

## Ecclesiastical Insurance Office PLC

### *Operating Company Covered*

### *By This Report*

Financial Strength Rating

### *Local Currency*

A-/Stable/—

### *Primary Credit Analysts:*

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### *RatingsDirect Publication Date*

March 31, 2011

### *Major Rating Factors*

#### *Strengths:*

- Very strong capitalization.
- Strong niche competitive position.

#### *Weaknesses:*

- Operating performance is viewed as weaker component of the rating despite being in the strong category.
- Relatively high compared to its peers' equity exposure.

### *Rationale*

The ratings on U.K.-based non-life insurer Ecclesiastical Insurance Office PLC reflect the company's very strong capitalization and strong niche competitive position. These positive factors are partially offset by the company's investment strategy. In our opinion, Ecclesiastical has maintained a consistently high exposure to equities. This increases its solvency capital requirement and earnings volatility. This is reflected by a relatively volatile operating performance for an 'A' rated company. The performance was also offset by natural catastrophe losses on the Ecclesiastical Underwriting Management Ltd. (EUML) book of business which was closed to new and renewing businesses in 2010.

Ecclesiastical's capitalization in our view has further strengthened and become very strong in 2010 after the company issued an additional £40 million in preference shares, which have been fully subscribed and are treated by Standard & Poor's Rating Services as hybrid in its risk-based capital model. Based on this model, Ecclesiastical has an extremely strong risk-based capital adequacy, a strong track record of reserving, and prudent reinsurance protection.

This is somewhat mitigated, however, by a dependence on the availability of reinsurance protection and by the extensive use of preference stock within its capital structure.

Ecclesiastical is a midsize non-life insurer with a strong niche competitive position centered on U.K. specialist property. The company has increasingly focused on its core specialist insurance of churches, independent schools, charities, care homes, and heritage properties in recent years, and we expect it to continue to do so.

Ecclesiastical's strong operating performance reflects our belief in Ecclesiastical's ability to achieve strong cross-cycle results, with limited underwriting volatility on its core business due to strong underwriting controls. We anticipate that, despite adverse performance on its non-core EUML book of business and difficult economic conditions, the company will report strong operating results for 2010, with five-year rolling net combined ratios below the company's target of 98% over the cycle. As of June 30, 2010, the net combined ratio was about 111% and heavily affected by adverse developments on the EUML book which was exposed to natural catastrophe losses in the Chile and Haiti earthquakes.

In our opinion, Ecclesiastical has maintained a consistently high exposure to equities. The risk to solvency associated with this investment strategy is moderated by the company's extremely strong capital adequacy ratio, however. The earnings, however, remain significantly affected by stock market volatility.

### ***Outlook***

The stable outlook reflects our expectation that Ecclesiastical's senior management team will continue to build a track record of prudent growth and development of core U.K. specialist property lines. Overall, we anticipate seeing fundamentally strong and stable earnings throughout the business cycle with five-year rolling net combined ratios below 98%. In addition, we expect above-average results for their sectors, which, in the absence of exceptional events, will display consistently profitable underwriting results on the company's core business. We also anticipate that Ecclesiastical will continue to deliver positive return on revenue in excess of 3% and return on equity in excess of 10%.

Meanwhile, we expect management to stick to its fairly aggressive investment strategy, with its exposure to equity markets mitigated by consistently strong risk-based capital ratios that support a higher rating.

A positive rating action may occur if Ecclesiastical demonstrates strong cross-cycle performance, with net combined ratios below 95% and ongoing improvement in its enterprise risk management (ERM) framework. We could consider lowering the rating in the event of a significant deterioration in operating results and capitalization, assuming there are no catastrophic/extreme losses. However, we do not anticipate a negative rating action in the medium term.

### ***Corporate Profile: U.K.-Focused, Predominantly Non-Life Insurer***

Ecclesiastical is a midsize non-life insurer headquartered in the U.K. In 2009, on a consolidated basis, it wrote non-life gross premiums of £428 million. Its main lines of business are commercial property (71%) and commercial liability (21%). Of gross premiums written (GPW), 73% come from the U.K., with the remainder chiefly originating from its Australian subsidiary. The company's main distribution channel is through intermediaries (68% of GPW).

