

**United Kingdom
Special Report****UK Non-Life Insurance —
The Only Way is Up****Analysts**

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Summary

When the UK non-life insurance industry entered a softening phase of the underwriting cycle during 2005, the gauntlet was thrown down for individual participants to demonstrate their ability to avoid the loss-making pitfalls of previous soft cycles. Through 2006, market conditions continued to remain challenging, yet insurers defied expectations with strong results — in part, of course, attributable to benign claims conditions — and signalled hopes that some of the lessons of the past had finally been learned. The test of nerve has continued into 2007 and indications currently suggest that insurers remain on the path of underwriting discipline.

Rate hardening has already been observed in some business lines during 2007, most notably in property and private motor. Other market segments are continuing to experience intense competition and aggressive pricing, particularly where new capacity has arrived to exert increased pressure on rates. This makes it imperative for insurers to continue to retain their discipline at all stages of the underwriting cycle.

Winter storm Kyrill and the severe flooding during summer 2007, which represented the most costly UK catastrophe event the insurance industry has faced, brought into sharp focus the potential risk that climate change may pose. The disaster placed under scrutiny insurers' risk management programmes and catastrophe modelling, and also reignited the debate between the government and the industry on flood defence expenditure. This was by no means the only test for UK insurers in 2007: the distribution landscape has been rapidly evolving as brokers attempt to manoeuvre themselves into a position of greater strength; and claims inflation continues to outpace premium rate increases in various classes of business.

Fitch looks prospectively at insurers' ability to weather and prosper in soft market conditions, and takes a positive view of those that are able to generate consistent earnings through the cycle. In this report, the agency examines the market's performance in 2006 and H107, the challenges that market participants have faced, and the obstacles that may hinder their ability to sustain profitability. Fitch also appraises the industry's level of capital strength based on initial results from Prism, Fitch's global economic capital model.

Rating Outlook

Fitch maintains a stable outlook on the UK non-life insurance sector, reflecting the agency's expectation that the number of upgrades will approximately be equal to the number of downgrades in the next 12 months. Encouraging trends have been observed in insurers' performance over the course of the last year, with strong profitability reported across the sector, and this has continued well into 2007. This is in spite of premium rate deterioration and intensifying competition, as well as the sobering effect of natural catastrophe activity, which represented a marked change from the benign claims environment in 2005.

The agency expects that UK insurers' efforts to improve the quality of their risk management and maintain capital discipline places them in a position of strength at this point of the cycle. Although performance may vary widely from company to company, Fitch considers that a majority of insurers should be able to demonstrate results that exceed previous experience during soft market cycles.

Financial Performance

Full-year performance reported by UK non-life insurers on the basis of 2006 results was, on the whole, very strong. Combined ratios were comparable with those achieved in 2005, underwriting discipline restricted growth to lines of business with the greatest prospects of profitability, and return on equity reached double digits for many of the leading players. This success was achieved against a backdrop of the habitual temptation of defending market share as premium rates deteriorated and opportunistic market entrants competed for the most attractive risks. Nevertheless, acting in insurers' favour was a benign claims environment that restricted losses occurring through natural catastrophe activity to a minimum.

This state of affairs gave way to a considerably more inclement first half of 2007. That insurers reached this point in generally good shape was as much down to good judgement as good luck, as the strong results and prudent reserving that had characterised 2006 allowed for a build-up of capital with which to face the more challenging conditions that lay ahead. Winter storm Kyrill caused widespread damage in the UK and Germany during January 2007, leading to a total insurance bill of around EUR5bn across Europe. Although several insurers reported reasonably high flood-related losses following the June floods, overall profitability held up well due to disciplined underwriting and good risk selection.

