

UBS Investment Research

Scottish Re Group

Lots of Concerns

■ Downgrading to Reduce 2

We are downgrading SCT to Reduce 2 from Neutral 2 given our increasing concerns with the company's earnings stability and quality, and risk profile.

■ Earnings stability and quality concerns

We have become increasingly concerned with SCT's earnings stability and quality. The company has missed consensus for four of the last five quarters, a positive non-recurring item drove the single quarter of outperformance, and without large tax benefits, two of the misses would have been significantly larger.

■ Increasing risk profile

SCT's risk profile seems to be rising with its recent acquisitions of large blocks in which mortality results will likely deteriorate with further seasoning. Added concerns include SCT's XXX reserve funding, tax status, and capital structure. We are concerned to a lesser extent that about 10% of 12/31/04E net U.S. traditional business in force was written in soft pricing conditions before 2003.

■ Valuation: Price/Book Versus ROE Regression

We are downgrading SCT to Reduce 2 with a \$19 price target from Neutral 2 with a \$26 price target. Our \$19 price target is based on a price/book vs. ROE regression analysis. (See Valuation Analysis.)

Highlights (US\$)	12/02	12/03	12/04E	12/05E	12/06E
Total Revenue	-	548,037	834,376	2,358,197	2,532,681
Operating earnings	-	40,788	79,294	137,742	151,917
Operating EPS (UBS, US\$)	-	1.27	2.13	2.84	2.77

Profitability & Valuation	5-yr hist. av.	12/03	12/04E	12/05E	12/06E
Operating ROE (exAOCI) %	-	-	-	-	0.0
BVPS (exAOCI, UBS, US\$)	-	19.07	20.50	22.94	25.31
PE (UBS) x	-	15.9	11.7	8.8	9.0

Source: UBS adjusted EPS is stated before goodwill-related charges and other adjustments for abnormal and economic items at the analysts' judgement.

Valuations: based on an average share price that year, (E): based on a share price of US\$24.90 on 17 Jan 2005; Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is adjusted by adding back goodwill amortization and excludes net realized investment gains/(losses) and extraordinary items.; Source: (A) - company accounts, (E) - UBS estimates, Consensus - I/B/E/S

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Global Equity Research

United States

Insurance, Life

Rating **Reduce 2**
Prior: Neutral 2

Price target **US\$19.00**
Prior: US\$26.00

Price **US\$24.90**

RIC: SCT.N BBG: SCT US

18 January 2005

Trading data

52-wk. range	US\$26.05-19.67
Market cap.	US\$0.89bn
Shares o/s	35.9m
Free float	84%
Avg. daily volume ('000)	132
Avg. daily value (US\$m)	3.2

Balance sheet data 12/04E

Shareholders' equity (exAOCI)	-
P/BV (UBS)	1.2x

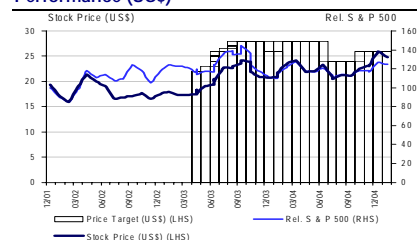
Forecast returns

Forecast price appreciation	-23.7%
Forecast dividend yield	0.8%
Forecast stock return	-22.9%
Market return assumption	8.2%
Forecast excess return	-31.1%

Operating EPS (UBS, US\$)

	12/04E			12/03
	From	To	Cons.	Actual
Q1	-	0.45	0.45	0.33
Q2	-	0.46	0.46	0.44
Q3	-	0.54	0.54	0.02
Q4E	-	0.69	0.67	0.50
12/04E	-	2.13	2.12	
12/05E	-	2.84	2.68	

Performance (US\$)



Source: UBS

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ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 15

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Lots of Concerns

We are downgrading Scottish Re Group (SCT) to Reduce 2 with a \$19 price target from Neutral 2 with a \$26 price target. The rationales for our downgrade are as follows:

