



➤ BENFIELD GROUP LIMITED

➤ March 2006

Benfield Bermuda Quarterly

Shaken and Stirred

➤ Benfield Industry Analysis and Research

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Shaken and stirred

Earnings eradicated

2005 profits were eradicated by hurricanes Katrina, Rita and Wilma. The total net loss for the BBQ group of USD2.8bn reversed from a profit of USD5.5bn in 2004. Losses were reported by eleven of the BBQ companies in 2005 compared with only one in the previous year. The average return on equity sank to a negative 6.0% from a positive 13.1% in 2004 and a peak of 19.1% in 2003. The aggregate combined ratio rose from 96.3% to 118.0% in 2005, with just two companies reporting combined ratios below 100%.

Underwriters chastened

Underwriters were chastened by the hurricanes. Storm losses of the BBQ group totalled USD11.3bn, and were equivalent to 24% of shareholders' funds (SHF) at 30 June 2005 as Wilma added to their woes in the fourth quarter. Companies reacted by reducing their risk appetite, changing their catastrophe models and underwriting assumptions and increasing reinsurance and retrocession protection.

Delayed reaction

The 2006 renewal witnessed robust price increases in lines most affected by the storms, but elsewhere expectations were tinged with disappointment as the response was more moderate. Nevertheless, reinsurance capacity is expected to tighten for the 1 July renewals and beyond. The recalibration of catastrophe models, a shrinking risk appetite for peak exposures, restructuring of coverage on a more restrictive basis and the increased cost of capital are generally expected to exert further sustained upward pressure on pricing.

Capital calls

Balance sheets in most cases were hit hard, but the swift replenishment of capital matched losses to leave the total capital of the BBQ group up 5% on the year at USD47.2bn. USD18.4bn of new capital flowed into Bermuda after Hurricane Katrina, with 53% going to the established companies, 40% to start-ups. Side cars accounted for the remainder.

First formers

Over USD8bn of capital flowed into new companies and sidecars, attracted by expected price increases and capacity shortages. Rating agencies were key to triggering the influx of new capital, and funding for many start-ups was completed only in late December. This contributed to muted demand from cedants, who gave weight to existing relationships and proven credit ratings. Consequently the volume of submissions, line sizes offered and signings were below expectations.

Ratings rule

Concerns over the ultimate losses incurred from the 2005 storms, capital adequacy and risk management caused the rating agencies to lower many of the Bermudian companies' ratings. Several companies saw their franchises seriously impaired or even destroyed as they paid the price of falling over the A- precipice. A.M. Best and S&P maintain a negative outlook on the reinsurance market and are particularly concerned about the underlying stability.

Premium income

Gross premium written of the BBQ group totalled USD57.1bn¹ in 2005. This represented a 6% increase over 2004, but the rate of growth more than halved for the second year in succession. Prices continued to soften in most markets in the first half of the year, but Hurricane Katrina arrested the downward trend. The 2006 renewal showed signs of robust price increases in certain lines, particularly those most affected by the storms. Underwriters reacted by reducing their exposure, changing their models and buying more reinsurance.

Premium income and market share

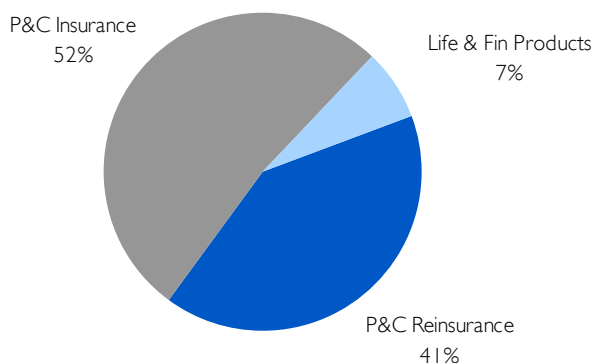
Total gross premium written (GPW) increased by 6% to USD57.1bn in 2005. The business mix is shown in Chart 1 and illustrates the diverse nature of Bermuda's book.

Chart 1

Business Mix of 2005 GPW

Company data, Benfield IAR

2005 GPW: USD57.1bn



Ranking by size of market share was little changed. ACE remained the largest company in this group with a 29% share of GPW as Chart 2 shows. Global reinsurance business represented only 10% of ACE's total GPW.

Growth rates were more varied than in 2004. In general there was a deceleration with some companies experiencing top-line contraction (Partner Re: -6%, White Mountains: -4%). Aspen was the leader with a GPW increase of 32%. This was principally attributed to strong advances in its core reinsurance business (+23%) and exceptional growth in its insurance business (+59%), particularly in specialty, with new offices opened and recruitment of new underwriters in August 2004². IPC results were again boosted by reinstatement premiums as the group wrote USD129m (27% GPW) compared with USD33m in 2004³

¹ PXRE GPW estimated at USD570mn based on annualised 9M 2005 figures.

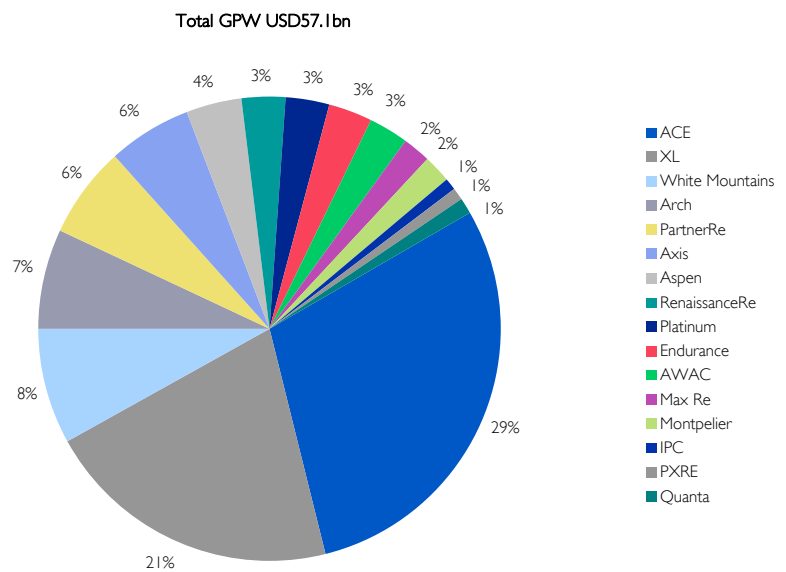
² Aspen press release 18 August 2004

³ IPC press release 21 February 2006

Chart 2

Distribution of 2005 GPW

Company data



Partner Re's GPW decreased by 6%, which the company attributed to a more competitive market and increased cedants' retentions.⁴ The 2% decline experienced at Endurance was mainly due to the decrease in Property per Risk Treaty (-41%) and Casualty Treaty (-22%), although these falls were mostly offset by increases in the Casualty Individual Risk and Aerospace and other Specialty lines. Table I shows premium growth by company.

⁴ Partner Re press release 26 April 2005.

Table 1
2005 Gross Premiums Written
Company data

USDmn	2002	2003	2004	2005	Change 2004/5
ACE	12,819	14,637	16,094	16,814	4.5%
XL	8,986	9,706	11,124	11,849	6.5%
White Mountains	4,422	3,823	4,792	4,602	-4.0%
Arch	1,487	3,226	3,668	4,015	9.5%
PartnerRe	2,706	3,625	3,888	3,665	-5.7%
Axis	1,108	2,274	3,012	3,394	12.7%
Aspen	375	1,307	1,586	2,093	31.9%
RenaissanceRe	1,173	1,382	1,544	1,809	17.2%
Platinum	n.a.	1,198	1,660	1,765	6.3%
Endurance	799	1,602	1,711	1,669	-2.5%
AWAC	923	1,573	1,708	1,560	-8.6%
Max Re	647	1,010	1,044	1,246	19.4%
Montpelier	608	810	837	979	16.9%
Quanta	n.a.	n.a.	494	609	23.2%
IPC	260	323	378	472	24.8%
PXRE	367	339	346	570	64.7%
Total	36,678	46,834	53,887	57,111	6.0%

Market outlook

The Benfield 2006 Renewal Report “Swings and Roundabouts” reported the profound effect of Hurricane Katrina on property catastrophe prices in loss affected areas of the USA and in the non-marine retrocession and marine reinsurance markets. Elsewhere, Katrina had a generally stabilising influence, arresting and, in some cases, reversing the downward trend in prices. The recalibration of catastrophe models, a shrinking risk appetite for peak exposures, restructuring of coverage on a more restrictive basis and the increased cost of capital were all identified as factors likely to exert further sustained upward pressure on pricing. It seemed likely that reinsurance capacity would be significantly tighter for 1 July renewals and all the more so later in the year if predictions for the 2006 hurricane season prove accurate.

