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Insurance

Reinsurers
UK
Credit Analysis

Lloyd's of London

Ratings

Lloyd's of London

Insurer Financial Strength Rating	A+

The Society of Lloyd's

Long-Term IDR	A

Lloyd's Reinsurance Company (China) Ltd

Insurer Financial Strength Rating	A+

Sovereign Risk

Foreign-Currency Long-Term IDR	AAA
Local-Currency Long-Term IDR	AAA

Outlooks

Lloyd's of London — Insurer Financial Strength Rating	Stable
The Society of Lloyd's — Long-Term IDR	Stable
Lloyd's Reinsurance Company (China) Ltd — Insurer Financial Strength Rating	Stable
Sovereign Foreign-Currency Long-Term IDR	Stable
Sovereign Local-Currency Long-Term IDR	Stable

Financial Data

Lloyd's of London

	31 Dec 07	31 Dec 08
Total assets (GBPm)	44,007.0	53,594.0
Total liabilities (GBPm)	30,558.0	39,415.0
Gross written premiums (GBPm)	16,366.0	17,985.0
Pre-tax income (GBPm)	3,846.0	1,899.0
Combined ratio (%)	83.9	91.2

Analysts

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Rating Rationale

- The rating of Lloyd's of London (Lloyd's) was affirmed on 23 July 2009, and reflects its resilient performance in 2008, in the context of the third-worst year on record for catastrophe losses, and amid significant volatility in the financial markets. The relatively conservative allocations of syndicates' invested assets, as well as invested assets backing the Central Fund, is a positive rating factor, and contributed to positive, albeit modest, investment returns in 2008. Underwriting performance was in line with expectations, given the high level of catastrophe losses during 2008, although there is still some volatility in the share of the industry's losses that Lloyd's assumes from year to year.

- Capital strength was maintained at levels supportive of the rating, with both funds at Lloyd's (FAL) and Central Fund assets increasing marginally during 2008. Fitch Ratings views the recent completion of the Equitas Phase 2 deal (see *Recent Events*) positively from a ratings perspective, as it substantially eliminates the risk of pre-1993 liabilities putting a strain on the Lloyd's market. Some uncertainty remains regarding the leadership transition of the Franchise Performance Directorate (FPD), and the impact this will have on the underwriting discipline of the market. In addition, its exposure to currency movements is considered relatively high, contributing additional volatility to the bottom line results.

- Fitch notes that earnings at Lloyd's in 2008 were supported by a significant level of FX gains, which are partly expected to reverse in 2009. In addition, underwriting performance benefitted from strong levels of reserve releases, which are expected to decline in the near term. In 2009-2010, Fitch expects earnings to be lower than the recent record performance of 2006 and 2007, with reduced contribution from investment income and reserve releases, but with some upward potential from the expected rise in premium rates.

- The Stable Outlook on the rating is driven by the expectation that its capital strength will be maintained in the near future and that underwriting profitability of the current year's business may improve, in the absence of major catastrophe activity, given the expectation of some increase of premium rates, albeit at a modest level.

Key Rating Drivers

- A significant reduction in volatility of results in the medium term and evidence of sustained profitability in soft market conditions will put positive pressure on the rating, although an upgrade is unlikely in the near term.

- A significant deterioration in profitability, poor performance relative to peers and erosion of capital, including Central Fund assets, will put negative pressure on the rating.

Recent Events

In June 2009, the UK High Court approved the Equitas Phase 2 deal (see *Key Events*).

In April 2009, Lloyd's repurchased the local-currency equivalent of GBP102m of its outstanding subordinated debt, taking advantage of the favourable pricing conditions in the market and its strong capital position.

Key Rating Issues

Strong Capitalisation, Benefitting From Mutuality at the Central Fund Level

The three-layered capital structure at Lloyd's (consisting of syndicates' Premium Trust Funds (PTFs), members' FAL and Central Fund) held up well in the tumultuous conditions of 2008. These sources of capital performed well due to underwriting profitability, the contribution from investments and maintained capital requirements for the syndicates, although the contribution from investments was down substantially, due to poor conditions in 2008. In Fitch's view, capitalisation is supportive of the current rating, and is expected to remain as such, provided no significant natural catastrophe activity leads to erosion of capital.

Good Financial Flexibility of the Central Fund and of Individual Market Participants

The variety of sources of funding for the Central Fund provides The Society of Lloyd's (the Society) with significant financial flexibility. The Society has powers to raise funds both internally through the use of contributions, levies and syndicate loans and externally through the capital markets. This flexibility has been illustrated in the past with the market's agreement to an increase in the Central Fund contributions from 0.5% to 1% for 2006, followed by a reduction to 0.5% in 2008. The GBP500m of hybrid debt raised through the capital markets in 2007 also illustrates this flexibility. At member level, a degree of financial flexibility has been demonstrated by the ability of a number of players to raise additional capital since the start of 2009 via rights issues or letters of credit (LOC) albeit at prices reflective of the difficult market conditions.

Good Underwriting Performance, With Support From Prior Years' Releases, Although Volatility Remains

The market's earnings in 2008 were hit both by catastrophe losses and poor investment returns. Partly offsetting this were the substantial gains made on the depreciation of sterling and releases from prior years' claims reserves. Overall, even amid the difficult conditions in the investment markets and losses arising from the third-worst catastrophe year for the insurance industry on record, Lloyd's was able to deliver its third-highest net income of GBP1,900m, which is viewed positively from a credit perspective. Less positively, the quality of these earnings suffered due to a strong contribution from FX gains, which are partly expected to reverse in 2009. In addition, Lloyd's share of the total insurance market losses in 2008 was high at 6%, compared with the average of around 3% in the years of low catastrophe activity.

