Review & Preview
October 15, 2012

# Rates Rise, but Economic Conditions Place Pressure on Performance

**Modest rate increases have been achieved for most lines of business in 2011 and 2012.**

Market conditions for U.K. non-life insurers remain challenging as the difficult economic environment curbs demand for coverage and insurers can no longer rely on reserve releases to improve profitability.

As investment returns remain low, insurers are coming under increasing pressure to focus on appropriate pricing. Rates for general insurance personal lines have improved, although those for commercial lines are lagging.

Motor risks continue to enjoy the greatest rate increases, although the market remains competitive in part due to the popularity of aggregator websites. In each of the past five years, the motor sector has posted combined ratios in excess of 100%, which primarily reflect claims inflation for bodily injuries. In 2012, margins remain under pressure.

The U.K. property market is also facing a challenging 2012 after severe flooding occurred in June and July. The Statement of Principles on the Provision of Flood Insurance agreement, set to expire by the end of June 2013, has the insurance industry and the government examining the best ways to continue providing flood coverage to at-risk homes.

Claims for employers' liability risks have decreased as the workplace has become safer. However, to an extent, improved working conditions have been offset by the greater propensity to claim. There is an increased potential for claims under professional indemnity and directors and officers' (D&O) policies in relation to turmoil in the financial markets and, more recently, the manipulation of the London interbank lending rate (LIBOR).

In addition to these challenges, U.K. non-life insurers are facing a prolonged period of uncertainty regarding the final specifications of Solvency II and the feasibility of the implementation target date of 1 January 2014. While smaller insurers may regard any delay as a welcome breathing space, the larger, well-prepared companies may lose anticipated advantages.

## Pressure Mounts to Achieve Profitable Accident-Year Underwriting

Low investment returns and shrinking reserve releases are resulting in insurers having to focus increasingly on adequate pricing of risks. In order to achieve profitability, insurers are focusing on underwriting terms and claims management and are relying on market analysis and good key data to provide competitive advantages. Modest rate increases have been achieved for most lines of business in 2011 and 2012, with the greatest rate increases occurring in the motor lines. However, appropriate pricing of risks is challenging as economic difficulties are suppressing demand for insurance products, while excess capacity is chasing what business is available.

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Commercial rate increases – ranging in the low single digits – are lagging behind those in the personal lines market. The competitive market conditions for commercial risks are expected to continue throughout 2012, with no strong upward turn in rates expected until at least 2013, as capacity remains plentiful.

Insurers have faced increasing competition for small to medium-sized enterprise (SME) risks, for which they often provide packaged products. The SME market is regarded as a growth area given its relatively low insurance penetration, resulting in weak rates and reduced profitability. The use of electronic trading is growing, particularly for small commercial and SME business, and competition is expected to intensify as insurers' prices become more transparent. In contrast, brokers remain the principal distribution channel for larger commercial risks.

### Low Yields Expected as U.K. Economy Remains Weak

The U.K. economy remains in fragile health. Weak economic activity is impacting some lines of business to a greater extent than others. While compulsory products are somewhat insulated, policyholders are more likely to consider purchasing lower limits and increasing excesses for discretionary products such as contents insurance. Insurers dependent on trade volumes are also being negatively affected. A deep recession could lead to a further reduction in demand for insurance products.

A protracted period of low investment returns is anticipated. U.K. insurers tend to invest in U.K. government bonds or high-quality corporate bonds, with little exposure to equities. Although returns are expected to be modest, owing to wider credit spreads and low yields on highly rated sovereign debt, A.M. Best does not anticipate a great degree of volatility for U.K. non-life insurers' investments.

Insurers are partially insulated from financial instability in the Eurozone as they tend to hold sterling investments to match their sterling liabilities. However, there is the potential for asset exposure as some U.K. insurers have subsidiaries within the Eurozone, while other U.K. insurers are subsidiaries of Eurozone companies. A significant deterioration in global financial markets remains a risk to U.K non-life insurers.