Comments from the Bermudians generally confirmed these observations. ACE saw “velocity” as the central theme to rates in 2006 i.e. moving in the right direction, but not tightening as fast as ACE would like or believe should be the case. ACE has raised property catastrophe pricing in line with expectations for frequency and severity. In the US, rates on short-tail business were increasing, while casualty was stable. International business pricing was seen as varied.⁵

Aspen reported an 11% rate increase on its book renewing on 1 January 2006. Increases of 4.5 to 6 times were seen on offshore energy risks in the Gulf of Mexico, with far lower exposure levels. Aspen said that it expected the best pricing for property reinsurance to become prevalent in the 2006 mid-year renewals or even in 2007. Indeed, Aspen expects a sharp correction in pricing

⁵ ACE Limited 4Q 2005 earnings conference call February 2006.

driven by the effects of increased risk aversion, re-calibrated catastrophe models, rating agency capital charges and scarcer retrocessional capacity.⁶

Axis cited inadequate rate increases for California earthquake exposed accounts in relation to the higher charges required by revised modelling going forward. In the US, national account rates were up by over 100%, with Axis expecting rates to firm further, while regional business, dependent on coastal exposure, was up between 10% and 30%. In Europe, rates were flat or up by 10-15%, but Axis expects pricing in Europe to react positively in 2007 to increased loss cost assumptions embedded in risk models.⁷

IPC reported an "encouraging" 1 January 2006 renewal and described an "improving market evolving into a hard market". European renewals were considered less robust, while Japan was "up but with reduced retro capacity". The market for renewals remained competitive, but IPC believes that demand for reinsurance will continue to increase as catastrophe models are recalibrated and the impact of rating agency requirements come to bear.⁸ Montpelier reported that international property catastrophe pricing did not meet expectations at 1 January 2006, but US pricing did with a significant increase in demand. Montpelier expects the property catastrophe market to tighten and prices increase as the "year rolls out".⁹

PartnerRe said the 1 January 2006 renewal represented less than 55% of non-life business written, down from 60% 2005, and said it represented a 2% decline based on constant exchange rates¹⁰. About 15% of business was not renewed, 9% due to cedants increasing their retention and 6% due to unsatisfactory pricing or terms and conditions in PartnerRe's view. The company cited expectations of mid-teens profitability on the business underwritten (assuming a "normal" loss experience, with no increase in the overall risk exposure.

RenaissanceRe observed a wide disparity in pricing conditions. In the USA the highest price increases were, unsurprisingly, on loss affected treaties, followed by accounts with large hurricane exposures. Nevertheless, RenaissanceRe said that even with large percentage increases, many US accounts still did not meet its return criteria whilst in Europe pricing was described as disappointing, being flat-to-down on a risk-adjusted basis. The situation was more attractive in the retrocession market with RenaissanceRe doubling its volume written at 1 January 2006 whilst taking advantage of the capacity reduction to offer more restricted cover.¹¹

XL commented that US property catastrophe business, accounts with no hurricane exposure increased by 5% to 10%, those with hurricane exposure, but no losses, improved by 23% on a risk adjusted basis relative to 2005. Rates on non-US catastrophe business in Bermuda were up 5% to 10%. In Europe and other international business, rates were stable-to-up dependent on exposure

⁶ Aspen Insurance Holdings Ltd 4Q 2005 earnings conference call 17 February 2006

⁷ Axis 4Q 2005 earnings conference call 8 February 2006

⁸ IPC Holdings Ltd press release 21 February 2006

⁹ Montpelier Re Holdings Ltd press release 16 February 2006

¹⁰ PartnerRe Ltd press release 30 January 2006

¹¹ RenaissanceRe Holdings Ltd 4Q 2005 Earnings conference call 8 February 2006

to losses in 2005; programmes exposed to Storm Irwin, for example, rose by 15% to 30%. Overall, XL's European account saw increases of 7%.¹²

Catastrophe assumptions

All companies were chastened by the effect of the hurricanes in 2005. Reactions included reductions to risk appetite, changes to catastrophe models and underwriting assumptions in advance of expected revisions to the vendor models plus increased reinsurance and retrocession purchases.

Among the comments made during the 4Q 2005 reporting season, ACE announced substantial revisions to its catastrophe risk models that addressed frequency and severity for all perils, not just wind. This has led to ACE raising prices, reducing aggregate exposures and buying more reinsurance.¹³ Aspen said it had reduced its risk tolerance from 1:100 year and 1:250 year peak zone exposures from 20% to 17.5% and from 30% to 25% respectively. Its underwriting model had reduced the return period for a USD55bn event from 1:103 years to a range of 1:30 to 1:40 years.¹⁴ Aspen had also purchased a reinsurance programme providing USD400mn of cover for 2006 and was considering a further USD100mn of protection and possibly a catastrophe bond.

Axis said it had made "material adjustments" to its model to recognise increased Atlantic hurricane frequency and severity assumptions including demand-led post-loss inflation. Axis declared it was also managing down its gross exposures and demanding more premium per unit of exposure.¹⁵ RenaissanceRe reported that it had increased frequency of US hurricanes and severity of major storms.¹⁶

¹² XL Capital Ltd 4Q 2005 earnings conference call 8 February 2006

¹³ ACE op. cit.

¹⁴ Aspen op. cit.

¹⁵ Axis op. cit.

¹⁶ Renaissance Re op. cit.

Earnings

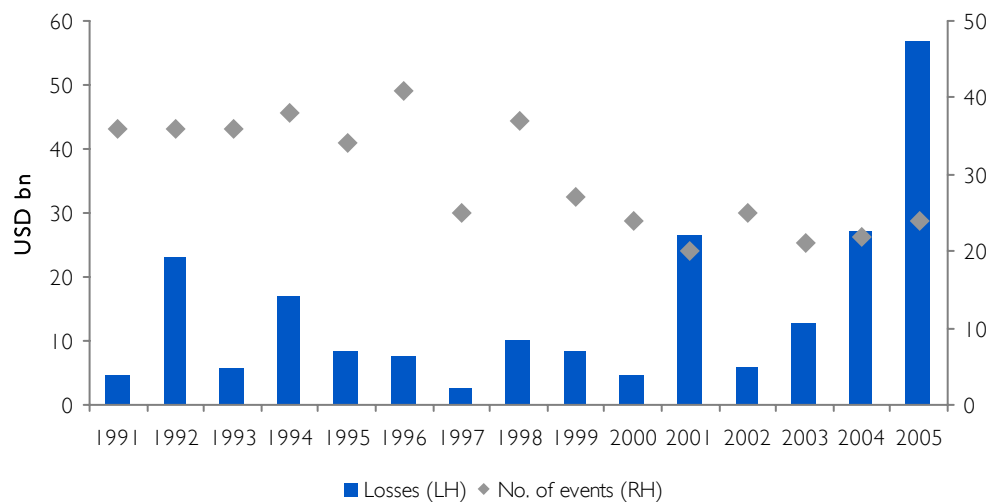
2005 profits were eliminated in 2005 by hurricanes Katrina, Rita and Wilma. The total net loss for the BBQ group was USD2.8bn compared with a profit of USD5.7bn in 2004. Eleven of the sixteen BBQ companies reported losses in 2005 whereas in 2004 there was only one. The aggregate combined ratio rose from 96.3% in 2004 to a record high of 118.0% in 2005, with only two companies, Arch and ACE, reporting combined ratios below 100%. A 22% increase in net investment income was insufficient to cover the sharply increased underwriting losses.

Storm losses

As in 2004, 2005 was dominated by a sequence of severe hurricane landfalls in the US that included the largest insured loss in history. In its preliminary estimates for 2005, ISO Property Claims Services (PCS) unit, which tracks US property losses, reported that US P&C insurers suffered USD56.8bn in insured property loss claims from 24 catastrophes.¹⁷ This surpassed the previous high of USD26.5bn recorded in 2001 from 20 events including 9/11. ISO PCS previously reported losses of USD50.3bn in November 2005, which included USD6.1bn for Hurricane Wilma. Chart 3 shows the annual amount and frequency of US insured property catastrophe losses since 1991. Excluding 2001, which was largely a man-made catastrophe year, the trend in the cost of natural catastrophe losses has been rising exponentially since 2000.

