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## Lloyd's

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# Lloyd's

## Major Rating Factors

### Strengths:

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

### Weaknesses:

- Relatively high reinsurance reliance
- Inherent operating performance volatility

<b>Holding Company:</b> Society of Lloyd's (The)
<b>Counterparty Credit Rating</b> <i>Local Currency</i> A+/Stable/--
<b>Operating Company Covered By This Report</b>
<b>Financial Strength Rating</b> <i>Local Currency</i> A+/Stable/--

## 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 relatively high reinsurance reliance 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, and policyholder loyalty. The attractiveness of Lloyd's as an operating platform is evinced by the significant increase in the number of new entrants to the Market over the past 12 months, either directly or through the acquisition of an existing operation.

Lloyd's prospective operating performance is expected to decline from the cyclical peak seen in 2006/2007, but to remain strong overall. Continued below-average catastrophe loss experience, reinforced by a significant uplift in the positive effect of releases from loss reserves held in respect of prior underwriting years, enabled the Market to post a combined ratio, return on revenue (RoR), and record profit before tax of 84.0%, 25.5%, and £3.8 billion for 2007, respectively. This was broadly in line with the very strong performance recorded for 2006, but in stark contrast to the £103 million loss recorded for 2005 (including net hurricane claims of £3.3 billion). Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded prior to 2002. Nevertheless, earnings volatility will remain a feature given the nature of the specialty business lines that continue to represent Lloyd's core business.

Capitalization is strong, supported by strong and improved capital adequacy and the expected continued efficacy of capital-setting processes. In the short to medium term, Standard & Poor's Ratings Services expects the Market will continue to report aggregate positive reserve movements. Relatively high reliance on reinsurance remains a detraction.

Lloyd's financial flexibility is strong, being principally derived from capital providers' continued support. Improvements over the past two years have resulted from the effective removal of risk related to Equitas following

the deal with National Indemnity Co. (NICO; AAA/Stable/--), the declining trend of annual undertakings given to insolvent Names, and the positive momentum that currently surrounds the Market, which makes Lloyd's an attractive platform for an increasingly diverse range of capital providers.

## Outlook

The stable outlook reflects Standard & Poor's expectations that:

- Subject to normal catastrophe loss experience for 2008, Lloyd's will post a combined ratio below 95% and ROR greater than 12%. Performance will weaken in 2009 in line with an anticipated continuing softening operating environment.
- Lloyd's main capital providers will remain committed to the Market.
- There will be further improvement in the London market's administrative processes.
- Catastrophe-related operational weaknesses will prove to have been successfully strengthened.
- Capital adequacy will remain strong, as reflected in central assets available for solvency purposes remaining at about £1.75 billion and Lloyd's solvency ratio remaining above 300%.
- Operating performance of the continuing Market will not be materially negatively affected by further net deterioration in technical reserves.

An outlook revision to positive is unlikely over the rating horizon and would depend on Lloyd's significantly outperforming targets over a sustained period. An outlook revision to negative is increasingly unlikely, but would probably be driven either by operating performance returning to levels seen prior to 2002, reflecting poor management of the softening underwriting cycle, or by the incurrence of a loss outside the Market's risk tolerance.

## Corporate Profile: Significant Participant In Worldwide Markets

The London-based Lloyd's insurance market is a significant participant in insurance and reinsurance markets worldwide. Lloyd's wrote gross premiums in 2007 of £16.4 billion across a diverse range of classes, predominantly via broker distribution (see Table 1).

**Table 1**

	--2007--		--2006--		--2005--	
	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)
Reinsurance	5,453	33.3	5,557	33.9	5,261	35.1
Casualty	3,364	20.6	3,572	21.8	3,402	22.7
Property	3,809	23.3	3,638	22.2	3,199	21.3
Marine	1,226	7.5	1,153	7.0	1,017	6.8
Motor	983	6.0	923	5.6	895	6.0
Energy	1,019	6.2	1,125	6.9	804	5.4
Aviation	464	2.8	393	2.4	375	2.5
Life	46	0.3	50	0.3	47	0.3
Total	16,364	100.0	16,411	100.0	15,000	100

For 2008, 71 syndicates (excluding the five special-purpose syndicates) are trading at Lloyd's, supported by 46 managing agencies and sourcing business from 176 brokers.

