

MARKET RESULTS

WWW.LLOYDS.COM/2006RESULTS

- 34 Market commentary
- 44 Report of Ernst & Young LLP to the Council of Lloyd's on the 2006
Lloyd's pro forma financial statements
- 45 Pro forma financial statements
- 55 Security underlying policies issued at Lloyd's

MARKET COMMENTARY

WWW.LLOYDS.COM/2006RESULTS

2006 HIGHLIGHTS

- Lloyd's gross premium income in 2006 increased 9.6% to £16,414m (2005: £14,982m).
- Lloyd's achieved a profit before tax of £3,662m (2005: loss of £103m) and a combined ratio of 83.1% (2005: 111.8%) reflecting the strong underlying performance and low loss incidence during the year.
- Hardening underwriting conditions in US catastrophe exposed business and stable or softening conditions elsewhere.
- In aggregate, claims development in respect of prior year reserves has been better than projected and has led to an overall surplus of £270m (2005: £14m).

2006 COMBINED RATIO

85.2%

ACCIDENT YEAR

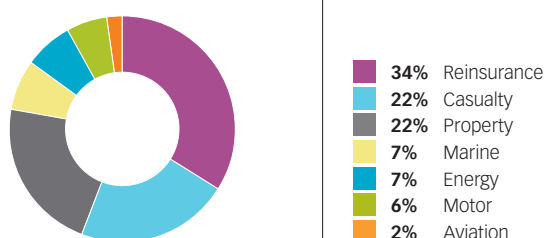
(2.1)%

PRIOR YEAR RESERVE MOVEMENT

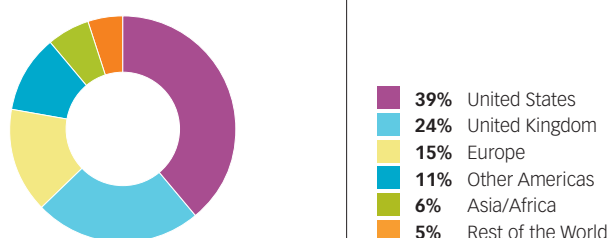
83.1%*

CALENDAR YEAR

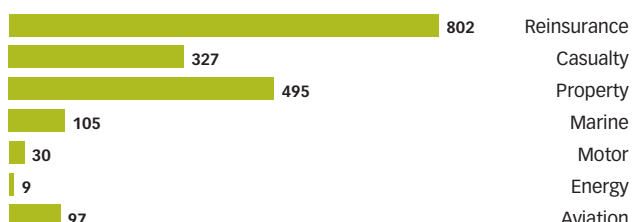
LLOYD'S BUSINESS BY CLASS



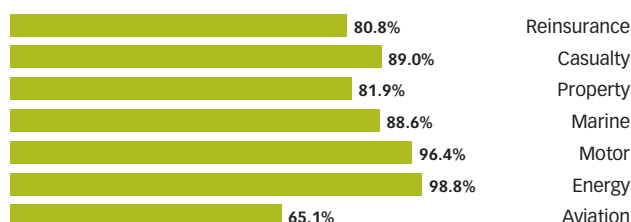
LLOYD'S BUSINESS BY REGION



LLOYD'S RESULT BY CLASS (£M)



LLOYD'S COMBINED RATIO BY CLASS*



*The combined ratio for the market and by class of business is the ratio of net incurred claims and net operating expenses to net earned premiums. The prior year reserve movement represents the ratio of the surplus/deficit arising on reserves at December 2005 to overall net earned premiums in calendar year 2006.

The overall combined ratio includes central adjustments in the technical account in respect of transactions between syndicates and the Society as described in notes 2 and 8 to the PFFS (pages 48 and 52). The combined ratios for individual classes of business do not include these adjustments as the market commentary for each class reflects trading conditions at syndicate level as reported in syndicate annual accounts.

Lloyd's reported excellent results for 2006 based on strong underlying performance across all major classes of business and the exceptional absence of major catastrophes. In addition, 2006 saw overall prior year claims development within projections and improved investment returns.

Following the record hurricane claims of 2004 and 2005, the US windstorm season defied predictions of above average activity. While 2006 was an exceptional loss-free year, the consensus view, including the opinions of RMS and scientists at Colorado State University, is that we remain in a cycle of above average North Atlantic hurricane activity.

The debate about climate change continues but it is a fact that the insurance industry will be affected by the increasing severity and frequency of extreme weather – a predicted side-effect of global warming. Lloyd's retains its risk appetite for providing coverage against extreme catastrophes with the focus remaining firmly on achieving the levels of return appropriate for the risks underwritten.

The US windstorm season was not the only area of major risk that passed quietly in 2006; non-catastrophe loss activity has been relatively benign despite significant individual claims in marine hull, cargo, cash-in-transit and airline markets.

Lloyd's achieved a profit for the financial year before taxation of £3,662m (2005: loss of £103m) in the pro forma financial statements (PFFS) and a combined ratio of 83.1% (2005: 111.8%). The PFFS aggregates the results of the syndicate annual accounts, notional investment return on funds at Lloyd's (FAL) and the Society of Lloyd's financial statements. The basis of preparation of the PFFS is set out in note 2 on page 48. The syndicate annual accounts reported an aggregate profit of £2,825m (2005: loss of £862m). These results are reported in a separate document (the Aggregate Accounts) and can be viewed on www.lloyds.com/financialreports. During 2006, certain syndicates changed their accounting policies in relation to foreign exchange resulting in a restatement of the comparative figures for 2005 within their annual accounts and the Aggregate Accounts have been restated accordingly. The restatements are not material and, therefore, the comparative figures within the PFFS have not been restated.

'Tale of two markets'

2006 saw an increase in gross premiums written of 9.6% to £16,414m (2005: £14,982m) driven by hardening of terms for catastrophe business, especially windstorm exposed risks in the US. However, we are currently seeing a 'tale of two markets'. Although rates have increased in wind-exposed catastrophe business in the US, non-catastrophe exposed business continues to soften. This has led to a clear disparity between the pricing of US windstorm exposed property risks and other classes, with many key casualty accounts reporting a third or fourth year of rate reductions. This makes good cycle management and underwriting discipline more important than ever.

The main classes of business where there is evidence of a pricing increase are those that were hit by the hurricane losses of 2004 and 2005. As a result, property direct, facultative and treaty, along with energy, have seen the biggest pricing changes and growth in gross premiums written. This demonstrates the flexibility of the Lloyd's

market and its ability to rapidly position capacity in order to take advantage of attractive terms supported by the diversity of its underwriting and an efficient capital base.

The cost and availability of reinsurance

In 2006, reinsurance capacity was in short supply for peak US catastrophe exposures, with increased prices and reductions in coverage. Notwithstanding alternative forms of capacity such as Industry Loss Warranty covers and catastrophe bonds, there was a marked emphasis on reducing direct and assumed reinsurance aggregate exposure and reviewing the point at which policies attached. The relative lack of reinsurance capacity had a significant impact on the way in which business was underwritten as well as the risk appetite of the market.

Prior year surplus

In aggregate, claims development in respect of claims reserves for prior years has been better than projected leading to an overall surplus on prior years of £270m (2005: £14m).

Claims development on longer-tail business written in the soft market conditions of 1997-2001 has stabilised. Following four years of material reserve strengthening for these lines, particularly US casualty business, 2006 showed a stable result.

Surpluses have emerged on claims reserves set up for business written during 2002-2004, where claims development has been benign and within expectations. These surpluses have more than offset the increases in claim estimates for the 2005 US hurricanes. Demand surge has led to claims inflation and together with increased business interruption claims on the energy account, resulted in a charge of £415m during the year. This increase in ultimate net claims estimates to £3,724m (2005: £3,309m) reflects the size and complexity of the US hurricane claims.

The majority of our homeowner and commercial property claims in the affected states have been paid. Inevitably, however, with a loss of this size and complexity there are a number of individual claims that are difficult to assess. Lloyd's is working hard to ensure that all valid claims are settled as swiftly as possible. We are aware that there have been a limited number of adverse judgements (although none against Lloyd's directly) that are currently being appealed. This adds to the uncertainty of the estimate of the final loss.

In aggregate, run-off years reported a near break-even result for 2006, being a deficit of £3m (2005: deficit of £325m) and syndicates backed by insolvent members supported by the Central Fund reported a small overall surplus.

The results of the major classes of business are discussed in detail on pages 37 to 43.

Investment review 2006

Syndicate assets are invested primarily in fixed interest securities of high credit quality. Increasingly, some syndicates are utilising additional asset classes, including equities, in order to maximise returns. However, such exposures form a very small proportion of syndicate assets overall. The currency of investments broadly reflects the currencies in which insurance business is written and this causes US dollar and sterling investments to dominate. In recent

years, rising yield levels have led to poor investment returns, particularly in the US. 2006 saw a modest improvement in returns as investment conditions in the US stabilised, although rising yields in sterling reduced overall returns. In total, syndicate investments returned £957m, or 4.2%, during the year (2005: £705m, 3.2%).

Market conditions, affecting the level and direction of bond yields, can cause significant variations between investment returns in different periods. However, the risk associated with syndicate investment strategies is limited by application of appropriate constraints, such that the probability of significant investment losses arising is relatively low. This is appropriate in view of the primary purpose of these assets, which is to be available to meet valid claims.

Members' capital is held centrally as FAL. A notional investment return of £651m (2005: £602m) has been included in the PFFS.

The investment performance in respect of central assets is described in the Society review on page 73.

Impact of US dollar exchange rate fluctuations

The US is the single largest market for Lloyd's and fluctuations in exchange rates impact the results. The US dollar has weakened during the year to a rate of exchange of 1.96 at the year end (2005: 1.72). The level of profitability in 2006 has led to many businesses holding a surplus of US dollar assets over liabilities. While Lloyd's distributes its profits by currency, this can lead to a loss on exchange when retranslating these balances into sterling prior to distribution. In addition, adverse timing differences can arise for those Lloyd's businesses adopting accounting policies that recognise non-monetary liabilities at transaction rates while the associated assets are reported at weaker year end exchange rates.

