Lloyd’s of London
Full Rating Report

Key Rating Drivers

**Disciplined Underwriting Approach:** Underwriting conditions across several major (re)insurance classes are deteriorating, making continued underwriting discipline by market participants important. The diversity provided by Lloyd’s of London’s (Lloyd’s) (re)insurance portfolio, by line of business and geographically, is expected to be resilient to a protracted period of price softening, should this occur.

**PMD’s Market Oversight Positive:** Fitch Ratings views the Performance Management Directorate’s (PMD) market oversight as key in the reduction in cross-cycle earnings volatility since it was established in 2003. Processes including business plan reviews and syndicate benchmarking have helped the Corporation of Lloyd’s and syndicates improve key aspects of underwriting, including pricing, reserving, claims management, risk-adjusted capital setting and catastrophe modelling techniques.

**Good Performance Versus Peers:** Lloyd’s has achieved marginally reduced cross-cycle earnings volatility in the context of the wider industry, both in absolute terms and when compared with peers. Fitch believes this is a direct result of the measures introduced by PMD and other Corporation departments.

**Continued Favourable Reserve Development:** The work undertaken by the PMD has provided Fitch with increased confidence that, on an aggregate basis, prior underwriting years will develop favourably in the next two years. Of the seven main business classes, casualty and motor reserves are the agency’s key focus.

**Extensive Financial Flexibility:** The variety of funding sources for the central fund (see Appendix B: Glossary) gives Lloyd’s significant financial flexibility, being able to raise funds both internally – through contributions, levies and syndicate loans – and externally through the capital markets.

**Strong Capitalisation:** Fitch expects capitalisation to support the rating, assuming future losses fall within limits expected by Lloyd’s. The three-layered capital structure at Lloyd’s – syndicates’ premium trust funds, members’ funds at Lloyd’s and the central fund – remained strong in 2013, helped by reduced large loss activity during the year.

Rating Sensitivities

**Upgrade Unlikely:** An upgrade is unlikely in the near to medium term, as credit metrics are not expected to strengthen significantly over the rating horizon.

**Underwriting Deterioration/Increased Leverage:** A downgrade may occur if the normalised combined ratio remains above 97% or if leverage, as measured by net premiums written to equity, rises above 1.2x.
Market Position and Size/Scale

Strong Market Position and Management Strategy Supportive of Rating

- Strong global franchise
- Steady progress of Vision 2025
- Product diversification stronger by class than by geography
- Broker-led distribution model
- Underwriting syndicates a unique market feature

<table>
<thead>
<tr>
<th>IFS Rating</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
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<tbody>
<tr>
<td>Debt</td>
<td></td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

Figure 1
Ratings Range Based on Market Position and Size/Scale

Strong Global Franchise

Lloyd’s strong market position, which Fitch considers as falling within the large market position and scale category, supports its rating. Lloyd’s is one of a select band of global (re)insurance providers capable of attracting high-quality and specialised business. Fitch views positively the presence of a detailed and defined business strategy executed by the Corporation’s (see Appendix B: Glossary) executive team.

Lloyd’s is a global insurance and reinsurance market comprising 94 syndicates. It writes business from over 200 countries and territories, and in 2013 reported gross written premiums (GWP) of GBP26.106bn (2012: GBP25.5bn).

Lloyd’s faces competition from a number of sources. These include: established and emerging global reinsurance hubs including Bermuda, Switzerland, Singapore and New York; large global reinsurance companies; smaller primary companies located within key markets; alternative risk transfer products including catastrophe bonds and other insurance-linked securities (ILS).
Steady Progress of Vision 2025
Vision 2025, published in May 2012, provided an insight into the strategic priorities for Lloyd’s over the next 10 to 15 years. The latest update provided by the Corporation in April 2014 should contribute to maintaining a strong rating, as Lloyd’s seeks to keep its marketplace competitive in the longer term. Key is the continuation of market oversight through the various functions of PMD, especially in the context of planned international growth, and facilitating access to the market for brokers and coverholders.