Chart 3

US property catastrophe losses, 1991-2005
ISO PCS



Storm losses reported by the BBQ group totalled USD11.3bn, up 33% on losses reported in 3Q 2005 due to increased provisions for Hurricanes Katrina and Rita and the impact of Hurricane Wilma, a 4Q event. Catastrophe losses in relation to capital bore most heavily on the mono-line property catastrophe underwriters PXRE, Montpelier and IPC with storm losses representing 106%, 76% and 49% of their 30 June 2005 SHF respectively. Four companies suffered losses of over USD1bn each (XL, Montpelier, Axis and ACE) with XL the largest in absolute terms at USD1.9bn. Four of the Class of 2001 (Aspen, Axis, Endurance, Platinum) reported catastrophe

¹⁷ ISO PCS press release 26 January 2006

losses in excess of 30% of 30 June 2005 SHF; a surprisingly high ratio given the diversified underwriting portfolios of these companies.

Table 2 shows the losses reported for 3Q 2005 and full year 2005 in relation to SHF at 30 June 2005 grouped into their formation cohorts. The class of 1985 – 1986 appeared to be the most resilient, but this reflects the heavy weighting of non-catastrophe business at ACE and XL.

Table 2

2005 Storm losses

Company data

	IH 2005 Shareholder Funds	3Q Losses	FY 2005 Losses	3Q Losses % of HI 2005 SHF	FY 2005 Losses % of HI 2005 SHF
IPC ¹⁸	1,743	750	849	43%	49%
PartnerRe	3,482	610	773	18%	22%
RenaissanceRe	2,823	573	909	20%	32%
Class of 1993	8,047	1,933	2,531	24%	31%
Arch	2,503	251	324	10%	13%
Aspen	1,608	406	507	25%	32%
AWAC	1,757	290	456	17%	26%
Axis	3,167	805	1019	25%	32%
Endurance	1,987	529	594	27%	30%
Max Re	1,025	112	157.4	11%	15%
Montpelier	1,463	972	1116	66%	76%
Platinum	1,273	321	459	25%	36%
Class of 2001	14,782	3,686	4,632	25%	31%
ACE	10,496	742	1049	7%	10%
PXRE	763	409	807	54%	106%
XL	8,372	1474	1865	18%	22%
Class of 1985 - 86	19,631	2,625	3,721	13%	19%
White Mountains	4,092	186	351	5%	9%
Quanta	437	68	90.2	16%	21%
Total	46,990	8,498	11,326	18%	24%

*All net of reinsurance, reinstatements and after tax except for Axis and White Mountains.

Underwriting performance

The weighted average combined ratio for the BBQ group (excluding Quanta due to insufficient data) leapt to 118.0% from the 96.3% in 2004. The loss ratio increased from 67.7% to 90.8% and was only marginally offset by a decrease in the expense ratio from 28.6% to 27.2%.

Thirteen of the fifteen BBQ companies reported combined ratios over 100% compared to two in 2004. The combined ratios of the three mono-line catastrophe reinsurers exceeded 200% and the spread between the highest and lowest reported ratios was 182 percentage points, the highest being PXRE at 282.9% and the lowest Arch at 95.9%. Table 3 shows the combined ratios for the BBQ group ranked by 2005 combined ratio.

¹⁸ Mid-point of 3Q loss estimate given in 7 October press release

Table 3

Combined ratios

Company data, Benfield IAR

	2003	2004	2005	2005	2005
	Combined Ratio	Combined Ratio	Combined Ratio	Loss Ratio	Expense Ratio
PXRE	74.7%	98.0%	282.9%	260.5%	22.4%
IPC	34.9%	77.9%	251.8%	237.0%	14.7%
Montpelier	50.3%	77.8%	200.7%	178.0%	22.7%
RenaissanceRe	56.4%	104.4%	139.6%	116.6%	23.1%
XL	102.6%	96.0%	132.9%	107.1%	25.8%
AWAC	85.0%	95.9%	124.4%	105.7%	18.7%
Endurance	84.7%	85.8%	123.5%	95.8%	27.7%
Aspen	78.1%	83.4%	117.2%	90.1%	27.1%
PartnerRe	93.2%	94.3%	115.9%	87.0%	28.9%
Platinum	84.8%	96.8%	114.6%	87.8%	26.8%
White Mountains	98.0%	101.0%	110.7%	75.2%	35.5%
Max Re	99.8%	93.2%	105.3%	92.4%	12.9%
Axis	73.6%	84.4%	101.8%	80.3%	21.5%
ACE	91.5%	96.4%	99.7%	74.4%	25.3%
Arch	90.0%	92.1%	95.9%	67.2%	28.6%
Weighted average	79.8%	91.8%	118.0%	90.8%	27.2%

Net income

The BBQ group reported an aggregate net loss of USD2.8bn as net income fell by over USD8.3bn. Investment income softened the blow of the storms, rising by 22% to over USD5.9bn in 2005, including realised gains.

Table 4

2005 Net Income

Company announcements,
Benfield IAR

USD mn	2003	2004	2005	Change 2004/5
ACE	1,417	1,153	1,029	-11%
Arch	279	317	256	-19%
Aspen	152	195	-178	-191%
AWAC	288	197	-160	-181%
Axis	531	495	95	-81%
Endurance	263	356	-221	-162%
IPC	261	139	-623	-550%
Max Re	121	134	7	-95%
Montpelier	407	240	-753	-413%
PartnerRe	492	492	-51	-110%
Platinum	144	85	-137	-262%
PXRE	98	23	-705	n.m.
Quanta	n.a.	-55	-93	68%
RenaissanceRe	623	164	-247	-250%
White Mountains	327	419	269	-36%
XL	412	1,167	-1,252	-207%
Total	5,816	5,520	-2,763	-150%

Note: Net income is after tax and net unrealised gains/losses, but before preferred stock dividends

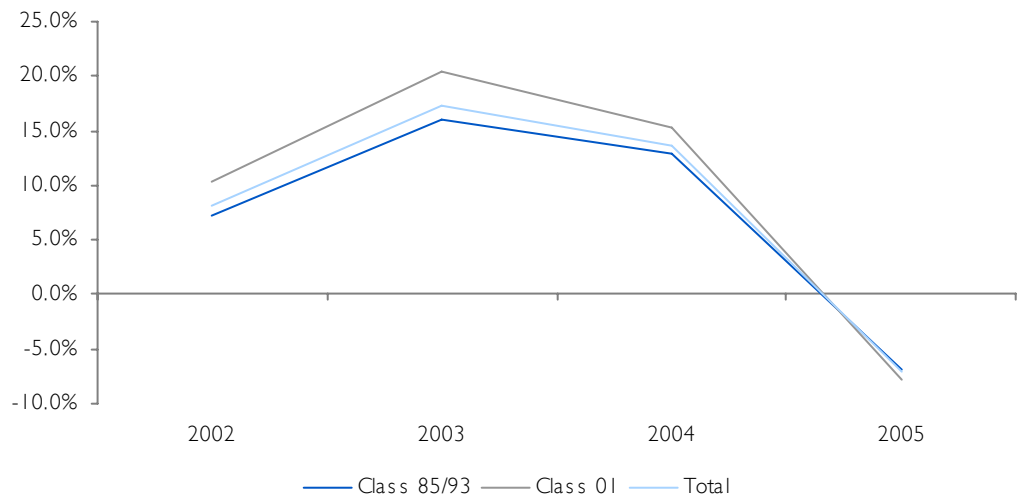
Only five of the BBQ companies reported profits, which together totalled USD1.7bn, compared to 15 out of 16 in 2004. ACE reported the highest dollar amount of net income in 2005 at USD1.0bn, which the company attributed to the benefit of diversification in years of severe and concentrated catastrophe loss experience. Renaissance Re reported the first full-year loss since inception in 1993.

Return on equity

Average return on equity (ROE)¹⁹ in 2005 continued its downward trend, but on a steeper gradient than that seen in 2004. Only Arch posted a double digit ROE in 2005 at 10.9%, although this was down from 16.1%. PXRE reported the largest fall in ROE from the 2004 level of 3.6% in 2004 to a negative 121.3% in 2005.

Chart 4 shows how the ROE spread between the class of 2001 and the older companies has narrowed and, in 2005, inverted. Up to and including 2004, the class of 2001 outperformed the older, established companies. The spread was widest in 2003 at 4.4 percentage points, which was also the peak year for returns since 9/11. Table 5 shows the individual company data ranked by 2005 results.

