

## Alterra Capital Holdings Ltd. And Operating Subsidiaries

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# Alterra Capital Holdings Ltd. And Operating Subsidiaries

## Major Rating Factors

### Strengths:

- Strong underwriting and operating performance.
- Significant depth and breadth of the management team.
- Strong enterprise risk management.
- Very strong capital adequacy.
- Strong competitive position.

### Weaknesses:

- Exposure to weather-related and man-made catastrophes.
- Reserving risk due to long-tail casualty writings.
- Lower proportion of premiums sourced outside the U.S. compared with peers.

<b>Holding Company:</b> Alterra Capital Holdings Ltd.
<b>Counterparty Credit Rating</b> <i>Local Currency</i> BBB+/Stable/--
<b>Operating Companies Covered By This Report</b>
<b>Financial Strength Rating</b> <i>Local Currency</i> A/Stable/--

## Rationale

The counterparty credit rating on Alterra Capital Holdings Ltd. (ACHL) and the insurer financial strength ratings on its operating insurance and reinsurance subsidiaries (collectively referred to as Alterra) are based on the group's strong and enhanced competitive position following the merger of Max Capital and Harbor Point. In addition, Alterra benefits from significant depth and breadth of the combined management teams of the former organizations. Operating and underwriting performance was strong at the former organizations, and it has remained strong for the merged entity. Capital adequacy is also very strong, and the group benefits from a conservative investment portfolio. Alterra's performance has been consistent with its financial strategy of lower volatility and above-average returns, and we believe that its enterprise risk management (ERM) approach has been the core function that created this performance and risk profile. Partially offsetting these positive factors are the potential pricing and reserving risks related to the group's significant long-tail casualty writings, given the low interest rates, soft pricing, and potential effects of inflation on the long-tail lines of businesses. Also, the company is exposed to losses stemming from weather-related and man-made catastrophes, which add earnings volatility. Lastly, even though the merger has enhanced the geographic diversification of Alterra, the company has a somewhat less global reach than certain other Bermuda-based insurers and reinsurers.

Standard & Poor's Ratings Services believes Alterra's competitive position is strong. The merged Harbor Point and Max Capital operations benefit from a larger and more diverse global platform by product, by customer segment, and by location. In addition, the combination of Max's reinsurance division with Harbor Point's has significantly increased Alterra's market presence in the reinsurance sector. Given Alterra's ability to switch resources to its more profitable lines, the merged group also benefits from greater flexibility to follow cycle-management strategies while reporting less volatility in premium writings on a consolidated basis. Even though the merger has improved geographic diversification of exposures, the consolidated entity is still more focused in the U.S. than internationally compared to its peers.

We view Alterra's management and corporate strategy as a strength to the ratings. The management team has been successful in integrating Max Capital and Harbor Point and converting the consolidated entity into a larger provider of reinsurance and specialty insurance. We consider that the senior management team at Alterra has significant depth and breadth and has been consistent in delivering strong and steady earnings based on a low volatility product offering with low severity prone risk profile. In our opinion, Alterra's strategy will likely continue to deliver strong earnings. We believe that the merger between Max Capital and Harbor Point has been completed successfully. In our opinion, the small overlap of products, clients, and staff between the two operations has helped Alterra to integrate the two companies thoroughly without any major disruptions.

For the full year 2010, operating performance was strong for Alterra. The company reported a consolidated net income of \$302 million, pretax operating income of \$321 million, return on revenue (ROR) excluding realized investment gains and losses of 23%, and gross premium written of \$1.4 billion. Including all corporate expenses, the combined ratio for property/casualty (P/C) operations was 90.7% in 2010. Alterra's operating results during the first nine months of 2011 were depressed by large catastrophe losses in the period. However, the company's performance has been better than that of most other global property catastrophe writers. Net income in this period was \$34 million, down from \$223 million in the same period of the prior year. Including all corporate expenses, the combined ratio for P/C operations including corporate expenses was 103.5% in this period.

Alterra's ERM is strong and a strength to the rating. The overall ERM process is heavily weighted toward quantitative metrics and analysis, and the company's ERM process drives its budgeting and planning, underwriting and pricing, claims management and reserving, capital and asset allocation, and ultimately risk selection. The global ERM platform provides an integrated approach to risk management, which permeates all areas of the organization. The ERM system handles asset and liability risks for both life and P/C businesses, tracks and models all deals from submission to termination, and tracks aggregations and accumulations across insurance, reinsurance, and assets. The company's ERM system also measures the probability of a decline in surplus, determines capital allocation, and manages its probable maximum losses (PMLs) for catastrophe, aviation, and other property lines.

Alterra's capital adequacy is very strong. On a quantitative basis, the group's capital adequacy, according to Standard & Poor's capital adequacy model, is well within the 'AAA' category, with 13% redundancy at that level. Alterra's capital adequacy benefits from a fairly clean balance sheet, with no legacy liabilities and minimal intangible assets. Exposure to income statement and balance sheet volatility from catastrophe losses, given its significant amount of property and property catastrophe writings, partially offsets this. However, the company has shown less volatility in years with high catastrophe activity than other Bermuda-based peers (pro forma basis assuming the merger occurred in 2006). Reserve risk is also an offsetting factor to very strong capital adequacy, given the group's significant writings in long-tail liability business.

## **Factors Specific To Holding Company**

The counterparty credit rating on ACHL reflects standard notching for a Bermuda-based insurance holding company to the financial strength ratings on its core operating subsidiaries. The two-notch difference is standard for Bermuda-based companies as the dividends that ACHL receives from its principal and largest operating subsidiary, Alterra Bermuda Ltd., are subject to fewer regulatory restrictions than are the dividends of a U.S.-domiciled company. The notching between the holding company and its operating companies reflects the holding company's dependence on dividends from its operating subsidiaries to meet debt service and other obligations. The payment of

dividends to ACHL by its operating insurance and reinsurance subsidiaries is subject to limitations imposed by law of Bermuda, Ireland, the U.K., and the U.S.