Product Diversification Stronger by Class Than by Geography
Business written by syndicates focuses on seven main classes (see Figure 2). Lloyd’s has a relatively high level of geographical concentration in the US and Canada (see Figure 3), specifically to the hurricane-exposed US energy fields in the Gulf of Mexico, which Fitch considers to have been a key factor in the historical volatility of results at Lloyd’s.

The main class of business at Lloyd’s, reinsurance, covers both short- and long-tail business, offering a variety of placement types including facultative, proportional treaties and non-proportional excess-of-loss placements. The US represents the main geographical region for the second major class, property, which includes both commercial and private property. The remaining main class, casualty, includes professional indemnity, medical malpractice, accident and health, directors’ and officers’ liability, financial institutions, general liability and employers’ liability. Business is mainly spread across US, UK and Europe.

The remaining classes are niche. The International Group of P&I Clubs’ programme constitutes a major part of the marine liability class. The motor book is UK focused, and includes niche non-standard risks such as high-value vehicles, vintage or collectors’ vehicles, high-risk drivers and affinity groups. The energy portfolio 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. Lloyd’s is an industry leader in the global aviation market, and has a balanced portfolio across all sectors of this class, including airline, aerospace, general aviation and space.

Broker-Led Distribution Model
Product distribution at Lloyd’s is primarily carried out through brokers and coverholders with some business placed directly with service companies (see Appendix B: Glossary) owned by managing agents. A large proportion of the business is conducted in the underwriting room, where face-to-face negotiations between brokers and underwriters take place. Most business is placed into the market by the 180 registered brokers.

Underwriting Syndicates Are Unique Market Feature
Syndicates are the vehicles used to underwrite insurance. They are not legal entities, and are unique to the Lloyd’s insurance market. Syndicates can be made up of a number of members or, as is becoming more common, just one corporate member.

Syndicates are run by managing agents, which 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. Managing agents are required to report financial results quarterly for their syndicates to Lloyd’s and to submit business plans annually or more regularly if they change.
Corporate Governance and Risk Management

Fitch considers corporate governance to be strong at Lloyd’s due to the insurer’s clear governance structure. The agency views favourably the existence of the Council of Lloyd’s, the governing body of the Society of Lloyd’s; the Council has ultimate responsibility for the management of the market as a whole.

External Oversight

From 1 April 2013, the Society of Lloyd’s and Lloyd’s managing agents have been dual-regulated. Prudential regulation is conducted by the Prudential Regulation Authority (PRA) while business conduct regulation is the responsibility of the Financial Conduct Authority (FCA). Lloyd’s members’ agents and Lloyd’s brokers are FCA-regulated firms.

The Council acts through the franchise board for many of its functions. Its members are appointed by the Council and are drawn from both within and outside the Lloyd’s market.

Clear Governance Structure

Strong and Well-Structured Risk Management Framework

Fitch views positively the approach taken by Lloyd’s to managing risk and corporate governance. The agency believes that the market structure of Lloyd’s leads to greater emphasis on the successful management of these areas to maintain the confidence of market participants. The market is overseen by the Council of Lloyd’s and the franchise board, while the Corporation, managing agents and members’ agents (see Appendix B: Glossary) are regulated by the Financial Services Authority.

Unique Risk Profile Leads to Separation of Risks

Lloyd’s has developed its risk management framework around two distinct types of risk: Corporation-level risks (financial, operational, regulatory and legal) and market (business)-level risks. Corporation risks are managed through a traditional governance structure, while market risks are managed by managing agents and the central team at Lloyd’s.

Revised Risk Governance Aligned with Incoming Solvency II Regime

Not only is the revised structure consistent with Solvency II requirements, it has also improved the clarity of roles and responsibilities relating to market oversight, and identified areas where further formalisation is required.

Ownership Neutral

Market Structure a Marginal Positive

Figure 4

Structure Diagram

Source: Lloyd’s Fitch

Fitch considers the structure of Lloyd’s as a market place rather than a company and that this is marginally positive for its ratings compared with traditional corporate insurers or reinsurers.
This view takes into account two primary factors: the “chain of security,” which provides a mixture of several and mutual claims-paying capital; and the subscription basis of underwriting used within Lloyd’s, which allows large complex risks to be underwritten by a group of syndicates.

