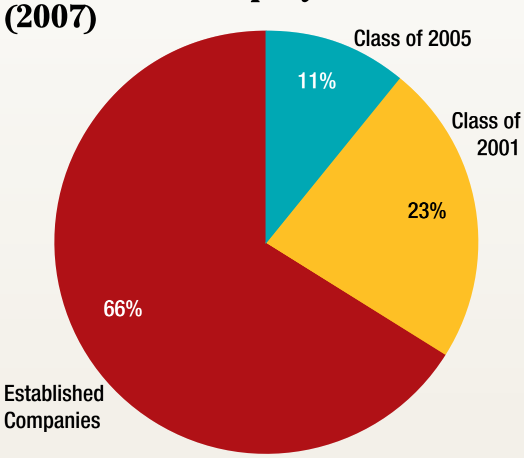
Bermuda – 2007 Financial Review

April 21, 2008

Sector
Property/Casualty

Outlook
Stable

Bermuda Insurers/Reinsurers — Shareholders' Equity Breakdown (2007)



Note: Total equity is the total reported equity of the company.
Source: A.M. Best Co.

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Bermuda Insurers Carry Strength Into a Softening Market

Bermuda-based property/casualty insurers bounced back from two years of unprecedented hurricane losses to post strong results in 2006 and 2007, but industry fundamentals are expected to continue deteriorating. Meanwhile, financial results produce interesting comparisons between the performance of established carriers and newer ones.

• First-quarter results provide reason to expect an acceptable rate of return in 2008, but margins will be lower than they have been in the past two years.

• The majority of Bermuda-based carriers are financially strong, as the fundamental quality of underwriting leads to record earnings.

• The Bermuda market sample reported excellent combined ratios for 2006 and 2007 of 83.6% and 82.9%, respectively.

• Pressure on companies to lower rates and loosen terms poses a challenge to effectively manage capital.

• Cedants purchasing less reinsurance make the stability of earnings less certain.

• Insurers are approaching July renewals cautiously in a fragile marketplace.

• A.M. Best maintains a stable ratings outlook on the Bermuda reinsurance/insurance sector, with most actions likely to be affirmations.

Exhibit 1
Bermuda Property/Casualty — Financial Indicators (2006-2007)

	YE 2006	YE 2007	% Change
Total Equity	66,393,585	75,969,628	14.4%
Net Premiums Written	43,826,961	44,178,667	0.8%
Net Premiums Earned	42,513,323	44,291,081	4.2%
Net Investment Income	6,525,624	7,928,076	21.5%
Net Realized Gains (Losses)	-62,868	241,738	-484.5%
Losses & LAE	23,834,770	24,308,389	2.0%
Operating Expenses	11,705,443	12,423,413	6.1%
Net Income	11,481,570	11,379,034	-0.9%
Loss & LAE Ratio	56.1%	54.9%	
Underwriting Expense Ratio	27.5%	28.0%	
Combined Ratio	83.6%	82.9%	
Less: Loss Reserve Development	-2.3%	-5.2%	
AY Combined Ratio (Normalized)	85.9%	88.2%	
Return on Equity %	20.5%	15.9%	

Data collected from financial statements of interactively rated Bermuda insurers/reinsurers.
Source: A.M. Best Co.