Chart 4
 Class 85/93 v Class 01 RoE
 Company data, Benfield IAR



Excluding Quanta

¹⁹ Return on Equity = (Net Income – tax + preferred dividends)/(Average of opening and closing SHF)

Table 5

2002/5 Return on equity

Company data, Benfield IAR

	2002	2003	2004	2005
Arch	4.5%	17.9%	16.1%	10.9%
ACE	1.2%	18.8%	12.3%	9.5%
White Mountains	36.7%	12.2%	12.2%	7.0%
Axis	14.7%	22.2%	16.3%	2.8%
Max Re	-1.0%	17.2%	15.4%	0.6%
PartnerRe	11.3%	21.0%	16.5%	-1.6%
AWAC	8.1%	15.7%	9.6%	-9.0%
Aspen	6.4%	14.0%	14.0%	-10.1%
RenaissanceRe	25.6%	31.1%	6.6%	-10.1%
Platinum	n.m.	14.5%	7.7%	-10.3%
Endurance	8.6%	18.4%	20.3%	-11.8%
XL	6.8%	6.1%	15.9%	-15.4%
IPC	13.1%	18.2%	8.6%	-38.0%
Quanta	n.a.	n.a.	-12.0%	-42.9%
Montpelier	14.4%	28.0%	14.1%	-53.6%
PXRE	18.7%	19.2%	3.6%	-121.3%
Average	9.9%	19.1%	13.1%	-6.0%

Balance sheet

Balance sheets were hit hard, but swift replenishment of capital matched losses to leave the total capital of the BBQ group up 5% on the year at USD47.2bn. Profits from the first half of 2005 were an insufficient buffer particularly for the catastrophe underwriters who collectively experienced almost a 25% depletion of capital. Liquidity and asset quality improved overall, though reinsurance recoverable asset and debt gearing increased.

A summary of the BBQ aggregate balance sheet is shown in Appendix I. Bonds remained the principal class of investment representing 48% of total assets at 31 December 2005, down two percentage points on the previous year end, while allocation to cash was up 2% and represented 9% of total assets. The reinsurance recoverable asset remained constant at 15% of total assets. Liquidity was strong as liquid assets (listed bond, equities and cash) were equivalent to 146% of net technical provisions, slightly down on the 149% the year prior. Debt leverage²⁰ increased from 16% to 18% as companies replenished capital with a mix of equity and debt. Debt issues included: Partner Re (USD400mn),²¹ Platinum (USD200mn),²² Renaissance Re (USD150mn draw down from a revolving credit facility)²³ and XL Capital (USD745mn issue hybrid debt/equity instrument)²⁴.

Reinsurance recoverable

Aggregate reinsurance recoverable asset (RRA) gearing, having shown a decrease from 2002, trended upwards once more from 65% in 2004 to 77% in 2005. RRA as a percentage of gross non-life technical reserves stayed constant at 28%.

²⁰ Debt Leverage Ratio = Debt/(Shareholders' Funds + Debt)

²¹ Partner Re press release 25 October 2005

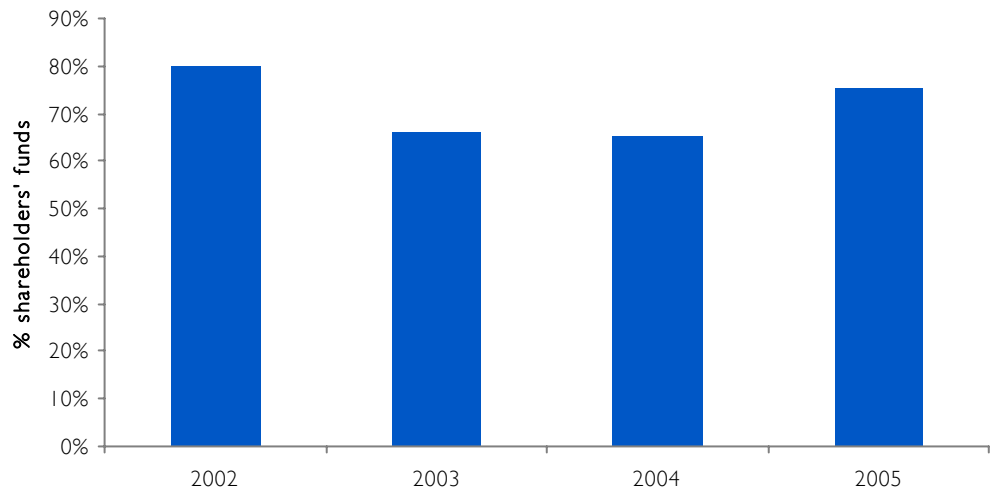
²² Platinum press release 21 October 2005

²³ Renaissance re press release 7 February 2006

²⁴ XL Capital press release 6 December 2005

Chart 5

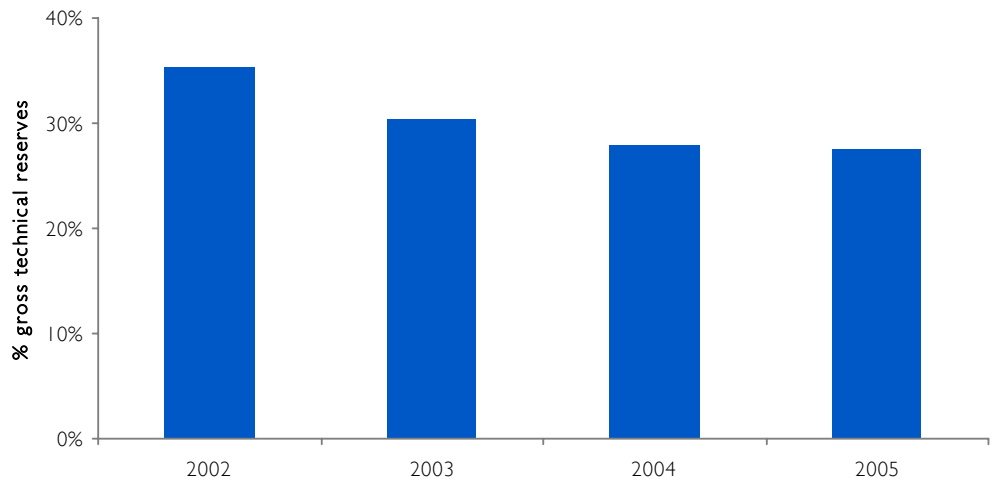
Reinsurance recoverable gearing
Company announcements,
Benfield IAR



Excluding Quanta

Chart 6

Reinsurance recoverable % of
gross technical reserves
Company announcements,
Benfield IAR



Excluding Quanta

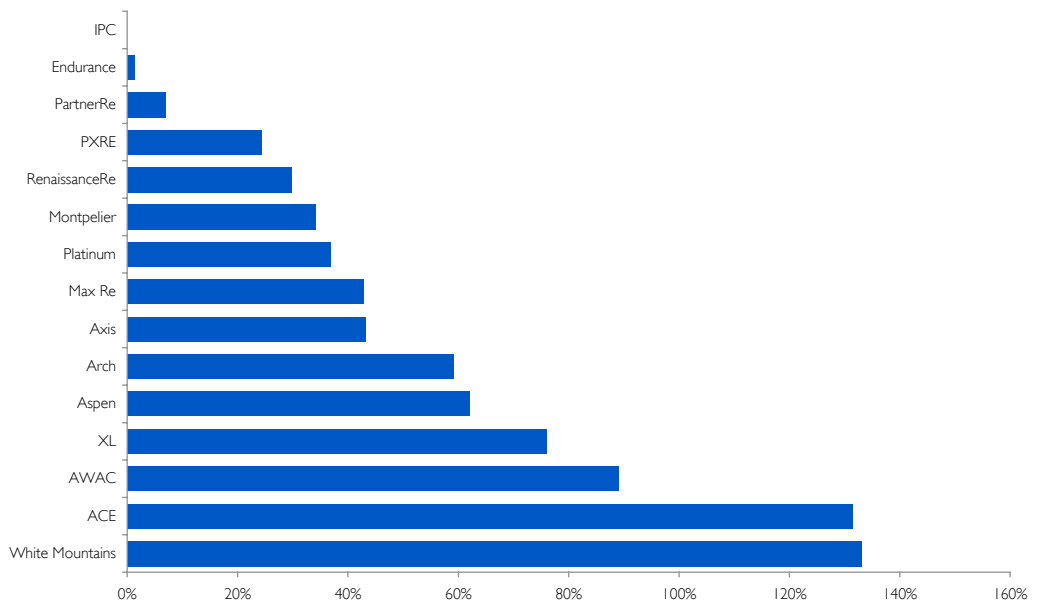
Aspen reported a near four-fold increase in the ratio of RRA to SHF, from 16% in 2004 to 62% in 2005. Aspen's reinsurance segment was the key driver, while proportionally (i.e. in terms of % of prior year base) it was the insurance segment, with RRA of loss reserves increasing by 757%. Losses from the storms weighed heavily. 90% of Aspen's RRA as at 31 December 2005 maintained at least an "A-" rating.

