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## QBE Underwriting - Syndicate 0386

**Primary Credit Analyst:**

Ali Karakuyu, London (44) 20-7176-7301; ali\_karakuyu@standardandpoors.com

**Secondary Credit Analyst:**

David Laxton, London (44) 20-7176-7079; david\_laxton@standardandpoors.com

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# QBE Underwriting - Syndicate 0386

## Lloyd's Syndicate Assessment

5/Stable (very low dependency)

Financial Strength Rating

None

## Financial Strength Ratings And Lloyd's Syndicate Assessments

Standard & Poor's Ratings Services' insurer financial strength rating on Lloyd's (Lloyd's or the Market; A+/Stable) remains the primary indicator of the level of financial security that is afforded to a policyholder of any syndicate trading in the Lloyd's Market. Lloyd's Syndicate Assessments (LSAs) evaluate, on a scale of '1' (very high dependency) to '5' (very low dependency), the extent of a given syndicate's dependence on the Lloyd's Market rating.

## Major Assessment Factors:

### Strengths:

- Very strong competitive position demonstrated by an exceptionally strong earnings track record
- Strategic alignment with, and operational and financial support provided by, QBE Insurance Group Ltd.
- Strong risk management framework

### Weakness:

- Reserving risk reflecting the syndicate's long-tail focus

## Rationale

The assessment on QBE Underwriting - Syndicate 0386 reflects the syndicate's very strong competitive position demonstrated by an exceptionally strong earnings track record; the strength of the support provided to it as a member of the strategically aligned Australia-based QBE Insurance Group Ltd. (QBE or the group; A/Stable/--; core operating subsidiaries are rated A+/Stable); as well as its strong risk management framework. The reserving risk posed by the syndicate's long-tail focus represents a weakness for the assessment.

As the leading specialist non-U.S. liability syndicate at Lloyd's, Syndicate 0386 enjoys a very strong competitive position, which is underpinned by its superior technical skills, proactive cycle management, and longevity. The syndicate takes leadership positions on about 88% of the business it underwrites. The syndicate has consistently and materially outperformed the Lloyd's Market average during its 35-year history reflecting the syndicate's focus on cycle management. Over the past five years, it has produced an average combined ratio of 72.2%, which is much stronger than the market average. In 2008, the syndicate recorded a pretax profit of £171 million with a combined ratio of 71.5% benefitting from significant reserve releases relating to prior years lowering the combined ratio by 11 percentage points. Standard & Poor's Ratings Services believes that the syndicate is likely to maintain its procyclical approach to capacity management, and believes that the longevity of the relationships it enjoys with its clients and other stakeholders will enable it to maintain its superior operating performance going forward.

Syndicate 0386 is closely strategically aligned with QBE. The syndicate forms an integral part of the group's Lloyd's operation, which Standard & Poor's considers core to QBE. The benefits the syndicate brings to the group include its exceptional earnings track record and the strength of its competitive position. In turn, the syndicate will continue to benefit from QBE's infrastructure, capital resources, and financial flexibility as a listed entity. We view QBE group's, and consequently Syndicate 0386's, enterprise risk management (ERM) as strong. The ERM framework at the syndicate level is robust and appears to be consistent with the risk management practices prescribed by the group.

The reserving risk posed to the syndicate by its long-tail focus is a weakness for the assessment, despite the syndicate's track record of reserving consistency. This reflects the syndicate's potential for future exposure to latent claims, legal risk, and claims inflation. This is to some extent offset by the syndicate's reserve margin (£96 million as at March 2009) that is held in excess of its best estimate.