Exposure to FX Movements Adds Volatility to Capitalisation Levels and Profitability

Fitch views negatively the high level of exposure to FX movements present in members' FAL, which during 2008 led to a shortfall in FAL of around GBP1.3bn, following significant movements in the USD against the GBP. Lloyd's responded by requesting agents to post additional capital to cover the shortfall, with injections to be finalised by 1 April 2009. A good level of Q408 investment income reduced some of the shortfall, and a balance of GBP500m remained due at end-June 2009. Three managing agents elected to reduce exposures/premiums to remain adequately capitalised and fulfil Lloyd's capital requirements at the current level of available capital. This exposure to FX volatility remains to date, although Lloyd's plans to partially address it by encouraging the managing agents to focus more on a suitable mix of assets by currency.

Exposure to Catastrophe Risks

The substantial exposure of Lloyd's to catastrophe risk is demonstrated by its higher-than-industry-average losses in years of high cat activity. Lloyd's makes bi-annual assessments of its exposure to major natural catastrophes. Relative to its exposure at the start of January 2008, the gross exposure for 2009 has increased moderately, mostly due to unfavourable movements in FX. Net exposure is also higher due to increased retention levels, driven by the increasing cost of reinsurance.

Leadership Transition of the FPD

Rolfe Tolle, the incumbent head of the FPD, has been an influential presence in the Lloyd's market since the FPD was established in 2003. His influence extended from supervision and monitoring of underwriting appetites of existing syndicates to involvement in the approval of all applications for entry into the Market by new syndicates. His tenure at Lloyd's concludes at the end of 2009. His replacement (Tom Bolt) joined Lloyd's in September 2009, giving him the opportunity for a few months of overlap to settle into the role. Bolt comes from an underwriting background, with over 20 years of insurance experience, most recently holding senior positions at Berkshire Hathaway and Flagstone Re. Fitch will continue to monitor the performance and impact the FPD exerts over the market under the new leadership.

Peer Analysis

Due to its unique structure and mix of business underwritten, Lloyd's has no directly comparable peers. However, some meaningful comparison can be made with the large global reinsurance players, as Table 1 shows. Among these companies, Lloyd's ranked third by premium income in 2008, and performed well against its peers on underwriting profitability, achieving the second-lowest combined ratio of 91.3% in 2008 and the lowest in 2007.

Table 1: Peer Analysis

	Net premiums earned		Combined ratio (%)		Shareholders' equity	
(EURm)	2008	2007	2008	2007	2008	2007
Munich Re	18,292	17,874	97.2	95.9	21,256	25,416
Berkshire Hathaway	17,352	21,607	82.5	87.7	78,199	86,404
Lloyd's	17,284	16,409	91.3	84.0	14,848	14,080
Swiss Re	9,096	11,992	99.2	92.4	13,686	21,324
Hannover Re	4,277	4,498	100.0	103.1	2,830	3,349

Note: Currency translations have been made at a constant 2008 exchange rate, using YE2008 for SHE and average 2008 for NPE
Source: Company annual reports, press releases, Fitch

Company Profile

Lloyd's is a global insurance market comprising 84 syndicates (at end-June 2009). It writes business from over 200 countries and territories and in 2008 reported gross written premiums of GBP17,985m (2007: GBP16,366m).

Most policyholders access the market through Lloyd's brokers. The market is overseen by the Council of Lloyd's and the Franchise Board, while the corporation, managing agents and members' agents are regulated by the Financial Services Authority (FSA).

Capital is provided to the market by members. They can be either private individuals (so-called "names") or corporate capital providers. At year-end 2008, 47% of the capital came from UK corporate sources, with 38% coming from worldwide corporate sources (including the US and Bermuda), and the remainder provided by around 1,900 individual members (either with unlimited liability or conversion capital). The proportion of corporate capital has grown steadily since the 1990s, but has remained relatively flat since 2005.

Syndicates are the vehicles used for underwriting policies. They are not legal entities and are a feature unique to the Lloyd's insurance market. Syndicates can be made up of numerous members, or, as is becoming more common, just one corporate member.

Syndicates are managed by managing agents. These are authorised, regulated legal entities. Managing agents' responsibilities are wide-ranging: they create and implement the syndicate's business plan, employ the underwriters that write the business and process claims. The managing agents are required to report financial results for the syndicates they manage to Lloyd's on a quarterly basis as well as to submit business plans on an annual basis. From 2005, managing agents have also been required to calculate the capital needed by the syndicate to fulfil its business plan and report this to Lloyd's.

Franchise Performance Directorate

Lloyd's has significantly improved the market's risk controls following the establishment of the FPD in January 2003. The aim of the FPD is to improve the market's long-term profitability and performance, with stated emphasis on cycle management in the context of the Three-Year Strategic Plan. It has brought in initiatives aimed at improving business information tools, to enable better-quality data for Lloyd's to assess pricing and rate monitoring processes, reserving and underwriting performance against agreed business plans. In addition, it has a number of benchmarking tools which are shared with the managing agents, which help the managing agents assess their performance against their individual syndicate business plans. During 2009, the new Performance Management Data (PMD) tool was launched, which will improve the level and quality of individual risk data collected from managing agents so that Lloyd's can better monitor the performance of syndicates.

The new entrants' process is managed by Lloyd's Relationship Management team, in conjunction with a multidisciplinary team including senior management from FPD. All new entrant applications must be approved by the Franchise Board. Since the beginning of 2008, 10 new syndicates and five new managing agents have been admitted by Lloyd's to commence operations in the market. Of the 10 new syndicates, two are to write life business, and four have been launched by well-established managing agents. Of the five Managing Agents, 3 are turnkey syndicates transitioning into Managing Agents and 2 are new Managing Agents. The uptick in new entrants partly reflects expectations of improving premium rates, as well as a desire for diversification by non-insurance capital providers. Fitch views positively the additional oversight over new members provided by Lloyd's, which exists for 12-24 months, with frequent reviews, visits and analysis. Additional uplift to capital held, on top of the 35% loading applied to all syndicates' internal capital assessment (ICA) results, is required for three years for all new entrants.

Chain of Security at Lloyd's

Insurance policies issued by Lloyd's are backed by what is often referred to as Lloyd's "Chain of Security", which has three main "links": syndicate-level assets, members' funds at Lloyds and the central assets held as part of the Central Funds at Lloyd's.

