

STANDARD
& POOR'S

Standard & Poor's Rating of the Lloyd's Market

December 2010



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December 2010

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Introduction

Lloyd's is an insurance market, not a single legal insurance entity. Capital providers termed "members" or "Names", each providing capital to back their liabilities, underwrite the insurance business within the Market on a several basis. In practice the members group into syndicates for the purposes of assuming insurance liabilities. Lloyd's structure, however, includes a Central Fund that provides partial mutualisation of the capital base. As a result, all Lloyd's policies are backed by Lloyd's common security, which enables Standard & Poor's to assign an Insurer Financial Strength Rating that applies across the Market.

The Insurer Financial Strength Rating of Lloyd's is a rating that applies currently and prospectively to each policy issued by Lloyd's from the 1993 year of account onwards. Lloyd's non-life liabilities for the years 1992 and prior, including those that are asbestos exposed, were mostly reinsured into Equitas Limited (Equitas). The rating does not apply to Equitas.

The rating applies to all syndicates regardless of their individual performance relative to other syndicates and Market aggregates. Inter alia, better performing syndicates contribute positively, and poorer performing syndicates contribute negatively, to the rating. Standard & Poor's separately provides syndicate specific analysis through its Lloyd's Syndicate Assessment (LSA) product.

The rating has been prepared based on information provided at formal meetings with the Corporation of Lloyd's management and participants in the Market including leading underwriters, managing agents and capital providers. The extensive programme of meetings with representatives of the above, together with confidential and public information supplied, has formed the basis for the rating. Standard & Poor's has maintained continuous "surveillance" over the rating since it was first assigned in 1997. This involves a review of public and confidential information, as it becomes available, and an ongoing dialogue with Lloyd's management.

Executive Summary

Major Rating Factors



Strengths:

- Strong competitive position.
- Strong operating performance.
- Strong capitalization.
- Strong financial flexibility.

Weaknesses:

- Relatively high utilization of reinsurance and letters of credit for capital support.
- Inherent operating performance volatility.

Rationale

The insurer financial strength rating on the Lloyd's insurance market (Lloyd's or the Market) reflects Lloyd's strong competitive position, strong operating performance, strong capitalization, and strong financial flexibility. These positive factors are partly offset, however, by Lloyd's relatively high utilization of reinsurance and letters of credit for capital support and the inherent potential for operating performance volatility.

Lloyd's competitive position is strong, supported by the positive attributes associated with its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance and reinsurance market, policyholder loyalty, and improving systems and processes. The attractiveness of Lloyd's as an operating platform is demonstrated by the continual flow of new entrants to the

Market in recent years. This has contributed to Lloyd's operating with a record level of capacity in 2010. This is not all positive in our view, since operating margins are under downward pressure in many of Lloyd's business lines. This, in turn, will demand increased oversight from the Performance Management Directorate.

Lloyd's prospective operating performance is expected to remain strong overall, but it continues to face challenges that we believe will result in lower profitability in 2010 and 2011, compared with the past four years (see Outlook section). The Market posted a record pre-tax profit of £3.9 billion in 2009 (£1.9 billion in 2008) and impressive operating statistics, including a combined ratio of 86.1% and a return on revenue (ROR) of 20%, but two factors should not be overlooked. Catastrophe losses during 2009 were one-fifth of the average level incurred by Lloyd's since 2001, and reserve releases from prior accident years contributed 40% of total reported underwriting profits in 2009. We do not consider either of these to be sustainable.

Lloyd's capitalization is strong, supported by what we consider to be very strong capital adequacy, strong quality of capital, Lloyd's much diminished exposure to legacy issues, and the efficacy of the capital-setting processes. However, Lloyd's high utilization of reinsurance capacity and of letters of credit (LOCs) to support its capital needs is a relative credit weakness. According to the technical specifications for Quantitative Impact Study 5 (QIS5), at least 50% of the regulatory capital requirement under Solvency II should be met by Tier 1 capital. LOCs are only eligible as Tier 2 capital, and represented £7.3 billion, or 55% of Members' Funds

Executive Summary *CONTINUED*

at Lloyd's (FAL) in 2009. It should be noted that FAL are set by Lloyd's at a level that are 35% higher than the current regulatory capital requirements. Nearly 90% of these LOC facilities are provided by 10 banks, so the Market is incurring some concentration risk.

Lloyd's financial flexibility is strong. The diversity of Lloyd's capital providers represents a unique strength for the Market. In addition to the strong flow of high-quality new applicants, financial flexibility is also reinforced by Equitas' \$7 billion reinsurance deal with National Indemnity Co. (NICO; AA+/Stable/--) and the declining trend of annual undertakings given to insolvent members. Solvency deficits amounted to just £59 million in 2009, down from £482 million in 2005.

Outlook

Our outlook on Lloyd's is stable. Negative pricing trends have accelerated for some lines of business during 2010. When coupled with low investment yields, this will suppress the Market's near-term earnings prospects. Lloyd's is expected to bear a large share of the Chilean earthquake losses, and has released a Market loss estimate of \$1.4 billion. This figure is higher and was released later than many peers, so we think it is less likely to develop negatively. Lloyd's has also estimated its exposure to the Deepwater Horizon loss at between \$300 million and \$600 million. Taken together, these events are expected to add around 7% to Lloyd's 2010 combined ratio.

We take this to suggest that a full-year combined ratio of 95% is achievable, assuming some limited additional catastrophe activity, and

that reserve releases continue at the same pace as in 2009. Although we expected the impact of prior-year releases on the Market's overall performance to diminish, this does not seem to be the case, looking at the 2010 interim results for the listed Lloyd's vehicles.

Lloyd's central assets of £2.8 billion at year-end 2009 are over £1 billion in excess of its minimum economic target. Despite this, we do not expect Lloyd's to reduce the amount of the Central Fund or contributions to it in the short term. Nor do we expect Lloyd's to adjust the 35% uplift that is applied to each member's Individual Capital Assessment (ICA). Lloyd's has submitted a preapplication for internal model approval to the U.K.'s Financial Services Authority (FSA), but this is not assured and the Solvency II standard formula would significantly raise capital requirements for the Market. We therefore believe that Lloyd's will adopt a conservative stance in the interim.

The likelihood of medium-term positive rating action is low. Impediments include the uncertainty regarding the overall impact of Solvency II on Lloyd's and the difficult operating environment in the lines of business that Lloyd's operates in. Ultimately, positive rating action would be conditional on the impact of Solvency II being neutral relative to peers, Lloyd's main capital providers remaining committed to the Market as they invest in separate operating platforms, and Lloyd's upholding strong operating performance. The likelihood of negative rating action is similarly low but would be driven either by operating performance returning to levels seen prior to 2002, reflecting poor management of a softening underwriting cycle, or by the occurrence of a major catastrophe loss.

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Corporate Profile: Significant Participant In Worldwide Markets

The London-based Lloyd's insurance market is a major participant in specialty commercial insurance and reinsurance markets worldwide. Lloyd's wrote gross premiums in 2009 of £22 billion across a diverse range of classes (see table 1), predominantly via broker distribution. This represented growth of 22% over 2008, or 8.3% on a constant exchange rate basis. Lloyd's ranked as the fifth largest reinsurer in 2009, according to our global survey.

As at Sept. 1, 2010, there were 87 syndicates (including five special-purpose syndicates) trading at Lloyd's, managed by 53 managing agencies. These figures include those managing agents and syndicates that are only authorized to underwrite reinsurance to close (RITC) contracts.

Lloyd's has very wide geographic coverage, with specific trading rights to write insurance business in 79 countries and the ability to write reinsurance in over 200 countries and territories. Nevertheless, a significant majority of income (65% in 2009) continues to be sourced from North America and the U.K.

TABLE 1
LLOYD'S/MAIN BUSINESS CLASSES
BY GROSS PREMIUMS WRITTEN

	--2009--		--2008--		--2007--		--2006--		--2005--	
	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)
Reinsurance ¹	7,993	36.4	6,299	35	5,455	33.3	5,560	33.8	5,243	35
Casualty	4,320	19.7	3,762	20.9	3,364	20.6	3,572	21.8	3,402	22.7
Property	4,954	22.5	3,971	22.1	3,809	23.3	3,638	22.2	3,199	21.3
Marine	1,606	7.3	1,334	7.4	1,226	7.5	1,153	7	1,017	6.8
Energy	1,371	6.2	1,150	6.4	1,019	6.2	1,125	6.9	804	5.4
Motor	1,118	5.1	939	5.2	983	6	923	5.6	895	6
Aviation	551	2.5	481	2.7	464	2.8	393	2.4	375	2.5
Life	60	0.3	49	0.3	46	0.3	50	0.3	47	0.3
Total	21,973	100	17,985	100	16,366	100	16,414	100	14,982	100

¹ Reinsurance GWP include Society results

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Competitive Position: Unique Brand, Subscription Market, Mutuality, And Licensing Provide Key Advantages

Lloyd's competitive position is very strong, supported by its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance/reinsurance market, and policyholder loyalty. This position has been further enhanced in recent years by a combination of Lloyd's improved financial strength, the successful completion of Equitas' deal with NICO, and improving London Market business processes which aim to make Lloyd's more competitive. The attractiveness of Lloyd's as an operating platform is demonstrated by the continual flow of new entrants to the Market in recent years, either directly or through the acquisition of an existing operation. This has contributed to Lloyd's operating with a record level of capacity in 2010. This is not all positive in our view, since operating margins are under downward pressure in many of Lloyd's business lines. In turn, this will demand increased oversight from the Performance Management Directorate.

Lloyd's draws significant competitive strength from its unique brand. Built over centuries, the brand is recognized globally and is often viewed as a key positive attribute among insurance buyers. Although the brand may not regain the position it had before the Market's near-demise during the mid-1990s, Lloyd's underwriters are still recognized as possessing a number of positive traits. These include a strong track record of timely settlement, particularly following major loss events, and their willingness and ability to offer innovative underwriting solutions to their clients.

Lloyd's is the world's largest subscription insurance market. Lloyd's has endorsed the European Federation of Insurance Intermediaries' (BIPAR)

principles, which seems to have resulted in fewer changes to the subscription market than was initially feared. Although Lloyd's managing agents operate as independent businesses, the size and diversity of underwriting capacity within the Market allows it to compete with the largest global (re)insurance groups. This diversity provides Lloyd's with a valuable competitive advantage in that it enables buyers and brokers to diversify risk placement in a single marketplace.

Lloyd's retains a critical mass of relevant underwriting, claims and broking expertise, and support services, remaining the cornerstone of diverse specialist underwriting niches, such as marine, energy, aviation, and certain nonmarine classes. This will, in our view, preserve London's status as a leading marketplace.

However, the proliferation of new regional hubs and the trend toward local placements presents Lloyd's with several challenges. More than 80% of participants at Lloyd's now have access to alternative platforms, and several of the large traditional capacity providers are investing heavily in their non-Lloyd's operations, thereby reducing their reliance on Lloyd's. In our view, this is due to several factors; Lloyd's does not have the same licensing advantages outside the U.S. surplus lines market; Lloyd's has an array of capital providers' whose interests are not always aligned; and local requirements often mean additional operational and regulatory complexity for Lloyd's.

The Market's resilience is evident, however, from the way it withstood Bermuda's emergence as a major competitor. It continues to extend its

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Competitive Position: Unique Brand, Subscription Market, Mutuality, And Licensing Provide Key Advantages *CONTINUED*

global reach, notably through the establishment of Lloyd's offices in Singapore, Japan, China, and most recently in Brazil, where it is the second largest reinsurer. It is also party to formative plans to recreate a New York Insurance Exchange, which, over a long period of time, could challenge Lloyd's position as the second-largest writer of U.S. surplus lines business, if successfully launched.

The features of business typically underwritten at Lloyd's include: complexity; large monetary exposure levels; and a high-severity, low-frequency profile of risk. It has accentuated this risk in recent years, capitalizing on well-priced U.S. catastrophe business. The resultant underwriting portfolio, although diverse, is weighted toward a highly credit-sensitive clientele. A significant majority of Lloyd's income is sourced from the U.S. and the U.K., which are particularly credit-sensitive markets compared with those in Continental Europe.

Lloyd's underweight position in Europe is, in our view, a competitive disadvantage relative to some peers, and one which we believe is difficult to redress. We acknowledge that operating margins have more recently tended to be lower in Europe, but there is some diversification benefit to be gained, and Solvency II may provide growth opportunities in the future.

Lloyd's predominantly sources its business through brokers--the most credit-sensitive distribution channel--and remains highly dependent on the top three large international broking groups (45% in 2009). Nearly one-third of Lloyd's business is also underwritten on a delegated authority basis, which is a higher-risk underwriting model, particularly so when pricing and terms and conditions are under pressure.

Owing to the credit-sensitive nature of its key stakeholders, confidence in Lloyd's among these constituencies is extremely important, hence the value placed by Standard & Poor's on the deal concluded between Equitas and NICO in 2006. Phase II of the NICO transaction was completed effective June 30, 2009. As a result, Equitas and relevant policyholders now benefit from the full \$7 billion of reinsurance cover provided under this arrangement (in addition to Equitas' reserves).

The U.K. High Court approved the insurance business transfer of the members' liabilities in respect of 1992 and prior non-life business written at Lloyd's to Equitas Insurance Ltd., a newly formed insurance company within the Equitas Group, authorized by the FSA. This transfer relieves the members and former members concerned from those liabilities under English law and the law of every other state within the European Economic Area. Standard & Poor's believes the Equitas/NICO deal renders as highly remote the potential for reserve inadequacy at Equitas to undermine confidence in Lloyd's at some point in the future.

The London Market's business administrative processes have historically been a drag on Lloyd's competitive position. In being less efficient than those of global market peers, they reduced London's relative attractiveness to policyholders in terms of service quality and cost. Since 2006, Lloyd's has embarked on a fairly ambitious business process reform agenda, focused on introducing common data standards, improving the process and speed of premium and claims payments, and hopefully, removing the residual frictional costs associated with trading at Lloyd's.

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Management And Corporate Strategy: Strategic Review Complete, Business As Usual

Management

As expected within a marketplace, the quality and sophistication of management varies. The Corporation has established a strong track record in relation to its prime goal of protecting, but in reality improving, the Lloyd's franchise, both in a financial and competitive sense. The success of this can be measured in the continual flow of high-quality new applicants to the Market. The more-recent success of the Corporation is evidence of the effectiveness of increasingly robust performance, risk-monitoring processes, tools, and benchmarks against which managing agents are assessed.

Part of the credit for the enhanced effectiveness of the Corporation in positively influencing Market behavior must, in our view, be attributed to the renamed Performance Management Directorate (PMD), which established an impressive track record under Rolf Tolle. His successor, Tom Bolt, has long experienced the cyclical behavior of the industry from both inside and outside the Lloyd's Market, and has shown no less vigor in enforcing market underwriting discipline. We have noted few changes, but more emphasis on and monitoring against, syndicates' business plans.

The Corporation has an array of tools, enhanced by the implementation of the Performance Management Data Return (PMDR) in 2009, to identify underperforming businesses at an early stage. It possesses the requisite authority to impose sanctions where warranted. These may include capital loadings, business plan restrictions, and requesting changes to the management team. Lloyd's has recently demonstrated its ability and willingness to impose such restrictions.

The FSA has ultimate responsibility for the regulation of the Market. Although the FSA's working relationship with the Franchise Board means that the Corporation effectively performs many of the regulator's duties, the FSA inspects and is actively engaged with individual managing agents and has imposed additional measures, beyond those suggested by Lloyd's, where problems have been identified.

Despite its improved effectiveness, the Corporation's remit remains somewhat limited. It can take necessary action to protect the Central Fund, Lloyd's reputation, brand, and ratings--hence, for example, the introduction from 2007 of underwriting, claims, and risk management principles and minimum standards. Nevertheless, while considering the above, the Corporation is constrained from promoting or undertaking activity that could be considered anticompetitive. In addition, it is understood that the Corporation is not expected to be a micromanager of managing agents. Therefore, the oversight it provides is designed to be robust without being overbearing.

That said, the requirements under Solvency II are demanding, more so given Lloyd's application for internal model approval, and require major improvements to risk management across the Market. Lloyd's has been forceful in preparing the Market for Solvency II, engaging its participants by creating a series of working groups, workstreams and dry runs, through regular dialogue and the publishing of advice, gap analyses, and benchmarking the level of preparedness of individual managing agencies.

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Management And Corporate Strategy: Strategic Review Complete, Business As Usual *CONTINUED*

Some managing agents are progressing better than others in their implementation of Solvency II. Lloyd's has mandated that each syndicate must have a full Solvency II standard internal model so as not to prejudice the Corporation's application.

Strategy

Following a period of market consultation, Lloyd's announced the results of its new three-year strategic plan in February 2010. In the main, it confirmed the tenets of the existing strategy, the pillar of which is for Lloyd's to be the market of choice, although it attached more weight to regulatory matters. The Corporation's stated priorities are; to preserve and enhance the competitiveness of Lloyd's in terms of accessing and transacting efficiently with(in) the market, ensuring Lloyd's is not disadvantaged by changing regulation especially Solvency II, and to continue to promote and enforce strong risk and performance management within the market. Lloyd's acknowledged its reliance on the U.S. and certain brokers for business, and increased weighting to more-volatile lines of business, but considers them to be part of its success and has no plans to shift focus.

