Lloyd's of London

Full Rating Report

Ratings

Lloyd's of London

Insurer Financial Strength Rating	A+

The Society of Lloyd's

Long-Term IDR	A
Subordinated debt	BBB+

Lloyd's Insurance Company (China) Ltd

Insurer Financial Strength Rating	A+

Outlooks

Insurer Financial Strength Ratings	Stable
Long-Term IDR	Stable

Financial Data

Lloyd's of London

	2011	2010
Total assets (GBPm)	76,548	70,610
Total liabilities (GBPm)	49,127	52,419
Gross written premiums (GBPm)	23,477	22,592
Pre-tax profit (GBPm)	-516	2,195
Combined ratio (%)	106.8	93.3
Return on capital (%)	-2.8	12.1

Related Research

European Insurers Capable of Withstanding Orderly Greek Exit (June 2012)

Hurricane Season 2012: A Desk Reference for Insurance Investors (May 2012)

Asia-Pacific Catastrophes Highlight Limitations in Risk Assessment (May 2012)

2012 Global Reinsurance Update (April 2012)

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Key Rating Drivers

Restoration of Underwriting Profitability: While the financial loss reported by Lloyd's of London (Lloyd's, or "the Market") at end-2011 fell short of Fitch Ratings' earnings expectations, the ability to absorb what has proved to be an unprecedented level of natural catastrophe losses has been demonstrated by the maintenance of the Market's capital strength. The agency expects a recovery in 2012 earnings, driven by a marked improvement in the underwriting result. Fitch forecasts a calendar-year combined ratio of c.95%.

PMD's Market Oversight: Fitch views the Performance Management Directorate's (PMD) oversight of Market participants as a key mechanism in improving earnings stability in the medium term. The agency will continue to monitor the influence of the PMD's efforts, paying particular attention to cycle management, improved long-term profitability and the performance of the market, which are the PMD's stated areas of emphasis.

Mixed Performance Versus Peers: Considered in the context of the wider industry, technical performance has marginally outperformed the peer average, although the reported loss highlights the limited ability of Lloyd's to offset underwriting losses through other income streams. The agency will continue to assess the volatility of earnings at Lloyd's in relation to a range of European and Bermudian reinsurers that the agency considers to represent its closest peer group.

Financial Flexibility: The variety of funding sources for the Central Fund (see *Appendix B: Glossary*) gives The Society of Lloyd's (the Society) significant financial flexibility. The Society has the ability to raise funds both internally – through contributions, levies and syndicate loans – and externally through the capital markets.

Capitalisation Remains Strong: Fitch expects that capitalisation will continue to support the current rating, assuming further losses fall within boundaries anticipated by the Market. The three-layered capital structure at Lloyd's (consisting of syndicates' Premium Trust Funds (PTFs), members' Funds at Lloyd's (FAL) and the Central Fund) remained strong in 2011, despite an uptick in large loss activity during the year.

Asia-Pacific Catastrophes Highlight Challenges: The concentration of major natural catastrophe losses across the Asia-Pacific region in 2011 illustrated some of the challenges that Lloyd's, and other industry participants, will need to overcome. The future strategy of Lloyd's, as set out in its Vision 2025 document, includes growth led by further expansion into emerging-market (EM) territories. Ensuring that such expansion is undertaken in a controlled and disciplined way is likely to present the PMD with increasing challenges.

What Could Trigger a Rating Action

Weakened Capitalisation: A marked erosion of capital, as measured on Fitch's risk-adjusted basis, but also considering losses falling to Central Fund assets, and poor underwriting performance relative to peers could lead to a downgrade of the ratings.

Reduced Earnings Volatility: Key drivers for an upgrade would be a reduced level of earnings volatility and underwriting results versus peers, in the wake of a large catastrophe event, or evidence of earnings resilience during a prolonged period of increased attritional losses and lower premium pricing conditions.