ACE reported the largest RRA, which increased by 7% to USD15.5bn net of bad debt provisions of USD0.8bn at 31 December 2005. In contrast the gearing ratio²⁵ decreased from 151% to 131%. 33% of net RRA was in respect of the Brandywine and Westchester run-offs, down from 36%. ACE also disclosed a more detailed analysis of its RRA position, albeit a quarter in arrears.²⁶ As at 30 September 2005, 26% of the RRA was not rated by internationally recognised commercial rating agencies. Of the rated RRA 95% was graded "A-" or higher. 51% of the outstanding RRA balance was due from 10 reinsurers, a ratio unchanged since 31 December 2004. ACE held collateral equivalent 26% of the USD11bn RRA attributable to active operations.

Chart 7

2005 Reinsurance Recoverable Asset as % of Shareholders' Funds

Company announcements



Capitalisation

Total equity shareholders' funds (SHF) of the fifteen companies increased marginally, by 5%, to USD47.2bn as at December 2005. It should be noted that the extent of capital raising was both wide and deep across the group. ACE was able to add nearly USD2bn to its SHF, although this was principally through the sale of additional shares in October 2005, citing expectations of using the capital for "growth opportunities in the global insurance and reinsurance markets"²⁷

²⁵ Reinsurance Recoverable/Consolidated Shareholders' Funds

²⁶ ACE Limited Financial Supplement (unaudited) 31 December 2005

²⁷ ACE Limited press release 4 October 2005.

Table 6

Shareholders' Funds as at 31 December 2005
Company announcements

USDmn	2002	2003	2004	2005	Change 2004/5
ACE	6,389	8,835	9,845	11,802	20%
Arch	1,411	1,710	2,242	2,480	11%
Aspen	878	1,299	1,482	2,040	38%
AWAC	1,682	1,979	2,139	1,420	-34%
Axis	1,961	2,817	3,238	3,512	8%
Endurance	1,217	1,645	1,862	1,872	1%
IPC	1,291	1,569	1,668	1,616	-3%
Max Re	594	805	937	1,217	30%
Montpelier	1,253	1,658	1,752	1,058	-40%
PartnerRe	2,077	2,604	3,352	3,093	-8%
Platinum	921	1,067	1,133	1,540	36%
PXRE	453	564	697	465	-33%
Quanta	n.a.	488	431	520	21%
RenaissanceRe	1,679	2,335	2,644	2,254	-15%
White Mountains	2,408	2,979	3,884	3,833	-1%
XL	6,570	6,937	7,739	8,472	9%
Total	30,786	39,281	45,043	47,195	5%

The short-comings of using of net premiums written as a proxy for measuring underwriting exposure, whether in a simple solvency margin ratio (SMR) or more sophisticated risk-based capital model, were brutally exposed in 2005. It was clear that such measures of capital adequacy were unable to reflect policy limits, accumulations of risk and cyclical pricing factors. It was notable that the three mono-line catastrophe underwriters (IPC, Montpelier and PXRE) which sustained the greatest proportional losses of capital in 2005 had by far the highest solvency margin ratios at the end of 2004. Nevertheless, whilst the SMR is at best only a crude indicator of underwriting gearing, it did illustrate the need for mono-lines to hold a much bigger buffer of capital to absorb potentially large catastrophe losses. The weighted average solvency margin ratio (SMR) increased slightly from 103% to 104% as shown in Table 7. Chart 6 shows the relationship between ROE and SMR.

Table 7

Solvency margin ratios

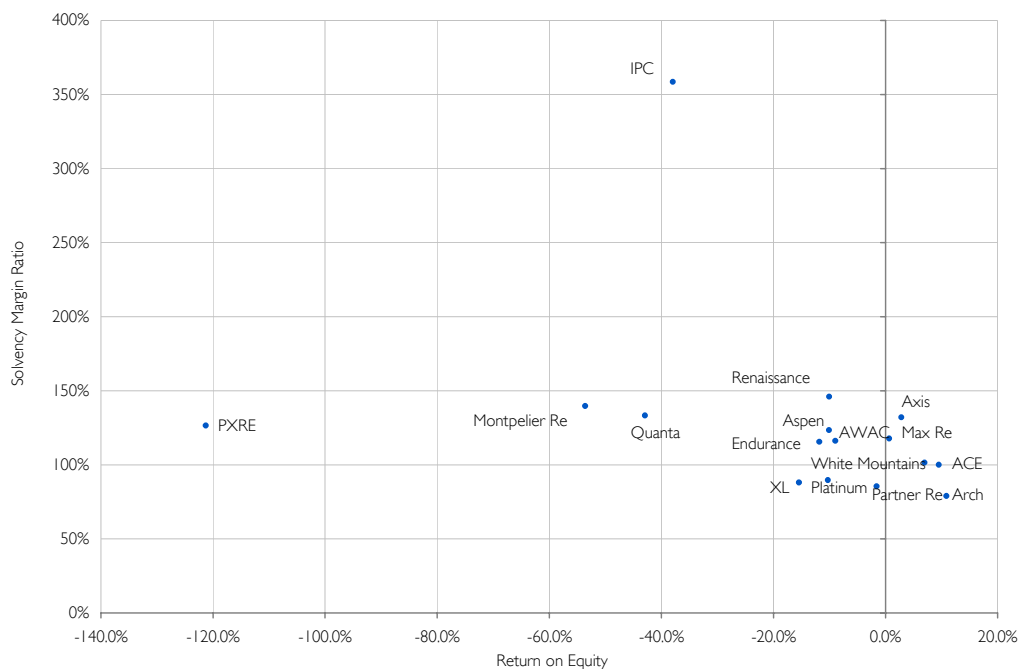
Company announcements

	2002	2003	2004	2005
ACE	79%	86%	86%	100%
Arch	112%	62%	75%	79%
Aspen	281%	119%	109%	124%
AWAC	199%	147%	156%	116%
Axis	193%	148%	134%	132%
Endurance	159%	103%	110%	116%
IPC	508%	509%	466%	359%
Max Re	100%	94%	106%	118%
Montpelier	221%	213%	234%	140%
PartnerRe	78%	73%	87%	86%
Platinum	n/a	91%	69%	90%
PXRE ²⁸	154%	203%	225%	127%
Quanta	n.a.	n.a.	103%	133%
RenaissanceRe	182%	203%	196%	146%
White Mountains	73%	99%	99%	102%
XL	94%	91%	86%	88%
Total	111%	103%	103%	104%

Chart 8

Return on Equity versus Solvency margin ratio 2005

Company announcements, Benfield IAR



²⁸ PXRE NPW estimated at USD368m

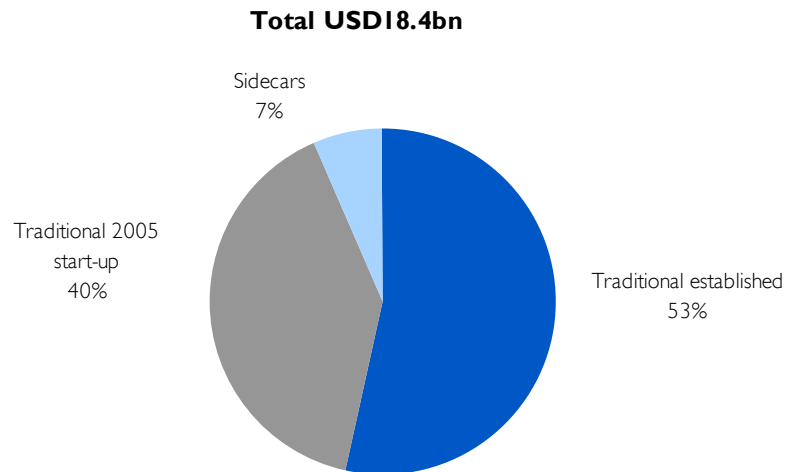
Capital influx

Capital flowed swiftly into Bermuda after Hurricane Katrina to replenish battered balance sheets and exploit the anticipated post-loss hardening of the market. A total of USD18.4bn was raised. The established companies received 53% of the capital and 40% went to the 2005 start-ups. The balance was invested in side-cars as shown in Chart 9.²⁹

Chart 9

Distribution of post-Katrina capital-raising

Company announcements, Benfield IAR



At the time of writing, the BBQ group had raised a total of USD9.8bn of capital split 83% equity and 17% preferred stock. This was equivalent to 21% of aggregate SHF as at 30 June 2005. The rapid raising of capital following, in some cases, the return of capital to shareholders earlier in the year suggests a carousel of capital has emerged with short-term risk being capitalised almost, seemingly, on an annual venture basis. How long this phenomenon is likely to be sustained is questionable and rating agency A.M. Best recently asked whether another year of losses will dampen investors' appetites for a stake in the (re)insurance sector.³⁰ Table 8 shows the individual capital raising positions for the BBQ group. XL represents a third of the total.

