

## Special Report

## Mid-Year 2005 Global Reinsurance Review and Outlook: Steady as She Goes, but Do Troubled Waters Lie Ahead?

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## ■ Summary

Fitch's rating Outlook on the global reinsurance sector remains stable. Fitch believes that the sector's underwriting, operating and capital trends over the next 12-24 months will remain consistent with expectations established in July 2004, when it revised its rating Outlook to Stable from Negative.

The unknown factor in Fitch's analysis is the effect Hurricane Katrina will have on the reinsurance sector. At the time of going to press, the low end of Katrina's potential loss estimates would make it the largest insured loss from a single event since the 11 September 2001 tragedy and the largest US hurricane loss since Hurricane Andrew in 1992. Katrina-related losses approximating the upper end of current estimates – or Katrina-related losses at the lower end of current estimates in conjunction with subsequent catastrophe-related losses – could be large enough for Fitch to reconsider its Stable Outlook. On the positive side, Hurricane Katrina occurred after a sustained period of technically adequate premium rates for the sector and strong capital formation.

Clearly Katrina will generate significant losses for the reinsurance sector and will contribute to further hardening of property/catastrophe premium rates for exposures in the southeastern portion of the US. Katrina's effect on individual reinsurers and on the sector's net capital flow is more difficult to assess at this time.

Excluding Katrina, the sector's recent trends have generally been favourable from an earnings and capital perspective. Although premium rates were softening, Fitch viewed this as a natural response, given the reinsurance sector's cyclical nature. Although the agency does not believe that the reinsurance sector is fully reserved for casualty business written at the height of the last soft market, its expectation is that the sector's adverse prior-accident-year reserve development will be modest relative to capital and to the high levels of adverse reserve development experienced during the dark days of 2001-2002.

In this report Fitch reviews:

- expected rating trends;
- key projected financial indicators and H105 results;
- expected trends affecting its Stable rating Outlook;
- conditions that could cause its rating Outlook to change

## ■ Expected Rating Trends

Fitch's Stable rating Outlook reflects its expectation for limited rating changes and for the number of rating downgrades and upgrades to approximate one another over the next 12-24 months. The number of Fitch's rating downgrades and upgrades have closely correlated over the last 18 months, with affirmations being the dominant course of action. The agency notes that the sector's average long-term and Insurer Financial Strength rating declined by one and two notches respectively between 2002 and mid-2005, reflecting the financial and operational difficulties reinsurers endured during that period and the consequent wave of downgrades.

Table 1: Rating Activity, 2002-2005\*

	2005*	2004	2003	2002
Downgrades (%)	11	18	29	53
Upgrades (%)	6	14	0	0
Affirmations (%)	83	68	71	47
Sector's Average Financial Strength Rating	A	A	A+	AA-
Sector's Average Long-Term Rating	BBB+	BBB+	A-	A-

\* Year to Date  
Source: Fitch

Fitch cautions readers that its rating Outlook is a directional indicator of expected future rating changes. In contrast, a fundamental sector Outlook typically refers to the sector's expected future operating environment and conditions. Rating Outlooks and fundamental outlooks can appear to be at odds. For example, the agency believes that the reinsurance sector will experience a modest amount of adverse prior-accident-year reserve development and that downward pressure on premium rates will continue in the near term. Although these trends are negative when viewed in the context of a fundamental outlook, they are neutral in the context of Fitch's rating Outlook because their expected effect is incorporated into its current ratings.

Although Fitch's expectation is for stable ratings for the sector as a whole, it believes that a limited number of reinsurers will likely experience rating changes over the next 12-24 months. Potential upgrade candidates include those reinsurers whose out-performance relative to their current rating level Fitch views as sustainable and whose business models and franchises demonstrate sustained viability through a variety of cyclical conditions.

Conversely, downgrades are likely for reinsurers that under-perform relative to their current rating level, and whose business models and franchises suffer materially during a cyclical downturn. Fitch views significant merger and acquisition activity and

expansion beyond core competencies as indicators that reinsurers may be experiencing difficulty coping with cyclical underwriting conditions.

## ■ Key Financial Indicators and 1H05 Results

### Underlying Results Reasonable Amid Heavy Catastrophe Losses

Fitch's expectation for the full year 2005 is that the sector's underlying financial results will be reasonably healthy but materially affected by catastrophe losses. The agency also expects the reinsurance sector's share of Katrina losses to be larger than its share of losses from the four hurricanes that struck the southeastern US in 2004, since catastrophe reinsurance programmes are typically designed to protect primary insurers from single high-severity events.

Although premium rates have been under pressure in most lines for a year or more, Fitch believes they are sufficient to generate an accident-year underwriting profit for the 2005 accident year, provided Katrina's actual industry-wide insured loss estimates are around USD10 billion. Additionally, although net written premiums will decline in 2005, the agency believes this trend may abate somewhat in 2006, given Katrina's anticipated upward effect on premium rates. Table 2 represents Fitch's 2005 underwriting profitability projections for the universe of reinsurers listed in Appendix B. Key projected data elements used in the projections are detailed in Table 3.

Table 2: 2005 Projections

	Low End of Range	High End of Range
Underwriting Gain (USDm)	(5,955)	3,140
Calendar Year Combined Ratio (%)	100.4	109.6
Accident Year Combined Ratio (%)	98.0	104.8

Source: Fitch

Table 3: 2005 Projections

(USDm)	Low End of Range	High End of Range
Net Premiums Written	89,076	90,453
Catastrophe-Related Losses	11,350	17,350
Adverse Prior Year Reserve Development	2,500	5,000

Source: Fitch

Fitch notes that underwriting profits for a particular calendar year have a reporting pattern that extends over multiple accident years such that results for a calendar year will typically include underwriting profits generated from the current accident year, the prior accident year and even older accident years.