Additional short-term priorities inevitably include market modernisation. The move to electronic claims files and accounting submissions have impressively cut processing times, but progress with electronic messaging (The Exchange) has been slow. Other initiatives are underway, including claims transformation aimed at improving claims handling and improving the coverholder experience and operational efficiency, the latter primarily through the development and roll out of standards.

The Market is considering various operating models for the future, beyond the current programme of improvement already underway.

Lloyd's is not minded to turn itself into an electronic trading platform, which might in the future be to the advantage of competing marketplaces.

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Enterprise Risk Management: Continuous Enhancement Remains A Key Priority For Lloyd's

Standard & Poor's considers the quality of Lloyd's enterprise risk management (ERM) to be adequate with strong risk controls, which is supportive of the rating. Standard & Poor's believes that it is unlikely that Lloyd's will experience losses outside its risk tolerances. The factors supporting the overall assessment are adequate risk management culture and strategic risk management, and strong risk controls overall.

For our ERM assessment, we have considered the Central Fund as a provider of protection to the Market and have assessed the risk controls and strategic risk management with this in mind. This ERM assessment does not reflect the ERM capabilities of the participants in the Lloyd's Market.

ERM is of high importance. The Market operates in numerous complex business lines, many of which have the potential to demonstrate extreme volatility. Individual syndicates have historically performed with significantly varying degrees of success. Centrally, Lloyd's continues to make considerable progress on ERM and further enhancements are planned. In Standard & Poor's view, the frequency and effectiveness of the interaction between the risk management team and the other directorates continues to improve. Nevertheless, ERM capabilities among managing agents continue to vary throughout the market.

Risk management culture is adequate and improving, reflecting the greater focus on and continued development of risk management at Lloyd's centrally. The Corporation seeks to perform its duties in a facilitative manner, although it has the option to adopt a more-prescriptive

approach as and when necessary. There are proposed developments of the governance structure and the risk appetite framework which should improve the oversight, quantification, and monitoring of the Corporation's risk taking. The Corporation, through the Lloyd's oversight teams, performs continuous, centrally coordinated, and holistic reviews of its managing agents across all areas of risk using the syndicate risk matrix.

Underwriting risk controls are assessed as strong. Although the risk controls employed by the underlying managing agents are varied, the oversight and ability to manage and review the business plans and capital held at the syndicate levels enables the Corporation to manage how the risk flows up from the syndicates to the Central Fund. The implementation of the PMDR has allowed more granular and timely analysis and monitoring of the underwriting risk assumed by the Central Fund throughout the year.

Catastrophe risk controls are assessed as adequate. The Corporation seeks to ensure there are appropriate levels of catastrophe risk aggregation control both within each managing agent and at the Market level, primarily using the RDS framework. This process has recently been supplemented by the reporting and aggregation of syndicate annual exceedance probability curves that will allow Lloyd's to measure this risk at various return periods. The assumptions used to aggregate the curves have been developed to use as much information as possible on the dependencies between syndicates, and to be prudent where such information is missing. However, the assumptions needed to aggregate the curves from different models may reduce some of the accuracy of this method.

Enterprise Risk Management: Continuous Enhancement Remains A Key Priority For Lloyd's *CONTINUED*

Reserve risk controls are assessed as strong. The comparison of reserve strength across the market produces an effective tool to highlight weaknesses that can be followed up through Lloyd's visits to the syndicates.

Standard & Poor's have not undertaken a review of Lloyd's risk models and, therefore, risk models are assessed as adequate. The Corporation performs continuous, centrally coordinated, and holistic reviews of its managing agents across all areas of risk using the ICA submissions and RDS as key inputs. The center has operated a Market-level stochastic model for a decade. Having been progressively enhanced, and now built on syndicate ICA inputs, it forms a key part of the capital adequacy dialogue with the U.K. FSA. Risk models used by the Corporation and the Market are being improved in line with Solvency II demands.

We have assessed strategic risk management as adequate. The Corporation's prime goal remains the protection of the Lloyd's franchise, a key element of which relates to financial security. In doing so, the Corporation can direct activity to protect the Central Fund, hence the introduction of underwriting, claims, and risk management minimum standards, the setting of relevant guidelines and generation of controls over the risks it itself manages (e.g., Central Fund investment policy).

We have assessed how the Corporation considers the risk against the reward of the Central Fund and how it optimizes the risk assumed by the Central Fund in relation to the levies it charges for this protection as adequate. We have not seen significant evidence of dynamic adjustment of the levies or the Economic Capital Assessment amounts to optimize the

risk versus return or strategic planning for managing the Central Fund to an optimal size.

The Corporation is constrained by law from promoting activity that optimizes Market profitability at the expense of competition. Therefore the Corporation cannot directly intervene to ensure the Market is able to optimize its return on risk-adjusted capital, and we have not considered the strategic risk management of the underlying syndicates in this assessment.

Emerging risk management is considered strong. Lloyd's is at the leading edge of a number of initiatives (e.g., *Lighthill Risk Network* and *Climatewise*) that are focused on the identification, and management, of emerging risks. Increasingly, Lloyd's is looking to draw on the research of leading academics and scientists in assessing the risk implications of emerging issues. A comprehensive database of emerging risks is maintained. This stores information in respect of approximately 370 individual risks and is used to produce a report that is regularly reviewed by Lloyd's risk committee. In addition, there is increasing interaction between the emerging risks team and other parts of the Corporation.

Standard & Poor's believes that the proposed developments, especially in the risk appetite framework, will have positive implications for our assessment. The development of the risk appetite framework and the resulting communication of quantitative tolerances should allow a more aligned and transparent risk strategy that may facilitate a broader use of risk in strategic decision-making. Therefore, these changes could result in an improvement in assessment of the Corporation's ERM capabilities in the foreseeable future.

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Accounting: Various Accounting Conventions Considered

Standard & Poor's analysis of Lloyd's relies on data provided under a number of accounting conventions, including fully audited three-year funds and U.K. generally accepted accounting principles (GAAP) accounting for syndicates, and unaudited pro forma financial statements for the Market. The latter, while externally reviewed, are unaudited and are generated to present Lloyd's aggregated results on a basis that is broadly comparable with results for general insurance companies.

Total adjusted capital within Standard & Poor's risk-based capital model has been derived in the capital model after applying adjustments for: 1) loss and unearned premium reserve discounting; 2) a 100% write-down of deferred acquisition costs; and 3) full hybrid equity credit given to the subordinated loan notes and perpetual subordinated capital securities issued by The Society of Lloyd's in 2004 and 2007, respectively.

Operating Performance: Strong, But Headline Numbers Obscure Weakening Prospects

We expect Lloyd's prospective operating performance to remain strong overall, but it continues to face challenges that we believe will result in lower profitability in 2010 and 2011 compared to the last four years (see Outlook section).

The Market posted a record pre-tax profit of £3.9 billion in 2009 (£1.9 billion in 2008) and impressive operating statistics; a combined ratio of 86.1% (91.3% in 2008), 20% ROR (16.3% in 2008) excluding investment gains, and a 3.9% total investment return. This represents a very strong level of performance in a challenging operating environment in absolute terms and relative to peers, but two factors should not be overlooked. Catastrophe losses during 2009 were one-fifth of the average level incurred since 2001 (10 percentage points of the combined ratio), and reserve releases from prior accident years contributed 40% of total reported underwriting profits in 2009. We consider neither of these factors to be sustainable.

Analysis of Lloyd's underwriting performance reveals that property reinsurance accounted

TABLE 2 LLOYD'S/OPERATING PERFORMANCE

(Mil. £)	2009	2008	2007	2006	2005	2004*	2003
Total gross premiums written	21,973	17,985	16,366	16,414	14,982	14,614	16,422
Annual change (%)	22.2	9.9	-0.3	9.6	2.5	-11	1.4
Total net premiums written	17,218	14,217	13,256	13,201	11,770	11,734	12,250
Annual change (%)	21.1	7.2	0.4	12.2	0.3	-4.2	9.8
Total revenue [¶]	18,069	14,339	14,320	13,645	12,490	12,329	12,156
Annual change (%)	26	0.1	4.9	9.2	1.3	1.4	7.5
Profit before tax	3,868	1,899	3,846	3,662	-103	1,367	1,892
Annual change (%)	103.7	-50.6	5	-3,655.3	-107.5	-27.7	126.9
Return on revenue ^{^*} (%)	20.3	12.1	23.2	22.7	-5.5	7.5	12.6
Net loss ratio (%)	51.5	61.3	50	49	80.7	64.8	57.2
Net expense ratio (%)	34.6	30.0	34	34.1	31.1	31.8	33.5
Net combined ratio (%)	86.1	91.3	84	83.1	111.8	96.6	90.7
Accident-year combined ratio (%)	91.7	100.5	90.5	85.2	111.9	93.9	85.7

*Restated. [¶]Net premiums earned plus allocated investment income. [^]Balance on the technical account for general business/total revenue.

Operating Performance: Strong, But Headline Numbers Obscure Weakening Prospects *CONTINUED*

for £825 million or 60% of the 2009 accident-year result because of a benign year for catastrophes. Casualty insurance produced a small accident-year profit in 2009 following two years of losses, and continued to experience strong positive gains on prior years, accounting for 31% of total reserve releases in 2009. Reserve releases, which lowered the overall combined ratio by 5.6 percentage points in 2009, came from all major segments except motor in 2009, which generated losses in each of the last four accident years. Energy business has produced a net £60 million underwriting loss in total since 2005.

The accident-year combined ratio (excluding large losses), which gives a reasonable indication of attritional claims for Lloyd's, has remained flat over the period 2007-2009, at just above 90% (see table 3 below), which is encouraging. Normalizing the combined ratio for an average catastrophe year, and excluding any profit emergence from prior underwriting years and foreign-exchange effects, however, produces a combined ratio of 101% in 2009. Implicit within our analysis is an expectation that the

impact of prior-year reserve releases on the Market's overall performance will diminish. Although we expected the impact of prior-year releases on the Market's overall performance to diminish, this does not seem to be the case, looking at the 2010 interim results for the listed Lloyd's vehicles.

Negative reinsurance pricing trends have accelerated during 2010. Coupled with low forecast investment returns, this will suppress the Market's earnings. Lloyd's total investment return of £1.8 billion in 2009 recovered strongly in line with credit spreads, but persistently low interest rates meant that the net investment yield weakened to 2.7% (3.6% in 2008). The efficacy of Lloyd's cycle management is expected to be an increasingly key driver of its earnings in the longer term. Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded before 2002. Nevertheless, earnings volatility will remain a feature given the nature of the specialty business lines that continue to represent Lloyd's core business.

Lloyd's is expected to bear a large share of the Chilean earthquake losses, and has released a Market loss estimate of \$1.4 billion. This figure is higher and was released later than some peers, so we think it is less likely to develop negatively.

Lloyd's has also estimated its exposure to the Deepwater Horizon explosion and oil spill in the Gulf of Mexico at between \$300 million and \$600 million. Taken together, these events are expected to add around 7% to Lloyd's 2010 combined ratio. This suggests to us a full-year combined ratio of 95% is achievable, assuming some limited additional catastrophe activity and that reserve releases continue at the same pace as in 2009.

TABLE 3 LLOYD'S/BREAKDOWN OF COMBINED RATIO (%)

(%)	2008	2009
Accident year combined ratio	90.5	87.3
+ Impact of non-monetary items	-2.7	2.3
+ Impact of major losses	12.7	2.1
- Prior year movements	9.2	5.6
= Reported calendar year combined ratio	91.3	86.1

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2005-2009 UNDERWRITING RESULT: CURRENT & PRIOR YEAR ACCIDENT PERFORMANCE



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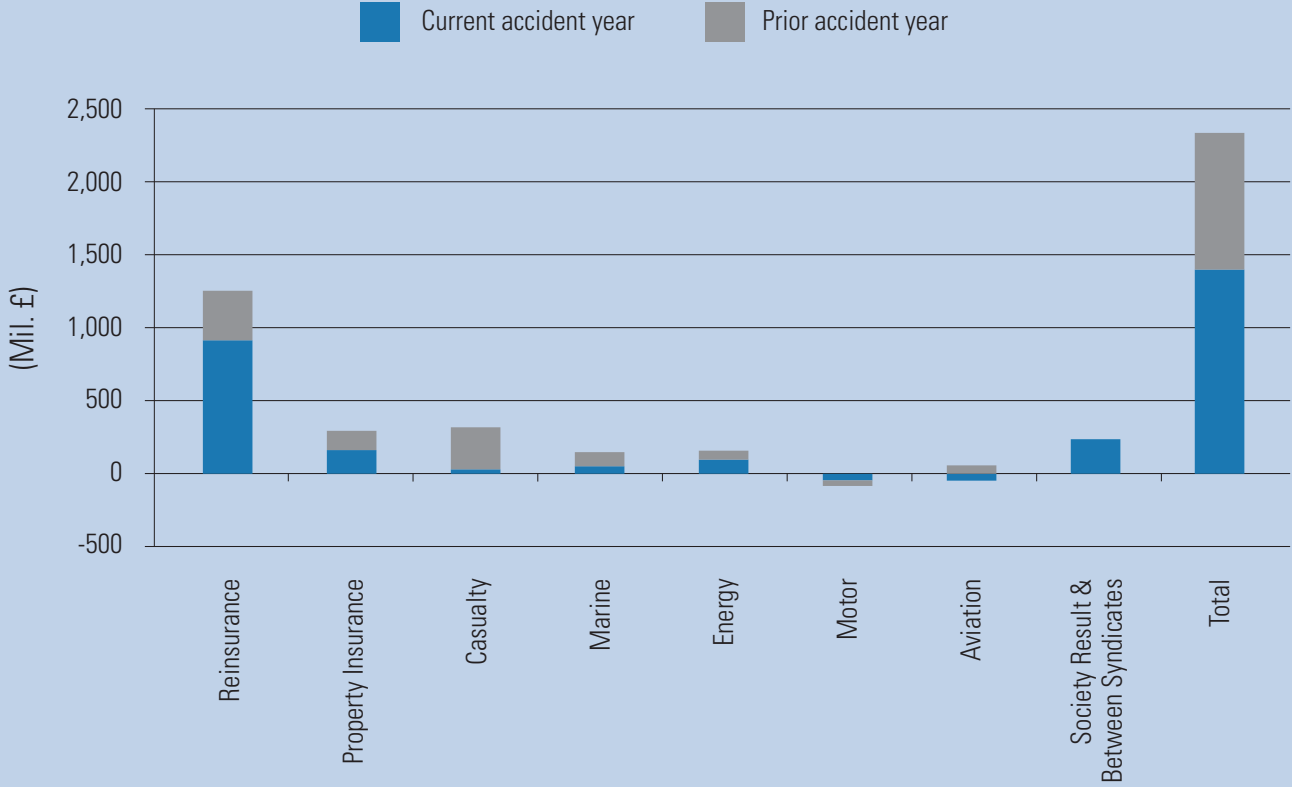
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2009 UNDERWRITING PROFIT



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CASUALTY INSURANCE UNDERWRITING RESULT



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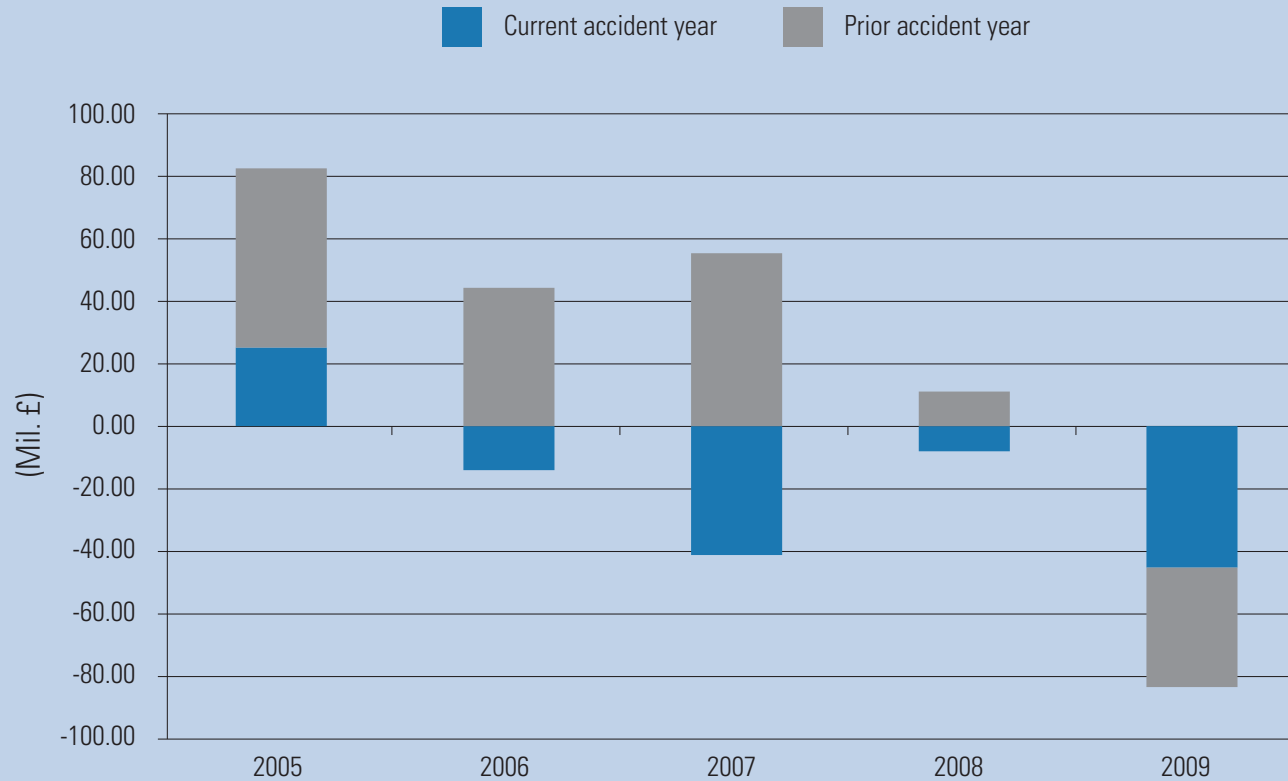
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MOTOR INSURANCE UNDERWRITING RESULT



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Investments: Conservative Investment Stance Pays Off

Lloyd's investments are very strong. The Market has historically pursued a conservative investment strategy, and this has partially insulated it from the extreme volatility seen in global financial markets. Invested assets can be separated into three groupings; those backing the members' funds at Lloyd's (FAL), premium trust funds (PTF), and central assets (including the Central Fund).