Looking ahead

Capacity for 2007

Market capacity has increased overall for 2007 and is currently £16.1bn (2006: £14.8bn). This increase in capacity reflects the continuing business opportunities available to Lloyd's in the aftermath of the 2005 US hurricanes.

It is important to note that capacity is only an indication of the business the market plans to write, provided market conditions remain attractive and show the appropriate potential profit margins.

Worldwide regulatory risk

Lloyd's operates worldwide in multiple regulatory and political jurisdictions. A number of industry commentators have highlighted the risk faced by insurers in the US, where state-led oversight can affect regional market conditions. While the recent legislative changes in Florida are not considered to have a significant direct impact on premium income for Lloyd's, there is a risk that other insurers, who perceive that this will impact their premium targets, will seek to move into other lines of business written by Lloyd's.

Windstorm Kyrill

Windstorm Kyrill was a powerful windstorm which swept across northern Europe on 18 January 2007. Industry loss estimates range from €2bn to €8bn (£1.4bn to £5.4bn).

Based on our current information, we consider that the loss to the Lloyd's market will be less than £200m and there will be a limited impact on future pricing terms and conditions.

2007 hurricane predictions

Initial predictions indicate that the 2007 hurricane season will be more active than average, with a relatively high probability of a major hurricane making landfall in the US and an above average chance in the Caribbean.

Managing the cycle

Strong market conditions and the exceptionally low level of catastrophes have led to the industry reporting excellent results for 2006. Notwithstanding that, the issue of volatile performance and managing the cycle remains of paramount importance. Indeed, market behaviour in non-US catastrophe lines, where rates are softening, only emphasises the need for discipline at this stage of the cycle.

In addition, after only 12 months of loss-free experience for US catastrophe, insurers are returning to this market providing additional direct and reinsurance capacity. While current market conditions support the market's business plan volumes and mix for 2007, managing insurance cycles continues to be a major challenge. Global liquidity remains very high, and the insurance market will continue to remain extremely competitive for the foreseeable future, in view of increasingly flexible capital markets.

There are several steps that the market can take to minimise the impact of competitive pressure. These include the reinforcing of a culture that puts a greater focus on the prudent setting of terms and conditions, including pricing, for the benefit of Lloyd's and policyholders, rather than underwriting for market share.

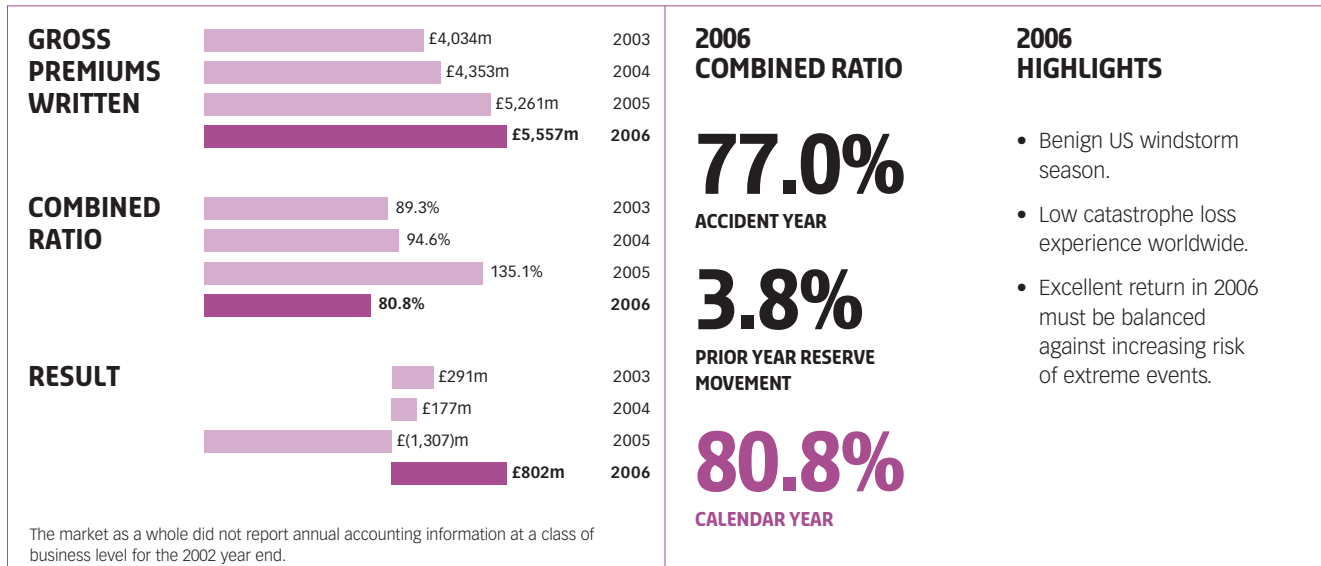
Improved processes will play a key role in helping to manage the cycle. Risk-based pricing, in turn, depends on using state-of-the-art risk modelling tools and loss data, and on robust internal communication systems that enable underwriters to gain access to this information. Proper pricing and reallocation of capital to achieve optimum returns also depends on incentive schemes that encourage underwriters to adopt this practice.

The Franchise Performance Directorate is supporting the market through providing feedback at a market and class of business level to give agents access to better information and analysis to help the market to assess risk.

Through a combination of underwriting for profit rather than market share and these tools, we believe that the market can go a long way to shield itself from some of the more damaging aspects of the cycle.

REINSURANCE: EXPERIENCED EXCELLENT RETURNS IN 2006

WWW.LLOYDS.COM/2006RESULTS



The reinsurance sector covers a wide range of classes and types, both short and long tail and uses a variety of placement types including facultative, or individual risk placements; proportional treaties; and non-proportional treaties such as excess of loss placements.

The main classes of business within this sector are property non-proportional risk, catastrophe excess of loss reinsurance and property facultative reinsurance. In addition, there is a limited amount of retrocessional business. A large proportion of this business provides protection for US insurance and reinsurance companies.

2006 performance

Following the 2004 and 2005 US hurricanes, the market, in conjunction with its catastrophe modelling advisers, has revisited loss severity and frequency assumptions. Lloyd's revised Realistic Disaster Scenarios in 2006 to include a \$100bn industry loss and a \$65bn industry loss from a hurricane making landfall in New England. The Realistic Disaster Scenarios also examined the impact of two events occurring in the same year.

Insurers and reinsurers are increasingly concerned with the concentration of property values in both Florida and further up the east coast of the US and have increased rates and tightened conditions accordingly.

Lloyd's reported gross written premiums for 2006 of £5,557m (2005: £5,261m), an increase of 5.6%, reflecting the strong trading conditions in US wind-exposed business. The market for non wind-exposed business continued to soften and increased pressure on profit margins.

An accident year combined ratio of 77.0% was achieved in 2006 (2005: 133.6%) reflecting the strong underlying performance and low loss incidence in this sector.

Despite meteorological experts forecasting an above normal Atlantic hurricane season, the US windstorm season was benign. Scientists have identified various possible reasons for the lack of hurricane activity during 2006. These explanations vary considerably, but the consensus is that climate conditions indicate that we are in a cycle of above average North Atlantic hurricanes and that 2006 was an exceptional year.

The catastrophe loss activity for other perils was also extremely low leading to excellent returns.

Prior year development

The prior year development has been affected by increases in the loss estimates for the 2005 US hurricanes.

Overall, prior year reserve strengthening added 3.8% (2005: 1.5%) to the combined ratio.

Risks and uncertainties

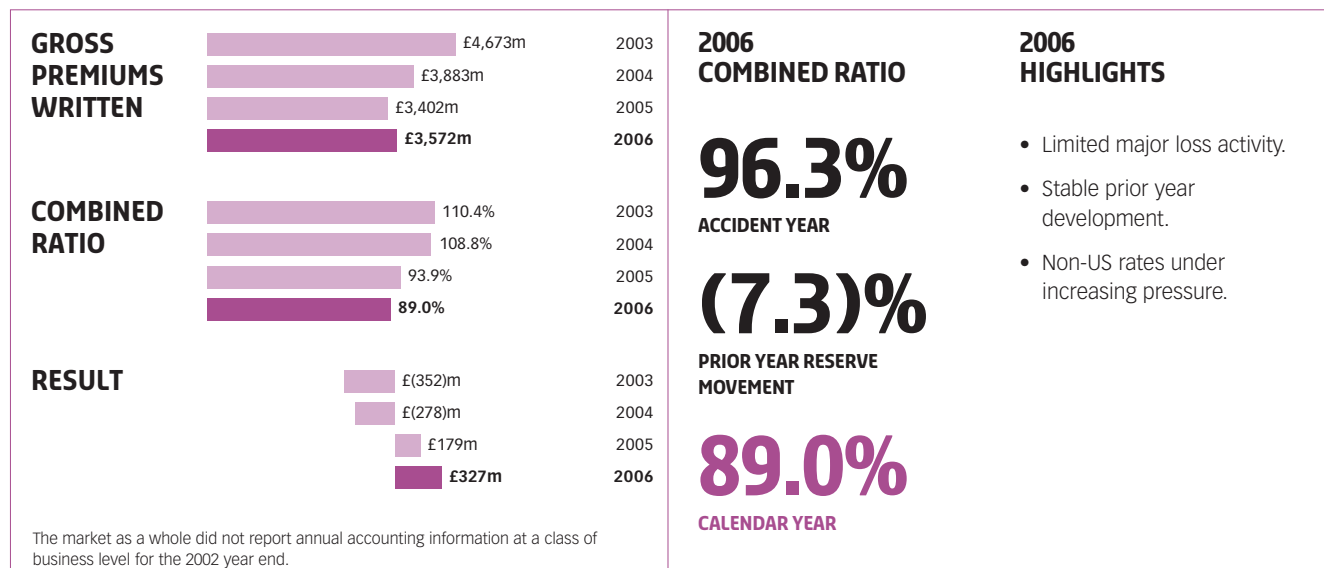
The renewal season is showing that outside of the US, pricing within the reinsurance sector remains flat to softening, although it is anticipated that windstorm Kyrill may serve to stabilise the European market.

The recent Florida legislation will reduce the industry's reinsurance premium income, which may lead to reinsurers seeking to utilise capacity elsewhere and increased competition.