²⁹ A sidecar is a special purpose vehicle in which third-party private investors, such as hedge funds, collaborate to provide extra underwriting capacity to existing reinsurers for property catastrophe retrocession and other short-tail lines of business

³⁰ A.M. Best press release 15 February 2006

Table 8

BBQ Post-Katrina capital-raising

Company announcements,
Benfield IAR

USDmnn	SHF 30 Jun 05	Equity capital	Preferred stock	Total capital raised as % of 30 Jun 05 SHF
ACE	10,496	1500	0	14%
Arch	2,503	0	200	8%
Aspen	1,608	595	223	51%
AWAC	1,757	0	0	0%
AXIS	3,167	200	500	22%
Endurance	1,987	200	200	20%
IPC	1,743	399	236	36%
Max Re	1,025	297	0	29%
Montpelier Re	1,463	620	100	49%
PartnerRe	3,482	150	0	4%
Platinum	1,273	377	146	41%
PXRE	763	490	0	64%
Quanta	437	54	81	31%
RenaissanceRe	2,823	0	0	0%
White Mountains	4,092	0	0	0%
XL	8,372	3200	0	38%
Total	46991	8,082	1,686	21%

Catastrophe bonds

PXRE and Montpelier Re issued catastrophe bonds through special purpose vehicles (SPV) as part of their post-Katrina replenishment of capital. PXRE issued two offerings of securities through its SPV Atlantic and Western Re Ltd in the Cayman Islands. The first transaction comprises two tranches of 5-year variable rate notes totalling USD300mn. Perils covered are US East and Gulf Coast hurricanes, North European windstorm and California earthquake and the trigger is parametric. The second transaction provides second event cover of USD250mn for the same perils as the first transaction.

Montpelier Re issued USD90mn of catastrophe bonds through Champlain Ltd, also a Cayman Islands SPV, in December 2005. The catastrophe protection provides two forms of parametric-triggered coverage over three years. The first transaction provides for the payment of up to USD75mn for modelled market losses arising from earthquakes in United States or Japan. The second transaction provides for the payment of up to USD5mn for second event modelled market losses arising from multiple hurricane and/or earthquake events in the United States, excluding Alaska and Hawaii.

New entrants and exits

Over USD8bn of capital flowed into new companies and sidecars, attracted by anticipated price increases and capacity shortages. Rating agencies were key to triggering the influx of new capital but for many start-ups funding was completed very late. This contributed to muted demand from cedants who also preferred to rely on existing relationships and proven credit ratings. Consequently the volume of submissions, line sizes offered and signings were below expectations.

Table 9 lists the new entities that are operational and were able to accept business for 1 January 2006 reinsurance renewal. The new companies plan to write a range of business including property catastrophe, property per risk, property retrocession, marine and energy insurance and reinsurance, terrorism and workers' compensation catastrophe reinsurance.

A total of USD7.5bn of capital has been raised by the nine new Bermudian companies started in 2005 compared to a total of USD8.6bn raised by six companies formed at the end of 2001. Sidecars accounted for a further USD1.2bn. Funding has been provided by a mixture of private equity funds, hedge funds, public subscription, and existing corporate financial resources. In several instances, prospective investors re-entered the market having invested in and subsequently realised gains made from the 2001 wave of start-ups. This time around, however, a key issue for the new ventures, as well as the established companies, will be the ability to achieve attractive returns in the face of the more stringent capital requirements imposed by the rating agencies. Forecast annual average RoE for the Class of 2005 is in the range of 12 to 19% compared with the 20 to 25% that was typical of the business plans of the Class of 2001 formed after 9/11. Writing a diversified portfolio of business is seen as a way of ameliorating the increased catastrophe capital loadings, but this presents its own challenges in managing a diversified book.

The new companies faced several challenges in the gallop to open for business by 1 January 2006. The raising of capital was usually contingent upon either the assignment or binding indication of a satisfactory rating, typically "A-", from either S&P or A.M. Best. Some companies found themselves waiting until the proverbial last minute for this capital trigger as the rating agencies were under pressure from existing clients to resolve various outstanding creditwatch and review positions. Not all the proposed new ventures' plans succeeded. Flagstone Re planned to raise USD1bn of capital, but had to be satisfied with less, necessitating a hasty scaling-down of its business plan. Other companies that were granted Class 4 licences by the Bermuda Monetary Authority (BMA), such as Ascendant Re and Castellum Re, failed to start at all. Infrastructure and staff were further issues. Facilities are in limited supply and some administrative functions have, initially, been out-sourced to external suppliers, most notably, International Advisory Services Ltd. In addition, some key personnel that transferred to new ventures in Bermuda have faced contractual and visa barriers.

7 Table 9

2005 Bermuda start-ups

Company information

	Opening capital USDmn	Ratings*	Lead investors	Business lines
Amlin Bermuda	1,000	A- A S&P	Amlin plc	Regional-US and international property CAT reinsurance
Ariel Re	1,000	A-	Consortium led by Don Kramer including The Blackstone Group, Texas Pacific, Thomas H. Lee Group	Property CAT reinsurance, XS property and general liability insurance, D&O insurance
Arrow Capital	102	Not rated	Goldman Sachs	Collateralised property CAT retro and ILW
Flagstone Re	715	A-	Lehman Bros, Haverford	Property and property CAT reinsurance, short-tail casualty reinsurance
Harbor Point	1,500	A	Chubb Inc., Stone Point Capital LLC	Property and casualty reinsurance
Hiscox Bermuda	502	A-	Hiscox plc	Third party reinsurance & QS participation in Hiscox existing business
Lancashire**	1,065	A-	Capital Z, Cypress, Och Ziff, Moore Capital, SAB Capital, Crestview	Property CAT retro, Marine & energy XL reinsurance, energy on & offshore insurance, property D & F, property & aviation terrorism insurance
New Castle Re	500	A-	Citadel	Property CAT & per risk, terrorism, WCA CAT
Omega Specialty	150	Not rated	Omega plc	Short-tail reinsurance & insurance
Validus Re	1,000	A-	Aquiline Capital, Goldman Sachs, Vestar, Merrill Lynch	Property CAT & per risk, marine, energy, aviation, satellite, war risk, terrorism, WCA CAT and other, short-tail, specialty lines
Total capital	7,534			

*All ratings are A.M. Best unless stated otherwise

** Benfield holds warrants to subscribe for 3.0% of the fully diluted share capital of Lancashire Holdings Limited ("Lancashire Holdings"), the holding company of Lancashire Insurance Company Limited ("Lancashire"). In addition, subsidiaries of Benfield have provided advisory services to Lancashire Holdings and Lancashire in relation to their initial incorporation and capital raising and may provide other services to those companies in the future. These subsidiaries have or will receive fees from Lancashire Holdings and/or Lancashire for the provision of those services. Lancashire may also choose to appoint Benfield as a reinsurance intermediary to place reinsurance on its behalf, in which case Benfield may also receive additional compensation

Sidecars

A novel feature of the 2005 round of new ventures has been the appearance of the sidecar. The sponsor reinsurer can benefit from the arrangement since it nominally remains in the market for volatile business such as retrocession, whilst passing the business and its associated risk and capital loadings off its balance sheet to the sidecar. The advantage of this arrangement may, however, be offset by the high capital charges from un-rated reinsurance recoverable they acquire. Reminiscent of the erstwhile Lloyd's Qualifying Quota Share, a typical arrangement employs a multi-year quota share of the selected short-tail lines of reinsurer's book to the sidecar. It remains to be seen how long the phenomenon of the sidecar will last, but the flexible and opportunistic nature of the sidecars may contribute less to potential future competitive pressure as the structures could be turned off more easily when markets turn down. Table 10 lists key sidecars.

