

Market Review

November 7, 2011

Sector

Non-Life

Additional Information

2011 Special Report:

A.M. Best Comments on Impact of Christchurch Earthquake on New Zealand Non-Life Industry

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New Zealand's Insurance Market On Cusp of Transformation

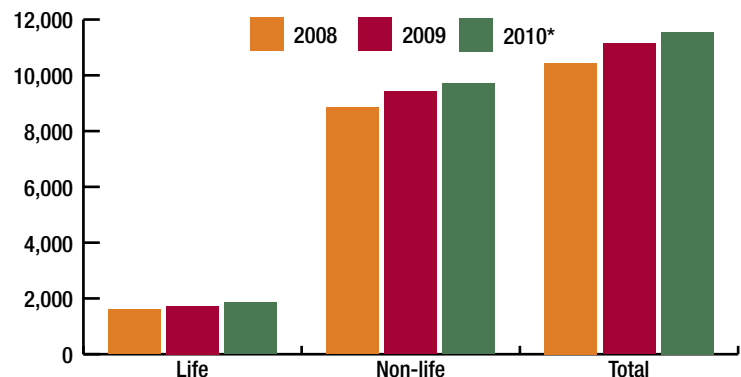
New Zealand's insurance market is in a state of transformation as it grapples with prolonged earthquake activity and regulatory developments.

The operating environment for the insurance and reinsurance industry has shifted dramatically in the wake of the Darfield and Christchurch earthquakes, and even the role of the country's Earthquake Commission is under review. A.M. Best notes:

- Insurers face a period of uncertainty as an estimated 8,000 after-shocks and earthquakes have occurred in the past year. While rebuilding projects present opportunities for growth in insurance premiums, construction programmes are being stalled until the ground settles.
- While reinsurance capacity is still available, coverage is more restrictive and comes at a significantly higher price. Reinsurers have lifted rates significantly for risks in the Christchurch region and imposed more onerous terms and conditions.
- Insurers that are continuing to underwrite earthquake risk are passing on the bulk of these increased reinsurance costs to policyholders. Companies are considering alternative risk transfer, such as the use of captives.
- Natural catastrophes are not the sole factor contributing to the remoulding of the insurance industry. Regulatory changes through the continued rollout of the Insurance (Prudential Supervision) Act 2010 are expected to lead to significant changes in the market. Licencing rules, minimum capital requirements and higher catastrophe risk capital charges are expected to contribute to consolidation.

New Zealand Non-Life and Life – Premiums (2008-2010)

(NZD Millions)



*Estimated

Source: Sigma World Insurance in 2010



Insurance Market Growth Slowed in Recent Years

New Zealand's insurance market has grown over the past few years, although the rate of expansion has been slowing. This reflects challenging economic conditions. Economic growth turned positive in mid-2010, but recovery will be modest and uneven. The International Monetary Fund currently predicts that gross domestic product (GDP) will expand by 2.02% for 2011 and by 3.75% in 2012. According to Statistics New Zealand, GDP increased by 1.6% in the first six months of 2011 compared with the first six months of 2010.

Exhibit 1 shows that total premiums increased an estimated 3.6% in 2010 to NZD 11,554 million (USD 8,337 million), compared with 6.8% growth in 2009. Growth has been driven by an increase in both non-life and life premiums; however, although life insurance premium as a percentage of GDP has crept higher, it remains less than 1%, compared with 5% for non-life insurance. This reflects consumers' preference to rely on social welfare as opposed to buying life products and the use of the KiwiSaver, a work-based savings retirement initiative in which New Zealand citizens 18 and older who are permanently employed are automatically enrolled.

The higher non-life penetration is driven in part by automatic insurance for certain products, including personal injury in the workplace and motor third-party liability. Medical malpractice and products liability are provided through the Accident Com-

pensation Corp., while earthquake cover for residential buildings and contents is available through the Earthquake Commission. These two public-sector funds account for approximately half of non-life premiums.

While greater demand for insurance and reinsurance is likely in areas hit by earthquakes over the past year, rebuilding projects have been stalled as aftershocks continue. The full impact of the earthquakes in New Zealand is yet to be seen, but some direct insurers and reinsurers do not want to increase their aggregation of property/casualty (P/C) risk in Christchurch, especially for earthquake cover, and are unwilling to underwrite new risks. In many cases, rates have increased dramatically, with reports that some (re)insurers are deliberately pricing themselves out of the market. (See **Earthquake Impact on the Local Non-Life Insurance Market**, page 6.)