## Outlook

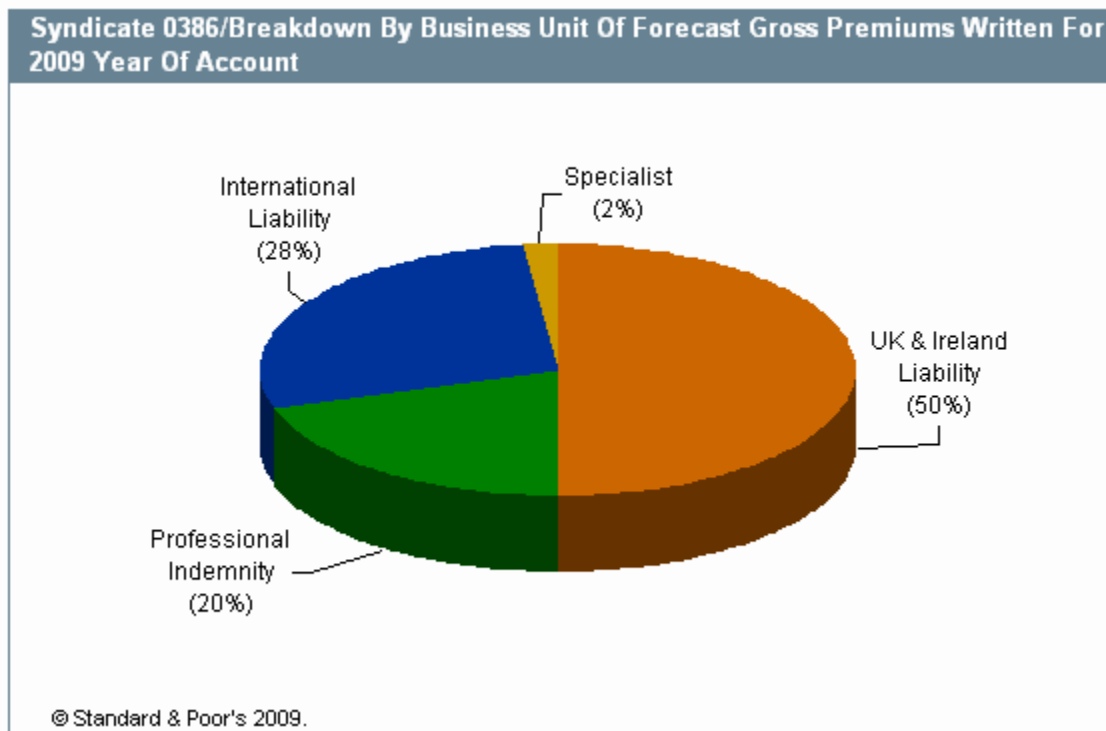
The stable outlook reflects Standard & Poor's view that the syndicate will maintain a procyclical approach to capacity management, thereby enabling it to maintain its superior operating performance going forward.

A material deterioration in Syndicate 0386's operating performance compared with that of the Lloyd's Market across the rating cycle could place downward pressure on the assessment. Events leading to a change in our view of the core status of the Lloyd's operation to QBE group would also likely place downward pressure on the assessment.

## Syndicate Profile: The Leading Specialist Non-U.S. Liability Syndicate At Lloyd's

The forecasted gross premiums written (GPW) for the 2009 year of account by segment are U.K. and Ireland (50%), international liability (28%), professional indemnity (20%), and specialist (2%) (see chart 1).

Chart 1



Syndicate 0386's underwriting capacity for 2009 remained unchanged at £340 million, where it has been since 2006. The syndicate, which is managed by QBE Underwriting Ltd. (QBE Underwriting), has been writing business at Lloyd's since 1974.

In recent years, QBE has steadily increased its economic interest in Syndicate 0386. For 2009, QBE will continue to provide 69.6% of the syndicate's capacity, up from 28% in 2000.

## Competitive Position: A Recognized Leader Within Its Core Markets

As the leading specialist non-U.S. liability syndicate at Lloyd's, Syndicate 0386 enjoys a very strong competitive position, underpinned by its superior technical skills, proactive cycle management, and the longevity of the relationships it enjoys with its clients and other stakeholders.