Fitch believes that results for the 2005 calendar year will benefit from business underwritten in accident years 2002 and 2003, when premium rates were at their hardest. Premium rates began to decline in the 2004 accident year and Fitch expects their effect to be felt beginning with the 2006 calendar year.

## Premium Rates under Pressure but Adequate

Fitch believes that supply and demand conditions have been exerting a moderate amount of pressure on premium rates. The global reinsurance sector's capital base grew materially through earnings in 2002-2004 and new capital, largely from hedge funds, continues to flow into the market in modest amounts. Active capital management in the form of special dividends and share repurchases has offset some of this new capital, and Fitch expects Hurricane Katrina to take a material amount of capital out of the sector, which will ease pressure on premium rates – whether it will be enough to offset pre-Katrina negative premium rate pressure remains to be seen.

On the demand side of the equation, Fitch believes that cedants are retaining more risk due to improvements in their own balance sheets and heightened motivation to avoid reinsurance disputes and collection issues. Partially offsetting these trends is the effect of higher demand for multiple-event covers, largely derived from the 2004 hurricane season, and slow but steadily increasing demand from developing markets such as China and India.

Potential loss exposures and recent loss history continue to vary widely by geographic location and line of business and premium-rate trends vary accordingly. Fitch's estimates of premium-rate changes in place for the January 2005 renewal season, which are currently affecting the sector's reported financial results, are shown in Table 4.

Table 4: Jan. 2005 Premium Rate Changes

Location/Business Class	Premium Rate Change (%)
Europe/Casualty	0 to +5
US/Casualty	-5 to -15
Europe/Property	-5 to -15
US (Non-Florida)/Property	0 to +10
US (Florida)/Property	+10 to +20

Source: Fitch

## Declining Reserve Adequacy Concerns

Fitch believes the sector's 2005 prior-accident-year reserve development will continue to be adverse but modest relative to equity. The accident-year loss ratios of several of the large US-based reinsurers that experienced significant adverse reserve development

for the problematic 1997-2001 accident years were in the 120%-140% range at year-end 2004. In Fitch's view they are less likely to experience material adverse development going forward.

Table 5 shows reserve development experienced by US and Bermuda-based SEC registrants in recent years. Although this analysis excludes several large non-US-based reinsurers and their US-based subsidiaries, Fitch views the data as reasonably representative of the overall sector's recent reserve-development trend. Fitch also believes that this data supports its view that future adverse reserve development is likely to be more manageable than it has been in the recent past.

Table 5: Reserve Development of US SEC Registrants

(USDm)	2004	2003	2002	2001	2000
Adverse Development	1,436	1,661	4,723	1,209	1,116
Adverse Development/ Equity (%)	4.2	5.4	22.4	5.6	7.6

Data excludes Berkshire Hathaway, Inc. because a large portion of its equity supports non-insurance businesses  
Source: Fitch, SNL Data

## Higher Investment Yields in US, Not So In Europe

The Federal Reserve Board has increased the federal funds rate by 200 basis points since mid-2004. While the yield curve has flattened somewhat in the face of these increases, investors have generally been directing new cash flows into consistently higher-interest-rate environments. Publicly traded reinsurers registered in the US and Bermuda (excluding Berkshire Hathaway subsidiaries) generated approximately USD10bn of net operating cash flow in 2004, so the incremental effect of higher yields is significant. Fitch expects the Federal Reserve to continue to raise rates in measured steps in the near to medium term and the investment yields generated by reinsurers investing primarily in the US to increase moderately.

Outside the US, the picture is somewhat bleaker: European interest rates have remained low, with the European Central Bank's main interest rate unchanged at 2.0% since June 2003. European reinsurers will inevitably have to operate in a low-interest-rate-environment for the foreseeable future, thus constraining significant improvements in their investment yields.

## H105 Results Were Solid

Reinsurers posted solid H105 results, reflecting manageable catastrophe-related losses, negligible reserve development and, in the US, the higher-interest-rate environment. Probably the most notable

event from an underwriting perspective was Windstorm Erwin, which swept through northern Europe in January, causing an estimated USD2bn in insured losses.

While the combined ratios of the sector overall and most individual reinsurers were higher than those reported in H104, they were still strong relative to those reported in recent years. The sector's net premiums written declined year on year and individual reinsurers' premium growth was mixed, with the number of reinsurers reporting a decline in net written premium approximating the number of reinsurers reporting an increase (see Appendix A).

## ■ Key Expected Trends and Their Effect on Fitch's Stable Outlook

Key trends and their anticipated incremental effect on Fitch's rating Outlook are summarised Table 6. These expected trends are discussed in further detail below.

Table 6: Key Trend Summary

Expected Trend	Effect on Rating Outlook
Increasing Pressure on Profitability	Neutral
Continued Flight to Quality	Neutral
Converging Relative Strengths and Weaknesses	Neutral
Additional M&A and Diversification Strategies Implemented	Negative
Increasing Uncertainty Due to US Regulatory Investigations	Negative
Potential Increases in Volatility Related to Terrorism Exposure	Negative
Movement Toward Common European Reinsurance Regulation	Positive
Increasing Use and Importance of Risk Modelling	Positive

Source: Fitch

### Increasing Pressure on Underlying Profitability

As a result of strong profitability recorded by the reinsurance sector in recent years, many players have strengthened their balance sheets following 9/11, the equity market crash in 2002/2003 and 2004's natural catastrophe losses. Both mature reinsurers and the Bermuda start-up class of 2001 now have significant capacity to employ in the sector.