Market Position and Size/Scale

Strong Market Position and Management Strategy Supportive of Rating

- Globally renowned (re)insurance Market
- Vision 2025 strategy likely to place additional responsibility on PMD
- Product diversification stronger by class than by geography
- Broker-led distribution model
- Underwriting syndicates a unique market feature

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

Source: Fitch

Globally Renowned (Re)Insurance Market

The strong market position of Lloyd's supports its current rating, which falls within the major position and scale category. Lloyd's is one of a select band of global (re)insurance players capable of attracting high-quality and specialised business. Fitch views positively the presence of a detailed and clearly defined business strategy executed by the Corporation's (see *Appendix B: Glossary*) executive team.

Lloyd's is a global insurance and reinsurance market comprising 87 syndicates. It writes business from over 200 countries and territories, and in 2011 reported gross written premiums (GWP) of GBP23,477m (2010: GBP22,592m).

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 players; and smaller primary players located within key markets.

Vision 2025 Strategy Likely to Place Additional Responsibility on PMD

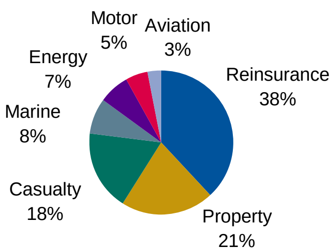
The publication of the Vision 2025 document in May 2012 provided an insight into the strategic priorities for Lloyd's over the next 10 to 15 years, key amongst these being growth led by further expansion into EM territories. While it primarily remains the responsibility of businesses operating at Lloyd's to determine how and where the growth is achieved, Lloyd's, through the PMD, is likely to face increasing challenges in ensuring that expansion into EM territories is undertaken in a controlled and disciplined way.

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 to the US and Canada (see Figure 3), specifically to the hurricane-exposed US energy fields in the Gulf of Mexico, which Fitch considers has been a key factor in the historical volatility of results at Lloyd's.

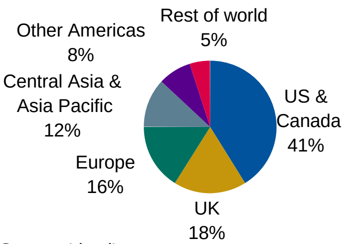
The main class of business at Lloyd's, reinsurance, covers both short- and long-tail business, offering a variety of placement types including facultative, proportional treaties and non-proportional treaties such as excess-of-loss placements. The US represents the main geographical region for the second major class, property, which includes both commercial and private property. The remaining main class, casualty, covers professional indemnity, medical

Figure 2
Lloyd's of London – Premium Distribution by Business 2011



Source: Lloyd's

Figure 3
Lloyd's of London – Premium Distribution by Geography 2011



Source: Lloyd's

Related Criteria
Insurance Rating Methodology (September 2011)

malpractice, accident and health, directors' and officers' liability, financial institutions, general liability and employers' liability. Business focus is spread across the US, UK and European markets in the most part.

The remaining classes have niche focus. 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 (see *Appendix B: Glossary*), 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 continues to be placed into the Market by the 178 registered brokers.

Underwriting Syndicates a Unique Market Feature

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 a number of members or, as is becoming more common, just one corporate member.

Syndicates are managed 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 for the syndicates that they manage to Lloyd's on a quarterly basis, and to submit business plans on an annual basis or on an ad-hoc basis if business plans change.

Corporate Governance & Risk Management

Fitch considers corporate governance to be strong at Lloyd's due to the insurer's clearly defined governance structure. The agency views favourably the presence 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 of Appointments

The appointment of nominated members is confirmed by the governor of the Bank of England, and the Council is regulated by the UK Financial Services Authority.

For many of its functions, the Council acts through the Franchise Board, whose members are appointed by the Council and are drawn from both within and outside the Lloyd's Market.

Clearly Defined 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 (FSA).

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 along 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

The revised structure has improved the clarity of roles and responsibilities relating to Market oversight, as well as identifying areas where further formalisation is required.