- **Earnings stability and quality.** We have become increasingly concerned with SCT's earnings stability and quality. The company has missed consensus for four of the last five quarters, a positive non-recurring item drove the single quarter of outperformance, and without large tax benefits, two of the misses would have been significantly larger.
- **Mortality experience.** We are concerned with the outlook for the company's mortality experience. Mortality experience on life reinsurance can deteriorate as the business ages, particularly after the three-year mark. As time passes, a larger proportion of SCT's business will have originally been assumed at least three years ago.
- **Acquisition pricing.** We are concerned with the pricing of SCT's recent acquisitions (ERC Life Re and ING Re) given that a number of more experienced competitors did not emerge as buyers of either property at the price SCT was willing to pay. It is unclear why SCT would have been strategically better positioned to complete these transactions.
- **Triple X exposure.** Excluding the impact of new business, we expect SCT's reserves for level-premium term (Regulation XXX) business to increase substantially in coming years. We expect that SCT's required collateral for Regulation XXX will increase by at least \$300-400 million per year, putting pressure on its returns and potentially limiting new business in the long-term due to collateral capacity strain. Securitizations are emerging as a potential solution, but there is no guarantee that they are a viable *long-term* solution. ING has committed to fund the reserve strain on the ING Re block, but SCT still does not have *long-term* (i.e., greater than 10-years), *fixed cost* funding in place for its remaining XXX exposure (although it does have a 5-year \$200 million facility). Furthermore, under the terms of the ING Re acquisition, the rate that ING charges SCT for the collateral will increase over time—from 1.0% on over \$2.3 billion of collateral in 2005 to 1.75% on a much larger (but still undetermined) amount in 2009. Therefore, while SCT is guaranteed to have collateral in place for the ING Re block, it may be at uneconomic prices (note that SCT can seek to replace this collateral which we would expect assuming it could secure more attractive financing).
- **Tax status.** We expect the \$560 million negative ceding commission from the ING Re deal to fully offset SCT's existing net operating loss (NOL) carryforwards (\$168.4 million as of year-end 2003 as disclosed in the 10-K). This factor, combined with the increasing proportion of the company's

business that is written in the U.S., suggests that SCT's effective tax rate may climb towards the U.S. corporate rate of 35% (from the 0% to negative annual rate it has enjoyed since its IPO) more quickly than originally anticipated. SCT acknowledges that the negative ceding commission from the ING Re deal will largely absorb its existing NOL carryforwards, but adds that it will write new business in 2005 that will replenish the NOLs. However, even if this is the case, at some point, statutory profits will overwhelm NOL carryforwards and create a dramatic and sudden tax rate increase.

- **Capital structure.** We remain concerned with SCT's capital structure (as discussed in our note of 7/27/04). Although SCT has amended the terms of its contingently convertible debt to require cash settlement, it is unclear how SCT will fund the cash settlement and it is also unclear how SCT will fund the holders' put option on this debt should the holders exercise. We are also concerned with the potential dilution from the purchase contract component of SCT's Hybrid Capital Units.

Earnings Stability Concerns

SCT has missed the consensus operating EPS estimate for four of the last five quarters and the one quarter in which it did surpass the consensus estimate—4Q03—the upside was driven largely by a non-recurring tax benefit (Table 1).

A track record of missing consensus estimates, and now under a lot of operational strain

Table 1: SCT - Actual Operating EPS Versus Estimates

Quarter	Actual Reported	Consensus Estimate	Actual Vs. Consensus	UBS Estimate(a)	Comments
3Q04	\$0.54	\$0.57	(\$0.03)	\$0.57	<ul style="list-style-type: none"> ■ Shortfall appeared driven by higher-than-expected operating expenses (due to what management described as costs of complying with Sarbanes-Oxley) and sequentially lower premiums ■ Shortfall came despite a \$0.07 per share tax benefit in the quarter; excluding this benefit, actual would have missed consensus by \$0.10 ■ SCT later restated 3Q04 operating EPS to \$0.51 as the result of an accounting error in the International segment; therefore, actual actually missed consensus by (\$0.06)
2Q04	\$0.46	\$0.52	(\$0.06)	\$0.50	<ul style="list-style-type: none"> ■ Management attributed shortfall to higher than anticipated claims expenses after resolution of a processing backlog related to ERC Life ■ Shortfall came despite a \$0.06 per share tax benefit in the quarter; excluding this benefit, actual would have missed consensus by \$0.12 ■ SCT later restated 2Q04 operating EPS to \$0.49 as the result of an accounting error in the International segment; therefore, actual actually missed consensus by (\$0.03)
1Q04	\$0.45	\$0.46	(\$0.01)	\$0.50	<ul style="list-style-type: none"> ■ Shortfall appeared driven by higher-than-expected operating expenses and taxes
4Q03	\$0.50	\$0.48	\$0.02	\$0.50	<ul style="list-style-type: none"> ■ Upside driven largely by a one-time tax benefit of about \$2 million or \$0.05 per share
3Q03	\$0.02	\$0.49	(\$0.47)	n/a: restricted	<ul style="list-style-type: none"> ■ Shortfall driven primarily by a \$0.30 per share charge related to revised reporting of death claims on two annuity reinsurance treaties

Note: (a) Unadjusted for dilution from contingent convertibles or Hybrid Capital Units.

Source: First Call, company data, UBS

We believe this trend calls into question both management's guidance and the sustainability of prior favorable operating trends.

We also note that two of the 2004 misses came from higher than anticipated operating expenses. This leads us to question whether the existing guidance for 2004 operating expenses is realistic. Although management attributed the 3Q04 shortfall to higher-than-anticipated costs of complying with Sarbanes-Oxley, we view Sarbanes-Oxley compliance costs as normal and ongoing operating expenses that should be expected by any public company in the current environment.

