting losses for the sector, policyholders' surplus rose 8.4% to \$80.9 billion.

In the first quarter of 2006, the sector reported an underwriting gain of \$30.8 million. Absent the previously mentioned Berkshire Hathaway LPT transactions, however, this is compared with an underwriting gain of approximately \$400 million in the same quarter in 2005. The 2006 first quarter produced a 98.5 combined ratio compared with 91.1 in the first quarter 2005, adjusted for impact of the one-time transactions. The deterioration in this year's first quarter combined ratio was driven by adverse loss development from the 2005 hurricanes and the overall decline in net premiums written.

On an accident-year basis, the combined ratio was 89.7 in the first quarter vs. 85.3 a year earlier, reflecting the overall softening relating to casualty classes. A.M. Best expects the accident-year combined ratio to continue to deteriorate in the coming quarters, as rates for casualty classes continue to moderate, tempered only by select opportunities in catastrophe exposed property classes where capacity remains tight.

Bermuda Market Takes Brunt of 2005 Hurricane Losses

The property/casualty Bermuda reinsurance market, which tripled between 2001 and 2004, increased a modest 5.4% in 2005, while other regions experienced stagnant growth because of the softening market. Bermuda has been able to hold its own in terms of premiums, due to the steady flow of business from the United States.

Many of the Bermudian companies, however, like the U.S. reinsurers, did not perform as well as their more diversified European counterparts in 2005.

For better or for worse, as Bermuda increas-

es its share of the U.S. ceded property catastrophe premiums, the fortunes of the two markets become more closely related. Bermuda bore the brunt of the globe's catastrophe losses in 2005 from hurricanes Katrina, Rita and Wilma (KRW) in the United States. Bermudian companies carried approximately \$11 billion of the insured property losses from the storms, however, losses still are developing and could go higher.

The Bermuda industry started 2005 with expectations for a better year. Early in 2005, Bermuda reinsurers—primarily the class

Table 4
Bermuda Class of 2005 vs. Class of 2001

Initial Best's Rating	Current Best's Rating*	Company/Instrument	Formed	Initial Capital (\$ Billions)	Lead Investors	Sponsor
Class of 2005						
A-	A-	Ariel Re	Nov 05	1.00	Blackstone, Texas Pacific, Thomas H. Lee	
A-	A-	Flagstone Re	Nov 05	0.50	West End Capital	
A	A	Harbor Point	Oct 05	1.30	Stone Point, Chubb	
A-	A-	Lancashire	Oct 05	1.00	Capital Z	
A-	A-	Validus	Oct 05	1.00	Aquiline, Merrill Lynch, Goldman Sachs	
A-	A-	Amlin Bermuda Ltd	Oct 05	1.00	Merrill Lynch, Goldman Sachs	
A-	A-	New Castle Re	Nov 05	0.50	Citadel Investment	
A-	A-	Hiscox Ins. Co.	Dec 05	0.50	Hiscox Plc	
A-	A-	Omega Specialty	Feb 06	0.17	Omega Underwriting Holdings Plc	
		Total		6.97		
Sidecars						
		Bay Point Re	Jun 06	0.25	Golden Tree Asset Management	Harbor Point
		Blue Ocean	Oct 05	0.30	Montpelier Re and other investors	Montpelier Re
		Cyrus Re	Nov 05	0.50	Highfields Management and others	XL Capital
		Flatiron Re	Dec 05	0.60	Goldman subsidiary	Arch Reinsurance
		Helicon Re	Dec 05	0.15		Folksamerica
		Monte Fort Re	May 06	0.20	Lehman	Flagstone Re
		Petrel Re	May 06	0.20	First Reserve Corporation	Validus
		Starbound Re	May 06	0.30	Merrill Lynch	Renaissance Re
		Total		2.50		
		Total Sidecars/Reinsurers		9.47		
Class of 2001						
A+	A	Allied World Assur Co Ltd	Nov 01	1.50	AIG, Chubb, Goldman Sachs	
A-	A-	Arch Capital Group Ltd	Nov 01	1.00	Warburg Pincus, Hellman & Friedman	
A-	A-	Aspen	Dec 02	0.20	Aspen Insurance Holdings Ltd	
A-	A	Axis Capital Holdings	Nov 01	1.70	MMC Capital	
A	A u	DaVinci Rein Ltd	Nov 01	0.40	RenaissanceRe, State Farm	
A-	A-	Endurance Speciality Ins Ltd	Nov 01	1.20	Aon, Texas Pacific, Thomas H. Lee	
A-	A-	Montpelier Re Hldgs Ltd	Nov 01	0.90	White Mountains, Cypress, Benfield	
A	A	Platinum	Nov 02	1.00	Initial Public Offering, St. Paul, RenaissanceRe	
A-	NR-4	Olympus Reins Co Ltd	Aug 02	0.50	Leucadia National, Gilbert Global, Franklin Mutual	
		Total		8.40		

* As of 7/31/2006

u Under Review

Source: A.M Best Co.

of 2001—faced with the challenge of maintaining an attractive return on equity, began returning what looked like excess capital to shareholders rather than use it to underprice business. At the time, the redeployment of capital seemed disciplined and rational, until hurricanes KRW.

Startups

After the 2005 storms, investors, primarily private-equity hedge funds, jumped in to replenish the lost capital. Approximately \$18 billion in new capital flowed into the Bermuda market, mostly in common and preferred equity from investors eager to get a share of the potentially high returns from hardening property catastrophe rates. Of that amount, approximately \$8 billion of the new capital was invested in nine startup companies and

sidecars to form the “class of 2005” (see **Table 4**). The rest of the new capital went into existing reinsurers that reloaded their capacity after the hurricane losses.

The estimated \$7 billion net increase in capital, between Bermuda’s approximate \$11 billion in catastrophe losses and the estimated \$18 billion in new capital, however, still may not be enough for some companies, as catastrophe and capital models have been recalibrated for the expected continuing increase in frequency and severity of catastrophe losses along the U.S. coastline.

All of the members of the class of 2005 were able to gain at least an A- financial strength rating, based on A.M. Best’s rigorous due diligence process. The ratings were assigned based on business plans that met very stringent capital requirements. Earnings

and capitalization assumptions were stress tested by A. M. Best to ensure that each company maintained a conservative capital cushion through various operating scenarios. Management experience and expertise were significant rating considerations as well as the operating infrastructure. Each venture demonstrated varying, yet reasonable degrees of proficiency in all these areas.

While A.M. Best's general approach to rating new company formations remains the same, this class of new (re)insurers finds itself in a different situation than did the class that began business in 2001-2002. The 2005 Bermuda startups are focused

primarily on providing reinsurance capacity for short-tailed lines of property catastrophe reinsurance, and marine and energy. As such, they are somewhat less diversified than the class of 2001.

In addition, unlike previous startups, some of these new companies lack a unique franchise in an increasingly competitive catastrophe market. Many of the new reinsurers did not get their capital and underwriting in place in time to make a full showing in January, so their marketability will be more fully tested throughout 2006. These companies, however, may be challenged to meet their plans in terms of premium and return on equity. The greatest opportunities

A.M. Best's Position on Sidecars

The tightening of reinsurance capacity in the property/casualty market has made the use of "sidecars" an attractive alternative to traditional retrocession. The sidecar is the offspring both of investors looking for risk with potentially high returns and of reinsurers/insurers strapped for capital after the catastrophe losses. Although sidecars have been used mainly for property and marine catastrophe reinsurance, they also have been created for life reinsurance.

A sidecar is set up as special-purpose vehicle (SPV) with a defined purpose and limited lifetime. Capitalized by third-party private investors—primarily hedge funds—sidecars usually are sponsored by a larger reinsurer/insurer. The SPV generally provides extra capacity to the sponsoring reinsurer/insurer through catastrophe quota-share or excess-of-loss reinsurance on an exclusive basis. They also are a way for reinsurers/insurers to move selected risks, usually catastrophic risks, off their books while earning underwriting fees from the sidecars.