As of Dec. 31, 2010, the company's financial leverage profile was conservative for the rating level, with financial leverage (total debt plus hybrid securities to total capital) at 12.7% and fixed-charge coverage of 10.6x. As of June 30, 2011, the group's financial leverage was 13.1% and fixed-charge coverage ratios decreased from historical levels to 1.2x primarily because of high catastrophes in the first two quarters of 2011. We don't see this reduction as an indication of reduced prospective coverage ratios for the company but more as a reflection of lower earnings resulting in a year of high catastrophe-related losses.

## Outlook

The stable outlook reflects our belief that Alterra's capital adequacy will remain very strong over the next two years, to offset potential volatility of the substantial catastrophe exposures. We expect financial leverage to remain modest at about 15%-20% through 2012 and fixed-charge coverage within 4x-6x (assuming annual catastrophe losses below \$100 million). For 2011, and assuming \$25 million of catastrophe losses for the remainder of the year, the combined ratio for the property/casualty segment including all corporate expenses will likely be about 100% with a ROR of 7%-10%. For 2012, assuming annual catastrophe losses of \$100 million, we expect the combined ratio including all corporate expenses to be 97%-100% and the ROR to be higher than 12%. For 2011, gross premiums written will likely reach \$1.9 billion, mostly because of the roll over of Harbor Point premiums into Alterra's financials and modest growth in Alterra at Lloyd's and Alterra Latin America. In 2012, gross premiums written likely will increase by low single-digit percentage points, mainly because of the expansion of Alterra Latin America and new underwriting teams at Alterra at Lloyd's.

Although we don't expect to change the ratings in the next two years, the ratings could come under pressure if the company's capital adequacy decreases and remains below the 'AA' level; if the company reports major adverse reserve development, stemming from its casualty loss reserves (more than 2.5 percentage points of net loss reserves); if underwriting performance lags that of its peers; if earnings volatility increases over multiple years; or if there is a major change in the risk profile of its investment portfolio.

We are unlikely to raise the ratings on Alterra over the next two years primarily because, in our view, the company's competitive position and global reach are unlikely to improve relative to its peers'.

## Competitive Position: Enhanced Diversification Following The Merger

We believe Alterra's competitive position is strong. Following the merger, Alterra benefits from a larger and more diverse platform by product, by customer base, and by location. In addition, the combination of Max's reinsurance division with Harbor Point's has significantly increased Alterra's market presence in the reinsurance sector. Given Alterra's ability to switch resources to its more profitable lines, the merged group also benefits from greater flexibility to follow cycle-management strategies while reporting less volatility in premium writings on a consolidated basis.

Harbor Point and Max Capital completed a merger of equals on May 12, 2010. The merger created Alterra Capital Holdings, a large insurance and reinsurance group with approximately \$2 billion in consolidated annual gross written premiums (GWP), \$2.8 billion in shareholders' equity as of Sept. 30, 2011, and more than 480 employees

worldwide. The group operates through 22 locations in 12 countries. Prior to the merger, Harbor Point was a pure global reinsurance player, and Max Capital wrote a combination of insurance and reinsurance covers on a worldwide basis. Alterra writes about 73% of its premiums in North America, 17% in Europe, and the remainder 10% in the rest of the world. The split between insurance and reinsurance is 38%/62%, and the split between short-tail and long-tail is 58%/42%. We believe that the company has a lower proportion of premiums sourced outside the U.S. compared with its peers.

There was relatively limited overlap between Harbor Point's and Max's reinsurance books of business, given Harbor Point's historical focus on large reinsurance accounts/clients and Max's focus on smaller reinsurance clients. This limited overlap has enabled Alterra to benefit from a significantly larger presence in the reinsurance sector (approximately doubling the individual companies' positions in the sector) while taking advantage of greater diversification by client, by account type, and by location. In addition, we believe that Alterra's larger capital base is attractive to cedants and gives the company the ability to more easily write business in certain markets where Harbor Point's or Max Capital's lower equity base might have been a limitation in the past. Even though Alterra's expanded platform benefits from greater flexibility to offer larger capacity and more varied product offerings, the merged company has kept low limits across its offerings to manage volatility and has not expanded substantially its product offerings due to current market conditions.

We believe that Alterra maintains cycle-management discipline, and the company will not hesitate to cut premium writings significantly in areas where management does not believe the business can meet its profitability thresholds or does not fit its strategy. For example, after the merger, the company decided to substantially decrease the larger quota-share agreements of general and professional liability, historically written by Harbor Point, due to softening pricing among other reasons. Also in August 2011, Alterra decided to sell its contract binding authority unit to Selective Insurance, as the business underwritten by this unit did not fit Alterra's strategy because of the size of the accounts written and also due to the fact that underwriting authority was not in-house. This is a clear differentiating factor with respect to other Bermuda players that offer both reinsurance and insurance products. The majority of the business Alterra writes is underwritten in-house and the company is very unlikely to delegate underwriting authority to third parties and prices every deal using proprietary pricing models, which are heavily weighted toward quantitative metrics and analysis.

Alterra has a horizontal approach to expanding the same lines of business across its underwritten platforms (reinsurance vs. insurance and across different geographic locations) to leverage specialization and know-how across units. Even though the company has this horizontal approach, the risks underwritten for the same line of business by different underwriting segments is structured in a way to prevent clash or aggregation of exposures. For example, Alterra offers property insurance and reinsurance, however, the reinsurance property portfolio is weighted more toward personal lines and the insurance portfolio is weighted more toward commercial lines, which helps the company reduce volatility of results by minimizing the likelihood that the same event would affect both the insurance and reinsurance segments to a similar extent. Notably, Alterra has formed focus groups for major lines of businesses across underwriting platforms, which conduct regular meetings to discuss recent developments, market conditions, and emerging risks in their respective areas of practice. The largest business segment at Alterra is the reinsurance segment, which accounts for approximately 46% of gross premium written. The insurance segment follows at 19%, U.S. specialty at 19%, and Lloyd's at 16%. The life and annuity reinsurance segment is more opportunistic and no contracts have been written since 2009. The company is no longer writing any new life and annuity business. The breakdown of premiums for the consolidated group for the first nine months of 2011 was:

property 38%, professional liability 21%, general casualty 17%, marine and energy 5%, automobile 5%, aviation 2%, agriculture 2%, accident and health 2%, medical malpractice 2%, workers compensation 2%, whole account 2%, and other short-tail 2%.