PTFs account for £31 billion of the total £46 billion of investments, and are invested primarily in high-quality bonds and cash. Including LOCs, one-third of syndicate investments were invested in government and related securities. This includes only limited exposure to European government debt because only 9% of syndicate investments are euro-denominated. Bond credit quality weakened during 2009 as the Market looked to maintain yields, but the average syndicate portfolio rating was still 'AA', with £1.1 billion of securities rated 'BBB' or below. The portfolio duration is about two years, shorter than the three-year liability profile. Only 3% of assets are held in hedge funds or equities.

TABLE 4 LLOYD'S/INVESTMENT SPLIT

(%)	2009	2008	2007	2006	2005	2004*	2003	2002
Bonds and other fixed-interest securities [¶]	58	57	56	55	58	54	78	78
Equities and other variable-interest securities	11	10	12	11	8	10	7	5
Cash and bank deposits	20	21	20	23	23	30	12	12
Loans and private placements	11	12	12	12	11	6	3	3
Other investments	0	0	0	0	0	0	0	1
Total investments	100	100	100	100	100	100	100	100

*Restated. [¶]Pre-2004 includes members' funds at Lloyd's.

The Central Fund's investment policy has always been somewhat more aggressive. Given the intended long-term nature of the Central Fund, this approach is understandable. On Dec. 31, 2009, 14% of investments were held in equities and hedge funds. The remainder was held in high-quality bonds and cash. Almost half of the bond portfolio consisted of sovereign or government-guaranteed debt, with half of this amount held in gilts or debt guaranteed by the U.K. government. Lloyd's currency matches its subordinated debt securities, hence the higher proportion of British pound sterling and euro assets than those held by the syndicates.

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Liquidity: Strong, Supported By Highly Liquid Invested Assets

Lloyd's liquidity is strong, supported by a substantial £9 billion cash position, high-quality bond portfolio, and substantial credit facilities in place to support capital and short-term liquidity requirements. Operating cash flow was negative £698 million in 2009 (positive £3.3 billion in 2008), partly as claims related to the 2008 hurricanes were paid out, and as new funds were invested. We expect positive operating cash flow to resume in 2010. Liquidity needs are significantly influenced by U.S. situs trust fund requirements, including Lloyd's 100% collateral requirements as an accredited reinsurer in the U.S

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Capitalization: Strong Adequacy And Quality

Lloyd's capitalization is strong, supported by what we consider to be very strong capital adequacy, strong quality of capital, Lloyd's much diminished exposure to legacy issues, and the efficacy of the capital-setting processes. Strong profits continue to emerge on prior-year loss reserves in aggregate, however, we expect this trend to progressively diminish. The syndicates' high reliance on LOCs to support their FAL and collateral requirements, and on reinsurance capacity to support their underwriting is a detraction.

Capital adequacy

Capital adequacy is considered to be very strong. Analysis of our capital model indicates extremely strong capital adequacy at year-end 2009, although certain structural aspects of the Market are not easily captured. Lloyd's central assets for solvency purposes--£2.8 billion at year-end 2009--have doubled since 2005. Part of this reflects the issuance of subordinated debt in 2007, of which £958 million was outstanding at year-end 2009.

Lloyd's is required to hold central assets in excess of any solvency deficits at individual syndicates. These solvency deficits amounted to just £59 million in 2009, down from £482 million in 2005. Lloyd's minimum surplus target is £1.7 billion. In spite of the current excess, both in relation to Lloyd's solvency test and relative to The

Society of Lloyd's 2010 ICA, we do not expect Lloyd's to reduce the amount of the Central Fund or contributions to it in the short term. Nor do we expect Lloyd's to adjust the 35% uplift that is applied to each member's ICA. Lloyd's has submitted a preapplication for internal model approval under Solvency II, however, its approval is not assured and the Solvency II standard formula would significantly raise capital requirements for the Market. We therefore believe that Lloyd's will adopt a conservative stance in the interim. Lloyd's also has the option to redeem one of its hybrids in 2014. Fixed charge coverage at The Society of Lloyd's of 2.1x in 2009 (1.7x in 2008) was marginal relative to the assigned debt ratings.

Quality of capital

Quality of capital is strong. Our analysis is based on the consolidation of the syndicates' annual accounts, the members' FAL and the Society of

TABLE 5 LLOYD'S/RESERVING TRACK RECORD

(%)	2009	2008	2007	2006	2005	2004 [†]	2003	2002
Calendar-year net combined ratio	86.1	91.3	84	83.1	111.8	96.6	90.7	98.6
Accident-year combined ratio	91.7	100.5	90.5	85.2	111.9	93.9	85.7	92.8
Prior-year reserve movement combined ratio points	-5.6	-9.2	-6.5	-2.1	-0.1	2.7	4.7	5.9
Run-off years' reserve movements (mil. £)	97	39	-48	-5	-324	-350	-329	N.A.
Continuing Market reserve movements (mil. £)	837	1,226	904	275	338	48	-343	N.A.

**Data on pro forma annual accounting basis. [†]Restated. N.A.--Not available.*

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Capitalization: Strong Adequacy And Quality *CONTINUED*

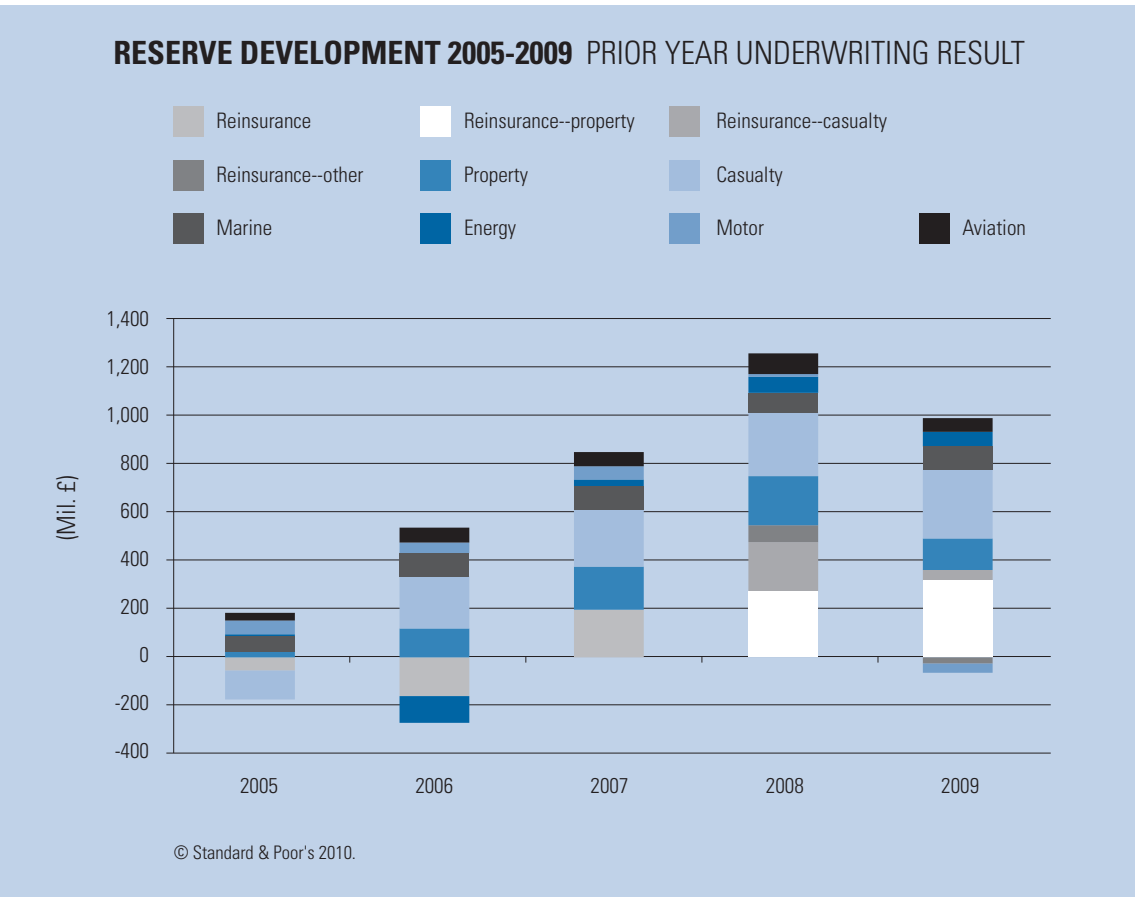
Lloyd's. There is therefore no consideration of intangible assets or leverage that may reside at the capital providers', where capital quality may be weaker.

Member's FAL is provided for either by depositing assets with Lloyd's, or through the provision of LOCs. According to the technical specifications for QIS5, at least 50% of the regulatory capital requirement under Solvency II should be met by Tier 1 capital. LOCs are only eligible as Tier 2 capital, and represented £7.3 billion, or 55% of Members' FAL in 2009. We do not believe that Lloyd's or its members will want to risk operating at the margin of this requirement, however it should be noted that FAL are set by Lloyd's at a level that are 35% higher than the current regulatory capital requirements. Nearly 90% of these LOC facilities are provided by 10 banks, so the Market is incurring some concentration

Loss reserves

Strong profits continued to emerge on most prior underwriting years and classes of business during 2009. The total amount released was £934 million, down from £1.3 billion in 2008. In aggregate, Lloyd's has

released £3.3 billion since 2005, and equivalent to 3%-4% of opening loss provisions in the last three years. Despite this, IBNR levels have been maintained at 40%-45% of total loss reserves. Standard & Poor's expects these releases to diminish but to persist for the continuing Market in



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Capitalization: Strong Adequacy And Quality *CONTINUED*

2010, particularly in respect of the 2002-2006 years of account. There were some areas of deterioration, such as U.K. motor and trade credit insurance, which performed poorly during the financial crisis, but Lloyd's main classes continued to see positive run-off. This included casualty insurance and casualty reinsurance, which have developed positively in the last two years. Motor only accounts for about 5% of total reserves.

The reported position of run-off years of account continues to improve. At financial year-end 2009, there were 13 syndicates with 22 open underwriting years (i.e., not closed after three years, as is normal), amounting to gross reserves of £1.8 billion. This compares to equivalent figures of 48 syndicates, 102 open underwriting years, and £7.0 billion in gross reserves in 2005. 2009 also saw a further net release of reserves held in respect of run-off liabilities of £97 million (£39 million in 2008).

Reinsurance

The proportion of reinsurance Lloyd's cedes as a percentage of gross premiums written now appears to have stabilized at around 20%, but remains high relative to that of peers. As a result, the Market's competitive position and future earnings remain relatively dependent on

TABLE 6 LLOYD'S/REINSURANCE USAGE

(Mil. £)	2009	2008	2007	2006	2005	2004*	2003	2002
Total gross premiums written	21,973	17,985	16,366	16,414	14,982	14,614	16,422	16,203
Total reinsurance ceded	4,755	3,768	3,110	3,213	3,212	2,880	4,172	5,043
Total net premiums written	17,218	14,217	13,256	13,201	11,770	11,734	12,250	11,160
Reinsurance ceded (as % of gross premiums written)	21.6	21	19	19.6	21.4	19.7	25.4	31.1
Reinsurers' share of claims outstanding¶	8,484	10,504	7,449	9,259	14,450	9,678	9,959	12,108
Capital and reserves	18,163	14,182	13,449	12,836	10,491	11,663	10,145	7,509
Reinsurers' share of claims outstanding (as % of capital and reserves)¶	46.7	74.1	55.4	72.1	137.7	83	98.2	161.2

*Restated. ¶Excludes intersyndicate reinsurance.

the continuing supply of adequate reinsurance capacity. Despite this, we believe the Corporation and managing agents' activity has ensured that the Market's reinsurance protection is broadly adequate and closely monitored.

Following 2008's catastrophe losses, Lloyd's saw a 38% increase to its reinsurance asset on Dec. 31, 2008. This fell back to £13.5 billion, or 71% of reported capital (including hybrids) in 2009. Although in our opinion the overall quality of the reinsurance asset was and remains strong, the potentially sharp increase in recoverables leaves the Market exposed to reinsurer dispute and default following major loss events in the future.

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Financial Flexibility: Diversity Of Capital Providers Positively Differentiates Lloyd’s

Lloyd’s financial flexibility is strong, being principally derived from capital providers’ continued support. The diversity of Lloyd’s capital providers represents a unique strength for the Market. Our view of Lloyd’s financial flexibility is also reinforced by the completion of Phase II of Equitas’ \$7 billion reinsurance deal with NICO, the declining trend of annual undertakings given to insolvent Names, and the positive momentum that continues to surround the Market, which makes Lloyd’s an attractive platform for an increasingly diverse range of capital providers.

Sources

Capital is supplied on the basis of an annual venture, with continuing support from providers needing affirmation each year. As a result, capital providers’ continued support, in terms of both willingness and ability, directly or indirectly underpins most of Lloyd’s capital sources. The longevity of any Lloyd’s investment will ultimately depend on factors such as: the attractiveness of underwriting conditions; the Lloyd’s platform enabling operations to outperform those outside of the Market; the effectiveness of the Corporation in minimizing the cost of mutuality, particularly by

reducing any strain on the Central Fund; and regulatory costs (in terms of compliance and the amount of capital held).

In part because some Lloyd’s managing agents are not in a position to operate meaningfully outside the Market, but largely due to the competitive advantages conveyed by the market outlined earlier, we

TABLE 7 LLOYD’S/CAPITAL REQUIREMENTS AND SOURCES	
Capital requirements	Capital sources
<i>Member/syndicate level</i>	
Underwriting losses	Premium trust funds
Increases in capacity	Members’ funds
Changes to ICA/ECA requirements	Cash calls
Liquidity requirements	Outward reinsurance
	Short-term bank facilities
	Parental guarantees
<i>Market level</i>	
Member solvency shortfalls	Central Fund and Corporation assets
Corporation liabilities	Central Fund subordinated loans
	Callable layer
	Centrally raised hybrid equity
	Membership levies

ICA--Individual capital assessment. ECA--Economic capital assessment.

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Financial Flexibility: Diversity Of Capital Providers Positively Differentiates Lloyd's *CONTINUED*

expect most current capital providers to remain committed to Lloyd's in the short-to-medium term. Nevertheless, there is a divergent trend between new entrants at Lloyd's, many of which are international groups that are seeking to extend the number of platforms they operate and exploit Lloyd's global licenses, and the large, more-established Lloyd's capital providers which are expanding in global (re)insurance markets independent of their Lloyd's operations.

Continued diversity within Lloyd's capital base will remain important. Standard & Poor's believes that mutualization would be weakened were underwriting capacity supplied by too few capital providers or if any one provider were to represent too great a proportion of the Market. Concentration of capacity among a few industry investors would mean less incentive to support the Market in the event of a call for extra funds because this could be construed as supporting a competitor.

Needs

Capital needs declined following Equitas' conclusion of its reinsurance transaction with NICO. Previously, Standard & Poor's had felt that capital providers could be required to support a shortfall scenario at Equitas. In addition, reflecting reducing negative reserve movements in aggregate, annual undertakings given to insolvent members continue to fall. Capital requirements under Solvency II represent an area of uncertainty, however.