Lloyd's has very wide geographic coverage, with specific trading rights to write insurance business in 74 countries and the ability to write reinsurance in many more. Nevertheless, a significant majority of income (68% in 2007) continues to be sourced from North America and the U.K.

## Competitive Position: Existing Competitive Strengths Enhanced By Equitas Deal And Improving Business Processes

Lloyd's competitive position is 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. The Market's already strong competitive position has been further enhanced in recent years by a combination of the successful completion of phase 1 of Equitas' deal with NICO and continued progress toward phase 2, as well as improving London market business processes. The attractiveness of Lloyd's as an operating platform is evinced by the significant increase in the number of new entrants to the Market over the past 12 months either directly or through the acquisition of an existing operation.

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 is unlikely to 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 an enviable 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. Although its managing agents operate as independent businesses, the size and diversity of underwriting capacity the Market can potentially provide in support of a market lead allows it to compete robustly with the largest global insurance groups.

The London market and Lloyd's have maintained their critical mass of relevant underwriting, broking expertise, and support services, remaining the "natural" home of diverse specialist underwriting niches, such as marine, energy, aviation, and certain nonmarine classes. Significant policyholder loyalty results in attractive business continuing its historical flow to London, enticing capital to support and sustain the Market. This is despite intense competition from other international insurance markets, particularly Bermuda. Further, in recent years there has also been an increased propensity for risks that might otherwise have found their way to London "sticking" within regional markets. Lloyd's has been proactive in its response to this emerging threat by further extending and, where necessary reinforcing, its global reach. Standard & Poor's expects this will remain a priority for the market over the medium term.

The features of business typically underwritten at Lloyd's include: complexity; large monetary exposure levels; and a high-severity, low-frequency profile of risk. The resultant underwriting portfolio, although diverse, is positioned 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 also predominantly sources its business through brokers--the most credit-sensitive distribution channel--and remains highly dependent on the top three large international broking groups. 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. With phase 1--the more significant of the deal's two phases--NICO provided \$5.7 billion of reinsurance cover above Equitas' held undiscounted claims reserves (\$8.7 billion at March 31, 2006).

Progress is continuing toward phase 2 of the deal, albeit at a slower pace than initially anticipated due to delays in the related legislative process. Nevertheless, phase 2 is expected to be concluded during 2009. This second phase of the deal envisages a transfer of liabilities from Names to Equitas, subject to High Court approval. Upon the successful transfer of liabilities, additional reinsurance cover of up to \$1.3 billion may be purchased. 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, thereby damaging the Market's competitive position.

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. This has maintained its momentum, and is bringing tangible benefits to clients and market participants alike. Contract certainty now represents "business as usual", and significant progress has been made toward the use of both electronic claims files (ECF; 90% of in scope claims now processed via ECF) and the accounting & settlement (A&S) repository. Having established its credentials, Standard & Poor's expects the Market Operations team will continue to pursue its agenda with an emphasis on removing the residual frictional costs associated with trading at Lloyd's. Future initiatives are expected to be framed in consultation with key stakeholders and subjected to a robust cost/benefit analysis.

## Management And Corporate Strategy: Improved Management Quality; Logical And Credible Strategy

### Management

The quality of the Market's management (at the Lloyd's corporation and managing agent levels) has improved to a point where it is more supportive of a stronger, less volatile prospective earnings profile. This can be attributed both to the corporation infrastructure, which has proved to be a positive influence on Lloyd's, and the improved quality of management within individual managing agents.

The corporation is laying down a credible track record in relation to its prime goal of protecting the Lloyd's franchise. This has been achieved through its experienced staff and the development of increasingly robust performance, risk-monitoring processes, tools, and benchmarks against which managing agents are assessed. The more challenging operating environment that lies ahead is expected to provide a stern test of the corporation's credentials, but Standard & Poor's believes the Franchise Performance Directorate (FPD) is well placed to respond effectively.

The corporation's remit is somewhat limited, however. 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 anti-competitive. 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.