Although several sidecars were formed after the 2005 hurricane season, they have been used at least since 2002. The magnitude of the 2005 hurricane losses, however, demonstrated how vulnerable these sidecars can become after a major catastrophe, with Olympus Reinsurance Co. Ltd., Bermuda, being an example.

Olympus Re was formed in 2002 as a sidecar to Folksamerica Reinsurance Co., New York, a member company of White Mountains Insurance Group Ltd., New York. White Mountains ceded to Olympus up to 75% of most of its short-tail excess-of-loss business, mainly property and marine, and 50% of its proportional property business. White Mountains, in turn, has been receiving an override commission on the ceded premiums. Folksamerica also has available to it a second Bermuda-based sidecar, Helicon Reinsurance Co. Ltd., formed in 2006.

Olympus' problems began, however, when White Mountains increased its 2005 loss estimates by \$203 million over the originally estimated pretax loss of \$351 million. Folksamerica, in turn, set its reserves for offshore energy and marine exposures for

Katrina and Rita at full policy limits and increased reserves on other exposures affected by all three storms.

Under terms of the Folksamerica quota-share reinsurance treaty with Olympus, \$143 million of the increased loss would be ceded to Olympus. Without other action, this cession would exhaust the bulk of Olympus' capital, according to White Mountains. In June 2006, White Mountains said it was in advanced discussions with Olympus and its two largest shareholders to reimburse Olympus for as much as \$137 million of the ceded losses. The arrangement also would waive override commissions due from Olympus after March 31, 2006, for reinsurance contracts effective Dec. 31, 2005 or before. The group expected such commission waivers to total about \$8 million.

With the reimbursement, Olympus' capital would be about \$140 million, roughly in line with its level before the increase in the loss estimate. Olympus would continue to receive cessions from Folksamerica and be responsible for losses on exposures ceded to it by Folksamerica. Olympus and its two largest shareholders would agree, at Folksamerica's option, to continue the quota share treaty with Folksamerica through the end of 2007.

A.M. Best's Analysis of Sidecars

In the past, A.M. Best has evaluated the capacity and general creditworthiness of sidecars to determine, in general, whether sidecars will strengthen, weaken or have no effect on the financial strength ratings of the sponsoring reinsurers. The analysis of these vehicles has focused on the structural integrity of the transactions and the analytical rigor applied by various experts and advisers, such as peril modelers and investment banks. However, A.M. Best also will go one step further to publish issuer credit ratings and/or debt ratings, where appropriate, on all sidecars and their corresponding debt, if any. As part of A.M. Best's rating analysis, the benefit of the transaction to the ceding company will be given a "haircut," depending on the operational and tail risks to the ceding company, should the sidecar not be sufficiently capitalized.

for coverage are in the southeastern United States, which means building up concentrations of business in a highly catastrophe prone area.

The stability of the capital in these start-ups and the long-term commitment of the 2005 investors also are concerns, as hedge-fund investors are noted for their nimbleness in getting in and out of markets to turn a profit (see **Exhibit 3** on hedge fund growth).

Losses Force Exits

At least four Bermuda reinsurers hobbled by 2004 and 2005 hurricane losses sought buyers and, failing that, moved into runoff after ratings downgrades made it difficult to renew existing business and attract new cedents.

- Alea Group Holdings' 2005 results were weakened by charges related to the year's storm losses totaling \$108.5 million and \$80 million in runoff charges. Alea moved into runoff late in 2005, as it could not attract a suitable volume of business after its ratings were downgraded in the third and fourth quarters of 2005. In the fourth quarter, Alea sold off three sets of renewal rights, including the 2006 renewal rights of its European property/casualty treaty portfolio to French reinsurer SCOR.

- PXRE Group Ltd., by March 2006, had lost one-third of its clients due to hurricane losses and subsequent ratings downgrades. As of early May 2006, about 65% of its in-force business had been either cancelled or nonrenewed, with the rate expected to climb. PXRE also is being sued by investors who claim the reinsurer misled them about the extent of its storm losses. The complaint says that PXRE's loss exposure to the hurricanes doubled to between \$758 million and \$788 million from the company's initial loss estimates.

- Quanta Capital Holdings Ltd., in runoff, exited the property reinsurance market after \$41 million in fourth-quarter 2005 losses related to hurricanes, environmental concerns and reserve strengthening.

- Rosemont Re, in runoff, with estimated storm-related losses of \$60 million from Katrina, \$30 million from Rita, and between \$8 million and \$15 million from Hurricane Wilma, entered an agreement with a private-equity investors' group for a fixed, up-front payment of \$2.5 million for its

Table 5
Best's Bermuda P/C Reinsurer Composite
Component 16 Companies

ACE Limited
Allied World Assurance Holdings Ltd
Arch Capital Group Limited
Aspen Insurance Holdings Ltd
AXIS Capital Holdings Limited
Endurance Specialty Holdings
Everest Re Group Ltd
IPC Holdings Ltd
Max Re Capital Ltd
Montpelier Re Holdings Ltd
PartnerRe Ltd
Platinum Underwriters Holdings Ltd
PXRE Group Ltd
Quanta Capital Holdings Ltd
RenaissanceRe Holdings Ltd
XL Capital Limited
Source: A.M. Best Co.

Table 6
Best's Bermuda P/C Reinsurer Composite

Category	2004 (\$ Billions)	2005 (\$ Billions)	% Change
Total Equity	\$44.9	\$47.4	5.6
Net Income	5.5	-3.3	N/A
Net Premium Written (NPW)	40.5	42.7	5.4
	%	%	% Points
Loss Ratio	68.9	92.8	23.9
Expense Ratio	26.0	26.6	0.6
Combined Ratio	94.9	119.4	24.5

Note: NPW is for all non-life business.
Source: A.M. Best Co

infrastructure, plus 8% commission on its renewals. Rosemont then became Ariel Reinsurance Co. Ltd., which took over its infrastructure.

Financial Results

With the Bermuda reinsurers showing a composite 2005 loss ratio of 92.8, up 23.9 points from 2004's 68.9, and with the composite 2005 combined ratio rising to 119.4 from 94.9, a composite operating loss could be expected. Indeed, the Bermuda industry saw a composite net loss of \$3.3 billion in 2005, following \$5.5 billion of net income in 2004 (see **Tables 5** and **6**).

Despite the 2005 industry net loss, total equity rose. As a result of new capital in hand by year-end 2005, composite total equity gained 5.6% to \$47.4 billion in 2005 vs. \$44.9 billion in 2004.

Lloyd's and London Market Manage '05 Losses with Lower Volatility

Lloyd's total net estimated claims from the U.S. hurricanes in 2005 were approximately \$5.9 billion, contributing to a combined ratio of 112% for Lloyd's as a whole. A.M. Best estimates a combined ratio for the major London market reinsurers of approximately 119% for 2005. The London market is a small group of U.K. companies that predominantly write reinsurance.

Of note is the reduction in volatility at both Lloyd's and the London market. In 2001, when the industry was hit by the World Trade Center loss, the combined ratios for Lloyd's and A.M. Best's group of London market reinsurers were 136% and 177%, respectively (see **Exhibit 6**). Although the events of 2001 and 2005 occurred at different stages in the underwriting cycle, the more modest impact of the extremely high catastrophe costs of 2005, over 2001, is an indicator of better risk management. Lloyd's, in particular, has restructured since 2001, with the formation of the Franchise Performance Directorate. There have been many changes, including a complete overhaul of Lloyd's realistic disaster scenarios to reflect the latest scientific and modeling developments.

Some other factors also are different in this cycle, particularly capital management, which has improved as a result of implementation of the Individual Capital Adequacy Standards (ICAS) regime across the U.K. market. Implementation of ICAS means that a sophisticated, risk-adjusted approach to capital now is used in the United Kingdom, which is a long way ahead of any other European country. U.K. companies have a greatly increased regulatory work burden as a result of ICAS, but A.M. Best believes it is worthwhile and may lead to less pricing volatility than in previous cycles.