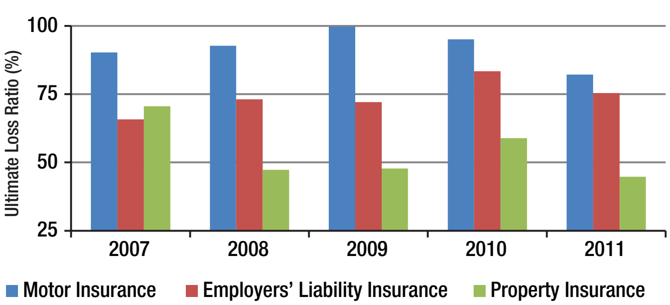
### Solvency II Creates Uncertainty

The prolonged delay to the introduction of Solvency II continues to frustrate many U.K. insurers. The new regulatory standard is currently still on schedule to come into force on 1 January 2014. However, the trilogue discussions – among the European Commission, Council of Ministers and Parliament – intended to produce a final version of Solvency II, were not concluded before the summer recess.

Material issues still need to be finalised regarding non-life calibrations, investment risk charges and equivalence rules. Hybrid instruments, not qualifying as Tier 1 or Tier 2 capital under the new regulatory regime, will be given a transitional period, although it is unclear how long this "grandfathering" period will last. Most of the larger U.K. insurance groups have issued hybrid debt.

Exhibit 1

**U.K. Non-Life – Gross Ultimate Loss Ratio At December 2011**




Source: A.M. Best Co., BestLink Best's Statement File – United Kingdom

## Exhibit 2

### Top 25 U.K. Non-Life Insurance Companies

Ranked by non-life gross premiums written in 2011.

(GBP Millions)

| | | Gross Premiums Written | | Underwriting Result [1] | | Capital and Surplus [2] | |
|---|---|---|---|---|---|---|---|
| Ranking | Company Name | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| 1 | Aviva Insurance Ltd [3] | 4,835 | 4,429 | -93 | n/a | 14,761 | 15,132 |
| 2 | Royal & Sun Alliance Insurance plc | 4,122 | 3,988 | -96 | -160 | 4,598 | 4,707 |
| 3 | UK Insurance Ltd [4] | 3,567 | 1,138 | -67 | -118 | 3,573 | 802 |
| 4 | AXA Insurance UK plc [5] | 3,205 | 3,075 | -124 | -194 | 1,496 | 2,205 |
| 5 | BUPA Insurance Ltd | 2,260 | 2,215 | 135 | 71 | 960 | 842 |
| 6 | ACE European Group Ltd | 2,179 | 2,204 | 56 | 29 | 995 | 937 |
| 7 | Chartis Europe Ltd | 2,148 | 2,251 | -42 | -56 | 1,231 | 1,219 |
| 8 | Great Lakes Reinsurance (UK) plc | 1,914 | 1,776 | 57 | 21 | 346 | 305 |
| 9 | Allianz Insurance plc | 1,764 | 1,594 | 68 | 32 | 922 | 875 |
| 10 | QBE Insurance (Europe) Ltd | 1,283 | 1,282 | -58 | -58 | 1,018 | 1,050 |
| 11 | National Farmers Union Mutual Insurance Society | 1,127 | 969 | 59 | -200 | 2,866 | 2,912 |
| 12 | XL Insurance Company Ltd | 1,072 | 987 | -99 | -72 | 522 | 501 |
| 13 | Ageas Insurance Ltd | 1,066 | 925 | 19 | -65 | 412 | 336 |
| 14 | Liverpool Victoria Insurance Company Ltd | 1,061 | 810 | 22 | -46 | 561 | 518 |
| 15 | British Gas Insurance Ltd | 1,029 | 813 | 74 | 38 | 210 | 154 |
| 16 | Aspen Insurance UK Ltd | 836 | 892 | -23 | 21 | 911 | 834 |
| 17 | FM Insurance Company Ltd | 796 | 766 | -44 | -39 | 385 | 400 |
| 18 | Chubb Insurance Company of Europe SE | 738 | 777 | 76 | 105 | 997 | 1,005 |
| 19 | CIS General Insurance Ltd | 669 | 574 | 20 | 15 | 274 | 284 |
| 20 | Tesco Underwriting Ltd | 655 | 87 | -1 | -18 | 141 | 123 |
| 21 | International Insurance Company of Hannover Ltd | 599 | 550 | 16 | 17 | 116 | 119 |
| 22 | Lloyds TSB General Insurance Ltd | 560 | 594 | 168 | 123 | 345 | 345 |
| 23 | Brit Insurance Ltd | 550 | 634 | 57 | 61 | 397 | 448 |
| 24 | St Andrews Insurance plc | 523 | 637 | 176 | 154 | 331 | 319 |
| 25 | Esure Insurance Ltd | 513 | 468 | 46 | -20 | 185 | 152 |