While the effect of Hurricane Katrina was largely

uncertain at the time of going to press, Fitch expects that excess capacity will make it increasingly difficult for reinsurers to grow profitable premium volumes as the sector moves into a soft market phase. While the agency anticipates that the 2005 calendar year will show reasonable underlying profitability for many reinsurers, 2006 is likely to be more competitive and 2007 will reach the point at which cycle-management strategies truly begin to be tested. At this time, Fitch would expect proactive reinsurers to cut back and even exit business lines that no longer remain technically profitable. Those reinsurers that continue to follow the market down are likely to show short-term profitability gains, but will suffer in the longer term as claims develop from the under-priced business.

Not only will declining premium-rate adequacy result in negative pressure on earnings, but the current low-interest-rate environment will also mean that reinsurers should not budget for significant investment income to support bottom-line growth. Although negative in terms of overall profitability, low investment returns may, however, hold up premium rates for longer than would otherwise have been the case, thus supporting a "soft landing" theory for the soft part of the reinsurance cycle rather than a more damaging "crash landing".

There are several features that develop in a soft reinsurance market where the supply of reinsurance capacity far outweighs demand for the product. As discussed above (*Premium Rates under Pressure but Adequate*), there is moderate pressure on premium rates. In addition, policy coverage is also likely to be widened as exclusions are removed, broader cover is incorporated into wordings and in some cases multiple-year policies are issued. While premium pricing is relatively easy to analyse, changes in coverage are much less transparent, but can be as damaging to reinsurers' underwriting performance as premium rate declines, or even more so.

To date, Fitch has been pleasantly surprised by the discipline shown by the reinsurance sector as the market begins to soften. There have not yet been signs of a feeding frenzy among reinsurance players seeking to employ their capital. Instead, there have been several examples of reinsurers deciding to return excess capital to shareholders through special

Table 7: Key Historical Financial Results

Historical Results (USDm)	H105	H104	2004	2003	2002	2001	2000
Net Premiums Written	43,274	48,500	91,830	93,196	82,631	63,536	58,140
Underwriting Gain (Loss)	1,702	2,585	468	3,403	(9,066)	(16,468)	(3,563)
Calendar Year Combined Ratio (%)	95.1	91.9	101.4	97.6	108.0	125.9	107.3

Source: Fitch.

For comparative purposes H104 data excludes Berkshire Hathaway's and SCOR's net premiums written.

dividends or share buy-backs. Fitch expects this form of capital management to intensify as the reinsurance market softens, but is also aware that reinsurers will not want to compromise their current credit ratings and will only employ active capital management strategies after close consultation with their rating agencies.

#### *Impact on Rating Outlook*

The current Stable Outlook for the reinsurance sector reflects Fitch's expectation of a "normal" underwriting cycle. As a result, a decline in earnings due to the transition into a soft market phase in itself is a neutral rather than a negative rating factor. Should the soft part of the underwriting cycle be deeper and longer than expected, thus resulting in earnings below the agency's forecasts, this is likely to result in negative pressure on the sector's rating Outlook.

#### Continued Flight to Quality

As a result of the downward shift in the reinsurance sector's ratings in recent years, cedants are paying increasing attention to reinsurers' credit quality. A flight to quality is giving higher-rated reinsurers access to most of the risks being distributed within the sector, while lower-rated reinsurers have access to a smaller subset of poorer-quality risks. Fitch expects this trend to continue and to be self-perpetuating, exacerbated as cedants, rating agencies and regulators develop capital models that increasingly apply differentiated capital charges to reinsurance recoverables of different credit quality. This in turn will result in a continued divergence between the underwriting results of higher-rated reinsurers and the underwriting results of lower-rated reinsurers.

Flight to quality will become increasingly evident as the reinsurance market softens and significant reinsurance capacity is available. Cedants, particularly those with recent favourable loss experience, will have improved bargaining power and are expected to insist on placing their business with the best possible available reinsurance security. Indeed, several recent market surveys have suggested that cedants are more concerned about the quality of their reinsurance security than with the price of the contract.

Fitch expects that supply and demand will further polarise the reinsurance sector between higher and lower-rated companies, with lower-rated companies facing adverse selection risk. It is therefore important that users of Fitch's ratings review the credit quality of individual reinsurers as well as the sector's rating Outlook before making commercial

decisions, as significant differences remain in reinsurers' credit profiles.

#### *Impact on Rating Outlook*

Fitch views the increased flight to quality in the reinsurance sector overall as neutral in terms of the sector's rating Outlook, as some reinsurers will benefit at the expense of others. This trend will emphasise the fact that the sector is not a homogeneous group and that material differences exist between individual reinsurers, including classes of business written, geographical focus and credit quality.

#### Converging Relative Strengths and Weaknesses

When the sector's capital base was depleted by the events of 11 September 2001 and large prior-year reserve charges taken during 2001-2002, new capital rushed into the sector in the form of reinsurance start-ups or re-capitalisations. Since then, Fitch has viewed start-up reinsurers' relative lack of exposure to potential reserve development, or "clean capital", as a key competitive advantage and their modest infrastructures and franchises and their lack of track records as key competitive disadvantages. Conversely, the agency viewed mature well-established reinsurers' exposure to potential adverse reserve development and capital adequacy concerns as key competitive disadvantages and their significant infrastructure, franchises, and large-invested asset bases upon which they could earn investment income as key competitive advantages.