In A.M. Best's view, businesses are likely to make significant progress with business process reform, particularly with contract certainty. The Financial Services Authority (FSA), the U.K. regulator, has given impetus to contract certainty by imposing an implementation deadline of 2006. This is in spite of setbacks, such as the failure of the Lloyd's-sponsored company Kinnect Ltd., which was formed primarily to create an insurance industry hub connecting the systems of brokers and underwriters.

Competition

Competition from outside the United Kingdom is an important issue for Lloyd's and the London market. The 2005 catastrophes were the impetus behind the formation of three Bermudian companies by groups trading in the Lloyd's market (see **Table 7**). There already was one existing Bermudian company, Catlin Insurance Co. Ltd., which originated from a Lloyd's operation. Aspen Insurance Ltd., formed in 2002, also had links to a Lloyd's operation, Wellington Underwriting plc, although it was not formally a part of the Wellington group.

Bermuda, of course, is a leading competitor of Lloyd's in the international reinsurance market. A.M. Best believes that the move to Bermuda by the three companies is for the most part motivated by a conventional desire to diversify the sources from which the companies write business. There is an established market in Bermuda for certain lines of business of which these companies now can be a part.

There is not a widespread trend for Lloyd's businesses to reduce underwriting at Lloyd's and replace Lloyd's operations with a company writing the same lines, although there are some companies that are doing this. A.M. Best sees no reason why Lloyd's cannot continue to trade successfully as part of a competitive market for international reinsurance and insurance business. It continues to have unique advantages for investors wishing to establish a long-term insurance business, writing a genuinely international portfolio of specialty lines business.

That is not to say that Lloyd's does not need to ensure that it protects and develops its attractiveness as a market. Recently, competitor markets have absorbed growth that might otherwise have found its way to Lloyd's. There has not been a

Table 7
Lloyd's Based Insurers Established in Bermuda

Bermudian Company	Rating*	Outlook
Catlin Insurance Company Ltd	A	Stable
Omega Specialty Insurance Co Ltd	A-	Stable
Hiscox Insurance Company (Bermuda) Ltd	A-	Stable
Amlin Bermuda Ltd	A-	Stable

* As of 7/31/2006
Source: A.M. Best Co.

significant number of startup operations within Lloyd's between 2005 and 2006. One or two Lloyd's operations are actively migrating business to alternative company operations, with a tendency for more volatile lines to be left in Lloyd's. There also are two powerful factors that Lloyd's does not control directly—taxation and regulation. So there are certainly some challenges, which A.M. Best sees as long-term and quite normal for a market in which participants have a choice of alternative strategies.

Market Trends

Overall there was a small increase in Lloyd's aggregate premium income in 2005 of just over GBP 300 million to GBP 15 billion, reflecting some improvement in the opportunities available in the reinsurance market, particularly in the final quarter of 2005 following the major U.S. hurricane losses. The increase in Lloyd's reinsurance premium was approximately GBP 1 billion to GBP 5.3 billion, but this increase was offset by a decline in business volume for most of Lloyd's other lines of business.

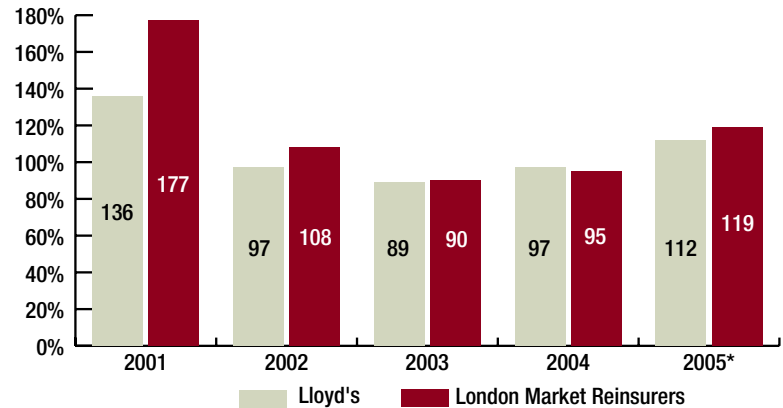
The pattern was similar for the London market companies, with a significant boost to reinsurance premium income in the aftermath of the catastrophes. The increase for the group of companies taken as a whole, however, was offset by a marked decline in income at one company that ultimately ceased trading early in 2006.

In 2006 there has been strong improvement in rates for property catastrophe reinsurance in the United States and the Caribbean, although the better market conditions have not extended to catastrophe exposure outside these areas. In Europe, for example, rates are stable. There now is an established soft market for casualty reinsurance, although weakening is somewhat less aggressive than anticipated. Into 2007, A.M. Best believes the more general softening in rates that characterized the first half of 2005 is likely to resume.

Capital

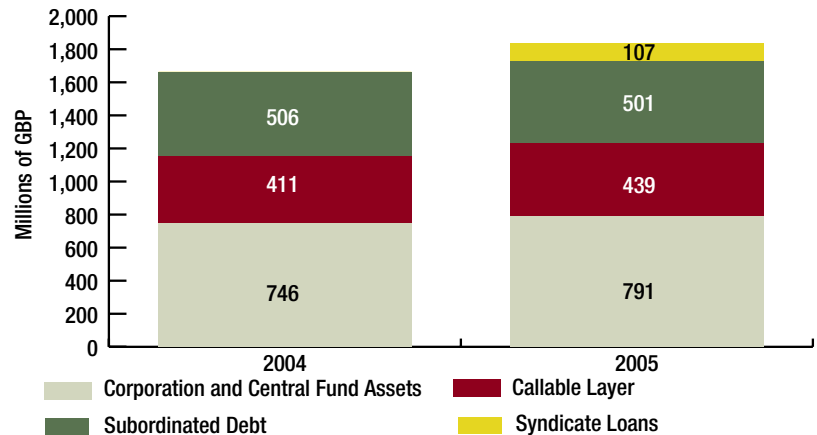
Despite producing a small loss in 2005, the year was positive for Lloyd's capitalization. Looking at Lloyd's central assets for solvency, both corporation and Central Fund assets were up, as was the callable layer, but the main driver for improvement in Lloyd's solvency position was the addition of the syndicate loans, as expected. As a result, Lloyd's solvency ratio improved to 380% in 2005, up from 300% in 2004 (see **Exhibit 7**). Lloyd's capacity also increased for 2006—up approximately 8% to GBP 14.8 billion, as underwriters

**Exhibit 6
Combined Ratios—Lloyd's vs. London Market Reinsurers**



* Estimated.
Source: A.M. Best Co.

**Exhibit 7
Lloyd's Central Assets for Solvency**



Source: Lloyd's

sought to take advantage of better-than-anticipated market conditions. Earlier in 2005, prior to the U.S. hurricane season, a reduction in capacity of approximately 7% had been planned.

For the London Market reinsurers, A.M. Best anticipates stable underwriting leverage (net premiums to capital and surplus) at a comparable level to the year-end 2004 ratio of 64%. The position for net reserves leverage (net technical reserves to capital and surplus) is likely to deteriorate to approximately 210% at year-end 2005, from 170% at year-end 2004. Several of the London companies were affected by substantial U.S. hurricane losses that materially increased the level of net technical reserves.

Investment Income

Investment income for both Lloyd's and the London companies is driven largely by returns in the fixed-income market. In 2005, investment income ratios were comparable to those in 2004, reflecting solid returns for sterling fixed-income investments but relatively low yields on U.S. dollar fixed-interest investments. Reinsurers in London maintain substantial U.S. dollar assets, because a significant proportion of the business written is transacted in U.S. dollars.

Equity markets performed well in 2005. In the United Kingdom, returns in excess of 20% were achieved, but this did not have a significant impact on syndicate investments or the London companies because of the concentration of investments in fixed-income markets. It did have a beneficial impact on the modest exposure that members' funds at Lloyd's have to equity markets and contributed to a high return achieved on Lloyd's central funds.