[1] Underwriting Result is before transfers to/from Equalisation Provision and includes allocated investment return.
[2] Capital and Surplus includes equalisation provisions.
[3] Aviva Insurance Ltd is the new consolidated return of the Aviva Group which previously filed two returns for Aviva International Insurance Ltd and Aviva Insurance UK Ltd. The 2010 comparatives are taken from the restated 2011 return and are not the aggregate of the previously filed 2010 returns.
[4] UK Insurance Ltd acquired the portfolios of Direct Line Insurance plc, Churchill Insurance Company Ltd and National Insurance and Guarantee Corporation Ltd during the year.
[5] AXA Insurance UK plc is the new consolidated return of the AXA Insurance Group, previously filed under AXA Insurance plc. The 2010 comparatives are taken from the 2010 return of AXA Insurance plc.
Source: A.M. Best research, based on FSA returns.

Any delay to the Solvency II implementation date would remove some of the competitive advantages anticipated by the larger and more sophisticated companies that tend to be fairly well-advanced in their preparations for Solvency II. These insurers have invested a considerable amount of time and expense in preparing for Solvency II compliance. The longer the delays, the greater will be the expense they are likely to incur. Conversely, a further postponement to the implementation deadline would provide smaller and less-prepared companies with some breathing space. Delays in Solvency II implementation would therefore reduce the drivers for mergers and acquisitions.

## Exhibit 3

### U.K. Property – Combined Ratios* (2007-2011)

(%)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| Accident-Year Combined Ratio | 122.8 | 104.2 | 99.7 | 106.0 | 97.5 |
| Effect of Prior-Year Reserve Movements | -5.9 | -6.1 | -6.1 | -4.8 | -0.2 |
| Calendar-Year Combined Ratio | 116.9 | 98.2 | 93.6 | 101.2 | 97.3 |

*Data are based on FSA returns for all firms reporting on a one-year underwriting basis.
Source: A.M. Best Co., BestLink® Best's Statement File – United Kingdom

### Property

Helped by reserve releases, property business has generally been profitable for insurers. **Exhibit 3** shows that in three of the past five years, the market has reported a calendar-year combined ratio below 100%. In 2010, the ratio was just above 100% due to losses related to the year's winter freeze, and 2007 earnings were affected by claims resulting from severe flooding.

Most years have developed favourably since 2002 (see **Exhibit 4**). In 2002, property insurers were initially forecasting a 61% loss ratio, which over time, has improved to 55%. The exception to this trend is the 2010 accident year, for which there has been a strengthening of loss reserves, primarily due to insurers underestimating losses from the U.K. winter freeze at the end of the year.

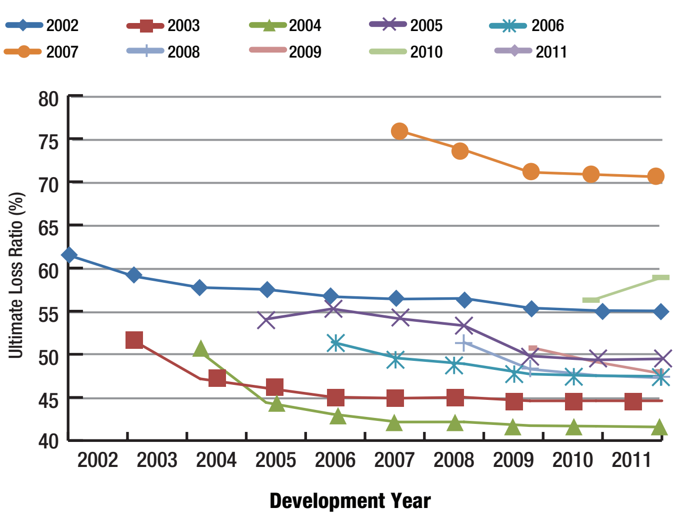
The U.K. property market has faced a difficult 2012, with the Association of British Insurers (ABI) estimating that the extreme rainfall in June will lead to claims of up to GBP 500 million. These estimates preceded further flooding in July. However, insured losses will not be on the same scale as those for the summer of 2007, which cost the insurance industry approximately GBP 3 billion.

