

The Litmus Rating Review

Reinsurance & Specialty Edition

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Introduction

This month we are introducing a regular calculation of sector rating averages from Best and S&P.

We calculate each agency's overall average for each cohort (the 'Majors' and the 'L-Zebedees') and an average based just on those carriers rated by both agencies.

The latter gives us a window into the relative degree of conservatism embedded in each agency's approach.

In line with our impression of much of the market's expectation, S&P emerges as the more conservative, but not by much!

We examine the differences in more detail in this month's commentary section.

In calculating the averages for the first time we took a look at the make-up of the two cohorts and particularly where the reinsurance operations of Fairfax and White Mountains should sit.

On balance we felt their profile was better suited to the L-Zebedee cohort and so we have moved them for this month onwards.

Also added to the L-Zebedee list this month are reference carriers for the Navigators, HCC (Houston Casualty) and Maiden Re groups. The make-up of the cohorts is discussed on page 4.

There have been two noteworthy rating upgrades since October's edition of the LRR. XL's core carriers were upgraded by S&P and put on a positive outlook by A.M. Best (an example where S&P rates higher than Best). Enhanced current year and prospective earnings were (as so often) the key. Allied World's core carriers meantime were upgraded by Best.

Finally from this month we are adopting the convention of just quoting in our commentaries the relevant A.M. Best 'Issuer Credit Rating' on carriers (the rating Best issues using the same rating scale as S&P but using the lower case; e.g. 'a+') rather than quoting both this and the financial strength rating.

We think this makes the discussion clearer. The relationship between Best's Financial Strength Ratings and its Issuer Credit Ratings for re/insurance carriers is covered on page 5.

Litmus Score Averages as at 21/11/2013						
<i>Majors</i>						
	S&P			A.M. Best		
	Mean LS ¹	Mean Rating	RI ²	Mean LS	Mean Rating	RI ²
Total Cohort	85.5	A+	R6	87.5	aa-	R3
Dual Rated Only	85.5	A+	R6	87.5	aa-	R3
<i>L-Zebedees</i>						
	S&P			A.M. Best		
	Mean LS ¹	Mean Rating	RI ²	Mean LS	Mean Rating	RI ²
Total Cohort	80.1	A	R5	82.4	a+	R2
Dual Rated Only	80.1	A	R5	82.8	a+	R2

¹LS=Litmus Score (see page 4)

²RI = Resilience Indicator (see page 5)

The Litmus Commentary

It's a question of capital—comparing Best and S&P ratings for the L-Zebedees cohort

It's a question of capital; or rather, it's a question of the relative importance given to capital in the overall analysis.

Firstly we should note that the average difference in rating outcomes is small. For the L-Zebedee cohort A.M. Best's mean rating¹ is 'a+' among those rated by both it and S&P, whereas S&P's mean rating is just one notch below at 'A'.

Even this somewhat overstates the difference. We have developed the concept of a 'resilience indicator' (see page 5) to highlight how far an average rating outcome is from dropping to the rating level below.

The S&P outcome for this highlights that its 'A' mean rating is actually closer to the 'A+' level than the 'A-' level. Whereas the Best mean rating resilience indicator identifies that its 'a+' mean is closer to the 'a' level rather than the 'aa-' level.

Thus both are close to the A/A+ rating boundary with S&P a little below and A.M. Best a little above.

Nonetheless important differences exist at the individual rating level. For A.M. Best, 10 groups in the L-Zebedee cohort have their reference carriers rated 'a+' or above, 5 of which are rated 'aa-' or higher. S&P rates only 6 of the reference carriers at 'A+' or above of which just 2 are rated 'AA-' or above.

Both agencies consider the same issues when producing their ratings, so what drives the difference?

Best has sometimes been regarded as simply being more inclined to assign higher ratings than S&P, but that assumption really does not bear up to detailed scrutiny of individual cases (at least for this sector). From our perspective the higher average rating is not derived from an inherent tendency to rate higher; rather it comes from the greater relative degree of emphasis A.M. Best gives to risk adjusted capital adequacy.