While the 2006 result reflected a strong performance in the reinsurance sector, managing aggregates and underwriting discipline continue to be the critical issues, especially as the low incidence of hurricane activity may not be repeated.

CASUALTY: OVERALL PERFORMANCE CONTINUES TO IMPROVE

WWW.LLOYDS.COM/2006RESULTS



Lloyd's casualty sector covers professional indemnity, medical malpractice, accident and health, directors' and officers' liability, financial institutions, general and employers' liability. A large proportion of casualty business provides coverage within the US market.

Casualty risks are particularly specialist and complex. The tort system and legal processes in the US continue to be a significant factor in dealing with long-term liability claims and this is being replicated in other countries as plaintiffs seek to reproduce the success achieved in the US. There are signs that tort reform in some countries, such as Australia, is partially addressing this risk and has resulted in reduced claims frequency.

2006 performance

2006 saw gross premiums written of £3,572m (2005: £3,402m). This is in line with the 2005 premium income levels but a reduction of over 20% from the peaks experienced in 2003.

During 2006, evidence of a two-tier market continued to emerge. US casualty rates have been largely stable although the market began to soften following the previous sharp increases in premium rates. Outside of the US, the market continued to soften with certain lines of business showing a decrease in rates and an erosion of margins.

The casualty sector achieved an accident year combined ratio of 96.3% (2005: 89.8%). This reflects the improved performance, compared to the soft market experienced in 1997-2001, arising from the more specialised mix of business being written. This result, together with the stabilisation of claims development in prior years, resulted in an overall profit of £327m (2005: £179m).

In recent years the US casualty market, in particular, experienced severe underwriting losses arising from litigation brought by investors due to falls in the stock market. 2005 saw a significant reduction in the number of class actions, a trend which has continued into 2006.

Prior year development

The long tail characteristic of casualty business means that prior year development has a significant bearing on the overall combined ratio.

Following significant deterioration in recent years, which drove the Lloyd's casualty sector into an aggregate loss position, 2005 saw a stabilisation in the claims development on prior years' reserves and this trend has continued in 2006.

There are encouraging signs that many Lloyd's businesses have now addressed the legacy issues arising on business written in soft market conditions in 1997-2001. In addition, surpluses have emerged in respect of claims reserves established on business written in 2002-2005. The impact on the combined ratio was an improvement of 7.3% (2005: deterioration of 4.1%).

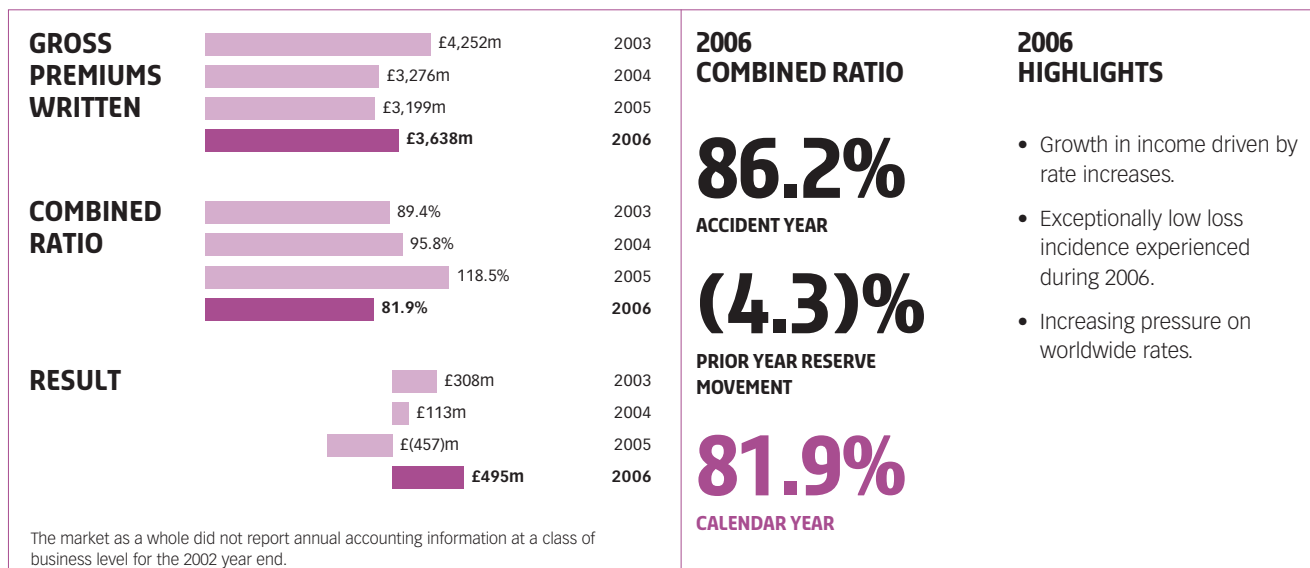
Risks and uncertainties

The 2007 renewals have shown a continuation of the trend experienced during 2006, with the US market generally stable with some classes showing signs of softening driven by the increased presence of new Bermudian markets in this class and general diversification pressures. The non-US market is experiencing sharp decreases in rates from the recent peaks.

A key risk is the macro economic environment and any major change could seriously affect the casualty sector. Although current underwriting conditions continue to show potential profit margins, the market will need to focus on managing terms and conditions as pressure on rates increases.

PROPERTY: STRONG TERMS AND CONDITIONS AND A BENIGN LOSS RECORD

WWW.LLOYDS.COM/2006RESULTS



The direct and reinsurance property business continues to be the largest sector at Lloyd's, with the US remaining the biggest market.

2006 performance

Over recent years the property sector has seen decreases in gross premiums written from the levels experienced in 2002 and 2003. This trend was reversed in 2006, which saw an increase of 13.7% to £3,638m (2005: £3,199m) driven by the hardening of terms for windstorm exposed risks in the US. This has been offset by the clear disparity between the pricing of US windstorm exposed property risks and other lines of business elsewhere, which continue to experience significant rate decreases.

This increase in premium income and the limited loss occurrence during the year contributed to an accident year combined ratio of 86.2% in 2006 (2005: 119.5%) and resulted in the sector declaring an excellent profit of £495m (2005: loss of £457m).

Prior year development

Overall, the claims development on prior years has been within expectations leading to a surplus that reduced the combined ratio by 4.3% (2005: 1.0%). While there have been instances of increases to the claims reserves for the 2005 US storms, these have been more than offset by releases from other areas of the account, particularly from reserves established in 2002 and 2003.

Risks and uncertainties

The renewal season in the early part of 2007 has shown a levelling off in rates for US windstorm exposed risks with an increase in competition as capacity in the market increases.

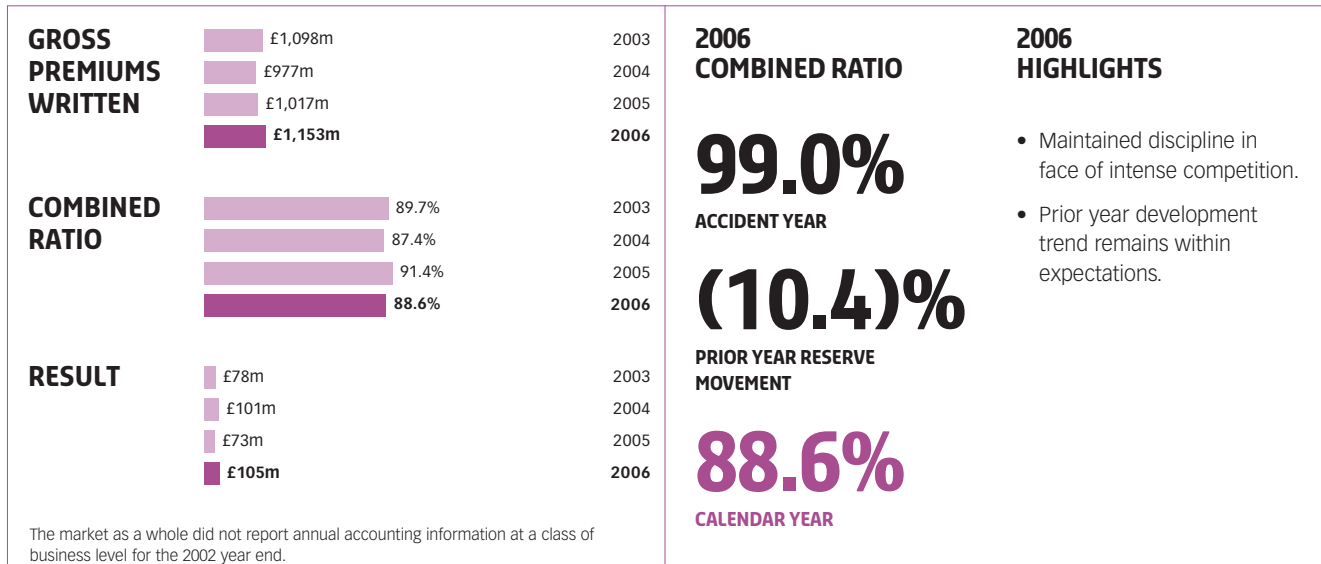
The need for the industry to continue to improve the understanding, capture and aggregation of exposures to natural catastrophes remains crucial. Underwriters will need to work closely with their modelling advisers and carefully assess the model outputs and 'sense check' the results.

For other property lines of business, the market continues to be extremely competitive with capacity increasing as insurers seek to diversify away from catastrophe business. Maintaining underwriting discipline in the face of this pressure on rates and erosion of margins is critical.

MARKET COMMENTARY continued

MARINE: OVERALL STRONG PERFORMANCE IN THE FACE OF INCREASED COMPETITION

WWW.LLOYDS.COM/2006RESULTS



The most significant classes of business within the Lloyd's marine sector are hull, cargo, marine liability and specie.

2006 performance

The marine sector achieved gross premiums written of £1,153m (2005: £1,017m) and an accident year combined ratio of 99.0% (2005: 98.8%).

Rates in the two largest marine classes, hull and cargo, remained relatively flat during the year. Following the losses caused by hurricane Katrina, anticipated rate increases in the hull and cargo classes of business were not as significant as expected.