### **Property/casualty reinsurance**

The reinsurance platform writes both short-tail property business and long-tail casualty business. Alterra's reinsurance unit's gross writings in the first nine months of 2011 totaled \$780.6 million, similar to \$781.8 million on a pro forma basis in the same period the prior year (accounting for Harbor Point's gross writings starting Jan. 1, 2010) but significantly down from a pro forma \$935 million in the first nine months of 2009. The main short-tail reinsurance lines that the group wrote were property and property catastrophe (which represented 38.5% of total year-to-date gross writings for this segment through the first nine months of 2011), followed by credit/surety (4.2%), agriculture (3.9%), marine and energy (2.7%), and aviation (2.0%). Among the main long-tail casualty lines were professional liability (17.8%), auto (10.2%), general casualty (7.8%), medical malpractice (4.6%), and workers' compensation (3.6%). Alterra offers reinsurance coverages on an excess-of-loss basis and on a quota-share basis from its offices in Bermuda, the U.S., London, Dublin, Bogota, and Buenos Aires.

### **Property/casualty insurance**

The property/casualty insurance platform accounted for \$298.5 million in gross writings through the first nine months of 2011, slightly up from \$286.4 million during the same period in 2010. This segment writes professional liability (representing 44.3% of the segment's business as of Sept. 30, 2011), excess liability (31.1%), property (20.6%), and aviation (4.0%). Professional liability includes errors and omissions liability insurance, directors' and officers' liability insurance, and employment practices liability insurance, and excess liability includes excess umbrella liability, excess product liability, excess medical malpractice, and excess product recall insurance. On excess liability, Alterra offers approximately \$25 million in gross limits, but through a 60% quota share, it retains only \$10 million on a net basis. Alterra's insurance segment offers property/casualty excess-of-loss insurance, primarily from its offices in Bermuda, the U.S., and Dublin, to Fortune 1000 companies.

### **U.S. specialty lines**

Max Capital started the U.S. specialty operations in 2007 to capture excess and surplus (E&S) business in the U.S. and to focus on small- to medium-size companies. In 2010, GPW totaled \$324 million, up from \$285 million in 2009 and \$194 million in 2008. In the first nine months of 2011, gross writings were \$242 million--a 6% increase over the same period in 2010. The principal lines of business in this segment are property (43.9% of the unit's gross writings), general liability (23.7%), inland and ocean marine (26.7%), and professional liability (5.7%).

### **Alterra at Lloyd's**

Alterra at Lloyd's underwrites specialty risks in multiple jurisdictions worldwide through Syndicate 1400, for which Alterra provides 100% of its underwriting capacity. Syndicate 1400 offers property reinsurance, personal accident insurance, and financial institutions insurance. This segment remains an area of growth for Alterra, which reported year-to-date gross writings of \$254.8 million as of Sept. 30, 2011, a 43% increase over the \$178.7 million reported during the same period in 2010. Property represented the largest line in this segment, accounting for 49.5% of year-to-date gross writings, followed by international casualty (19.8%), accident and health (12.3%), financial institutions (7.5%), professional liability (7.4%), and aviation (3.0%).

### **Life and annuity reinsurance**

Within its life and annuity reinsurance segment, Alterra has focused on closed-block reserve buyout transactions, writing a limited number of transactions per year with large variations in annual premium volume. The underlying products are European retirement benefits. This segment has specialized in investment-spread business with predictable cash flows and few options for policyholders. Because of the lack of profitable business opportunities and the low investment yields since 2009, Alterra has not identified any life and annuity transactions that have met its return hurdles. Consequently, Alterra has determined to not write any new life and annuity reinsurance contracts in the foreseeable future as it places greater emphasis on leveraging its property/casualty platform.

### **Prospective**

For 2011, gross premiums written will likely increase to \$1.9 billion, mostly because of the roll over of Harbor Point premiums into Alterra's financials and modest growth in Alterra at Lloyd's and Alterra Latin America. In 2012, gross premiums written likely will increase by low single-digit percentage points, mainly because of the expansion of Alterra Latin America and new underwriting teams at Alterra at Lloyd's. We also expect that management will continue to implement cycle-management strategies and reduce its exposure in lines of business where profitability prospects do not meet Alterra's minimum thresholds, amid continued softening market conditions.

## **Management And Corporate Strategy: Significant Depth And Breadth Of Senior Management Team**

We view Alterra's management and corporate strategy as marginally positive and a strength to the ratings. The management team has been successful in integrating Max Capital and Harbor Point and converting the consolidated entity into a larger provider of reinsurance and specialty insurance. We believe that the senior management team at Alterra has significant depth and breadth and has been consistent in delivering a strategy based on a low volatility product offering with low severity prone risk profile. This approach will likely continue to deliver strong and steady earnings.

In our opinion, Alterra has a proven track record of executing and converting plans into positive earnings and increased competitive platforms, as demonstrated recently by the smooth and fast integration of Max Capital and Harbor Point with respect to underwriting, risk management, investments, human resources, and financial reporting. Even though the merger generated no significant staff reductions and expense savings were minimal, given the relatively small overlap of business between Harbor Point and Max Capital, the resulting company is of significant size and well diversified by client base, account type, and underwriting expertise.