Simply put; under S&P's rating criteria it's extremely difficult

for even those re/insurers with the highest levels of risk-adjusted capital to be rated above 'A+' unless what S&P refers to as the 'business risk profile' is also at the "very strong" level. A "very strong" business risk profile is something that the agency stresses is, by its nature, difficult to achieve.

The business risk profile reflects analysis of the issues that drive long-run 'earnings quality' (the structural ability to generate profits and the expected volatility of those profits). Some of this has to do with the economic characteristics of the market involved, but a lot of this relates to the rated organisation's perceived market power and an associated ability to out-perform its peers.

Since a financial strength rating is specific to the ability to pay valid insurance claims – not a general analysis of business quality – the importance S&P attaches to this might seem a bit unnecessary. But S&P believes that the ability to generate high quality future earnings is the bedrock of future solvency.

All of the above are issues Best cares about too, and for the same reason. But they overlay that to a greater degree than S&P with the core premise that risk-adjusted capital adequacy represents the credit risk 'protection' afforded to policy-holders and, ultimately, the ability to pay future claims is about the future capital adequacy derived from the current position.

Both perspectives essentially address the same issues and often end up in the same place. But it's the greater degree of emphasis in the aggregate by A.M. Best on capital, rather than any innate tendency to rate higher in this sector, that drives most of the rating differences we see in reinsurance and speciality lines.

¹Note—we are using A.M. Best's ICR ratings; they use lower case for these ratings

Individual Agency Activity

A.M. Best

Largely rating affirmations from Best this month (the Tower group whose ratings were downgraded to B++ does not really fit our coverage profile).

However the core carriers of Allied World were upgraded to 'a+' with a stable outlook. Also the core carriers of XL (rated 'a') were moved to a 'positive' outlook.

Fitch

Fitch withdrew its ratings on the Fairfax group (including Odyssey Re). From its commentary we presume these ratings had been 'unsolicited' and Fitch has simply chosen not to maintain these.

Fitch placed the US sovereign rating on negative watch but noted that the handful of AAA re/insurer ratings it publishes

would be unaffected by a downgrade (unless this is caused by a wider systemic problem within the US economy). We could, however, imagine that the increased capital charges for re/insurer holders of treasuries might impact some of Fitch's rated universe overall.

The agency has announced the publication of 'unrated issuer reports' on selected re/insurers. These are only available to subscribers and run through Fitch's take on key aspects of the credit profile without publishing a rating outcome. Talanx is included in the initial coverage.

The agency has published a paper on its new capital model (The Prism Factor-Based Capital Model) and is requesting feedback. The model is somewhat simpler in its execution than the original Prism model and is also moving from being an 'economic capital model' to a 'rating agency capital model'. In essence this means the addition of some conservatism beyond what a purely theoretical economic perspective might be.

Litmus Blog Archive

The following articles and guides are available from our blog (litmusanalysisblog.wordpress.com)

Reinsurers and GSII: Global, certainly; important, for sure; but 'systemically' risky? (15th October 2013)

How the regulatory trend to treat the largest reinsurers as a source of systemic risk is both potentially counter-productive and missing an opportunity to add to the stability of the world financial system.

Lloyd's on the cusp of 'AA' range ratings; this could be a game-changer (20 September 2013)

The potential for those with a 'Lloyd's platform' to offer 'AA' range paper if one of the three agencies acts on their current 'positive' rating outlooks, including current or potential market participants who could never realistically expect to achieve that rating level for their carriers outside of the market.

The Litmus First XI – Top Tips for Managing the Relationship with your Rating Agency (15 September 2013)

A summary reference guide to the most common issues we see when re/insurers feel their rating is not what they deserve.

The Litmus Analysis Quick Reference Guide – to non-life re/insurer key metrics and ratios (12 September 2013)

Moody's

Largely rating affirmations this month (although broker Cooper Gay was downgraded).

S&P

As noted earlier the agency upgraded the core carriers of the XL group to 'A+' (stable outlook), the first of our covered groups to have a higher S&P rating for its core carriers than its Best rating.

S&P also assigned a positive outlook to the 'A+' ratings of SCOR's core carriers following their review of the group's economic capital model.