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Overview Of The Lloyd's Market

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1. Lloyd's market participants

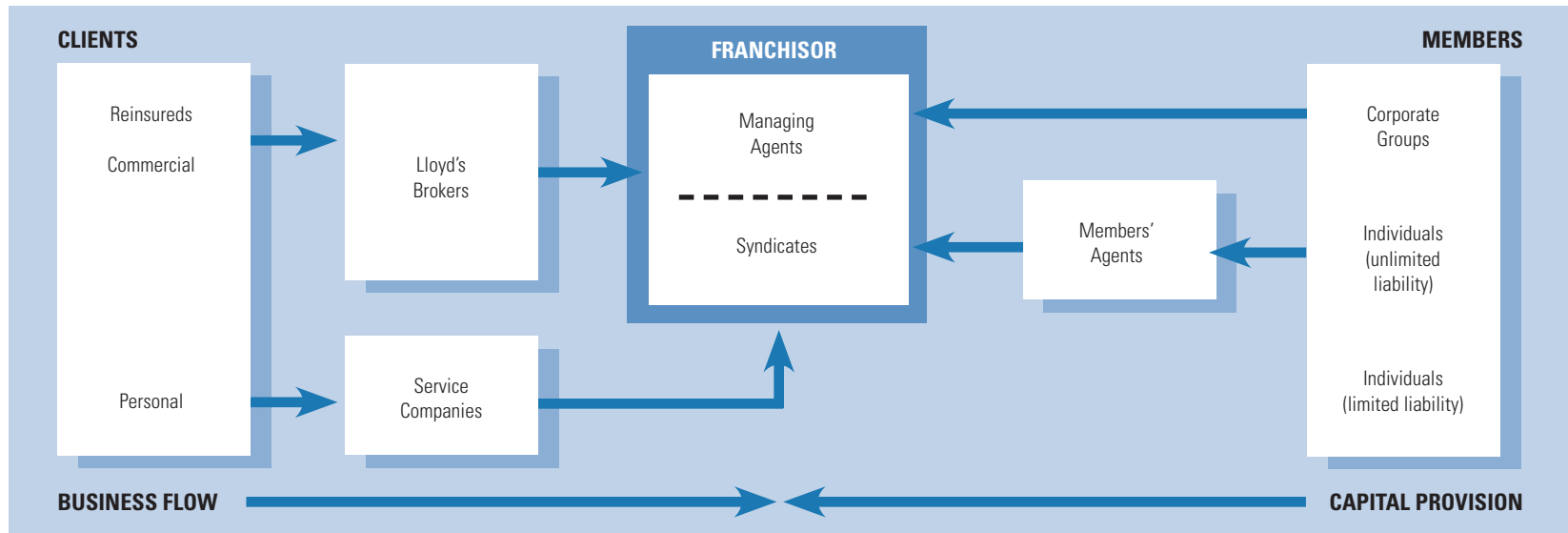
The Lloyd's Market is a unique insurance provider. First established in the late 17th century, it has, in the intervening 300 years, developed a worldwide reputation for an ability to provide innovative solutions for its

clients. Lloyd's is not an insurance or reinsurance company, but a partially mutualised, competitive market place. Within it buyers of insurance and reinsurance look to have their demand satisfied by risk carriers -- the Lloyd's capital providers (also referred to as 'Names' or 'members'), with the risk transfer process being facilitated by brokers.

The key components of the Lloyd's market are:

- Members;
- Syndicates;
- Managing agents;
- The Society of Lloyd's;
- Brokers; and
- Members' agents.

The structure of the marketplace can be represented diagrammatically as follows:



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Overview Of The Lloyd's Market *CONTINUED*

1.1 Members

Members are the capital providers and risk carriers at Lloyd's. Annually they group together to form syndicates, managed on their behalf by managing agents, in order to severally accept insurance risk in return for insurance premiums.

Prior to the 1994 underwriting year, all Lloyd's members were private individuals who accepted insurance risk on a bespoke and unlimited-liability basis, i.e. individually they put at risk the whole of their personal wealth. Following the severe losses suffered by Lloyd's in the 1988 to 1992 underwriting years, the wealth of the supporting members was seriously eroded. As a result the Market's governing body, the Council, looked to corporations to solve the developing capital shortage problem.

Corporate members, when introduced for 1994, were initially restricted to spread vehicles i.e. they did not restrict their capital support to one syndicate or managing agency. From the 1995 year of account, the nature of corporate capital provision took a significant turn with the creation within the market of Integrated Lloyd's Vehicles (ILVs).

In its purest form an ILV involves the common ownership (by a holding company) of both a managing agency and corporate member, thereby integrating the provision of management and capital to a single syndicate.

ILVs have developed either anew or through the purchase, by investors, of an existing managing agency, followed by the gradual acquisition by those investors of participation rights on an established syndicate managed by the purchased agency. ILVs are expected to remain as the dominant membership structure at Lloyd's over the long-term.

As a direct result of this structural reform, the Lloyd's market capital base has altered markedly since the mid 1990s, with a dramatic decline in both the number of 'traditional' unlimited members and the total value of capacity contributed by them to the market. New unlimited liability members are no longer admitted to the market. As a result their number has declined steadily either through conversion to limited liability, resignation or death (average age is currently more than 65). However the rate of unlimited liability members' exit from the market has slowed considerably in recent years, with a remaining core showing a desire to continue underwriting. Some had been reluctant to move to limited liability arrangements because previous tax laws meant this would cause them to forfeit any accrued tax losses. This barrier to conversion was removed in 2005 by changes to the governing legislation. This partially explains the sharp decline seen in the number of unlimited members in that year.

The following chart shows the progression in the mix of capital providers at Lloyd's since 1995.

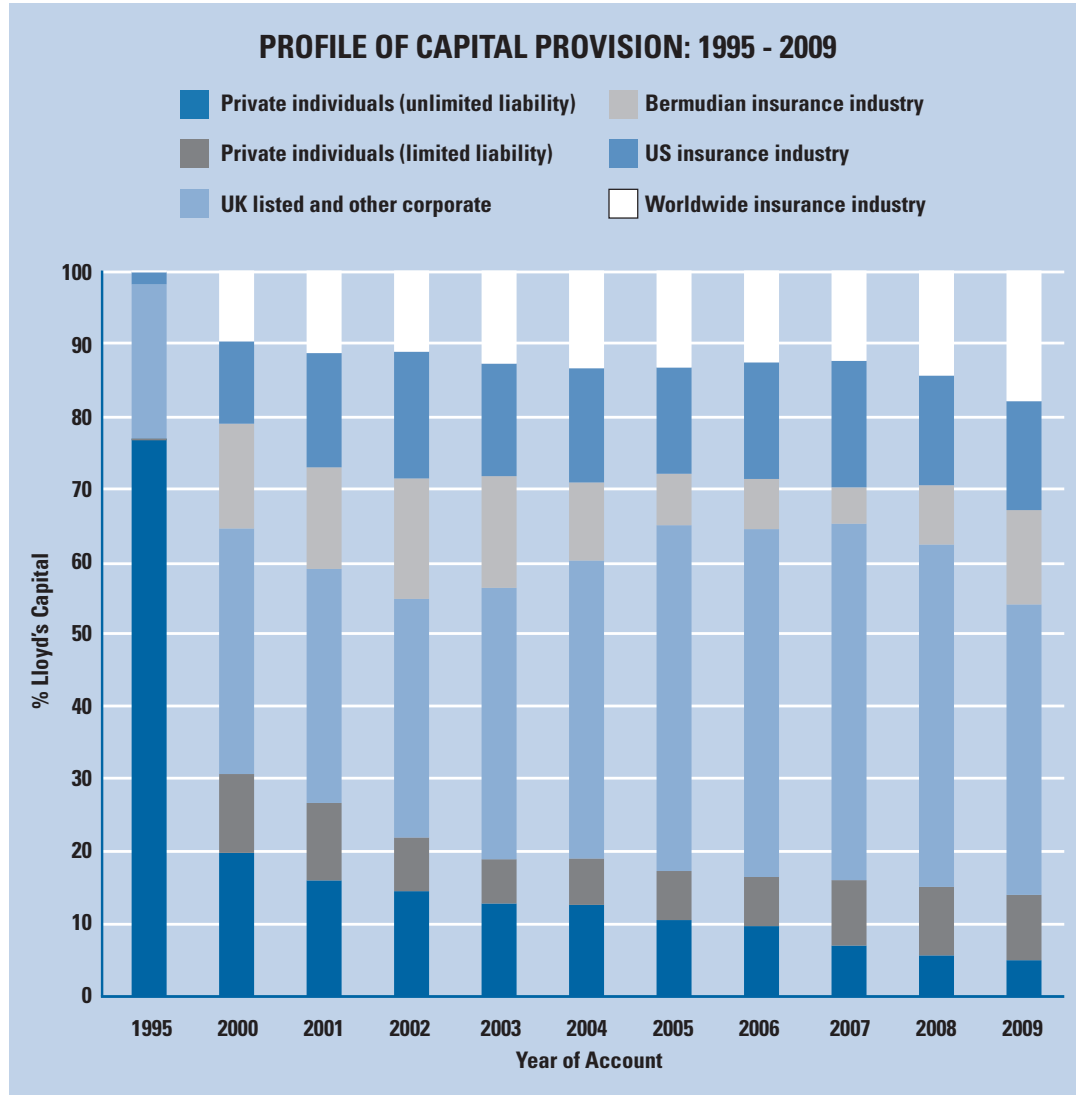
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The table shows a healthy diversity of capital providers both from inside and outside the insurance industry and the sustained growth in capacity provided by UK ILVs, particularly over the past decade.

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1.2 Syndicates

Syndicates, that have unique numeric identifiers, consist of groups of Lloyd's members, and are not legal entities in themselves. A total of 86 began trading at Lloyd's for the 2010 year of account. An appointed managing agent manages them, on behalf of the members.

Syndicates are annual ventures, meaning that they form at the beginning of each underwriting year and disband or close once the result for the underwriting year is determined, usually three years after its commencement. Each annual venture is closed once all outstanding and incurred but not reported claims are reinsured into a successor syndicate through the reinsurance to close (RITC) mechanism.

Part of a managing agent's role is capital management. Members have a right of tenure for the capacity on a syndicate they support and are required to indicate their intentions as to their future support in advance of each underwriting year. Members may increase their participation ("pre-empt") if the syndicate's managing agent indicates that additional capacity is required or decrease it ("de-empt"). Rights of tenure may be transferred bilaterally or in annual "capacity auctions" organized by Lloyd's.

The trend towards ILVs, and in the short term the demands under Solvency 2, mean that syndicate consolidation is expected to continue. However, Lloyd's is characterised by an entrepreneurial spirit and the presence of capital providers willing to back underwriting teams. As a result the formation of new syndicates, which has increased since 2006, will remain a constant feature of the market.

Special Purpose Syndicates (SPS), of which there were five as at September 1, 2010, were a new feature of the market for 2007. These facilitate unaligned capital participation via a reinsurance arrangement for a predefined period, rather than direct participation on a syndicate.

See Appendix 2 for a list of the 20 largest syndicates operating at Lloyd's.

1.3 Managing agents

Managing agents provide management and other services to syndicates. The agent appoints and employs the underwriter(s), other management and staff and determines the underwriting policy of the syndicate in conjunction with underwriters. It also provides the syndicate's business infrastructure (staff, premises, computer systems, etc.). The associated costs are normally charged directly to the syndicate. The agent usually charges capacity-based fees and profit commissions to members in order to cover non-syndicate specific costs and to supply profits. The number of managing agents has fallen dramatically from 196 in 1985 to 53 in 2010 (48 in 2009). The falling number of managing agents reflects the fall in the numbers of members and consequent trend of consolidation across the market.

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1.4 The Society of Lloyd's

The Society of Lloyd's oversees and supports the underwriting activity of Lloyd's members. It is not permitted to transact insurance business in its own right. The Society acts through the Council of Lloyd's, its governing body. The Council's powers are wide ranging and include the ability:

- To manage and supervise the affairs of the Society;
- To regulate and direct the business of insurance within the Market;
- To borrow money or apply levies to members in order to raise funds for use as central assets; and
- To apply central assets to meet members' liabilities.

1.5 Brokers

Substantially all insurance business conducted within the Lloyd's market involves a broker acting as a facilitator between clients (and/or another broker) and underwriters. The ability to place business with Lloyd's syndicates was historically restricted to a limited number of "Lloyd's brokers", although non-Lloyd's brokers could place business via a Lloyd's broker. In addition some managing agents have established service companies to market their syndicates' business (mainly UK motor and other personal lines) directly to non-Lloyd's brokers or to policyholders.

Recent changes to the Lloyd's Act 1982 removed the restriction that generally requires managing agents to accept or place business only through a Lloyd's broker. Nevertheless, the Lloyd's broker designation has been retained. The U.K Government believed that the preexisting

constraints on broker access placed 'an unnecessary burden on Lloyd's which represented a potential barrier to further business development.'

In 2001, following a review of distribution arrangements, Lloyd's implemented a Lloyd's broker accreditation process which was also designed to widen access to Lloyd's by enabling non-Lloyd's brokers from around the world to become Lloyd's brokers.

Lloyd's brokers were regulated by Lloyd's prior to July 2000, on which date Lloyd's in effect delegated this role to the General Insurance Standards Council, an industry-wide non-statutory body established to accredit and regulate UK brokers. This responsibility transferred to the Financial Services Authority in 2005. Lloyd's continues to control the accreditation of Lloyd's brokers centrally; applicants for accreditation as Lloyd's brokers must meet certain financial and suitability criteria and Lloyd's is therefore able to exercise some control over reputational risks to the market. The onus, however, has shifted to managing agents to manage the credit risks related to Lloyd's brokers.

Today, Lloyd's brokers range from subsidiaries of the major global broking groups to specialist brokers focusing on particular business lines. The number of Lloyd's brokers has risen since accreditation was introduced and as at October 1, 2010, stood at 181, of which 18 are located outside the UK.

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1.6 Members' agents

Members' agents manage the supply of predominantly private (though also some corporate) capital to syndicates, through the provision of advisory (they assist members with their syndicate selection) and administrative services to individual members. In the face of declining numbers of members the quantum of members' agents has also reduced markedly from 268 in 1985 (of which 158 were combined managing / members' agents) to 4 in 2010.

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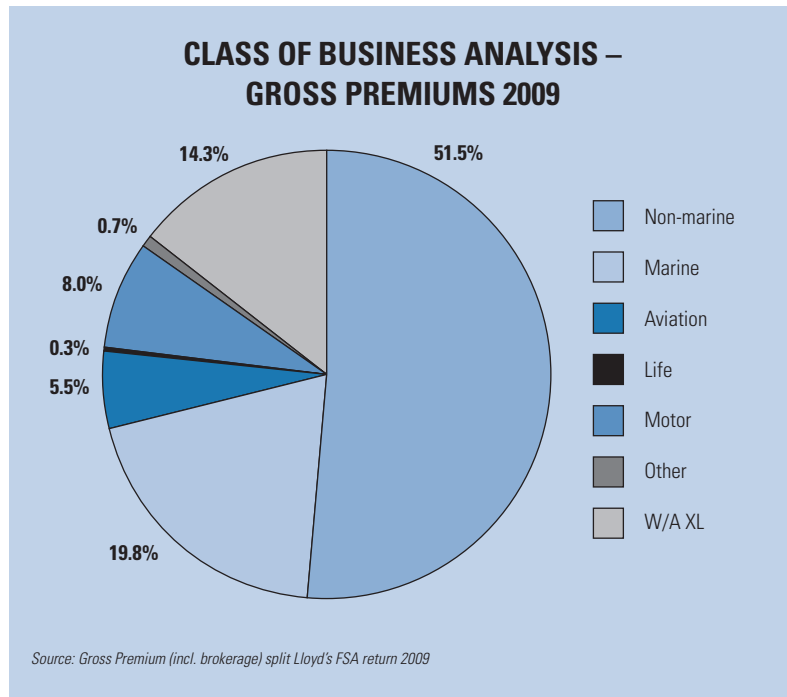
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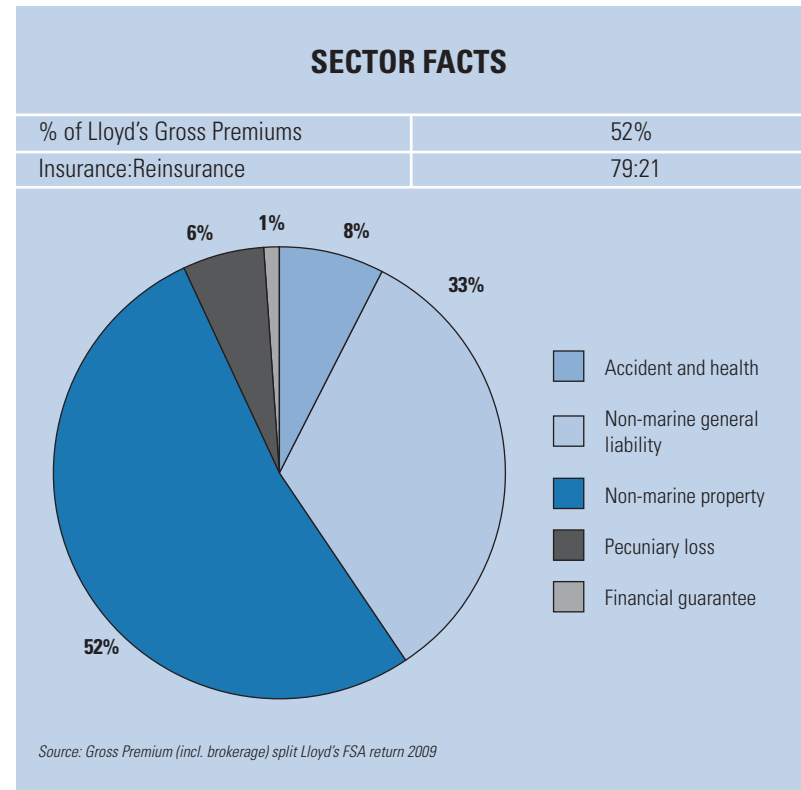
2. Lloyd's business profile

Lloyd's underwriting portfolio is extremely diverse, having evolved over its three hundred year history from a focus on marine insurance. Reflecting the market's risk appetite, common denominators of business typically underwritten (with the possible exception of motor and life business) include complexity, large monetary exposure levels and a high severity/ low frequency risk profile.