On Aug. 2, 2011, John Berger, the CEO of Alterra Reinsurance and prior CEO of Harbor Point, left the company to pursue a new career opportunity. Since then, Thomas C. Wafer has become CEO of Alterra Reinsurance. Mr. Wafer, who has more than 30 years of reinsurance experience, was President of Alterra Reinsurance USA from November 2009 to July 2011, worked for Harbor Point from 2005 to 2009, and worked for Chubb Re from 1998 to 2005. Although we consider the departure of John Berger a significant loss for Alterra due to his recognition as a reinsurance industry leader and his track record at Harbor Point and Chubb Re, we see the change in senior management in Alterra's reinsurance segment as a neutral rating factor. The change in CEO of Alterra's reinsurance segment has not produced any turnover in key personnel in the segment or any changes in strategy, the three Chief Underwriting Officers are still working for Alterra, and the new CEO of Alterra's reinsurance segment is an internal

promotion and expected to continue the prevailing strategy.

### **Operational management**

Given the limited overlap of businesses and products between Harbor Point and Max Capital (primarily on the reinsurance side), the merger of these businesses has been straightforward. Max's reinsurance unit was combined with Harbor Point's operations into one single (and much larger) reinsurance segment. Because Max Capital's reinsurance business had primarily focused on small and midsize clients and Harbor Point underwrote larger reinsurance clients, the reinsurance books of business were largely complementary to each other. In addition, Max Capital's other segments (U.S. specialty, property/casualty insurance, and Lloyd's) have remained much the same as they were prior to the merger. We believe these factors have significantly decreased Alterra's execution risks and have led to a successful and fast integration.

### **Financial management**

As of year-end 2010, Alterra's standard for financial performance was a long-term return on average shareholders' equity (ROE) of 15% over the underwriting cycle with a specific range for ROE volatility. Starting in 2011, the company has reset its financial standard for operating performance to an ROE equal to 10% plus the risk free rate over the underwriting cycle. We view this change in financial standards at Alterra more as a reflection of current low interest rates than as an intention of the company to lower its performance standards.

Alterra's property catastrophe risk tolerance is conservative at about 20% of the company's beginning of year shareholders' equity for a modeled 1-in-250 year event. We believe that Alterra's performance has been consistent with its financial strategy of lower volatility and above-average returns, and its ERM approach has been the core function that created this performance and risk profile.

Alterra repurchased \$208 million of common shares in 2010 and \$170 million during the first nine months of 2011; about \$157.5 million of share repurchases were still available under the Board's authorized share repurchase program. Even though the company will continue to repurchase its own shares opportunistically, we do expect it to maintain conservative capital adequacy and debt leverage ratios.

## **Enterprise Risk Management: Strong, Core Function And A Strength To The Ratings**

We view Alterra's ERM capabilities as strong, based on the group's consistently strong scores for risk-culture, risk controls, risk models and strategic risk management, partially offset by a score of adequate for emerging risk management. ERM is integral to our rating on Alterra as a diversified insurance and reinsurance carrier, with sophisticated product offerings and susceptibility to severity from natural catastrophes and inflation on a longer-term basis from its casualty lines. While the company has inherent diversification, there is potential for extreme event contagion.

The risk culture at Alterra is scored as strong because of our favorable view of Alterra's risk management at the executive level, clear accountabilities of the risk management team, and the firm's retention policies with a number of management and board personnel familiar with Harbor Point's operations. Risk reporting is formal, frequent, and used by the management and board for oversight of the enterprise risk position and risk appetite.

Risk controls at Alterra are strong due to a predominance of strong scores for controls related to individual risks. A score of strong for investment risk controls reflects the presence of guidelines approved by the board and an active,

yet conservative investment strategy.

An integrated underwriting platform, a track record of results at Max and Harbor Point, a system of underwriting audits, peer reviews combined with granular exposure management, and opportunistic shifts in lines of business lead to a strong score for risk controls related to underwriting, pricing, and cycle management. An active oversight for the risk is provided by the underwriting committee of the board that establishes risk tolerances, reviews, and monitors underwriting guidelines and participates in a periodic review of underwriting operations.

We view reserve risk controls as strong based on the process of setting reserves, the claims management process in place, integrated pricing, reserves and claims management platforms, conservative reserve releases, and the high percentage of IBNR reserve (around 70% for property and casualty operations as of year-end 2010) as a % of total reserves held.

A well-defined risk appetite for catastrophe risks, a focus on data quality for catastrophe modeling and pricing, awareness for market share (in terms of losses) along with a multi-model (vendor-based and experience-based) approach influence a strong score for catastrophe risk controls. Historically, Max/Harbor Point have not been outliers when there have been headline causing hurricanes and their loss estimates have proven to be accurate--this is a positive influence on our scores for catastrophe risk controls and reserving risk controls as well.

We score Alterra's counterparty credit risk controls as adequate and they support the overall ERM score, given that the insurer uses reinsurance mainly to manage line size, clash and aggregation of exposures.

Operational risk controls at Alterra are viewed as adequate--our view reflects the significant progress since the merger as the integration plans that were mentioned have been executed with minimal systems integration remaining. Key management and Board members from both companies remain to make sure institutional memory is not lost.

The score for emerging risks management is adequate because of a robust process for identifying and managing emerging risks through discussions at various committees, environmental scans from external sources, and quarterly reporting to the Board on emerging risk issues.

We consider Alterra's risk models strong. Our view reflects the existence of mature models at Alterra--a global underwriting model helps track and control deals, improve pricing consistency, and view aggregate exposures--enhanced by Alterra's track record of close to accurate loss estimates when tested in previous hurricanes (Ike/Gustav and Chilean earthquake). In addition, the integrated risk management system and the firm's reliance on multiple models (for catastrophe management) and multiple methodologies (for reserving, pricing, exposure management) are viewed favorably. A strong score for strategic risk management is supported by management's understanding and use of economic capital models for a variety of strategic decisions.

Standard & Poor's believes that Alterra's commitment to risk management is an important factor in the firm's success, and we expect enhancements to the ERM practices, particularly if risks grow in complexity and size.