### Historical

The syndicate's competitive advantages spring from the continuity of its capacity, its technical expertise, and the longevity of the relationships it has developed with its clients and other stakeholders. The information-led advantages the syndicate derives from its own comprehensive historical database are supplemented by the fact that, as a recognized leader, it sees most of the employers' and third-party liability business that is placed within Lloyd's. The syndicate estimates that it leads about 88% of the business it writes. In addition, it believes that its larger client portfolio for the professional indemnity and international accounts is insulated, at least to some extent, from softening prices by the longevity of its client relationships. This, when coupled with an impressive level of underwriting discipline and claims reputation, enables the syndicate to outperform even in a softening market.

As part of an ongoing integration during 2007, the group combined the syndicate's and the company's casualty operations. The integrated division comprises a pool of expertise offering a broad range of specialist casualty products across a variety of distribution channels.

In 2008, the syndicate's gross premium income decreased to £412 million in (£436 million in 2007) largely reflecting the reduction in premium rates. The portfolio has a strong U.K. bias and is consequently heavily geographically concentrated. The U.K. and the rest of the European Union accounted for 65% of the syndicate's GPW in 2008.

About 78% of total premium volume is led by London brokers, with the balance coming via regional brokers who place the business with the syndicate's dedicated underwriting agencies in the U.K. and Ireland. The agency-led business has a regional focus, thereby providing some diversification to the "big ticket" risks written via the broker market. An important element of geographic diversification is provided by the international liability account.

The syndicate has only incidental exposure to the litigious U.S. environment, mainly via its U.K. and international portfolios where some non-U.S.-based groups have a U.S.-domiciled affiliate. Syndicate 0386's U.S.-domiciled exposures account for a modest 1% of total premiums written.

### Prospective

Syndicate 0386 will continue to actively manage the rating cycle. Following the year-on-year reduction in premium income since 2005, we forecast that the syndicate's gross premium income is likely to remain stable over the rating horizon largely reflecting the reduced pressure on pricing.

The allocation of business between the syndicate and QBE's company platform is governed by a protocol designed to protect the interests of the external Names. Consequently, we do not expect to see material reallocation of business between the two platforms for the foreseeable future.

## Management And Corporate Strategy: Long, Established Track Record Of Proactive Cycle Management

We consider the syndicate's management as a positive factor for the assessment. Management's ultimate goal is to maintain its strong earnings track record. The syndicate's proactive cycle management and consistent outperformance of the Market speak for themselves.

Over the assessment horizon, Standard & Poor's does not expect a material reallocation of the syndicate's business to QBE Insurance (Europe) Ltd. (core operating subsidiary of QBE; rated A+/Stable/--), largely due to the residual economic interest in the syndicate currently held by the traditional Names, which is likely to persist at least for the medium term. This is evidenced by QBE's failed attempt, in 2008, to buy out the capacity held by the traditional Names.

QBE currently provides more than two-thirds of the syndicate's underwriting capacity and, as such, the syndicate is required to compete for capital against the group's myriad of operating entities, both in Europe and beyond. For the financial year ended Dec. 31, 2008, the Lloyd's division contributed approximately 19% of the group's aggregate gross premiums earned, with Syndicate 0386 representing about 31% of QBE's business at Lloyd's. Lloyd's premium contribution was somewhat diluted by the group's recent acquisitions in the U.S. The group is forecasting that Lloyd's is likely to contribute 18% of total gross earned premium at year-end 2009. In Standard & Poor's

opinion, however, Lloyd's will continue to remain a significant part of QBE's business.

### **Operational management**

The syndicate's superior cycle management is one of its key strengths, underpinning its ability to consistently outperform the Market. Syndicate 0386 adopts a highly proactive approach to the management of its underwriting capacity in response to market opportunities. The compensation structure rewards underwriters and management for outperformance of internal targets. The syndicate has been consistently outperforming the targeted return on capital employed which is set at 15%. With the recent integration of the casualty business of the company and Lloyd's operation, the syndicate will derive further operational efficiencies.

### **Financial management**

The syndicate's approach to financial management is well developed. In keeping with the policy enshrined at the group level, the syndicate does not take significant risk in respect of its investment portfolio.