The Lloyd's market is characterised by partial mutuality. The mutuality only exists at the central assets level. Prior to this link, members' liabilities are several,

Table 2: Claims-Paying Resources at Lloyd's 31 December 2008

	(GBPm)	Level at which funds are held	Liability
Premium trust funds	38,306	Syndicate	Several
Funds at Lloyd's	10,630	Member	Several
Central Fund	852	Society	Joint
Corporation assets	138	Society	Joint
Subordinated debt/securities	1,082	Society	Joint

Source: Lloyd's

including within an individual syndicate. Table 2 illustrates the claims-paying resources present in the Lloyd's market at end-December 2008.

Ownership Structure

Lloyd's is a marketplace rather than a corporation or company, and thus does not have owners or shareholders like all other traditional insurance companies. Capital is provided to Lloyd's by corporate and individual members, as described in the section above.

Key Events

In June 2009, the UK High Court gave the necessary approval for Phase 2 of the Equitas deal to go ahead. Under Phase 2 of the deal, Equitas has purchased further USD1.3bn of reinsurance cover from Berkshire Hathaway for a premium of GBP40m, with Lloyd's paying a further GBP18m.

In April 2009, Lloyd's repurchased the local currency equivalent of GBP102m of its outstanding subordinated debt, taking advantage of the favourable pricing conditions in the market and its strong capital position. In Fitch's opinion, this transaction, while marginally positive for the quality of capital, had no material impact on the Insurer Financial Strength Rating.

In 2009, Lloyd's continued its international development, gaining approval as the first 'admitted' reinsurer in Brazil. It opened an office in Brazil in April 2009. In addition, representative offices were opened in Ireland and Poland during 2008. In 2009, Lloyd's obtained approval for an establishment licence in Portugal.

A rolling Three-Year Plan for 2009-2011 was revised during 2008 and published in December 2008, with the emphasis on managing the challenging conditions in the financial markets and changing conditions in the insurance markets, and maintaining underwriting discipline among managing agents. While a focus remains on managing the soft cycle which persists in a number of business lines, the FPD has also recognised the importance of preparing the market for a potential turning of the cycle, with measures such as fast-track approval of revised business plans and the associated changes to capital requirements considered.

On 27 March 2007, Phase 1 of Lloyd's arrangement for the Equitas/Berkshire Hathaway deal became effective. Under Phase 1, Berkshire Hathaway provides USD14bn of reinsurance cover (USD5.7bn above the net undiscounted claims reserves at end-March 2006) to Equitas for GBP358m, of which Lloyd's paid GBP72m during 2007. Under the agreement, Berkshire Hathaway's unit National Indemnity Co has taken on the staff and operations of Equitas and will now handle the run-off of Equitas's liabilities.

Also during 2007, Lloyd's issued GBP500m of Tier 1 subordinated hybrid debt, with the proceeds used to repay the syndicate loans and strengthen the Central Fund. This was the second debt issuance made by Lloyd's, with the first issuance going to market in 2004 and raising GBP500m of subordinated debt.

Progress in the market reform initiative continues to be made, with over 80% of all claims and original premium transactions now being processed electronically, after the launch of the Electronic Claims File (ECF) in September 2006.

In April 2007, Lloyd's established a subsidiary in China (Lloyd's Reinsurance Company (China) Ltd), and saw significant growth in Lloyd's Asia platform based in Singapore, expanding to 15 syndicates by 2009. Initiatives focused on expanding the franchise into South America, India and the Middle East continued during 2007.

Products

The portfolios of syndicates at Lloyd's benefit from significant diversification across both products and geographies. The split of premiums by line of business has remained stable (see Table 3).

Table 3: Lloyd's Split of GWP By Non-Life Line of Business

	2008	2007	2008 (%)	2007 (%)
Reinsurance	6,298	5,453	35	33
Property	3,971	3,809	22	23
Casualty	3,762	3,364	21	21
Marine	1,334	1,226	8	8
Energy	1,150	1,019	6	6
Motor	939	983	5	6
Aviation	481	464	3	3
Total	17,935	16,318	100	100

Source: Fitch

The reinsurance sector covers both short and long tail, with a variety of placement types including facultative, proportional treaties and non-proportional treaties such as excess-of-loss placements. The largest classes of business within reinsurance are property facultative, catastrophe excess of loss and property non-proportional risk excess. The sector also includes class-specific reinsurance such as energy and aviation.

The property sector covers both commercial and private property, with the US responsible for the largest geographical share of the segment.

The 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 is within the US, UK and European markets.

The marine sector's most significant classes of business are hull, cargo, marine liability and specie. The International Group of P&I Clubs' programme constitutes a major part of the marine liability class of business.

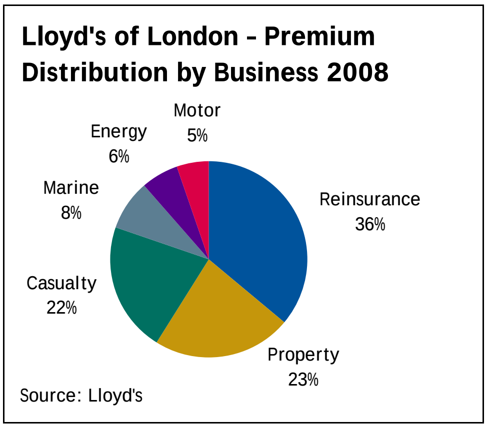
The mix of motor business written within Lloyd's has changed recently, moving away from private car insurance due to strong competitive pressure from the traditional insurance market and consumer-facing organisations such as supermarkets and aggregator websites. Less than half the current motor premium income at Lloyd's comes from private car insurance, and the shift has been towards company fleet business and non-standard risks such as high-value vehicles, vintage or collectors' vehicles, high-risk drivers and affinity groups. Around 16% of motor business originates outside the UK.