### **Accounting**

Although Max Capital and Harbor Point completed a merger of equals when forming Alterra, Max Capital was the formal acquirer of Harbor Point in the transaction. On the transaction date, Max Capital was renamed Alterra Capital Holdings Ltd. Any of Alterra Capital Holdings' prior-year financial statements from before the merger represent solely Max Capital. With the merger, Alterra recorded Harbor Point's acquired assets and liabilities at

their fair values, and it recorded the difference between the purchase price and the fair values as a negative goodwill gain. The merger and acquisition expenses for the full year 2010 included \$96 million of negative goodwill, with \$28 million of transaction expenses and \$19 million of accelerated stock-based compensation. Following the merger, Harbor Point's existing goodwill of \$252 million was eliminated. In addition, its loss reserve increased by \$91 million to adjust it to fair value.

## **Operating Performance: Strong Performance With Low Volatility**

We view Alterra's operating performance as strong. The company aims to minimize the volatility of results by diversifying its portfolio geographically, by offering low limits, and, ultimately but not less important, by structuring the business written across its operating underwriting platforms in a way to prevent clash and aggregation of losses. By design, Alterra has a less volatile product offering with less severity prone risk profile, which will likely continue to deliver strong and steady earnings.

On a pro forma basis (as if the merger with Harbor Point were completed on Jan. 1, 2006), Alterra's P/C operations including all corporate expenses would have produced an average combined ratio of 92.7%, an average ROR excluding realized investments gains and losses of 22%, and an average pretax operating income of \$308 million in the period 2006-2010. These figures include a 100% allocation of corporate expenses to the P/C segment. In this period, on a consolidated basis including life and health reinsurance results, net income averaged about \$275 million per year.

For the full year 2010, operating performance was strong for Alterra. The company reported consolidated net income of \$302 million, pretax operating income of \$321 million, ROR excluding realized investment gains and losses of 23%, and gross premium written of \$1.4 billion. The ROE of 13.5% in 2010 was below the company target of 15%; however, in our opinion, the ROE was more reflective of excess capital at Alterra (even after share repurchases and extraordinary dividend paid) than depressed profitability. The combined ratio including all corporate expenses was 90.7% for the full year 2010. Also for the full year 2010, property catastrophe-related and major per risk losses incurred by Alterra from the New Zealand earthquake, Deepwater Horizon oil spill, Chilean earthquake, European windstorm Xynthia, Australian hailstorms, and Australian floods were \$55 million (less than 2% of Alterra's equity as of year-end 2010) or \$122 million on a pro forma basis (reflecting the losses the company would have incurred had the merger with Harbor Point occurred on Jan. 1, 2010). We believe that the low combined ratio that Alterra delivered in a year of high catastrophe activity is a reflection of the low volatility risk profile of the company.

Alterra's operating results during the first nine months of 2011 were depressed by large catastrophe losses; however, the company's performance has been better than most other global property catastrophe writers with balanced portfolios. Net income in this period was \$34 million, down from \$223 million in the same period of the prior year. The P/C segment produced a combined ratio including all corporate expenses of 103.5%. Property catastrophe losses resulted from severe weather conditions in the United States in the second and third quarters, and those stemming from the earthquake in Japan, the earthquake in New Zealand, and the floods in Australia in the first quarter of 2011. Depressed earnings in the first nine months of 2011 totaled about \$198 million net of reinsurance and reinstatement premiums (or about 18.5% combined ratio points), which represented less than 7% of Alterra's equity as of year-end 2010. Catastrophe losses in 2011, mostly affected Alterra's reinsurance and Alterra at Lloyd's segments. The combined ratio for the first nine months of 2011 reflects about 10% (or about \$110 million) points

benefit from net favorable development on prior year loss reserves derived principally from Alterra's insurance and reinsurance segments.

### **Prospective**

We expect that Alterra's consolidated earnings will remain strong and supportive of the ratings. For 2011, and assuming \$25 million of catastrophe losses for the remainder of the year, the combined ratio for the property/casualty segment including all corporate expenses will likely be about 100% with a ROR of 7%-10%. For 2012, assuming annual catastrophe losses of \$100 million, we expect the combined ratio including all corporate expenses to be 97%-100% and the ROR to be higher than 12%.

## **Investments And Liquidity: Conservative Investments And Strong Liquidity**

Standard & Poor's views Alterra's investments and liquidity as strong. The investment strategy is conservative. As of Sept. 30 2011, the bulk of the portfolio (85% of total portfolio) consisted of highly rated fixed-income securities and a substantial amount of cash and cash equivalents (11%). It has a small allocation in other investments (4%), mostly in hedge funds, for diversification purposes, and also in structured deposits and private equities.

As of Sept. 30, 2011, the company's \$6.8 billion fixed-income portfolio consisted of well-diversified and high-quality securities, with an average credit rating of 'AA' and an average duration of 4.2 years (including cash portfolio). The company's fixed maturities investment guidelines prescribe that a minimum average credit rating of 'AA' has to be maintained for the fixed maturities investment portfolio and also that the company cannot leverage this portfolio. Excluding the assets backing the life and annuity reinsurance reserves, the duration is lower than 4.2 years and is consistent with the average duration of non-life loss reserves. As of Sept. 30, 2011, an immediate 100 basis point increase in market interest rates would have resulted in an estimated decrease in the fair value of the fixed income portfolio of about 4.6% (or \$317.5 million), and an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in the fair value of the fixed income portfolio of about 5.1% (or \$356.5 million).