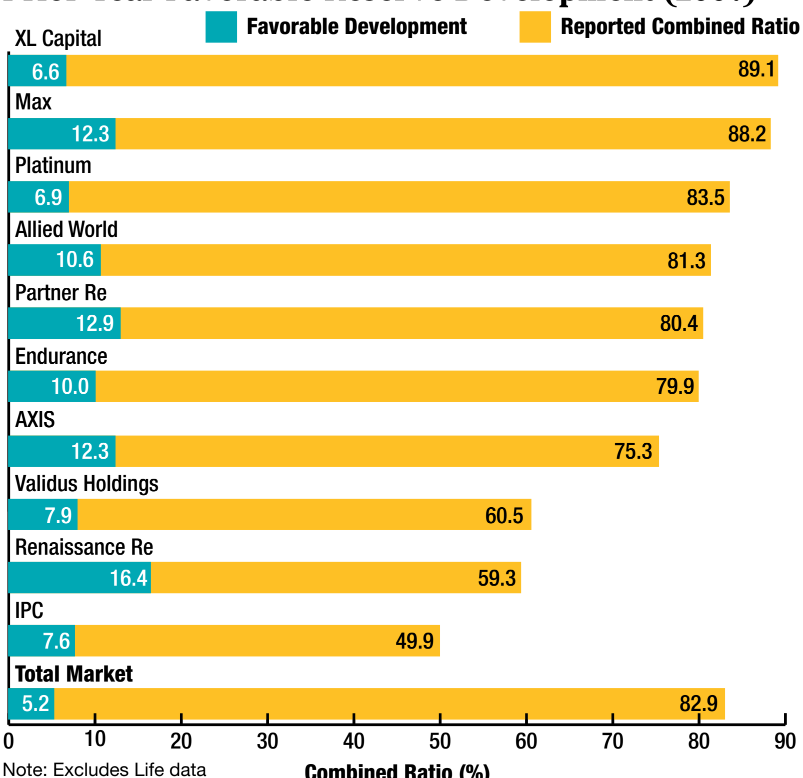
Navigating Shallower Waters

Just two years after the gouging of balance sheets and earnings through unprecedented hurricane losses, the Bermuda-based property/casualty insurance market can look back on 2006 and 2007 and remember the best of times. Financial results of interactively rated insurers over this two-year period produce interesting comparisons between the performance of established carriers and newer company formations.

The overwhelming conclusion is that the majority of carriers on the island are financially strong, benefiting from record earnings produced by the fundamental quality of underwriting operations. As can be expected, balance sheets with few exceptions are in the best shape in years. The longer term view, however, is that industry fundamentals will continue to deteriorate, barring any industry-changing event. Pressure on companies to lower rates and loosen terms challenges the effective management of capital, while cedants purchasing less reinsurance make the stability of earnings less certain. Compounding these factors are significant capacity in the markets and pressure to deploy capital with fewer opportunities. It is important to remember the basic concept that a balance sheet reflects only a point in time, and the currently declining fundamentals are a major contributor to tomorrow's quality of capital.

Exhibit 2

Bermuda Property/Casualty — Prior Year Favorable Reserve Development (2007)



Note: Excludes Life data
Source: A.M. Best Co.

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On the positive side, first-quarter results provide reason to anticipate an acceptable rate of return in 2008 for the Bermuda market, but at lower margins then reported in the past two years. Nevertheless, as the July renewal season looms, insurers in Bermuda seem to sense that they're on thin ice, and none wants to be the one to break it. Undoubtedly, as in prior cycles, there will be winners and losers. That said, A.M. Best is maintaining a stable ratings outlook on the Bermuda reinsurance/insurance sector, which implies that the majority of rating actions likely will be affirmations, with few upgrades or downgrades. During the past several years, carriers have reassessed their respective risk profiles while enhancing internal risk measurements and risk-accumulation capabilities. A.M. Best will closely monitor underlying trends to assess the effectiveness of these capabilities throughout the softening phase of the underwriting cycle. Top-line revenues and underlying exposure bases should be expected to contract during this period for prudent underwriting organizations. In the long run, the resulting contraction of capacity, while difficult to master, will help lessen the depth of the market downturn.

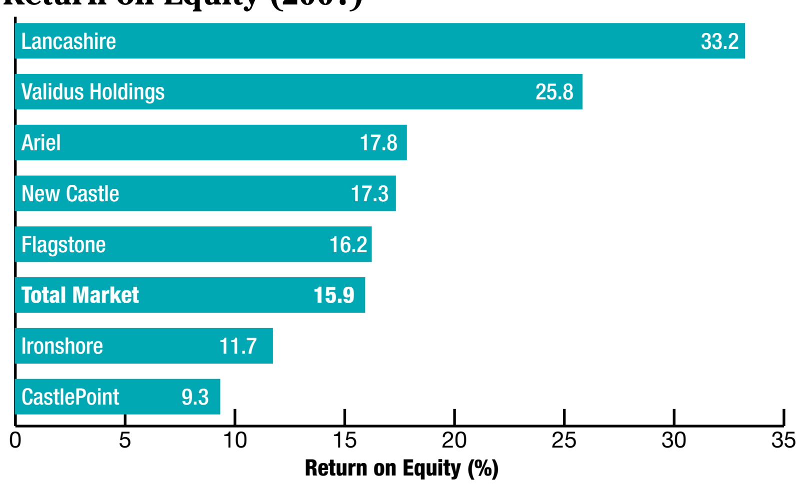
Bermuda Property/Casualty Results

The Bermuda market sample reported excellent underwriting results for calendar years 2006 and 2007, producing combined ratios of 83.6 and 82.9, respectively. A characteristic also shared by both of these years is the modest level of insured catastrophe losses, despite an increase in frequency of catastrophes on a global scale in 2007. Underwriting results for 2007 also show significant reserve releases for prior accident years, which reduced the combined ratio by more than five percentage points. The magnitude of reserve releases varies by carrier, but several companies experienced double-digit reserve redundancies relative to earned premiums. A.M. Best believes recent accident years warrant redundancies but is cautious that there could be an element of optimism in releasing "greener" accident years prematurely. Nonetheless, A.M. Best does not view the trend of reserve releases as sustainable and expects the redundancies to be largely exhausted through 2009. Supporting this view are pressure on rates and the ever looming concern over an uptick of severity in casualty lines exposed to factors such as medical cost inflation. As underlying trends weaken, the onset of a predicted active hurricane season, as well as other perils that include ongoing earthquake exposure, further magnify the challenges facing the industry.