Although Fitch has maintained its stable outlook on the sector, there are some circumstances which could cause this outlook to be revised:

- As cycle management continues to be one of the most important considerations for UK non-life insurers at the present time, it is imperative that insurers remain faithful to their stated strategies of writing profitable business only. Pricing below the technical rate is still a significant risk, and one that has been realised in previous soft cycles, and a repeat of such tendencies could lead to a repeat of the long and deep soft cycles of the past, although Fitch believes that this outcome is now less likely.
- A major catastrophe of a 1 in 100 year magnitude, such as a UK windstorm generating GBP5-10bn of insurance claims, would provide an insightful and eye-opening test for the market, and would also differentiate the performance and adequacy of risk selection of various insurers. Although the summer floods were notable by their severity, Fitch believes they represented more of an earnings than a solvency issue. A significant catastrophe would demonstrate more clearly the effectiveness of the enterprise risk management (ERM) frameworks to which insurers have devoted much attention in recent years.
- A pronounced downturn in investment markets could have serious consequences for some insurers, particularly at a time of softening rates not only in the UK but also in Europe. However, in general terms, the risk that such an eventuality could pose to insurers is less pronounced now that it was at the start of this decade, as insurers have reallocated their investment portfolios away from equities and towards bonds. Insurers are also now less reliant on investment income to support their technical result.

Capital Strength

Fitch has developed a global economic capital model, named Prism, which is a major step forward in third-party analysis of insurer capital quality. With this analytical tool the agency has been able to determine the capital strength of individual UK non-life entities and the industry on an aggregate basis. Further detailed information on Prism can be found at www.fitchratings.com/prism.

During the first half of 2007 Fitch carried out "beta" testing on a sample representing GBP27bn of gross written premium, or almost 70% of the UK non-life market by premium volume, based on financial information as at year-end 2005. The results of the testing revealed that the average Prism score for the non-life

market was 'A', which, for most companies, supported the agency's existing view of their capital strength. Larger companies tended, on average, to achieve higher Prism scores than smaller companies. The average rating for the group of insurers with gross premium written in excess of GBP2bn was 'A+', while the average rating for the group of insurers with gross premium written below GBP1bn was 'BBB+'.

- Please refer to "2006 Capital Scores for European Insurers - Comparative Analysis", available on www.fitchratings.com, for further information

Fitch has since developed a methodology that enables the aggregation of regional Prism results between life and non-life sectors and across countries, as well as risks and capital in markets where a regional Prism capital model is currently unavailable. In December 2007 the agency published beta results on aggregated scores based on year-end 2006 data for UK non-life groups, representing 61% of the industry by gross written premium volume. The beta Prism score for the overall capital score of UK non-life insurers was again 'A', testifying to the resilient balance sheets of major market competitors during a period of softening premium rate conditions. The average final Prism score for individual entities also remained at 'A'.

Capital reallocation activity during 2007 has underscored the capital strength from which the industry has been benefiting. Following the publication of YE06 financial results, several leading insurers have identified surplus capital for redistribution in the interests of economic efficiency. This has given insurers the choice of using this capital to grow through organic expansion or acquisitions, or of returning capital to shareholders through share buybacks or dividend payments. As market conditions have proven challenging, the preferred option has been to repatriate capital to shareholders, as the following table demonstrates:

Percentage Split of Prism Scores by Category, 2006

'AAA'	17
'AA'	24
'A'	34
'BBB' or under	25
Average	A

Source: Fitch

Fitch views the reallocation of surplus capital as a process that can differentiate the capital management strategy of one insurer from another. The rationale behind any specific capital reallocation strategy is key to determining its prudence, and to understanding management's view of the relative interests of shareholders and policyholders. Fitch believes that in 2006 – and to date in 2007 – non-life insurers have not utilised excess capital in an unreasonable manner, and there has been refreshingly little evidence of opportunistic volume growth from existing market competitors.

Capital Reallocation of Major UK Insurers, 2007

	Share buyback	Payout ratio (%)
Allianz	-	23
Aviva	-	29
Axa	-	39
Brit	GBP50m	23
Hiscox	-	19
R&SA	-	26
Zurich	CHF1.25bn	35

Source: Fitch, company news releases

Reserving

The average level of reserving adequacy for non-life insurers is now considerably better than it was during the previous soft market. This turnaround has been facilitated by a favourable premium rating environment, which has contributed towards good operating performance that has allowed for a build-up of reserves.