As expected within a marketplace, the quality and sophistication of management varies. The performance of some Lloyd's managing agents in the 2005 hurricane season highlighted some catastrophe risk control deficiencies that appeared to be common to the reinsurance and insurance industries. Management action in the intervening period has sought to address highlighted weaknesses, but the consistency and effectiveness of these corrective measures has yet to be fully stress tested given the relatively benign catastrophe loss experience of the past two years.

Nevertheless, there has been an improvement in the general quality of managing agents' management. The teams in place at most managing agents can be credited with successfully steering their businesses through the last soft market. As a result, generally they either already have the skills to manage underwriting cycles or will have gained valuable experience that will stand them in good stead as the cycle continues to turn down.

### Strategy

In recent years, Lloyd's risk profile has heightened. The Market has increasingly found itself focusing on more volatile specialty lines business as a result of the exit of less volatile personal lines and retail operations.

Standard & Poor's believes that Lloyd's strategy, although ambitious, is logical and credible. It is focused on realizing the "Optimal Platform" concept within the medium term, which, if achieved, would result in Lloyd's being more attractive to clients, brokers, and capital providers alike. The successful achievement of the Optimal Platform is increasingly important if the Market's long-term competitive position is to be protected in light of the attractions offered by other international insurance and reinsurance markets.

The Optimal Platform seeks to deliver five clear benefits--namely, a clear and transparent performance management framework, capital advantages, a secure and highly rated market, cost-effective and easy access to the world's major markets, and efficient business processes. A strong focus on the last two of these objectives is expected over the rating horizon, in addition to a continued emphasis on cycle management.

Standard & Poor's believes that the achievement of the Optimal Platform will be challenging. Matters are helped by the franchise business model, which can be used to facilitate required change and the experience of Lloyd's CEO, Richard Ward, with regard to improving the efficiency and profitability of exchanges. The Optimal Platform's delivery will ultimately be determined, however, by the support and drive it gains from, in particular, its largest, most influential managing agents.

## Enterprise Risk Management: Further Enhancements Remain A Key Priority For Lloyd's

Standard & Poor's considers the quality of the Market's enterprise risk management (ERM) to be adequate, which is supportive of the rating. 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, the variability of the ERM capabilities evident among managing agents continues to constrain the overall assessment on the market as a whole.

Risk management culture is adequate and improving, reflecting the greater focus on 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. Catastrophe risk appetite at the center is expressed in terms of exposure to deterministic realistic disaster scenarios (RDS). These RDS were developed by Lloyd's, but are used by many (re)insurers worldwide. Risk controls are adequate, but the market structure dictates that their implementation is decentralized.

Underwriting risk controls are adequate, but the capabilities of individual managing agents are varied. Nevertheless, reflecting the corporation's belief that Market performance in underwriting activities remains too variable, the underwriting management principles and minimum standards have been successfully implemented and are expected to be further refined and enhanced over the medium term. A project is currently under way to improve the granularity of the underwriting data the FPD is able to access for monitoring purposes. If successfully implemented, Standard & Poor's believes this project will further enhance FPD's ability to oversee the market's underwriting performance, which will be a key focus over the rating horizon.

Catastrophe risk-related risk controls are adequate. The corporation seeks to ensure there are appropriate levels of cat risk aggregation control both within each managing agent and at the Market level, primarily using the RDS framework. Despite the central oversight, the performance of some Lloyd's managing agents in the 2005 hurricane season highlighted some catastrophe risk control deficiencies, in common with many in the reinsurance and insurance industries. Management action in the intervening period has sought to address highlighted weaknesses, but the consistency and effectiveness of action is yet to be tested.

Reserve risk-related controls are adequate. Reserve integrity at the managing agent level has benefited from the requirement for all syndicates to obtain actuarial certification of their reserves and corporation oversight. The inherent reserving risk faced by the Market has diminished considerably in recent years both as a consequence of the completion of Phase 1 of the NICO transaction, and a persistent reduction in both the number of run-off years of account and the magnitude of the undertakings given to insolvent members. Nevertheless, Standard & Poor's expects the more challenging operating environment to preface an uplift in reserving risk over the medium term.

The corporation performs continuous, centrally coordinated, and holistic reviews of its managing agents across all areas of risk using the Individual Capital Assessment (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. Financial Services Authority.