Snapshot of the Top Five Non-Life Insurers

The New Zealand non-life insurance market is fragmented but dominated by a number of large insurers, many of which have Australian parent companies. The five largest insurers control about three-quarters of the non-life market

Based on analysis of these five companies – Insurance Australia Group (NZ) Holdings Ltd., Vero Insurance New Zealand Ltd., AMI Insurance Ltd., Lumley General Insurance (NZ) and Tower Insurance Ltd. – there have been a number of notable trends in recent years.

As **Exhibit 2** shows, the five largest non-life insurers have increased their total net premiums written (NPW) in recent years. NPW grew by 2.5% in 2009 and 4.5% in 2010.

Combined ratios have fallen from 102% in 2008 to 91% in 2010, reflecting a reduction in net claims incurred, although the recent earthquake activity will result in insurers posting a loss for 2011. Net operating expenses increased in 2010 as commissions rose.

The top five non-life insurers have been readjusting their investment portfolios in recent years (see **Exhibit 3**).

Exhibit 1 New Zealand Non-Life & Life – Key Market Statistics (2008-2010)

Indicator	2008	2009	2010 (Estimated)
Population (000s)	4,276	4,321	4,369
Gross Domestic Product (NZD Billions)	184.17	185.91	194.74
Change in Real GDP (%)	-0.07	-2.02	1.66
Insurance Penetration (Life) (% of GDP)	0.87	0.93	0.95
Insurance Penetration (Non-Life) (% of GDP)	4.80	5.07	4.98
Insurance Penetration (Total) (% of GDP)	5.67	6.00	5.93
Insurance Premium (Life) (NZD Millions)	1,605	1,725	1,855
Insurance Premium (Non-life) (NZD Millions)	8,838	9,425	9,699
Insurance Premium (Total) (NZD Millions)	10,443	11,150	11,554
Change in Premium Volume (Total) (%)	8.99	6.77	3.62

Sources: International Monetary Fund, World Economic Outlook Database, September 2011; *Sigma World Insurance in 2010*

As expected, the investments of P/C companies are largely in bonds and cash. In 2008, bonds and other fixed-interest securities represented 64% of the aggregated investment portfolios of the five largest non-life insurers, and in 2010 this had increased to 68.9%. Meanwhile, investments in shares and other variable-interest instruments represented 6.9% of total assets in 2008. In 2010 they contributed 1.7%.

Real estate is among the smallest investment sectors (2% of total assets in 2010) for the top five non-life insurers. However, the decline in New Zealand's property market could lead to revaluation losses.

The value of investments for the five largest non-life insurers increased by 30.5% from 2008 to reach NZD 2.52 billion in 2010. However, as **Exhibit 4** shows, net investment return experienced some volatility, reaching 8.9% in 2008 but decreasing to 4.9% in 2010.

Relatively low interest rates could provide a stable stream of investment earnings over the near term, although investment yields may remain flat. Furthermore, insurers that liquidate assets to cover earthquake losses will likely experience a decline in investment income.

New Zealand insurers and their parent companies are considering capital and operational aspects. Capital enhancement may be necessary to meet solvency standards and strengthen balance sheets in the wake of the earthquake losses.

Specific economic challenges in New Zealand could also impact the environment in which domestic insurers operate. A.M. Best's country risk rating methodology identifies risks specific to the country that could compromise an insurer's ability to meet its financial obligations. Countries are placed into one of five tiers, ranging from "CRT-1" (Country Risk Tier 1), denoting a stable environment with the least amount of risk, to "CRT-5" (Country Risk Tier 5) for countries that pose the most risk. New Zealand is categorised as a CRT-2 country with moderate levels of economic risk and low levels of political and financial system risk. This is the same category

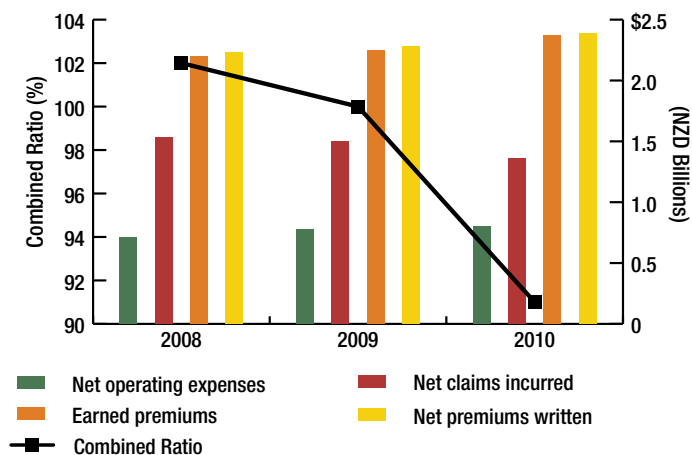
as for countries such as Japan (also a CRT-2), while in comparison Australia is a CRT-1 country.