There has also been a shift within the industry towards greater reserving prudence. For more recent accident years, reserves have tended to be established more conservatively. Losses for the soft-market accident years of the late 1990s, when reserve deficiencies were common, have largely been paid, and liabilities for this period now represent a reassuringly modest proportion of the sector's total reserves. Reserve development in recent years has been considerably more positive. This has not only offset any continued deterioration observed in older accident years but has also led to some insurers releasing reserves and enhancing operating profitability.

Despite the positive trends observed on an aggregate basis, reserve levels are unlikely to be enhanced from their present position as industry profitability comes under pressure through 2008. Instead, reserve surpluses that have been already

accumulated may start to be eroded for those insurers that have been over-reliant on releasing reserves to support their underwriting results.

This has been particularly evident in the motor market, where insurers have been supporting their underwriting results with reserve releases since 2004, helping to smooth performance and mask any underlying volatility in loss ratios. The reported combined ratio for the motor market has remained stable in the past few years, thanks to aggregate releases in the period 2004-2006 of almost GBP1.5bn. The underlying volatility of the motor market is shown in further detail in the *Market Conditions* section below.

The strongest evidence that reserving adequacy is now superior to that in previous soft markets can be observed in the liability market. On an aggregate basis, liability insurers released reserves in 2005 and 2006 following successive years of reserve strengthening between 2000 and 2004. This trend follows greater understanding of and expertise in writing liability risks, which has resulted in improved pricing and reserving for a historically long-tail class of insurance business. However, this honeymoon period could soon come to an end if the influence wielded by some of the opportunistic newcomers to the market proves too great, and leads to significant rate reductions and the acceptance of business without adequate attention paid to the complex and constantly evolving legal environment that surrounds it.

While Fitch welcomes reserve releases as evidence that prudent reserving strategies are being practiced, any significant divergence between the underwriting and accident-year loss ratios may suggest over-reliance on strong historical reserving to achieve underwriting profitability. Such an approach to underwriting is also likely to imperil an insurer's future ability to underwrite profitably as market conditions deteriorate. Insurers that are able to achieve strong underlying performance that is bolstered by reserve releases are those that are likely to be best equipped to adapt to the evolving competitive environment.

- The Mack CV is derived using triangulations of claims paid and claims incurred from FSA return forms 23, 31 and 32

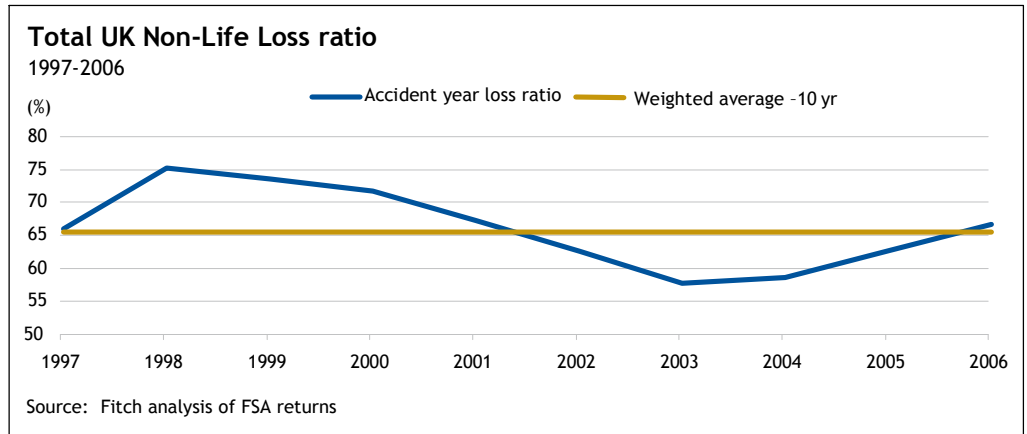
In Prism, Fitch calculates a coefficient of variation, or CV, for insurers' reserves using the Mack method. This is a stochastic reserving approach widely used in the actuarial community that considers the volatility of loss development factors by line of business. For the non-life industry in 2005, the Mack CV ranged from 5.3% to 27.8%, with an average of 16.2%. At the lower end of the range were short-tail writers in more predictable lines such as motor insurance, whereas the higher Mack CVs tend to belong to those insurers that have a heavier focus on longer-tail liability lines.