## **Accounting: High Level Of Transparency Maintained**

Syndicate 0386 has been running its business on the basis of its annually reported U.K. generally accepted accounting principles (GAAP) financials since its acquisition by QBE in 2000, reflecting the financial metrics that are of most significance to its parent.

## **Enterprise Risk Management: Strong Risk Management Framework**

Standard & Poor's views QBE group's, and consequently Syndicate 0386's, enterprise risk management (ERM) as strong. The group's key risks include insurance underwriting and pricing, catastrophe, and acquisition risks, which are all managed in an effective manner. The ERM framework at the syndicate level is robust and appears to be consistent with the risk management practices prescribed by the group. Although QBE has a well-diversified business profile, the broad nature of its operations combined with its acquisition-based growth strategy makes it an inherently difficult business to manage. Consequently, ERM capabilities of QBE are very important to the rating.

Risk management functions have a high visibility and priority across the group via the Group Chief Risk Officer (CRO) role, with reporting lines to the Audit Committee. The Board's participation in the management of risk across each business unit, combined with the business unit manager's responsibility of their own respective risks, supports the group's strong risk management culture. The number of staff involved in risk management is relatively high, and most operations benefit from the expertise of a local CRO. The group's risk management initiatives include several programs and workshops, which is evidence that the group has a high focus that a strong risk-culture is filtered to levels below senior management.

QBE group continues to enhance its risk management framework and this remains a high priority for the group. More evidence of these efforts is apparent surrounding QBE's usage of its economic capital model (ECM) in strategic decisions. QBE group's usage of the ECM has improved and is now mostly embedded into most risk/reward decisions, capital management, and strategic decisions. Additionally, the group's modeling expertise is viewed as strong. QBE group's credit and market risk management philosophy is conservative and based on the group's strategy that it does not want to add undue investment-related risk to existing insurance-related risk. QBE group's emerging and operational risk management practices are assessed as not as strong as some peers, but are

adequate.

For a vast and diverse operation, the insurer has a robust process to identify and evaluate risk-reward trade-offs and uses that process to consistently optimize risk-adjusted returns. This process has also supported QBE's success in executing its acquisition-growth strategy. However, such an acquisition-based strategy exposes the group to an inherent risk of various business operations being new to the group, and staff and processes unseasoned to QBE's ERM conventions. A higher level of confidence in the framework will come gradually with a sustained track record of effective execution of its ERM process. Greater confidence and stronger evidence of an entrenched excellent risk culture in the organization and across all management levels would support a higher ERM score. Also important would be an improvement in QBE's ability to identify and to manage emerging and operational risks of the group.

## Operating Performance: Consistent, Material Outperformance Of The Lloyd's Market Average

Syndicate 0386 has consistently and materially outperformed the Lloyd's Market average during its 35-year history. Standard & Poor's believes that the continuation of the syndicate's procyclical approach to capacity management will enable it to sustain its superior operating performance going forward.

### Historical

The syndicate's procyclical approach to capacity management has led to a weighted-average return on capacity of 27.4% during this time over the last 10 years.

On a GAAP basis, the syndicate has reported a five-year average combined ratio of 72.2% between 2004 and 2008, placing it at the top end of the Market and its wider peer group. This is an exceptional level of performance for a long-tail book of business, particularly when the conservatism of the syndicate's reserving approach is taken into account. Reserve releases have been a consistent feature of the syndicate's profits. This has not weakened reserve adequacy, which remains strong in our view.

In 2008, the syndicate recorded a pretax profit of £171 million with a combined ratio of 71.5%. The syndicate benefited from significant reserve releases relating to prior years lowering the combined ratio by 11 percentage points.

Resulting from its very conservative investment portfolio geared toward 'AAA' rated bonds, the syndicate managed to post a good investment return of 4.3% in 2008.

### Prospective

We forecast that the syndicate will continue to outperform the Lloyd's market over the long term.