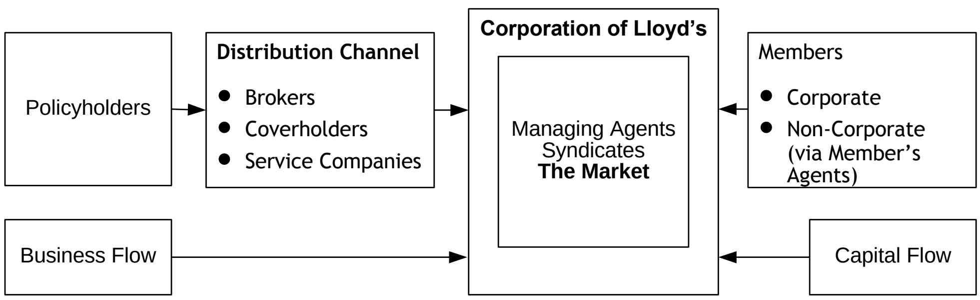
Ownership is Viewed as Neutral

Market Structure Viewed as Marginal Positive

Fitch considers the structure of Lloyd's, being a market place rather than a company, as marginally positive for its ratings compared with traditional corporate reinsurers. This view considers two primary factors: (i) the "Chain of Security," which provides a mixture of several and mutual claims-paying capital; and (ii) the subscription basis of underwriting used within Lloyd's, allowing large complex risks to be underwritten by a group of syndicates.

Figure 4

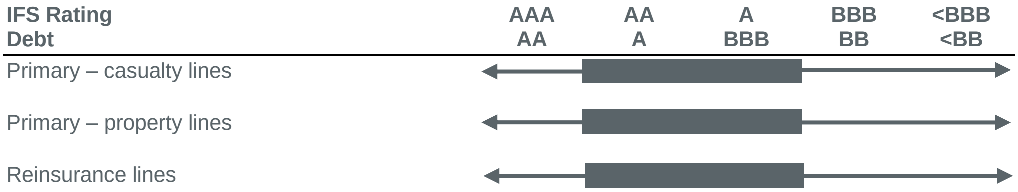
Structure Diagram



Source: Lloyd's Fitch

Industry Profile and Operating Environment

Figure 5
Ratings Range Based on Industry Profile/Operating Environment



Source: Fitch

Sovereign and Macroeconomic Risks

Fitch rates the sovereign obligations of the United Kingdom at ‘AAA’ with a Negative Outlook; 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 levels, the ratings of insurance organisations and other corporate issuers in the United Kingdom are not directly constrained by sovereign or macroeconomic risks.

United Kingdom

Foreign Currency

Long-Term IDR	AAA
Short-Term IDR	F1+

Local Currency

Long-Term IDR	AAA
Country Ceiling	AAA

Outlooks
Negative

Strength
Progress made in reducing the government’s structural budget deficit and credible fiscal consolidation effort.

Weakness
Limited fiscal space to absorb further adverse economic shocks.

Reinsurance Industry Supports Wide Range of Ratings

The provision by reinsurers of risk-transfer services for the primary insurance industry generally requires companies operating in this sector to hold higher-quality credit ratings. The achievable range of ratings (see Figure 2) reflects this.

Generally Low Barriers to Entry

The reinsurance industry generally has low barriers to entry, as seen by the wave of start-up reinsurers (primarily in Bermuda) entering the market following significant catastrophe events.

Fitch notes that the barriers to entry to Lloyd’s itself are quite high, with the PMD keeping a tight control on the number of new syndicates and managing agents entering the Market. One reason for this is to protect the mutual capital layers from unscrupulous underwriting.

Cyclical Pricing

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

Underwriting Margins for Primary Classes Remain 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 continues to believe that the inability at present 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, which exhibits some similarity based on scale and geographical scope.

2011 Underwriting Performance Suggests Reduced Volatility

Despite recording a significant net loss at end-2011, the underwriting performance of Lloyd's, when considered in the context of unprecedented catastrophe losses during 2011, has exhibited a marginally lower level of volatility than average. Lloyd's achieved a Fitch-calculated combined ratio of 106.8%, which saw a 14.4pp deterioration on 2010. In contrast, Fitch's monitored universe of reinsurers achieved an average combined ratio of 109.1%, with a 15.2pp deterioration on 2010. This could reflect the efforts made by the PMD to protect the Market from outsized losses.

Considered in the context of the wider industry, technical performance has marginally outperformed the peer average, although the reported loss highlights the limited ability of Lloyd's to offset underwriting losses through other income streams. While investment income offers a degree of offset, the conservative asset allocation and subsequent low yield are insufficient to offset a major underwriting losses.

