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Research Update: Lloyd's Upgraded To 'A+' On Completed Equitas Reinsurance Transaction And Process Reform

United Kingdom

Summary

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■ Rationale

On April 23, 2007, Standard & Poor's Ratings Services raised its insurer financial strength rating on the U.K.-based Lloyd's insurance market (Lloyd's or the Market) to 'A+' from 'A'. At the same time, Standard & Poor's raised its counterparty credit rating on The Society of Lloyd's to 'A+' from 'A'. The outlook is stable.

The upgrade reflects the recent successful conclusion of phase 1 of the Equitas group's (Equitas; not rated) transaction with National Indemnity Co. (NICO; AAA/Stable/--); progress with regard to phase 2; and the unstoppable momentum behind improving London Market business processes.

In the Equitas transaction, NICO will provide up to £3.8 billion (\$7.0 billion) of reinsurance for Equitas' loss reserves, rendering the likelihood of a future Equitas deficit and any related contribution from Lloyd's remote. Phase 1 involves a £3.1 billion reinsurance, and phase 2 involves a novation of liabilities from Lloyd's members to Equitas and the provision of a further £0.7 billion of reinsurance.

The ratings reflect Lloyd's strong competitive position, strong operating performance, strong capitalization, and strong financial flexibility. These positive factors are partly offset, however, by relatively high reinsurance reliance and continuing operating performance volatility. The consistency and effectiveness of strengthened catastrophe risk controls are also yet to be tested.

Major rating factors:

- Lloyd's competitive position is strong, supported by the positive attributes associated with its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance and reinsurance market, and policyholder loyalty. The Market's competitive position has been enhanced further by the recent successful conclusion of phase 1 of the Equitas transaction with NICO and progress with regard to phase 2, as well as the unstoppable momentum behind improving London Market business processes.
- Lloyd's prospective operating performance will be strong. Extremely benign catastrophe loss experience led to the Market posting a combined ratio of 83.1% and record profit before tax of £3.7 billion for 2006, in stark contrast to the 111.8% combined ratio and £103 million loss recorded for 2005. Pricing levels have passed their peak, but the Market still provides an attractive underwriting environment. Standard & Poor's improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels tolerated prior to 2002. Some performance volatility will remain, however, reflecting the nature of the business lines on which Lloyd's focuses.
- Capitalization is strong, supported by strong and improved capital adequacy and the expected continued efficacy of capital-setting processes. In the short to medium term, Standard & Poor's expects the

continuing Market (that is, syndicates not in run-off) to report aggregate positive reserve movements. Relatively high reliance on reinsurance remains a detraction.

- Lloyd's financial flexibility is strong, being principally derived from capital providers' continued support. This was most recently demonstrated by capital providers' response to the capital and liquidity demands generated by the 2005 hurricane season and recent Market capacity increases. Flexibility has also improved in light of the progress being made with regard to Equitas' reinsurance transaction and the declining trend of Central Fund undertakings to insolvent members.
- The 2005 performance of some Lloyd's franchisees highlighted some catastrophe risk control deficiencies that appeared to be common to the reinsurance and insurance industries. Management action in the intervening period has sought to address highlighted weaknesses, but its consistency and effectiveness is yet to be tested following the benign nature of 2006.

■ Outlook

The stable outlook reflects the following expectations of Standard & Poor's:

- Subject to normal catastrophe loss experience for 2007, Lloyd's will post a combined ratio below 95% and ROR greater than 12%. Performance will weaken in 2008 in line with an anticipated continuing softening operating environment.
- Lloyd's main capital providers will remain committed to the Market.
- There will be further rapid improvement in the London Market's administrative processes. Momentum should continue to build with regard to claims processing, accounting and settlement, and policy placement, and legacy issues will start to be addressed.
- Catastrophe-related operational weaknesses will prove to have been successfully strengthened.
- Capital adequacy will remain strong, as reflected in central assets available for solvency purposes remaining at about £1.75 billion and Lloyd's solvency ratio remaining above 300%.
- Operating performance of the continuing Market will not be negatively affected by further net deterioration in technical reserves. The drag on Lloyd's from run-off syndicates will continue to decline.
- Undertakings given to insolvent members will continue declining (charge for undertakings was £114.6 million in 2006).
- Equitas will successfully complete phase 2 of the NICO transaction.

An outlook revision to positive is unlikely in the medium term, and would depend on Lloyd's significantly outperforming targets over a sustained period. An outlook revision to negative is also unlikely, but would likely be driven mainly by operating performance returning to levels recorded prior to 2002, reflecting poor management of the softening underwriting cycle. Failure to complete the administrative process reform would also result in a negative outlook.

■ Ratings List

| | To | From |
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| Lloyd's | | |

Insurer financial strength rating
A+/Stable A/Positive

Underwriters at Lloyds of London, Illinois
Insurer financial strength rating
A+/Stable A/Positive

Underwriters at Lloyds of London, Kentucky
Insurer financial strength rating
A+/Stable A/Positive

Lloyd's Reinsurance Co. (China) Ltd.
Insurer financial strength rating
A+/Stable A/Positive

Society of Lloyd's (The)
Counterparty credit rating
A+/Stable/-- A/Positive/--

NB: This list does not include all ratings affected.

Ratings information is available to subscribers of ClassicDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.eclassicdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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