Fitch believes that start-up reinsurers' competitive advantages and mature reinsurers' competitive disadvantages have now begun a slow and steady path toward convergence. Start-up reinsurers' exposure to potential adverse reserve development has increased, as they have diversified into different business lines and as their books of business season. At the same time, mature reinsurers' exposure to adverse reserve development and capital adequacy concerns have declined as they have taken reserve charges and in some cases raised external capital.

Similarly, Fitch believes that start-up reinsurers' competitive disadvantages and mature reinsurers' competitive advantages have begun to converge. Start-up reinsurers have built infrastructures, franchises, and track records. While mature reinsurers have maintained their strong positions in these areas, they have started to converge with start-up reinsurers' positions on a relative basis.

#### *Impact on Rating Outlook*

Over an extended period of time, Fitch believes that convergence will have a harmonising effect on

individual companies' ratings and thus views this convergence as a neutral factor when evaluating the sector's rating Outlook.

#### More Mergers and Acquisitions and Diversification Strategies Implemented

Fitch expects the approaching soft market will fuel merger and acquisition activity. When reinsurers are unable to grow profitable premium volumes organically, one option is to grow through M&A. History has shown that it is extremely difficult to deliver tangible shareholder value through M&A, as reinsurers have found it difficult to extract sufficient economies of scale and synergies. Of more concern has been the extent to which acquired legacy issues have resulted in a significant drag on future earnings.

Although Fitch believes M&A activity will intensify over the medium term, it is more likely that reinsurers will look to acquire portfolios of business or teams of underwriters rather than exposing themselves to liabilities and associated legacy issues. It is also likely that substantial warranties would be required by an acquirer to protect itself against adverse reserve development on the book of business being acquired.

A further consequence of the approaching soft market is that reinsurers may consider diversification as a means to employ capital more efficiently. Diversification comes with its own set of risks and, if not properly controlled, can result in value destruction rather than creation. Fitch is particularly concerned about specialist property catastrophe reinsurers that may decide to diversify into US casualty lines. This form of diversification requires the recruitment of appropriate underwriting, actuarial and legal resources, together with the implementation of specialist systems and controls.

#### *Impact on Rating Outlook*

Fitch views an increase in M&A activity and diversification strategies as a signal that individual reinsurers may be having a difficult time achieving profitable organic growth in competitive conditions. The agency also considers the sector's track record on M&A and diversification to be mixed at best and thus views them as a negative when evaluating its rating Outlook.

#### US Regulatory Investigations Add Uncertainty

The New York Attorney General's investigation into the insurance industry, announced on 14 October 2004, has centred on three issues: contingent commissions, bid rigging and finite insurance/reinsurance. The elimination of contingent commissions and bid rigging may ultimately have a negative impact on premium pricing both in the

primary and reinsurance sector. However, Fitch believes the investigation's main impact on the reinsurance industry will come from the examination into finite reinsurance products.

The investigations are ongoing and no firm conclusions can be drawn regarding findings against finite reinsurers. At the very least, given the attention the industry is now experiencing from prosecutors and regulators, the purpose of finite reinsurance as a tool to enhance financial statements will become more transparent to the market. This could hurt insurers that rely on it for capital support and financial flexibility, and make the product less attractive in the future, thus lessening demand and hurting sellers. It is noteworthy that reinsurers have already reported a decrease in demand for finite reinsurance products in 2005, particularly from US cedants. Fitch believes that smaller transactions, where higher compliance costs make the transaction's benefits more tenuous, are increasingly unlikely to be completed.

In the extreme, Fitch would also be concerned if the investigations revealed any activities that were deemed to be illegal or fraudulent. Ultimately, if any wrongdoing is discovered, these investigations may result in challenges similar to those being felt today in the brokerage industry regarding contingent commissions and bid rigging, specifically for those offering and buying the product.

Finite reinsurance providers include reinsurers that specialise in finite risk and composite reinsurers that offer both finite reinsurance and traditional reinsurance. Companies that specialise in finite reinsurance will be hurt the most from reduced product demand. In these cases, adverse rating actions may follow. However, it is important to note that most of the finite reinsurance capacity comes from large, diversified reinsurers. In these cases, finite reinsurance is a relatively small portion of overall business and rating actions may be avoided.

#### *Impact on Rating Outlook*

The ongoing investigations into contingent commissions, bid rigging and finite reinsurance have only modest negative rating implications for the reinsurance industry. As finite reinsurance represents only a small proportion of the total reinsurance business, reduced demand for this product is likely to result in a drag on earnings rather than an erosion of the sector's capital. Reduced demand for finite reinsurance products is also likely to result in some increase in demand for traditional reinsurance. However, it is possible that a small number of specialist reinsurers may experience negative rating actions as a result of material declines in premium volumes or exposure to possible legal action. The

loss of key personnel and franchise damage could also result in negative rating actions.

#### Potential Increases in Volatility Related to Terrorism Exposures

Regrettably, the world is now constantly exposed to the serious threat of terrorism, forcing individuals to change their everyday way of life. Insurers and reinsurers also have to adapt to the increasing threat of terrorist attacks and the ensuing commercial challenges.

The bombs that exploded on four trains in Madrid in March 2004, the attack by four suicide bombers on London's transport system in July 2005 and the failed attack in London during the same month demonstrate that the horrific events in the US on 11 September 2001 were not an isolated event. Insurers and reinsurers must operate on the basis that further attacks will occur – the only uncertainty is where and when.