Figure 6
Peer Analysis

	Net premiums written[a]		Combined ratio (%)		Shareholders' equity	
(USDm)	**2011**	**2010**	**2011**	**2010**	**2011**	**2010**
ACE Limited (IFS Rating 'AA−'/Pos)[b]	979	1,075	85.5	72.5	24,516	22,974
Berkshire Hathaway (IFS Rating 'AA−'/Sta[b])	9,867	9,171	107.1	95.2	164,850	157,318
Everest Reinsurance Company (IFS Rating 'AA−'/Sta)	3,288	3,325	119.7	100.7	6,071	6,284
Hannover Re (IFS Rating 'A+'/Sta)	8,651	7,514	104.5	98.5	7,262	6,732
Lloyd's of London (IFS Rating 'A+'/Sta)	29,725	27,194	106.8	93.3	28,320	28,380
Munich Reinsurance Company (IFS Rating 'AA−'/Sta)	22,053	18,664	114.1	101.0	30,190	30,291
Partner Reinsurance Company Ltd (IFS Rating 'AA−'/Sta)	3,688	3,961	125.4	95.1	6,468	7,207
SCOR S.E. (IFS Rating 'A+'/Sta)[b]	4,993	4,463	105.8	99.8	5,712	5,725
Swiss Re (NR)	13,571	10,669	101.5	94.2	31,287	26,906

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
[a] NWP for non-life reinsurance operations
[b] Denotes operating company Insurer Financial Strength rating
Source: Company annual reports, financial supplements, and SEC filings

Figure 7

Capitalisation and Leverage

(GBPm)	2007	2008	2009	2010	2011	Fitch's expectation
Adjusted debt leverage (%)	9	9	6	6	5	Leverage will remain largely unchanged or reduce slightly in the near term. Assuming that major losses fall within the bounds anticipated by the market for the remainder of 2012, Fitch does not foresee a significant change in the level of capitalisation in the near term.
Estimated statutory solvency surplus	2,297	2,475	2,756	2,923	2,980	

Source: Fitch

Capital Strength Derived from Member and Central Capital

- Growth of Members' Funds improves risk-adjusted capitalisation
- Financial leverage remains at a modest level
- Modest total financing commitments (TFC) ratio
- Risk-based approach to setting capital at member level and central capital

Fitch considers the capitalisation of Lloyd's to be supportive of its current rating, with strength being derived from assets held as part of member capital and central capital. Capital and reserves were largely unchanged at GBP18.2bn at end-2011, while both leverage and the TFC ratio remained at modest levels at end-2011. Assuming a normalised level of large losses for the remainder of 2012, Fitch expects capitalisation to strengthen marginally.

Growth of Members' Funds Improves Risk-Adjusted Capitalisation

Considered on Fitch's risk-adjusted basis, the capitalisation of Lloyd's improved marginally in 2008 to 2011, as growth in Members' Funds outstripped growth in net written premiums (NWP), which represent a key element of the risk-based capital charges.

Financial Leverage Remains at a Modest Level

Financial leverage, as calculated by Fitch, showed a marginal improvement to 5% at end-2011 (end-2010: 6%). Lloyd's continued to repurchase outstanding debt during 2011, purchasing GBP27.4m of principal, at a modest profit. During 2010, GBP21m was repurchased.

Modest TFC Ratio

Lloyds' TFC ratio remained at a modest level at end-2011, improving to 11% (end-2010: 12%). The primary driver was an increase in the value of adjusted capital captured under the ratio.

Risk-Based Approach to Setting Capital at Member Level

At member level, capital 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 loadings if it deems the syndicate's calculations deficient. Lloyd's believes that the 35% uplift allows for sufficient capital to maintain financial strength and credit ratings at their current levels. In 2012, Lloyd's has maintained its 35% uplift, and continues to review its methodology to reflect changing market, macroeconomic and legislative conditions.