2.1 Non-marine

The sector includes a very diverse range of property and casualty business classes. Initially it was incidental to marine (hence the origin of its name) but it is now the market's most significant sector in terms of premium volume.



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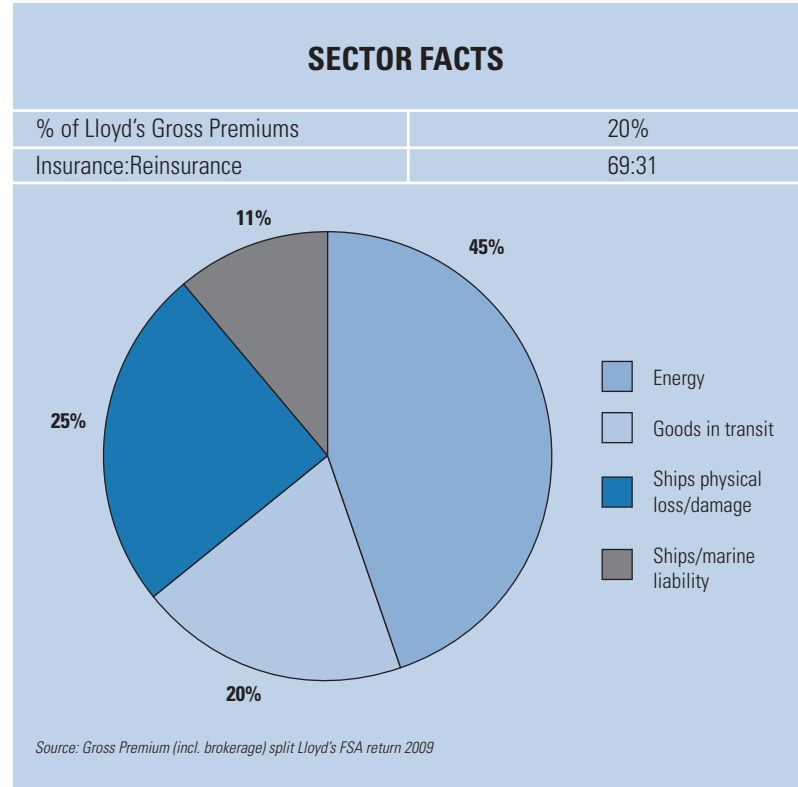
Lloyd's is arguably not the 'natural' home for much non-marine business in the way that it is perhaps for marine and aviation, reflected in a low estimated global market share. However Lloyd's has a number of significant global positions in diverse lines such as property facultative and risk excess, property catastrophe reinsurance, directors and officers liability (D&O; albeit in recent years the Market has significantly curtailed its exposure to the US market and reinsurance of this line), errors & omissions (E&O) and professional indemnity. Lloyd's remains a leader of catastrophe business and despite the emergence of Bermuda in the mid-1980s has increased its market share of global reinsurance.

A substantial amount of business is drawn from the US excess and surplus lines market where Lloyd's is the second largest writer. Lloyd's is an eligible excess and surplus lines insurer in all states except Kentucky and has direct licenses in Illinois, Kentucky and the US Virgin Islands.

2.2 Marine

Marine was the Lloyd's market's original business line. Today the sector includes traditional marine (hull and cargo), liability, energy (offshore and onshore oil and gas installations and associated liability) as well as reinsurance of these lines (Lloyd's provides a significant proportion of the International Association of Protection & Indemnity (P&I) Clubs' reinsurance requirements).

London is the 'natural' home of the marine market because of a number of historical factors:



- Britain was a major seafaring nation with dependencies established across the globe;
- London has, for centuries, provided a critical mass of marine underwriting and broking expertise;
- Marine law was formed under English law and the predominance of the English courts and arbitration continues today for marine business; and

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- Other support functions to the sector such as the Salvage Association and Lloyd's Register of Shipping are based in London.

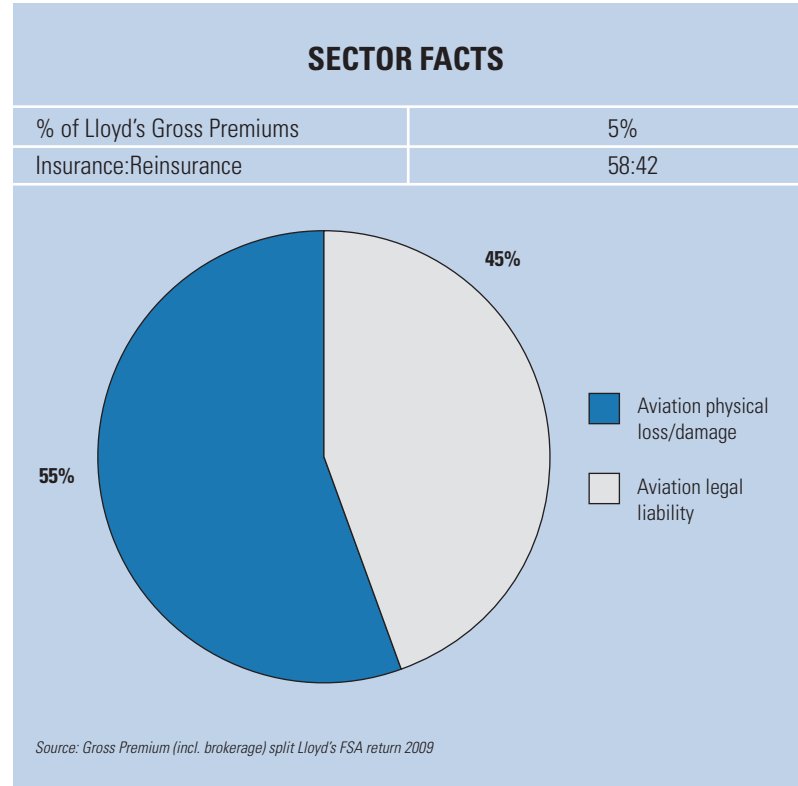
Nevertheless, Lloyd's estimated market share has declined quite significantly in recent years. This reduction has occurred through the natural development of domestic marine insurance markets and by greater risk retention by the P&I Clubs and oil and gas company captive insurers. Outside London, Lloyd's major competitors lie in the US, Scandinavia, France, Germany and increasingly in Russia and Asia.

2.3 Aviation

The characteristics of the aviation market are similar to those of the marine market except that it is inherently even more volatile. Aviation business covers hull, liability risks, and reinsurance thereof.

London is also the 'natural' home of this market. Reasons for this include:

- Aviation underwriting is highly specialised. There is a critical mass of respected underwriters based at Lloyd's, supported by London broking expertise;
- Aviation has a need for large amounts of capital that can, in the vast majority of cases, only be provided on a subscription basis;
- Lloyd's participates in aviation business across the globe since local insurance markets tend to retain little or no exposure because of the volatile nature of the business; and



- Support functions to the sector are concentrated in London (such as the major international aircraft hull surveyor firms).

As a result the London market is shown virtually all of the major worldwide airline business with the result that a number of major insurers have set up companies in London in order to participate in this market.

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That said, there has been a degree of consolidation within the Aviation sector and Lloyd's has lost market share to some other markets, particularly the specialist aviation pools.

2.4 Motor

The profile of the Motor business line is out of character with the others present at Lloyd's, it being more high frequency, low severity in nature. It represented about 5% of Lloyd's 2009 gross premiums written, and is almost entirely written on an insurance rather than reinsurance basis.

Collectively, Lloyd's remains one of the largest insurers in the UK motor market based on premiums. However a number of the motor writers have concluded that they do not require the comprehensive international infrastructure (with the associated expense in what is a very price sensitive sector) found at Lloyd's. The result has been the migration from Lloyd's of a number of businesses to either UK FSA regulated companies or to Gibraltar (in order to take advantage of the lowest minimum capital requirements in the EU).

2.5 Life

Life business at Lloyd's has traditionally been restricted to Key Man, Group Life and Term Life insurance. Lloyd's restriction on the ability of its members to write life business with a tenure exceeding 10 years was lifted for the 2001 year of account, with the term limit now being set at 25 years. Despite this, the sector is likely to remain small for the foreseeable future (under 0.5% of Lloyd's 2009 gross premiums written).

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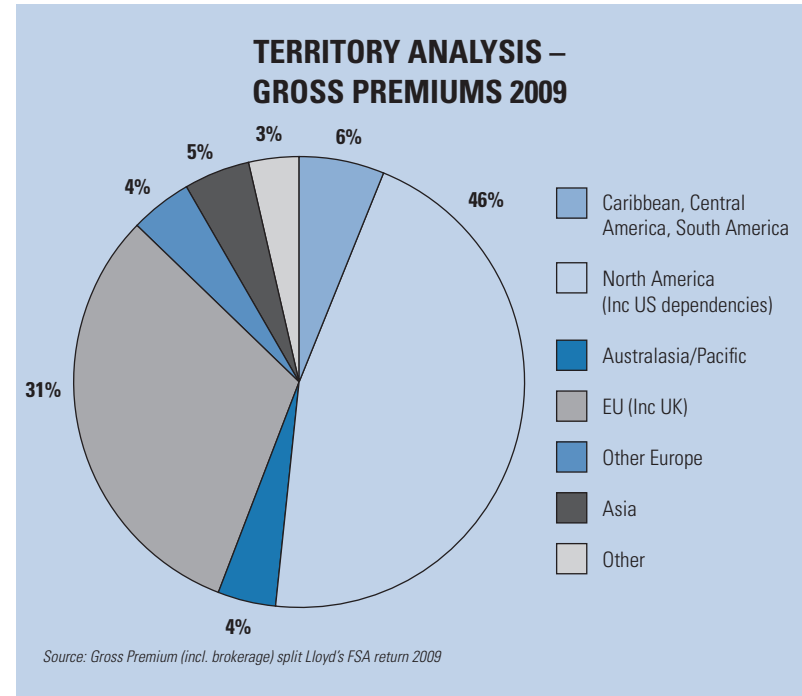
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2.6 Geographic diversification

Lloyd's has a very wide geographic coverage, with specific licenses to write insurance business in 79 countries and the ability to write reinsurance in many more.

A significant majority of income continues to be sourced from the US and UK (known to be particularly credit sensitive markets). Many managing agents have recognised this territorial dependence and are attempting to enhance their positions elsewhere around the globe, some independently of their Lloyd's operations. Particular emphasis is being placed on the Far East and Continental Europe, although it will take many years to grow this business to a level significant enough to balance the geographical risk portfolio split.



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3. Governance and management of the Lloyd's market

The governing body of the Lloyd's market is the Council of Lloyd's (the Council), a statutory body established by the Lloyd's Act 1982. The Council is responsible for the management and supervision of the market. As at 23 March 2010, the 17 Council members included six members who work in the Lloyd's market (working members), and six external members (including four corporate representatives). These Council members are directly elected by Lloyd's membership, normally for a term of three years. Six further members are nominated by the Council, five of the six are independent members; the sixth is the CEO. All Council members are approved by the FSA. Recent amendments to the Lloyd's Act 1982 have removed the restriction on a working member of Council serving consecutive three year terms. Previous requirements mandated that a working member take a minimum of a year's break between terms. The recent amendments have also relaxed the rule requiring the Chairman and Deputy Chairman of Lloyd's to be elected from the working members of the Council. Hence, it is now feasible for a non-working member of Council to become Chairman. Were this to occur then, to ensure that an appropriate balance of representative views is maintained, at least one of the Deputy Chairmen of Lloyd's would be required to be a working member. The tenure of the current chairman, Lord Levene of Portsoken, runs until 31 December 2011.

Whilst the Council remains the governing body of Lloyd's and discharges some functions directly, it mainly acts through the Franchise Board (see 3.2).

The day to day running of the market is undertaken by the Corporation of Lloyd's. It is responsible for developing the strategy for Lloyd's, the

performance management of the market and determining the appropriate levels of capital for those that wish to operate at Lloyd's. In addition it provides certain central services such as accounting, treasury, general administration and property management to market participants, recovering the cost of these services through fees, levies and recharges. It employs the market's executive including the Chief Executive Officer, the directors and staff ("the executive").

3.1 The Lloyd's Franchise

The franchise business model, introduced in 2003, is intended to improve Lloyd's long-term profitability and performance, through the creation of a more disciplined market place. In addition, Lloyd's has recognised that within the specialty niches it focuses on it has to compete for increasingly transient capital and business. The concept of an "Optimal Platform" has been developed to provide strategic direction for the market.

The Optimal Platform concept, with its associated workstreams and milestones, is designed to deliver five clear benefits, characterized by a set of features describing what the Lloyd's platform will offer to businesses in the Market.

1. *A clear and transparent performance management framework that supports the achievement of superior operating returns through recognizing the specific characteristics of each managing agent.*

Features of this benefit would include:

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- A performance framework that recognises, reacts to and rewards the relative performance of individual managing agents and raises standards across the market;
 - Provision of differentiated levels of support and intervention by the Corporation, depending on the capabilities of each managing agent;
 - Business planning tools that enable managing agents, their capital providers and the Corporation to better understand the risks and performance potential of individual businesses.
2. *A capital framework in which the benefits of mutuality demonstrably outweigh the costs and which cannot be readily duplicated outside Lloyd's.*
- Features of this benefit would include:
- Risk-adjusted capital-setting process, based on the FSA's ICAS regime, that reflects the level of exposure of mutual assets to an individual business and 'commercially prices' this accordingly, taking into account the market's ratings requirements and each managing agent's enterprise risk management capability;
 - Capital structures, including mutual assets, that can be tailored and give managing agents the opportunity to benefit from strong ratings and obtain increased returns for their capital providers, compared to trading on a standalone basis;
 - The cost of maintaining Lloyd's mutual assets targeted to average less than 1% of gross written premiums across the insurance cycle;
- Managing agents able to increase their capital resources expeditiously to take advantage of business opportunities as they arise;
3. *A secure, highly rated market.*
- Features of this benefit would include:
- Within reasonable bounds of expectation, appropriate ratings maintained throughout the insurance cycle; and
 - Capability to survive a '1 in 200' industry level event and enable managing agents to trade forward with a secure rating.
4. *Cost effective, easy access to the world's major markets supported by a global brand and licence network.*
- Features of this benefit would include:
- A turnkey licence structure that offers access to the major markets in specialist property and casualty risks;
 - Managing agents have access to a variety of distribution channels, and brokers are able to place risks with Lloyd's in a simple, cost effective manner;
 - Proactive market development in partnership with managing agents and a network of international offices that provide support services; and
 - A leading global brand and reputation, which help managing agents to win and retain preferred business.

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5. *A framework of standards for business processes that enables firms to deliver services to customers at a cost and level of risk comparable with other platforms, and offsets the inherent costs of a subscription market.*

Features of this benefit would include:

- Fast, expert service from quotation through to claims settlement;
- Brokers and other producers can deal easily with Lloyd's underwriters, using simple, streamlined processes with costs comparable to other markets;
- Easy access to Lloyd's underwriting expertise and range of insurance products irrespective of location; and
- Centrally sponsored, value-added services and tools which support high quality, efficient transaction of business.

Existing underwriting, risk management and policyholder service guidelines are key available levers for improving the market's profitability. Each managing agent is expected to compile syndicate business plans within them. If a managing agent wishes to operate outside the guidelines, it has to justify its position and obtain approval. The guidelines are designed to address issues such as:

- Profitability by product line - There should be a reasonable expectation of making a gross underwriting profit on each line of business every year;
- Catastrophe exposure - Catastrophe exposure should be analysed using approved tools or methods with each managing agent managing

its exposure to a minimum agreed return period. The maximum allowable (ie without the specific consent of the Franchise Board) gross and net exposure to a single Lloyd's specified Realistic Disaster Scenario (RDS) event for a given syndicate is currently 75% and 20% of syndicate capacity respectively;

- Reinsurer selection – Syndicates are obliged to place their reinsurance with reputable, secure providers. To ensure this is the case, each managing agent must have an approved reinsurer selection process;
- Gross line size - Individual risks should not be allowed to threaten large portions of a syndicate's capital. Therefore the maximum gross line that a syndicate should have on an individual risk is 10% of capacity;
- Reinsurance leverage - Each syndicate should retain a net minimum amount of exposure on each risk and no syndicate should pursue an aggressive arbitrage strategy; and
- Service standards - Each managing agent should adhere to the service standards covering policy production and premium and claims payment as defined by the "London Market Principles" (LMP; see section 5).

The Corporation is committed to raising standards in the Market. During 2005 and 2006 principles and minimum standards with regard to claims, followed by risk management and underwriting were published. In subsequent years three additional standards have been introduced covering 'Effective Operational Processes', 'Governance' and 'Protecting Lloyd's Reputation and Brand'. These provide a broad range of measures against which managing agents are monitored, with the results of this

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exercise being factored into regulatory capital requirements. From 2007, and now as a precondition of business plan approval, all managing agents are required to be able to demonstrate their compliance with the minimum standards. Some examples of the requirements in respect of a selection of the minimum standards are provided below:

Examples of minimum standards with regard to risk management include:

- There is a clear governance structure in place that supports risk management by providing clearly defined accountabilities, expectations and reporting requirements for all relevant parties;
- The organization has a process to identify and understand all significant risks to the achievement of its business objectives;
- The organization has in place sufficient measures and checks to enable the ongoing monitoring of its internal and external risk environment; and
- The organization's risk management framework is integrated with the capital modelling processes and methodology, allowing management effectively to assess overall capital needs, enhance capital allocations and measure the return on risk.