Regulatory Transformation Commenced

Before the earthquake activity, the insurance sector was braced for a major overhaul as the Reserve Bank of New Zealand (RBNZ) took over regulation of the sector. The Insurance (Prudential Supervision) Act 2010 (IPSA), which received Royal Assent on

Exhibit 2

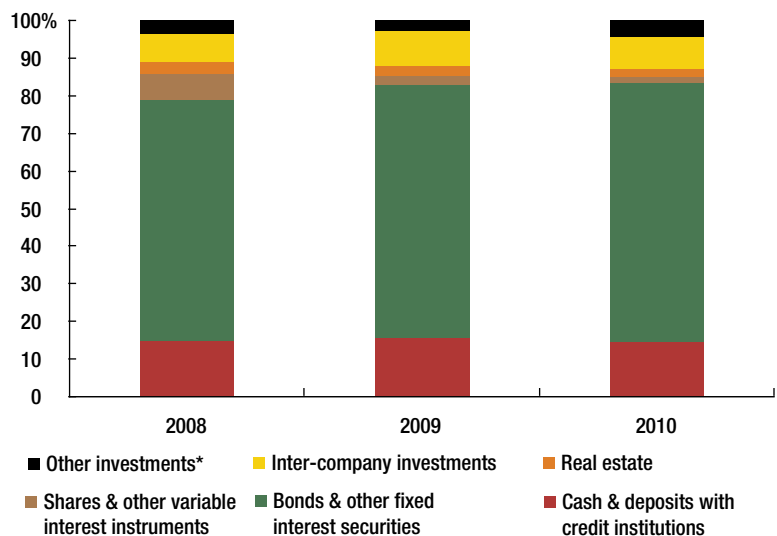
New Zealand Non-Life – Aggregated Combined Ratio & Premiums for Top 5 Insurers (2008-2010)



Source: A.M. Best Co.

Exhibit 3

New Zealand Non-Life – Top Five Insurers' Invested Asset Mix (2008-2010)



* Policy loans, mortgages and loans are included in this category. Source: A.M. Best Co.

7 September 2010, is expected to lead to significant changes as it is rolled out over the coming years during a transition period.

Greater focus has arisen on the financial strength of companies with the introduction of the act. Insurers need to at least meet provisional licensing requirements by March 2012 and obtain a full licence by September 2013. Licencing requirements include compliance with solvency standards, scrutiny of the suitability of senior personnel and appropriate risk management policies.

Most non-life insurers have been required to carry a financial strength rating (FSR) since 1994, although the new act extends this to all insurers with a few exceptions. Exceptions include small insurers with annual gross premiums written (GPW) of less than NZD 1.5 million that were carrying out insurance business in New Zealand before 7 September 2010, as well as friendly societies. A.M. Best was the first rating agency approved by the RBNZ in April 2011. Ratings must be disclosed on the licensed insurer's Internet site, and the RBNZ must be notified of any change in rating or if it is placed under review for a possible downgrade.

The IPSA also introduces minimum solvency capital (MSC) levels of NZD 5 million for life insurers and NZD 3 million for non-life insurers. For non-life captives, a MSC level of NZD 1 million is being proposed under the solvency standard.

In addition to their current annual audited financial statements, the act also

requires insurers to provide the regulator with interim financial statements. The RBNZ gains powers to gather information regarding insurers at all times and/or appoint an investigator to a company. It will be able to prepare a recovery plan for the company; cause it to stop carrying out business; remove, replace or appoint key officers; and apply for an insurer to be liquidated or placed into voluntary administration.

The insurance industry is also bracing itself for the impending Catastrophe Risk Capital Charge, which was published in October 2011. For financial reporting periods commencing on or after 8 September 2016, the loss return period will be set at a 1-in-1,000-year event. This is being phased in over a few years, with the capital charge being 1-in-750 years from 8 September 2015 to 7 September 2016.