Looking ahead, A.M. Best anticipates a continuation of the low returns of recent years, although rising interest rates are likely to lead to improved yields for U.S. dollar assets. This will serve to

increase the focus on underwriting as rates soften, because investment returns are likely to provide insufficient cover for a significant deterioration in underwriting returns.

Loss Development

A.M. Best draws some comfort from the near-neutral reserve position for Lloyd's as a whole at year-end 2005. As anticipated by A.M. Best, there was a substantial reduction in the level of deterioration in Lloyd's direct casualty insurance reserves at year-end 2005. An anticipated shift to higher deterioration for reinsurance business, however, did not materialize.

Farther ahead, there is still scope for further deterioration in Lloyd's casualty reinsurance reserves relating to business written in the late 1990s up to 2001, but A.M. Best believes the impact on Lloyd's is likely to continue to decline. Some of the more significant cases relating to this period now have been settled, and it is possible to estimate the level of reserves needed for outstanding cases with a higher degree of certainty than in previous years.

European Reinsurers Post Profits in Spite of Record Losses

A number of European global reinsurers suffered the largest catastrophe losses in history in 2005, primarily as the result of U.S. hurricanes, which amounted to approximately \$6 billion (before tax and equalization reserves). Despite this, the global European reinsurers were able to post a profit, although earnings of companies with relatively high exposure to these catastrophes dropped significantly (see **Exhibit 8**).

Munich Re, Swiss Re and Hannover Re carried the biggest catastrophe losses in 2005; while losses for Convergium and SCOR were significantly lower, as these reinsurers had reduced their U.S. exposures prior to the storms (see **Exhibit 9**). A.M. Best expects that most European reinsurers will be able to record technical profits following combined ratios well above 100% in 2005 (see **Exhibit 10**) and anticipates an improvement of the combined ratio to below 100% at year-end 2006. This is based on the expectation of significantly lower catastrophe claims, but also on the stable premiums

in most classes of business. Underwriting results of A.M. Best's peer group are likely to be impacted positively by continued cost-cutting measures of Convergium and SCOR in 2006.

No significant natural catastrophe has negatively impacted results in the first half of 2006, leading to excellent underwriting results. A.M. Best believes, however, that good underwriting results in 2006 are likely to lead to a resumption of increased competition in premium rates.

Capitalization

Despite the large catastrophe losses from the U.S. hurricanes, European global reinsurers were able to strengthen their capital (mostly from retained earnings) or at least stabilize it (see **Exhibit 11**). These European reinsurers continue to explore forms of balance sheet protection other than traditional reinsurance through securitization (such as the catastrophe bonds issued by Munich Re or Swiss Re) or structured reinsurance (such as Hannover Re's K5 transaction).

Renewals

The 2006 renewal season experienced by a number of Europe-based global insurers confirmed A.M. Best's belief that the maintenance of reinsurers' current financial strength depends on the ability to generate earnings supportive of risk-adjusted capitalization through a period of more frequent and more severe natural catastrophe claims. Reinsurers will need to adapt both their underwriting strategies and risk controls to this changing landscape. Also, if underwriting results continue to be extremely volatile, investors may be reluctant to provide additional capital. That also would negatively impact the financial flexibility of the reinsurance sector.

Following the Continental European renewal season in January 2006 and the Asian renewal season in April 2006, U.S. renewals in July are expected to create a clear trend of significant increases, perhaps of 100% or more, in business lines affected by the storms. Other lines are expected to remain stable.

The substantial increases in the loss-affected lines, primarily offshore marine and property catastrophe, in A.M. Best's opinion are insufficient to compensate for the losses incurred by reinsurers in 2005. As a result of the severity of the U.S. storms and predictions that such events are likely to occur more frequently, reinsurers are reassessing their internal models and aggregate exposure. In some instances, this has led to a reduction in limits by reinsurers.

Risk Management

A.M. Best believes that reinsurers are adapting their catastrophe models to take into account the lessons learned from Katrina and other catastrophe events. A.M. Best also believes that European reinsurers are acknowledging that as a result of the increased frequency of catastrophe claims, it is not sufficient to protect their capital base; they also need to protect their earnings, to some extent, in order to not lose shareholder support. Most global European reinsurers are in the process of adopting, or already have adopted, a risk-management system with the aim of both protecting capital and earnings within certain limits.

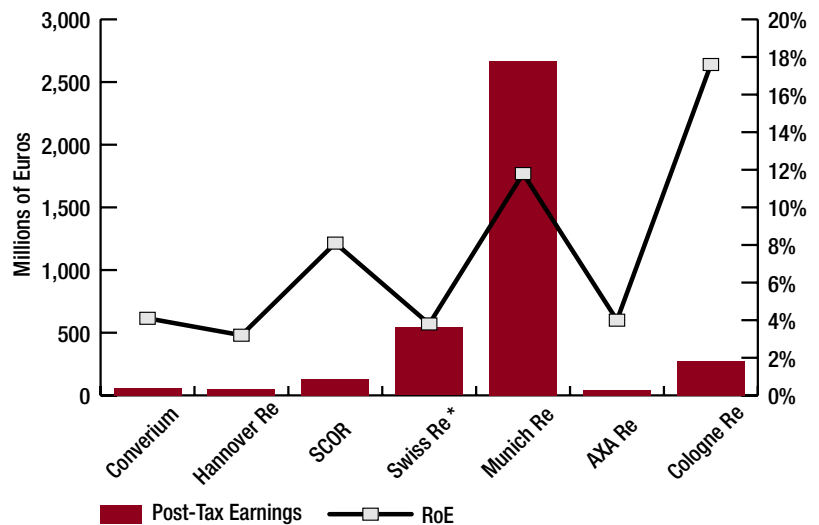
European Market

Europe had its own share of natural catastrophes, though not comparable in magnitude to those in the United States. In 2005, winter storm Erwin and the August floods that

spread across Switzerland, Austria, Germany and other central European countries cost European reinsurers approximately \$1.9 billion.

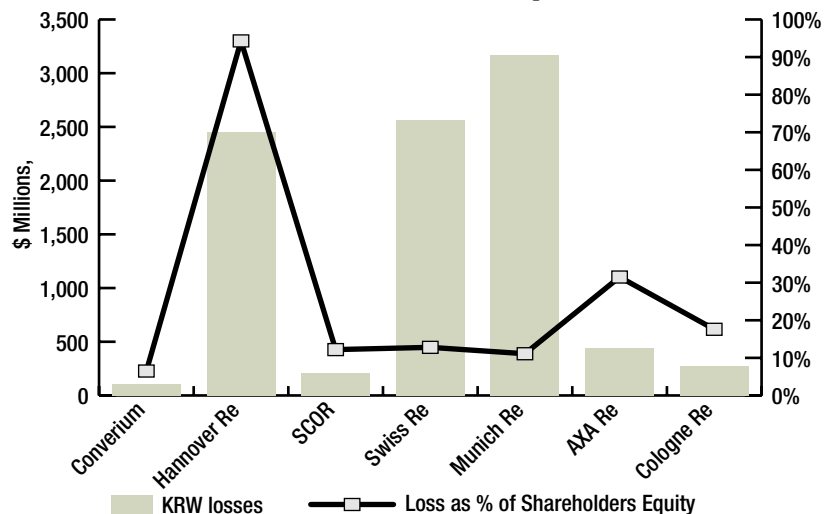
Each of these events highlighted the uncertainties reinsurers face when reinsuring natural catastrophe risks. Notwithstanding this, catastrophe protection facilities, as in France or Spain, which are guaranteed or supported by the respective governments, reduce the exposure of reinsurers to such risks in Europe.