Market Conditions

Loss Ratio Trends

The ability to generate consistent earnings through the insurance cycle is one of the hallmarks of a financially strong insurer. Maintaining underwriting discipline is clearly a challenge, given the conflicting pressures of growing the top line and the bottom line, and Fitch believes that insurers that are able to exercise restraint during soft market conditions will be in the best position to prosper when premium rate conditions improve.

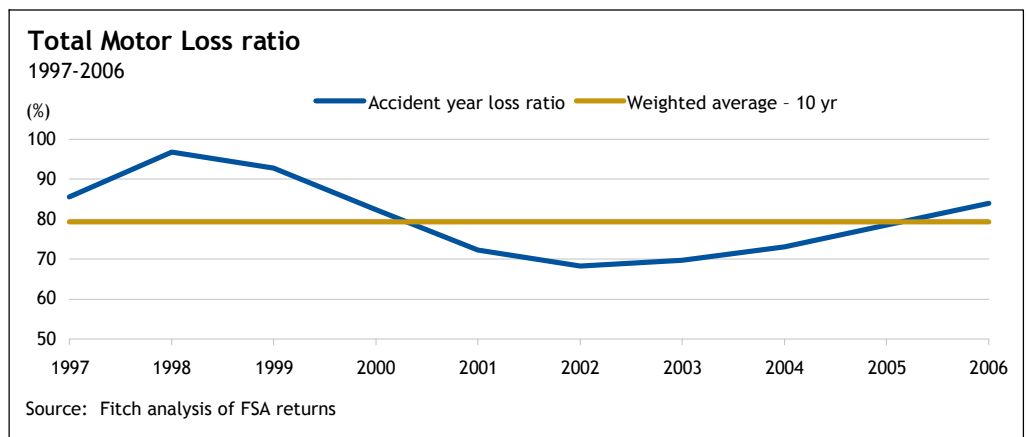
Although rate hardening has been observed in some lines of business, the non-life insurance market as a whole remains in the firm grip of soft rate conditions. The chart below highlights the development of the total loss ratio since 1997.



The market loss ratio reached 66.6% in 2006, its highest level since 2001, testifying to the declining rate adequacy within the market. Compared with the previous soft cycle (which the chart shows was at its peak in 1998, with a loss ratio of 75.3%), Fitch expects market discipline now to have improved. Reduced reliance on investment returns and the recent experience of under-reserving and under-pricing will combine to steer the industry away from the deep, prolonged soft cycles of the past.

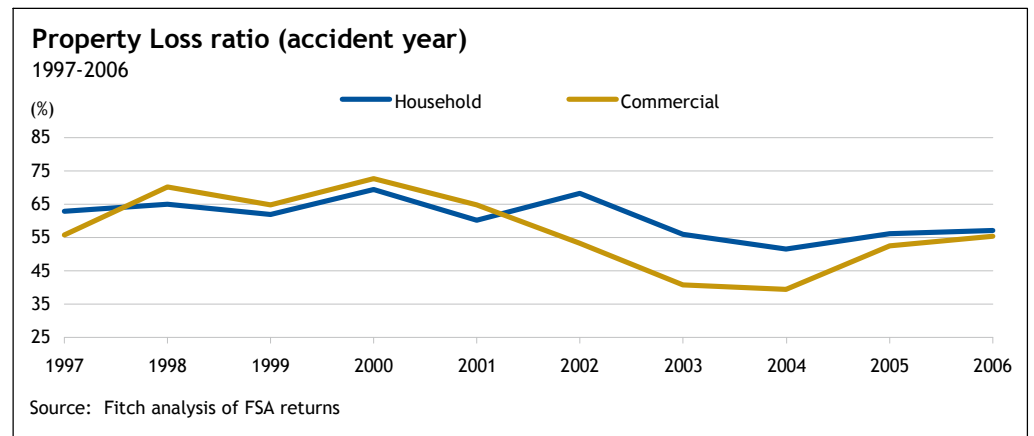
Motor Insurance

On an accident-year basis – a true barometer of the underlying quality of an insurer’s earnings as this measure strips out reserve releases – steady deterioration has been observed in the motor combined ratio since 2002, with the loss ratio increasing from 68.6% to 84.0% in 2006. This reflects the detrimental effect price-based competition has had on the motor market over this period.