Figure 8

Debt-Servicing Capability and Financial Flexibility

(GBPm)	2007	2008	2009	2010	2011	Fitch's expectation
Interest coverage – market (x)	84.6	27.3	55.5	33.3	-6.9	Interest coverage will remain strong in the medium term, with the level of absolute coverage for 2012 expected to improve, reflecting the agency's expectations of a recovery in reported profitability. Fitch does not foresee a significant increase in interest expense in the near term.
Interest coverage – society (x)	3.1	1.4	2.1	4.9	1.4	
Interest paid	46.0	72.1	71.0	68.0	65.0	

Source: Fitch

Strong Debt-Servicing Capability and Good Financial Flexibility

- Cross-cycle ability to service debt expected to remain strong
- Flexibility of repayment options
- No immediate maturities

Fitch expects the ability of Lloyd's to service its debt obligations to remain strong in the foreseeable future. The agency notes that Lloyd's has a variety of mechanisms available to raise capital, including member calls, Central Fund contributions, increased loading for required capital on top of ICA, charging a premium levy and raising subordinated debt.

Cross-Cycle Ability to Service Debt Expected to Remain Strong

Lloyd's continues to exhibit a strong debt-servicing capability, despite a reduction in the level of interest coverage since 2008. Fitch expects coverage to improve for 2012, reflecting expectations of a recovery in earnings.

Flexibility of Repayment Options

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 syndicate contributions, syndicate loans and investment income. Moreover, 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.

No immediate Maturities

Lloyd's has no immediate debt falling due, with the outstanding issues having call dates in 2014 and 2015. The subordinated debt issues of 2004 and 2007 are obligations of the Society.

Figure 9

Financial Performance and Earnings

(GBPm)	2007	2008	2009	2010	2011	Fitch's expectation
Pre-tax profit/(loss)	3,846	1,899	3,868	2,195	(516)	Lloyd's will report an improved underwriting result at end-2012, reflecting what has proved, to date, to be a more benign major loss year. This expectation remains dependent upon the 2012 U.S. windstorm season proving unexceptional.
Operating ratio (%)	68.6	84.3	75.3	85.7	101.4	
Combined ratio (%)	84.0	91.3	86.1	93.3	106.8	

Source: Lloyd's, Fitch

Catastrophe Losses Key Near-Term Earnings Driver

- Continued assessment of PMD's ability to regulate earnings volatility
- Reinsurance: Subdued rate rises likely to temper improved 2012 result
- Property: Uncertain claims development adds to pricing pressure
- Casualty: Challenge of low-yielding investment horizon continues
- Marine: Rating environment expected to remain challenging
- Energy: Recent trend of low losses keeps rates under pressure
- Motor: Return to profitable underwriting not a certainty
- Aviation: Reduced loss activity raises prospect of further rate softening

Fitch believes that Lloyd's will report substantially improved results in 2012, driven by a recovery in technical profitability. This reflects the agency's expectation of a markedly lower catastrophe burden during 2012. While the Market reported continued premium growth to GBP23.5bn (+3.9%, or +6% at a constant rate of exchange) in 2011, an unprecedented level of losses arising from major catastrophes (GBP4.6bn) resulted in a reported loss of GBP516m (2010: profit of GBP2.2bn). The combined ratio deteriorated to 106.8%, which included 25.5pp for major claims (2010: 93.3%, 12.7pp).

While H112 witnessed a marked reduction in major loss events, the current US windstorm season, to which Lloyd's would be materially exposed, contains the potential to adversely influence earnings for the remainder of 2012.

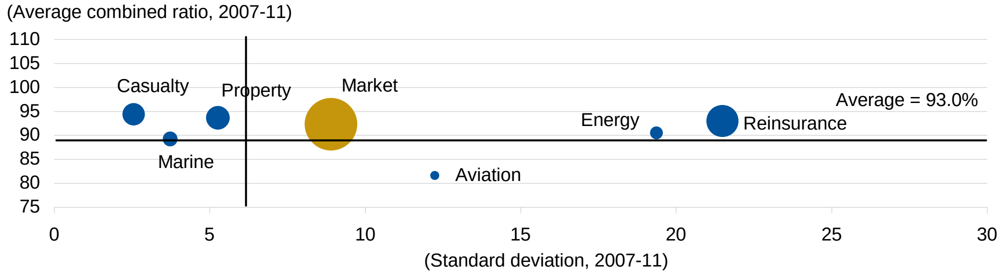
Continued Assessment of PMD's Ability to Regulate Earnings Volatility

Fitch will continue to assess the volatility of earnings at Lloyd's relative to a group of large European and Bermudian reinsurers considered by the agency to represent its closest peers. Fitch views the PMD's oversight of market participants as a key mechanism in improving the stability of results at Lloyd's and will continue to monitor the influence of its efforts on earnings. The inherent volatility present within business written by Lloyd's is illustrated by the degree of result variation experienced by individual classes (see Figure 10). Investment returns have exhibited a greater degree of stability, helped by conservative asset allocation.