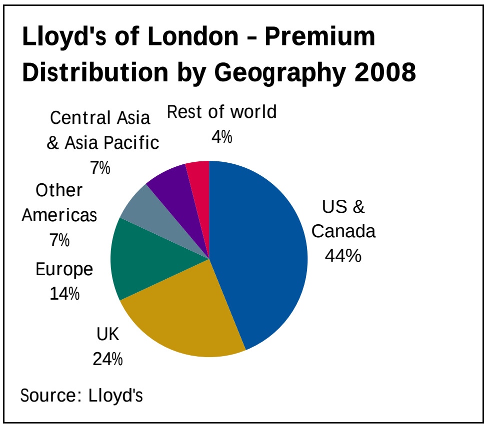
The risks underwritten as part of the energy portfolio include a variety of onshore and offshore property and liability classes, ranging from construction to exploration and production, refinery and distribution. A significant part of the portfolio is offshore energy business and a large proportion of this is located in the Gulf of Mexico.

Lloyd's is an industry leader within the global aviation market and has a balanced portfolio across all sectors of this class, including airline, aerospace, general aviation and space business.

Target Markets

Lloyd's provides insurance and reinsurance cover to a wide variety of segments across the globe, and Fitch considers it a well-diversified provider. The current geographical reach of Lloyd's has not changed materially since 2006 (see the Lloyd's of London – Premium Distribution by Geography 2008 chart). In addition, Lloyd's is committed to expanding its presence in Asia and Latin America: recent initiatives include the opening of the Lloyd's subsidiary in China and an office in Brazil.





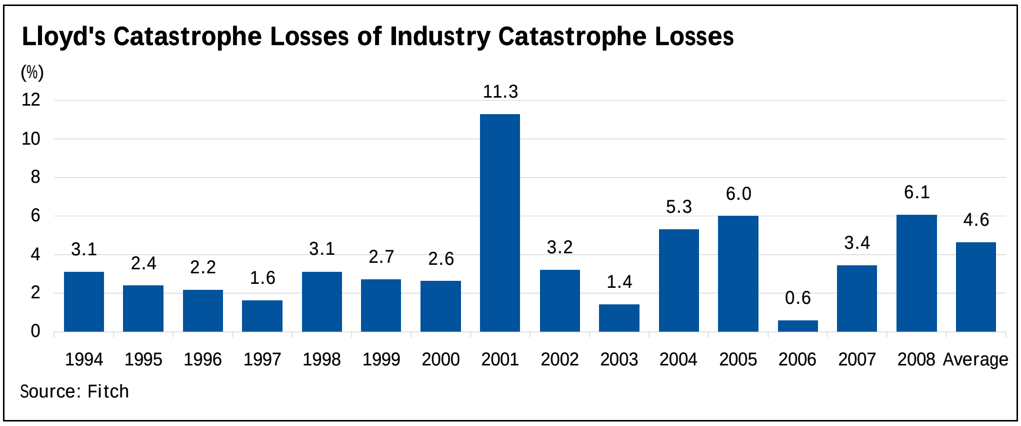
Distribution Channels

The distribution of products at Lloyd's is primarily carried out through brokers, with some business placed directly with service companies owned by managing agents. A large proportion of the business is conducted in the underwriting room at Lloyd's, where face-to-face negotiations between brokers and underwriters take place. Most business continues to be placed into the market by the 176 firms of Lloyd's brokers.

Financial Analysis

Profitability

The market's earnings in 2008 were hit by a combination of catastrophe losses and lower investment returns. Partly offsetting this were the substantial gains made on the depreciation of sterling and continuing strong reserve releases from prior accident years. Overall, even amid the difficult conditions in the investment markets and losses arising from the third-worst cat year on record, Lloyd's still delivered its third-highest net income of GBP1,900m, which is viewed positively from a credit perspective. Less positively, Lloyd's share of the total insurance market losses in 2008 was high, at around 6%, compared with the average of around 3% in the years of low cat activity. Fitch has in the past stated that a true reflection of the FPD's efforts will come in years of high catastrophe activities, and that its success will be best measured by its ability to demonstrate reduced volatility of results relative to the rest of the industry. While this volatility still exists, when viewed in the context of Lloyd's risk profile and relative to other reinsurance players, its performance in 2008 was relatively resilient, with ROE reaching 13.7%, down from a record 29.3% in 2007.



Underwriting performance in 2008 was negatively impacted by a high level of cat activity, as well as a softening rate environment, offset to some extent by prior year releases. Accident year combined ratio deteriorated relative to the 2007 result, but was strong and compared well to peers in the context of the high level of cat losses suffered by the market.

Table 4: Underwriting Performance - Combined Ratio[a] (CR)

(%)	2008	2007	2006
Acc. yr. (excl. cat) CR	91.1	87.0	84.8
Catastrophes	12.7	3.8	0.4
Prior yrs.	(6.3)	(5.9)	(2.1)
Calendar yr. CR	**97.5**	**84.9**	**83.1**

[a] All years excl. FX gains/losses
Source: Fitch

The quality of earnings in 2008 suffered due to a high contribution from one-off FX gains, which are expected to reverse in 2009. Table 5 shows historical profitability by source of profit, as well as expected profitability for 2009, assuming a "normal" cat year, 5% growth in GWP and no further movements in FX apart from the reversal of the some of the 2008 gains. The table also demonstrates Lloyd's partial historical dependence on prior year profits and investment income, both of which are expected to reduce in the near future.

Table 5: Financial Year

	2004	2005	2006	2007	2008	2009F
Underwriting result (excl. PY & FX)	1,160	(580)	3,055	2,341	32	921
Prior years (excl. FX)	(302)	14	270	866	856	600
Investment income[a]	635	793	704	784	414	289
FX gains/(losses)	70	(117)	(226)	115	853	(370)
Other income/expense	(196)	(213)	(141)	(260)	(256)	(219)
Net income	**1,367**	**(103)**	**3,662**	**3,846**	**1,899**	**1,221**

[a] Excludes technical interest
Source: Lloyd's, Fitch

On a calendar year basis, taking into account performance of both the current and the prior years, 2008 was profitable for all classes of business, apart from energy (which was affected by the hurricanes), although the motor business was very close to break-even. Aviation, where the current year's pricing continues to suffer from a lack of adequate rates and overcapacity, benefitted the most from prior year releases. The motor business also faces a difficult competitive environment, with limited support from prior year releases.