With the addition of the \$573.1 billion in-force block of business from ING Re and related new business initiatives, we suspect that SCT is experiencing a lot of operational strain. It was little more than one year ago that SCT took a sizable charge to revise reporting of death claims on two annuity reinsurance treaties. And, in 2Q04, SCT experienced higher than anticipated claims expenses after the resolution of a processing backlog related to ERC Life. Most recently, on December 30, 2004, SCT announced an earnings restatement for 2Q04 and 3Q04 to correct an accounting error in the International segment. SCT has implemented stronger audit guidelines and added to its audit staff, but with the addition of ING Re, we think the operational strain could possibly generate more reporting issues.

Mortality Pricing Adequacy Concerns

According to SCT, it uses the Society of Actuaries Basic 1985-90 Select and Ultimate table (SOA 1985-90) as its base table for pricing (before adjustments for issue age, underwriting, and duration). However, more recent inter-company mortality studies by the Society of Actuaries (such as the SOA 1990-95 study) have indicated that the mortality slope (i.e., the degree to which death rates increase in each successive duration of an in-force block of life insurance or reinsurance) is actually steeper than that reflected in the SOA 1975-80 table.¹ Furthermore, like the SOA 1975-80 table, the SOA 1985-90 base table—as used by SCT—also has a flatter mortality slope than indicated by recent inter-company mortality studies.

Pricing off a mortality table that is too flat and then incorporating additional mortality improvement?

Like most life reinsurers today, SCT says it prices for 10 years of mortality improvements from its base assumptions. As SCT is assuming mortality improvements—according to Chief Actuary Cliff Wagner—from a base table that already appears to have a slope that is too flat, we question the appropriateness of the company's pricing methodology.

Various industry observers, including SCT, have pointed out that mortality from the later durations of the more recent studies might overstate mortality as this business was written before the advent of preferred underwriting (more extensive underwriting that gives discounted rates to insureds in particularly good health) and blood testing. However, 1) preferred underwriting only became

¹ Larry Warren, Chief Actuary of National Benefit Life (a Citigroup subsidiary), "The Relationship of Mortality Projections and the Underlying Mortality Tables Used" Reinsurance News, June 2002.

prevalent in the industry in the late 1990s; 2) most industry observers expect the impact of preferred underwriting to wear off² as the business ages; and 3) given the newness of preferred underwriting, no one is yet sure how quickly it will wear off. Given these factors, we would expect the true slope of the mortality table to still be steeper than that suggested by SOA 1985-90, even if it is not as steep as suggested by the SOA 1990-95 study.

SCT has made the case that its pricing process starts with the 1985-90 industry table and then it adjusts the table “to assure that the mortality assumptions by duration are consistent with the underwriting practices for the business being priced.” However, we reiterate our concern that these adjustments make the mortality slope flatter and the pricing table more aggressive than the original SOA 1985-90 table.

Further, SCT, correctly in our view, points out that the SOA 1990-95 table does not represent an anticipated pattern of mortality for any one homogenous block of business. However, again, our concern is that even with a homogeneous block of business written with preferred underwriting, the preferred underwriting is likely to wear off over time and this is not reflected in SCT’s pricing.

We also estimate 10% of SCT’s 2004 year-end (i.e., post acquisition) net in-force U.S. business was written in the soft pricing environment prior to 2003. We are concerned whether this business was priced adequately given that many industry participants have acknowledged industry pricing declined throughout the late 1990s and into the early 2000s to levels that may have been uneconomic.

Finally, as discussed in the next section, we are concerned that the benefits ratios on coinsurance business (which we think comprises the majority of SCT’s U.S. traditional life reinsurance in force) will increase more rapidly than most investors are anticipating.

Is the Winner the Loser?

We question whether the winner is really the loser in the two acquisitions that SCT has announced within the past year and a half—ERC Life Re (a portion of ERC’s U.S. life reinsurance business) and ING Re’s U.S. individual life reinsurance business. The ERC Life Re block acquisition in 4Q03 and the ING Re acquisition (which SCT completed on 12/31/04) will likely account for about three-quarters of SCT’s 12/31/04 gross face amount in force.

² Policies written with preferred underwriting can show mortality experience in the early years of very low percentages of the SOA 1975-80 table. However, as time passes from the original underwriting, the favorable characteristics that allowed the policyholder to qualify for preferred underwriting in the first place begin to dissipate. As a result, experience could develop to much higher percentages of the SOA 1975-80 table. For example, someone who was lean at time zero could become obese in by year five. Someone who did not smoke at time zero could begin smoking. Someone who did not have cancer at time zero could develop cancer. And the list goes on.