The primary and reinsurance markets' responses to terrorism risks have varied widely around the globe. In a few territories, terrorism schemes have been established either through government sponsorship or through industry-funded pools. Countries that have established such schemes include Australia, Austria, France, Germany, Israel, Namibia, Netherlands, South Africa, Spain, Sri Lanka, the UK and the US. These terrorism schemes vary widely, with different premium levels, retentions, exclusions, limits and definitions of terrorism.

Reinsurers have typically excluded terrorism risks from policy wordings since 11 September 2001. Whereas property policies in the past included terrorism as a policy extension, terrorism capacity is now available from the reinsurance market only as a separate policy with carefully controlled limits, coverage and premium. As a result, the reinsurance industry is significantly more distanced from the threat of terrorism than primary insurers.

Probably the most significant development in the area of terrorism insurance is whether or not the US Treasury extends the Terrorism Risk Insurance Act ("TRIA") following its expiry on 31 December 2005. TRIA was designed to provide a temporary federal terrorism insurance programme following 9/11, allowing insurers time to rebuild their balance sheets. If TRIA is not extended into 2006, demand for specific terrorism reinsurance protection will inevitably increase, thus creating both opportunities and threats for the reinsurance sector.

If reinsurers are able to price terrorism risk appropriately and limit exposure through restricted policy conditions, the demand for terrorism

reinsurance will improve the reinsurance industry's overall results. However, due to the volatile nature of terrorism exposures, reinsurers that under-price risks or provide broad coverage are likely to face substantial losses. Overall, Fitch is sceptical that reinsurers have sufficient underwriting information and modelling capabilities to underwrite terrorism exposures with the same level of technical expertise that is used to underwrite other catastrophe exposures.

#### *Impact on Rating Outlook*

Fitch's Stable Outlook for the reinsurance sector partly reflects the limited terrorism exposure that is currently assumed. If reinsurers decide to take on more terrorism risk as a result of the termination of TRIA, or schemes funded by government or industry are abandoned in other countries, this would add potential volatility to the sector's financial results and negative pressure to its rating Outlook.

#### Risk Modelling Increasingly Important to Decision-Making Process

Reinsurers' risk-modelling capabilities have increased exponentially since the early 1990s. In 1992, Hurricane Andrew acted as a catalyst for developing property catastrophe models, initially relating to windstorm and earthquake exposures. With further developments in technology and increases in the understanding and appreciation of data, the approach taken by reinsurers to risk modelling has evolved and risk models have been enhanced.

Reinsurers have actively recruited actuarial resources over the last decade to drive risk modelling. However, a greater understanding of other sciences is also required as part of the process and reinsurers have actively recruited in the areas of meteorology, mathematics, seismology and economics to better understand the risks they face.

Reinsurers' large investments in risk modelling over recent years have extended the risks that can be assessed beyond simply windstorms and earthquakes. Models are now being applied to assess workers' compensation, personal accident, directors' and officers' insurance, and even terror risks. In fact, models can now be used to manage a complete portfolio, thus aiding the development of underwriting strategies, pricing, risk selection and retrocessional purchasing.

Risk modelling is likely to continue evolving, especially in the areas of investment risk, credit risk, and other non-insurance types of operational risk. Reinsurers today have a much more sophisticated armoury of tools to assist them in efficiently

allocating their capital. As a result, Fitch expects that those reinsurers that invest in modelling capabilities will ultimately produce better underwriting results and enhance their return on capital employed.

### *Impact on Rating Outlook*

Fitch views the increased sophistication of risk models used by reinsurers as a positive development. If application and adherence to the results of risk modelling ultimately improve the sector's profitability across the cycle, this could have positive implications for the reinsurance sector's rating Outlook. Enhanced modelling capabilities' recent and rapid emergence makes it too early to tell whether this will actually be the case. The possible benefits from risk modelling are not likely to become fully apparent until the soft part of the underwriting cycle is reached.

### Positive Development of Common European Reinsurance Regulation

Fitch views positively the decision taken by the European Parliament to approve the Reinsurance Directive in June 2005. Formal adoption of the Directive is expected later in 2005 and each of the 25 EU member countries will have two years in which to implement it.

The Directive will create a pan-European regulatory framework for reinsurers. There is currently no harmonised reinsurance supervision in the EU and the level of regulation varies widely from country to country: at one end of the spectrum, European reinsurers are required to meet the same regulatory requirements as primary reinsurers; in a few countries, reinsurers remain virtually unregulated.

European reinsurers will be able to trade throughout the EU under one licence, either through branch offices or by way of "freedom of services". This single passport for European reinsurers, based on common regulatory requirements, will reduce the administrative burden of reinsurers seeking multiple European licences and unify regulatory standards at a relatively high level.

Fitch believes that the introduction of consistent EU reinsurance regulation will aid European reinsurers in their negotiations with US authorities for the removal of gross funding requirements when non-US reinsurers (so-called alien reinsurers) underwrite business in the US. If changes to US reinsurance funding requirements are achieved, this would level the playing field between US domestic reinsurers and non-US reinsurers. Fitch would see changes to US funding requirements as neutral for the reinsurance industry as a whole, as non-US

reinsurers would benefit at the same time as US reinsurers would lose a competitive advantage.

### *Impact on Rating Outlook*

The standardisation of reinsurance regulation across the EU is seen by Fitch as a positive development, especially as this will require improved and more consistent disclosure. The agency does not believe that the new regulatory framework will prove overly burdensome to European reinsurers. The benefits of prudential oversight will outweigh the potential disadvantages of competitive constraints

### ■ Conditions that Could Change Fitch's Rating Outlook

Fitch believes that the following are the most likely scenarios that could cause it to consider revising its Outlook from Stable to Negative.