Table 6: Lloyd's Combined Ratio (%)[a]: By Line of Business

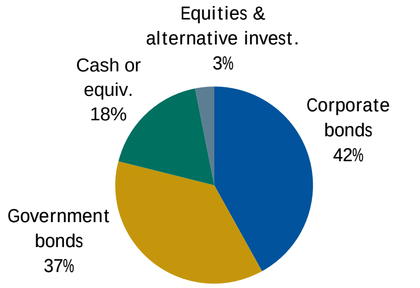
Calendar year	2008	2007	2006	2005	2004
Reinsurance	83.8	81.7	80.8	135.1	94.6
Casualty	95.1	92.7	89.0	93.9	108.8
Property	96.7	86.3	81.9	118.5	95.8
Marine	84.6	87.4	88.6	91.4	87.4
Motor	99.6	98.4	96.4	91.2	93.3
Energy	123.8	73.4	98.8	146.9	82.5
Aviation	86.8	84.5	65.1	70.6	72.6

[a] Includes impact of movement in prior-year reserves
Source: Lloyd's, Fitch

Investments and Liquidity

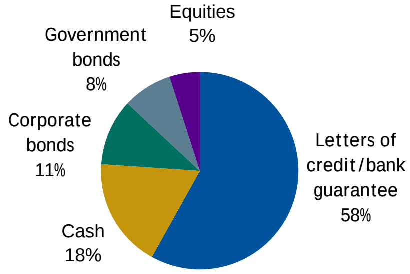
Lloyd's operates a conservative investment policy. It has investment criteria for all of the links in the Chain of Security. Asset allocation is fairly conservative when looking at the aggregate of PTFs, FAL and the Central Fund; however, substantial variation exists at the PTFs and FAL levels for individual syndicates, which was reflected in a wide variation of investment returns among syndicates in 2008.

Syndicate PTF Investments
31 Dec 2008



Source: Fitch

Members' FAL Investments
31 Dec 2008



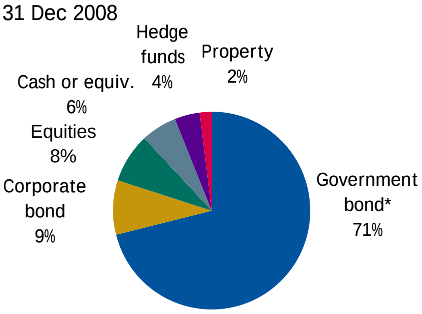
Source: Fitch

The PTFs investments follow the guidelines set out by the FSA, and are generally invested in liquid, short-duration, high-quality assets. Around 80% of assets are invested in bonds, of which 79% are 'AAA' to 'AA' rated. The amount of bonds rated below 'A' increased from GBP404m (2007) to GBP828m (2008). Syndicates' investments had no material exposure to subprime assets.

FAL investments are dominated by LOC (58%), and this proportion has not changed during the credit crunch, indicating the banks' willingness to engage in this form of lending to the Lloyd's market participants. For LOC, 10 relatively well-rated banks account for 85% of LOC provided. While there is some concentration in the exposure to banks' LOC, the majority of these banks are now partly or wholly supported by national governments, hence the level of concentration is not a major concern to Fitch.

Lloyd's Central Fund assets are invested predominantly in bonds and have enjoyed good returns in recent years, although there has been a significant amount of volatility in the performance of various asset classes. There are no exposures to subordinated or structured debt within Central Fund bond portfolios. The liquidity of the Central Fund assets is good, with the majority of assets able to be liquidated within seven days, at a market price. The ROA was 8.2% in 2008, primarily due to interest rate movement on fixed asset securities, offset by losses on investments in equities.

Central Fund Investments
31 Dec 2008



* Incl G'ment guaranteed and supranational bonds
Source: Fitch

Reinsurance Protection and Credit Quality

Each syndicate is required to make its own reinsurance arrangements. Across the market, the "external"' reinsurance utilisation rate is around 21% (2007: 19%), down from a high of 25% in 2003. Reinsurance within the market between syndicates is excluded from this ratio.

Reinsurance Recoverables

Lloyd's has been proactively managing its reinsurance recoverables, one of the largest entries on its balance sheet, which at year-end 2008 totalled GBP10.5bn (shown as reinsurers' share of technical reserves on page 17 in the balance sheet) significantly down from a peak of GBP17.4bn at the end of 2001 following the 11 September 2001 terrorist attack in the US, but up 34% from YE07 due to recoveries associated with Hurricane Ike and foreign exchange movements. Fitch regards the reinsurance recoverables as generally of high quality, with 95% of reinsurers being rated 'A-' and above, and adequately diversified.

The value of aged debt is also at its lowest since 2001, with GBP161m aged at six months or greater — a 36% improvement on year-end 2007 figures. There has been a marked improvement in this area, as it has been a key area of focus for Lloyd's, and meetings are regularly held with managing agents, brokers and reinsurers to address this issue. As a result, the definition of "aged" debt has been revised from 12 months to six months old, as older debt has been eliminated from the balance sheet.

Reserve Adequacy and Development

Lloyd's reserving position has improved significantly since both the 1992 and prior liabilities were reinsured into Equitas in 1996 and then subsequently further reinsured with the Berkshire Hathaway Phase 1 and Phase 2 deals in 2007 and 2009. Prior to the establishment of Equitas, the long-tail exposures (including asbestos) which existed within Lloyd's were extremely large and jeopardised the functioning of the entire Lloyd's market.

Equitas was therefore set up to provide some degree of "finality" to the names concerned and to allow the Lloyd's market to continue trading. In return for reinsuring the 1992 and prior liabilities, Equitas was capitalised with a transfer of existing reserves and additional reinsurance premiums from individual members. At its eventual launch in September 1996, Equitas was capitalised at GBP14.8bn.