The motor loss ratio in 2006 remains some way from the peak of 96.8% recorded in 1998, but is above the 10-year average of 79.4%. The combined ratio was slightly above 100% on an accident-year basis when commissions and expenses are included, confirming that in the absence of reserve releases, immediate remedial action needs to be taken by motor insurers in order for sustainable underwriting results to be achieved. In 2007 there has been an overall increase in private motor rates, suggesting that insurers are acting to prevent significant losses occurring. Competition in fleet business, however, remains intense.

Property Insurance



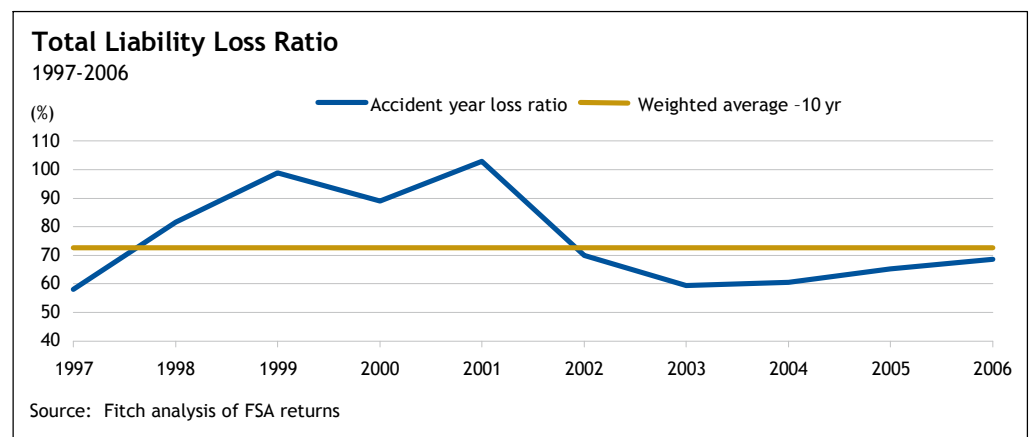
Since 2004 there has been a steady deterioration in the household and commercial property loss ratio. This reflects the stable premium rate environment, particularly in the household market, and the modest uptick in claims inflation over this period. Fierce competition in personal lines business has resulted from the emergence of more cost-efficient direct distribution channels and this has caused the loss ratio to trend above that of the commercial property market since 2002.

Through to the end of 2006, property insurers had benefited from two years of benign claims conditions. Market results in 2006 continued to be very strong and demonstrated that in spite of intensifying competition, insurers successfully managed to write their property portfolios at profitable levels.

Winter storm Kyrill and the UK flooding have already ensured that 2007 will not be remembered in the same way. The flat rating environment in the household market has given way to substantial rate increases – in some cases double-digit percentage rises have been applied – and underlying competitive pressure in the commercial market continues.

Liability Insurance

The fortunes of the liability insurance market have undergone a remarkable transformation since the widespread turmoil in the market at the start of this decade. Pricing has improved, risk selection has become more precise – particularly as far as policy wordings are concerned – and industry expertise has grown from the experience of the lean years.



The liability market loss ratio of 68.6% in 2006 remained below the 10-year average of 72.6%. Despite this, the underlying trend has been of a gradual increase in the loss ratio since 2003, and in the first half of 2007 rate decreases have taken place

in certain classes of liability business. These have been expedited and compounded by the entrance to the market of pockets of new liability capacity, most notably originating in Bermuda, which has led to some opportunistic risk-taking. Such new entrants are beginning to have a negative effect not only on rates but also on terms and conditions.