The market structure, and competition law, dictate that the corporation cannot directly intervene to ensure the actions taken by individual managing agents enable the Market to optimize its risk-adjusted return on capital (RAROC). This continues to be a somewhat constraining factor for our assessment of the Market's strategic risk management capabilities, which are considered adequate overall. However, some of the Market's participants exhibit strong strategic risk management in their own right and we expect this group to expand in the future.

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/or scientists in assessing the risk implications of emerging issues. A comprehensive database of emerging risks is maintained. This stores information in respect of approximately 240 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 directorate.

## 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 fund and U.K. 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.

The key adjustments made within Standard & Poor's risk-based capital model from published financial statements are:

- Recognition of loss-reserve discount; and
- Full hybrid equity credit given to the subordinated loan notes and perpetual subordinated capital securities issued by The Society of Lloyd's (A+/Stable/--) in 2004 and 2007, respectively.

## Operating Performance: Strong, Although Volatility To Remain A Feature

**Table 2**

Lloyd's/Operating Performance						
(Mil. £)	2007	2006	2005	2004*	2003	2002
Total gross premiums written	16,366	16,414	14,982	14,614	16,422	16,203
Annual change (%)	(0.3)	9.6	2.5	(11.0)	1.4	0.6
Total net premiums written	13,256	13,201	11,770	11,734	12,250	11,160
Annual change (%)	0.4	12.2	0.3	(4.2)	9.8	0.8
Total revenue¶	14,479	14,158	12,490	12,329	12,156	11,313
Annual change (%)	2.3	13.4	1.3	1.4	7.5	7.5
Profit before tax	3,846	3,662	(103)	1,367	1,892	834
Annual change (%)	5.0	(3,655)	(107.5)	(27.7)	126.9	(126.8)
Cumulative profit before tax post 2000	7,177	3,331	(331)	(228)	(1,595)	(3,487)
ROR* (%)	25.5	25.5	(6.4)	8.1	12.9	10.5
Net loss ratio (%)	50.0	50.8	79.7	64.8	57.2	62.3
Net expense ratio (%)	34.0	32.3	32.1	31.2	33.2	32.6
Net combined ratio (%)	84.0	83.1	111.8	96	90.4	94.9
Accident-year combined ratio (%)	90.5	85.2	111.9	93.5	85.7	89

\*Restated. ¶Based on allocated investment income. N.A.--Not available.

Assisted by highly favorable underwriting conditions, Lloyd's recent operating performance has improved materially to strong from the marginal levels seen prior to 2002. Continued below-average catastrophe loss experience, reinforced by a significant uplift in the positive effect of releases from loss reserves held in respect of prior underwriting years, enabled the Market to post a combined ratio and record profit before tax of 84.0% and £3.8 billion for 2007, respectively, broadly in line with the very strong performance recorded for 2006, but in stark contrast to the 111.8% and £103 million loss recorded for 2005 (including net hurricane claims of £3.3 billion).

Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded prior to 2002. Nevertheless, earnings volatility will remain a feature given the nature of the specialty business lines that continue to represent Lloyd's core business.

The pricing cycle is well past its peak. Margins are declining across the board and pricing for most classes of business can be expected to test its technical level within 12 months. Prior year reserve releases are expected to persist, and in all likelihood increase, over the medium term, thereby subsidizing what we expect will be a significant and persistent decline in accident-year profitability. To some extent this trend has already been borne out by the Market's results for first-quarter 2008. The combined ratio for the 2008 accident year increased by five percentage points to 94.8%, while the positive effect from prior year reserve movements increased by 1.8 percentage points to 5.5%.

Subject to normal catastrophe loss experience for 2008, Standard & Poor's expects Lloyd's to post a combined ratio below 95% and ROR greater than 12%. Performance will weaken in 2009 in line with an anticipated continuing softening operating environment. Underwriting losses related to subprime, and the broader dislocation in global capital markets, are not expected to be material in the context of current-year earnings. The key determinant of earnings in the longer term will be the speed at which premium rates soften and terms and conditions broaden, combined with the efficacy of Lloyd's cycle management.

The Market's investment return for 2008 is expected to be adversely affected by the spread-widening seen during the year to date, and the reduced yield available on U.S. government securities. The investment yield is expected to be within the range of 3.5% – 4.5%, substantially below the level reported for financial year-end 2007 of 5.6%.