ACE is by far the largest group on the island, with 2007 nonlife net premiums written at nearly $11.6 billion. XL Capital remains the island's second-largest writer with $6.3 billion of nonlife net premiums, followed by Everest Re and PartnerRe with net premiums written at $3.9 billion and $3.2 billion, respectively. The significance of the Class of 2001 insurers launched after the Sept. 11 attacks is evident, with Arch and Axis each writing almost $3 billion of premiums. Although the Class of 2005 ramped up activities in 2007, the collective premium volume of these companies, established in the wake of Hurricane Katrina, does not exceed any of the three largest carriers on the island.

Established carriers, in large part, experienced declines in gross and net premiums written, which could point to carriers holding the line on price discipline. Less evident are changes in exposure, which should be declining at the same rate. Challenges for premium growth will continue in 2008 as the supply and demand for capacity are unbalanced, with more capital chasing less available premium. Based on first-quarter writings, market participants

Exhibit 3
Bermuda Start-Up Insurers/Reinsurers — Return on Equity (2007)

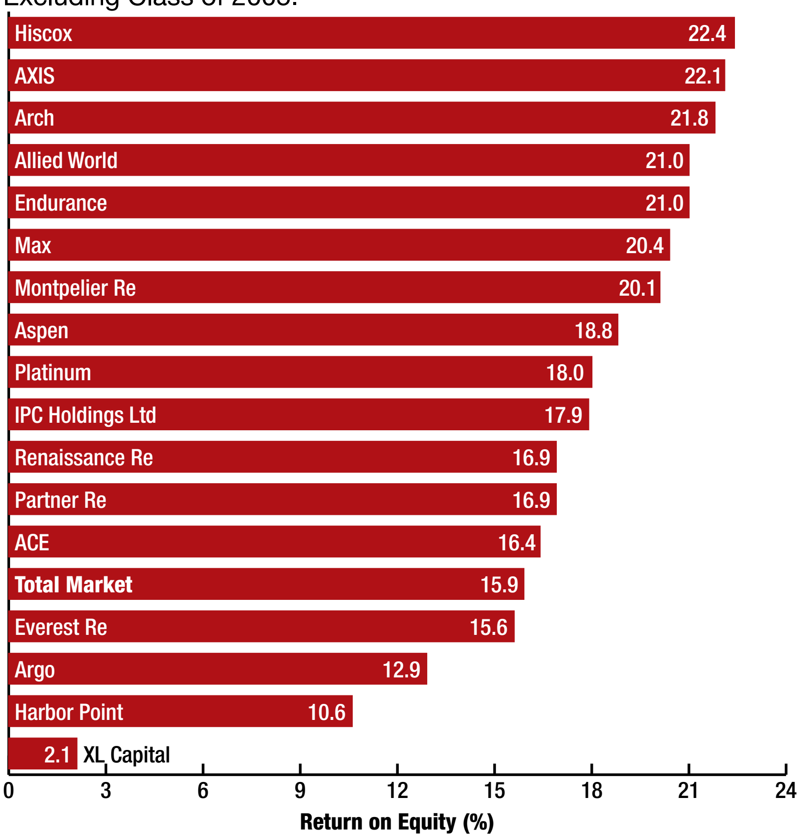


Note: Total equity is the total reported equity of the company.
Source: A.M. Best Co.

appear to be acting rationally. The longer term actions of participants will tell the story of this market cycle.

Strong operating cash flow continued to fuel increases in invested assets and corresponding investment income. In 2008, the lower interest rates and uncertainty in the capital markets likely will impact investment income yields. The subprime crisis has affected Bermuda carriers in the form of asset write-downs but thus far has not materially impacted the market's operating results. The subprime questions going through 2008 include: Is the worst over, and what will the impact be on the carriers with directors and officers or errors and omissions exposure? The systemic risk within the financial markets resulting from subprime losses and the general credit crunch bring to light the perils of correlation risk and the failure of models to measure actual risk and exposure. A challenge in monitoring correlation risk is that correlations often are uncovered after losses emerge.