Positive signs of sustainable improvement in the liability market's overall health, however, have been evidenced via the aggregate reserve releases that have taken place in 2005 and 2006. These trends suggest that pricing adequacy has now reached a more realistic level.

UK Flooding

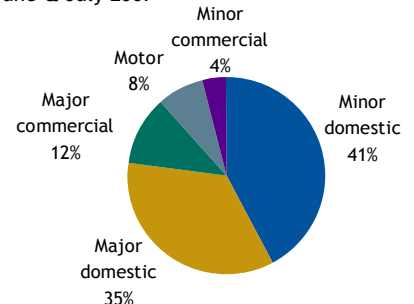
The summer of 2007 will be remembered by the UK insurance industry as the costliest on record following the severe flooding that wreaked havoc in parts of northern and southern England. The events in June and July cost UK insurers a combined total of over GBP3bn, with the claims distribution split as shown in the chart above.

Insurers were generally well protected by strong reinsurance coverage for the flood events, although there were some individual variations. The flooding was different in character to previously observed such events, largely due to the damage caused to properties that had not been identified as being located in existing flood plains, but in terms of magnitude, the catastrophe was of a scale that insurers would have assessed in their catastrophe modelling. Consequently, reinsurance programmes proved sufficiently strong to absorb flood losses and limit the net exposure for most UK insurance groups. The catastrophe was more of an earnings issue than one that impaired insurers' capital strength and therefore Fitch did not make any changes to its UK non-life ratings resulting directly from the flooding.

The hidden benefit of the natural disasters during 2007 has been a sooner-than-expected return to an improved operating environment for UK non-life insurers. Insurers have raised rates, become more selective over coverage and lobbied the government for increased spending on flood defences. Premium rates have increased for both commercial and domestic property business, and in the areas most prone to flooding deductibles have been increased to reduce the risk residing on insurers' own balance sheets.

Breakdown of UK Flooding Claims Costs

June & July 2007



Source: Association of British Insurers

- “The government has completely failed to grasp the importance of improving Britain’s flood defences in the wake of the devastating floods across the UK”
- *ABI news release, 9 October 2007*

Proposed Government Expenditure on Flood Defences

Year	Spend (GBPbn)
2008/09	0.65
2009/10	0.7
2010/11	0.8
Total	2.15

Source: Association of British Insurers

The government's commitment to expenditure on flood defences has been publicly criticised by the Association of British Insurers (ABI), which has called for a spend over three years over GBP2.25bn as opposed to the GBP2.15bn that the government has outlined. Fitch notes that this represents a shortfall of less than 5%.

The UK is unique compared with the rest of the Europe in that the insurance industry, not the government, bears primary responsibility for the cost of flooding claims. Continued government reluctance to bolster spending may call into question insurers' willingness to continue providing flooding coverage as part of household and commercial policies and may ultimately lead to a reshaping of the property insurance sector.

Speculation has been rife that the flooding is evidence of global climate change, and that such events are likely to become a more regular feature of UK weather patterns. Although the existence and impact of climate change remains the subject of much debate, the certainty is that if climate change is becoming a real risk factor for insurers it will no longer be possible to base the cost of economic damage on historically accumulated data. This may have serious implications for the extent of coverage that insurers will be willing to provide at reasonable prices.

Distribution

Distribution in the UK non-life market is in a state of flux and numerous distribution models are vying for supremacy. Insurers themselves have been forced to react nimbly to ensure they capitalise on new opportunities, and the clearest indication of this has been the trend towards insurers purchasing brokers to ensure that control over distribution remains in their own hands.

In personal lines, the growth of direct sales continues to drive down the cost of distribution, yet has also heightened competitive forces. The rapid emergence of aggregator websites has provided a cost-effective solution for insurers to access significant customer volumes yet has elevated the importance of price even further, thus increasing the intensity of competition.

The direct channel is also becoming increasingly topical in the small- to medium-sized enterprise (SME) sector as insurers are able to offer off-the-shelf solutions to the least complex clients.