Figure 10

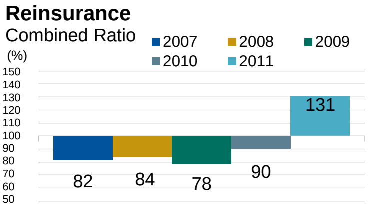
Lloyd's by Major Business Category

Volatility of combined ratio, 2007-11



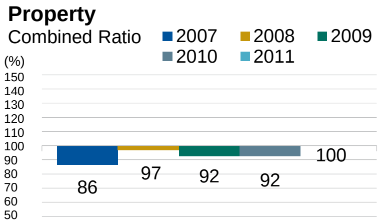
Size of bubble denotes GWP
Source: Fitch, Lloyd's

Figure 11



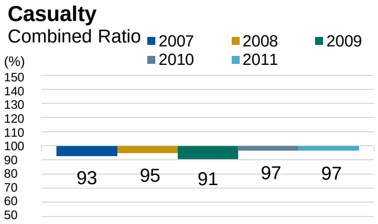
Source: Lloyd's

Figure 12



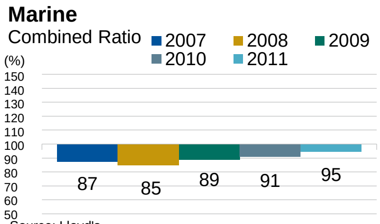
Source: Lloyd's

Figure 13



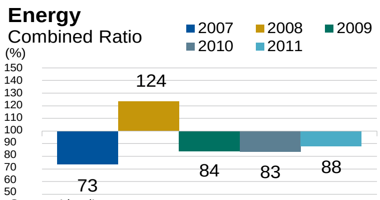
Source: Lloyd's

Figure 14



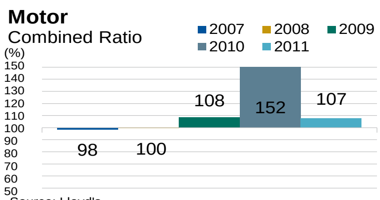
Source: Lloyd's

Figure 15



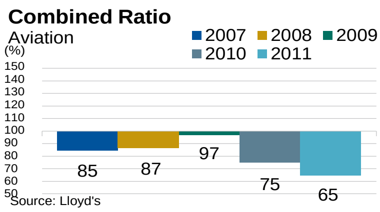
Source: Lloyd's

Figure 16



Source: Lloyd's

Figure 17



Source: Lloyd's

Reinsurance: Subdued Rate Rises Likely to Temper Improved 2012 Result

Fitch expects the main insurance class at Lloyd's to achieve a marked improvement in results at end-2012. While the dominant property sub-treaty class bore the brunt of 2011's catastrophe losses, the agency's prediction reflects expectations of a reduced level of catastrophe burden in 2012. Lower-than-expected premium rate increases, with meaningful rate hardening so far having been confined to loss-affected insurance lines and geographical regions, will temper overall profitability.

Property: Uncertain Claims Development Adds to Pricing Pressure

Conditions remained challenging in 2011, with contingent business interruption (CBI) losses arising from the Thai floods weakening the underwriting result. Tail development from these claims remains unclear, raising the possibility of reduced support from prior-year reserve movements at end-2012. Fitch notes that underwriting profitability for this class in 2010 and 2011 was largely supported by prior-year surpluses. The prospect of limited price rises could, to some degree, mitigate any deterioration in prior-year development.