Industry Profile and Operating Environment

Sovereign and Country-Related Constraints

Fitch rates the sovereign obligations of the United Kingdom at ‘AA+’ with a Stable Outlook, and the Country Ceiling is ‘AAA’. The Country Ceiling expresses the maximum limit for foreign-currency ratings of most but not all issuers in a given country. Given these very high levels, the ratings of UK insurance organisations and other corporate issuers are not likely to be constrained by sovereign or macroeconomic risks, and in the specific case of Lloyd’s of London there are no constraints biting.

<table>
<thead>
<tr>
<th>IFS Rating</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>&lt;BB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary – casualty lines</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
</tr>
<tr>
<td>Primary – property lines</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
</tr>
<tr>
<td>Reinsurance lines</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
<td>🟢</td>
</tr>
</tbody>
</table>

Source: Fitch

Ratings in Reinsurance Industry Strong

The provision by reinsurers of risk-transfer services for the primary insurance industry requires companies operating in this sector to hold higher-quality credit ratings, typically not lower than ‘A−’. The achievable range of ratings (see Figure 5) reflects this.

Low Barriers to Entry

The reinsurance industry has low barriers to entry, as indicated by the wave of start-up reinsurers (primarily in Bermuda) entering the market after significant catastrophe events. The barriers to entry to Lloyd’s are high, as the PMD keeps tight control on the number of new syndicates and managing agents entering the market. One reason is to protect the mutual capital layers from unscrupulous underwriting.

Cyclical Pricing

Reinsurers are more susceptible to cyclical pricing trends, which result from changes in supply and demand for different business lines.

Underwriting Margins for Primary Classes Under Pressure

Underwriting margins for many of the primary insurance classes written in the London market have been under pressure for some time, and Fitch believes that the major obstacle to an upturn in pricing is the strong capitalisation of the sector, with significant underwriting capacity and sustained competition. The agency believes that the present inability of the London market to generate sufficient returns on capital will be the key driver of improved pricing in the next 12-24 months.
Peer Analysis

Due to its unique structure and mix of business underwritten, Lloyd’s has no directly comparable peers. Figure 6 provides an illustration of Lloyd’s alongside the global group of reinsurance companies that have some similarities in scale and geographical scope.

Reduction in Earnings Volatility vs. Peers

Lloyd’s compares favourably with other multinational reinsurers on average underwriting performance across a number of years. Operating leverage – net written premiums (NWP)/equity – is higher than for most peers, although this metric remains within acceptable boundaries for the rating.

![Figure 6](image)

Peer Analysis

<table>
<thead>
<tr>
<th>(USD$m)*</th>
<th>2013</th>
<th>2012</th>
<th>Combined ratio (%)</th>
<th>Combined ratio volatility (pp)*</th>
<th>Shareholders’ equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ACE Limited (IFS Rating AA/Stable)</strong></td>
<td>17,025</td>
<td>16,075</td>
<td>91.0</td>
<td>3.1</td>
<td>28,825</td>
</tr>
<tr>
<td><strong>Berkshire Hathaway (IFS Rating AA-/Stable)</strong></td>
<td>37,210</td>
<td>35,727</td>
<td>93.7</td>
<td>2.2</td>
<td>221,890</td>
</tr>
<tr>
<td><strong>Everest Reinsurance Company (N/R)</strong></td>
<td>5,005</td>
<td>4,081</td>
<td>97.7</td>
<td>13.4</td>
<td>6,968</td>
</tr>
<tr>
<td><strong>Hannover Re (IFS Rating A+/Stable)</strong></td>
<td>16,519</td>
<td>15,917</td>
<td>98.0</td>
<td>3.7</td>
<td>8,112</td>
</tr>
<tr>
<td><strong>Lloyd’s of London (IFS Rating AA-/Stable)</strong></td>
<td>31,688</td>
<td>30,882</td>
<td>92.8</td>
<td>8.4</td>
<td>33,788</td>
</tr>
<tr>
<td><strong>Munich Reinsurance Company (IFS Rating AA-/Stable)</strong></td>
<td>65,706</td>
<td>64,581</td>
<td>98.5</td>
<td>9.2</td>
<td>35,794</td>
</tr>
<tr>
<td><strong>PartnerRe Company Ltd (IFS Rating AA-/Stable)</strong></td>
<td>5,397</td>
<td>4,573</td>
<td>95.1</td>
<td>17.6</td>
<td>5,856</td>
</tr>
<tr>
<td><strong>SCOR S.E. (IFS Rating A+/Stable)</strong></td>
<td>12,143</td>
<td>10,990</td>
<td>97.5</td>
<td>4.4</td>
<td>6,860</td>
</tr>
<tr>
<td><strong>Swiss Re (IFS Rating A+/Stable)</strong></td>
<td>30,478</td>
<td>25,344</td>
<td>90.4</td>
<td>7.4</td>
<td>32,952</td>
</tr>
</tbody>
</table>