The majority of the fixed-income holdings consisted of a diverse portfolio of corporate securities (47% of the portfolio on a fair value basis), with the largest issuer representing 2% of the portfolio. It also has a substantial amount of residential mortgage-backed securities (17%) that are primarily agency backed, along with U.S. and non-U.S. government and agencies securities (23%). Commercial mortgage backed securities, asset backed securities, and municipal bonds represent 6%, 3%, and 3% of the total fixed income portfolio respectively. The currency breakdown of the fixed income portfolio is US\$ (80%), euro (16%), GBP (2%), and the remainder 2% in other currencies. About 72% of the fixed income portfolio is invested in the United States and the remainder 28% in the rest of the world. As of Sept. 30, 2011, the company held European government securities of \$768 million (or 10% of total investment portfolio) with the following breakdown: France \$283 million, Germany \$255 million, Netherlands \$150 million, Ireland \$27 million, Belgium \$21 million, United Kingdom \$17 million, Denmark \$6 million, and other countries \$9 million. Alterra does not hold government securities issued by Greece, Italy, Portugal, or Spain. Notably, the majority of the foreign sovereign investments are accounted as held to maturity (mostly backing life and annuity reinsurance reserves) and, hence, market price fluctuations do not introduce volatility in Alterra's financials.

As of Sept. 30 2011, other investments of \$312 million were allocated as follows: \$276 million in hedge funds (88%), \$25 million in structured deposits (8%), and the remainder 4% in other investments. The hedge funds are

invested in nine strategies in 31 underlying funds, with the largest allocations to long/short equity, global macro, funds of funds, distressed securities, and diversified arbitrage. Generally, the funds in which Alterra invests require at least 30 days notice of redemption and certain funds have a lock-up period, characteristics that make this portfolio much less liquid than the fixed income portfolio. As of Sept. 30, 2011, Alterra's hedge fund portfolio, value-at-risk, was estimated to be 12.0% at the 99.0% level of confidence and with a three-month time horizon.

### **Liquidity**

Alterra's liquidity is strong and supportive of the rating. Alterra generated positive net operating cash flows of \$275 million during the first nine months of 2011 compared with \$169 million in the same period in the prior year. In addition, the company benefits from liquid invested assets and a highly rated fixed-income portfolio, including \$427 million of unrestricted cash and cash equivalents as of Sept. 30, 2011.

### **Prospective**

Standard & Poor's expects Alterra to maintain a high-quality and well diversified investment portfolio. As a buy and hold investor, Alterra is not expected to make any material change in its investment portfolio composition. Overall, we expect other investments to be about 5% of the investment portfolio and liquidity to remain strong.

## **Capitalization: Very Strong, Benefiting From A Clean Balance Sheet**

Alterra's capital adequacy is very strong. Even though Alterra suffered considerable catastrophe losses in the first half of 2011 and has repurchased its own shares, its shareholders' equity slightly decreased to \$2.8 billion as of Sept. 30, 2011 from \$2.9 billion as of year-end 2010. On a quantitative basis, the group's capital adequacy, according to Standard & Poor's capital adequacy model, is well within the 'AAA' range, with 13% redundancy at that level. The capital model includes a net aggregate exposure property catastrophe (re)insurance charge to incorporate the company's PMLs based on the one-in-250-year return period.

Alterra's capital adequacy benefits from a fairly clean balance sheet, with no legacy liabilities and very few intangible assets. Exposure to income statement and balance sheet volatility from catastrophe losses, given its significant amount of property and property catastrophe writings, partially offsets this. However, the company has shown less volatility in years with high catastrophe activity compared to other Bermuda-based peers (pro forma basis assuming the merger occurred in 2006). Reserve risk is also an offsetting factor to very strong capital adequacy, given the group's significant writings in long-tail liability business (the book is split about evenly long-tail and short-tail writings).

### **Reserves**

We view Alterra's reserving process as strong and reserves as adequate. The company's internal actuaries produce a quarterly reserve study by segment. The actuaries review each contract, and they combine the initial pricing selections with real-time claims information and reserve development patterns. The chief actuary oversees this process. In addition, Ernst & Young performs an independent annual review of the company's reserves. Prior to the Max Capital and Harbor Point merger, both companies generated favorable reserve development in the past few years.

Alterra reported \$110 million of favorable reserve development during the first nine months of 2011, primarily from its insurance and reinsurance segments. Net favorable development was \$111 million for the full year 2010 mainly stemming from workers compensation, property, general casualty, professional liability and whole account lines of

business, partially offset by net unfavorable development on marine and energy lines. This compares with \$87 million of net favorable development for the full year 2009 on professional liability, property, and general casualty lines offset by net unfavorable development on marine and energy lines. Favorable development of prior period loss reserves at Alterra has been less than 6% in 2010, 2009, and 2008 and has averaged 4% over the past nine years. Alterra's incurred-but-not-reported reserves as a percentage of total reserves remained high at 70% as of year-end 2010, slightly down from 71% at year-end 2009.

### **Reinsurance**

Alterra uses reinsurance to manage its line sizes, PMLs, and risk aggregation between lines of businesses. The company evaluates reinsurance purchases based on their contributions to ROE. Alterra tends to use more reinsurance when starting a new line of business and to support its primary insurance writings. Despite the increase in shareholders' equity following the merger, the company continues to use a significant amount of reinsurance and still offers low limits in order to reduce volatility of results. Alterra uses reinsurance for all of its operating segments, but it purchases more reinsurance for its insurance and U.S. specialty segments compared with its reinsurance, Lloyd's, and life segments. The company has reduced its reinsurance utilization on its U.S. specialty segment as this book matures. Nevertheless, the reinsurance utilization rate declined to 23% as of Sept. 30, 2011, from 26% at year-end 2010.

### **Prospective**

Standard & Poor's expects capital adequacy to remain very strong in 2011 and 2012. Provided that risk-adjusted capital remains within our expectations, we do not expect the share buybacks or dividend payments to have any effect on the ratings.

## **Financial Flexibility: Strong, Supported By Modest Financial Leverage**

Alterra has strong financial flexibility based on its access to both the equity and debt markets, as demonstrated just after its formation by issuing \$350 million in senior notes in September 2010. Prior to the formation of Alterra, Max Capital Group Ltd. had a track record of raising capital by issuing debt and equity in the financial markets and through private placements. Additionally, the company's financial flexibility also benefits from large credit facilities and its reinsurance utilization is low.