## Investments: Conservative Investment Stance

**Table 3**

Lloyd's/Investment Split						
(%)	2007	2006	2005	2004*	2003	2002
Bonds and other fixed-interest securities¶	56	55	58	54	78	78
Equities and other variable-interest securities	12	11	9	10	7	5
Cash and bank deposits	20	23	27	30	12	12
Loans and private placements	12	12	6	6	3	3
Other investments	0	0	0	0	0	1
Total investments	100	100	100	100	100	100

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

Lloyd's investments are very strong. Trust funds are primarily invested in either cash or high-quality, highly liquid fixed-income securities. The investment portfolio is of short duration, partly due to the annual venture, which requires syndicates to distribute all closed-year profits to members.

The Central Fund's investment policy has always been somewhat more aggressive than that of managing agents, with 15% of investments held in equities and hedge funds at Dec. 31, 2007 (23% at Dec. 31, 2006). Given the intended long-term nature of the Central Fund, this approach is understandable. Standard & Poor's expects that the Central Fund investment stance will remain prudent overall.

## Liquidity: Remains Strong

Lloyd's liquidity is strong, supported by a substantial cash position, high-quality bond portfolio, increasingly positive operational cash flow (£2.26 billion in 2007 compared with £0.93 billion in 2005), and substantial credit facilities in place to support short-term liquidity requirements.

Liquid asset coverage of technical reserves improved slightly for 2007 to 132% (128% in 2006), and is expected to remain comfortably in excess of 100%.

U.S. situs trust funding requirements place an additional burden on the Market's liquidity and financial flexibility.

## Capitalization: Strong And Improved Capital Adequacy Enhanced By Reported Reserve Surpluses

Capitalization is strong, supported by strong and improved capital adequacy and the expected continued efficacy of capital-setting processes. In the short to medium term, Standard & Poor's expects the continuing Market to report aggregate positive reserve movements. Continuing relatively high reliance on reinsurance, however, remains a detraction.

### Capital adequacy

Standard & Poor's risk-based capital model indicates improved and strong capital adequacy at Lloyd's. Capital shows relatively low reliance on reserve discount, deferred acquisition costs, and hybrid equity.

This view of improved capital adequacy is supported by other measures including the level of central assets for solvency purposes--£2.46 billion at year-end 2007 and well ahead of expectations of about £1.75 billion--and Lloyd's solvency ratio, which was well in excess of 1,000% at year-end 2007--considerably above both our 300% target and the 2006 level of 785%.

Standard & Poor's expects the corporation will be better able to define the optimal level of central fund assets going forward.

Management action is expected to support continuing strong Market capital adequacy, the corporation maintaining capital levels reasonably above the regulatory minimum (currently 35% higher at member level considering also the uplift provided by central assets), to meet Optimal Platform objectives.

### Loss reserves

**Table 4**

Lloyd's/Reserving Track Record*						
(%)	2007	2006	2005	2004†	2003	2002
Calendar-year net combined ratio	84.0	83.1	111.8	96.0	90.4	94.9
Accident-year combined ratio	90.5	85.2	111.9	93.5	85.7	89.0
Prior-year reserve movement combined ratio points	(6.5)	(2.1)	(0.1)	2.5	4.7	5.9
Run-off years' reserve movements (mil. £)	(48)	(3)	(325)	(350)	(329)	N.A.
Continuing Market reserve movements (mil. £)	904	273	339	48	(343)	N.A.

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

During 2007, releases on prior-year loss reserves accounted for £856 million, or more than 20%, of the Market's net profit after tax. In the short to medium term, Standard & Poor's expects such releases to persist for the continuing Market, particularly in respect of the 2002 and subsequent underwriting years. The reported position of run-off years of account continues to improve more quickly than anticipated. At financial year-end 2007, there were 54 run-off years open with gross reserves at £2.7 billion. This compares to equivalent values at the end of 2005 of 102 and £7.0 billion, respectively. These reserves required only a modest aggregate strengthening of £48 million during 2007. Syndicates backed by insolvent members supported by the Central Fund reported a small overall surplus in 2007. These years, however, continue to have the potential to be more problematic. They do not have the same degree of prospective support from positive reserve development to offset continuing although declining negative movements.