- **More experienced bidders appear to have passed.** We are concerned that other very experienced bidders (including RGA and Munich Re) apparently were not competitive with SCT's pricing of the blocks. Our discussions with various industry participants suggest that numerous parties were initially interested in the businesses, but ultimately, could not match SCT's bids. Given SCT's relatively short track record in writing traditional U.S. life reinsurance (since 2000), compared with other bidders that may have been in the business for decades, we question what SCT's competitive insight in pricing the business could have been.
- **We think mortality will deteriorate as the business seasons further.** According to SCT, the ERC Life Re block was originally assumed by ERC Life Re (or its predecessors) in 1998 and 1999. This means that the majority of the business is at least seven to eight years old. Based on data reported to the Munich American Survey, we estimate that about 45% or \$260 billion of the gross face amount SCT has assumed through the ING Re deal was first assumed before 1/1/02 (i.e., more than three years ago). Furthermore, according to SCT, 69% or \$395 billion of the ING Re block is coinsurance. When a life reinsurer coinsures business, the premiums are fixed for the life of the business. However, as the policyholders age, the benefits naturally increase. This means that as the block ages, the benefits ratio increases. We think the benefits ratios on SCT's coinsurance business may increase more quickly than most investors are anticipating.

Triple X Funding Requirements

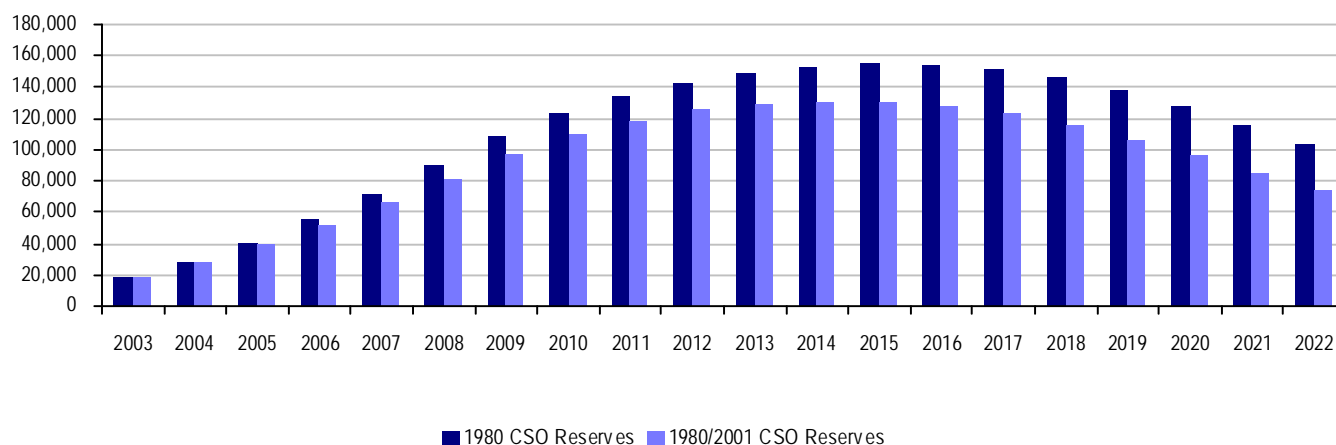
We expect that SCT's required collateral reserves for Regulation XXX will increase by at least \$300-400 million per year, putting pressure on its returns and potentially limiting new business in the long-term due to collateral capacity strain. Securitizations are emerging as a potential solution, but there is no guarantee they are a viable *long-term* solution.

We believe a key threat now facing the reinsurance industry—and SCT included—is the “humpbacked”³ development pattern of reserves under Regulation XXX (a statutory reserve requirement for U.S. level-premium term business written on or after January 1, 2000). We expect Regulation XXX to be a major issue for the life reinsurance industry in the coming years and to compel SCT to continue its pattern of annual equity issuances. According to estimates by actuarial consulting firm, Milliman USA, total industry XXX reserves were about \$18 billion at year-end 2003. However, Milliman expects this reserve amount to grow to about \$41 billion at year-end 2005 (2.3 times the 2003 level),

³ This industry terminology developed from the resemblance of a XXX reserve development chart to a humpbacked whale in profile.

\$90 billion by year-end 2008 (5.0 times the 2003 level), and then ultimately top out at about \$155 billion in 2015, a full 8.6 times the 2003 level (see Chart 1).⁴

Chart 1: Estimated Industry XXX Reserve Development Pattern (\$ millions)



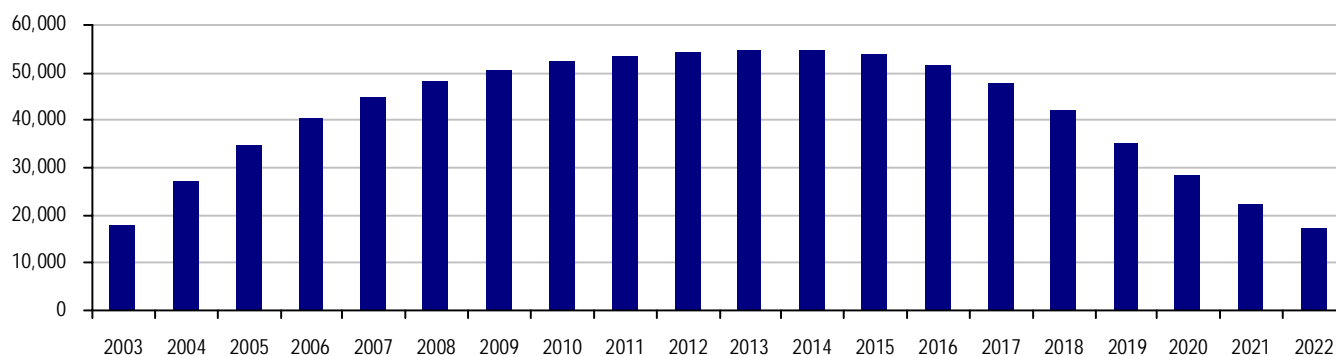
The 1980/2001 CSO reserves bars are calculated using the 1980 CSO mortality table for business written up to December 31, 2003, and the 2001 CSO table thereafter.