**Exhibit 8
European Global Reinsurers—
Post-Tax Earnings and Return on Equity**



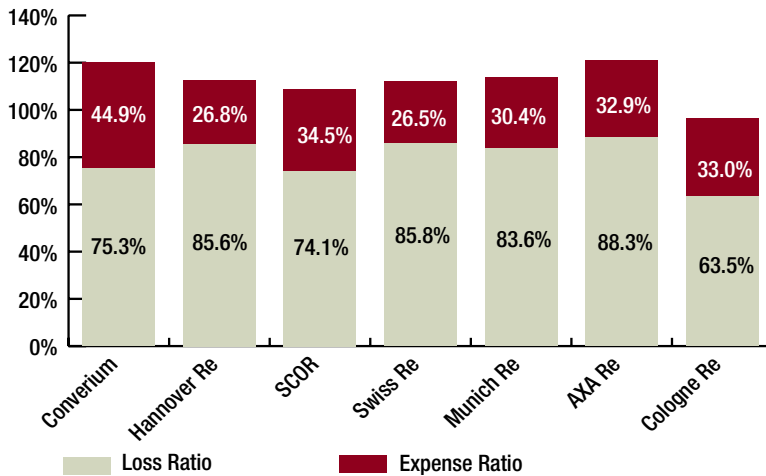
* Before equalization reserves.
Source: A.M. Best Co.

**Exhibit 9
Gross KRW Losses of Global European Reinsurers**



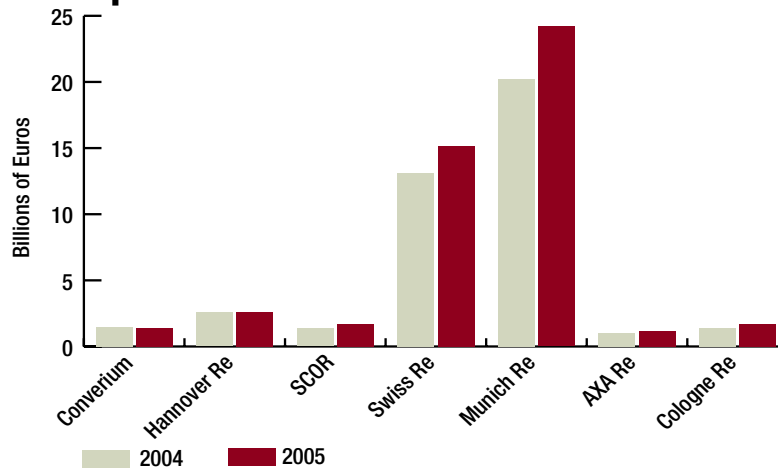
AXA Re and Conventium only net available. AXA Re only Katrina reported.
Currency translation based December 31, 2005 exchange rates.
Source: A.M. Best Co.

Exhibit 10 European Global Reinsurers— Underwriting Performance 2005



Note: AXA Re includes expenses for both life and non-life segments.
Source: A.M. Best Co

Exhibit 11 European Global Reinsurers — Development in Shareholders Funds*



*Excluding minority interest.
Source: A.M. Best Co.

Continental European Renewals

European renewals in 2006 have been influenced by the U.S. storms, which have helped stabilize premium rates that previously were softening across Europe. A portion of this stability resulted from the higher net retentions by primary insurers with strong balance sheets, which were less pressured to accept higher reinsurance costs.

Although European reinsurers have been able to keep most rates stable, A.M. Best believes that the downward pressure on pre-

miums that started prior to the U.S. hurricanes will resume, especially if reinsurers' underwriting results turn favorable in 2006. In addition, the primary markets, especially motor, are becoming increasingly competitive, and reinsurers will not be able to distance themselves from this competition. This is particularly true where proportional reinsurance still is predominant, as in Germany.

Market Environment: Germany

In Germany's primary motor insurance segment, pressure on liability rates continues, which is creating concern among reinsurers about accelerating competition and price reductions. As a result, reinsurers have continued attempts to shift the motor portfolio to nonproportional in order to become more independent from developments in the primary markets.

Reinsurance buyers with international exposure have been facing steep rate increases, while rates have remained flat otherwise. Capacity for industrial liability, especially pharmaceutical liability, has remained scarce.

Market Environment: France

Reinsurers continue to increase motor liability rates, from 25% to 30%, in response to adverse reserve development and ongoing claims inflation for bodily injury claims. Some reinsurers are significantly reducing their capacity in this field. Primary insurers are responding to the rate hikes by increasing their net retention, partially aided by their improved capitalization. Reinsurers trying to avoid high-frequency claims are happy with this development.

Market Environment: Italy

Expectations for reductions in motor rates, given 2005's good results, were not met due to reinsurers sticking to pricing discipline following the U.S. hurricanes. General liability has been plagued with adverse reserve development, mainly due to lengthy court decisions leading to high social inflation. Insurers are reluctant to underwrite such risks, resulting in lower capacity for these risks.

Capacity

For reinsurers dependent on retrocession, capacity is generally shrinking, which may have a negative impact on reinsurers that cede significant risks to retrocessionaires.

Continental European reinsurance is dominated by the larger players, such as Munich Re and Swiss Re. Only a few smaller reinsurers remain, and most of those are not leaders, providing capacity only for niche markets. A number of smaller reinsurers in Central Europe, however, are trying to expand into other reinsurance markets.

The recent merger between GE Insurance Solutions, U.S., and Swiss Re Group is reducing the market further. A.M. Best believes that the merger is likely to reduce retrocession capacity and could impact the ability of primary insurers to find sufficient reinsurance cover in certain lines of business. Further merger activity in the Continental Europe property/casualty reinsurance sector is likely to be limited, partially due to the limited number of players. Life reinsurance

may be a field where existing reinsurers will want to grow in order to reduce the dependence on the relatively volatile property/casualty sector.

Solvency II

So far, Solvency II is having a limited impact on Continental European reinsurers. This is the result not only of the extended time frame for implementation (envisaged for 2010), but also of wide variations in regulators' response time. Most of the larger reinsurers already have implemented their own internal capital models with the aim of making them compliant with the Pillar I requirements of Solvency II. The main challenges will be regulatory oversight of risk-management practices (Pillar II) and disclosure requirements (Pillar III).

European Life Reinsurers Expect Sharp Decline in Premium Growth

Life Reinsurance

The considerable decline expected in growth of 2006 European life reinsurance premiums to an estimated 5% to 7%, from the roughly 15% average annual growth in the previous six years, not only indicates tepid demand for the product but presages a transformation of the marketplace.

After several years of extraordinary growth, life reinsurers, faced with declining demand and heightened competition, either are beginning to assume higher levels of risk (as evidenced in increased volumes of reinsurance of annuities, pensions and disability covers) or are moving into solutions such as securitization. The majority of growth in life reinsurance premiums in 2006 is likely to come from these higher-risk annuity and disability covers, as well as from some significant financial agreements (though financing, per se, is less widespread than a few years ago). The first reinsurance of pension liabilities started appearing in 2005—despite the uncertainty surrounding the longevity risk. In addition, some of the larger life reinsurers have started providing solutions, such as securitization, that either have been outside their scope or, until recently, purely competitive to their product offering.

Tempering Demand and Increasing Competition

Tempering the demand for life reinsurance

has been the continuing strong performance of the financial markets that has helped rebuild the balance sheets of primary insurers and encouraged them to retain higher levels of risk. The strong growth in unit-linked sales throughout Europe, with the products' diminished capital strain, has resulted in further reduction in demand for traditional life reinsurance.

In addition, some of Europe's largest insurers have been looking to the capital markets for capital relief and to improve financial flexibility, in the form of either equity-like debt or, increasingly, securitization of life liabilities.

Adding to the decline in life reinsurance premiums has been the significant reduction in cession ratios in some markets, as older financing business is replaced with risk premium treaties, though there are some signs of a return to agreements with financing elements. The majority of these transactions is expected to be handled by the largest three to four reinsurers with the necessary robust capitalization to absorb the capital strain.