Following the pricing reductions seen over the recent years the syndicate managed to maintain its overall premium rates at a flat level at the January 2009 renewal. In the absence of reserve releases the syndicate is forecasting a combined ratio of about 100% for year-end 2009. However, we anticipate that the syndicate is likely to report a lower combined ratio given the potential for further reserve releases with respect to loss reserves held in respect of prior underwriting years. At the same time, we anticipate that the syndicate is likely to continue earning an appropriate risk-adjusted return on its capital across the assessment horizon.

The expected continuation of the syndicate's conservative investment strategy will cap the investment contribution or losses that can be expected in any given year, which should reinforce the syndicate's focus on generating an appropriate risk-adjusted return on the capital it deploys for underwriting purposes.

## **Investments: Low Appetite For Investment Risk Set To Persist**

Syndicate 0386 adopts a conservative investment policy, mirroring that applied at the QBE group level.

The syndicate invests primarily in money market instruments and fixed-interest securities. These are predominantly 'AAA' rated, but carry a minimum rating of 'A-'. For the financial year ended Dec. 31, 2008, variable-interest securities constituted a 14% of total invested assets. The syndicate does not have any exposure to "subprime" residential mortgage-backed securities or related instruments, nor does it have any exposure to investments carrying guarantees from financial guarantee insurers (known as monoliners).

In our opinion, the syndicate will continue to have a conservative investment strategy over the long term.

## **Liquidity: Considered Strong**

The liquidity of the syndicate is considered strong and fully reflective of the Lloyd's membership requirements for funds to be readily liquid. The syndicate has a strong and stable liquidity ratio, and low level of insurance debtors.

## **Capitalization: Strong Overall, Partly Reflecting The Capital Position At QBE**

Capitalization is strong, underpinned by Lloyd's comprehensive risk-based approach to capital provision and reinforced by the strength of the capital position at the QBE group level.

The level of funding QBE has been required to provide in support of its overall participation at Lloyd's is 67.9% of capacity for 2009. Although this is well above Lloyd's minimum level, largely reflecting Syndicate 0386's long-tail focus, it has fallen from 80% in 2006 because of Syndicate 0386's track record of superior operating performance

Historically, one-half of the FAL (Funds at Lloyd's) requirement was met by the issuance of \$770 million of the innovative ABC securities (rated at 'A-'). For 2009, QBE has successfully managed to finance the balance of its FAL requirement with letters of credit, which are uncollateralized.

### **Reinsurance**

The extent of Syndicate 0386's reliance on reinsurance is substantial, although the overall quality of the syndicate's reinsurance counterparties is considered strong.

The syndicate uses reinsurance both to manage its peak exposures and to enable it to offer its clients the level of capacity they desire without disproportionately exposing its capital base. This enables the syndicate to contribute a maximum line size of £50 million on the employer's liability and general liability classes toward a QBE casualty maximum line size of £100 million while using reinsurance to limit its net exposure.

The syndicate's reinsurance utilization ratio has averaged 15% over the past three years. For the financial year

ended Dec. 31, 2008, on an annually accounted basis, Syndicate 0386 had reinsurance recoverables due to it of £329 million, representing about 97% of its current underwriting capacity. This asset is predominantly held in respect of claims incurred but not yet reported, however, and is likely to be overstated due to the syndicate's conservative reserving approach.

The overall credit quality of the syndicate's reinsurance counterparties is considered strong. The establishment of long-term relationships with reinsurers is of particular importance in respect of long-tail business, and Swiss Reinsurance Company Ltd. (A+/Stable/A-1) has been the leader on the core component of the outward program since the syndicate's formation. The syndicate's level of dependency on cessions within Lloyd's has diminished significantly over the past five years. These accounted for only 1% of the syndicate's outward reinsurance cessions in respect of the 2008 underwriting year, down from more than 15% in 1999.

### Reserves

The reserving risk posed to the syndicate by its long-tail focus is a weakness for the assessment at its current level, despite its track record of reserving consistency. This reflects the syndicate's potential for future exposure to latent claims, legal risk, and claims inflation.