More generally the agency has continued with the publication of the individual analytical reports behind its recently launched IICRAs (insurance industry & country risk assessments). The UK, Japan and Australian P&C country reports were among those published in the last month. S&P also upgrade the Marsh & McLennan Companies corporate credit rating to BBB+/Stable.

A straightforward summary of how the most commonly used ratios are calculated and why they are used. Including in each case our guide to 'whether a higher number is better or worse'.

The Perils of Ineffective Use of Ratings (5 September 2013)

A run though of how the use of ratings by brokers and buyers (in either an economic or governance context) needs to reflect what they actually are (forecasts) and background information to how best to use them.

Reinsurer profitability and the interest rate myth; part 2 (14 August 2013)

An update to our original note on how the idea that reduced investment returns within re/insurer P&L's is the cause of weak earnings is nonsense and that it is competition within the industry, not lack of investment income, that truly drives earnings down.

International Group of P&I Club Ratings Updated on S&P New Criteria: At Last, Sense has Prevailed (7 August 2013)

How in moving to its new rating criteria and associated updates of all of its ratings, S&P has seemingly addressed a long-standing anomaly in its ratings around the 'failure' potential for what it perceives as the weaker P&I clubs.

Lloyd's, Aon, the Berkshire 'side car' and the history of the London Market; what really is the strategic concern? (9 July 2013)

A discussion on why, given the London market's history as a hub for intellectual property based on the co-insurance model, the Aon/Berkshire side-car should be seen as an endorsement of London's competitive strengths.

Ratings of Catlin, Lancashire, Partner Re and Platinum Underwriters highlight the fundamental impact of ERM vs. capital on S&P's reinsurer ratings (30 June 2013)

A review of how the greater disclosure from S&P in its rating reports highlights how their analysis of each reinsurer's ERM fundamentally impacts the final outcome.

Spanish reinsurer rating updates highlight sovereign rating impact and differences between S&P and AM Best (24 June 2013)

How S&P's treatment of sovereign risk is creating some unusually big differences in rating outcome between itself and A.M Best, including where this pushes a rating below the common 'market requirement' of 'A-'.

The make-up of the 'Litmus Rating Review' ('LRR') cohorts

The two cohorts covered within the LRR are chosen to provide a representative picture of the credit profile of the international reinsurance & specialty lines sector. As the LRR is a ratings-focussed publication the nature of each group's business profile as that relates to ratings plays a role in its inclusion overall and the cohort it is assigned to.

The 'Majors'

Either non-life reinsurance groups that we regard as inherently global (including those who also write material amounts of life reinsurance business) or those globally

active primary groups with material 'third-party' reinsurance operations.

The 'L-Zebedees'

Either groups whose operations are highly orientated to the kind of reinsurance and speciality business written in the major hubs of London, Zurich, Bermuda, Dublin or Singapore OR sub-groups who fit this profile and who appear operationally or financially discrete from the total group profile (Odyssey Re and Sirius International being examples of the latter).

Litmus Composite Score (LCS) Methodology

Overview

The two most widely referred to rating agencies in the global reinsurance and specialty lines sector are A.M. Best and S&P. Most groups active internationally in the sector have a financial strength rating (FSR) from both agencies assigned to at least their main carriers. We highlight the rating assigned to what we would consider to be a main group carrier (or where that is not clear, a significant carrier for the group in this sector). This is described by us as the 'group reference carrier'. Lloyd's syndicates are not considered for this as we use the Lloyd's market rating for LRR reporting.

We begin by producing the Litmus Score (LS). This translates each agency's Financial Strength Rating (FSR) on the group reference carrier to a numerical score. The exact score assigned reflects both the rating and the rating outlook. As A.M. Best uses a different rating scale from S&P for FSRs we use the A.M. Best Issuer Credit Rating (ICR) assigned to the group reference carrier (and its outlook).

Where ratings from both agencies exist we then produce the Litmus Composite Score (LCS) and map that back to the S&P rating scale.

Where there is no clear outcome for the LCS mapping we use Fitch and/or Moody's ratings as 'tie-breakers'. If this still produces no clear outcome we then give greatest weight to the rating from whichever of S&P and A.M. Best has the lowest mean Litmus Score for the cohort from those carriers rated by both agencies.