The marine liability account continues its track record in producing good results and achieved moderate rate increases during 2006. The International Group of P&I Clubs programme constitutes a major part of this class of business.

Specie, the insurance of highly valued items such as fine art, remains a very competitive market, although rates remained stable. The result of this class was affected by significant cash-in-transit losses.

Prior year development

An overall release from prior years' reserves reduced the combined ratio by 10.4% for the year (2005: release of 7.4%). This has continued the trend for prior years to develop within expectation with a surplus arising for the fourth consecutive year.

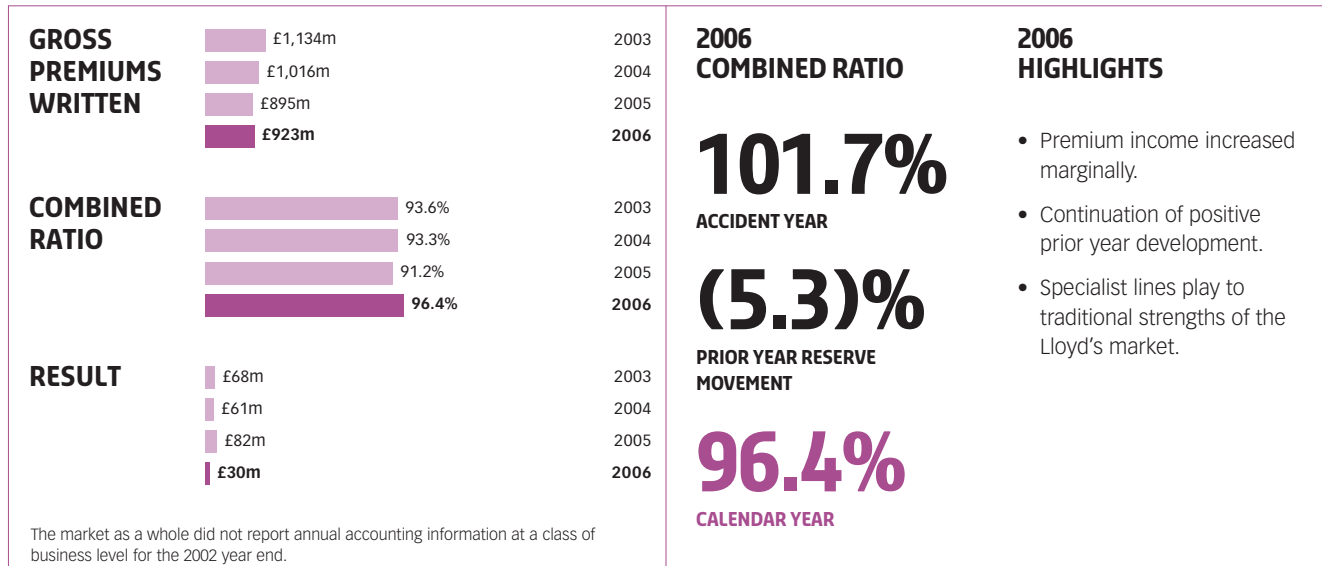
Risks and uncertainties

For the hull, cargo and marine liability classes of business the renewal season to date has been relatively flat. Within the specie class of business, those lines impacted by the cash-in-transit losses have seen large increases in rates, elsewhere rates have come under increasing pressure with rate reductions in evidence.

With the growth in world trade, bigger ships are being built to meet the demand for tonnage which leads to increasing exposure and added volatility. This volatility increases the 'miss factor' inherent in marine hull and may lead to insurers, who do not experience the losses, putting additional pressure on terms and conditions.

MOTOR: SPECIALIST NICHE BUSINESS CONTINUES TO PRODUCE REASONABLE RETURNS

WWW.LLOYDS.COM/2006RESULTS



In recent years this class has become less prominent in the market as a whole but remains an important part of our overall business. In the face of intense competition within the private car market from large consumer-facing organisations such as supermarkets, the mix of motor business written within Lloyd's has changed, with a shift of emphasis to company fleet business and non-standard risks such as high value vehicles, vintage or collectors' vehicles, high risk drivers and affinity groups to the extent that less than half the current premium income derives from private car insurance.

The bespoke nature of these risks plays to Lloyd's traditional strengths as the exposures are more complex and require a higher level of skill and experience to underwrite effectively.

The overseas market continues to be an important part of our portfolio, with around 25% now originating outside of the UK.

2006 performance

Overall, the UK motor market has experienced softening rates since 2003. While there was upward pricing pressure on the wider private car market, the fleet sector has not seen rate increases of any substance. Partly as a consequence of this, the accident year shows a small underwriting loss with a combined ratio of 101.7% (2005: 97.3%). Total gross premiums written were £923m (2005: £895m).

Claims inflation continues to increase, largely driven by increased litigation costs and changes to the basis of some court awards in respect of periodic payments.

Prior year development

The trend in claims development proving to be within initial projections continued in 2006. This led to an overall release of £44m, reducing the combined ratio by 5.3% (2005: 6.1%).

Risks and uncertainties

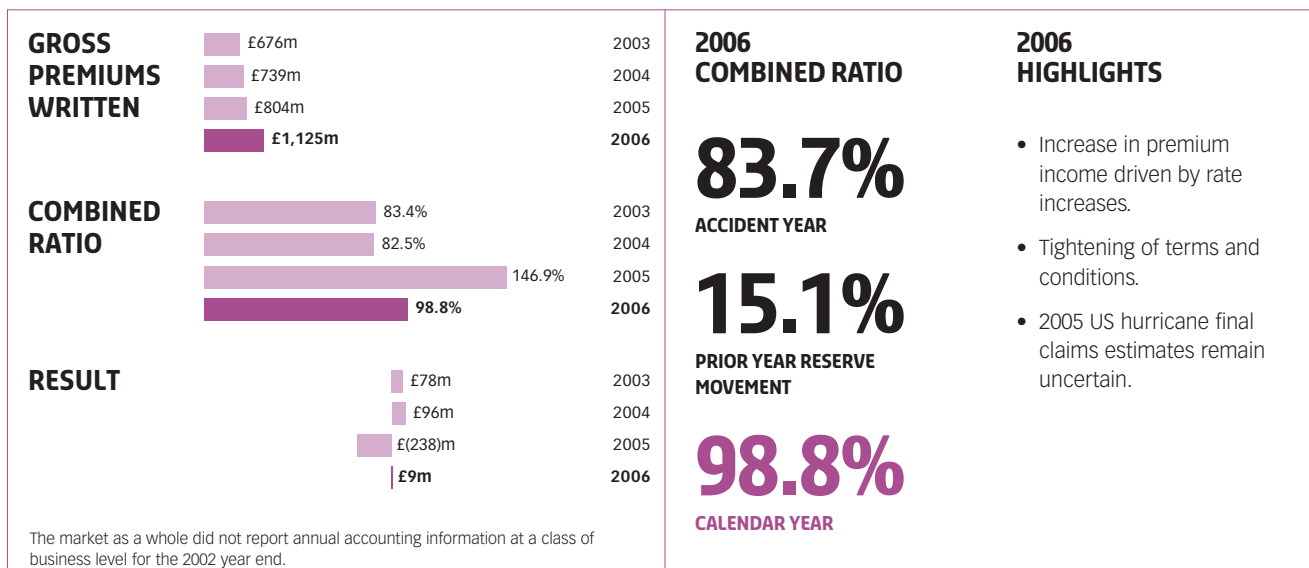
Early indications in 2007 are that rates for commercial and private car business are beginning to show signs of stabilisation following reductions experienced in recent years.

The Lloyd's motor market is facing increased competition following an increase in capacity coming from the company market into areas that would historically have been written in Lloyd's.

Motor insurers will need to maintain their focus on the key risks to their business from claims inflation, including levels of court awards.

ENERGY: STRONG PERFORMANCE IN 2006 OFFSETS DETERIORATION ON 2005 US STORMS

WWW.LLOYDS.COM/2006RESULTS



The Lloyd's energy market includes a variety of onshore and offshore property and liability classes, ranging from construction to exploration and production, refinery and distribution.

A significant part of the portfolio is offshore energy business and a large proportion of this is located in the Gulf of Mexico.

2006 performance

In aggregate, 2006 saw an increase in gross premiums written of 39.9% to £1,125m (2005: £804m) predominantly due to the significant rate increases experienced in Gulf of Mexico business.

At the start of 2006, the cost and reduced availability of reinsurance cover led to a capacity shortage and an increased focus on managing and reducing aggregate exposures.

Gulf of Mexico risks were restructured with a tightening of terms and conditions, particularly in respect of cover for business interruption (pre-assigned cost per barrel of lost production, agreed contract value, agreed daily indemnity and an increase in waiting periods (deductibles)).

Elsewhere, offshore business has also seen rate increases, although towards the latter stages of 2006 this trend became less evident as markets diversified away from the Gulf of Mexico.

Onshore energy markets have experienced rate increases in catastrophe exposed lines of business, with rates remaining stable elsewhere.

The accident year combined ratio for 2006 was 83.7% (2005: 148.5%), which offset the prior year reserve deterioration and resulted in an overall profit for the year of £9m (2005: loss of £238m). The accident year performance was driven by the large increases in premium income combined with a relatively benign loss experience.

Prior year development

The prior year reserve movement added 15.1% to the overall combined ratio reflecting an overall deterioration of £111m (2005: release of 1.6%, £8m).

The prior year development has been affected by the deterioration in the 2005 US hurricane estimates predominantly due to escalating wreck removal costs, costs of plugging and abandoning wells and claims inflation following the demand surge arising from a lack of skilled labour. The sheer number of separate energy claims leads to uncertainty in assessing ultimate claims costs.