With the transfer of long-tailed liabilities into Equitas, the reserving position of Lloyd's is now much less volatile, as the proportion of long-tailed reserves is significantly diminished. Over the last two years, the results of Lloyd's have benefitted from reserve releases, on the back of the hard market environment of the early 2000s, when profitable business was written at high premium rates, and prudent reserves were established. In 2008, overall reserve releases reached GBP856m, excluding the impact of FX, as claims continued to develop within projections for the third year running. Fitch believes these releases from prior reserves reflect actual redundancies, rather than a weakening in reserve strength. However, Fitch also believes this to be the peak of releases, with future releases to be at more modest levels, excluding impact of any FX movements.

The ratio of incurred but not reported (IBNR) claims to total reserves has remained stable since 2003 at around 45%, which, given no significant change in the mix of business underwritten, suggests that reserving strength has not been compromised by the recent releases. In addition, IBNR usage (defined as the ratio of decrease in IBNR during the calendar year to starting IBNR) has declined significantly in recent years to around 25% on a gross basis and 20% on a net basis, down from a high of over 40% on a gross basis in 2003. This reduction supports the releases from reserves, and reduces the severity of any potential deterioration in IBNR. In addition, the incurred cost of the 2005 US hurricanes stabilised during 2006 and 2007, with no further deterioration of reserves relating to these claims expected in the future. The incurred cost of the 2008 accident year storms, while still in the early stages, is also developing as expected. The level of gross incurred losses for sub-prime/credit crunch-/Madoff-related claims remains relatively modest and has been stable in recent months.

Capitalisation

In Fitch's view, Lloyd's has strong capitalisation. The capital strength of Lloyd's is derived from assets held as part of member capital and central capital. Following the 10% decline in net assets during 2005 (when Lloyd's was hit hard by the impact of the US hurricanes) capitalisation improved significantly, increasing by 35% over the following three years to reach GBP14.2bn of net assets at YE08.

Lloyd's follows a risk-based approach to setting the capital at member level and Central Capital. At member level, the capital is set at 135% (this percentage has not changed since 2006) of the syndicates' ICA result — Lloyd's reviews each syndicate's ICA in detail, and requires uplifts if it deems the syndicate's calculations deficient. Lloyd's believes that the 35% loading allows for sufficient capital to maintain financial strength and credit ratings at their current levels. In 2009, Lloyd's has maintained its 35% uplift, but is revising some areas of its methodology to reflect changes regarding diversification and correlations assumptions. In addition, the process will in future move to a stochastic approach for modelling of underwriting and reserving risks. Results of this modelling with be used as a benchmark for comparison to syndicates' own ICA models. In 2009, capital requirements are expected to increase, due to the planned increase in the volume of business written. Fitch views the capital requirements imposed by Lloyd's on the market participants as appropriate for the current level of rating, and will monitor any substantial changes in these requirements over time.

The Central Capital requirement decreased in 2008 and again in 2009, driven by some revisions to the society's ICA model and a change in some assumptions. In particular, for the 2009 capital requirement, reductions were driven by expectation of stabilisation in rates from previous projections of reductions, and by the revision of correlation and volatility assumptions, which Fitch views as somewhat optimistic in the current conditions. These decreases were offset by some changes in assumptions on market risk, as well as currency movements. Partly as a result of reduction in capital requirement, as well as a slight increase in free central assets, coverage of the ICA requirement improved moderately.

The FSA regularly reviews a sample of syndicates' ICAs in parallel with Lloyd's, and has in the past identified only a small number of cases where it would have applied a higher uplift than that recommended by Lloyd's.

Financial Leverage and Balance Sheet Quality

Fitch believes Lloyd's uses a minimal amount of financial leverage on the balance sheet, with the leverage levels able to increase up to the 30% range before it would exceed Fitch's range of leverage guidelines at the current rating level. The capital structure of Lloyd's includes two issues of subordinated bonds and perpetual securities, amounts to GBP1.1m of subordinated debt on the balance sheet at YE08 and results in modest levels of leverage. According to its hybrid equity criteria, Fitch had originally designated each of these as class D securities and assigned 75% equity credit to them for the purposes of calculating capital adequacy and financial leverage. As these securities near their effective maturity dates, determined by the call and step up dates, the equity credit is reduced to 50%, 25% or 0%.

Fitch believes that Lloyd's has good quality of capital, with very low levels of intangible assets and deferred acquisition costs.

Debt-Servicing Capabilities

The subordinated debt issued in 2004 and 2007 is the obligation of the society. In a going-concern scenario, the society has several options available for the repayment of principal and interest, as it has complete discretion over the use of the Central Fund. The Central Fund receives a regular supply of funds from the syndicate contributions, syndicate loans and investment income. Furthermore, if necessary, the society could increase members' contributions, impose a premium levy as it has in the past, or use the callable layer. These can all be used on an ongoing basis to pay the interest on the debt.