The Litmus Score (LS)

The LS is calculated out of 100. Each notch on the S&P rating scale is covered by 4 points on the LS scale. For example, a AA- rating with a stable outlook is assigned an LS of 88, whereas an A+ rating with a stable outlook is assigned an LS of 84.

A positive or negative outlook respectively increases or decreases the LS relative to that for the stable outlook by one point.

The Litmus Composite Score (LCS)

The LCS is the arithmetic mean of the LS outcomes. Where the group reference carrier has only one rating from A. M. Best or S&P this is not assigned. We do not substitute either a Fitch or Moody's rating in such a case as this would challenge the consistency of the calculation process (however we are very open to market participant feedback on this).

In the event that the LCS comes out at a point equidistant from the relevant ratings scale mappings (e.g. as with an LCS outcome of 86 being two points from both the AA- and A+ mappings) we employ the 'tie-breaker' process described later.

Rating Scale Mapping Tie-breakers

Where, as noted above, the LCS comes out at a point equidistant from the relevant ratings scale mappings, we use the Fitch and/or Moody's Insurer Financial Strength Ratings (IFSs) on the group reference carrier as the tie-breaker. Both ratings are used if both exist or just one if not.

Litmus Scores calculated from Fitch/Moody's IFSs are not included in the LCS (as this would challenge the consistency of the calculation); rather they simply impact the selected rating scale mapping of the LCS where a tie-break on this is required. Thus, if the Fitch/Moody's LS outcome is below

The Use of A.M. Best ICRs

In order to create a consistent basis of calculation we use the A.M. Best ICR issued on the group reference carrier as this is assigned using the same scale as S&P FSRs. It should be noted that we are making no judgment as to whether S&P and A.M. Best ratings are equivalent when expressed using the same scale.

A.M. Best assigns ICRs to rated carriers that issue policies at the same level as the FSR (but, as above, using the same scale that S&P uses for its FSRs). The outlook can however vary between Best's FSR and ICR on the same rated carrier. This is because of the greater number of gradations in the S&P-type scale. For the LS and LCS calculations we use the ICR rating and outlook.

that of the LCS the lower mapping is selected; and if the Fitch/Moody's LS outcome is above that of the LCS the higher mapping is selected. In the event that neither Fitch nor Moody's ratings on the group reference carrier exist, or that they also do not differentiate between the two mapping options, the S&P/A.M. Best rating from the agency with the lower mean LS for that cohort (on those group reference carriers rated for both) is given greater weight in deciding the mapping (this does not change the LCS).

Litmus Composite Score (LCS) Resilience Indicator (RI)

The LCS Resilience Indicator highlights how close the LCS outcome is to a rating scale mapping below its current level.

RI Code		LCS Mapping Description
R7	Highest	The current rating mapping reflects the application of a negative 'tie-break' and hence the LCS is the highest possible for that rating scale mapping
R6	High	The LCS is materially above the median score for that rating scale mapping
R5	Moderately High	The LCS is somewhat above the median score for that rating scale mapping
R4	Average	The LCS is exactly at the median score for that rating scale mapping
R3	Moderately Low	The LCS is somewhat below the median score for that rating scale mapping
R2	Low	The LCS is materially below the median score for that rating scale mapping
R1	Lowest	The current rating mapping reflects the application of a positive 'tie-break' and hence the LCS is the lowest possible for that rating scale mapping