A.M. Best understands that the floods in 2012, to date, will be classed as a number of small individual events. Consequently, it is unlikely that reinsurance programmes will be hit, and losses will principally be retained in the primary market.

Prior to the 2012 floods, rates had experienced some upward pressure, although increases were modest. Rates are expected to gain further momentum post the June and July floods, but to what extent remains to be seen. The recent flooding in September will add further pressure to lift rises.

## Exhibit 4

### U.K. Property – Gross Ultimate Accident-Year Loss Ratio Development (2002-2011)




Source: A.M. Best Co., BestLink® Best's Statement File – United Kingdom

The level of weather-related losses is a key driver of performance in the property sector, and flood risk in particular is a major concern. In 2000, U.K. property insurers agreed to provide flood coverage under an agreement known as the Statement of Principles on the Provision of Flood Insurance (SoP), provided the government invested in adequate flood defence programmes. The agreement, however, is set to expire on 30 June, 2013.

To ensure that insurance for homes at risk of flooding remains widely available and affordable, work is underway to establish a successor arrangement to the SoP. An approach, encouraging individuals and communities to continue taking actions to reduce the risk of flood damage, is being sought.

The U.K. government – with the insurance industry's support – is considering a way of formalising the existing pricing arrangements under the SoP, and maintaining the current cross-subsidy between lower-risk and higher-risk policyholders. This would be achieved through an internal industry levy, avoiding increasing costs for those not at risk, whilst helping households to continue to afford insurance in flood-prone areas. In addition, there have been significant advances in flood-risk mapping and forecasting which, in turn, is giving insurers the ability to more accurately ascribe the level of flood risk to individual properties.

The property sector also faces challenges with the depressed financial environment. There is anecdotal evidence that, during recessions, theft and fraudulent and exaggerated claims increase. While the number of fraudulent claims may reportedly be rising, it is difficult to determine if this is a consequence of increased dishonest activity or a result of insurers employing more accurate fraud-detection systems and techniques.

### Motor

Despite increasing rates over the past few years, the motor market posted a combined ratio in excess of 100% from 2007 to 2011 (**Exhibit 5**). Prior-year reserve releases made a substantial contribution to the overall combined ratio in 2007 and 2008. However, in 2009, an accident-year combined ratio of 121.6%, combined with a drop in prior-year reserve releases, resulted in a calendar-year combined ratio of almost 120%.

## Exhibit 5

### U.K. Motor – Combined Ratios* (2007-2011)

(%)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| Accident-Year Combined Ratio | 113.0 | 114.7 | 121.6 | 113.5 | 104.6 |
| Effect of Prior-Year Reserve Movements | -11.5 | -9.2 | -2.1 | 5.3 | 0.2 |
| Calendar-Year Combined Ratio | 101.4 | 105.6 | 119.5 | 118.8 | 104.7 |

*Data are based on FSA returns for all firms reporting on a one-year underwriting basis.
A.M. Best Co., BestLink® Best's Statement File – United Kingdom

Substantial rate increases from 2009 have had a positive impact on the accident-year combined ratio, although it was still in excess of 100% in 2010 and 2011. The market has also strengthened its reserves in these two years by over five percentage points in 2010, and marginally in 2011.

While the insurance motor market remained unprofitable in 2011, underwriting performance did improve. It is unclear whether motor will be a profitable line of business for 2012. To an extent, motor insurers can operate with combined ratios in excess of 100% as they are generally part of larger companies that have opportunities to cross-sell other personal line products, such as building and contents insurance.

It is unclear how long insurers will be able to sustain rate increases, and whether such rises will enable companies to build up adequate reserves, given bodily injury trends. Rates for individual motorists will also be influenced by a European Court of Justice ruling in March 2011, which will ban European Union member states from using gender as a criterion for financial services pricing from December 2012.

An increase in U.K. motor insurance rates has been fuelled in part by a higher claims frequency. The number of claimants per event appears to have stabilised but bodily injury claims continue to increase as a proportion of overall claims. It is not clear whether this upward trend in motor bodily-injury cases can be curtailed by growing political and industry action.