While demand is being depressed further, the supply of reinsurance for life products is increasing, especially as nonlife composite reinsurers look to the life business to provide greater stability in financial performance and to alleviate pressure on capitalization (see **Exhibit 12**).

The resulting marketplace is likely to be skewed toward the largest and the lowest-cost

competitors. Apart from financing business, larger reinsurers are making inroads into the securitization market, starting as consolidators of life insurance liabilities prior to these liabilities being securitized.

Further, certain low-cost, specialist reinsurers are continuing to increase their penetration in the European markets and are showing signs of success, especially in national markets with greater fragmentation—as a larger number of competitors get smaller pieces of the market—and strong reinsurance presence. The trend is expected to gain momentum, fueled by the continuing commoditization of reinsurance of mortality covers.

Profitability

Profitability has remained high over the past four years, 2002 to 2005, in the European life reinsurance sector, driven mainly by exceptional investment results. By and large, life reinsurers have managed to report return on premiums in the region of 7% to 8% during this period, which is exceptional when compared with the historical average of less than 5% (see **Exhibit 13**). There have been two main drivers for this performance: First, during the four-year period, shrinking investment yields of primary insurers (and mounting losses on the property/casualty side for composite reinsurers) fueled a strong growth in demand for life reinsurance, which was followed by significant underwriting profits among reinsurers. Second, during the same period, strong investment performance underpinned the profitability of life reinsurers, with investment yields close to 8%, again well above the yields achieved normally.

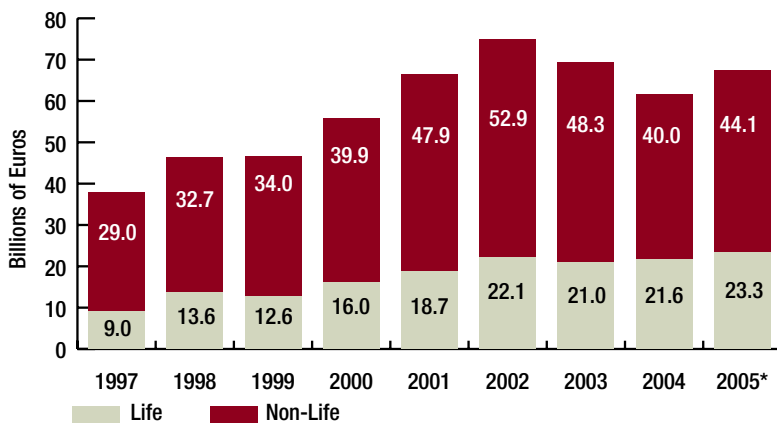
The investment yields for reinsurers and life insurers, however, now have come in line, as the underlying investment portfolios have converged in terms of their composition due mainly to shifts in the investment portfolios of primary life insurers. While this is not going to pose a significant problem in terms of profitability, it is likely to reduce the appeal of traditional reinsurance solutions at a time when primary insurers can achieve similarly high yields.

Capital Adequacy

Capital adequacy has returned almost to pre-2002 levels, due to the rebuilding of the capital bases over the past four years, mainly driven by increased economic capital. While increased profitability after 2003 has helped increase equity, the majority of companies have moved toward strengthening their capital bases through the issuance of debt with equity characteristics. Risk-adjusted capitalization has been improved further through reporting of the economic impact of embedded guarantees as required by International Financial Reporting Standards, which, in turn, has resulted in improved asset-liability matching.

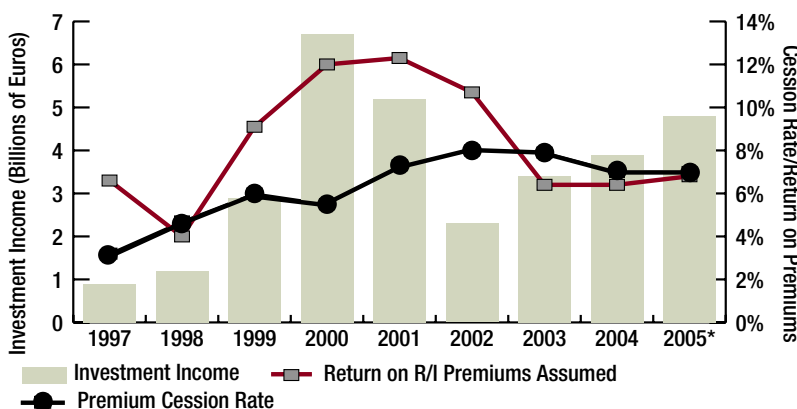
Looking forward, capital adequacy is likely to come under pressure due to the increased risk levels of the products likely to be reinsured in the short to medium term. Relief should be provided from a totally new source—monetization of the value of in-force business. The application of European Embedded Value, as a result of the top 30 companies having agreed to consistent

Exhibit 12
European Life Reinsurance—
Premiums of Top 6 Reinsurance Groups



* Estimated
Source: A.M. Best Co.

Exhibit 13
European Life Reinsurance—Investment Income
Vs. Premium Cession Rate/Return on Reinsurance
Premiums Assumed



* Estimated
Source: A.M. Best Co.

assumptions to be used in calculations, has created a platform of greater comparability and convergence of embedded values, and thus has enabled the securitization of the value of in-force business, with the first cases having appeared in 2005.

Rating Trends

Ratings are likely to remain stable, mainly based on the expectation that capitalization—at least among the largest players—is likely to remain stable, and financial performance is not likely to deteriorate.

Regulation

The implementation of the new regulatory regime in the United Kingdom provides a good indication of what is expected in Europe through the implementation of Solvency II. The first area affected is likely to be investments and, with that, asset-liability matching. The sophistication of solutions in this area is likely to increase, but at the same time the investment portfolio mix is likely to be biased toward lower risk and, as a consequence, lower yield.

Over the longer term, this move toward lower-risk investments and reduced invest-

ment yields is likely to result in a reassessment of the current, high-risk products reinsured.

Mergers and Acquisitions

The acquisitions of Gerling by HDI; GE Risk Solutions by Swiss Re; and Revios by SCOR were focused partly or fully on acquiring a life reinsurer. Such activities need to be assessed considering the financial conditions of the companies involved, rather than as a general trend toward increased merger-and-acquisition activity in the life reinsurance sector. There are not enough “pure” life reinsurers left in the market for the trend to continue.

That being said, most life and composite reinsurers are likely to consider inorganic growth after having largely rebuilt their capital bases following the benign conditions in the financial markets of the past few years. This, combined with the fact that primary insurers are likely to start reducing their traditional cessions, may give new impetus to acquisition activity. Such likely will take the form of acquisitions of old books of business or pension liabilities, with the intention of providing reinsurance and securitization solutions to protect the financial stability of these portfolios and to accelerate the emergence of profits.

U.S. Life Reinsurance: A Mature Market, But Opportunities Remain

Market pricing dynamics are changing, albeit gradually, in the U.S. life reinsurance market—a doubled-edged sword, at best. Prices are rising as the life reinsurance market shrinks to fewer, more-disciplined suppliers due to consolidation and exits from the market.

Primary insurers, perhaps spoiled by the bargain-basement rates of the past, are resisting the price hikes by retaining more business and at least are exploring, if not using, risk-transfer alternatives in the capital markets.

So, although the competitive landscape and pricing environment generally are stable, A.M. Best believes several factors will pressure longer-term returns. Higher rates are expected to translate into lower new business volume. On the other hand, the price increases are not expected to increase underwriting income significantly, either, as they may be a game of “catch-up”

with older, aggressive pricing practices.

A.M. Best expects the U.S. life reinsurance industry will be facing more moderate growth rates in premiums of 4% to 5% annually in the near future, in contrast to the double-digit rates of growth in the last decade. This strong growth has been fueled by reinsurers’ very favorable pricing practices that, in effect, have encouraged direct writers to retain less business while offering highly competitive rates on commodity-like products, such as level term life.

As such, a lot of older reinsurance business may have been mispriced, and further price hardening may be required just to maintain acceptable margins. One prime example of the consequences of mispricing was the sale of ING Re’s book of business to Scottish Re at the end of 2004 for a negative ceding commission, a clear indication that the book was underperforming.