Combined ratio: Net losses and loss-adjustment expenses divided by net premiums earned plus underwriting expenses divided by net premiums earned.
Shareholders' equity is organisation-wide equity and therefore depends on the company’s reporting practices; it may include equity that supports operations other than property/casualty reinsurance operations.
Financial statement figures for some European reinsurers have been translated into US dollars using year-end or 12-month average rates of exchange, as appropriate. This has led to some exchange-rate distortion between financial years.
* Foreign exchange rates used for NPW = average rate.
* NWP includes primary and reinsurance operations.
* 2009-2013, non-life reinsurance business.
* Denotes operating company Insurer Financial Strength Rating.
* Standard deviation.
Source: Company annual reports, financial supplements, and SEC filings.
Figure 7
Capitalisation and Leverage (GBPm)

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial leverage (%)</th>
<th>Lloyd’s est. statutory solvency surplus</th>
<th>NPW/equity (x)</th>
<th>Net Leverage (x)</th>
<th>TFC Ratio* (x)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>6</td>
<td>2.756</td>
<td>0.95</td>
<td>2.8</td>
<td>0.1</td>
</tr>
<tr>
<td>2010</td>
<td>6</td>
<td>2.905</td>
<td>0.97</td>
<td>3.0</td>
<td>0.1</td>
</tr>
<tr>
<td>2011</td>
<td>5</td>
<td>2.976</td>
<td>1.01</td>
<td>3.2</td>
<td>0.1</td>
</tr>
<tr>
<td>2012</td>
<td>5</td>
<td>3.121</td>
<td>0.99</td>
<td>3.0</td>
<td>0.1</td>
</tr>
<tr>
<td>2013</td>
<td>4</td>
<td>3.123</td>
<td>0.94</td>
<td>2.9</td>
<td>Fitch’s expectation</td>
</tr>
</tbody>
</table>

Leverage will remain largely unchanged or reduce slightly in the short term. Assuming major losses fall within the bounds anticipated by Lloyd’s for the rest of 2014, Fitch does not foresee a significant change in the level of capital in the near term.

Strong Member and Central Capital
- Growing capital resources improve risk-adjusted capitalisation
- Low financial leverage and TFC ratio for rating level
- Risk-based approach to setting member level and central capital
- Mutual assets supported by central fund contributions

Growing Capital Resources Improve Risk-Adjusted Capitalisation
Fitch considers the capitalisation of Lloyd’s to be adequate for the current rating, with strength derived from assets held as part of member capital and central capital. Capital and reserves increased to GBP20.4bn at end-2013 (2012: GBP19.3bn), while both leverage and the TFC ratio remained modest at end-2013. Assuming a normal level of large losses for the rest of 2014, Fitch expects risk-adjusted capitalisation to remain adequate for the ratings.

The Fitch-assessed risk-adjusted capitalisation of Lloyd’s improved in 2013, as growth in members’ funds outstripped growth in NWP, a key element of the risk-based capital charges.

Low Financial Leverage and TFC Ratio For Rating Level
Lloyd’s repurchased GBP180m of principal during 2013 at a loss of GBP15m. Consequently, financial leverage calculated by Fitch reduced to 4% at end-2013 (end-2012: 5%).

Lloyd’s TFC ratio was unchanged at end-2013 at 0.1x (end-2012: 0.1x), which is viewed as low.