Summary Rating Data

(GBPm)	2004	2005	2006	2007	2008
Key financials					
Total revenue	12,901.0	13,268.0	14,930.0	15,263.0	15,174.0
Operating result	1,563.0	110.0	3,871.0	4,106.0	2,155.0
Net income	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Combined ratio (%)	96.7	111.8	82.8	83.9	91.2
Return on revenue (%)	12.1	0.8	25.9	26.9	14.2
Total assets	39,171.0	43,404.0	42,503.0	44,007.0	53,594.0
Total adjusted equity	11,663.0	10,491.0	12,836.0	13,449.0	14,182.0
Coverage of the estimated minimum margin (x)	6.2	5.6	6.1	6.3	6.2
Business statistics					
Nonlife gross written premiums	14,614.0	14,982.0	16,414.0	16,366.0	17,985.0
Annual change (%)	(11.0)	2.5	9.6	(0.3)	9.9
Total gross written premiums	14,614.0	14,982.0	16,414.0	16,366.0	17,985.0
Annual change (%)	(11.0)	2.5	9.6	(0.3)	9.9
Nonlife net written premiums	11,734.0	11,770.0	13,201.0	13,256.0	14,217.0
Annual change (%)	(4.2)	0.3	12.2	0.4	7.2
Total net written premiums	11,734.0	11,770.0	13,201.0	13,256.0	14,217.0
Annual change (%)	(4.2)	0.3	12.2	0.4	7.2
Operating statistics					
Total revenue	12,901.0	13,268.0	14,930.0	15,263.0	15,174.0
Operating result	1,563.0	110.0	3,871.0	4,106.0	2,155.0
Net income	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Return on revenue (ex. gains) (%)	12.1	0.8	25.9	26.9	14.2
Return on revenue (incl. gains) (%)	12.1	0.8	25.9	26.9	14.2
Return on assets (incl. gains) (%)	3.6	(0.2)	8.5	8.9	3.9
Return on book equity (incl. gains) (%)	12.5	(0.9)	31.4	29.3	13.7
Return on adj. equity (incl. gains) (%)	12.5	(0.9)	31.4	29.3	13.7
Nonlife					
Incurred loss ratio (%)	64.8	80.7	49.0	50.0	61.4
Commission ratio (%)	23.8	24.7	25.1	26.3	27.0
Expense ratio (%)	7.5	7.4	6.9	8.4	8.9
Reins. comm., profit participation, other ratio (%)	0.6	(1.0)	1.7	(0.9)	(6.0)
Combined ratio (%)	96.7	111.8	82.8	83.9	91.2
Portfolio performance					
Net investment income	1,167.0	1,498.0	1,729.0	2,007.0	957.0
Running yield (%)	3.9	4.5	4.9	5.6	2.4
Running yield (incl. realised gains) (%)	3.9	4.5	4.9	5.6	2.4
Running yield on technical reserves (%)	2.3	2.7	3.6	4.7	1.8
Total yield (incl. unrealised gains) (%)	3.9	4.5	4.9	5.6	2.4
Portfolio composition (%)					
Real estate	0.0	0.0	0.0	0.0	0.0
Shares	10.2	8.5	11.1	11.5	10.2
Affiliate equity	0.0	0.0	0.0	0.0	0.0
Affiliate loans	0.0	0.0	0.0	0.0	0.0
Bonds	54.4	57.9	54.6	56.3	56.7
Loans	0.0	0.0	0.0	0.0	0.0
Mortgages	0.0	0.0	0.0	0.0	0.0
Cash and bank deposits	35.3	33.6	34.2	32.2	33.0
Bank deposits	9.5	10.6	11.7	11.9	11.8
Current bank accounts and cash	25.8	23.0	22.6	20.3	21.2
Deposits with cedents	0.0	0.0	0.0	0.0	0.0
Other invested assets	0.1	0.0	0.0	0.0	0.0

Source: Fitch

Summary Rating Data (Cont.)

(GBPm)	2004	2005	2006	2007	2008
Financial statistics					
Total assets	39,171.0	43,404.0	42,503.0	44,007.0	53,594.0
Total adjusted equity	11,663.0	10,491.0	12,836.0	13,449.0	14,182.0
Change in adj. equity (%)	15.0	(10.0)	22.4	4.8	5.5
Coverage of the estimated minimum margin (x)	6.2	5.6	6.1	6.3	6.2
Non-life technical reserves/non-life NPW (%)	201.4	237.0	195.4	198.5	237.2
Non-life claims reserves/non-life NPW (%)	163.4	197.7	160.0	162.4	196.4
Life technical reserves/life NPW (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Non-life technical reserves/adj. equity (%)	202.6	265.9	200.9	195.6	237.8
Technical reserves/adj. equity (%)	202.6	265.9	200.9	195.6	237.8
Invested assets/(adj. equity + technical reserves) (%)	89.0	91.2	90.9	93.0	92.6
Liquid assets/technical reserves (%)	132.8	125.5	136.0	140.6	131.5
Investment leverage (%)	27.5	28.2	30.3	31.6	31.9
Affiliated investment leverage (%)	27.5	28.2	30.3	31.6	31.9
Debt/capital (%)	4.2	4.6	3.7	7.0	7.1
Interest coverage (x)	n.a.	n.a.	n.a.	n.a.	n.a.
Fixed charge coverage (x)	n.a.	n.a.	n.a.	n.a.	n.a.
Nonlife reinsurance utilisation ratio (%)	19.7	21.4	19.6	19.0	21.0
Life reinsurance utilisation ratio (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Tax rate (%)	0.0	0.0	0.0	0.0	0.0
Minority interests/net income (%)	0.0	0.0	0.0	0.0	0.0
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0