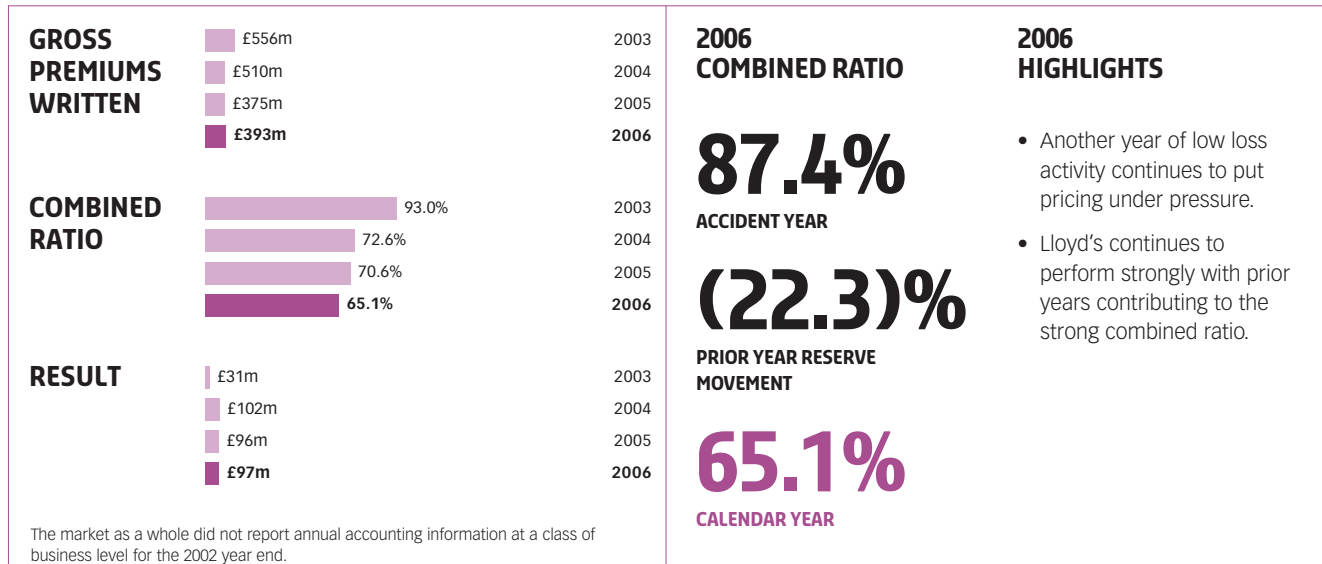
Risks and uncertainties

The early 2007 renewal season shows that the rates achieved in 2006 are being maintained.

The market should concentrate on maintaining its pricing and aggregate exposure discipline and continue to develop a more sophisticated approach to pricing catastrophe risk in order to produce less volatile results in future.

AVIATION: CONTINUES TO PERFORM STRONGLY DESPITE PRESSURE ON RATES

WWW.LLOYDS.COM/2006RESULTS



Lloyd's is an industry leader within the global aviation market and has a balanced portfolio across all sectors of this specialist class, including airline, general aviation, products, air traffic control, war and terrorist coverage, airports and satellite business.

2006 performance

The aviation class continued to produce excellent results with a profit of £97m (2005: £96m) and an accident year combined ratio of 87.4% (2005: 80.4%). Gross premiums written were £393m (2005: £375m).

The aviation market was severely affected by the heavy losses of 2001, namely 9/11 and Queens. As a result, pricing, terms and conditions improved sharply and significantly. Since 2001, the loss experience has been well below the industry long-term average, due to the industry's continuing investment in new aircraft and safety systems, increased security both at airports and on the airlines and improved regulation. These factors have attracted new capacity and led to a reduction in rates from their peak in late 2001.

Within the airline sector there have been five consecutive years of rate reductions and an increase in exposure as a result of growth in both worldwide air passenger traffic volumes and fleet values.

Diminishing margins within the airline sector has led to diversification into other aviation lines and softening rates in the products and airports liabilities markets as a result.

Prior year development

An overall release from prior years' claims reserves reduced the combined ratio by 22.3% (2005: release of 9.8%). This release continues the trend for benign claims development on prior years' reserves across the entire portfolio, including airlines, aviation war and space.

Risks and uncertainties

Exceptional performance in recent years has resulted in over capacity within the aviation sector and, therefore, softening underwriting conditions and it would appear that the market is approaching the bottom of the cycle.

While the improvements in technology, security and regulation have contributed to a low loss incidence in recent years, pilot error continues to be the main cause of airline losses. The potential for increases in loss frequency and severity is still considered to be high.

As rates continue to fall and margins are eroded following the recent benign claims experience, there is a significant risk that airline premiums will reach levels that will be insufficient to meet a single major catastrophe. It is, therefore, critical that appropriate steps are taken to manage the cycle and maintain discipline in the face of these falling rates.

REPORT OF ERNST & YOUNG LLP TO THE COUNCIL OF LLOYD'S ON THE 2006 LLOYD'S PRO FORMA FINANCIAL STATEMENTS

We have examined the Lloyd's pro forma financial statements ('PFFS') for the year ended 31 December 2006, which comprise the pro forma profit and loss account, the pro forma statement of total recognised gains and losses, the pro forma balance sheet and the pro forma cash flow statement and the related notes 1 to 14 which have been prepared on the basis set out in note 2.

This report is made solely to the Council of Lloyd's in accordance with its instructions to us. Our work has been undertaken so that we might state to the Council those matters which we are required to state in this report in accordance with the Council's instructions and for no other purpose. To the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the addressee of this report for our work, for this report, or for the conclusions we have formed.

Respective responsibilities of the Council of Lloyd's and Ernst & Young LLP

The Council of Lloyd's is responsible for the preparation and approval of the PFFS.

Our responsibility is to examine the PFFS and to report to you whether the PFFS have been properly prepared in accordance with the basis of preparation set out in note 2.

Basis of conclusion

The PFFS have been compiled in part from an aggregation of financial information extracted from the balance sheet and profit and loss account included in syndicate annual accounts by the managing agent of each syndicate, which has been submitted to the Council of Lloyd's and on which the auditors of each syndicate have reported. We have relied absolutely on those reports by syndicate auditors. We have not audited those extractions. Our work is solely intended to enable us to make this report.

Our work, which has been carried out in accordance with International Standard on Assurance Engagements, ISA 3000, 'Assurance Engagements other than audits or reviews of Historical Financial Information', consisted principally of making enquiries of the Council of Lloyd's and applying analytical procedures to the financial information and underlying financial data. It excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions as included in the PFFS. We have also carried out such investigations and examined such evidence, on a test basis, as we considered necessary to form an opinion as to whether the PFFS have been properly prepared in accordance with the basis of preparation note 2.

However, our work provides less assurance than an audit or a review in accordance with International Auditing Standards. We have not performed an audit and, consequently, we do not express an audit opinion on the financial information set out in the PFFS.

Conclusion

In our opinion, the PFFS for the financial year ended 31 December 2006 have been properly prepared in accordance with the basis of preparation set out in note 2.

Ernst & Young LLP, London

28 March 2007

PRO FORMA PROFIT AND LOSS ACCOUNT

for the year ended 31 December 2006

Technical account	Note	2006		2005	
		£m	£m	£m	£m
Gross premiums written – continuing operations			16,390		14,979
– discontinued operations	5		24		3
	9		16,414		14,982
Outward reinsurance premiums			(3,213)		(3,212)
Premiums written, net of reinsurance			13,201		11,770
Change in the gross provision for unearned premiums		(644)		230	
Change in provision for unearned premiums, reinsurers' share		131		(215)	
			(513)		15
Earned premiums, net of reinsurance			12,688		11,785
Allocated investment return transferred from the non-technical account			957		705
			13,645		12,490
Claims paid					
Gross amount		11,718		10,181	
Reinsurers' share		(5,120)		(3,418)	
			6,598		6,763
Change in provision for claims					
Gross amount		(4,524)		6,726	
Reinsurers' share		4,145		(3,984)	
			(379)		2,742
Claims incurred, net of reinsurance			6,219		9,505
Net operating expenses	11		4,327		3,668
Balance on the technical account for general business			3,099		(683)
Attributable to: – continuing operations			3,032		(538)
– discontinued operations	5		67		(145)
Total			3,099		(683)
Non-technical account					
Balance on the technical account for general business			3,099		(683)
Syndicate investment return		957		705	
Notional investment return on funds at Lloyd's		651		602	
Investment return and other income on Society assets		121		191	
		1,729		1,498	
Allocated investment return to the technical account		957		705	
			772		793
Other expenses			(209)		(213)
Result on ordinary activities before tax	8		3,662		(103)
Statement of total recognised gains and losses	Note		2006 £m		2005 £m
Result for the financial year			3,662		(103)
Other recognised gains and losses			38		42
Total recognised gains and losses	8		3,700		(61)

PRO FORMA BALANCE SHEET

as at 31 December 2006

	Note	2006		2005	
		£m	£m	£m	£m
Investments					
Financial investments	12		27,165		26,967
Deposits with ceding undertakings					
			17		14
Reinsurers' share of technical provisions					
Claims outstanding		9,259		14,450	
Unearned premiums		771		696	
			10,030		15,146
Debtors					
Debtors arising out of direct operations		3,520		3,853	
Debtors arising out of reinsurance operations		3,190		3,629	
Other debtors		382		685	
			7,092		8,167
Other assets					
Tangible assets		22		17	
Cash at bank and in hand	13	7,926		8,045	
Other		20		10	
			7,968		8,072
Prepayments and accrued income					
Accrued interest and rent		98		93	
Deferred acquisition costs		1,582		1,503	
Other prepayments and accrued income		163		91	
			1,843		1,687
Total assets					
			54,115		60,053
Capital, reserves and subordinated loan notes					
Members' funds at Lloyd's		11,282		10,206	
Members' balances	14	597		(408)	
Members' assets (held severally)		11,879		9,798	
Central reserves (mutual assets)		957		693	
Capital and reserves	8	12,836		10,491	
Subordinated loan notes		497		501	
			13,333		10,992
Technical provisions					
Provision for unearned premiums		7,024		6,829	
Claims outstanding		30,377		37,719	
			37,401		44,548
Deposits received from reinsurers					
			69		142
Creditors					
Creditors arising out of direct insurance operations		831		884	
Creditors arising out of reinsurance operations		1,643		2,228	
Other creditors including taxation		715		1,113	
			3,189		4,225
Accruals and deferred income					
			123		146
Total liabilities					
			54,115		60,053

Signed on behalf of the Council of Lloyd's on 28 March 2007.