Examples of minimum standards with regard to underwriting include:

- There is an effective process for challenging the annual business plan which itself forms part of the long-term plan for each managed syndicate;
- There are effective systems and controls over each managed syndicate's underwriting including where underwriting authority has been delegated to another entity;

- The syndicate has appropriate pricing methodologies and effective rate monitoring processes;
- There are effective systems in place for the recording and reporting of underwriting-related data to management and the Corporation; and
- There are effective controls in place with regard to outwards reinsurance arrangements.

Examples of minimum standards with regard to claims include:

- Managing agents should have appropriate claims resources, skills and management controls in place in each line of business they propose to write;
- Reserves on open claims should be reviewed and, as appropriate, revalidated at least every 12 months;
- Reserves on open claims should be reassessed within 30 days of receipt of additional information that could have a bearing on the level of the reserve;
- Reserves for major claims should be validated via an internal peer review process.

The Corporation's role is intended to be primarily facilitative. However it is understood that it will become increasingly prescriptive in requiring change when a managing agent does not respond to the facilitative approach, or where a managing agent's underperformance threatens the security and the profitability of the Lloyd's market. The options available to Lloyd's include:

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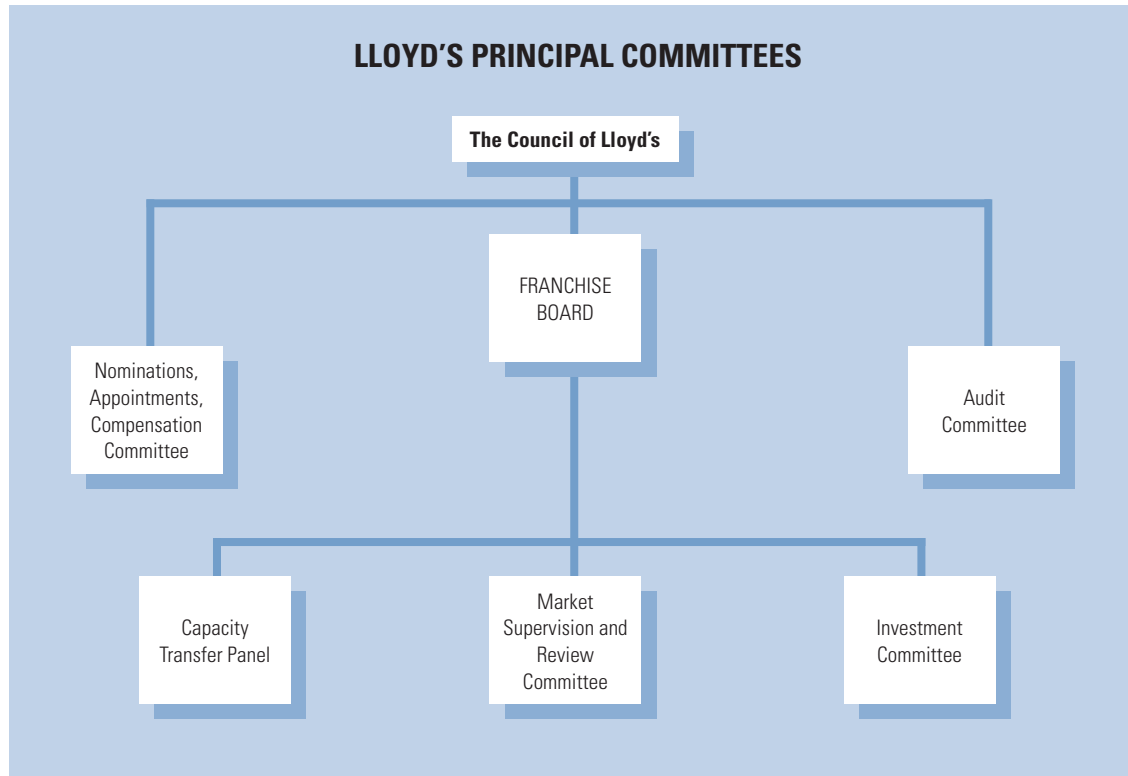
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- The ability to conduct a detailed review of a managing agent and its syndicates;
- The imposition of constraints on the managing agent, such as limits on underwriting for the rest of that year on a particular line of business;
- The application of capital loadings to the syndicate's ICA;
- The imposition of other requirements such as to require the managing agent to purchase additional reinsurance to cover over-exposure to a RDS on a net basis;
- As a last resort, the managing agent's removal from the Lloyd's franchise.



Lloyd's Franchise governance structure is summarized in the diagram below.

3.2 The Franchise Board

The Franchise Board has 10 members drawn from both inside and outside the Lloyd's market. The Chairman of Lloyd's, the Chief Executive Officer, Director of Finance, Risk Management and Operations and the Director of Performance Management are joined by a maximum of four non-executive members drawn from outside the market and a maximum of three non-executive members drawn from experienced practitioners within the Lloyd's market. Franchise Board appointments are made by Council upon the recommendation of the Nominations, Appointments and Compensation Committee of the Council (NACC).

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Specific Franchise Board functions include:

- Supervising, regulating and directing the business of insurance at Lloyd's;
- Setting the market supervision framework, in compliance with FSA requirements;
- Setting policy for the admission and removal of participants in the Lloyd's market;
- Admitting and removing managing agents; and
- Determining the guidelines for managing agents and approving the annual plan and budget of Corporation.

The Council on recommendation from the NACC, appoints the CEO to carry out the day to day operation of the Corporation. The CEO in turn appoints the directors and other members of the executive to carry out those functions.

3.3 The Market Supervision and Review Committee (MSARC)

MSARC takes decisions regarding the exercise of Lloyd's enforcement powers. It also acts as a review body capable, where appropriate, of amending, modifying or withdrawing certain decisions taken by the executive affecting managing agents.

3.4 The Capacity Transfer Panel

The Capacity Transfer Panel has been established principally to exercise the Council's powers in relation to minority buyouts and mergers.

3.5 The Investment Committee

The Investment Committee sets the investment objectives and parameters of centrally managed assets and is responsible for monitoring the performance of these funds. In addition, it monitors the investment operations of the Treasury department in respect of all funds under its management and approves all investment counterparties.

3.6 The Audit Committee

The Audit Committee's role ensures that the financial activities of Lloyd's are subject to independent review and audit. Reports from internal and external auditors on aspects of internal control and reports from the Legal and Compliance department on internal and overseas compliance are reviewed by the Audit Committee and appropriate action taken in response.

3.7 Nominations, Appointments and Compensation Committee (NACC)

The NACC is principally responsible for making recommendations to the Council on the appointment of the Chairman, CEO, new nominated Council members, Franchise Board members, members of a number of the Council and Franchise Board committees and the Secretary to the Council. The NACC reviews the remuneration of these individuals and makes recommendations to the Council on the remuneration of the members of these bodies.

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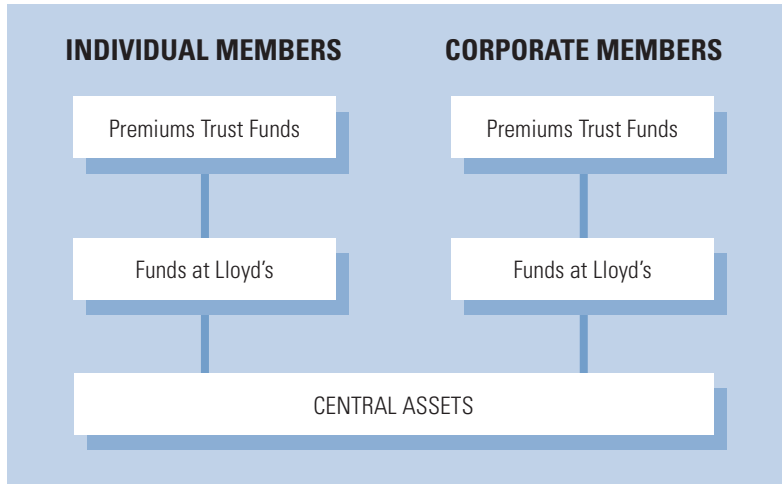
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4. Lloyd's "chain of security"

The following diagram sets out the current "chain of security" available to support policies underwritten at Lloyd's.



Recourse to a link in the chain takes place upon the non-availability of assets in the preceding link.

4.1 Premiums Trust Funds (PTFs)

These funds are held at syndicate level and are the resource for the payment of policyholder claims in normal circumstances. As well as paying claims, underwriting (syndicate and personal) expenses are paid from the PTFs and overseas regulatory deposits are funded from them. They are held under the trusteeship of directors or officers of Lloyd's managing

agents. They consist of investments, debtors, creditors and cash. The PTFs are segmented into funds covering non USD dollar cashflows (the Sterling Premium Trust Funds or SPTF) and those covering USD cashflows (the Lloyd's Dollar Trust Fund or LDTF). Details of the PTFs and other trust fund arrangements to which Lloyd's has to comply are provided in section 8 below.

4.2 Funds at Lloyd's

Funds at Lloyd's (FAL) are member specific and are held under the trusteeship of Lloyd's. The amount of FAL provided determines the maximum amount of gross premiums that may be written on behalf of each member for each year of account. The methodology as to how members' FAL is calculated is set out in section 6.2.

Each new member's FAL must be a minimum of £350,000 for the first 12 months of underwriting. After the first year of underwriting the capital requirement is based on the funding requirement established through the ICA capital setting process with no minimum. The minimum was as little as £100,000 in 1989.

FAL consists of cash, investments, letters of credit and bank and other guarantees held in the following funds:

- Lloyd's Life and Non-Life Deposits.
- Personal Reserve Funds - non-compulsory funds consisting of profits retained from closed years of account and other amounts paid in by the member.

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- Special Reserve Funds - non-compulsory tax efficient funds consisting of a proportion of retained profits from closed years of account. They relate to individual members only.

4.3 Funds in Syndicates (FIS)

Since 2007 fully aligned corporate members have been able to hold the capital supporting their underwriting within the syndicate Premiums Trust Fund as FIS rather than under the trusteeship of Lloyd's.

4.4 Central assets

Lloyd's central assets are the most tangible form of mutualisation within the market. They can be applied at the Council's discretion in order to:

- Extinguish a member's underwriting liability (with a right of reimbursement from the member);
- Enable a member to confirm annual solvency; and
- Cover any other purpose appearing to the Council to further the 'objects' of Lloyd's.

Central assets consist of the Central Fund, the callable layer and "other" central assets.

4.4.1 The Central Fund

The Central Fund, consisting mainly of investments and cash (rather than letters of credit), is Lloyd's fund of last resort. It partially mutualises Lloyd's capital base since annual contributions to it from all members are

available to pay for the liabilities of insolvent members. PTFs and FAL are member specific as Lloyd's members trade on a several, not joint, liability basis. As a consequence and unlike the Central Fund, the capital provided by a member backs only that member's share of liabilities attributable to each syndicate on which that member participates. It is not available to support the risks of other members participating on the same or other syndicates.

All members contribute annually towards the Central Fund. Currently members contribute at the rate of 0.5% of their overall premium limit. New corporate members underwriting on new syndicates contribute at a rate of 2.0% for their first three years of operation at Lloyd's.

In November 2005 the Central Fund was bolstered via the proceeds from the Society's issuance of long term debt consisting of a sterling tranche of £300 million and a second Euro tranche of €300 million. The notes are subordinated to the claims of senior creditors in the event of the Society winding up, and interest can be deferred under certain circumstances at the option of the Society. In June 2007 the Society issued a further £500 million of Tier 1 subordinated debt, enabling it to fully refinance the £333 million of outstanding syndicate loans. In April 2009 €47.3 million of the Euro denominated notes, and £59.6 million of the Tier 1 issuance was repurchased by the Society.

4.4.2 The 'Callable Layer' and 'Other Assets'

Lloyd's has the right to make a pro-rata call of up to 3% of a member's overall premium limit in the underwriting year in which the call is made.

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This callable layer can be drawn directly from PTFs without seeking the consent of members. Further calls can be made but only with the consent of members in a general meeting.

Finally remaining net assets of the Corporation are also available to meet liabilities.

4.3.3 A solution to the problem of run-off years

Lloyd's has recognised the need for a solution to the problem of run-off years of account (that is underwriting years of account remaining open after 3 years) in order to further reduce a risk factor to the Central Fund. The number of open syndicate years continues to decline at a rapid rate. There were 22 such years of account as at December 31, 2009 (37 at December 31, 2008), split by underwriting year as follows:

Underwriting Year	Number of Open Years (Year-end 2009)	Number of Open Years (Year-end 2008)	Number of Open Years (Year-end 2007)
1997	0	2	3
1998	2	6	8
1999	2	7	10
2000	3	6	11
2001	3	5	9
2002	4	4	8
2003	3	3	3
2004	1	1	1
2005	1	1	1
2006	0	2	
2007	3		
Total	22	37	54

Commercial solutions continue to be pursued, facilitated by Lloyd's. Significant progress is now being made, due to a more active RITC market, which has made RITC premium quotations more economically viable from a cedants perspective, and reduced uncertainty as liabilities mature.

Lloyd's continues to take an interest in the effective management of remaining open years of account via regular meetings with runoff managers. Historically efforts have included:

- The implementation of a standard risk based approach to run off;
- Strengthening of Lloyd's run off team;
- Monthly or quarterly reporting requirements on all open years, including the reasons for non closure and the strategy and timetable for achieving closure;
- Centralised approach to investment management; and
- Standardised approach to reinsurance asset protection, claims management, reporting, outsourcing and service levels.

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5. Market reform

The London insurance and reinsurance market has gradually evolved over time in a piecemeal fashion. As a result many of the administrative processes operating within it are not as efficient as those of global market peers, reducing the attractiveness of London to policyholders in terms of service quality and cost. Recognising this a joint IUA-Lloyd's Forum was set up in July 1999 to create and launch a common set of far reaching standards and protocols, the "London Market Principles" (LMP), now referred to as Market reform.

Market reform draws support from within both the London underwriting and broking businesses. Key sponsors include Lloyd's, the International Underwriting Association (IUA; the London based organisation for international and wholesale insurance and reinsurance companies), the Lloyd's Market Association (LMA; represents the interests of managing agents and syndicates operating at Lloyd's) and the London and International Insurance Brokers Association (LIIBA; representative body of the London broking community).

Market reform operates through the renamed London Market Reform Group (LMG). The LMG and Lloyd's jointly set strategy for and drive market modernisation. Each of the key Market reform work streams is driven by a Project Board of specialist practitioners, reporting to the LMG.

Recent market reform initiatives—contract placement, electronic claims files (ECF) and electronic accounting and settlement—have delivered notable efficiencies and are now considered business as usual, albeit some enhancements are still to be made. ECF "went live" in September 2006 and it is estimated that more than 90% of 'in scope' claims are now processed via ECF. A new claims transformation programme has been launched, which is intended to improve the speed of claims handling by standardising and simplifying the processing of low value claims in particular.

Progress with electronic messaging via The Exchange, whereby ACORD (a not-for-profit insurance data standards body based in New York and London) international data standards are used to transmit basic information between brokers and managing agents, has been slower than anticipated, but now seems to have more engagement from the Market participants. The LMG hopes to extend the usage of The Exchange beyond risk placement and endorsement to other areas such as accounting, claims and reporting, but there is still much to deliver on in respect of the original project.

The LMG is also tasked with improving the process by which coverholders access and operate within the Market.

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6. Regulation of the Lloyd's Market

The regulatory oversight environment with regards to Lloyd's has continued to evolve over the past decade. On November 30, 2001 the FSA assumed responsibility for regulation of the Society and the underwriting agents in the market and has taken steps to exercise more directly its responsibility for the prudential regulation of the Lloyd's market. Its overriding aim is to develop requirements that ensure Lloyd's policyholders continue to have a similar level of protection to that which policyholders of other insurers have. In addition the FSA has stated that it will continue to ensure the requirements for Lloyd's and insurance companies are consistent unless there are justifiable reasons why they should not be.

In practical terms, prior to January 1, 2003 the Lloyd's Council had previously performed its regulatory role through delegation to the Lloyd's Regulatory Board (LRB) and in turn the Regulatory division of the Corporation of Lloyd's. With the implementation of the Franchise structure, the LRB was abolished effective January 1, 2003. The former Market Supervision department was also restructured and renamed Risk Management. Other selective functions previously undertaken by Market Supervision were reassigned / realigned (e.g. responsibility for run off fell under the Performance Management Directorate (PMD)). The primary role of Risk Management is to identify, monitor and address operational, aggregate and systemic risks that threaten the Lloyd's franchise and to implement an effective Risk Model for Lloyd's. This includes collecting, reviewing and processing market level data, which is analysed by the PMD.

6.1 The FSA's prudential regulation of the Lloyd's market

The Society and the individual managing agents are considered by the FSA to manage all the significant prudential risks that affect Lloyd's policyholders. Accordingly the FSA applies prudential requirements to the Society and managing agents (rather than previously just the Society) on the basis of whichever of the two is best placed to control the relevant risk.