Consolidation and Capacity

While consolidation has weeded out companies not fully committed to the market, A.M. Best believes that further major consolidation is unlikely. The leading life reinsurers (see **Tables 8** and **9**) already are quite large, with current cost structures indicating that little may be gained from further acquisition activity.

While consolidation has enabled the remaining players to build strong and defensible market positions, new capacity is an issue in the marketplace. Only one company—Wilton Re—entered the marketplace in 2005. In 2006, two other companies expanded into the U.S. life reinsurance market: Bermuda-based ACE Group Ltd and XL Capital Ltd. A.M. Best believes there may be others over the next few years.

With limited significant new supply, prices are likely to continue to creep upward. As such, opportunities for new entrants remain, but capital-raising challenges are formidable. Competi-

tion for capital between life and nonlife business segments, particularly within major international players, has heated up considerably after the 2005 U.S. hurricanes. Since the hurricanes, capital-market investors have been rushing into the property catastrophe reinsurance market with the expectation of rapidly rising rates in this segment. However, as prices rise in life reinsurance, A.M. Best expects increasing investor interest in new life reinsurance startups, as well.

Moreover, existing players such as Aegon N.V. are expressing interest in growing market share. In addition, there is heightened interest in block acquisition-type reinsurance deals. A recent example is Goldman Sachs' acquisition of a block of variable annuity business through its wholly owned subsidiary Allmerica Financial Life Insurance & Annuity Co. Although there may be some new capacity coming to market, A.M. Best believes the life reinsurance marketplace is unlikely to change in any significant way over the near to medium term.

Table 8
Leading U.S. Life Reinsurers by Amount in Force
Nonaffiliated business—2005

Company	AMB#	\$ Billions
RGA Reinsurance Company	09080	1,186.3
Swiss Re Life & Health America Inc	07283	1,083.8
Munich American Reassurance Company	06746	677.2
Security Life of Denver Insurance Co *	07029	656.9
Lincoln National Life Insurance Co	06664	536.8
Scottish Re (U.S.) Inc	08785	496.0
Employers Reassurance Corporation	06976	431.3
Transamerica Occidental Life Ins Co	06848	382.3
Generali USA Life Reassurance Company	09189	271.3
Transamerica Financial Life Insurance Co	07267	266.5

*Life reinsurance business acquired by Scottish Re year-end 2004
Source: A.M. Best Co—Schedule S

Table 9
Leading U.S. Life Reinsurers by Premium
Nonaffiliated Business - 2005

Company	AMB#	\$ Millions
RGA Reinsurance Company	09080	6,434.0
London Life Reinsurance Company	60237	2,142.7
Munich American Reassurance Company	06746	1,835.9
Lincoln National Life Insurance Co	06664	1,776.5
Scottish Re (U.S.) Inc	08785	1,646.3
Swiss Re Life & Health America Inc	07283	1,498.5
Security Life of Denver Insurance Co *	07029	1,374.4
Transamerica Occidental Life Ins Co	06848	1,329.6
General Re Life Corporation	06234	1,138.6
Transamerica Financial Life Insurance Co	07267	829.2

*Life reinsurer business acquired by Scottish Re year-end 2004.
Note: Assumed premium includes annuity business.
Source: A.M. Best Co—Schedule S.

Update on Regulation XXX

In addition to demand for traditional mortality reinsurance protection, companies continue to look to reinsurers to provide relief from statutory reserve strain associated with Regulation XXX. While a number of larger companies have effectively employed capital-market solutions, smaller and medium-sized companies rely more heavily on reinsurance as a solution for XXX because they do not have the scale to access the capital markets on a cost-effective basis. However, as reinsurance rates rise, A.M. Best expects more companies to explore ways to achieve the scale necessary to make a XXX funding solution more viable. One possibility is to reduce the amount of reinsurance until the direct writer holds enough redundant reserves to make a capital-market solution more practical. If this approach gains in popularity, the amount of business ceded to the life reinsurance industry could be diminished materially. Reinsurers also need solutions to fund assumed business with XXX reserve implications. Scottish Re, for example, has successfully accessed the capital markets by issuing credit-enhanced notes to fund reserves ceded to an onshore captive. RGA completed a transaction, as well.

Secondary Guarantees Offer Opportunities

One area with limited reinsurance coverage involves secondary guarantees on

variable annuities (VAs). Increased demand for VA secondary guarantee reinsurance is expected to remain largely unmet given the potential volatility of the underlying market-based annuities and that hedging strategies designed to mitigate these risks are imperfect. Preliminary interest in this market, however, is beginning to emerge.

Health Reinsurance Still Wide Open

A.M. Best continues to believe there is opportunity for new entrants in health reinsurance, as

the current market is characterized by demand that exceeds supply. Health reinsurance currently is limited to niche products or business lines such as Medicare supplement and long-term care. Some major reinsurers that had participated in health reinsurance pools no longer do so and have placed those books of business into runoff. A.M. Best further believes that established life reinsurers have only limited plans to expand product offerings to include health reinsurance, and accordingly, supply is unlikely to increase over the near to medium term.

Explosive Securitization Growth Splits Between Life and Nonlife

Securitization

Insurance securitizations rose sharply to record levels in 2005, with annual issuance topping \$5 billion for the first time (see **Exhibit 14**). Growth of new concepts for risk-linked and cash-flow instruments also has been explosive. Instruments ranging from working-layer securitizations to securitizations of future profits were placed with the capital markets last year. Overall activity in just the first half of 2006 already has topped that of 2005.

Securitization in 2005 was split evenly between life and nonlife segments of the insurance industry. Collateralization of Regulation XXX reserves dominated life activity, while catastrophe bonds were the dominant factor on the nonlife side.

Cat Bond Issuance More Than Doubles

Accounting for nearly half of all new industry securitizations, catastrophe bond issuance (both property/casualty and life) more than doubled in 2005, exceeding 2003's prior record by 10.5%. With 2006's issuance already close to all of last year's, a new record issuance level virtually is assured this year (see **Exhibit 15**).

The scope of the catastrophe bond market has expanded in recent years with the addition of mortality bonds, such as Swiss Re's Vita II issuance in 2005 and Scottish Re's 2006 Tartan Capital issuance aimed at transferring risk of pandemic mortality levels to the capital markets. On the P/C side, catastrophe bonds have been structured to hedge exposures to the offshore oil industry.

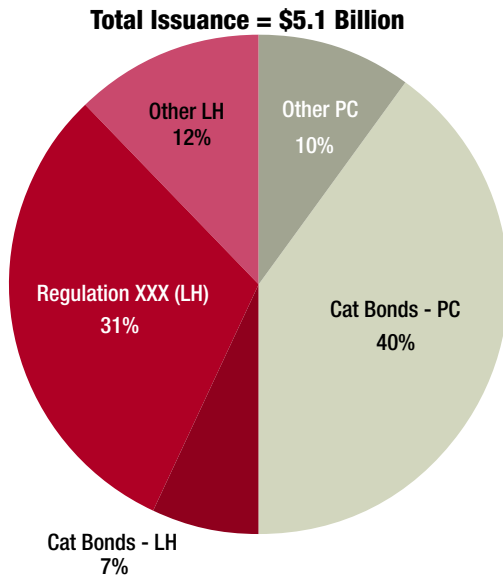
These instruments provide increased competition to reinsurers as well as expanded risk-transference opportunities for the reinsurance industry, offering an alternative to retrocession. One advantage offered by a cat bond—usually maturing in three to five years—is the lack of exposure to annual renewal pressures.

The more traditional securities tied to natural catastrophe losses also have had a particularly active year, with unusual developments resulting from the severity of loss tied to the 2005 U.S. hurricane season. It appears that the unexpected level of damage will trigger the first total loss on a cat bond (Kamp Re 2005). The hurricanes also caused the leading catastrophe modelers to reassess their models. From a hurricane standpoint, updated models generally have increased estimates significantly for activity rates, vulnerability, and loss amplification. Applied to existing cat bonds, these new models have considerably increased attachment probabilities.