Risk-Based Approach to Setting Member Level and Central Capital
Capital at the member level is set at 135% of the syndicates’ individual capital assessment (ICA) result. This percentage has not changed since 2006. Lloyd’s reviews each syndicate’s ICA in detail, and requires an additional capital loading if it considers the syndicate’s business plan exposes the central fund to additional risk.

Lloyd’s believes that the 35% uplift allows for sufficient capital to keep financial strength and credit ratings at current levels. Fitch expects that Lloyd’s will maintain the 35% uplift to members’ regulatory solvency requirements for 2015, having applied the same level of uplift in 2014. Lloyd’s continues to review its methodology to reflect changing market, macroeconomic and legislative conditions.

Mutual Assets Supported by Central Fund Contributions
The mutual layer or third link in Lloyd’s chain of security includes contributions that are collected through an annual levy from members. The levy is 0.5% of premium (2% for new members on new syndicates), with the value of central fund net assets standing at GBP1.51bn in 2013 (2012: GBP1.46bn). As with the member uplift, Lloyd’s reviews the level of future capital contributions required from the market in line with changing conditions.
Strong Debt-Servicing Capability and Good Financial Flexibility

- Strong financial flexibility
- Ability to service debt likely to remain strong
- Flexibility of repayment options

Strong Financial Flexibility

Lloyd’s has a variety of mechanisms available to raise capital, including member calls, Central Fund contributions, the requirement of additional capital on top of the ICA, charging a premium levy and raising subordinated debt.

Ability to Service Debt Likely to Remain Strong

Fitch considers Lloyd’s debt-servicing ability as strong for its rating level. In 2013, fixed-charge coverage excluding unrealised gains and losses improved to 56x from 40x the previous year. Given Lloyd’s strong earnings generation capabilities, the agency expects this ratio to remain above 40x in 2014 in the absence of any significant earnings event.

The Society has two tranches of outstanding subordinated debt, with the euro-denominated tranche being callable in November 2014 and the sterling-denominated tranche in November 2015. Both tranches are obligations of the Society of Lloyd’s and mature in November 2024 and 2025 respectively. Lloyd’s is reviewing its financing options ahead of the euro note call date.

Flexibility of Repayment Options

In a going-concern scenario, Lloyd’s has several options available for the repayment of principal and interest, as it has complete discretion on the use of the central fund. This receives a regular supply of funds from syndicate contributions, syndicate loans and investment income. If necessary Lloyd’s could increase members’ contributions, impose a premium levy (as it has in the past) or use the callable layer. These can all be used to pay the interest on the debt.

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Figure 8
Debt-Servicing Capability and Financial Flexibility

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Fitch’s expectation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest coverage – market (x)</td>
<td>55.8</td>
<td>33.2</td>
<td>8.0</td>
<td>44.6</td>
<td>59.7</td>
<td>Interest coverage to remain strong in the medium term, although the level of coverage depends on refinancing options taken by Lloyd’s when euro-subordinated notes are called later in 2014. Fitch does not foresee a significant increase in interest expenses in the near term.</td>
</tr>
<tr>
<td>Interest coverage – society (x)</td>
<td>2.4</td>
<td>8.0</td>
<td>2.3</td>
<td>2.7</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td>69</td>
<td>66</td>
<td>64</td>
<td>62</td>
<td>56</td>
<td></td>
</tr>
</tbody>
</table>

Source: Fitch
Market Performance Benefits from PMD Oversight

- Improved results in 2013 due to low catastrophe burden
- Adequate if softer pricing across main sub-classes
- PMD demonstrates tangible results

Improved Results in 2013 Due to Low Catastrophe Burden

End-2013 pre-tax income improved to GBP3.2bn (2012: GBP2.8bn). The strong result was mainly driven by the absence of significant catastrophe events throughout the year. In 2013, major claims amounted to GBP873m, which equates to 4.4 additional percentage points (pp) on the combined ratio (2012: GBP1.8bn or 9.7pp), well below Lloyd’s five-year average of GBP2.2bn or 12.5pp. There were no material catastrophe events in 1H14. The US windstorm season, which runs from June to November, could adversely influence earnings for the rest of 2014.