Lloyd's

Regulatory oversight occurs at Lloyd's centrally in respect of the insurance business of each member, or the resources that it holds in support of the members business (such as FAL and central assets). Ultimately Lloyd's is centrally required by the FSA to:

- Establish and maintain appropriate controls over the risks affecting funds held and managed centrally, including managing risk within appropriate limits.
- Assess the capital needs for each member, taking into account the capital needed to support the insurance business carried on through each syndicate, as assessed by managing agents. This reflects the fact that Lloyd's centrally has an aggregate view across the market and that managing agents do not. In particular Lloyd's can take account of members' participations on more than one syndicate, assets held outside syndicates, and the liabilities central assets are exposed to.

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The Franchise Board is treated similarly to the way the FSA regards the equivalent bodies of other firms. Lloyd's chooses how to carry out its functions and makes its own rules and imposes its own capital requirements.

The main purpose of Lloyd's risk management function is the management of risk throughout the franchise as a whole. Risk management also looks to ensure that members and the market as a whole are not exposed to undue risk, and therefore that the central assets (Central Fund, other assets etc) represent tangible protection for policyholders. Finally it provides support to the activity of the Franchise Board (discussed earlier).

The FSA's assessment of the effectiveness of the functions Lloyd's performs helps to guide how much work is needed to be done by the FSA and in which areas, consistent with its overall risk-based approach to supervision.

Managing Agents

Regulatory oversight occurs at the managing agency level in respect of the insurance business carried on through each managed syndicate as if the business of the syndicate were the business of a firm. Ultimately each managing agent is required to:

- Establish and maintain appropriate controls over risks affecting insurance business carried on through syndicates, including credit risk and market risk, within limits that are substantially the same as those for insurance companies; and

- Assess the capital needed to support the insurance business carried on through each managed syndicate.

The FSA's approach and the amount of work undertaken is driven by the risk each managing agent poses to its statutory objectives. The FSA assesses this through the same risk assessment framework applied to other regulated firms (including the Society). There is a base level of supervision with regard to each managing agent. Partially through on-site visits to managing agents the FSA considers:

- A managing agent's overall business strategy;
- The nature and permanence of the capital supporting the business managed;
- The risks underwritten;
- The systems put in place to ensure proper control and monitoring of their underwriting;
- Agent high level controls (committee structures, reporting lines, the role and effectiveness of non-executive directors, internal audit arrangements) and other key aspects of the systems and controls.

6.2 Regulatory capital adequacy assessment

The FSAs overall aim is to ensure that the amount of capital held by regulated entities is adequate to protect against significant risk of insolvency. To this end and after extensive consultation, a new capital adequacy assessment framework, consistent with that applied to other regulated insurance entities, has been rolled out at Lloyd's replacing the

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“Risk Based Capital” (RBC) regime. For capital setting and benchmarking in 2011, Lloyd's is implementing the Member Capital Allocation (MCAT) tool and the Integrated Capital Platform (ICP).

6.2.1 Framework overview

At a minimum Lloyd's is required to hold at all times capital (of a prescribed quality) sufficient to meet the the “Minimum Capital Requirement” (MCR), being the capital requirement set out in the European Directives.

6.2.2 Generation of syndicate ICAs

Managing agents are required to carry out regular assessments of the amount of capital that is adequate for the size and nature of each managed syndicate (ICA), calibrated such that the probability of resources being insufficient to meet liabilities is no more than 0.5% to ultimate based on one year of new business. In doing so they must consider the potential risks facing the syndicate operation including:

- Insurance risk: the risk of loss arising from the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities;
- Credit risk: the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion (e.g. reinsurers, brokers, coverholders);
- Market risk: the risk that arises from fluctuations in values of, or income from assets, or in the interest or exchange rates;

- Liquidity risk: the risk that sufficient financial resources are not maintained to meet liabilities as they fall due;
- Group risk: the potential impact of risk events, of any nature, arising in or from membership of a corporate group; and
- Operational risk: the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Member capital is not held at the syndicate level and the framework introduces the concept of a “Balancing Amount” as a mechanism to translate between member capital and required syndicate capital. This is the amount of capital which, following analysis, is needed to support syndicate-level risks but which is in excess of that held within the syndicate itself e.g. held by Lloyd's centrally as FAL or central assets. Each managing agent is required to inform Lloyd's of the required balancing amount for each syndicate. Lloyd's has to then confirm back to the managing agent the balancing amount that will be considered in setting centrally held capital. Following that confirmation, managing agents are able to comply with the requirement to ensure that capital resources are adequate for each syndicate.

The FSA has confirmed that it will continue to permit the admissibility of letters of credit while they are exceptionally allowed at Lloyd's under the Insurance Directives and permit them to be counted as tier 1 capital. However, under Solvency II, letters of credit for FAL are expected to be counted as tier 2 capital. According to the technical specifications for QIS5, at least 50% of the regulatory capital requirement under Solvency II should be met by Tier 1 capital.

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As noted above managing agents are required to calculate an ECR for the syndicate and use this as a benchmark for the ICA. The standard ECR model comprises capital charges based on asset categories, claims and premium reserves that vary depending on the class of underwriting business and whether the business is written directly or is proportional or non-proportional reinsurance.

In practice the ICA and ECR are discussed between the managing agent and Lloyd's (the FSA retains the right to undertake this work but is currently happy to delegate it to Lloyd's and review managing agency output on a sample basis) before one of two outcomes is agreed:

1. The ICA is confirmed as adequate; or
2. The ICA is not considered adequate in which case advice is given by Lloyd's to managing agents as to how much the ICA should be increased.

If following its sampling of managing agency ICAs the FSA feels they are not adequate, "Individual Capital Guidance" (ICG) can be given as to how much additional capital over and above the ICA is required. As for insurance companies, managing agents would need to be able to demonstrate how they could raise capital to the level of any ICG or alternatively how they could control the identified risks.

6.2.3 Translation of syndicate ICAs to member ECAs

The FSA recognizes that Lloyd's responsibility for setting the member capital requirements is fundamental to its role of ensuring that central

assets are adequate, are not exposed to undue risk and represent tangible protection for policyholders. Hence Lloyd's is required to carry out regular assessments of the amount of capital that is adequate for the size and nature of business underwritten by each member utilizing the ICA approach.

Work undertaken by the managing agents is the main input for Lloyd's assessment of capital required at a member level (syndicate ICAs being apportioned to members based upon their syndicate participation per year of account). However Lloyd's, in calculating the 'Member ICA,' also considers factors such as the risks and controls relating to FAL and central assets, diversification benefits accruing to members underwriting on more than one syndicate.

As regulatory benchmarks are considered by the FSA to be the minimum level of capital required, Lloyd's remains free to set a higher overall capital requirement for its members after considering franchise/commercial perspectives. In deciding whether to further enhance Member capital requirements above the regulatory minimum as presented by Member ICAs, Lloyd's considers for example the target ratings necessary to support Lloyd's core business lines, perceived capital strength of competitors, default statistics and third party capital models. If deemed necessary capital uplifts aimed at achieving the non-regulatory driven aims can be included resulting in an "Economic Capital Assessment" (ECA) for each member. The current level of uplift applied to standalone syndicate ICAs is 35%.

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In order to smooth the transition from the RBC regime, changes to capital requirements were initially restricted to a +/- 15% corridor of 2006 RBC benchmarks. This corridor was widened in 2007 to +/- 20%, and was removed in 2008. The current minimum FAL ratio is 25% of capacity for members where EU motor is at least 85% of their portfolio (and 40% for all others). The gearing inherent in the ratio is a major attraction of Lloyd's to capital providers.

6.2.4 The Lloyd's market ICA

To arrive at the Lloyd's market ICA, the six risk categories (insurance, credit, market, liquidity, group and operational risk) are considered with regard to Lloyd's centrally and if necessary additional capital requirements are set, after considering the degree of correlation between the identified risks. Examples of risk at this level include:

- Insurance risk: the runoff of orphan syndicates being supported by the Central Fund;
- Credit risk: exposure to providers of letters of credit;
- Market risk: risk to Central Fund assets of changes in interest rates, equity volatility;
- Liquidity risk: risk of Central Fund cash calls in excess of solvency deficits;
- Group risk: exposure to subsidiaries such as Lioncover Insurance Company Ltd; and
- Operational risk: underwriting cycle mismanagement and the risk of loss of the 1986 Lloyd's building.

Capital available to meet these risks is provided by Lloyd's central resources (see section 4.3).

The output of the Lloyd's ICA is discussed with the FSA before one of two outcomes is agreed:

- 1) The ICA is confirmed as adequate.
- 2) The ICA is not considered adequate in which case "Individual Capital Guidance" (ICG) is given as to how much additional capital over and above the ICA is required.

6.3 The Insurance Reorganisation and Winding-up Directive for Lloyd's

On August 10, 2005 Directive 2001/17/EC of the Council of March 19, 2001 was implemented with regard to the Lloyd's market. Previously there did not exist a legal mechanism for the coordinated application of reorganisation measures and winding-up procedures to the Lloyd's market as a whole.

The directive requires, first, that only the competent authorities of the home state of the insurance undertaking are entitled to commence reorganizing or winding up proceedings and, secondly, that in the event of a winding-up of an insurance undertaking, direct insurance claims (not reinsurance claims) shall take precedence over any other claim on the whole of the insurance undertaking's assets with only some permissible exceptions (e.g. claims by social security systems and claims on assets subject to 'rights in rem' i.e. security interests).

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The regulated "insurance undertaking" for the purpose of this and other EU insurance directives is "the association of underwriters known as Lloyd's" (members of Lloyd's taken together), which, however, is not a legal entity.

The directive's provisions were therefore interpreted in the implementing regulations not to apply directly to the isolated insolvency of particular members of Lloyd's. Rather the scope of the directive's provisions was deemed appropriate only where there is a material risk that the solvency requirements applicable to the undertaking as a whole will not be met (i.e. that not all policyholders will be paid).

Despite the importance of the Central Fund being recognised there are no provisions within the regulations that grant members' insurance creditors any rights over the Society's assets (in particular the Central Fund). Technically the general position is that insurance creditors at Lloyd's are the creditors of the relevant members as opposed to the Society. Therefore in the distribution of the Society's assets in a winding-up the senior creditors of the Society would rank ahead of policyholders. The exception to this general position is where the Society has given a Central Fund undertaking to a corporate member who is otherwise insolvent. Policyholders of this member have the benefit of that undertaking which represents a senior liability of the Society. As such it ranks pari passu with the other senior creditors of the Society.

In practice Standard & Poor's believes that with the intervention of the courts and FSA the vast majority of the Central Fund's assets will be applied for the benefit of policyholders. In a winding up scenario a small portion would be made available to pay for the winding up/runoff process but it is expected that there would be external pressure to ensure that amounts were kept to a minimum.

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7. Distribution of profits

Lloyd's move to annual accounting has been accompanied by changes to the rules governing the distribution of profits from the Market. Previously a member would typically have to wait three and a half years from commencement of underwriting before receiving cash profits. The underwriting year result would be declared after three years and profit distribution would occur roughly six months later. The process in effect trapped profits within the market and was argued to put Lloyd's at a competitive disadvantage compared to other insurance companies.

From 2006 managing agents have been able to make interim profit distributions from syndicate premium trust funds to members personal reserve funds (PRFs) by reference to the annual accounting result at the end of each calendar year if they consider it appropriate having regard to the need for working capital and prudential margins and any requirements made by the Council of Lloyd's. Payment of profit to members out of the PRF is controlled by a release test which for active members ensures funds in excess of required capital only are released. Additional prudential safeguards have been put in place in the release test for non-active capital providers.

The Franchise board has also agreed that from 2006 profits/losses reported in half year interim results will be recognised within the capital setting process for the forthcoming trading year and for release test purposes. Due to the nature and seasonal exposures of much of Lloyd's business any credit for profit will be restricted to 25% (previously 10%) of a member's ECA.

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8. Lloyd's Trust Funds

Lloyd's has a complex and burdensome trust fund structure. Lloyd's is required to hold all underwriting income in trust for the benefit of policyholders. Trust fund balances at year-end 2009 were as follows:

	<i>£ Million</i>
Premium Trust Funds (PTFs) and Lloyd's Dollar Trust Funds (LDTFs)	19,417
Lloyd's American Trust Funds (LATFs)	NIL
Joint Asset Trust Funds (JATFs)	136
Credit for Reinsurance Trust Funds (CRTFs) and Surplus Lines Trust Funds (SLTFs)	7,775
Illinois Trust Fund	410
Kentucky Trust Fund	127
Lloyd's Canadian Trust Funds (LCTFs) and Margin Fund	2,110
Lloyd's Australian Trust Funds	848
Lloyd's South African Trust Funds	107

- PTFs are funds held at syndicate level and are used for all non-dollar underwriting cash flows. Individuals from Lloyd's managing agents are the trustees. The PTFs also include non- US/Canadian overseas deposits held by Additional Securities Limited, a subsidiary of Lloyd's.
- The LDTFs are similar to PTFs. The funds were set up in 1995 for business denominated in US dollars incepting from August 1995.
- The LATFs are similar to the PTFs and covered all Lloyd's business denominated in US dollars written before August 1995. However, the relevant forms of trust deed were amended in March 2009 so that these liabilities are now secured by assets held in the CRTFs and SLTFs.
- The JATFs comprise two funds (the Reinsurance Fund and the Surplus or Excess Lines Fund) and are required to support US situs business. Each is held in two mutual funds in New York with Citibank as trustee. These funds can only be accessed when a policyholder's claim remains unpaid after recourse to the other relevant US funds. It is possible that the continuing Lloyd's market would be required to replenish them if they were used to pay US reinsurance or surplus lines claims not met by Equitas.
- The CRTFs and SLTFs are similar to the LATFs, but relate to US situs reinsurance and surplus lines business. Lloyd's US licensing terms require the CRTFs and SLTFs to be adequate to meet 100% and 30% respectively of gross US liabilities, i.e., without giving credit for reinsurance ceded by Lloyd's to US companies. Lloyd's must provide quarterly reports and annual actuarial certifications of liabilities. These trust funds are funded by the Premium Trust Funds.

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- The Illinois and Kentucky Trust Funds are held to back Lloyd's direct underwriting licenses in those states.
- The LCTFs are similar to the PTFs except that the funds are located in Canada and the Royal Trust Corporation of Canada is the trustee.

Whilst Lloyd's is not disadvantaged relative to other alien (re)insurers in the US, the CRTF and the JATFs still represent substantial over funding of US dollar liabilities. This practice has been raised within the EU and amongst US regulators as being both anti competitive and protectionist (there is no similar regime within the EU). Discussions aimed at creating a level playing field in this regard between the EU and US are progressing.