Source: Milliman USA

XXX reserves grow dramatically even on *in-force* business, i.e., the insurer does not have to write new business for its XXX reserves to continue increasing. This is because as the policyholders in the insured block age, mortality costs naturally increase, but given the level-premium nature of the product, premiums do not. The result of this is that an insurer’s decision to cease writing new business will not obviate an XXX reserve strain problem. To put this in context, even if all insurers had stopped writing new XXX business in 2004, industry reserves would still increase to about \$35 billion at year-end 2005 (1.9 times the 2003 level), \$48 billion by year-end 2008 (2.7 times the 2003 level), and then ultimately topped out at about \$55 billion (3.1 times the 2003 level) in 2013, (see Chart 2).

⁴ For details on Milliman’s methodology in developing these estimates, see Juliette M. Burden, Gary R. Kelly, Bradley M. Smith, “XXX Implications” Reinsurance News, August 2004.

Chart 2: Estimated Industry XXX Reserve Development—Business In Force at December 31, 2003 (\$ millions)



Source: Milliman USA

To extrapolate the projections to SCT, we first estimated the face amount of XXX business that SCT will have in force at year-end 2004 after the ING Re transaction has closed. We know that 1) SCT has indicated that 75% or about \$79 billion of the U.S. traditional life business written by SCT prior to the ERC Life acquisition was XXX level-premium term business; 2) the ERC Life block was primarily pre-XXX business and should therefore be excluded; 3) about 52% of the in-force face amount of the ING Re block at year-end 2003 was XXX business; and 4) SCT’s 2004 production guidance is \$55-70 billion (a midpoint of \$62.5 billion). Summing these amounts, we estimate that SCT should have roughly \$440 billion of XXX business in force by face amount at year-end 2004 (Table 2).

Table 2: Estimated XXX Face Amount Pro Forma ING Re Acquisition, Year-End 2004 (\$ billions)

Pre-ERC Gross Face Amount In Force (75% of \$105 billion)	\$79
ING Re (52% of \$573.1 billion)	298
Estimated SCT Origination Post-ERC, Pre-ING Re (2004 production guidance midpoint)	63
Total	\$440

Source: UBS

To estimate XXX reserve development on SCT’s in-force book (i.e., excluding new business written in 2005 and later), we project the run-off of the face amount in force at year-end 2004 using the same lapse rates as those used in the Milliman USA industry projections. We then apply Milliman USA’s reserve factors to the year-end face amounts. The results of this analysis are shown in Table 3.

Table 3: Estimated SCT XXX Reserve Growth Excluding New Business, Including ING Re (\$ billions, except as noted)

	2004	2005	2006	2007	2008	2009	2010
Face Amount In Force (no post-2004 origination)	466	425	391	361	335	313	273
Lapse Rate (Milliman Industry Estimate)		-8.7%	-8.2%	-7.6%	-7.1%	-6.7%	-12.6%
Reserves per \$1,000 In Force (\$) (Milliman Industry Estimate)	13.98	19.49	24.78	29.80	34.52	38.91	45.96
Estimated XXX Reserves	6.5	8.3	9.7	10.8	11.6	12.2	12.6
Annual Growth (%)		27%	17%	11%	8%	5%	3%
Annual Change		1.8	1.4	1.1	0.8	0.6	0.4

Source: Lapse rates and reserves per \$1,000: industry estimates (not specific to SCT) from Milliman USA; remaining estimates: UBS

As one can see from Table 3, SCT's XXX reserves on in-force business should grow rapidly in coming years. While these numbers are only approximations based on an extrapolation from projected industry experience and SCT's actual in-force business may differ significantly from the model office profile assumed in Milliman USA's study, we think the projections are at least correct in general order of magnitude. SCT, itself, estimates that the increase should be \$300-400 million per year at the peak.

While our SCT's estimated peak increases of \$300-400 million per year are lower than our estimates, these reserves are still quite material. SCT explained that the difference between our estimate using Milliman factors and its own estimates is that SCT's distribution of business is different from that of Milliman's model—since it focuses on 10-year level term business.

On the other hand, our projections may be conservative compared with SCT's actual XXX reserve development as the projections above do not include any new business written in 2005 or later. In reality, we expect SCT to continue writing new XXX business after 2004.