Adequate if Softer Pricing Across Main Sub-Classes

Fitch maintains that the global supply of underwriting capacity will outstrip demand during 2014 and expects further softening in a number of major sub-classes. However, pricing in the London market is largely adequate.

PMD Demonstrates Tangible Results

PMD’s oversight of market participants has played a key role in improving the overall technical performance of the Lloyd’s market, in Fitch’s view. Since the PMD was established in 2003, processes including business plan reviews and syndicate benchmarking have helped PMD and syndicates improve key aspects of underwriting, including pricing, reserving, claims management, risk-adjusted capital setting and catastrophe modelling techniques. Figure 10 highlights the relative stability of return on capital in recent years, and the higher level of solvency maintained within the market.

Figure 9
Financial Performance and Earnings (GBPm)

<table>
<thead>
<tr>
<th>Year</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Fitch’s expectation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax profit/(loss)</td>
<td>3,868</td>
<td>2,195</td>
<td>(516)</td>
<td>2,771</td>
<td>3,205</td>
<td>Lloyd’s is likely to report a strong, if marginally lower, technical result at end-2014, assuming weaker reinsurance pricing conditions and a level of losses arising from natural catastrophes not exceeding those of the long-run average.</td>
</tr>
<tr>
<td>Operating ratio (%)</td>
<td>75.6</td>
<td>86.0</td>
<td>101.6</td>
<td>84.1</td>
<td>82.5</td>
<td></td>
</tr>
<tr>
<td>Combined ratio (%)</td>
<td>86.1</td>
<td>93.3</td>
<td>106.8</td>
<td>91.1</td>
<td>86.8</td>
<td></td>
</tr>
<tr>
<td>ROE (%)</td>
<td>23.9</td>
<td>12.1</td>
<td>(2.8)</td>
<td>14.8</td>
<td>16.2</td>
<td></td>
</tr>
</tbody>
</table>

Source: Lloyd’s, Fitch

Figure 10
Lloyd’s Return on Capital and Solvency

Lloyd’s Return on Capital
Solvency Ratio

Source: Statistics Relating to Lloyd’s 2013, pages 28, 227, 228; Lloyd’s data for 1948 – 1999 on three year accounting (assuming written=earned premium and 25% bokerage on NPW), and from 2000 onwards on annual accounting basis.
Conservative Investment Policy for All Links in the Chain of Security

- PTFs: high-quality and liquid first source of policyholder repayment
- FAL: second repayment layer support point
- Central fund: mutual layer available at discretion of Council of Lloyd’s
- Strong liquidity position supported by high-quality, liquid assets

PTFs: High-Quality and Liquid First Source of Policyholder Repayment

PTFs are the first resource for paying policyholder claims from a syndicate. Investments are held in liquid, short-duration, high-quality assets with a round 83% of assets invested in bonds, of which 85% were rated ‘BBB’ or above (2012: 88%).

FAL: Second Repayment Layer Support Point

FAL represents the second layer of capital provided by members to support their underwriting. The amount of deposited funds is determined by the Corporation, which reviews each syndicate’s ICA and applies an uplift based upon the syndicate’s business plans. The capital is held in trust as readily realisable assets. Letters of credit (LOCs) represent a significant proportion of assets within FAL (49% at end-2013). Fitch considers the pool of banks providing LOCs to Lloyd’s as well diversified and with strong ratings.

Central Assets: Mutual Layer Available at Discretion of Council of Lloyd’s

Central assets are the third level of security at Lloyd’s, and are available at the discretion of the Council of Lloyd’s to meet any valid claim that cannot be met by the resources of any member. The central assets value was GBP2.4bn at end-2013, 72% invested in bonds.

Strong Liquidity Position Supported by High-Quality, Liquid Assets

Lloyd’s maintains a strong liquidity position, which is supported by a significant level of high-quality liquid assets held at by the PTF, FAL and central fund.
Increased Confidence of Continued Favourable Development

- Prior-year surplus generated by all classes except motor
- Casualty generates strong releases
- Reserving position greatly improved following Equitas

Prior-Year Surplus Generated by All Classes Except Motor

This trend was driven by favourable claims’ experiences across all the main classes of business at Lloyd’s, which resulted in a 8.0pp improvement in the calendar-year combined ratio (2012: 7.2pp). Motor reserves required strengthening in 2013, mainly due to the uncertainty about the discount rate used to determine large bodily injury claims awards such as PPOs. Fitch is cautious about how this class will perform over the coming years, with adequate control of claims costs the key factor for determining profitability.