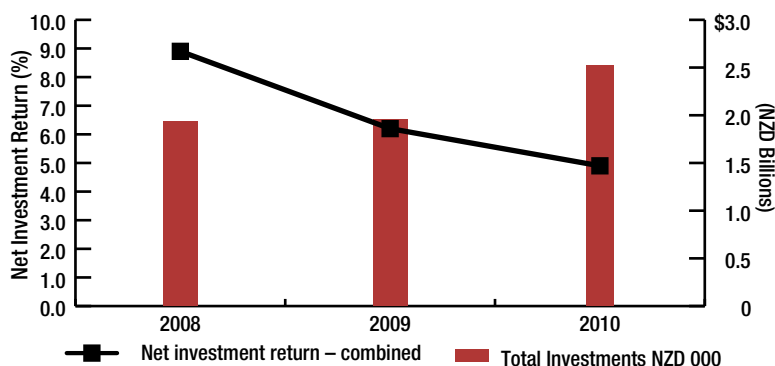
For the financial reporting periods of 8 September 2013 to 7 September 2015, projected insurance losses should be the maximum amount of catastrophe reinsurance held before the date of gaining a full licence, or an amount equivalent to a 1-in-500-year loss return period – whichever is greater. The RBNZ expects this initial calibration not to cause most insurers “significant concern.” It added that “adequate time” is being provided for insurers that may require additional reinsurance.

However, some industry participants feel a 1-in-1,000-year event level is excessively high. They note that in Australia, the concentration risk capital charge assumes a return period of 1-in-250 years.

Regulatory change is also being considered for the Accident Compensation Corp. (ACC), which provides no-fault compensation to victims of accidents, for example for work-related injuries. A consultation is under way to open up work-related personal injury insurance to private competition from 1 October 2012, with the ACC continuing in its existing form.

If the market is liberalised, industry commentators expect it will be a handful of the larger insurers that offer a range of new products.

Exhibit 4
New Zealand Non-Life – Top Five Insurers’ Net Investment Return & Total Investments (2008-2010)



Source: A.M. Best Co.

A.M. Best's Rated Companies In New Zealand

In the past year, there have been a number of downgrades of local insurers following the Darfield Earthquake (7.1 magnitude on 4 September 2010), Christchurch Earthquake (6.3 magnitude on 22 February 2011), the aftershocks on 13 June 2011 and other quake activity.

In addition to the downgrades shown in **Exhibit 5**, in March 2011, AMI Insurance's FSR was downgraded from A+ to A-. The government supported the insurer, which had more than NZD 350 million in reserves, with a five-year "backstop" agreement to provide as much as NZD 500 million to settle claims if needed. In July, AMI more than doubled its reinsurance cover from its previous NZD 600 million limit to NZD 1.3 billion per event.

A.M. Best also withdrew the FSR (B-) for New Zealand Local Authority Protection Programme Disaster Fund (LAPP) in May 2011 at the company's request. The FSR for LAPP was first downgraded from A to B++ in February.

There is still uncertainty regarding the final insurance bill for the earthquake damage. In August, the Earthquake Commission (EQC) increased its estimate by NZD 4 billion to NZD 7.1 billion after new data became available from actual field assessments. A high court subsequently ruled that the EQC must

pay to a maximum of NZD 100,000 for each event, not just for the year, before claims can be made to commercial insurers.

The Darfield quake was farther away from Christchurch, and there were no fatalities and fewer commercial losses. However, insurers and loss adjusters are attempting to discern what damage was caused by this quake and subsequently by the Christchurch quake. Property insurers face operational challenges in assessing and settling claims, as access to large parts of the Christchurch city centre has been restricted, making claims assessment difficult.

Claims have included property and infrastructure damage, business interruption and inventory damage. Large losses have also arisen from unmodelled elements, including landslide and liquefaction.

Earthquake Impact on the Local Non-Life Market

Unsurprisingly, the earthquake activity has had a profound impact on the EQC. As with the rest of the insurance market, the EQC has found difficulties in obtaining multiyear reinsurance contracts.

In October, the government unveiled plans to increase the premium levy on home insurance from February 2012 from

Industry Consolidation Anticipated

While the insurance market has grown in recent years in terms of total gross premiums written (GPW), there are considered to be too many indigenous insurers for New Zealand's 4.4 million inhabitants – a population that is only slightly larger than that of Melbourne, Australia (4.1 million, according to the Australian Bureau of Statistics). According to the RBNZ, in December 2010 there were approximately 160 registered entities, of which 75% were non-life insurers (including medical insurers) and the remainder were life insurers.