The combination of modeling changes and the imminent cat bond loss have created market perceptions of increased risk, and this has led to increased interest rate spreads in the existing market.

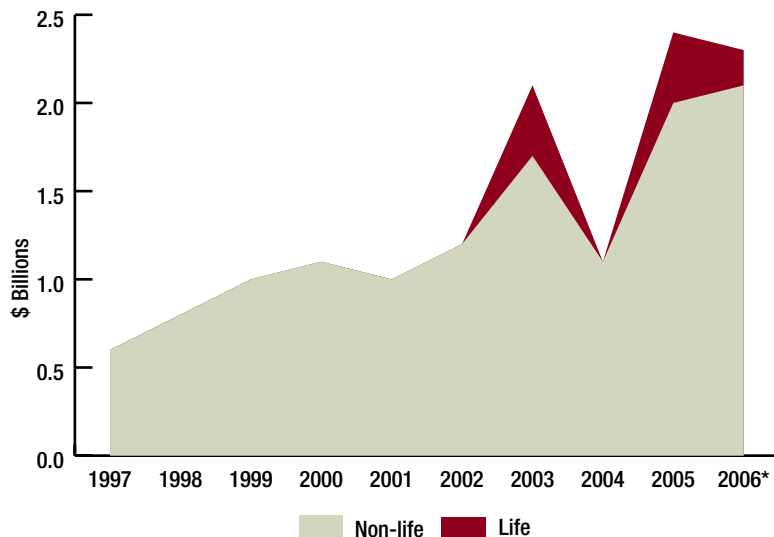
These conditions also have made investors more cautious about the type of triggers they will accept in cat bonds, shying away from indemnity cat bonds. From a rating agency perspective, however, non-indemnity cat bonds come with basis risk. In this context, basis risk generally reflects the possibility that a cat bond may not be

**Exhibit 14
2005 Insurance Securitizations**



Source: A.M. Best Co.

**Exhibit 15
Catastrophe Bond Issuance**



*2006—Year-to-date June 30th.

Sources: Guy Carpenter/MMC Securities Corp., A.M. Best Co.

triggered for covered perils when the catastrophic event occurs. Due to the basis risk of catastrophe bonds, A.M. Best is in the process of establishing the amount of reinsurance credit that would accrue to insurance companies sponsoring catastrophe bonds.

Other Insurance Securitizations

Although collateralization of Regulation XXX reserves on life insurance policies was the second-largest area of total insurance securitization in 2005, after cat bonds, it likely will be the largest category in 2006. Issuance was nearly \$1.6 billion in 2005, or roughly 31% of the total industry's annual securitization. Issuance in 2006, however, is soaring, already nearly double that of 2005 and well ahead of year-to-date 2006 cat bond issuance.

Also in 2005, the life side saw active monetization of premiums as well as securitization of future profits of a portfolio of in-force U.S. life insurance policies. In the 2006 market, it is anticipated that a bond is being structured as a disability reserves securitization in an approach to free up regulatory reserve requirements.

On the nonlife side, again offering some competition to traditional reinsurance, new securitization concepts have led to the implementation of working-layer securitizations for both credit insurance and auto insurance.

Though still in its infancy, the general concept of insurers and reinsurers transferring risks to the capital markets has gained broad acceptance, with new securitization concepts surfacing with increasing frequency. As the more-established instruments begin showing rapid growth in established markets, some of the current innovations, such as working-level securitizations, will spread in use and could become established markets by the end of the decade.

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GUIDE TO BEST'S FINANCIAL STRENGTH RATINGS

A Best's 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
Secure	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+	Very Good	Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.
Vulnerable	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 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 Ratings to identify companies whose assigned ratings are based on group, pooling or reinsurance affiliation with other insurers.

	Modifier	Descriptor	Definition				
Rating Modifiers	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.				
Affiliation Codes		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:

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 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.

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GUIDE TO BEST'S CREDIT RATINGS

A Best's 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 Ratings are not a warranty of a company's ability to meet its ongoing financial obligations.

Long-Term Credit Ratings

A **Best's Long-Term Debt Rating** (issue credit rating) is an opinion as to the issuer's ability to meet its ongoing financial obligations to security holders when due. These ratings are assigned to debt and preferred stock issues.

	Rating	Descriptor	Definition
Investment Grade	aaa	Exceptional	Assigned to issues, where the issuer has, in our opinion, an exceptional ability to meet the terms of the obligation.
	aa	Very Strong	Assigned to issues, where the issuer has, in our opinion, a very strong ability to meet the terms of the obligation.
	a	Strong	Assigned to issues, where the issuer has, in our opinion, a strong ability to meet the terms of the obligation.
	bbb	Adequate	Assigned to issues, where the issuer has, in our opinion, an adequate ability to meet the terms of the obligation; however, is more susceptible to changes in economic or other conditions.
Non-Investment Grade	bb	Speculative	Assigned to issues, where the issuer has, in our opinion, speculative credit characteristics, generally due to a moderate margin of principal and interest payment protection and vulnerability to economic changes.
	b	Very Speculative	Assigned to issues, where the issuer has, in our opinion, very speculative credit characteristics, generally due to a modest margin of principal and interest payment protection and extreme vulnerability to economic changes.
	ccc, cc, c	Extremely Speculative	Assigned to issues, where the issuer has, in our opinion, extremely speculative credit characteristics, generally due to a minimal margin of principal and interest payment protection and/or limited ability to withstand adverse changes in economic or other conditions.
	d	In Default	In default on payment of principal, interest or other terms and conditions. The rating also is utilized when a bankruptcy petition, or similar action, has been filed.

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 uses its Long-Term Credit Rating Scale when assigning Issuer Credit Ratings. While the above definitions apply to entities which do not issue insurance obligations, in certain markets or product lines, particularly where the credit market scale is widely recognized, A.M. Best also assigns Issuer Credit Ratings to insurance companies. The definitions applied to insurance companies that are assigned an Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Very Good; (bb) - Fair; (b) - Marginal; (ccc-cc) - Weak; (c) - Poor; (rs) - Regulatory Supervision/Liquidation.

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. A company's Long-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. Ratings may also be assigned a Public Data modifier ("pd") which indicates that a company does not subscribe to A. M. Best's interactive rating process.

Short-Term Credit Ratings

A **Best's Short-Term Debt Rating** is an opinion as to the issuer's ability to meet its financial obligations having maturities generally less than one year, such as commercial paper.

	Rating	Descriptor	Definition
Investment Grade	AMB-1+	Strongest	Assigned to issues, where the issuer has, in our opinion, the strongest ability to repay short-term debt obligations.
	AMB-1	Outstanding	Assigned to issues, where the issuer has, in our opinion, an outstanding ability to repay short-term debt obligations.
	AMB-2	Satisfactory	Assigned to issues, where the issuer has, in our opinion, a satisfactory ability to repay short-term debt obligations.
	AMB-3	Adequate	Assigned to issues, where the issuer has, in our opinion, an adequate ability to repay short-term debt obligations; however, adverse economic conditions will likely lead to a reduced capacity to meet its financial commitments on short-term debt obligations.
Non-Investment Grade			
	AMB-4	Speculative	Assigned to issues, where the issuer has, in our opinion, speculative credit characteristics and is vulnerable to economic or other external changes, which could have a marked impact on the company's ability to meet its commitments on short-term debt obligations.
	d	In Default	In default on payment of principal, interest or other terms and conditions. The rating also is utilized when a bankruptcy petition, or similar action, has been filed.

A **Best's Short-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the issuer to meet its senior financial commitments on obligations maturing in generally less than one year. A.M. Best also uses its Short-Term Rating Scale when assigning Issuer Credit Ratings. 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 (aaa to c) 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 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.

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