The U.K. insurance industry is also experiencing an increase in the use of periodical payment orders (PPOs) to settle high-value personal injury claims, such as brain or spine damage. Under PPO settlements, claimants receive an initial lump-sum award together with regular payments to cover ongoing medical costs. The requirement for all U.K. drivers to have unlimited third-party liability cover means that PPOs are most prevalent in motor claims.

The long-term nature of these liabilities exposes motor insurers to longevity risk – the risk that a person will live longer than expected – as well as inflation and investment risk. Insurers pass much of the risk of large payouts to the reinsurance market, which has begun to impose restrictions on coverage and higher prices.

Some governmental and insurance industry initiatives being taken, in theory, could reduce the cost of claims. In May 2012, the Office of Fair Trading (OFT) provisionally referred the U.K. private motor insurance market to the Competition Commission. The OFT suspected there were features of the market that were increasing the cost of repair and replacement vehicle claims, made by drivers that were not at fault for road traffic accidents, causing higher insurance premiums.

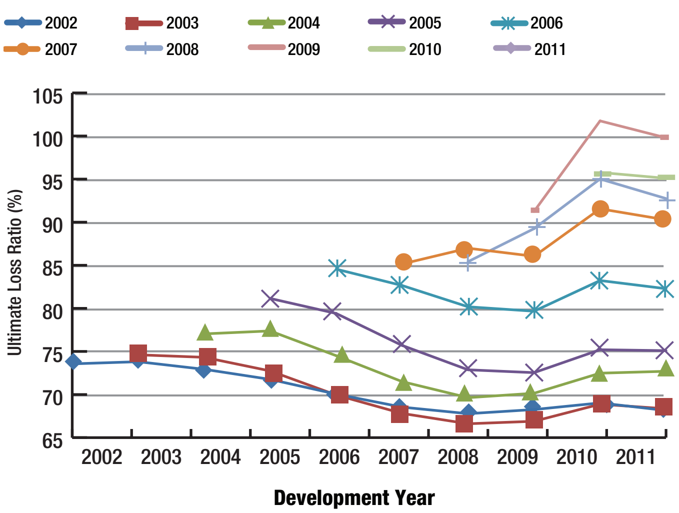
The OFT found that insurers of not-at-fault drivers – as well as their brokers, credit vehicle-hire providers and other service suppliers to motor insurers – could generate revenues through referral fees or rebates. This could inflate the costs of the at-fault driver's insurer.

Theoretically, the government's decision to implement the majority of the recommendations proposed by Lord Justice Jackson in his Review of Civil Litigation Costs should lead to a reduction in the cost of claims. The Jackson Review proposed a ban on referral fees, however, A.M. Best believes the impact of the review may be limited, as an increased propensity to make claims has become embedded in society.

The motor market remains competitive. Aggregator websites – which are already widely used in the personal motor market – are becoming more prevalent in the commercial market and are increasing price-based competition, particularly for small risks such as vans. Risks for small fleets of vehicles are still placed by brokers, but intermediaries are increasingly using e-trading platforms. The medium-to-large sized fleets continue to be traditionally underwritten.

Exhibit 6

**U.K. Motor – Gross Ultimate Accident-Year Loss Ratio Development (2002-2011)**




Source: A.M. Best Co., BestLink Best's Statement File – United Kingdom

Telematics is still in its infancy, but growth is anticipated. A telematics GPS device fitted into vehicles enables insurers to monitor and measure driving performance and offers the potential to improve claims performance. For the motorist, telematics represents a personalised insurance product, based on when and how the vehicle is driven.

## Liability

Over the past five years, earnings for the liability sector have been affected by weak premium rates, a more litigious claims environment and inconsistent reserve movements (**Exhibit 7**). Performance has also been hit by claims related to the financial crisis and subsequent economic downturn.