The question then becomes: How will this financially impact SCT? XXX reserves are a statutory concept, which means that none of these numbers will show up directly in SCT's GAAP financial statements. However, they still should have a very real economic impact on SCT as XXX reserves must be funded somehow—whether by letters of credit or assets in trust (necessary to allow the client primary insurer to take statutory reserve credit for ceding the business), securitization, or retrocession. In the end, somebody somewhere must pay the piper. Given the economic dynamics of the U.S. life reinsurance marketplace, the commodity-like nature of XXX reinsurance, and the novelty of XXX securitization programs, we think this has been—and will continue to be—the reinsurer.

We think that SCT has been using all of the various sources of funds to varying degrees. On June 25, 2004, SCT closed a five-year \$200 million structured finance facility with HSBC Bank USA. SCT also entered into a new \$175

million 364-day unsecured letter of credit facility on December 29, 2004, with an option to increase the facility to \$200 million.

Under the terms of the ING Re acquisition, ING has agreed to provide SCT with a collateral facility for the block's XXX and universal life with secondary guarantees (ULSG) business for the life of the business. As of June 30, 2004, collateral of \$2.3 billion was outstanding under the facility. The cost of the facility to SCT will increase over time as illustrated in Table 4, motivating SCT to try to find alternative sources of funding.

Table 4: ING Re Collateral Facility (\$ millions)

	2Q04	2004	2005	2006	2007	2008	2009 and thereafter
Facility Size - end of period	\$2,266	n/a	N/a	n/a	n/a	n/a	n/a
Facility Fee - Percent	n/a	1.000%	1.000%	1.000%	1.250%	1.500%	1.750%

Source: Company data

We also expect SCT to fund at least a portion of the significant annual XXX reserve strain with new equity issuance. The company has stated that it will raise \$200 million in new equity in mid-2005 (in addition to the early 2005 equity issue to finance the ING Re transaction). Based on the XXX reserve development pattern, we would expect these annual equity issuances to continue for the next several years.

Will Securitization Solve the XXX Problem?

SCT and other industry players have suggested that XXX reserve securitizations could be one solution to the XXX reserve problem. SCT has completed a \$200 million, five-year structured facility with HSBC (as mentioned above) and Genworth has completed two XXX securitizations, issuing \$600 million in 30-year floating rate notes through a special purpose life insurer. Although securitization may be preferable to the more traditional means of addressing XXX reserve strain, as discussed below, we do not expect it to be a panacea.

Why Securitization Might Be A Solution to the XXX Problem

- In theory, unlike letters of credit, securitization vehicles can be a source of *long-term* funding for redundant XXX reserves and can be less expensive to the insurer than non-collateralized long-term debt or equity funding.
- In theory, a securitization vehicle could provide an insurer with a *fixed-cost* means of laying off the significant risks (mortality, lapse, interest-rate, and expense) of long-term level-premium term or universal life with secondary guarantees.

Why Securitization Might *Not* Be A Solution to the XXX Problem

- The fixed costs (e.g., legal, accounting, actuarial) of securitization are high. Therefore, securitization is only viable for large blocks of business.

- Will securities investors or bond insurers be willing to accept the risk of, in effect, coinsuring ULSG or long-term level-premium term insurance when professional life reinsurers with a sophisticated knowledge of these risks (e.g., RGA) are, themselves, uncomfortable with these risks? If they are willing to accept these risks, will they be willing to do so 1) at prices the insurers view as economic or 2) in transaction structures where the insurer retains no residual interest?

- As a corollary to the point above, the novelty and complexity of the securitized instrument (long-term level premium term insurance) and its related risks present barriers to traditional fixed-income investors. The XXX securitizations to date have all been private placements and, according to Tillinghast, the investors in the transactions have been largely other life insurers. Once traditional investors do become familiar with product, the question then becomes whether the reinsurers' demand for XXX securitization capacity can be satisfied out of the amount the market is able to absorb.

- To date, we are unaware of any very long-term (i.e., greater than 10-year), fixed cost XXX securitization vehicle, even though Regulation XXX came into force on January 1, 2000. The vehicles we are aware of are either variable cost or medium-term. If securitization is truly a viable solution to the Regulation XXX issue, we think it is odd that no transaction in the five years since Regulation XXX has been in force has provided a long-term, fixed-cost alternative.

- Both Genworth's XXX securitizations and the SCT transactions involved vehicles that Genworth and SCT, respectively, continued to consolidate under FASB Interpretation No. 46 (FIN 46). Although neither Genworth nor SCT have disclosed sufficient information for us to determine to what degree these transactions involved substantive risk transfer, the substantive risk transfer was likely limited given the continued consolidation under FIN 46.

Tax Status

SCT's tax strategy has been to take advantage of 1) the net operating losses (NOLs) generated by its growing U.S. business (U.S. life companies writing new business can book large statutory reserves which result in statutory and tax losses); and 2) its ability to cede business offshore to its subsidiary in Ireland where the corporate tax rate is only 12.5%.