Ratings Round-up, LS and LCS outcomes - Majors											Ratings as at 21/11/2013	
We have used the following abbreviations -							¹ Pos=Positive, St=Stable, Neg=Negative					
² F=Fitch, M=Moody's							³ ISO 3166-1 Alpha-2 codes					
Groups/Sub-groups	LUCID Company Name	S&P Ratings		A.M. Best Ratings			LCS Calculations				GRC Details	
		S&P FSR/Outlook ¹	Litmus Score	AM Best FSR	AM Best ICR/Outlook ¹	Litmus Score	Litmus Composite Score (LCS)	LCS Ratings Mapping	LCS Resilience Indicator	Tie-break Source ²	GRC Domicile ³	LUCID For details of the LUCID system, email info@litmusanalysis.com
Cohort: Majors												
Ace	ACE Tempest Reinsurance Ltd	AA-/Pos	89	A+	aa/Pos	93	91	AA (LCS)	R3		BM	ACEG/A1445A
Alleghany	Transatlantic Reinsurance Co	A+/St	84	A	a+/St	84	84	A+ (LCS)	R4		US	ALLE/A1213A
Berkshire Hathaway	National Indemnity Co	AA+/Neg	95	A++	aaa/St	100	97.5	AA+ (LCS)	R6		US	BEHA/A2374A
Everest Re	Everest Reinsurance Co	A+/St	84	A+	aa-/St	88	86	AA-(LCS)	R1	F	US	EVER/A1756A
HDI	Hannover Rueckversicherung SE	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4		DE	HDIG/A2565A
Mapfre	Mapfre Re, Compania de Reaseguros SA	BBB+/Neg	71	A	a/Neg	79	75	A- (LCS)	R3		ES	MAPF/A2319A
Munich Re	Munich Reinsurance Co	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4		DE	MUNR/A2234A
Partner Re	Partner Reinsurance Co	A+/St	84	A+	aa-/St	88	86	AA-(LCS)	R1	F	BM	PART/A1957A
QBE	QBE Reinsurance Corp	A+/St	84	A	a+/Neg	83	83.5	A+ (LCS)	R3		US	QBEG/A2544A
SCOR	SCOR Global P&C SE	A+/Pos	85	A	a+/St	84	84.5	A+ (LCS)	R5		FR	SCOR/A2437A
Swiss Re	Swiss Reinsurance Company Ltd	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4		CH	SWRE/A1798A
Tokio Marine	Tokio Millenium Re AG	AA-/Neg	87	A++	aa+/St	96	91.5	AA (LCS)	R3		CH	TOMA/A2016A
XL	XL Re Ltd	A+/St	84	A	a/Pos	81	82.5	A+ (LCS)	R2		BM	XLGR/A2200A

Please note that Litmus Analysis is not a rating agency

Ratings can and do change and we strongly advise readers to check with the relevant websites for A.M. Best (www.ambest.com) and/or S&P (www.standardandpoors.com) for the latest information and the relevant rating definitions.

Where a rating or outlook has changed since the date noted above Litmus will be pleased to consider recalculating the LS, LCS and RI privately for any LRR reader on request. This is a complimentary service and we are pleased to offer this wherever practical, however it is subject to our other commitments and availability.

Litmus has not sought any endorsement from AM Best or S&P for the LS and LCS calculation methodology and results. Nor do we offer an endorsement of the AM Best or S&Ps ratings quoted here.

Please note that the Litmus Scores are not ratings; Litmus Analysis is not a rating agency.