### Exhibit 7

**U.K. Liability – Combined Ratios* (2007-2011)**

(%)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| Accident-Year Combined Ratio | 106.4 | 106.9 | 108.6 | 113.8 | 118.0 |
| Effect of Prior-Year Reserve Movements | -8.9 | 1.2 | -4.0 | -7.1 | -9.3 |
| Calendar-Year Combined Ratio | 97.4 | 108.1 | 104.7 | 106.7 | 108.7 |

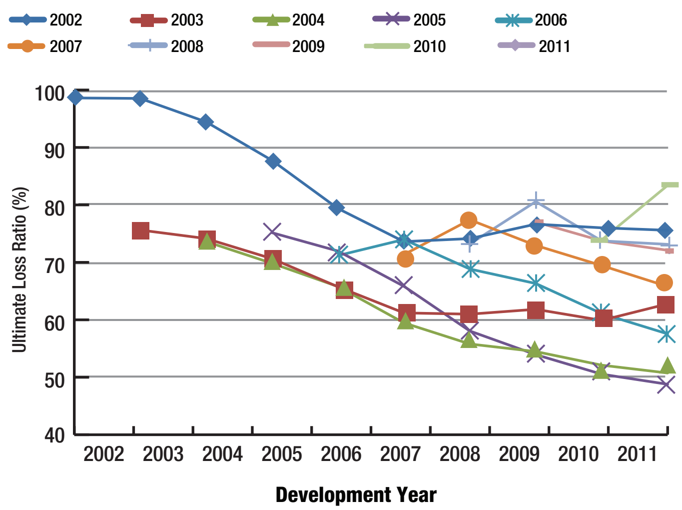
*Data are based on FSA returns for all firms reporting on a one-year underwriting basis.
A.M. Best Co., BestLink® Best's Statement File – United Kingdom

Determining adequate pricing and reserving is particularly problematic for long-tail liability lines because of the extended period between a policy being underwritten and a claim being paid. In recent years, A.M. Best believes the risk of under-reserving has been exacerbated by strong competition and weak market conditions. In addition, the uncertain economic outlook makes it harder to predict claims trends, which means that reserving for long-tail lines has become more difficult.

In general, there have been broadly favourable loss ratio developments for employers' liability (EL) risks. When market conditions for liability business were good, from 2002 to 2006, the ultimate accident-year loss ratios have improved by 13 to 26 percentage points (see **Exhibit 8**). However, positive reserve development for more recent accident years has been modest, and reserves for the 2010 accident year had to be strengthened last year.

### Exhibit 8

**U.K. Employers' Liability – Gross Ultimate Accident-Year Loss Ratio Development (2002-2011)**




Source: A.M. Best Co., BestLink® Best's Statement File – United Kingdom

Claims experience for EL risks has been positively affected by improvements to workplace safety. However, to an extent, the fact that people are more likely to claim offsets the improved working conditions. There are concerns that, as companies rein in their spending during these difficult economic times, claims will increase.

The development of a claims culture in the U.K. is also evident in public liability insurance. According to the ABI, claims for this line of business increased by 18% between 2007 and 2011.

For professional indemnity (PI) risks, claims experience remains unfavourable for certain professions, including solicitors and architects. Rates for these professions exposed to the property sector remain high as capacity is withdrawn. Outside of these lines of business, PI rates remain under pressure, with modest rate rises barely adequate to cover claims inflation.

It is too early to predict if there will be an increase in PI or D&O claims as a result of the LIBOR scandal. On the PI side, claims could come from customers who feel deceived by being sold products that were linked to the LIBOR rate. Claims under D&O policies could arise from shareholders who have seen a decline in share prices. Shareholder lawsuits against company directors would be based on the notion that the directors had failed to fulfil their corporate governance responsibilities.

## Market Capitalisation Remains Robust

Financial performance in the U.K. non-life sector remains under pressure in 2012. Flood losses have pushed up insurers' loss ratios, and the weak economic environment is having a negative impact on both investment returns and loss experience.

Earnings support from positive prior-year development is expected to reduce, narrowing the gap between accident- and calendar-year performances. A.M. Best expects reserve releases on business written during hard-market conditions, from 2002 to 2006, to be lower than in the recent past as these years reach maturity. Moreover, the uncertain economic outlook, claims inflation and competitive pressure on terms and conditions, are exacerbating concerns regarding the adequacy of reserves for recent accident years.

On a positive note, premium rates for U.K. non-life risks are increasing, most notably in classes with poor recent loss experience, such as motor. However, upward pricing movements are somewhat constrained by strong competition.

In spite of these performance pressures, no material erosion of capital is anticipated for U.K. non-life insurers and the market is expected to maintain its strong capitalisation.

Published by A.M. Best Company

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**SR-2012-156**