### *Evidence of Deep and Pronounced Soft Market*

Fitch's rating Outlook is intended to look through "normal" soft markets so that it does not have to consider changing the rating Outlook in response to expected cyclical conditions. As a result, the most worrisome aspect from the agency's perspective would be a soft market that appears destined to be as deep and pronounced as the last soft market, which suffered double-digit declines in premium rates across most business lines and which arguably was brought to a complete end only after 11 September 2001. Given the relatively short duration of the last hard market, a deep and prolonged soft market could be a signal that the reinsurance sector's already limited pricing power – and thus its credit quality – had declined. In this situation, Fitch would likely revise its rating Outlook to Negative.

In "Mid-Year 2004 Global Reinsurance Outlook" (dated 7 September 2004, available on [www.fitchratings.com](http://www.fitchratings.com)), Fitch identified the following factors to monitor in gauging the depth and duration of what was, and continues to be, a softening market:

- the severity of declines in premium rates;
- loss cost assumptions that are inconsistent with medical and other inflationary trends;
- accident-year loss ratios that are inconsistent with historical trends and current conditions;
- investment returns that deviate significantly from historical averages; and
- net capital inflows into the market despite seemingly soft market conditions.

These were among Fitch's primary considerations when evaluating its rating Outlook for 2005 and they

continue to be relevant indicators of soft market conditions.

#### *Large Sector-Wide Shock Loss*

An insured industry-wide loss from a single catastrophe that approximates USD20bn in addition to “normal” run-rate catastrophe losses could cause Fitch to reconsider its Stable Outlook. A single loss to the tune of USD20bn is approximately 2.5 times Fitch’s estimate of the reinsurance sector’s average annual catastrophe losses for the 10-year period through 2004. While such an event would likely lead to a rapid increase in premium rates, it could also lead to significant market disruption. At the time of going to press, Hurricane Katrina’s insured loss estimates ranged from USD9bn to USD25bn. As loss estimates become firmer, they could cause Fitch to reconsider its Stable rating Outlook. Favourably, Hurricane Katrina occurred after a sustained period of technically adequate premium rates and strong capital formation for the sector.

#### *Evidence of a Sustained Increase in Hurricane Frequency*

Amid the various theories on global warming, one may wonder whether the (re)insurance industry faces an extended period of greater than historical average hurricane frequency. The hurricane season was very active in 2004 and forecasters promise another active season in 2005.

If Fitch became convinced that this was the case, and was also convinced that the reinsurance sector had not altered its pricing and risk management strategies

to incorporate this higher hurricane frequency, it would likely consider revising its Stable rating Outlook to Negative. This is unlikely, primarily because of a lack of solid proof of the various theories on global warming and the recent increase in hurricane frequency. The agency also believes that if these theories turn out to be correct, the climatic changes will take years if not decades to develop fully, which should give the reinsurance sector ample time to adapt.

#### *Positive Rating Drivers*

The three factors cited above are scenarios where Fitch would likely consider revising its Outlook from Stable to Negative. This begs the question under what conditions would Fitch consider revising its Stable rating Outlook to Positive? Realistically, there are not many. Global reinsurers operate in a cyclical industry with low entry barriers, where a significant part of the product they sell (capital) is largely fungible. As a result, it is difficult to foresee an environment in which the number of anticipated rating upgrades would materially outweigh the number of rating downgrades.

That said, indications that the sector’s pricing power and thus credit quality have improved would come from convincing long-term evidence that future soft markets would be shorter in duration and characterised by less severe pricing pressure than they have been historically. Under these circumstances Fitch would consider revising its rating Outlook to Positive.