Alterra may borrow up to \$400 million under its revolving credit facility on an unsecured basis for general and corporate purposes. The company had no borrowings under this facility as of Sept. 30, 2011. Furthermore, Alterra may issue US\$1.525 billion and GBP90 million in letters of credits (LOCs) under its various credit facilities. At the end of third-quarter 2011, US\$899.1 million and GBP70.1 million of LOCs were issued and outstanding.

Alterra has no immediate debt maturities (\$100 million due in 2017 and the remainder \$350 million is due in 2020) and its financial leverage as of June 30, 2011, was conservative at 13.1%. Because of the catastrophe losses in the first six months of 2011, the fixed-charges coverage ratio decreased from historical levels to 1.2x. We don't see this reduction as an indication of reduced prospective coverage ratios for the company but more as a reflection of lower earnings resulting in a year of high catastrophe losses.

**Table 1**

**Alterra Capital Holdings Ltd.--Business Statistics**

	--Year ended Dec. 31--							Five-year average
	First six months of 2011	2010	2009	2008	2007	2006	2005	
Gross premiums written (\$ mil.)	1,192	1,411	1,375	1,254	1,078	865	1,246	1,197
Change in gross premiums written (%)	54.70	2.60	9.63	16.32	24.63	(30.56)	N/A	4.52
Net premiums written (\$ mil.)	918	1,040	895	840	797	635	1,047	841
Change in net premiums written (%)	70.80	16.22	6.46	5.48	25.52	(39.39)	N/A	2.86
Net premiums earned (\$ mil.)	729	1,172	834	814	818	665	1,053	861
Change in net premiums earned (%)	49.50	40.53	2.56	(0.54)	22.99	(36.88)	N/A	5.73
Total assets under management (\$ mil.)	8,009	7,861	5,262	5,357	5,123	4,536	4,223	5,628
Growth in assets under management (%)	N/A	49.39	(1.77)	4.57	12.94	7.40	N/A	14.51
Reinsurance utilization (%)	22.99	26.31	34.94	33.01	26.12	26.65	15.97	29.41

**Table 2**

**Alterra Capital Holdings Ltd.--Operating Statistics**

	--Year ended Dec. 31--							Five-year average
	First six months of 2011	2010	2009	2008	2007	2006	2005	
Total revenue (\$ mil.)	846	1,400	1,007	997	1,007	816	1,165	1,045
EBIT (\$ mil.)	(2)	335	278	(138)	345	232	24	210
EBIT adjusted (\$ mil.)	24	321	199	112	163	153	(6)	189
EBITDA (\$ mil.)	(1)	337	278	(138)	345	232	24	211
EBITDA adjusted (\$ mil.)	25	322	199	112	163	153	(6)	190
EBIT adjusted to total equity adjusted (%)	2.20	14.30	13.97	7.79	10.95	11.92	(1.00)	11.79
EBITDA adjusted to capital (%)	2.80	11.62	11.15	6.16	8.99	9.50	(0.38)	9.48
Net income (\$ mil.)	(14)	302	246	(175)	303	217	0	179
Return on revenue (%)	2.83	22.90	19.74	11.20	16.17	18.73	(0.51)	17.75
Return on revenue (incl. realized capital gains/losses) (%)	(0.24)	23.68	25.56	(18.47)	29.04	25.90	2.76	17.14
Return on equity (%)	(2.01)	13.49	17.31	(12.24)	20.39	16.91	0.02	11.17
Return on assets (%)	(0.09)	4.48	4.49	(2.29)	6.26	4.62	0.50	3.51
Realized gains/EBITDA (%)	2576.79	4.23	28.39	180.88	52.89	34.06	163.45	60.09
Administrative expense ratio (%)	19.30	18.63	19.12	21.26	20.12	13.41	6.63	18.51
Commissions expense ratio (%)	18.56	16.02	12.07	9.19	11.64	12.44	9.45	12.27
Expense ratio (%)	37.86	34.65	31.19	30.45	31.76	25.85	16.08	30.78
Non-life loss ratio (%)	70.86	56.07	62.40	68.85	63.97	67.70	93.37	63.80
Non-life combined ratio (%)	108.71	90.72	93.59	99.30	95.73	93.55	109.45	94.58
Non-life (favorable)/unfavorable prior year loss ratio (%)	(0.13)	(9.47)	(11.04)	(0.19)	(0.12)	(0.02)	0.18	(10.64)
Non life-accident year loss ratio (%)	83.67	65.54	73.44	87.56	76.31	69.34	75.50	74.44
Non-life accident year combined ratio (%)	121.52	100.19	104.63	118.01	#####	95.19	91.58	105.22
<b>Cash flows</b>								
Net cash flow from operating activities (\$ mil.)	149	308	193	482	228	405	644	323.4

**Table 2**

<b>Alterra Capital Holdings Ltd.--Operating Statistics (cont.)</b>								
Net cash flow from investing activities (\$ mil.)	94	318	29	194	(377)	(274)	(382)	(22.1)
Net cash flow from financing activities (\$ mil.)	(170)	(417)	(499)	(93)	101	(7)	(230)	(183.1)