Table 10

Sidecars

Company information

Company	Opening capital USDmn	Founders/Sponsor	Lines of business
Cyrus Re	500	Highfields Capital/XL	Property catastrophe from XL
Flatiron Re	256*	Arch Capital Group	Property catastrophe quota share exclusively from Arch Re Ltd
Rockridge Re	91	West End Capital/Montpelier	Pre-Katrina unit. Assume higher-layer, short-tail risks from Montpelier
Blue Ocean	300	Montpelier	Former retro book of Montpelier. Cayman Islands

* Loan capital

Not listed in the sidecar table is Helicon. White Mountains Re renewed its 2006 quota-share reinsurance arrangements with Olympus Re on modified terms.³¹ Under the revised arrangements, Folksamerica Re cedes up to 35% of its short-tailed excess of loss business to Olympus Re and a newly-formed reinsurer, Helicon, in exchange for an over-ride commission. The combined pro-forma capital of Olympus Re and Helicon at 1 January 2006 was approximately USD330mn compared with USD651mn of capital reported by Olympus Re at 31 December 2004.

Demand muted

Validus Re commented on the 1 January 2006 renewal reporting that USD220mn of GPW was bound in its targeted property, marine, energy and specialty lines.³² Otherwise, demand for the new markets from reinsurance buyers was generally muted. The arrival of most of the new companies in the third and fourth week of December 2005 was too late for many buyers, who, in general had already found sufficient capacity. Existing relationships with well-known reinsurance counterparties were important considerations for buyers, particularly in cases with losses, whilst some of the established reinsurers were reluctant to participate on programmes led by new companies. A degree of scepticism about the security of the new markets was also evident, despite clean capital bases and the generous distribution of "A" grade ratings. Buyers in many cases took the view that whilst all "A-" ratings are equal, some "A-" ratings are more equal than others. Consequently, the volume of submissions to most of the 2005 start-ups and the modest line sizes

³¹ White Mountains Insurance Group Ltd press release 2 February 2006

³² Validus Holdings Ltd press release 31 January 2006

written were below expectations, whilst signings for the 2005 companies were invariably less favourable than those of the renewing markets. The reactions of the new companies to unfulfilled business expectations will be an important point of vigilance as 2006 unfolds.

Exits

Five Bermudian companies have either stopped underwriting or re-orientated their business since Hurricane Katrina. In October 2005 Goshawk plc announced that investors led by Don Kramer would pay Rosemont Re USD2.5mn for its infrastructure. In addition, the new reinsurer, Ariel Re, will pay 8% commission based on renewing Rosemont Re business.³³ Also in October 2005, Quanta announced its withdrawal from the property catastrophe reinsurance business to allow capital to be redirected to its specialty insurance businesses.³⁴ Four months later A.M. Best lowered its rating of Quanta to "B++" from "A-" following the announcement of very poor 4Q 2005 results. This precipitated a review of the business including a potential sale and using excess capital to repay debt or return value to shareholders.³⁵ PXRE was also hit hard by the rating agencies following a large increase in storm loss estimates, which has resulted in the company investigating strategic alternatives.³⁶

In January 2006 Alea Group Holdings (Bermuda) Ltd announced that it had moved into run-off due to the impact on business volume following rating downgrades in the summer of 2005. However, reserve development and storm losses were also significant factors.³⁷ Olympus Re was downgraded two notches by A.M. Best from "A-" to "B+" on 15 September 2006 and no longer writes open market third party reinsurance. Rosemont Re, Olympus Re and Quanta were all formed in response to 9/11 with Class 4 licences and A.M. Best ratings of "A-".

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³³ Goshawk Insurance Holdings plc press release 24 October 2005

³⁴ Quanta Capital Holdings Ltd press release 31 October 2005

³⁵ Quanta Capital Holdings Ltd press release 3 March 2005

³⁶ PXRE Group Ltd press release 16 February 2006

³⁷ Alea Group Holdings (Bermuda) Ltd press release 30 January 2006

Credit ratings

The ratings of the Bermudian companies have been under pressure reflecting their significant exposure to the 2005 hurricanes. Several companies saw their franchises seriously impaired or destroyed as they paid the price of falling over the A-Minus precipice. The rating agencies maintain a negative outlook with concerns about the underlying stability of the market.

A.M. Best lowered the ratings of 10 of the 21 companies it covers, whilst the ratings of 6 of the 15 companies historically covered by Standard & Poor's (S&P) have been lowered. The downgrades were mostly a reaction to the size of the 3Q 2005 hurricane losses incurred (which in many cases exceeded expectations), reduced capitalisation and concerns about risk management. Table 11 lists the ratings of the established Bermudians with changes since 30 June 2005 highlighted in bold.

7 Table 11

Bermuda credit ratings

A.M. Best, Standard & Poor's,

Reinsurer	S&P 30 Jun 05	S&P 1 Mar 06	A.M. Best 30 Jun 05	A.M. Best 1 Mar 06
ACE Tempest Re	A+	A+	A+	A+
Alea Bermuda Ltd	A-	NR	A-	NR
Arch Re	NR	A-	A-	A-
Aspen UK/Aspen BDA/Aspen US	A/A/NR	A/A/NR	A/A-/A-	A/A-/A-
AWAC	NR	NR	A+	A
AXIS	A	A	A	A
Catlin Insurance Co	NR	NR	A	A
Endurance	A-	A-	A	A-
IPCRe Ltd	A+	A	A+	A
Max Re	NR	NR	A-	A-
Montpelier Re	A-	A-	A	A-
Olympus Re	NR	NR	A-	B+
PartnerRe	AA-	AA-	A+	A+
Platinum Underwriters	NR	NR	A	A
PXRE	A	BBB-	A	B++
Quanta	NR	NR	A-	B++
RenaissanceRe	AA-	A+	A+	A
Rosemont Re	NR	NR	A-	NR
Top Layer Re	AA	AA	A+	A+
White Mountains	A-	A-	A	A
XL Re	AA-	A+	A+	A+

Chart 10 shows the development of the BBQ group's S&P ratings measured by gross written premiums. The reduction in Double "A" grade paper, particularly following the S&P downgrades of RenaissanceRe and XL in 2005 is significant. PXRE was downgraded and in February 2006.

Chart 10

Rating of BBQ gross premiums
Standard & Poor's,
Benfield IAR

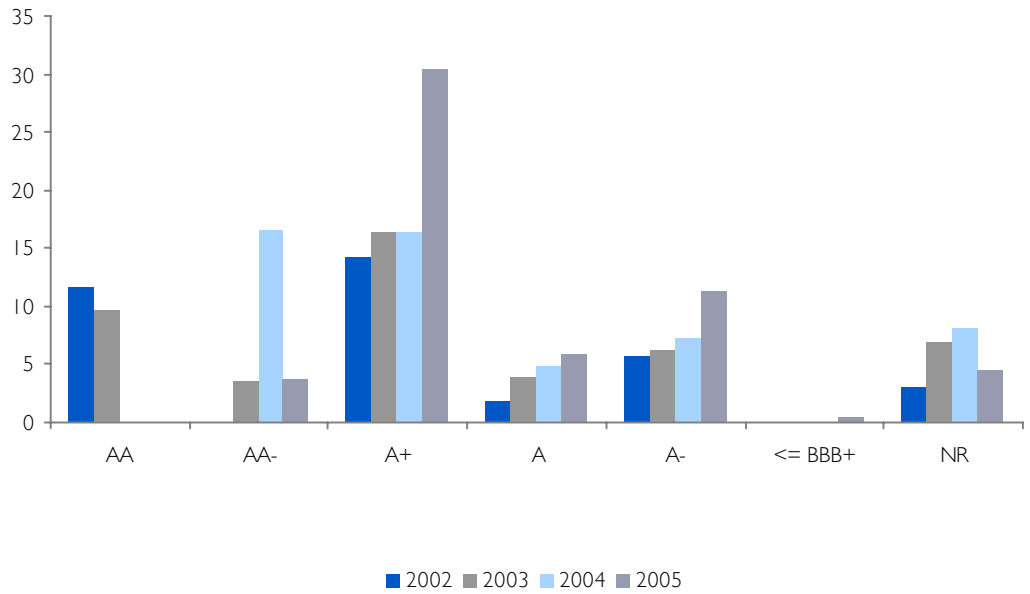
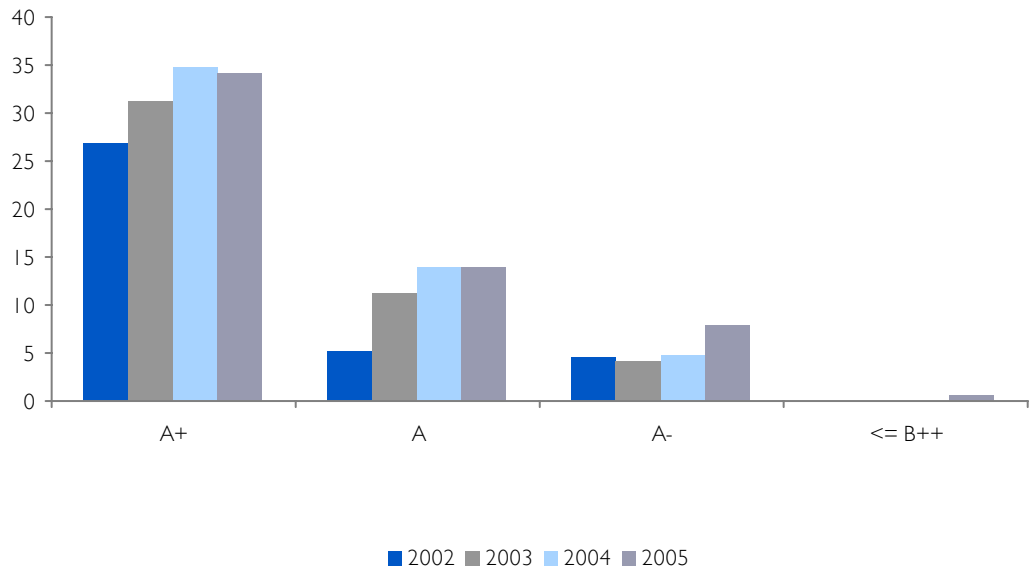