Some of the smaller, niche insurers could fall short of new standards under the Insurance (Prudential Supervision) Act (IPSA) as minimum capital requirements (MCRs) are deemed to be too onerous. Most insurers used an actuary before the act, which has made it compulsory to appoint an actuary to assess insurance liabilities. However, some smaller companies will find this an additional compliance cost.

Furthermore, the more onerous catastrophe risk capital charge is expected to increase reliance on reinsurance, and the cost of such coverage is greater in the wake of the Christchurch quakes. The combination of these factors will make it harder for insurers to survive independently.

The larger insurers are expected to be in a position to increase their presence and acquire smaller players. The Trans Tasman insurers are best placed to meet the new solvency requirements, as they are already complying with legislation from the Australian Prudential Regulation Authority (APRA).

While the new IPSA rules are not intended to directly fuel industry consolidation, this consequence is inevitable. The RBNZ's own annual report for 2010-2011 anticipates that the new act may lead to some insurers merging and others exiting the industry.

5 cents to 15 cents for every NZD 100 of cover, with an annual cap of NZD 207. This will increase the annual levy revenue from about NZD 86 million to about NZD 260 million.

A review of the EQC scheme is under way, but no major change to it is anticipated in 2012. Market participants generally appear to support the principles behind the scheme, but they say recent events have highlighted potential capital issues.

Some insurers have withdrawn coverage from earthquake risks in Christchurch. Civic Assurance – the trading name for New Zealand Local Government Insurance Corp. Ltd. – ceased offering property insurance for most councils on 1 July. Civic Assurance, which provides insurance for 46 councils, was unable to obtain reinsurance.

Zurich New Zealand will no longer write any new earthquake cover for areas outside of Auckland, Northland and Waikato. Meanwhile, Ecclesiastical Group, which owns Ansvar in New Zealand, announced in

September 2011 that it would cease underwriting earthquake cover in New Zealand. It is exploring whether protection can be offered in the future as an earthquake stand-alone product or as part of a broader cover, through an underwriting agency.

A number of other insurers are said to be reviewing the extent to which they are willing to provide earthquake cover, although this is being offset by some insurers increasing their presence or new entrants to the market, given the higher rates.

Most insurance costs for the recent earthquakes are expected to fall on international reinsurers or the government. Insurance broker Aon Benfield estimates nearly two-thirds of losses were reinsured. As there is no state reinsurer in New Zealand, the insurance market depends heavily on the international reinsurance community. Munich Re and General Re have regional offices in Auckland, and other reinsurers commonly underwrite Australian and New Zealand programmes from their Australian offices. Bermudian and London market

Exhibit 5

New Zealand Non-Life & Life – A.M. Best Ratings

As of 31 October 2011.

Company	FSR and Outlook	Action	Date	ICR and Outlook	Action	Date
Aioi Nissay Dowa Insurance Co. Ltd. NZB	A (stable)	Affirmed	11/16/2010	a+ (stable)	Affirmed	11/16/2010
AMI Insurance Ltd.(1)	A- (stable)	Affirmed	6/7/2011	a- (stable)	Affirmed	6/7/2011
Ansvar Insurance Ltd.	B++ (negative)	Downgraded	9/28/2011	bbb (negative)	Downgraded	9/28/2011
China Taiping Insurance (NZ) Co. Ltd.	B++ (stable)	Affirmed	11/29/2010	bbb (stable)	Affirmed	11/29/2010
CIGNA Life Insurance New Zealand Ltd.	A- (stable)	Affirmed	12/28/2010	a- (stable)	Affirmed	12/28/2010
Consumer Insurance Services Ltd.	B++ (stable)	Affirmed	7/15/2011	bbb (stable)	Affirmed	7/15/2011
Contractors Bonding Ltd.	B+ (stable)	First	8/2/2011	bbb- (stable)	Assigned	8/2/2011
Farmers' Mutual Group	A (stable)	Affirmed	6/14/2011	a (stable)	Affirmed	6/14/2011
Fidelity Life Assurance Co. Ltd.	A- (stable)	Affirmed	1/19/2011	a- (stable)	Affirmed	1/19/2011
FMG Insurance Ltd.	A g (stable)	Affirmed	6/14/2011	a (stable)	Affirmed	6/14/2011
New India Assurance Co. Ltd. NZB	A- (negative)	Affirmed	1/24/2011	a- (negative)	Affirmed	1/24/2011
NZ Local Authority Protection Programme Disaster Fund (2)	NR (not rated)	Downgraded/ Withdrawn	5/26/2011	NR (not rated)	Downgraded/ Withdrawn	5/26/2011
New Zealand Local Government Ins. Corp. Ltd.	B++ (negative)	Downgraded	7/18/2011	bbb+ (negative)	Downgraded	7/18/2011
Pacific International Insurance Ltd.	B+ (positive)	Affirmed	4/18/2011	bbb- (positive)	Affirmed	4/18/2011
Police Health Plan Ltd.	B++ (stable)	First	5/13/2011	bbb (stable)	Assigned	5/13/2011
Sovereign Assurance Co. Ltd.	A+ (stable)	Affirmed	12/21/2010	aa- (stable)	Affirmed	12/21/2010
TOWER Health & Life Ltd.	A- (stable)	Affirmed	7/29/2011	a- (stable)	Affirmed	7/29/2011
TOWER Insurance Ltd.	A- (stable)	Affirmed	7/29/2011	a- (stable)	Affirmed	7/29/2011
TOWER Life (N.Z.) Ltd.	A- (stable)	Affirmed	7/29/2011	a- (stable)	Affirmed	7/29/2011
Union Medical Benefits Society Ltd.	A- (stable)	First	7/5/2011	a- (stable)	Assigned	7/5/2011
Virginia Surety Co. Inc. NZB	A- (positive)	Affirmed	11/23/2010	a- (positive)	Affirmed	11/23/2010