Ecclesiastical is ultimately owned by Allchurches Trust Ltd., of which it is the principal operating entity. With close connections to the Anglican church, Allchurches' main objective is to promote Christianity, which it does through charitable distributions. Ecclesiastical has several subsidiaries including Australia-based Ansvar Insurance Ltd. (BBB+/Stable/—) and Ansvar Insurance (New Zealand) Ltd (not rated). At the beginning of 2011, Ansvar U.K., Ecclesiastical's U.K. subsidiary transferred its business into Ecclesiastical under a Part VII transfer. Ansvar U.K.'s premium income in 2010 was about £27 million. Ecclesiastical's financial services and life operations are not referred to in this report as they represent less than 5% of gross premium income. Most of its life operations (with profit fund and most of their non-profit life fund) were transferred to Engage Mutual Assurance for £3.6 million in November 2010.

***Competitive Position: Strong In U.K. Specialist Property***

Table 1

<b><i>Ecclesiastical Insurance Office PLC Competitive Position</i></b>					
	<b><i>—Year-ended Dec. 31—</i></b>				
<b><i>(000s £)</i></b>	<b><i>2009</i></b>	<b><i>2008</i></b>	<b><i>2007</i></b>	<b><i>2006</i></b>	<b><i>2005</i></b>
Total revenue	329,705.0	331,845.0	311,959.0	326,095.0	288,671.0
Gross premiums written	447,821.0	403,608.0	386,915.0	403,316.0	361,686.0
Annual change in gross premiums written (%)	11.0	4.3	(4.1)	11.5	0.5
P/C: Gross premiums written	427,698.0	384,693.0	365,711.0	358,283.0	346,634.0
P/C: Annual change in gross premiums written (%)	11.2	5.2	2.1	3.4	0.8
Life: Gross premiums written	20,123.0	18,915.0	21,204.0	45,033.0	15,052.0
Life: Annual change in gross premiums written (%)	6.4	(10.8)	(52.9)	199.2	(5.3)
Net premium earned	276,929.0	261,265.0	253,638.0	278,053.0	241,509.0
Annual change in net premium earned (%)	6.0	3.0	(8.8)	15.1	(0.2)
Total assets under management	1,276,094.0	1,129,327.0	1,191,709.0	1,152,361.0	1,017,716.0
Growth in assets under management (%)	13.0	(5.2)	3.4	13.2	14.0

P/C—Property and casualty.

In our opinion, Ecclesiastical has a strong niche competitive position centered on U.K. specialist property business. The company has been focusing increasingly on its core specialist operations in recent years, and we expect it to continue to do so.

We believe Ecclesiastical's strong niche competitive position is derived from its participation as a leading insurer of churches, independent schools, charities, care homes, and, lately, heritage properties. These large, core niches represent about 65% of the company's GPW in the U.K., and the proportion is rising. They regularly record gross loss ratios below the consolidated Ecclesiastical gross loss ratio, implying that they are particularly attractive. The company is successfully applying the skills it developed in church insurance to the four other types of property, particularly its specialist underwriting, claims, survey, and valuation expertise, and risk management services. Ecclesiastical is a leading insurer of Anglican church property in all its main markets. In the U.K., for example, more than 95% of Anglican churches insure with the company. Ecclesiastical has also exported its specialist commercial property knowledge overseas.

Most of the other U.K. premiums are derived from specialized commercial property similar to the core businesses (for example, sheltered accommodation, Catholic monasteries, and hospitals), and

specialist household business, such as holiday home and clergy schemes. The small personal motor book is also specialized (for example, clergy and classic cars). Liability business is written only as a supplement to a property risk.

The company mainly focuses on profitability. Its only specific market-share target is for its Anglican church property business. Nevertheless, the U.K. Anglican church book of business will decline in relative importance over time, due to its very limited growth prospects.

Ecclesiastical has been refining its business profile over the past eight-to-nine years, and will continue to do so in our view. However, further refinements will be minor and we do not anticipate concentration on the core specialist businesses to diminish. For example, in 2009, Ecclesiastical's parent acquired a minority stake in another insurance broker to improve its distribution capabilities and the diversity of its income. In 2010, Ecclesiastical placed its EURL business into run-off and transferred out the majority of its life operations.

### ***Management And Corporate Strategy: Good, Consistent Execution***

Management has consistently proved its commitment to refining its strategy and has overseen a strong improvement in many aspects of the company's profile over the past five years, particularly in its ERM, its competitive position, which is now very clearly focused, and its operating performance of core businesses. Operational and financial management are good and improving, although equity exposure remains high. We do not anticipate any material changes to strategy with the exception of fine-tuning and clearer focus on its core businesses over the next two-to-three years.