Lord Levene of Portsoken, Chairman

Richard Ward, Chief Executive Officer

PRO FORMA CASH FLOW STATEMENT

for the year ended 31 December 2006

	2006 £m	2005 £m
Result on ordinary activities before tax	3,662	(103)
Depreciation	2	2
Realised and unrealised losses/(gains) and foreign exchange	1,553	(1,060)
Net purchase of investments	(1,065)	(2,212)
Notional return on funds at Lloyd's	(651)	(602)
(Decrease)/increase in technical provisions	(1,822)	4,314
Decrease/(increase) in debtors	721	(519)
(Decrease)/increase in creditors	(859)	1,031
Cash generated from operations	1,541	851
Income taxes received	2	82
Net cash from operating activities	1,543	933
Cash flows from financing activities		
Net profits paid to members	(1,616)	(994)
Increase in loans	-	40
Interest paid	(46)	(39)
Net decrease in cash holdings	(119)	(60)
Cash holdings at 1 January	8,045	8,105
Cash holdings at 31 December	7,926	8,045

NOTES TO THE PRO FORMA FINANCIAL STATEMENTS

as at 31 December 2006

1. Introduction

Lloyd's is not an insurance company. It is a Society of members which underwrite insurance (each for their own account) as members of syndicates. The pro forma financial statements (PFFS) are prepared so that the financial results of Lloyd's and its members taken together and their net assets can be compared with general insurance companies.

2. Basis of preparation

General

The PFFS include the aggregate of syndicate annual accounts (Aggregate Accounts), members' FAL and the financial statements of the Society of Lloyd's (pages 93 to 132).

The aggregate of syndicate annual accounts report the audited results for calendar year 2006 and the financial position at 31 December 2006 for all syndicates which transacted business during the year. They include the syndicate level assets, which represent the first link in the chain of security (see pages 55 to 58). The Aggregate Accounts are reported as a separate document and can be viewed at www.loyds.com/financialreports. During 2006, certain syndicates changed their accounting policies in relation to foreign exchange resulting in a restatement of the comparative figures for 2005 within their annual accounts and the Aggregate Accounts have been restated accordingly. The restatements are not material and, therefore, the comparative figures within the PFFS have not been restated.

The capital provided by members is held centrally as FAL and represents the second link in the chain of security. The non-technical account of the PFFS includes a notional investment return on FAL.

The Society of Lloyd's audited financial statements report the central resources of the Society, which forms the third link in Lloyd's chain of security.

The profit and loss account in the PFFS aggregates the syndicate underwriting results, the notional investment return on members' capital and the results of the Society of Lloyd's. The balance sheet in the PFFS aggregates the assets held at syndicate level, members' assets held as FAL and the central resources of the Society. Overall, the PFFS aggregate the results and resources of the Society and its members and reflect all the links in Lloyd's chain of security as described in detail in the 'Security underlying policies issued at Lloyd's' section on pages 55 to 58. The PFFS may, therefore, be used as a reasonable presentation of the results and state of affairs of the Lloyd's market on a basis that is broadly comparable with general insurance companies.

Taxation

The PFFS report the market's result before tax. Members are directly responsible for tax payable on their syndicate results and investment income on FAL. For consistency, the results of the Society are also included pre-tax in the profit and loss account. The balance sheet includes the tax provisions in the Society financial statements.

Funds at Lloyd's

FAL comprise the capital provided by members to support their underwriting, and are the equivalent of capital shown in insurance companies' accounts. The valuation of FAL has, therefore, been included in the pro forma balance sheet.

FAL are available to meet cash calls made on the member in respect of a syndicate. The assets in FAL must be readily realisable, may include letters of credit and bank and other guarantees, and must be at least equivalent to the aggregate of the member's net FAL requirement and certain liabilities in respect of its underwriting business. Each member's net FAL requirement to support its underwriting at Lloyd's is determined using Lloyd's Individual Capital Assessment (ICA) capital setting methodology.

A notional investment return on FAL has been calculated, which is the equivalent of insurance companies generating investment return on the capital that they hold to support their underwriting. The notional investment return is calculated on the average value of FAL during the year, based on indices yields on each type of asset held. The typical investment return on bank deposits has been applied to FAL provided as letters of credit or bank guarantees.

Society of Lloyd's financial statements

The PFFS include the results and assets reported in the consolidated financial statements of the Society of Lloyd's, comprising the financial statements of the Society of Lloyd's and all its subsidiary undertakings, the Lloyd's Central Fund and the Society's interest in associates.

Transactions between syndicates and the Society

- (1) Central Fund contributions, members' subscriptions and other market charges levied by the Society are reported as net operating expenses in the syndicate annual accounts and as income in the Society financial statements.
- (2) Central Fund claims and provisions to discharge the liability of members where they have unpaid cash calls and do not have the resources to meet those cash calls are reported as a profit and loss charge and balance sheet liability in the Society financial statements.

The Central Fund other income includes recoveries from insolvent members. The syndicate annual accounts for calendar year 2006 and earlier years include those members' results and at the balance sheet date will report the outstanding liability within members' balances.

- (3) Syndicate loans to the Central Fund (and annual interest payments on the loans) are reported as assets (and accrued income) within the syndicate annual accounts. The Society financial statements report the loans as equity and account for interest payable when the Council formally approves interest payments.
- (4) Loans funding statutory overseas deposits are reported as assets within the syndicate annual accounts and as liabilities in the Society financial statements.

Transactions between the syndicates and the Society which have been reported within both the syndicate annual accounts and the Society financial statements have been eliminated (note 8).

Intra-syndicate loans

The syndicate annual accounts report debtor and creditor balances for intra-syndicate loans totalling £372m (2005: £315m). These amounts have been eliminated from the amounts reported in the balance sheet to provide a more meaningful presentation of the balance sheet for users of the PFFS.

Subordinated loan notes

In accordance with the terms of the subordinated loan notes, the capital raised is available for payment to policyholders in advance of repayment to the note holders. Accordingly, the amount of the notes is included in the 'capital, reserves and subordinated loan notes' as reported in the pro forma balance sheet.

3. Accounting policies notes

A. Aggregate Accounts

General

Under the Insurance Accounts Directive (Lloyd's Syndicates and Aggregate Accounts) Regulations 2004, managing agents must prepare the syndicate annual accounts under UK GAAP. However, where UK GAAP permits different accounting treatments, each managing agent is able to adopt the accounting policies it considers most appropriate to its syndicate. The following accounting policies are, therefore, generic in nature.

Premiums written

Premiums written represent premiums on business incepting during the year, together with adjustments for premiums written in previous accounting periods. Premiums written are stated before deduction of commissions but net of taxes, duties levied on premiums and other deductions.

Unearned premiums

Written premiums are recognised as earned according to the risk profile of the policy. Unearned premiums represent the proportion of premiums written in the year that relate to unexpired terms of policies in force at the balance sheet date, calculated on the basis of established earnings patterns or time apportioned as appropriate.

Reinsurance premium ceded

Outwards reinsurance premiums are accounted for in the same accounting period as the premiums for the related direct or inwards business being reinsured.

Claims provisions and related recoveries

Gross claims incurred comprise the estimated cost of all claims occurring during the year, whether reported or not, including related direct and indirect claims handling costs and adjustments to claims outstanding from previous years.

The provision for claims outstanding is assessed on an individual case basis and is based on the estimated ultimate cost of all claims notified but not settled by the balance sheet date, together with the provision for related claims handling costs. The provision also includes the estimated cost of claims incurred but not reported ('IBNR') at the balance sheet date based on statistical methods.

These methods generally involve projecting from past experience of the development of claims over time to form a view of the likely ultimate claims to be experienced for more recent underwriting, having regard to variations in the business accepted and the underlying terms and conditions. For the most recent years, where a high degree of volatility arises from projections, estimates may be based in part on output from rating and other models of the business accepted and assessments of underwriting conditions. The amount of salvage and subrogation recoveries is separately identified and, where material, reported as an asset.

NOTES TO THE PRO FORMA FINANCIAL STATEMENTS

continued

as at 31 December 2006

The reinsurers' share of provisions for claims is based on the amounts of outstanding claims and projections for IBNR, net of estimated irrecoverable amounts, having regard to the reinsurance programme in place for the class of business, the claims experience for the year and the current security rating of the reinsurance companies involved. Statistical techniques are used to assist in making these estimates. The two most critical assumptions as regards claims provisions are that the past is a reasonable predictor of the likely level of future claims development and that the rating and other models used for current business are fair reflections of the likely level of ultimate claims to be incurred.

The directors of each syndicate's managing agent consider that the provisions for gross claims and related reinsurance recoveries are fairly stated on the basis of the information currently available to them. However, the ultimate liability will vary as a result of subsequent information and events, which may result in significant adjustments to the amounts provided. Adjustments to the amounts of claims provisions established in prior years are reflected in the financial statements for the period in which the adjustments are made. The methods used, and the estimates made, are reviewed regularly.

Unexpired risks provision

A provision for unexpired risks is made where claims and related expenses arising after the end of the financial period in respect of contracts concluded before that date, are expected to exceed the unearned premiums under these contracts, after the deduction of any acquisition costs deferred.

The provision for unexpired risks is calculated at syndicate level by reference to classes of business which are managed together, and may take into account relevant investment return.

Acquisition costs

Acquisition costs, comprising commission and other costs related to the acquisition of new insurance contracts are deferred to the extent that they are attributable to premiums unearned at the balance sheet date.

Foreign currencies

Income and expenditure in foreign currencies are translated into pound sterling using the exchange rates prevailing at the date of the transactions or, the average rate may be used when this a reasonable approximation.

Where the overseas operations for a syndicate are treated as a branch, its branch assets and liabilities are translated into pound sterling at the rates of exchange ruling at the balance sheet date. The exchange differences arising are normally accounted for through the statement of total recognised gains and losses.

For other overseas operations, monetary assets and liabilities are translated into pound sterling at the rates of exchange ruling at the balance sheet date. Resulting exchange differences on translation may be recorded in the profit and loss account or through the statement of total recognised gains and losses.