Ratings Round-up, LS and LCS outcomes - "L-Zebedees"											Ratings as at 21/11/2013	
We have used the following abbreviations -											¹ Pos=Positive, St=Stable, Neg-Negative	
² F=Fitch, M=Moody's											³ ISO 3166-1 Alpha-2 codes	
Groups/Sub-groups	LUCID Company Name	S&P Ratings		A.M. Best Ratings			LCS Calculations				GRC Details	
		S&P FSR/Outlook ¹	Litmus Score	AM Best FSR ¹	AM Best ICR/Outlook ¹	Litmus Score	Litmus Composite Score (LCS)	LCS Ratings Mapping	LCS Resilience Indicator	Tie-break Source ²	GRC Domicile ³	LUCID For details of the LUCID system, email info@litmusanalysis.com
Cohort: L-Zebedees												
Arch	Arch Reinsurance Ltd.	A+/St	84	A+	aa-/St	88	86	A+ (LCS)	R7	F,M	BM	ARCH/A1412A
Argo	Argonaut Insurance Co.	A-/Neg	75	A	a/St	80	77.5	A- (LCS)	R6		US	ARGO/A1344A
Allied World	Allied World Assurance Co.	A/St	80	A	a+/St	84	82	A (LCS)	R7	M	BM	AWAC/A2272A
Amlin	Amlin AG	A/St	80	A	a/St	80	80	A (LCS)	R4		CH	AMLI/A1118A
Aspen	Aspen Insurance UK Ltd	A/St	80	A	a/St	80	80	A (LCS)	R4		UK	ASPE/A1435A
Axis	AXIS Specialty Ltd	A+/St	84	A+	aa-/St	88	86	A+ (LCS)	R7	F,M	BM	AXIS/A2433A
Beazley	Beazley Insurance Co	N/R	N/A	A	a/St	80	N/A	N/A	N/A		US	BEAZ/A4417A
Canopus ⁴	Canopus US Insurance Inc.	N/R	N/A	A-	a-/Neg	75	N/A	N/A	N/A		US	BREG/A4442A
Catlin	Catlin Insurance Company Ltd	A/St	80	A	a/St	80	80	A (LCS)	R4		BM	CATL/A1692A
Endurance	Endurance Specialty Insurance	A/St	80	A	a/St	80	80	A (LCS)	R4		BM	ENDU/A1958A
HCC	Houston Casualty Company	AA/St	92	A+	aa/St	92	92	AA (LCS)	R4		US	HCCG/A3685A
Hiscox	Hiscox Insurance Company	A/St	80	A	a+/St	84	82	A+ (LCS)	R1	F	UK	HISC/A2528A
Lancashire	Lancashire Insurance Co.	A-/St	76	A	a/Pos	81	78.5	A (LCS)	R2		BM	LANC/A2448A
Lloyd's	N/A	A+/Pos	85	A	a+/Pos	85	85	A+ (LCS)	R5		N/A	N/A
Maiden	Maiden Insurance Company	BBB+/Neg	71	A-	a-/St	76	73.5	BBB+ (LCS)	R6		BM	MAID/A1999A
Markel ⁵	Markel Bermuda Ltd.	A/St	80	A	a/St	80	80	A (LCS)	R4		BM	MARK/A1261A
Montpelier	Montpelier Reinsurance Ltd.	A-/St	76	A	a/St	80	78	A (LCS)	R1	F	BM	MONT/A2090A
Navigators	Navigators Insurance Co.	A/St	80	A	a+/St	84	82	A (LCS)	R7	S&P	US	NAVI/A4468A
Odyssey Re ⁴	Odyssey Reinsurance Co.	A-/St	76	A	a+/St	84	80	A (LCS)	R4		US	FAIR/A1855A
Platinum	Platinum Underwriters Bermuda Ltd.	A-/St	76	A	a/St	80	78	A (LCS)	R1	F	BM	PLAT/A2336A
Renaissance	Renaissance Reinsurance Ltd.	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4		BM	RENRA1894A
Sirius International ⁴	Sirius International Insurance Corporation	A-/St	76	A	a/St	80	78	A (LCS)	R1	F	SW	WHMO/A2259A
Validus	Validus Reinsurance Ltd.	A/St	80	A	a/St	80	80	A (LCS)	R4		BM	VALI/A1992A
W R Berkley	Berkley Insurance Co.	A+/St	84	A+	aa-/St	88	86	A+ (LCS)	R7	S&P	US	WRBE/A1759A

⁴These are sub-groups of the ultimate parent group. See 'Cohort make-up' for description.

⁵Markel Bermuda (formerly Alterra Bermuda) is used as the Markel group GRC as S&P doesn't currently rate the Markel group carriers that were not part of the acquisition. It should be noted that both S&P and A.M. Best's current ratings on the 'Alterra' carriers (including those now branded as 'Markel') don't reflect 'core' status to the group.

Please note that Litmus Analysis is not a rating agency

Important footnotes to this table are shown on page 6 under the 'Majors' table.

About Litmus Analysis

Litmus is staffed by senior ex-rating agency personnel and provides a range of analytical services to the re/insurance markets and those that serve them.

<p>Training Services</p>	<p>We will shortly be announcing our training dates for 2014; the first courses we will be offering are listed below. To be kept up to date and for further details, visit litmusanalysisblog.wordpress.com/training-courses/.</p> <ul style="list-style-type: none"> • Understanding and analysing non-life re/insurer financials and key ratios • The mathematics of reinsurance (for non-mathematicians) • How to understand and use ratings effectively and appropriately • Essentials of the new S&P insurance ratings criteria • Understanding the global re/insurance markets <p>Or email us at papers@litmusanalysis.com.</p>
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