### ***Strategy***

Over the past eight-to-nine years, management has consistently refined its strategy by eliminating peripheral or unprofitable businesses to concentrate on profitability. As a result, Ecclesiastical is a more streamlined and focused company than it was just a few years ago.

Ecclesiastical has clear financial goals that stretch until 2015, which include achieving a consistent group average net combined ratio of 98% or better over a rolling five-year period. Amongst these goals is Ecclesiastical's aim to increase its turnover by 11% on average per year, year-on-year over the next five years which we view as challenging, particularly in the current economic conditions and still very competitive market. The company also reviewed its objective to reduce its gross expense ratio (based on Ecclesiastical's calculations of gross expenses on GPW) to 15% initially by 2012 and now by 2015 from 19% in 2009. This demonstrates that these results will be difficult to achieve. We also expect the net loss ratio to be around 60%, which may prove to be difficult to achieve given rising metal prices, climate changes, and increasing natural catastrophe events. That said, if these targets are achieved, this may positively affect the company's competitive position, operating performance, and capitalization scoring.

Ecclesiastical's mission is to: "run an independent and successful financial services organization...to produce profit and service for the benefit of church and community." In practice, this has meant providing specialist non-life, as well as life, insurance not only to the Anglican Church, but also to other religions and secular interests. Ecclesiastical does so commercially, aiming to earn enough to finance its growth and pay dividends to its shareholders and a grant to its ultimate parent, Allchurches. The company is aiming to pay a substantial grant to Allchurches Trust of £20 million by 2015 (£9.2 million regular grant expected in 2010, and £8.5 million in 2009). Based on the company's position

following the discontinuation of the EUML business and improved underwriting performance going forward, we view this target as a medium-level challenge in the absence of extreme or catastrophic losses.

Key elements of the underlying strategy are: to continue to focus on property insurance, with liability insurance written only as part of a package; and to continue to focus on lines of business where Ecclesiastical has or can achieve a competitive advantage, both in the U.K. and abroad. These lines of business are churches, independent schools, charities, care homes, and heritage properties. We view the strategy, which concentrates on clearly defined niche and lines, very positively.

### ***Operational management***

In our view, Ecclesiastical has a management team with good depth and breadth across all significant business units, which can absorb the loss of senior managers without significantly disrupting operations in the U.K. Ecclesiastical's management team has now established a track record of success in carrying out its plans.

### ***Financial management***

We believe Ecclesiastical's financial management is good. The company is actively utilizing stochastic capital models to add further depth to claims forecasting, budgeting, capital management, and investment strategy. However, we believe that the company's revised financial goals up to 2015 may be difficult to achieve. We regard Ecclesiastical's reserving practices and, to a lesser extent, its capital structure and use of reinsurance as conservative.

In our view, Ecclesiastical's financial risk is high. The company remains exposed to a relatively high level of equities. There is no obvious need for short-term liquidity or long-term capital, particularly after the opportunistic issue of £40 million of preference shares in 2010, which we view as hybrid, together with all preference shares issued by the company in the past.

### ***Enterprise Risk Management: Adequate With Strong Controls***

We assess Ecclesiastical's ERM framework as adequate with strong risk controls. We believe that it is unlikely that Ecclesiastical will experience losses outside its risk tolerances. The major factors supporting this assessment are an adequate management culture and strong risk controls for the main risk areas. Currently there is no formal framework to consider risk versus reward throughout the company and, as such, we consider strategic risk management to be adequate.

We view the company's ERM as moderately important to the ratings, given the large amount of capital held by Ecclesiastical and the relatively stable business profile.

Ecclesiastical is continually developing its ERM and is moving toward a more robust and transparent framework. The group has recently implemented, or is still in the process of developing, many of the appetites, systems, and controls. Therefore, we will need to see further embedding and improvement in the framework in the next couple of years.

### ***Accounting: Conservative And Transparent***

We use the published consolidated reports and accounts for Ecclesiastical Insurance Office PLC (Company Number 24869) for this analysis, combined with financial information provided by the company.

Ecclesiastical prepares its consolidated accounts in accordance with International Financial Reporting Standards (IFRS). We do not expect the adoption of further IFRS and International Financial Reporting Interpretations Committee decisions to affect the group's results.