Source: Fitch

Balance Sheet

(GBPm)	2004	2005	2006	2007	2008
Assets					
Investments					
Real estate					
Shares	3,202.0	2,962.0	3,891.0	4,255.0	4,529.0
Affiliate equity					
Affiliate loans					
Bonds	17,095.0	20,279.0	19,174.0	20,811.0	25,176.0
Loans					
Mortgages					
Cash and bank deposits	11,081.0	11,764.0	12,019.0	11,911.0	14,644.0
Bank deposits	2,976.0	3,719.0	4,093.0	4,414.0	5,216.0
Current bank accounts and cash	8,105.0	8,045.0	7,926.0	7,497.0	9,428.0
Deposits with cedents	15.0	14.0	17.0	9.0	10.0
Other invested assets	34.0	7.0	7.0	4.0	18.0
Total investments (non-linked)	31,427.0	35,026.0	35,108.0	36,990.0	44,377.0
Unit linked investments					
Total banking assets					
Insurance receivables	3,444.0	3,853.0	3,520.0	3,428.0	4,663.0
Reinsurance receivables	3,411.0	3,629.0	3,190.0	2,918.0	3,763.0
Other receivables	687.0	685.0	382.0	318.0	419.0
Life acquisition costs					
Non-life acquisition costs					
Differences from consolidation					
Tangible assets	16.0	17.0	22.0	26.0	30.0
Goodwill					
Other intangible assets					
Accruals	174.0	184.0	261.0	299.0	334.0
Other assets	12.0	10.0	20.0	28.0	8.0
Total assets	39,171.0	43,404.0	42,503.0	44,007.0	53,594.0
Liabilities					
Technical reserves					
Unearned premium reserve	6,780.0	6,829.0	7,024.0	7,282.0	9,043.0
Reinsurers' share	(872.0)	(696.0)	(771.0)	(841.0)	(1,167.0)
Less deferred acquisition costs	(1,444.0)	(1,503.0)	(1,582.0)	(1,656.0)	(2,064.0)
Outstanding claims reserve	28,849.0	37,719.0	30,377.0	28,971.0	38,420.0
Reinsurers' share	(9,678.0)	(14,450.0)	(9,259.0)	(7,449.0)	(10,504.0)
Other technical provisions					
Reinsurers' share					
Total non-life technical reserves	23,635.0	27,899.0	25,789.0	26,307.0	33,728.0
Total technical reserves (non-linked)	23,635.0	27,899.0	25,789.0	26,307.0	33,728.0
Unit linked liabilities					
Total banking liabilities					
Reinsurance deposits	37.0	142.0	69.0	42.0	161.0
Insurance payables	458.0	884.0	831.0	697.0	770.0
Reinsurance payables	1,894.0	2,228.0	1,643.0	1,534.0	2,517.0
Provisions for other risks and charges					
Short-term debt					
Long-term debt					
Subordinated debt - liability	506.0	501.0	497.0	1,012.0	1,082.0
Secured lending					
Fund for future appropriation					
Other creditors	758.0	1,113.0	715.0	774.0	883.0
Accruals	220.0	146.0	123.0	192.0	274.0
Other liabilities					
Total liabilities	27,508.0	32,913.0	29,667.0	30,558.0	39,415.0

Source: Fitch

Balance Sheet (cont.)

(GBPm)	2004	2005	2006	2007	2008
Equity					
Members FAL	9,622.0	10,206.0	11,282.0	9,858.0	10,630.0
Members balances	1,426.0	(408.0)	597.0	2,652.0	2,562.0
Central fund balance	615.0	693.0	957.0	939.0	990.0
Corporation reserves					
Reserve for own shares					
Profit and loss account					
Total shareholders' funds	**11,663.0**	**10,491.0**	**12,836.0**	**13,449.0**	**14,182.0**
Claims equalisation reserve					
Minority interests					
Total equity	**11,663.0**	**10,491.0**	**12,836.0**	**13,449.0**	**14,182.0**
Surplus value of investments	0.0	0.0	0.0	0.0	0.0
Uncalled capital	0.0	0.0	0.0	0.0	0.0
Own shares (treasury stock)	0.0	0.0	0.0	0.0	0.0
Adjusted equity	**11,663.0**	**10,491.0**	**12,836.0**	**13,449.0**	**14,182.0**

Source: Fitch

Profit & Loss Account

(GBPm)	2004	2005	2006	2007	2008
Nonlife technical account					
Gross written premiums	14,614.0	14,982.0	16,414.0	16,366.0	17,985.0
Premiums ceded	(2,880.0)	(3,212.0)	(3,213.0)	(3,110.0)	(3,768.0)
Net written premiums	11,734.0	11,770.0	13,201.0	13,256.0	14,217.0
Change in UPR	(63.0)	(15.0)	513.0	159.0	421.0
Net premiums earned	11,797.0	11,785.0	12,688.0	13,097.0	13,796.0
Gross claims paid	8,387.0	10,181.0	11,718.0	8,741.0	9,736.0
Reinsurance recoveries	2,967.0	3,418.0	5,120.0	2,515.0	2,158.0
Net claims paid	5,420.0	6,763.0	6,598.0	6,226.0	7,578.0
Change in claims case reserves	2,226.0	2,742.0	(379.0)	321.0	886.0
Change in IBNR					
Net claims incurred	7,646.0	9,505.0	6,219.0	6,547.0	8,464.0
Premium refunds					
Acquisition costs	2,805.0	2,913.0	3,191.0	3,449.0	3,720.0
Increase in deferred acquisition costs					
Administrative expenses	880.0	872.0	910.0	1,117.0	1,267.0
Renewal commission					
Reinsurance commission and profit participation					
Other underwriting income/(expenses)	(70.0)	117.0	(226.0)	115.0	853.0
Total underwriting expenses (excl. FX)	3,755.0	3,668.0	4,327.0	4,451.0	4,134.0
Technical interest	532.0	705.0	957.0	1,223.0	543.0
Nonlife underwriting result	928.0	(683.0)	3,099.0	3,322.0	1,741.0
Non-technical account					
Investment income	1,167.0	1,498.0	1,729.0	2,007.0	957.0
Investment expenses					
Less technical interest	(532.0)	(705.0)	(957.0)	(1,223.0)	(543.0)
Net investment income	635.0	793.0	772.0	784.0	414.0
Interest paid	0.0	0.0	0.0	0.0	0.0
Operating result	1,563.0	110.0	3,871.0	4,106.0	2,155.0
Non-insurance activities					
Amortisation of goodwill and other intangibles					
Other income/(expenses)	(196.0)	(213.0)	(209.0)	(260.0)	(256.0)
Pre-tax income before realised gains	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Realised capital gains/(losses)					
Less technical realised gains/(losses) in life account					
Pre-tax income	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Tax					
Net income	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Minority interests					
Change in claims equalisation reserve					
Unrealised capital gains/(losses)					
Less technical unrealised gains/(losses) in life account					
Reported net income	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0
Allocation of profit					
Profit brought forward	0.0	0.0	0.0	0.0	0.0
Ordinary dividends	0.0	0.0	0.0	0.0	0.0
Preferred dividends	0.0	0.0	0.0	0.0	0.0
To reserves	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Profit carried forward	0.0	0.0	0.0	0.0	0.0
Balance	1,367.0	(103.0)	3,662.0	3,846.0	1,899.0

Source: Fitch