As of year-end 2003, SCT had a total of \$168.4 million in NOL carryforwards expiring in years 2012 through 2018. However, the \$560 million in negative ceding commission income from the ING Re transaction will apparently be ordinary income in the U.S. and, therefore, absent other tax planning initiatives by SCT, should absorb the full amount of the NOL carryforwards.

SCT says its tax associated with the negative ceding commission will largely be absorbed by its existing NOL. U.S. life companies writing new business can book large statutory reserves, which result in statutory and tax losses. SCT expects to write \$90-100 billion face amount of new business in 2005, which it anticipates will replenish the NOLs being used in connection with the ING acquisition. However, if this is the case, at some point, statutory profits will overwhelm NOLs and create a dramatic and sudden tax increase.

SCT claims to have not ceded any business since the end of 2000 to its Bermuda or Cayman companies, but for one exception. SCT has ceded some business to one of its Bermuda companies that elected a number of years ago to become a U.S. taxpayer under Section 953d of the Internal Revenue Code.

With the increasing amount of its business being generated in the United States after the ING Re acquisition, we also question whether in the future, the IRS may take the position that SCT is “engaging in a trade or business in the United States” and therefore subject to U.S. federal income tax at the full 35% rate. According to SCT’s own risk disclosures in its 2003 Form 10-K, “Because there are no definitive standards provided by the Internal Revenue Code of 1986..., regulations or court decisions as to which activities constitute being engaged in the conduct of a trade or business within the United States and as the determination is essentially factual in nature, the [IRS] could contend that Scottish Re...is engaged in a trade or business in the United States for U.S. federal income tax purposes, and thus may be subject to U.S. federal income tax....”

Will SCT become subject to full U.S. federal income taxes?

Capital Structure Issues

We have various remaining concerns with SCT’s capital structure including 1) funding of the cash settlement of its contingently convertible debt; 2) the holders’ put option on the contingently convertible debt; and 3) dilution from the Hybrid Capital Units.

Put Option on Contingently Convertible Debt

On 10/26/04, SCT amended the terms of its \$115 million in contingently convertible debt to require that the face amount of the debt be settled in cash upon conversion. With this amendment, SCT may continue to use the treasury method for calculating EPS dilution from the contingent convertibles, rather than the more punitive “if-converted” method under FASB’s Emerging Issues Task Force Issue (EITF) Issue No. 04-8. Although this amendment obviates the immediate dilution concern raised in our note of 7/27/04, it does not address two separate issues:

- Given that SCT must now settle conversion of the debt in cash, how will it fund the cash conversion without new financing—particularly in light of the XXX funding concerns described above?

- The amendment of the conversion terms still does not address our remaining concern with the contingent convertibles—the embedded put option.

Under the terms of SCT's contingent convertibles, holders can put the securities back to SCT for cash at 100% of principal on December 6, 2006; December 1, 2010; December 1, 2012; and December 1, 2017. We view this as a risk to SCT although current GAAP does not require SCT to reflect this risk in its financial statements.

We believe this provision is risky given that investors would likely exercise the put option if the debt's fair value—including the value of the conversion feature—has fallen below its face amount, i.e.,

- (1) if interest rates have increased significantly since the time of issue (which is reasonably probable given that the securities were issued in the low interest rate environment of November 2002);
- (2) if SCT's stock price has declined significantly below the conversion price of \$21.71 making the conversion feature less valuable (which is within the realm of possibility given the issues we outlined above); or
- (3) if the issuer's credit situation has deteriorated (which is, again, within the realm of possibility in our view given the issues outlined above).

If circumstances #2 and #3 were to occur for SCT, they would likely occur simultaneously and also coincide with situations where SCT would have the greatest need to hold on to its cash and would find refinancing the most difficult and expensive.

Dilution Remains from the Hybrid Capital Units (HyCUs)

We are also concerned with the accounting treatment of SCT's \$143.8 million 5.875% HyCUs, issued in December 2003. Although the HyCUs are not contingently convertible and, therefore, will not be subject to EITF 04-8, the SEC is now looking closely at certain structured transactions that either have a specific accounting treatment as their goal, have no apparent business or economic purpose, or both. In our view, the HyCU is such a structured transaction.

SCT's HyCUs consist of 1) a purchase contract that requires the holder to purchase SCT shares for cash on February 15, 2007 (with the number of shares purchased depending on the stock price at that time); and 2) a convertible preferred share that is mandatorily convertible into cash (and stock, to the extent the conversion is in the money) on May 21, 2007. The purchase contract pays the holder a cash coupon of 4.875% and the convertible preferred share pays the holder a cash coupon of 1%.

At the time the HyCUs were issued, SCT took a charge of \$20.5 million to shareholders' equity (representing the net present value of the interest payments on the purchase contract), rather than recognizing the coupon on the purchase contract as interest expense over the life of the instrument.

In our view, this accounting treatment inflates both EPS and ROE. Accordingly, we have decided to strip out the impact of this treatment and adjust SCT's financials to 1) add back to earnings the 1% dividend on the convertible preferred; 2) dilute EPS by the number of shares issued under the purchase contract (the shares issued under the convertible preferred are immaterial); and 3) add to book value the additional equity from the settlement of the purchase contract. In total, these adjustments dilute SCT's EPS by 10%.