Exhibit 4
Bermuda Insurers/Reinsurers — Return on Equity (2007)
Excluding Class of 2005.



Note: Total equity is the total reported equity of the company.
Source: A.M. Best Co.

The capacity of the Bermuda market, expressed as shareholders' equity, significantly increased in 2007 to more than $75 billion. This includes incumbents generating capital through earnings and the Class of 2005, representing more than $10 billion of new capital. The impact of compounded capital is clear, as the market's total equity increased 46% from 2005 to 2007 (excluding the Class of 2005). Interestingly, the Class of 2001 leads Bermuda in terms of growth in equity compared with more established players. A leading reason is that carriers such as Arch, Axis and Allied World Assurance were better positioned to capitalize on the hard market years, as the Class of 2001 benefited from timing and the ripeness of the property/casualty markets. The lack of catastrophes in 2006 and 2007 amplified results and accumulation of capital. Additionally, these carriers have been able to build investment income as balance sheets mature to supplement favorable underwriting performance.

These gains have facilitated considerable share repurchases, as the vast majority of carriers have active share-repurchase programs in place, and most carriers increased shareholder dividend payments. Capital management clearly is a major challenge in 2008, as management teams have maintained they will not chase bad business despite pressure to generate returns. In 2008, a dominant theme also will be mergers and acquisitions, and CEOs should expect to field calls from investment bankers pitching opportunities as routinely as drinking the morning cup of coffee.

Beyond the Numbers

As companies look for opportunities in a competitive market, the respective business positions of each could either garner opportunities or create challenges. In Bermuda, companies are segmented by:

• Established players typically, with more than 10 years of operations;

• The Class of 2001, which benefited greatly from the timing of its formation and successful execution; and

• The Class of 2005, which is off running and aggressively seeking additional strategies to fully deploy capacity.

A.M. Best maintains its start-up methodology on carriers for a period of five years. Therefore, the Class of 2001 carriers no longer are viewed as start-up formations in A.M. Best's rating evaluation.

Over the long run, the performance of the Class of 2001 could align more with that of the established players, as the younger companies face the challenges of their first soft market. While new company formations do not have any drag from legacy issues, it cannot stay that way forever, as today's writings could become tomorrow's legacies given the "tail" effect of casualty claims payouts. The Class of 2005, for that matter, will continue to find ways to deploy capital. Many carriers have evolved beyond their initial business plans, migrating to longer tail classes as opportunities have proven harder to find.

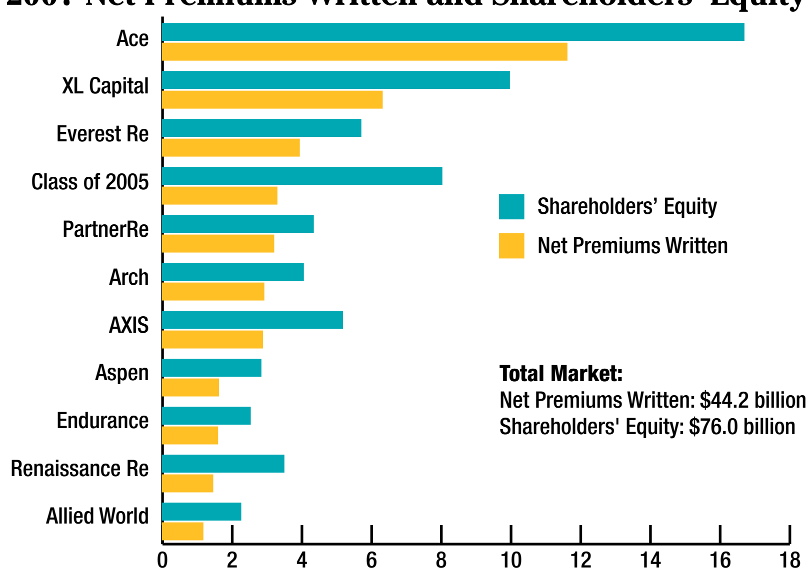
The island's interest in U.S. excess and surplus lines specialty markets continues unabated, as carriers such as Max Re, Montpelier Re and Endurance have set up domestic operations. Another major trend is Bermuda companies entering Lloyd's markets through the formation of a Lloyd's syndicate, such as Aspen and Montpelier Re, or through transactions such as Ariel Holdings and Validus Holdings acquiring Atrium and Talbot, respectively. A common theme of these trends is admittance to essential distribution networks to access certain classes of business. Each entity's goals may differ but are to satisfy one or both of the following: management's desire to diversify away from catastrophe business, or shareholders' requirements to garner more return by deploying more capacity and accessing perceived profitable business opportunities. Excluding pure reinsurers such as PartnerRe and Platinum Underwriters, established carriers such as Ace, XL Capital and Everest Re have had a presence in the U.S. primary markets for years and have developed seasoned books of business. The attractiveness of Lloyd's to the Class of 2005 has its own merits in the immediate access to global markets through the Lloyd's licenses and higher financial strength rating.