Investments

Investments are stated at current value at the balance sheet date. For this purpose, listed investments are stated at their bid price market value, and deposits with credit institutions and overseas deposits are stated at cost.

Unlisted investments for which a market exists are stated at the average price at which they are traded on the balance sheet date or the last trading day before that date.

Syndicate investment return

Syndicate investment return comprises all investment income, realised investment gains and losses and movements in unrealised gains and losses, net of investment expenses, charges and interest.

Realised gains and losses on investments carried at market value are calculated as the difference between sale proceeds and purchase price. Unrealised gains and losses on investments represent the difference between the valuation at the balance sheet date and their valuation at the previous balance sheet date, or purchase price, if acquired during the year, together with the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

Syndicate investment return is initially recorded in the non-technical account. A transfer is made from the non-technical account to the general business technical account. Syndicate investment return has been wholly allocated to the technical account as all syndicate investments relate to the technical account.

Taxation

Under Schedule 19 of the Finance Act 1993 managing agents are not required to deduct basic rate income tax from trading income. In addition, all UK basic rate income tax deducted from syndicate investment income is recoverable by managing agents and consequently the distribution made to members or their members' agents is gross of tax. Capital appreciation falls within trading income and is also distributed gross of tax.

No provision has been made for any United States Federal Income Tax payable on underwriting results or investment earnings. Any payments on account made by the syndicate during the year are included in the balance sheet under the heading 'other debtors'.

No provision has been made for any overseas tax payable by members on underwriting results.

Operating expenses

Operating expenses (including pension and other staff costs) have been charged to the syndicates in accordance with the policies adopted by the managing agents.

Profit commission

Where profit commission is charged by the managing agent it does not currently become payable until after the appropriate year of account closes, normally at 36 months. The profit commission is accrued in the profit and loss account in accordance with the earned profit.

B. Funds at Lloyd's

FAL are valued in accordance with their market value at the year end, and using year end exchange rates.

Investments are stated at current value at the balance sheet date. For this purpose, listed investments are stated at their bid price market value, and deposits with credit institutions and overseas deposits are stated at cost.

Unlisted investments for which a market exists are stated at the average price at which they are traded on the balance sheet date or the last trading day before that date.

C. Society of Lloyd's

The accounting policies adopted in the Society of Lloyd's financial statements are as set out on pages 96 to 101.

4. Variability

Calendar year movements in reserves are based upon best estimates as at 31 December 2006 taking into account all available information as at the balance sheet date. These estimates are subject to variability until the date at which the underlying claims are settled. Such changes in best estimate are reflected in the technical account of the year in which they occur.

5. Discontinued operations

Continuing/discontinued operations represent the analysis reported in the syndicate annual accounts between business that they are continuing to underwrite and business that they have ceased to underwrite. It is quite possible, however, that business discontinued by one syndicate continues to be written at Lloyd's by one or more other syndicates.

When a syndicate has ceased underwriting, their operations are reported as discontinued within the syndicate's annual accounts. Where the entire book of business continues to be written by another syndicate, however, an adjustment is made in the PFFS to reflect the continuing nature of this business to Lloyd's and its members as a whole.

Where business has been reported as discontinued in 2006, the results for that business have also been reported as discontinued in the 2005 comparative figures.

6. Members' funds at Lloyd's

The valuation of members' FAL in the balance sheet totals £11,282m (2005: £10,206m).

The notional investment return on FAL included in the non-technical profit and loss account totals £651m (2005: £602m).

7. Society of Lloyd's

The results of the group financial statements of the Society included in the profit and loss account are a net profit of £275m (2005: £183m) in the technical account and a net loss of £88m (2005: £13m loss) in the non-technical account.

NOTES TO THE PRO FORMA FINANCIAL STATEMENTS

continued

as at 31 December 2006

8. Aggregation of results and net assets

A reconciliation between the results, statement of realised gains and losses and net assets reported in the syndicate annual accounts, members' FAL and by the Society is set out below:

	2006 £m	2005 £m
Profit and loss account		
Result per syndicate annual accounts	2,825	(862)
Result of the Society	84	(25)
Central Fund claims and provisions in Society financial statements	116	224
Central Fund recoveries from insolvent members	(20)	(12)
Taxation charge/(credit) in Society financial statements	7	(17)
Interest receivable on syndicate loans to Central Fund accrued in syndicate annual accounts	(1)	(4)
Notional investment return on members' funds at Lloyd's	651	602
Elimination of prior year adjustment in syndicate annual accounts	-	(9)
Result on ordinary activities before tax	3,662	(103)

	2006 £m	2005 £m
Statement of total recognised gains and losses		
Result for the financial year	3,662	(103)
Other recognised gains and losses per syndicate annual accounts	39	67
Other recognised gains and losses of the Society	(1)	(1)
Elimination of prior year adjustment in syndicate annual accounts	-	(24)
Total recognised gains and losses	3,700	(61)

	2006 £m	2005 £m
Capital and reserves		
Net assets per syndicate annual accounts	657	(448)
'Equity' of the Society	957	693
Central Fund claims and provisions	159	166
Members' funds at Lloyd's	11,282	10,206
Syndicate loans to Central Fund in syndicate annual accounts	(214)	(107)
Interest receivable on syndicate loans to Central Fund accrued in syndicate annual accounts	(5)	(4)
Elimination of prior year adjustment in syndicate annual accounts	-	(15)
Total capital and reserves	12,836	10,491

Transactions between syndicates and the Society which have been reported within both the syndicate annual accounts and the Society financial statements have been eliminated in the PFFS as set out in note 2.

9. Segmental analysis

The syndicate returns to Lloyd's provided additional information to derive the following table in respect of the classes of business reviewed in the market commentary.

	Gross premiums written £m	Net earned premium £m	Result £m
2006			
Reinsurance	5,557	4,186	802
Casualty	3,572	2,964	327
Property	3,638	2,730	495
Marine	1,153	921	105
Motor	923	829	30
Energy	1,125	737	9
Aviation	393	278	97
Life	50	40	2
Total from syndicate operations	16,411	12,685	1,867
Transactions between syndicates and the Society (notes 2 and 8) and insurance operations of the Society	3	3	275
Total per PFFS	16,414	12,688	2,142

	Gross premiums written £m	Net earned premium £m	Result £m
2005			
Reinsurance	5,261	3,722	(1,307)
Casualty	3,402	2,949	179
Property	3,199	2,474	(457)
Marine	1,017	853	73
Motor	895	937	82
Energy	804	508	(238)
Aviation	375	327	96
Life	47	33	1
Total from syndicate operations	15,000	11,803	(1,571)
Transactions between syndicates and the Society (notes 2 and 8) and insurance operations of the Society	(18)	(18)	183
Total per PFFS	14,982	11,785	(1,388)

10. Life business

The PFFS include the results of all life and non-life syndicates transacting business during 2006. The results and net assets for life syndicates are not material and have not been separately disclosed in the profit and loss account and balance sheet. The results for life business are reported in the segmental analysis (note 9).

11. Net operating expenses

	2006 £m	2005 £m
Acquisition costs	3,354	2,921
Change in deferred acquisition costs	(163)	(8)
Administrative expenses	910	872
	4,101	3,785
Loss/(profit) on exchange	226	(117)
	4,327	3,668

NOTES TO THE PRO FORMA FINANCIAL STATEMENTS

continued

as at 31 December 2006

12. Financial investments

	2006 £m	2005 £m
Shares and other variable yield securities and units in unit trusts	3,078	2,398
Debt securities and other fixed income securities	19,174	20,279
Participation in investment pools	813	564
Loans and deposits with credit institutions	4,093	3,719
Other	7	7
	27,165	26,967

13. Cash at bank and in hand

Cash at bank and in hand includes letters of credit and bank guarantees held in trust within members' FAL to meet policyholder claims as required, totalling £5,851m (2005: £5,595m).

14. Members' balances

	2006 £m	2005 £m
Balance at 1 January	(408)	1,426
Result for the year	2,824	(875)
Distribution on close of 2003 (2002) year of account	(1,956)	(890)
Advance distributions	(296)	(625)
Cash calls	571	568
Loan to the Central Fund	(107)	(107)
Other movements	(31)	95
Balance at 31 December	597	(408)

Members participate on syndicates by reference to years of account. Members' ultimate results, assets and liabilities are assessed by year of account with reference to policies incepting in that year of account. Members' balances represent the net profit/(loss) to be distributed/(collected) by syndicates to/(from) the members.

SECURITY UNDERLYING POLICIES ISSUED AT LLOYD'S

as at 31 December 2006

Summary

Lloyd's is not an insurance company. It is a Society of members, both corporate and individual, which underwrite insurance in syndicates. These syndicates can comprise one single corporate member or any number of corporate and individual members, underwriting severally for their own account.

There were 66 syndicates, as at 1 January 2007, registered to conduct business at Lloyd's in 2007. Each syndicate is managed by a managing agent. Managing agents write insurance business on behalf of the member(s) of the syndicate, which receive profits or bear losses in proportion to their share in the syndicate for each underwriting year of account. The adoption of annual accounting and presentation of the syndicate annual accounts do not change the allocation of profits and losses to members.

The capital provided by every member is assessed according to the Lloyd's Individual Capital Assessment (ICA) capital setting framework. When agreed, each ICA is then 'uplifted' (by 35% for 2006) to provide an extra buffer to support Lloyd's rating and financial strength. This uplifted ICA, which is the Economic Capital Assessment (ECA) is used to determine members' capital requirement subject to prescribed minimum levels.

The Lloyd's chain of security

The three key features of the Lloyd's chain of security provide strong security to all Lloyd's policyholders, reflected in the high ratings assigned by leading rating agencies.

The first two links in the Lloyd's chain of security each operate on a several basis: each member's resources are only available to meet their share of claims. The third link represents assets available to meet the liabilities of any member on a mutual basis. The key features of the chain of security are summarised below and the sections which follow describe each of these links in greater detail.

The chain of security supports policies written for the 1993 and subsequent years of account for non-life business and all life business written at Lloyd's. Liabilities in relation to the 1992 and prior years of account for non-life business were reinsured into Equitas as at 31 December 1995, as part of 'Reconstruction and Renewal'.