## Reinsurance

**Table 5**

Lloyd's/Reinsurance Usage						
(Mil. £)	2007	2006	2005	2004*	2003	2002
Total gross premiums written	16,366	16,414	14,982	14,614	16,422	16,203
Total reinsurance ceded	3,110	3,213	3,212	2,880	4,172	5,043
Total net premiums written	13,256	13,201	11,770	11,734	12,250	11,160
Reinsurance ceded as % of gross premiums written	19.0	19.6	21.4	19.7	25.4	31.1
Reinsurers' share of claims outstanding¶	7,449	9,259	14,450	9,678	9,959	12,108
Annual change (%)	(20)	(36)	49	(3)	(18)	(16)
Capital and reserves	13,449	12,836	10,491	11,663	10,145	7,509
Reinsurers' share of claims outstanding as % of capital and reserves¶	55.4	72.1	137.7	83.0	98.2	161.2

\*Restated. ¶Excludes intersyndicate reinsurance.

The proportion of reinsurance Lloyd's cedes as a percentage of gross premiums written has reduced in recent years, but remains high relative to that of peers. As a result, the Market's competitive position and future earnings remain relatively dependent on the continuing supply of adequate reinsurance capacity. Despite this, we believe corporation and managing agents' activity has ensured that the Market's reinsurance protection, although significantly reconfigured, is broadly adequate. Key has been alterations in underwriting during recent renewals to substantially reduce assumed aggregate liability. This has somewhat offset changes to reinsurance protections observed, which include higher retentions, curtailment of sideways cover, less broad protection, and the greater use of industry loss warranty products.

Following the 2005 hurricanes, Lloyd's saw a 49% increase to its reinsurance asset at Dec. 31, 2005. Although the overall quality of the asset was and remains strong, the sharp increase left the Market exposed particularly to reinsurer dispute. Standard & Poor's believes this will continue to be the case following major loss events in the future.

## Financial Flexibility: Improved In Light Of Equitas Deal Phase 1 And Declining Insolvent Name Undertakings

**Table 6**

<b>Lloyd's/Capital Requirements And Sources</b>	
<b>Capital requirements</b>	<b>Capital sources</b>
<b>Member/syndicate level</b>	
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
<b>Market level</b>	
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.

Lloyd's financial flexibility (the balance between capital requirements and sources) is strong and improved in light of the diminished uncertainty following Equitas' deal with NICO, the declining trend of annual undertakings given to insolvent Names, and the positive momentum that currently surrounds 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. Recent administrative changes have eased the constraints surrounding the distribution of profits from Lloyd's, although Funds at Lloyd's have remained at a similar level. As a result, capital providers' continued support, in terms of both willingness and ability, directly or indirectly underpins the majority of Lloyd's capital sources.

The parent companies of corporate members regularly review their Lloyd's exposure, and in some cases such reviews have resulted in complementary operations being established outside the Market. 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 franchise board 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 most Lloyd's managing agents are not yet in a position to operate meaningfully outside the Market, but largely due to the positive momentum currently surrounding Lloyd's, Standard & Poor's expects the majority of current capital providers to remain committed to Lloyd's in the short to medium term.

**Table 7**

<b>Lloyd's/Financial Flexibility</b>						
<b>(Mil. £)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Market capacity	15,954	16,101	14,788	13,722	14,961	14,396

**Table 7**

<b>Lloyd's/Financial Flexibility(cont.)</b>						
Change (%)	(1.0)	8.9	7.8	(8.3)	3.9	18.0
Annual undertakings to insolvent names granted/(released)	13.0	(14.8)	114.6	217.6	149.5	185.9
Change (%)	187.8	(112.9)	(47.3)	45.6	(19.6)	(46.3)

N.A.--Not available.

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 have declined following Equitas' conclusion of phase 1 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. For 2008, these will be at £13 million.

### Ratings Detail (As Of July 30, 2008)\*

#### Holding Company: Society of Lloyd's (The)

Issuer Credit Rating

*Local Currency*

A+/Stable/--

Junior Subordinated (3 Issues)

A-

#### Operating Company Covered By This Report

##### Lloyd's

Financial Strength Rating

*Local Currency*

A+/Stable/--

#### Domicile

United Kingdom

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligations or obligations within that specific country.

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