Largest 20 Syndicates By Gross Premiums Written

Rank	Syndicate	Managing Agent	2009			2008			2007		
			GWP	% Total (£m)	Cum. % Market GWP	GWP	% Total (£m)	Cum. % Market GWP	GWP	% Total (£m)	Cum. % Market GWP
1	2003	Catlin Underwriting Agencies Ltd	1,604	7.30%	7.30%	1,318	7.33%	7.33%	1,215	7.42%	7.42%
2	623/2623	Beazley Furlonge Ltd	1,242	5.65%	12.95%	1,034	5.75%	13.08%	932	5.69%	13.12%
3	2001	Amlin Underwriting Ltd	1076	4.90%	17.85%	842	4.68%	17.76%	901	5.51%	18.62%
4	2999	QBE Underwriting Limited	1040	4.73%	22.58%	852	4.74%	22.50%	978	5.98%	24.60%
5	33	Hiscox Syndicates Ltd	1034	4.71%	27.29%	885	4.92%	27.42%	996	6.09%	30.69%
6	4472	Liberty Syndicate Management Ltd	1025	4.66%	31.95%	951	5.29%	32.71%	1,045	6.39%	37.07%
7	510	R J Kiln & Co Ltd	925	4.21%	36.16%	757	4.21%	36.91%	678	4.14%	41.21%
8	2987	Brit Syndicates Limited	897	4.08%	40.24%	714	3.97%	40.88%	647	3.95%	45.17%
9	1084	Chaucer Syndicates Ltd	799	3.64%	43.88%	642	3.57%	44.45%	526	3.21%	48.38%
10	4444	Canopus Managing Agents Ltd	675	3.07%	46.95%	484	2.69%	47.14%	469	2.87%	51.25%
11	218	Equity Syndicate Management Ltd	635	2.89%	49.84%	555	3.09%	50.23%	569	3.48%	54.72%
12	1414	Ascot Underwriting Limited	602	2.74%	52.58%	506	2.81%	53.04%	538	3.29%	58.01%
13	1183	Talbot Underwriting Ltd	586	2.67%	55.25%	383	2.13%	55.17%	344	2.10%	60.11%
14	1200	Argo Managing Agency Ltd	530	2.41%	57.66%	409	2.27%	57.45%	325	1.99%	62.10%
15	386	QBE Underwriting Ltd	417	1.90%	59.56%	412	2.29%	59.74%	436	2.66%	64.76%
16	2488	ACE Underwriting Agencies Ltd	400	1.82%	61.38%	437	2.43%	62.17%	393	2.40%	67.16%
17	5000	Travelers Syndicate Management Ltd	380	1.73%	63.11%	320	1.78%	63.95%	295	1.80%	68.97%
18	457	Munich Re Underwriting Ltd	366	1.67%	64.78%	333	1.85%	65.80%	309	1.89%	70.85%
19	2007	Novae Syndicates Limited	356	1.62%	66.40%	315	1.75%	67.55%	274	1.67%	72.53%
20	3210	Mitsui Sumitomo at Lloyd's Ltd	331	1.51%	67.90%	353	1.96%	69.51%	360	2.20%	74.73%
		GWP of 20 largest syndicates	14,920			12,502			12,230		
		Lloyd's Market GWP	21,973	100.00%		17,985	100.00%		16,366	100.00%	

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Gross Premiums By Risk Group And Region

	2007			2008			2009		
£ million	Direct	R/I	Total	Direct	R/I	Total	Direct	R/I	Total
Aviation combined	0	0	0	0	0	0	0	0	0
Aviation legal liability	221	172	393	260	200	460	301	236	537
Aviation physical loss/damage	238	183	421	301	227	528	397	268	665
Long term	44	3	47	51	4	55	49	7	56
Energy	936	450	1,386	993	485	1,478	1,278	669	1,947
Goods in transit	514	127	641	594	176	770	665	186	851
Ships physical loss/damage	501	162	663	634	224	858	794	279	1,073
Ships/marine liability	165	135	300	190	171	361	248	225	473
Motor	1,174	44	1,218	1,139	241	1,380	1,282	471	1,753
Accident and health	476	136	612	505	179	684	645	207	852
Non-marine general liability	2,633	394	3,027	2,764	469	3,233	3,175	582	3,757
Non-marine property	3,496	1,194	4,690	3,646	1,334	4,980	4,459	1,470	5,929
Pecuniary loss	424	37	461	491	56	547	584	73	657
Financial Guarantee	86	8	94	116	6	122	107	16	123
Specific inwards XL RI	0	102	102	0	115	115	0	147	147
Lloyd's Japan	0	0	0	0	0	0	0	0	0
Third party RITC	0	0	0	0	0	0	0	0	0
Whole a/c XL RI	5	2,306	2,311	3	2,411	2,414	0	3,153	3,153
Total	10,913	5,453	16,366	11,687	6,298	17,985	13,984	7,989	21,973

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Gross Premiums By Risk Group And Region *CONTINUED*

£ million	2007			2008			2009		
	Direct	R/I	Total	Direct	R/I	Total	Direct	R/I	Total
Caribbean	174	392	566	169	441	610	256	556	812
Central America	17	117	134	19	157	176	23	198	221
North America	5,128	2,140	7,268	5,546	2,439	7,985	6,888	3,030	9,918
South America	11	152	163	16	237	253	20	293	313
US Dependencies	46	25	71	47	20	67	60	31	91
Africa	140	124	264	144	139	283	194	196	390
Indian and Atlantic Oceans	2	6	8	3	8	11	4	8	12
Asia	176	478	654	220	575	795	283	780	1,063
Australasia/Pacific	507	110	617	592	148	740	745	208	953
Middle East	92	148	240	100	172	272	120	236	356
Eastern Europe	10	33	43	18	40	58	24	52	76
EFTA	214	118	332	231	140	371	305	170	475
European Union	4,309	1,456	5,765	4,471	1,580	6,051	4,918	1,980	6,898
Former USSR Republics	9	69	78	16	93	109	13	118	131
Other Western Europe	78	85	163	95	109	204	131	133	264
Inter-syndicate reinsurance	0	0	0	0	0	0	0	0	0
Worldwide Total	10,913	5,453	16,366	11,687	6,298	17,985	13,984	7,989	21,973

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Earmarking Of The Central Fund

All figures in £million

Year	Central Fund Net Assets	Solvency Shortfalls
1970	21.2	0.4
1971	24.3	0.6
1972	28.5	0.6
1973	29.1	0.7
1974	23.0	0.2
1975	35.9	0.1
1976	38.8	-
1977	52.3	-
1978	58.1	0.1
1979	59.8	0.5
1980	72.5	0.8
1981	83.4	0.8
1982	108.8	0.5
1983	135.8	1.7
1984	173.4	6.2
1985	211.5	64.8
1986	279.2	237.3
1987	254.4	24.0
1988	303.6	12.9
1989	384.5	21.8

All figures in £million

Year	Central Fund Net Assets	Solvency Shortfalls
1990	376.2	30.3
1991	438.0	67.9
1992	1,113.0	354.9
1993	903.7	661.6
1994	737.5	1,057.9*
1995	540.9	1,001.2*
1996	236.3	0.5
1997	144.2	1.7
1998	212.2	6.4
1999	252.8	7.4
2000	322.8	11.5
2001	326.8	92.6
2002	476.2	85.1
2003	711.0	79.8
2004	604.5**	91.9
2005	555.8**	163.9
2006	626.8**	147.4
2007	767.0**	123.2
2008	852.0**	93.0
2009	983.0**	45.3

Source: Lloyd's Market Reporting

1. Central Fund balance represents the net value of the Fund after provision has been made for taxation.

2. The earmarkings for 1986 include an extraordinary amount relating to the PCW settlement.

3. Solvency shortfalls are those at the relevant year end, not after the completion of the subsequent solvency test in respect of that year.

4. For 2002/2003 the figure in the shortfall column represents unutilised undertakings rather than solvency shortfalls.

*The shortfalls were covered by the available assets of the Central Fund, the net assets of the Society and a credit for part of a double count in respect of losses which are covered by errors and omissions reserves.

** Reported under IFRS - 2004 restated. Figures presented for net assets in 2004 – 2006 exclude loans to the Central Fund.

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Credit FAQ: Lloyd’s - Identifying The Market’s Financial Strength

The Lloyd’s insurance market (Lloyd’s or the Market) is a unique insurance provider, and needs to be addressed in a way that acknowledges these qualities when it comes to its rating.

Standard & Poor’s Ratings Services already rates the financial strength of the Market (insurer financial strength rating A+/Stable), as well as assigning ratings and assessments to a number of Market participants, to The Society of Lloyd’s (the Society; A+/Stable/—), and to the Society’s subordinated debt issues (A-).

However, Lloyd’s is not an insurance or reinsurance company, but a partially mutualized, competitive marketplace within which buyers of insurance and reinsurance look to have their demand for risk transfer satisfied by risk carriers—the Lloyd’s members.

The Lloyd’s members (or capital providers) are the ultimate risk carriers at Lloyd’s. Annually, the capital providers group together to form syndicates in order to accept risk, severally not jointly. It is because of this unique structure that a specialized approach is needed when offering opinions on the individual syndicates.

Frequently Asked Questions

How can Standard & Poor’s provide a rating opinion on the Lloyd’s Market?

Lloyd’s structure includes a Central Fund that provides partial mutualization of the capital base. As a result, all Lloyd’s policies are

backed by Lloyd’s common security, which enables Standard & Poor’s to assign an insurer financial strength rating (FSR) that applies across the Market.

To what does Standard & Poor’s rating on the Lloyd’s Market apply?

Standard & Poor’s FSR on Lloyd’s applies currently and prospectively to each policy issued by Lloyd’s from the 1993 year of account onward.

Lloyd’s non-life liabilities for 1992 and prior years have been reinsured into Equitas Ltd. The FSR on Lloyd’s does not apply to Equitas.

The rating scale used for Lloyd’s is consistent with all Standard & Poor’s FSRs, enabling the financial security offered by Lloyd’s to be compared directly with insurance companies. But importantly, the FSR on Lloyd’s applies to all syndicates, regardless of their individual performance relative to other syndicates and market aggregates.

Why doesn’t Standard & Poor’s assign FSRs to syndicates?

Standard & Poor’s does not believe that under the Market’s current legal and regulatory structure FSRs on syndicates are appropriate. This view reflects the fact that syndicates are groupings of one or more capital providers, managed on their behalf by a managing agent, and are not legal entities in themselves. Furthermore, regulatory action is the arbiter of default in an FSR and, due to the mutualization of Lloyd’s through the Market’s Central Fund, regulatory action resulting from concerns as to ability to meet claims would be marketwide, not syndicate specific.

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Credit FAQ: Lloyd's - Identifying The Market's Financial Strength *CONTINUED*

To address these issues and meet the insurance and capital markets' need for a more specific view of the syndicates, Standard & Poor's does offer an opinion on a syndicate's continuity characteristics in the form of a Lloyd's Syndicate Assessment (LSA). This measures the dependency of syndicates on Lloyd's Central Fund, brand, international licensing agreements, infrastructure, and, ultimately, on the Lloyd's FSR.

How should the LSAs be used and interpreted?

LSAs are assigned on a scale of 'LSA 1' to 'LSA 5', indicating the likely continuity of each syndicate reflecting its relative dependency on Lloyd's support, both financial and nonfinancial. A syndicate assigned an LSA of 'LSA 5' is considered to have 'very low dependency', which Standard & Poor's views as positive, whereas 'LSA 1' indicates 'very high dependency', which is viewed as negative.

The lower the LSA, in our view the lower the likelihood of the syndicate being a long-term Market participant, at least in its current form. This measure of continuity has been welcomed by cedents and brokers, who wish to ensure that relationships can be maintained over the life of the policy and claims period.

Are there any circumstances under which Standard & Poor's can assign an FSR to a Lloyd's capital provider?

Where a capital provider is an incorporated legal entity and where a guarantee is provided by another rated entity, an FSR can be assigned. The guarantee must meet Standard & Poor's guarantee criteria, and must be

enhanced to reflect the unique features of the Lloyd's Market. Specifically, this means:

The guarantee needs to explicitly address the requirement that, should the central Lloyd's claims payment process be inoperable for whatever reason, including regulatory action, there is a method through which valid claims can continue to be paid to policyholders; and

The guarantee is triggered when the corporate capital member does not make timely payment of any amount, once finally determined to be due and payable, from premium trust funds and funds at Lloyd's. There should be no reliance upon payments from the Lloyd's Central Fund.

How does having this guaranteed capital provider rating affect policyholder security?

If a syndicate retains the corporate capital provider as its single capital provider, then all policies issued by Lloyd's on behalf of the syndicate in effect benefit fully from the guarantee provided.

How is the Lloyd's Market's creditworthiness with respect to financial obligations assessed?

The Society of Lloyd's, the entity whose members provide the capital to underwrite the insurance and reinsurance risks assumed by Lloyd's, carries a counterparty credit rating predicated upon the current 'A+' long-term FSR on the Lloyd's Market.

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Credit FAQ: Lloyd’s - Identifying The Market’s Financial Strength *CONTINUED*

Standard & Poor’s considers that senior creditors of the Society have access to the same pool of central assets that is available to policyholders. Senior creditors have the power to petition for the winding-up of the Society. In the event of a winding-up of the Society, senior creditors of the Society would currently rank at least pari passu with the policyholders of members. In carrying out its functions, it is expected that the Society will ensure it can meet its obligations to repay its own senior creditors when applying central assets to meet the underwriting liabilities of its members.

How do these different ratings relating to Lloyd’s—the FSR on Lloyd’s, the counterparty credit rating on The Society of Lloyd’s, the subordinated debt rating on the notes issued by the Society, the FSRs on Lloyd’s capital providers, and the LSAs on the syndicates—interact?

Standard & Poor’s singular measure of financial strength for the Lloyd’s Market is its FSR on Lloyd’s, which applies to all policies issued by Lloyd’s from 1993 onward.

The rating on the subordinated debt issued by the Society of Lloyd’s relates to the Society’s financial capacity to meet obligations under the terms of the notes.

Where a syndicate retains a single rated corporate capital provider, all policies issued by Lloyd’s on behalf of the syndicate in effect benefit fully from the guarantee provided, and therefore offer the financial security of the guarantor.

The LSAs provide a benchmark to counterparties looking for an opinion on the likelihood of the continued presence of their underwriting partner. LSAs can be used to differentiate syndicates, all of which benefit from at least the financial strength of the Lloyd’s Market.

Therefore, when determining the financial strength backing a policy issued by Lloyd’s on behalf of a syndicate, the Lloyd’s Market FSR always applies. But if the syndicate is backed by a single guaranteed corporate capital provider, then the FSR on the capital provider should be used. The LSAs offer differentiation of syndicates with a focus on likely continuity of Market participation.

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Standard & Poor's Insurer Financial Strength Ratings

A Standard & Poor's Insurer Financial Strength Rating is a current opinion of the financial security characteristics of an insurance organisation with respect to its ability to pay under its insurance policies and contracts in accordance with their terms. This opinion is not specific to any particular policy or contract, nor does it address the suitability of a particular policy or contract for a specific purpose or purchaser. Furthermore, the opinion does not take into account deductibles, surrender or cancellation penalties, timeliness of payment, nor the likelihood of the use of a defence such as fraud to deny claims. For organisations with cross-border or multinational operations, including those conducted by subsidiaries or branch offices, the ratings do not take into account potential that may exist for foreign exchange restrictions to prevent financial obligations from being met.

Insurer Financial Strength Ratings are based on information furnished by rated organisations or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit in connection with any rating and may on occasion rely on unaudited financial information. Ratings may be changed, suspended, or withdrawn as a result of changes in, or un-availability of such information or based on other circumstances.

Insurer Financial Strength Ratings do not refer to an organisation's ability to meet non-policy (i.e. debt) obligations. Assignment of ratings to debt issued by insurers or to debt issues that are fully or partially supported by insurance policies, contracts, or guarantees is a separate process from the determination of Insurer Financial Strength Ratings, and follows

procedures consistent with issue credit rating definitions and practices. Insurer Financial Strength Ratings are not a recommendation to purchase or discontinue any policy or contract issued by an insurer or to buy, hold, or sell any security issued by an insurer. A rating is not a guarantee of an insurer's financial strength or security.

Rating scale

An insurer rated 'BBB' or higher is regarded as having financial security characteristics that outweigh any vulnerabilities, and is highly likely to have the ability to meet financial commitments.



An insurer rated '**AAA**' has extremely strong financial security characteristics. 'AAA' is the highest Insurer Financial Strength Rating assigned by Standard & Poor's.



An insurer rated '**AA**' has very strong financial security characteristics, differing only slightly from those rated higher.



An insurer rated '**A**' has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

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Standard & Poor's Insurer Financial Strength Ratings *CONTINUED*



An insurer rated **'BBB'** has good financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.

An insurer rated 'BB' or lower is regarded as having vulnerable characteristics that may outweigh its strengths. 'BB' indicates the least degree of vulnerability within the range; 'CC' the highest.

An insurer rated **'BB'** has **marginal** financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.

An insurer rated **'B'** has **weak** financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.

An insurer rated **'CCC'** has **very weak** financial security characteristics, and is dependent on favourable business conditions to meet financial commitments.

An insurer rated **'CC'** has **extremely weak** financial security characteristics and is likely not to meet some of its financial commitments.

An insurer rated **'R'** has experienced a **regulatory action** regarding solvency. The rating does not apply to insurers subject only to non-financial actions such as market conduct violations.

An insurer designated **'NR'** is **not rated**, which implies no opinion about the insurer's financial security.

Plus (+) or minus (-) signs following ratings from 'AA' to 'CCC' show relative standing within the major rating categories.

CreditWatch highlights the potential direction of a rating, focusing on identifiable events and short-term trends that cause ratings to be placed under special surveillance by Standard & Poor's. The events may include mergers, recapitalisations, voter referenda, regulatory actions or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is needed to evaluate the rating. A listing, however, does not mean a rating change is inevitable, and whenever possible, a range of alternative ratings will be shown. CreditWatch is not intended to include all ratings under review, and rating changes may occur without the ratings having first appeared on CreditWatch. The "positive" designation means that a rating may be raised; "negative" means that a rating may be lowered; "developing" means that a rating may be raised, lowered or affirmed.

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Standard & Poor's Insurer Financial Strength Ratings *CONTINUED*

'pi' Ratings, denoted with a 'pi' subscript, are Insurer Financial Strength Ratings based on an analysis of published financial information and additional information in the public domain. They do not reflect in-depth meetings with an insurer's management and are therefore based on less comprehensive information than ratings without a 'pi' subscript. 'pi' ratings are reviewed annually based on a new year's financial statements, but may be reviewed on an interim basis if a major event that may affect an insurer's financial security occurs. 'pi' ratings are not modified with '+' or '-' designations, nor are they subject to potential CreditWatch listings.

National Scale Ratings, denoted with a prefix such as 'mx' (Mexico) or 'ra' (Argentina), assess an insurer's financial security relative to other insurers in its home market. For more information, refer to the separate definitions for national scale ratings.

Quantitative Ratings, denoted with a 'q' subscript, were discontinued in 1997. The ratings were based solely on quantitative analysis of publicly available financial data.

The ● next to a company's rating in the list means that this company is a Standard & Poor's Security Circle insurer. Security Circle insurers voluntarily underwent Standard & Poor's most comprehensive review and have achieved one of our four top rating categories. In addition, the company has agreed to cooperate with Standard & Poor's ongoing monitoring of its financial condition.

Secure Ratings:

BOSTON
BUENOS AIRES
CHICAGO
DALLAS
DUBAI
FRANKFURT
HONG KONG
JOHANNESBURG
LONDON
MADRID
MELBOURNE
MEXICO CITY
MILAN
MOSCOW
NEW YORK
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