Valuation Analysis

We are lowering our price target for SCT to \$19 from \$26. Our \$19 price target is based on a price/book versus ROE regression analysis. Our analysis assumes SCT will eventually generate ROEs of no more than 7% based on the following factors:

- Adjustments to both the income statement and balance sheet for the closing of the ING Re transaction at 12/31/04 and related financing;
- The impact of the approximately \$200 million equity issuance that SCT has announced it is likely to complete in mid-year 2005;
- The likelihood of a substantially higher benefits ratio—perhaps greater than 400 bps higher—given the risks of its SOA 1985-1990 table usage and that more of the business is becoming seasoned. In addition, we are concerned with the pricing of SCT's recent acquisitions (ERC Life Re and ING Re) given that a number of more experienced competitors did not emerge as buyers of either property.
- An eventual spike in the company's tax rate to over 20% from 3-5% (2004 guidance);
- Rising reserving costs associated with its growing Regulation XXX exposure;
- Our look-through analysis of SCT's outstanding Hybrid Capital Units as discussed above.

Our earnings do not reflect most of these events because it may take time to play out. But our return assumptions, not only reflect the above issues, but also our concern with SCT's near-term earnings stability and quality as reviewed earlier in this piece.

According to our price/book versus ROE regression model, a company with a 7% ROE warrants an approximately 0.88x price/book multiple. Applying this multiple to estimated 4Q05 book value per share (excluding AOCI) of about \$21.50 results in a one-year price target of \$19.

We expect the deterioration in SCT's benefits ratio to be gradual—since SCT controls reserves. However, we would not be surprised to see substantial adverse deviations along the way, which investors may eventually realize are here to stay.

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Investment risks include adverse mortality, rapid interest rate changes, weak credit and economic conditions, earnings dilution, and ratings downgrades.

■ **Analyst Certification**

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UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	Buy 2	FSR is > 10% above the MRA, lower degree of predictability	Buy	36%	32%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	Neutral 2	FSR is between -10% and 10% of the MRA, lower degree of predictability	Hold/Neutral	53%	35%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	Reduce 2	FSR is > 10% below the MRA, lower degree of predictability	Sell	11%	29%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 December 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price
Genworth Financial ^{2a,4,6,16}	GNW.N	Neutral 2	US\$25.72
HSBC ^{2a,4,8,16}	HSBA.L	Buy 1	881p
ING ^{2b,2c,4,5,16}	ING.AS	Buy 2	€22.07

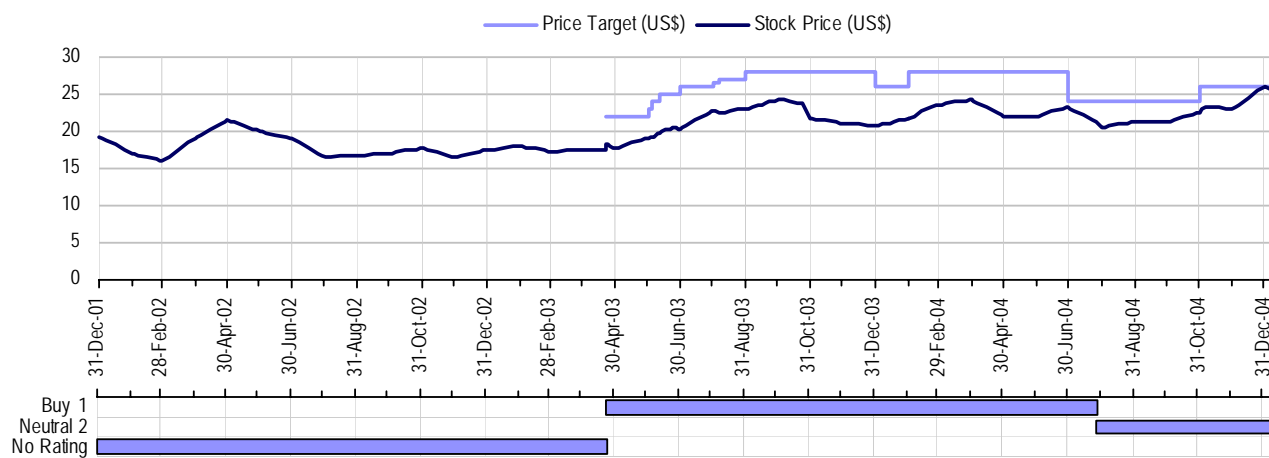
Company Name	Reuters	Rating	Price
RGA ¹⁶	RGA.N	Not rated	US\$47.50
Scottish Re Group ^{2a,4,5,6,16}	SCT.N	Reduce 2	US\$24.90

Price(s) as of 17 January 2005. Source: UBS.

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Scottish Re Group (US\$)



Source: UBS; as of 17 January 2005.

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