**Table 3**

	<b>--Year ended Dec. 31--</b>							<b>Five-year average</b>
	<b>First six months of 2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	
Total invested assets (\$ mil.)	8,009	7,861	5,262	5,357	5,123	4,536	4,223	5,628
Change in invested assets (%)	2.31	49.39	(1.77)	4.57	12.94	7.40	N/A	14.51
Total invested assets adjusted (\$ mil.)	8,009	7,861	5,262	5,357	5,123	4,536	4,223	5,628
General account invested assets (\$ mil.)	8,009	7,861	5,262	5,357	5,123	4,536	4,223	5,628
Separate accounts/unit linked assets (\$ mil.)	0	0	0	0	0	0	0	0
Invested assets to total assets (%)	86.31	89.21	85.60	86.23	87.86	87.12	87.31	87.20
Invested assets to loss and unearned premium reserve (%)	n/a	202.06	185.20	198.24	229.15	199.24	(4485.25)	202.78
Net investment income (\$ mil.)	117	222	170	182	188	150	107	182
Realized capital gains/(losses) (\$ mil.)	(26)	14	79	(250)	183	79	39	21
Unrealized gains/(losses) (\$ mil.)	0	81	51	10	0	(30)	(9)	22
Net investment yield (%)	5.87	3.39	3.20	3.47	3.90	3.43	2.53	3.48
Net investment yield including realized gains/(losses) (%)	4.57	3.61	4.68	(1.30)	7.68	5.23	3.46	3.98
Net investment yield including realized and unrealized gains/(losses) (%)	4.57	4.85	5.63	(1.11)	7.69	4.53	3.24	4.32
Common equity investment/capital (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Real estate investments to capital (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
<b>Portfolio composition (% of invested assets)</b>								
Bonds (%)	83.30	83.67	80.61	68.21	71.51	66.76	63.53	74.15
Equity investments (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Cash and short-term investments (%)	12.32	11.52	13.35	17.72	7.76	9.74	7.44	12.02
Real estate (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investments in affiliates (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investment funds(%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mortgages and loans (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investments in partnerships, joint venture and other alternatives investments (%)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other investments (%)	4.37	4.81	6.04	14.07	20.73	23.50	29.04	13.83

**Table 4**

	<b>--Year ended Dec. 31--</b>							<b>Five-year average</b>
	<b>First six months of 2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	
Total assets (\$ mil.)	10,553	9,917	7,340	7,252	6,539	5,849	5,911	7,379
Adjusted total assets (\$ mil.)	9,279	8,812	6,148	6,212	5,830	5,207	4,837	6,442

**Table 4**

<b>Alterra Capital Holdings Ltd.--Capitalization Statistics (cont.)</b>								
Common equity (\$ mil.)	2,793	2,918	1,565	1,280	1,584	1,390	1,176	1,747
Change in common equity (%)	(4.58)	86.51	22.21	(19.17)	13.94	18.24	N/A	24.35
Total adjusted capital (\$ mil.)	2,798	2,964	1,637	1,302	1,679	1,528	1,125	1,822
Change in total adjusted capital (%)	(2.38)	81.10	25.72	(22.44)	9.84	35.86	N/A	26.02
<b>Reinsurance and reserves</b>								
Reinsurance utilization (%)	22.99	26.31	34.94	33.01	26.12	26.65	15.97	29.41
Reinsurance recoverables to shareholders' equity (%)	45.62	37.88	76.18	81.19	44.73	46.22	91.38	57.24
Non life loss reserves to total shareholders' equity (%)	114.77	102.29	141.46	166.21	113.38	132.38	(38.59)	131.14
Non life loss reserves/net premiums written (%)	174.88	288.41	260.03	355.54	362.68	311.71	(58.65)	315.67
Liquid assets/loss and unearned premium reserves (%)	n/a	192.34	174.01	170.35	181.66	152.42	(3182.84)	174.16

**Table 5**

<b>Alterra Capital Holdings Ltd.--Financial Statistics</b>									
	<b>--Year ended Dec. 31--</b>								
	<b>First six months of 2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>Five-year average</b>	
EBITDA interest coverage (x)	1.2	10.6	8.6	3.0	3.7	10.3	(0.3)	7.2	
EBITDA fixed-charge coverage (x)	1.2	10.6	8.6	3.0	3.7	10.3	(0.3)	7.2	
Debt leverage including pension deficit as debt (%)	13.06	12.70	5.68	15.64	8.42	0.64	24.62	8.62	
Financial leverage including pension deficit as debt (%)	13.06	12.70	5.68	15.64	8.42	0.64	24.62	8.62	
U.S. unrestricted cash interest coverage (x)	0.0	7.2	10.0	(4.6)	6.9	14.7	0.0	6.8	
U.S. unrestricted fixed charge coverage (x)	0.0	7.2	10.0	(4.6)	6.9	14.7	0.0	6.8	

**Ratings Detail** (As Of December 28, 2011)

**Holding Company: Alterra Capital Holdings Ltd.**

Issuer Credit Rating

*Local Currency*

BBB+/Stable/--

Senior Unsecured (1 Issue)

BBB+

**Operating Companies Covered By This Report**

**Alterra Bermuda Ltd.**

Financial Strength Rating

*Local Currency*

A/Stable/--

Counterparty Credit Rating

*Local Currency*

A/Stable/--

**Alterra America Insurance Co.**

Financial Strength Rating

*Local Currency*

A/Stable/--

Issuer Credit Rating

*Local Currency*

A/Stable/--

<b>Ratings Detail</b> (As Of December 28, 2011) <b>(cont.)</b>	
<b>Alterra Europe PLC</b>	
Financial Strength Rating	
<i>Local Currency</i>	A/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A/Stable/--
<b>Alterra Excess &amp; Surplus Insurance Co.</b>	
Financial Strength Rating	
<i>Local Currency</i>	A/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A/Stable/--
<b>Alterra Reinsurance USA Inc.</b>	
Financial Strength Rating	
<i>Local Currency</i>	A/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A/Stable/--
<b>Related Entities</b>	
<b>Alterra Capital Europe Ltd.</b>	
Issuer Credit Rating	
<i>Local Currency</i>	BBB+/Stable/--
<b>Alterra Capital UK Ltd.</b>	
Issuer Credit Rating	
<i>Local Currency</i>	BBB+/Stable/--
<b>Alterra Finance LLC</b>	
Senior Unsecured (1 Issue)	BBB+
<b>Alterra USA Holdings Ltd.</b>	
Issuer Credit Rating	
<i>Local Currency</i>	BBB+/Stable/--
<b>Domicile</b>	Bermuda

\*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.

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