## Appendix A – First Half 2005 Data on Select Global Reinsurers

(USDm)	Net Premium Written			Combined Ratio %			Retention Ratio %			Shareholders Equity		
	1st Half 2005	1st Half 2004	Change (%)	1st Half 2005	1st Half 2004	Change	1st Half 2005	1st Half 2004	Change	Jun 2005	Dec 2004	Change
Munich Re	9,024	9,258	-2.5	97.7	93.9	3.8	97.8	95.8	2.1	27,095	26,217	877
Swiss Re	8,686	8,768	-0.9	93.6	95.3	(1.7)	94.4	94.5	(0.0)	18,353	15,138	3,214
GE Insurance Solutions/ ERC	3,782	4,542	-16.7	109.0	106.5	2.5	NR	NR	NR	10,085	9,415	670
Hannover Re	2,654	1,972	34.6	93.6	92.4	1.2	88.0	77.4	10.6	3,615	3,319	296
PartnerRe Ltd.	1,944	2,175	-10.6	87.5	84.8	2.7	98.7	98.9	(0.2)	3,482	3,352	130
XL Capital Ltd	1,915	2,053	-6.7	91.5	76.6	14.9	87.0	87.7	(0.7)	8,372	7,739	633
Transatlantic Holdings, Inc	1,769	1,835	-3.6	97.7	95.1	2.6	89.7	88.2	1.5	2,722	2,587	135
Everest Re Group, Ltd.	1,413	1,409	0.2	86.0	92.1	(6.0)	99.8	99.2	0.6	3,756	3,713	43
Odyssey Re Holdings Corporation	1,153	1,103	4.6	97.4	95.5	1.9	89.9	88.8	1.0	1,714	1,586	128
Aspen Insurance	1,119	873	28.2	70.6	60.9	9.6	82.7	85.5	(2.9)	1,608	1,482	126
AXIS Capital Holdings Limited	1,018	773	31.7	75.3	57.1	18.3	99.4	98.0	1.4	3,167	3,238	(71)
ACE Limited	890	937	-5.0	76.8	67.4	9.4	98.3	98.9	(0.6)	10,496	9,843	653
Converium	866	2,079	-58.3	120.7	116.3	4.4	95.9	93.6	2.3	1,648	1,720	(72)
Arch Capital Group Ltd.	828	915	-9.5	85.3	82.1	3.1	95.6	96.4	(0.8)	2,503	2,242	261
Scor	765	777	-1.5	98.6	106.8	(8.2)	92.3	90.5	1.8	2,146	1,721	425
Allied World Assurance Holdings	759	784	-3.2	86.3	83.3	3.0	80.1	79.8	0.3	1,757	2,139	(382)
Platinum Re	725	610	18.8	80.3	78.3	2.0	99.1	98.2	0.9	1,273	1,133	140
RenaissanceRe Holdings Ltd.	713	767	-7.1	50.5	36.5	14.0	88.1	87.6	0.6	2,823	2,644	179
White Mountains Re (Folksamerica)	705	618	14.1	93.0	89.4	3.6	NR	NR	NR	4,092	3,884	208
Endurance Specialty Holdings Ltd.	645	728	-11.4	79.5	69.5	10.0	100.0	99.6	0.4	1,987	1,862	125
QBE Group	562	556	1.1	90.4	89.3	1.0	56.5	61.9	(5.4)	3,418	2,789	630
Montpelier Re Holdings Ltd.	511	480	6.6	62.6	45.0	17.5	87.8	88.2	(0.4)	1,463	1,752	(289)
Max Re Capital Ltd.	324	233	39.0	86.0	81.4	4.6	93.1	95.2	(2.1)	1,025	937	88
IPC Re	274	267	2.8	47.2	22.2	25.0	93.7	94.3	(0.6)	1,743	1,668	75
PXRe	177	141	25.6	42.7	26.1	16.6	92.4	87.9	4.5	763	697	67
Rosemont Re	51	71	-28.3	85.9	95.2	(9.4)	83.8	82.5	1.2	263	260	3
Berkshire Hathaway Inc.	NR	3,775	NR	92.0	90.4	1.6	NR	NR	NR	88,086	85,900	2,186
<b>Total</b>	<b>43,274</b>	<b>48,500</b>	<b>-10.8</b>	<b>95.1</b>	<b>91.9</b>	<b>3.2</b>	<b>92.9</b>	<b>93.5</b>	<b>(0.6)</b>	<b>209,453</b>	<b>198,975</b>	<b>10,478</b>

Where possible life, primary non-life and financial/finite reinsurance data has been excluded from this analysis depending on the individual company's reporting practice

NR - Not reported.

Combined ratio - Net losses and loss adjustment expenses divided by net premium earned plus underwriting expenses divided by net premiums written

Berkshire Hathaway and QBE Group - Combined ratios - Net losses and loss adjustment expenses divided by net premium earned plus underwriting expenses divided by net premiums earned

Berkshire Hathaway: Includes consolidated data for General Re and National Indemnity

Toa Re - Year End March

Shareholders equity is organisation-wide equity and thus depending on the company's reporting practice, may include equity that supports operations other than property/casualty reinsurance operations.