First link – syndicate level assets

All premium receipts and reserves at syndicate level are held in premiums trust funds or overseas regulatory deposits. Profits are distributed only after provision for all outstanding liabilities.

Premiums Trust Funds and overseas regulatory deposits*: £28,173m

Second link – members' funds at Lloyd's

Capital requirements are determined for each member by Lloyd's ICA capital setting framework, subject to prescribed minimum levels.

FAL*: £11,282m

Third link – central assets

At the discretion of the Council, the Central Fund is available to meet any portion of any member's insurance liabilities that the member is unable to meet in full.

Society central resources excluding the subordinated debt liability and the callable layer*: £1,454m

* As at 31 December 2006.

The first link

The first link in the chain of security is the member's premiums trust funds, and other assets held in trust at syndicate level. To protect the interests of policyholders, all premiums and other monies received or receivable in connection with the member's underwriting business are initially paid into the premiums trust funds, managed by the managing agent of the syndicate concerned. Payments from these funds may only be made to meet permitted trust outgoings: claims, reinsurance premiums, underwriting expenses and the like, including funding overseas regulatory deposits. Profit is not distributed until provision has been made for all outstanding liabilities.

There are separate premiums trust funds for life business and non-life general business. There is a further segregation in that a number of the premiums trust funds are exclusively available to support certain overseas underwriting of members. The Lloyd's Dollar Trust Funds (LDTF) receive premiums in respect of US dollar denominated non-life business underwritten or incepting on or after 1 August 1995. Receipts in respect of non-life US dollar denominated business originally written and incepting before that date are held in the Lloyd's American Trust Fund (LATF) of each member, in New York. There are separate LATFs in New York for US dollar denominated life business, whenever written or incepting.

SECURITY UNDERLYING POLICIES ISSUED AT LLOYD'S

continued

as at 31 December 2006

The other overseas premiums trust funds are the Lloyd's Canadian Trust Fund (LCTF) in Canada, comprising members' underwriting receipts in respect of Canadian situs business and the Lloyd's Asia trust funds for general business written by members through service companies in Singapore.

Members must ensure that there are sufficient funds in the members' premiums trust fund for the syndicate to meet all claims, necessary expenses and outgoings in connection with the syndicate business; they are required to meet a request to make such funds available (a 'cash call'). Cash calls are met by members from their own resources or, if necessary, from their FAL or, at the Council's discretion, the New Central Fund.

Premiums trust funds are used to fund overseas regulatory deposits. The US situs business of each syndicate is supported by US situs syndicate level trust funds (for US situs surplus lines business, US situs reinsurance business as accredited reinsurers, and for Illinois and Kentucky licensed business respectively). In addition, separate joint asset trust funds provide joint security for members' US situs surplus lines, US situs reinsurance and Kentucky business respectively.

These deposits would be available to meet judgment debts of a member in respect of business connected with the relevant overseas territory in the event that the relevant premiums trust fund of the member, even after replenishment from other links in the chain of security and other free assets of the member in question, was inadequate.

Underwriters also maintain regulatory deposit trust funds in Australia and South Africa and various deposits in other countries.

The total value of all the above funds was £28,173m in aggregate, at 31 December 2006.

The second link

The second link is members' FAL. FAL comprise the three trust funds in which members' assets may be held: the Lloyd's deposit, the special reserve fund and the personal reserve fund held under the terms of the premiums trust deed. These are each available to meet cash calls made on the member in respect of a syndicate. The assets in FAL must be readily realisable, may include letters of credit and bank and other guarantees, and must be at least equivalent to the aggregate of the member's net FAL requirement and certain liabilities in respect of its underwriting business. FAL will include assets lodged by members to cover deficits declared by syndicates. Where syndicates report such losses on open years that do not immediately trigger a cash call requirement at syndicate level, members are required to deposit additional assets centrally to cover these deficits, so that their FAL are sufficient to meet both open year losses and their ECA.

Minimum capital ratios are set at 40% of overall premium limits (25% for those members writing mainly EU motor business).

Individual members underwrite with unlimited liability and thus may be required to meet their share of claims to the full extent of their wealth. A corporate member may also have assets, beyond its FAL, which can be called upon to meet its underwriting liabilities.

As at 31 December 2006, the total value of FAL held in trust by members amounted to £11,282m in the aggregate.

The third link

The third link is the central resources of the Society. These are the assets of the Central Fund (comprising the New Central Fund and the 'Old' Central Fund) and other assets of the Society.

The New Central Fund has been established to be available, at the discretion of the Council of Lloyd's, to ensure that policyholders' claims are met in the event of members being unable to meet their underwriting liabilities relating to 1993 and post non-life business and all life business. In practice, this entails the payment of syndicate cash calls where a member is unable to do so from their FAL or their own resources.

The New Central Fund is funded by annual contributions from members. In addition, the net resources are enhanced by loans made to it by syndicates. These amounts are treated as equity in the Society's financial statements. Repayment of these loans may be deferred at the discretion of the Council of Lloyd's although current expectations are that repayment will be made upon closure of the relevant years of account. The net assets of the Central Fund as at 31 December 2006 were £843m.

In 2004, Lloyd's issued subordinated loan notes which, as at 31 December 2006, are included as a liability of £497m within the Society's financial statements. As set out in note 20 to the Society's financial statements, payments on the notes are subordinated to certain payments which may be made out of central assets, including payments made to discharge the liabilities of an insolvent member to any person (including any policyholders) arising out of or in connection with insurance business carried on at Lloyd's by that insolvent member.

Central Fund assets may be supplemented by a 'callable layer' of up to 3% of members' overall premium limits in any one calendar year. These funds would be drawn from premium trust funds (described and included in the first link).

In addition, the other assets of the Society, totalling £114m at 31 December 2006, are available to meet underwriting liabilities in the last resort.

In aggregate, the value of the central resources of the Society (excluding the subordinated debt liability and the callable layer), amounted to £1,454m at 31 December 2006.

Aggregate resources

The total of syndicate assets, members' FAL and central resources of the Society as at 31 December 2006, after the elimination of syndicate loans to the Central Fund and annual interest receivable, were £40,690m. The total of net syndicate technical provisions at the end of 2006 was £27,357m. The total net resources of the Society and its members were therefore £13,333m (excluding the subordinated debt liability) as shown in the PFFS on page 46.

The results on which the aggregated resources are based are determined by aggregating the assets and liabilities of all members and those of the Society. The aggregate declared resources of the Society do not represent a consolidated statement of the financial position of Lloyd's business taken as a single entity and, as indicated above, the first two links of the chain of security operate on a several, not mutual, basis.

Solvency controls

One of the most important controls on the solvency of the members of Lloyd's is the annual solvency test.

The annual solvency process requires the managing agent of each syndicate to estimate and provide for all current and future liabilities for each year of account. These liabilities (ie solvency reserves or 'technical provisions for solvency') are subject to a statement of actuarial opinion. In the event that it is not possible for the managing agent to secure an unqualified actuarial opinion for any reason, the solvency reserves would be determined by the Lloyd's Actuary, who would provide a report to the FSA. In addition, any syndicate which is not able to secure an unqualified actuarial opinion will normally be subject to a monitoring review by Lloyd's. There were no qualified actuarial opinions at 31 December 2006.

The Lloyd's solvency test has two stages to the calculation:

Firstly, each member's solvency position is calculated. Each member must have sufficient assets – those held in the premiums trust funds, overseas regulatory deposits and its FAL – to cover its underwriting liabilities and on top of this an additional solvency margin. The solvency margin is calculated separately for each member, determined essentially as the greater of 16% of total annual premium income or 23% of average claims incurred over a three-year period. Premiums and claims in respect of certain types of liability business have their value increased by 50%, for the purpose of this calculation. Where a member's assets are not sufficient to cover the aggregate of its underwriting liabilities and its solvency margin, the member has a solvency shortfall.

The second part of the solvency test calculation requires that the net central assets of the Society must be sufficient to cover the aggregate of all members' shortfalls calculated at the solvency test date. Central assets include the value of the Central Fund and the other net assets of the Society, excluding the subordinated debt liability but including the callable layer – for this purpose, the 'effective' callable layer, ie that part of the callable layer not attributed to members with a solvency shortfall.

Lloyd's is required to maintain solvency on a continuous basis, and the solvency position of each member – and thus of Lloyd's as a whole – is monitored on a regular basis. The FSA are advised of the results of this monitoring.

The solvency test sets out the assets required to be held in trust by members to meet underwriting liabilities and solvency margin. This is the minimum capital requirement for all members.

Lloyd's will take action where the member has insufficient assets to meet their ECA, which will include requiring the member to cease underwriting unless new funds are provided.

Each year, Lloyd's files a return – the Lloyd's Return – with the FSA. This return is intended to ensure Lloyd's regulatory reporting requirements are in line with other UK insurers, adapted where appropriate to reflect Lloyd's unique structure. This return reports the results of Lloyd's solvency test.

SECURITY UNDERLYING POLICIES ISSUED AT LLOYD'S: FINANCIAL SUMMARY

As at 31 December 2006

	2006 £m	2005 £m
I Syndicate level assets (several basis)	28,173	29,109
Elimination of syndicate loans to Central Fund and annual interest receivable	(219)	(111)
	27,954	28,998
II Members' funds at Lloyd's (several basis)	11,282	10,206
III Central assets (mutual basis)		
Net Central Fund assets	843	670
Subordinated debt	497	501
Other net assets of the Society	114	23
	1,454	1,194
Total resources of the Society of Lloyd's and its members	40,690	40,398
Net syndicate technical provisions	(27,357)	(29,406)
Total net resources of the Society of Lloyd's and its members	13,333	10,992

Notes

1. This financial summary has been compiled by aggregating the assets and liabilities of all the underlying syndicates, the declared members' qualifying assets and other net assets of the Society of Lloyd's. The statement does not purport to disclose the solvency position of each member of Lloyd's.
2. The 'total net resources of the Society of Lloyd's and its members' agrees to the 'capital, reserves and subordinated loan notes' shown in the PFFS as set out on page 46.