Research Update:
Lloyd's Outlook To Positive On Improved Competitive Position, Ongoing Capital Model Development; 'A+' Ratings Affirmed

Primary Credit Analyst:
Dennis P Sugrue, London (44) 20-7176-7056; dennis_sugrue@standardandpoors.com

Secondary Contact:
Mark Coleman, London (44) 20-7176-7006; mark_coleman@standardandpoors.com

Table Of Contents

Overview
Rating Action
Rationale
Outlook
Related Criteria And Research
Ratings List
Research Update:

Lloyd's Outlook To Positive On Improved Competitive Position, Ongoing Capital Model Development; 'A+' Ratings Affirmed

Overview

• Our view of Lloyd's (Lloyd's, the Corporation's or the Market's) competitive position has improved relative to its peers, and the Market has continued to make progress toward implementing its internal model for use in the capital setting process despite delays in Solvency II implementation in Europe.
• The Market's 2011 results were broadly in line with our expectations in spite of record losses in the year, and stronger than global peers.
• We are affirming our 'A+' long-term insurer financial strength ratings on Lloyd's, and our 'A+' counterparty credit ratings on The Society of Lloyd's.
• We are revising the outlook to positive from stable, which means that we could raise the ratings if Lloyd's continues to outperform, retains its capital base, and successfully implements its internal model from 2013.

Rating Action

On Aug. 28, 2012, Standard & Poor's Ratings Services affirmed its 'A+' insurer financial strength ratings on U.K.-based Lloyd's insurance market (Lloyd's, the Corporation or the Market). At the same time, we affirmed our 'A+' long-term counterparty credit ratings on The Society of Lloyd's. We revised the outlooks on all of these ratings to positive from stable.

Rationale

The outlook revision reflects our improved view of Lloyd's competitive position, its operating performance in 2011—which was broadly in line with our expectations in spite of record losses—and continued progress toward implementing the internal model despite delays in transition to the Solvency II regime in Europe. We also observe that the convergence between Lloyd's internal model and the proposed standard formula for required capital is much reduced following changes to capital charges for non-EU natural catastrophe business.

The ratings reflect Standard & Poor's view of Lloyd's very strong competitive position, strong operating performance, strong capitalization, strong enterprise risk management, and strong financial flexibility. These positive factors are partly offset, however, by Lloyd's relatively high utilization of reinsurance and letters of credit (LOCs) for capital support and the inherent
potential for operating performance volatility.

Lloyd's competitive position is very strong, and a key driver for the rating. This position is supported by the positive attributes associated with its unique brand, its attraction as the world's largest subscription market, London's continued position as a major international insurance and reinsurance market, policyholder loyalty, and improving systems and processes. The attractiveness of Lloyd's as an operating platform is evidenced by the continual flow of new entrants and capital providers to the Market in recent years. We expect that Lloyd's will maintain this very strong competitive position, and will continue to enhance it through growth in developing markets in terms of both premiums and capital contribution.

Lloyd's historically strong operating performance supports the rating, and we would expect this to continue in the medium term. The Market has outperformed peers with strong and stable results, and demonstrated less volatility than in the past. We believe that much of this can be attributed to the oversight of the Performance Management Directorate (PMD). We expect operating performance to remain strong, however it will be under pressure from marginal rate adequacy in many lines, low investment returns, and a diminished contribution from releases on prior years. Our base-case projection for Lloyd's operating results would be a combined ratio in the 93%-95% range for full years 2012 and 2013, with pretax profits of at least £1.5 billion and return on revenues of 8%-10%. This assumes catastrophe losses in line with the historical average for the market.

The inherent volatility in operating results continues to be a relative rating weakness, in our view. The nature of much of the business written at Lloyd's--characterized by complexity, large monetary exposure levels, and a high-severity, low-frequency profile of risk--lends itself to potential volatility in earnings. We do not expect Lloyd's to change its underwriting profile materially, however the underwriting oversight in place through the PMD, the more-clearly-defined risk appetites and limits, and the realistic disaster scenario framework all help to mitigate and contain this volatility, as was demonstrated in 2011.

Lloyd's capitalization is strong, supported by what we consider to be very strong capital adequacy, strong quality of capital, Lloyd's much diminished exposure to legacy issues, and the efficacy of the capital-setting processes. In aggregate, Lloyd's has released £5.5 billion in loss reserves since 2005. Despite this, incurred but not reported (IBNR) levels have been maintained at 40%-45% of total loss reserves. Lloyd's high utilization of reinsurance capacity and LOCs--the latter represented £8.1 billion or 53% of members' funds at Lloyd's in 2011--to support its capital needs is a relative credit weakness. LOCs are only eligible as Tier 2 capital under Solvency II proposals, which require 50% of available funds to come from Tier 1 capital. We do not believe that Lloyd's or its members will want to risk operating at the margin of this capital requirement under Solvency II. We view LOCs as a shorter-term capital solution that cannot necessarily be relied upon in the long term.
Lloyd's financial flexibility is strong. The diversity of Lloyd's capital providers represents a unique strength for the Market. In addition to Lloyd's ability as a mutual to call upon its members for further capital and the strong flow of high quality new applicants, financial flexibility is also reinforced by the declining trend of annual undertakings given to insolvent members. Solvency deficits amounted to just £155 million at Dec. 31, 2011, down from £482 million in 2005. We expect this financial flexibility to remain strong, and improve as Lloyd's looks to maintain its mutual structure, while expanding the diversity and scope of its capital providers to developing markets.

**Outlook**

The positive outlook on Lloyd's reflects our view of the Market's improving competitive position, strong results in 2011 in spite of large catastrophe losses, and our belief that the risk to capital from not achieving internal model approval under Solvency II is reduced following further refinements to Lloyd's model and the capital charges currently proposed under the standard model.

An upgrade in the next 12-24 months would be contingent on Lloyd's continuing to improve its competitive position, and its ability to maintain and increase commitment of capital providers, both existing and prospective. This could be supported by establishing, implementing, and meeting credible deliverables as part of the strategic planning process and development of Vision 2025. We would also expect to see Lloyd's operating metrics continue to outperform peers before we considered an upgrade. In addition, we would expect to see Lloyd's using its internal model effectively in the capital-setting process from 2013.

We could revise the outlook to stable if there were a loss of capital providers, should the capital providers incur capital requirements or costs of doing business that impair the profitability of doing business in the market. Similarly, we could revise the outlook to stable if we fail to see Lloyd's convert the aspirations of Vision 2025 into a credible plan that should further improve the Market's competitive position and diversify its capital base,. Although we believe it is unlikely, if we were to see operating performance returning to levels seen prior to 2002, reflecting poor management of a softening underwriting cycle; or if a major catastrophe loss leads to losses outside of the Market's risk tolerances, we could revise the outlook.

**Related Criteria And Research**

- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010

[Research Update: Lloyd's Outlook To Positive On Improved Competitive Position, Ongoing Capital Model Development; 'A+' Ratings Affirmed]
Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

To From
Lloyd's Underwriters at Lloyds of London, Kentucky
Underwriters at Lloyds of London, Illinois
Lloyd's Insurance Co. (China) Ltd.
Financial Strength Rating
Local Currency A+/Positive/-- A+/Stable/--

The Society of Lloyd's
Counterparty Credit Rating
Local Currency A+/Positive/-- A+/Stable/--

Ratings Affirmed

The Society of Lloyd's
Junior Subordinated A-

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.