Insurers have been pursuing affinity relationships with increased vigour during 2006 and 2007, not only to tap into large groups of customers that can be relatively easily segmented, but also to defend their market positions from competitors. Recent examples include the pairing of Fortis Insurance N.V. (rated 'AA-') with Alliance & Leicester (rated 'AA-') and high street electrical retailer Currys, Equity Insurance with MAN Financial Services, and the Post Office's extension of its partnership with Junction until 2012.

In commercial lines, brokers are starting to wrest control over distribution. Towergate's GBP95m takeover of the Broker Network in November 2007 was the latest indication that the largest commercial brokers are attempting to gain control over commissions, revenue and products, thereby moving the industry away from the traditional model of independent brokers distributing commercial insurance products.

Insurers have counteracted these moves by taking ownership of brokers themselves, attempting to realign the industry towards a multi-tie model where brokers have less independence. Competition is being concentrated into the hands of fewer and fewer large players as a result of insurer-driven consolidation of the intermediary market and is restricting the market's ability to be flexible on price and product customisation.

Axa (rated 'AA-') has been particularly active in acquiring brokers through subsidiary Venture Preference. The acquisitions of Stuart Alexander and Layton Blackham in January 2007 were followed by the purchase of independent commercial broker Smart & Cook in April 2007, which propelled Axa to the position of second-largest SME broker in the UK. This acquisition was followed by the purchase of two further brokers in November 2007.

Groupama has also been notable for its pursuit of brokers through broking division Gan UK. The French-owned insurer has added motorcycle broker Carole Nash (December 2006), the Bollington group (June 2007) to give the insurer closer access to the lucrative SME sector, and Lloyd's broker Lark (September 2007). Its broker integration strategy, however, differs from Axa's, as Groupama will keep its acquisitions as separate organisations.

Broker consolidation has been on the cards for some years. The broker market has historically been highly fragmented, and the burden of regulation, ageing demographic profile of key personnel and influx of capital has hastened merger and acquisition activity. Fitch expects consolidation to continue, in particular at the smaller end of the market where volume pressures are most acute.

Claims Inflation

Recent changes in the legal system are having a detrimental impact on the cost of claims and the industry's ability to accurately set the level of claims reserves. Personal injury claims costs in motor and liability business have been a particular issue and recent court rulings have placed upwards pressure on claims, as has the underlying cost of medical treatment, which has exceeded the rate of inflation.

The 2003 Courts Act is likely to result in a greater proportion of claim payouts being settled on a structured settlement basis rather than as an upfront sum, as at present. Payments over time will increase the total average amount that insurers have to pay. Motor insurers have been faced with legislative changes that require them to reimburse the National Health Service (NHS) for the cost of treating patients injured in road accidents.

More recently, the November 2006 ruling to award periodic payments using an interest rate based on earnings inflation rather than the Retail Price Index is expected to increase claims costs further. Although this decision may yet be overturned, the impact could be substantial if compensation settlements are awarded above price inflation.

The actual level of claims inflation continues to give insurers cause for concern. A report released by the International Underwriting Association of London (IUA) has confirmed that the cost of bodily injury claims has risen by an average 9.5% a year between 1996 and 2006, with average claims inflation exceeding 10% for claims exceeding GBP80,000. Counteracting measures, such as keeping the small claims limit low and increasing the fast-track limit, have yet to have a notable contribution, although have ensured the rising cost of claims is reined in. Efforts made by insurers to use rehabilitation to control claims costs have had a similar effect, yet debate continues over the real effectiveness of this approach.

Fitch estimates that liability claims inflation now runs at only around 3-4% per annum. This relative stabilisation is likely to be further ensured by the House of Lords ruling in October 2007 that workers exposed to asbestos will not be entitled to compensation if they subsequently develop pleural plaques. Since the 1970s, the ABI estimates that insurers have paid out around GBP1.4bn for pleural plaque claims.

Property claims inflation is around 9% per year, though this figure does include demand surge for widespread events such as the UK flooding. Should the impact of climate change prove to be material, property claims inflation would have the potential to increase significantly further.

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