Casualty Generates Strong Releases

Fitch is cautious about the future development of this major longer-tail class, although the continuing positive trend, combined with evidence suggesting a significant reserve margin is still held across the market, gives greater confidence that further surpluses will be generated in the next two years. In 2013, the level of surplus in casualty was equivalent to 2.4pp on the combined ratio (2012: 4.8pp).

Reserving Position Greatly Improved Following Equitas

The reserving position of Lloyd’s improved significantly after 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, respectively. The transfer of pre-1993 liabilities into Equitas in 1996 reduced the volatility of the reserving position of Lloyd’s, as the proportion of long-tailed liabilities significantly diminished.

<table>
<thead>
<tr>
<th>Reinsurance</th>
<th>Property</th>
<th>Casualty</th>
<th>Marine</th>
<th>Energy</th>
<th>Motor</th>
<th>Aviation</th>
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<tbody>
<tr>
<td>-5.8</td>
<td>-3.4</td>
<td>-8.3</td>
<td>-7.4</td>
<td>-6.2</td>
<td>3.9</td>
<td>-16.6</td>
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<tr>
<td>-9.5</td>
<td>-6.7</td>
<td>-4.5</td>
<td>-7.5</td>
<td>-18.3</td>
<td>36.7</td>
<td>-24.5</td>
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<td>-6.0</td>
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<td>-7.8</td>
<td>-9.7</td>
<td>-1.7</td>
<td>-26.5</td>
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<tr>
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<td>-4.8</td>
<td>-3.9</td>
<td>-19.1</td>
<td>-0.9</td>
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<td>-11.2</td>
<td>-8.4</td>
<td>-2.4</td>
<td>-7.4</td>
<td>-11.3</td>
<td>4.2</td>
<td>-23.7</td>
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</table>

<table>
<thead>
<tr>
<th>Loss reserve development/Equity (%)</th>
<th>Loss reserve development/NEP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-6.6</td>
<td>-6.6</td>
</tr>
<tr>
<td>-5.6</td>
<td>-6.0</td>
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<tr>
<td>-6.4</td>
<td>-6.5</td>
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<tr>
<td>-7.4</td>
<td>-7.2</td>
</tr>
<tr>
<td>-8.2</td>
<td>-8.0</td>
</tr>
</tbody>
</table>

Note: Negative figures indicate a surplus development from prior years, whereas positive figures indicate a deficit.

Source: Fitch
Reinsurance, Risk Mitigation and Catastrophe Risk

Adequate Risk Management and Reinsurance
- Reinsurance recoverable steady; reinsurer credit quality strong
- Stable external reinsurance utilisation rate
- Risk oversight on society and market level
- Well established exposure management

Reinsurance Recoverable Steady; Reinsurer Credit Quality Strong
The level of net reinsurance recoverables was stable at GBP10bn at end-2013 (2012: GBP10.9bn), significantly down from a peak of GBP14.5bn at end-2001 after the 11 September 2001 attacks in the US. Fitch regards the reinsurance recoverables as high quality, with 96% of counterparties rated ‘A’ or above.

Stable External Reinsurance Utilisation Rate
Each syndicate is required to make its own reinsurance arrangements. Across the market, the external reinsurance utilisation rate is 16% (2012: 17%). Reinsurance within the market between syndicates is excluded from this ratio.

Risk Oversight on Society and Market Level
Given its unique structure, Lloyd’s oversees and manages risks at the Corporation level in addition to establishing guidelines, control functions and monitoring, at market level. Responsibility for the market level function is held by the syndicate risk committee, which is directly involved in all syndicate oversight activities, including oversight of the new entrants’ process, change of control and performance monitoring. The financial risk committee is responsible for all financial risks at market and Corporation levels whereas the Corporation risk committee is solely focused on Society risk issues including international regulation and conduct risk.