Over the past 11 years, the syndicate has reported a modest release equating to 2.3% of the inward reinsurance-to-close (RITC) premium. However, over recent years the syndicate reported large reserve releases. In 2008, management decided to reduce the explicit reserve margin to 4% of RITC from 5%. The level of conservatism adopted by the syndicate when setting its reserves is consistent with the philosophy applied at the group level. It is also thought to reflect the onus the continued involvement of traditional Names provides to the managing agency to ensure that it sets reserves at a level sufficient to ensure that equity between Names is achieved. The stability of the syndicate's portfolio over time, and its impressive levels of client persistency, also aid the integrity of the reserving process (see table 1).

**Table 1**

Syndicate 0386/Impressive Consistency Of Reserves Over Time													
--Underwriting year--													
(Mil. £)	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	Average
RITC Received	728.9	640.4	626.5	575.5	492.9	419.6	380.1	333.9	304.4	268.6	230.5	171.2	431.0
Profit / (loss) on RITC received	49.8	23.7	29.2	8.6	(13.5)	1.4	4.8	(0.5)	9.2	6.4	0.9	(1.4)	9.9
Profit / (loss) as % of RITC received	6.8	3.7	4.7	1.5	(2.7)	0.3	1.3	(0.1)	3.0	2.4	0.4	(0.8)	2.3

RITC--Reinsurance-to-close.

The only material strengthening of reserves was made in respect of the 2001 and prior underwriting years. This was attributable to a tightening of the reserving basis in respect of the professional indemnity account (particularly where the syndicate is a follower) following a review. Standard & Poor's derives comfort from the fact that the reserves now held in respect of the problematic areas of the account continue to show positive development.

## Financial Flexibility: Closely Strategically Aligned With The QBE Group

Most of the syndicate's financial flexibility is derived from its membership of the QBE group. The syndicate forms an integral part of the group's Lloyd's operation, which Standard & Poor's considers core to QBE. This is due to the

large size of QBE's Lloyd's operation relative to the whole group and the underwriting expertise and diversification benefits it brings to the group. In turn, the syndicate benefits from QBE's infrastructure, capital resources, and financial flexibility as a listed company.

Nevertheless, the proportion of the group's premium income produced by QBE Underwriting is expected to diminish over time because it is likely that the group will pursue its growth through acquisition outside Lloyd's where practicable. This has been demonstrated through QBE's two significant acquisitions in the U.S. in 2007.

**Table 2**

<b>QBE Underwriting - Syndicate 0386/Key Financial Data</b>					
<b>--Year ended Dec. 31.--</b>					
<b>(%)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Operating performance</b>					
Combined ratio	71.5	70.4	77.6	60.6	80.8
Loss ratio	53.6	42.7	44.0	30.1	52.7
Expense ratio	17.9	27.7	33.5	30.4	28.1
Return on revenue	38.2	38.3	34.1	48.5	29.8
<b>Investments and liquidity</b>					
Receivables ratio	13.5	13.9	12.1	11.4	8.3
Liquidity ratio	107.8	109.1	124.2	136.8	133
Investment yield	4.3	4.3	4.7	4.6	4.9
<b>Reinsurance</b>					
Premium retention ratio	87.1	85.7	83.5	87.4	82.9
Loss retention ratio	77.3	82.1	92.4	90.7	90.3
<b>Reserves</b>					
Reserves/net premiums written	352.4	306.9	293.8	284.8	293.4

**Ratings Detail (As Of July 23, 2009)\*****QBE Underwriting - Syndicate 0386**

<b>Holding Company</b>	QBE Insurance Group Ltd.
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<b>Domicile</b>	United Kingdom
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\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

**Additional Contact:**

Insurance Ratings Europe; [Insurancelnteractive\\_Europe@standardandpoors.com](mailto:Insurancelnteractive_Europe@standardandpoors.com)

**Additional Contact:**

Insurance Ratings Europe; [Insurancelnteractive\\_Europe@standardandpoors.com](mailto:Insurancelnteractive_Europe@standardandpoors.com)

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