### ***Operating Performance: Strong Underwriting Performance On A Five-Year Rolling Basis***

Table 2

<b><i>Ecclesiastical Insurance Office PLC Operating Performance</i></b>					
<i>—Year-ended Dec. 31—</i>					
<i>(000s £)</i>	<i>2009</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>
Return on revenue (%)	3.0	30.5	8.1	9.7	14.0
Return on equity (%)	15.3	(4.4)	7.4	16.9	28.6
EBIT	79,167.0	(22,021.0)	36,436.0	77,752.0	101,835.0
Net loss ratio (%)	52.8	63.7	69.3	55.5	54.5
Net combined ratio* (%)	89.6	100.8	102.9	88.5	83.7
Net investment yield (%)	4.4	6.1	5.0	4.4	4.9

\*Source: Ecclesiastical Insurance Office PLC.

Based on preliminary financial results, Ecclesiastical's operating performance in 2010 is below our expectations, with forecasted net combined ratios around 102%, compared with an expected 95%-97%. The deterioration is mainly due to losses experienced on its discontinued EUML book of business which was exposed to the Chile and Haiti earthquakes in 2010. Having said that, the company is still on target delivering a strong cross-cycle performance with rolling five-year net combined ratios of about 97% in 2010.

The performance of the core U.K. business in 2010 was strong given the major freeze events, with reported net combined ratios of 98.5% (five-year rolling average 96.2%). This business will continue to represent a major chunk of Ecclesiastical's operations going forward, after the EUML and a majority of the life operations were discontinued in 2010. This reflects our belief in Ecclesiastical's ability to achieve strong cross-cycle results with limited underwriting volatility in its core property and church-related business. This strong performance is largely caused by Ecclesiastical's cautious underwriting, some rate increases, and high client retention levels.

#### ***Prospective***

In our view, Ecclesiastical will continue to produce strong underlying profits, particularly in the U.K. We believe that Ecclesiastical is resisting its competitors' pressure and gradually raising rates. As Ecclesiastical is committed to active cycle management, we anticipate the net combined ratio for the overall business to be around 95%-97% in 2011. Investment performance will likely continue to be exposed to equity market volatility through 2011. Therefore, we find return on revenue and return on equity difficult to forecast due to the high level of equity exposure in highly volatile equity markets so far in 2011.

**Investments: Consistently High Equity Exposure**

Table 3

<b>Ecclesiastical Insurance Office PLC Liquidity And Investments</b>					
	<b>—Year-ended Dec. 31—</b>				
<b>(000s £)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Liquidity ratio (x)	4.9	6.3	5.3	5.1	5.4
Invested assets to total assets (%)	67.6	65.3	68.3	71.1	88.0
<b>Investment portfolio composition</b>					
Cash and cash equivalents (%)	15.2	12.9	15.2	20.3	16.6
Total bonds (%)	50.3	56.5	43.8	37.6	42.2
Common stock (%)	30.5	25.4	34.8	35.7	35.0
Real estate (%)	2.2	2.6	3.2	3.5	3.3
Total mortgages and loans (%)	1.8	2.6	3.0	2.8	2.9
Investments in affiliates (%)	0.0	0.0	0.0	0.0	0.0
Investments in partnerships, joint ventures, and other alternative investments (%)	0.0	0.0	0.0	0.0	0.0
Other investments (%)	0.0	0.0	0.0	0.0	0.0
Total portfolio composition (%)	100.0	100.0	100.0	100.0	100.0

Ecclesiastical has maintained a consistently high exposure to equities. The risk to solvency associated with this investment strategy is moderated, however, by the company's extremely strong capital adequacy. No change is expected either in the investment strategy or in the investment portfolio's risk profile. Having said that, a two-fund approach was introduced in 2010 to provide greater clarity to the company's investment philosophy relating to liabilities and excess capital. The investment portfolio covering liabilities had 10% equity exposure in 2010, with a maximum limit of 15%, while excess capital fund is 61% exposed to equities, with a maximum limit of 85% of the total invested portfolio. At present, Ecclesiastical can afford to take such an aggressive equity exposure due to excess of capital. We continue to view this strategy as risky for the company.

We anticipate the company will maintain its above-average equity exposure.