Well Established Exposure Management
The exposure management function at Lloyd’s is part of the PMD and has grown significantly over past years. It is responsible for the modelling and monitoring of market and Corporation exposure to catastrophic risks, as well as being home to an emerging risk department. Catastrophe risk is modelled at both the member and Society level, with analysis supplemented by a set of deterministic scenarios which relate to specific catastrophic event scenarios. Syndicates are required to consider additional scenarios, should the Lloyd’s RDSs be inappropriate for their specific business profile.
Appendix A: Other Ratings Considerations

Below is a summary of additional ratings considerations of a “technical” nature that are part of Fitch’s ratings criteria.

Group IFS Rating Approach

The Lloyd’s insurance entities listed on page 1 are rated on a group approach, with all entities considered “Core”.

Notching

The unique corporate structure of Lloyd’s, as a market place rather than a corporation, makes reference to operating and holding companies inappropriate. A description of how the respective ratings of Lloyd’s entities were reached is provided below. Fitch considers the regulatory environment in the United Kingdom to be “Strong”.

Notching Summary

Society of Lloyd’s
- The Society’s IDR is linked to the IFS rating assigned to Lloyd’s. The Society has no legal liability for the insurance liabilities of members other than where it has issued an undertaking. Undertakings are liabilities of the Society and constitute unsecured obligations ranking pari passu with other senior unsecured liabilities. Fitch has therefore aligned the Society’s IDR with the implied IDR of Lloyd’s.

IFS Ratings
- Due to the existence of policyholder priority, a baseline recovery assumption of “Good” applies to the IFS rating, and Fitch used standard notching from the implied IDR.
- The insurance policies issued by Lloyd’s are supported by a chain of security that includes Lloyd’s premium trust funds, members’ funds at Lloyd’s and the Central Fund. The Central Fund and central assets of the Society of Lloyd’s, a legal entity distinct from the members of Lloyd’s, provide partial mutuality to the Lloyd’s market. It is this mutuality that enables Fitch to assign an IFS rating to Lloyd’s rather than to individual syndicates.

Debt
- Not applicable.

Hybrids
- Junior subordinated debt ratings of The Society of Lloyd’s (issuer) are based on a standard baseline recovery assumption of Below Average, and are designated by Fitch as having material loss-absorption features. Standard notching was used.

Hybrids – Equity/Debt Treatment

<table>
<thead>
<tr>
<th>Hybrid</th>
<th>Amount</th>
<th>CAR Fitch (%)</th>
<th>CAR Reg override (%)</th>
<th>FLR Debt (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub debt</td>
<td>GBP153m</td>
<td>0</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Sub debt</td>
<td>EUR214m</td>
<td>0</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Sub perpetual</td>
<td>GBP392m</td>
<td>0</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Fitch

Exceptions to Criteria/Ratings Limitations

None.
Appendix B: Glossary

Central Fund
The fund financed by (among other things) contributions from Lloyd’s members and administered by the Council primarily as a fund for the protection of policyholders.

Corporation of Lloyd’s
This comprises the executive of the Council of Lloyd’s, Lloyd’s franchise board and their respective committees. The Corporation does not underwrite insurance or reinsurance itself but provides the licences and other facilities that enable business to be underwritten worldwide by managing agents acting on behalf of members.

Coverholder
A company or partnership authorised by a managing agent to enter into a contract or contracts of insurance to be underwritten by the members of a syndicate managed by it, in accordance with the terms of a binding authority.

Members’ Agent
An underwriting agent that has permission from Lloyd’s to be appointed by a member to provide services and perform duties of the same kind and nature as those set out in the standard members’ agent agreement. These services and duties include advising the member on which syndicates he should participate in, the level of participation in such syndicates and liaising with the member’s managing agents.

Service Company
A service company coverholder is an approved coverholder that Lloyd’s has agreed can be classified as a service company because it is a wholly owned subsidiary either of a managing agent or of a managing agent’s holding company, and which is normally only authorised to enter into contracts of insurance for members of its associated syndicate and/or associated insurance companies.
The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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