Chart 11 shows the same analysis using A.M. Best ratings. The chart excludes Alea Bermuda, Olympus Re and Rosemont Re, which sustained downgrades to B++ or below because they are not included in the BBQ group.

Chart 11

Rating of BBQ gross premiums
A.M. Best, Benfield IAR



Concomitant with the downgrades, the rating agencies also adjusted their capital adequacy models to reflect the increasing severity and frequency of natural catastrophe events. These were discussed in more detail in the Benfield IAR 2006 renewal report.³⁸

Rating precipice

The perils of arbitrary rating precipices and downgrade cancellation triggers were again highlighted in the first quarter of 2006. Alea Group's A.M. Best and S&P ratings were lowered from "A-" to "B++" and "BBB+" respectively in 3Q 2005. In January 2006 Alea announced that it had moved into run-off as a result of the inability to attract a suitable volume and quality of business following the rating agency downgrades in 3Q and 4Q 2005.³⁹

In February 2006, A.M. Best and S&P lowered their respective "A-" ratings of PXRE by one notch following the announcement that 4Q 2005 financial results would be hindered by USD281mn – 311mn of net pre-tax adverse development on previously reported Katrina, Rita, and Wilma hurricane losses. At the time PXRE expressed the hope that it would continue to trade on "BBB+/" "B++" ratings, but acknowledged the potential negative impact of the adverse rating actions and said that it would be "exploring strategic alternatives."⁴⁰ PXRE's ratings were further downgraded following the announcement of 4Q 2005 results on 22 February 2006 in which PXRE said that 75% of its NPW was exposed to rating downgrade cancellation option clauses.⁴¹ At the time only 7.5% of the cancellation options had been exercised, but momentum was increased after the 4Q 2005 earnings announcement.

On 2 March 2006 Quanta announced poor 4Q 2005 results and a concurrent downgrade of its A.M. Best rating from "A-" to "B++". In another example of capitulation to the arbitrary view that sub-A- ratings represent an unacceptable level of counterparty risk, Quanta said that it too would be investigating "strategic alternatives" including the potential sale of some or all of the businesses and the potential use of excess capital to repay debt or to return value to our shareholders. The company said it would continue to operate in business lines that did not require an "A-" rating. It expected to continue operating its Lloyd's Syndicate 4000, which is covered by the higher A.M. Best, Fitch and S&P ratings of the Lloyd's market.⁴² Significantly, neither PXRE nor Quanta were insolvent or illiquid at the time of the downgrades and both companies remain confident of their ability to meet all current obligations.

Negative outlook

The rating agencies are maintaining a negative outlook on the reinsurance sector. A.M. Best extended its negative outlook for the Bermudian reinsurance market in February 2006 expressing a particular concern that the underlying stability of the market remained, in its opinion, tenuous.⁴³ The agency believes that Bermuda is susceptible to price competition and that if anticipated (and planned) increases are not forthcoming, companies might be forced to find alternative business.

³⁸ Benfield Industry Analysis & Research report "Swings and Roundabouts - Reinsurance Market and Renewals Review" January 2006

³⁹ Alea op cit

⁴⁰ PXRE Group Ltd press release 16 February 2006

⁴¹ PXRE Group Ltd press release 22 February 2006

⁴² Quanta Capital Holdings Ltd press release 2 March 2006

⁴³ A.M. Best 15 February 2006 op cit

Conversely, whilst an active storm season in 2006 or further reserve development might prolong harder market conditions, this would put pressure on earnings and more heavily debt-laden balance sheets.

S&P had lowered its outlook on the reinsurance sector from stable to negative on 28 September 2005 reflecting concerns about near-term strains on financial strength arising from Hurricanes Katrina and Rita. Other concerns which S&P raised included reduced financial flexibility, availability and affordability of retrocession, and the inherent difficulty in accurately modelling and pricing complex risks, although the agency noted that the hard market would be prolonged with the prospect of strong non-life underwriting performance in 2006 and 2007.⁴⁴ S&P repeated its negative outlook on 13 December 2005 expressing additional concerns about low differentiation among industry players and low barriers to entry.⁴⁵

⁴⁴ Standard & Poor's Press Release 28 September 2005

⁴⁵ Standard & Poor's Press Release 13 December 2005

Appendix I Summary aggregate balance sheet

Table 82

Summary balance sheet

Company announcements

	2002	2003	2004	2005
Assets				
Cash and cash equivalents	13,658	12,201	11,996	19,002
Bonds	53,926	73,270	95,084	111,084
Equities	2,027	2,834	5,016	5,747
Reinsurance recoverable	24,614	25,673	29,123	34,507
Other assets	34,016	40,137	47,170	53,044
Total assets	128,240	154,115	188,389	223,384
Liabilities				
Loss and LAE Reserves	54,043	65,091	82,905	106,192
Unearned premiums	15,613	19,424	21,389	21,671
Life funds	4,180	5,368	6,782	8,205
Debt	5,670	5,993	8,522	10,587
Other liabilities	15,645	17,639	23,345	29,042
Total liabilities	95,152	113,515	142,943	175,698
Shareholders' Equity				
Paid-up & additional capital	21,600	19,456	18,837	25,335
Retained earnings	7,851	8,986	13,778	8,334
Other shareholders' equity	3,637	12,158	12,831	14,016
Total shareholders' equity	33,088	40,601	45,446	47,685

Excluding Quanta

Appendix 2 The Bermuda multi-licence system

Bermuda introduced a multi-license system of regulation in 1995, which categorised non-life insurance company operations into four classes. Captive insurance companies typically apply for a licence in either Class 1, 2, or 3.

Class 1

A single parent captive insurance company owned by one or more affiliates of a group and underwriting only the risks of the owners of the insurance company and affiliates of the owners.

Class 2

Multi-owner captives which are defined as insurance companies owned by two or more unrelated persons provided that the captive underwrites only the risks of the owners and affiliates of the owners and/or risks related to or arising out of the business or operations of the owners and affiliates. A Class 2 license will also apply to single parent and multi-owner captives writing no more than 20 percent of net premiums from risks which are not related to or arising out of the business or operations of their owners and affiliates.

Class 3

Applies to insurers and reinsurers not included in Class 1, 2, or 4. This includes finite reinsurers; reinsurers writing third party business; insurers writing direct policies with third party individuals; and, single-parent, group, association, agency or joint venture captives where more than 20 percent of net premiums written are from risks which are unrelated to the business of the owners.

Class 4

Insurers and reinsurers underwriting direct excess liability insurance and/or property catastrophe reinsurance risks.

Appendix 3 Minimum solvency requirements

The minimum solvency requirement for Bermudian licensed insurers is the greater of the minimum capital and surplus test or premium test.

Table 13

Minimum Solvency Requirements for Bermudian (re)insurance companies
Bermudian Monetary Authority

Class of Insurer	1	2	3	4
Greater of: Minimum Capital & Surplus	USD120,000	USD250,000	USD1,000,000	USD100,000,000
Premium Test First USD6mn of NPW	20%	20%	20%	50%*
NPW in excess of USD6mn	10%	10%	15%	50%*
Loss Test/Loss & Loss Expense Reserve	10%	10%	15%	15%

* For Class 4 insurers, the test is 50% of NPW with maximum deduction for reinsurance of 25% of GPW.

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