Source: Company annual reports and Fitch Insurance Database

## Appendix B – Historical Data on Select Global Reinsurers

	Net Premium Written			Combined Ratio			Retention Ratio			Equity		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002
Munich Re	16,939	18,871	16,685	101.3	95.8	121.8	87.8	93.0	93.5	26,053	21,400	13,199
Swiss Re	11,777	13,035	10,133	99.9	91.3	102.8	94.8	94.9	91.4	14,210	10,968	10,684
Berkshire Hathaway Inc.	6,338	7,382	10,708	96.2	102.2	96.3	NR	64.0	102.7	85,900	77,596	64,037
GE Insurance Solutions/ ERC	5,867	6,760	5,771	120.8	109.2	166.8	NR	82.5	68.3	8,248	7,943	6,664
Hannover Re	4,556	3,914	3,586	96.7	96.1	94.8	85.6	72.2	63.0	3,319	2,723	1,646
Transatlantic Holdings, Inc	3,749	3,341	2,500	101.4	95.3	100.7	90.5	91.8	85.4	2,587	2,377	2,031
PartnerRe Ltd.	3,444	3,290	2,481	93.3	93.7	95.3	99.4	99.3	98.3	3,352	2,594	2,077
Converium	3,113	3,458	3,007	119.3	96.8	102.6	91.7	90.6	94.2	1,720	2,083	1,738
Everest Re Group, Ltd.	3,041	2,894	2,638	110.0	102.7	95.2	99.7	96.4	92.7	3,713	3,165	2,369
XL Capital Ltd	2,874	2,865	2,564	95.2	114.7	97.3	83.2	84.2	80.8	7,739	6,937	6,570
Odyssey Re Holdings Corporation	2,127	2,012	1,596	99.3	95.0	95.5	93.9	88.7	90.5	1,586	1,390	1,056
Scor	2,032	2,763	3,379	103.9	126.2	120.1	94.5	91.1	89.1	1,719	701	1,013
Korean Re	1,712	1,350	1,186	95.5	96.6	96.5	68.9	67.6	67.7	368	287	238
Caisse Centrale de Reassurance	1,635	1,132	838	87.1	124.4	73.4	96.3	96.9	96.8	1,124	902	717
Arch Capital Group Ltd.	1,588	1,567	883	92.1	84.9	77.1	95.8	96.4	97.1	2,242	1,711	1,411
Toa Reinsurance Group	1,358	1,196	1,009	103.5	105.7	118.3	100.0	100.0	100.0	1,294	844	971
White Mountains Re (Folksamerica)	1,246	889	679	104.3	94.9	99.0	64.5	63.0	70.3	3,884	2,979	2,408
QBE Group	1,246	1,169	851	97.2	95.4	95.1	77.9	81.6	73.5	3,448	2,145	1,601
Axa Re	1,245	1,448	2,268	104.8	115.1	114.6	75.9	67.6	71.1	1,368	1,617	1,273
Platinum Re	1,182	827	298	93.3	83.8	69.0	98.8	96.9	-	1,133	1,067	921
Endurance Specialty Holdings Ltd.	1,119	1,041	517	86.3	74.1	68.4	99.0	99.8	94.0	1,862	1,645	1,218
AXIS Capital Holdings Limited	1,060	654	314	66.3	61.3	60.1	97.0	98.1	100.0	3,238	2,817	1,961
Aspen Insurance	1,009	821	234	82.7	78.5	88.0	85.7	81.9	81.2	1,482	1,299	878
RenaissanceRe Holdings Ltd.	931	790	697	95.3	44.5	54.6	87.3	84.5	76.3	2,644	2,335	1,642
Mapfre Re	922	622	428	86.2	88.2	93.3	67.0	65.7	61.5	623	369	253
Montpelier Re Holdings Ltd.	749	778	566	79.2	47.7	56.0	89.5	96.1	93.1	1,752	1,658	1,253
Sirius International	603	492	445	99.7	117.3	107.7	83.7	86.6	80.7	999	845	801
Olympus Re	521	523	299	91.3	56.3	53.2	100.0	100.0	100.0	653	719	623
Allied World Assurance Holdings	394	340	164	98.0	82.5	75.5	96.6	100.0	100.0	2,139	1,979	1,682
IPC Re	358	308	254	78.1	34.9	34.1	94.8	95.4	97.8	1,668	1,569	1,291
Max Re Capital Ltd.	314	301	138	81.6	76.2	79.8	93.7	94.4	100.0	937	805	594
PXRe	310	278	294	98.5	49.1	47.1	89.5	82.1	80.2	697	565	453
Rosemont Re	132	176	192	110.3	100.7	73.4	89.7	87.8	94.5	242	260	-
<b>Total</b>	<b>91,830</b>	<b>93,196</b>	<b>82,631</b>	<b>101.4</b>	<b>97.6</b>	<b>108.0</b>	<b>88.0</b>	<b>85.1</b>	<b>85.9</b>	<b>260,857</b>	<b>222,495</b>	<b>172,976</b>

Where possible life, primary non-life and financial/finite reinsurance data has been excluded from this analysis depending on the individual company's reporting practice

NR - Not reported.- Combined ratio - Net losses and loss adjustment expenses divided by net premium earned plus underwriting expenses divided by net premiums written

Berkshire Hathaway and QBE Group Combined ratio - Net losses and loss adjustment expenses divided by net premium earned plus underwriting expenses divided by net premiums earned

Berkshire Hathaway: Includes consolidated data for General Re and National Indemnity

Korean Re and Toa Re - Year End March.

Shareholders equity is organisation-wide equity and thus depending on the company's reporting practice, may include equity that supports operations other than property/casualty reinsurance operations.

Source: Company annual reports and Fitch Insurance Database

## Appendix C – Fitch's Ratings on Select (Re)insurance Organizations

Group	Insurer Financial Strength Rating	Long-Term/ Senior Debt Rating *	Rating Outlook	Rating Watch
Ace Ltd.	A+	A-	Stable	-
Arch Capital Group	A-	BBB-	Stable	-
Axa	AA	A+	Stable	-
Berkshire Hathaway, Inc.	-	AAA	Negative	-
General Reinsurance Corporation	AAA	AA+	Stable	-
National Indemnity Company	AAA	-	Stable	-
Brit Insurance Limited	A+	-	Stable	-
China International Reinsurance Co. Ltd.	A-	BBB-	Stable	-
Converium	BBB-	B+	Stable	-
Employers Re / GE Insurance Solutions Corp.	AA-	A-	Stable	-
ESG Reinsurance Bermuda, Limited	B-	-	Negative	-
Everest Re Group	AA-	A-	Stable	-
Folksamerica Reinsurance Company / White Mountains	A	BBB	Stable	-
Hannover Rueckversicherung AG	A+	A+	Stable	-
Imagine Re	A	-	Stable	-
Lloyds of London	A	A	Stable	-
Mapfre Re	A+	A+	Stable	-
Max Re	A	BBB	Stable	-
Montpelier Re	A-	BBB-	Stable	-
Munich Re Group	AA-	AA-	Stable	-
Odyssey Re	BBB+	B+	-	Negative
Partner Re	AA	A+	Stable	-
PMA Capital Insurance Company	B-	B	Stable	-
PXRE Group	A-	BBB-	Stable	-
QBE Group	A+	A	Stable	-
Reaseguradora Patria Internacional, S.A.	BBB	-	Stable	-
RenaissanceRe	A+	A-	-	Negative
Scor Group	BBB	BBB-	Stable	-
Swiss Re Group	AA+	AA+	Stable	-
XL Capital	AA	A	-	Negative
<b>Average Sector Rating</b>	<b>A</b>	<b>BBB+</b>		

\* Long-term / senior debt ratings may be on the parent holding company.

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