(1) In addition to the two affirmations shown here, in March 2011, AMI Insurance's FSR was downgraded from A+ to A-.

(2) A.M. Best downgraded the FSR and ICR for New Zealand Local Authority Protection Programme Disaster Fund (LAPP) to B- and bb-, respectively, and withdrew the ratings in May 2011 at the company's request. LAPP had been subject to a series of rating actions, beginning with a FSR downgrade from A to B++ in February. Source: A.M. Best Co.

reinsurers also have a significant presence in New Zealand.

New Zealand government delegates made their first trip to the Monte Carlo Rendezvous de Septembre in 2011 to ensure the continuing support of the reinsurance community. They said recent events have resulted in an improvement in risk, with stronger building codes to ensure new builds are at a higher standard, and an improved awareness of previously unknown fault lines.

To date, international reinsurers are continuing their quest to diversify risk, and New Zealand is among the most mature and disciplined insurance markets in the Asia Pacific region. However, many are setting lower limits on their exposures to New Zealand risks and are pricing risks according to sector and region.

As anticipated, reinsurance rates increased significantly during the 1 July renewal season, particularly for property catastrophe cover in areas where claims were incurred, and rates doubled or trebled in some cases. Losses in the region from the earthquake and tsunami in Japan and flooding in Australia have added further pressure to rates. Insurers' ability to absorb increased reinsurance costs depends on the strength of their balance sheets. The extent to which they are able to pass on higher rates and more onerous terms to customers is not yet clear.

There are approximately 200 brokers in New Zealand, and the Insurance Brokers Association of New Zealand (IBANZ) has 180 member firms controlling annual premiums of about NZD 2.3 billion. Brokers account for about 85% of corporate risks and 15% of personal lines, and they state that in addition to higher reinsurance rates,

terms and conditions have been tightened for reinsurance coverage. Retention ratios are higher for primary insurers, and brokers say they are approaching greater numbers of reinsurers than in previous years for larger commercial risks.

There is some concern about the availability of reinsurance for certain lines of business, particularly contractors all risks, construction, engineering, erection and business interruption. Some reinsurers debated excluding earthquake risks in the Christchurch region during the July renewals, but this did not happen.

Considerably higher rates and more onerous terms and conditions could result in greater interest in forming captive insurers. The larger insurance brokers are carrying out feasibility studies for the use of captives, with Singapore expected to be a popular domicile for new formations. There is also some discussion with regard to using catastrophe bonds. However, to date, the traditional insurance and reinsurance markets are considered preferable to alternative risk transfer.

There is some pressure for the government to become the insurer of last resort to enable building projects to get under way where insurance has been unavailable or expensive. This could be funded by the creation of a taxpayer-funded financial guarantee.

While the 1 January, 2012 renewal season for the Trans Tasman insurers is considered less significant than the 1 July period, terms set by the major Australian and New Zealand companies with multibillion dollar catastrophe programmes will be telling. The insurance industry is braced for the earthquake activity to have further implications. For example, it could lead to a greater focus on other natural catastrophes, such as flood risk.

Published by A.M. Best Company

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SR-2011-311