**Liquidity: Strong Balance Sheet Liquidity**

Ecclesiastical's liquidity or cash building ability is strong in our view. On June 30, 2010, Ecclesiastical reported strong net cash flow from operations of £67.4 million, which easily covered preference share dividends (£2.9 million on June 30, 2010). Ecclesiastical maintained its consistently liquid balance sheet, with liquid assets to total net technical reserves at a strong level of 175% on June 30, 2010, compared with 145% on June 30, 2009. Additional liquidity is available through an overdraft facility of £2 million, and the company potentially has access to cash held by Allchurches and Ecclesiastical Insurance Group PLC, Ecclesiastical's immediate parent. We do not anticipate any significant changes in the company's liquidity.

**Capitalization: Very Well Capitalized And Reserved**

Table 4

<b>Ecclesiastical Insurance Office PLC Capitalization</b>					
	—Year-ended Dec. 31—				
(000s £)	2009	2008	2007	2006	2005
Reinsurance utilization (%)	35.8	34.7	34.1	30.0	32.7

Ecclesiastical's very strong capitalization is based on its extremely strong risk-based capital adequacy, a strong track record of reserving, and prudent reinsurance protection. This is somewhat mitigated, however, by a dependence on the availability of reinsurance protection, and by its extensive use of preference stock within its capital structure.

**Capital adequacy**

Ecclesiastical's consolidated capital adequacy, as measured by Standard & Poor's risk-based capital model, is extremely strong based on forecasted Dec. 31, 2010 financials. The quality of capital, however, is less strong because a significant proportion is derived from preference shares, which we class as hybrid equity. It should be noted, however, that Ecclesiastical has doubled its shareholders equity over the past five years. We expect Ecclesiastical's consolidated capital adequacy ratio to remain at least strong over the rating horizon.

**Reserves**

Ecclesiastical has strong reserves on a consolidated basis. Its ratio of net technical reserves to net premiums written as of Dec. 31, 2009, was 175% (Dec. 31, 2008: 183%) and has been consistently high in recent years. The company aims for modest long-term over-reserving.

**Reinsurance**

Ecclesiastical relies fairly heavily on reinsurance, but this is not a significant issue as the company is aware of its dependence, and the risks associated with this dependence have been identified and are managed. In addition, a set of contingency plans are being developed. Ecclesiastical consistently cedes between 30%-38% of its non-life premiums, and its ratio of non-life net technical reserves to gross technical reserves has remained very stable at about 70% (Dec. 31, 2009: 71%).

The company uses reinsurance to provide capacity for its property risks. Reinsurance is mainly achieved by proportional treaty. For 2010, maximum individual risk retentions remain at about 1% of shareholders' funds of £374.9 million as of June 30, 2010. Because of the strategic importance of its proportional reinsurance program, the company maintains long-term relationships with good-quality reinsurers.

Ecclesiastical also uses reinsurance for catastrophe protection. The group U.K. property catastrophe protection for 2010 was £175 million in excess of a £12 million retention, which is in line with Ecclesiastical's average modeled one-in-250-year loss. A £12 million loss represented about 3% of shareholders' funds on June 30, 2010. The quality of the reinsurers is strong, with most of the 2010 program protected by reinsurers rated 'A' or higher.

**Financial Flexibility: Constrained, But Good**

Table 5

<b>Ecclesiastical Insurance Office PLC Financial Flexibility</b>					
<i>(000s £)</i>	—Year-ended Dec. 31—				
	2009	2008	2007	2006	2005
Debt leverage (%)	1.6	1.5	3.1	2.4	2.1
Financial leverage (%)	1.6	1.5	3.1	2.4	2.1

We consider Ecclesiastical's financial flexibility (the ability to source capital and liquidity relative to requirements) to be constrained, but good. There is no obvious need for short-term liquidity or long-term capital, particularly after the opportunistic issue of £40 million of preference shares in 2010. The company has access to some sources of additional liquidity (see "Liquidity" section), although after the preference share issue, its ability to raise further long-term debt capital is more restricted. Ecclesiastical is, however, confident that it could easily arrange new proportional reinsurance or bank debt to alleviate any potential capital strain. It should also be noted that Ecclesiastical can derive some additional flexibility through the reduction of its gift aid payable to the parent (in 2010, pre-tax gift aid of £19.3 million; plan for 2011 is £11.5 million), however, it is relatively limited in absolute terms.

**Ratings Detail (As Of 31-Mar-2011)\*****Operating Company Covered By This Report**

Ecclesiastical Insurance Office PLC

Financial Strength Rating

Local Currency

A-/Stable/—

Counterparty Credit Rating

Local Currency

A-/Stable/—

**Domicile**

United Kingdom

\*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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