Diversification's benefits often are misconstrued when it comes to A.M. Best's view in the ratings process. Clearly, a carrier with established operations, experienced management and localized market presence more than likely would gain from a diversified business position with regard to geography and product lines. As easy as it is to see the cyclicality of the industry in total, there are many cycles within the cycle, given the various lines and locations of coverage. A diversified carrier can benefit from noncorrelated business with regard to long-term performance. However, there are risks with diversification, particularly when many competitors are seeking similar opportunities. Only time will tell who makes the correct decision, but A.M. Best believes new business entails greater risks. The ultimate question is whether they were worth the reward.

Regulatory Update

As the Bermuda insurance market continues to grow, the Bermuda Monetary Authority (BMA), the regulator of the financial services sector, also has grown in terms of its role within the global financial system. As a result, the BMA's standards of regulation have become subject to increased scrutiny by regulators around the world, as well as by other stakeholders, including investors and policyholders. This comes at a time when regulation of the insurance industry is in the midst of a transformation: the European Union is implementing its Solvency II initiative, and

Exhibit 5
Bermuda Insurers/Reinsurers — 2007 Net Premiums Written and Shareholders' Equity



Note: Excludes Life data.
Source: A.M. Best Co.

the United States is contemplating a federal charter; reform of collateral requirements for non-U.S. reinsurers; a principles based approach to insurance regulation; and many other potential changes.

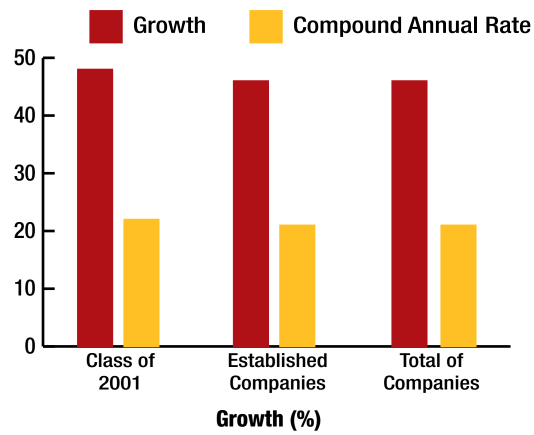
Similarly, the BMA has initiated plans to enhance its regulatory framework. Among the initiatives implemented by the BMA are utilizing a risk-based capital model, which can be supplemented with a company's own capital model, and the requirement for all Class 4 companies to file financial statements prepared under generally accepted accounting principles by the fourth quarter of 2008. Some Class 3 companies are to follow in 2009 in an effort to increase transparency.

These efforts are driven by the BMA's commitment to adopt internationally compliant regulatory standards to compete with other jurisdictions, given the growth of the Bermuda insurance market and the increased scrutiny of the BMA's standards of regulation.

Conclusion

The evolution of the Bermuda insurance/reinsurance market has accelerated over the most recent two years, and Bermuda is clearly as prominent as any market in the world. Established players have experienced very strong results with modest exceptions, and the Class of 2001 has proven to be a formidable competitor. The Class of 2005 started profitably but now faces challenges as markets continue to soften. First-quarter earnings highlight favorable results heading into the July 1 renewal and peak of hurricane season. However, 2008 has started with some notable catastrophes, including European windstorm Emma and tornadoes in the continental United States. Renewals at Jan. 1 and April 1 continue to point to a mismatch between capacity and demand, and rates in the majority of businesses clearly are under pressure.

Exhibit 6
Bermuda Insurers/Reinsurers — Shareholders' Equity Growth (2005-2007)
Excluding Class of 2005



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Source: A.M. Best Co.

A.M. Best believes the majority of Bermuda-based carriers are financially strong relative to rating levels and can survive a major catastrophe in good financial standing. The concerns lie with underlying fundamentals and an industry that in the past decade has experienced shock losses of unforeseen magnitude. Although improved significantly over the most recent five-year period, accident-year loss reserves are deteriorating. A.M. Best sees the sizable reserve releases of 2006 and 2007 as unsustainable. These factors point to concern over the long-term operating performance of the rated entities on the island. As much as enterprise risk management (ERM) is touted, the coming years clearly will test the execution of this discipline.

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