Casualty: Challenge of Low-Yielding Investment Horizon Continues

Capacity remains in this class despite the challenging outlook, although prior years continue to generate surpluses. While some uncertainty remains regarding a possible increase in claims arising from the financial crisis, Fitch will continue to closely assess the overall adequacy of reserves for this class.

Marine: Rating Environment Expected to Remain Challenging

The tragic loss of the Costa Concordia does not appear to have been sufficient to improve general pricing conditions for this class. The movement of key indicators, including the deterioration of the combined ratio and declining underwriting profitability, between 2008 and 2011 highlights the challenge that marine underwriters continue to face in maintaining profitability.

Energy: High Non-Windstorm Losses Counter Benign Hurricane Season

While the class benefited from another quiet hurricane season across the major US energy fields in 2011, a sharp rise in non-windstorm-related losses suggests that pricing for certain risks could increase through 2012. Legal rulings in respect of the Deepwater Horizon disaster, which has seen the sharing of culpability amongst parties, have also prompted the industry to review cover and pricing. However, abundant capacity continues to keep terms and conditions under pressure, placing greater emphasis on underwriting control of what is a highly technical class.

Motor: Return to Profitable Underwriting not a Certainty

The slowing rate of increase in personal motor premiums, coupled with a political crusade to reduce the financial burden faced by motorists, suggests that the top of the market, in pricing terms, could be close. While a raft of policy proposals aimed at controlling the flow and cost of fraudulent claims should help the industry to an extent, Fitch remains unconvinced that an industry-wide restoration of profitability will be achieved.

Aviation: Reduced Loss Activity Raises Prospect of Further Rate Softening

The smallest class at Lloyd's reported a further improvement in its technical result in 2011 following a relatively benign claims period. With the market continuing to supply adequate capacity, the rating environment for 2012 is likely to remain challenging.

Figure 18

Investments and Asset Risk

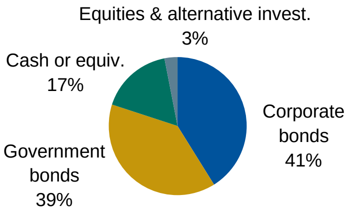
(GBPm)	2007	2008	2009	2010	2011	Fitch's expectation
Invested assets	36,990	44,377	46,264	48,494	51,424	Investment profile and strategy will remain fairly constant in the near term. Currently, the greatest challenge is the persistence of a low-yielding investment environment, which would continue to place pressure on earnings.
Investment return (%)	5.6	2.4	3.9	2.7	1.9	
Liquid assets/tech reserves (%)	140.6	131.5	147	143.3	137.8	

Source: Fitch

Figure 19

Syndicate PTF Investments

End-2011

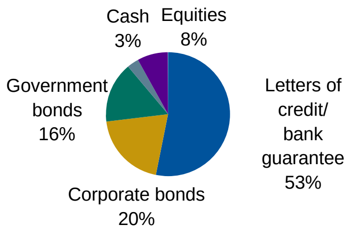


Source: Lloyd's

Figure 20

Members' FAL Investments

End-2011

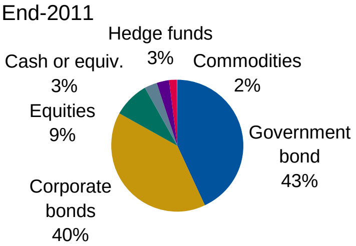


Source: Lloyd's

Figure 21

Central Fund Investments

End-2011



Source: Lloyd's

Conservative Investment Policy for All Links in the Chain of Security

- PTFs: First source of policyholder repayment is high-quality and liquid
- 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

Fitch considers the overall asset allocation for Lloyd's to be fairly conservative when looking at the aggregate of Premium Trust Funds (PTFs), Funds at Lloyd's (FAL) and the Central Fund. However, the agency notes that substantial variation exists at the PTF and FAL levels for individual syndicates.

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

PTFs are the first resource for paying policyholder claims from a syndicate. Investments are generally invested in liquid, short-duration, high-quality assets. Around 81% of assets are invested in bonds. Of the 41% of investments held in corporate bonds, 91% are rated 'A' or above.

FAL: Second Repayment Layer Support Point

FAL represent the second layer of capital provided by members to support their underwriting. The amount of deposited funds is determined by the Corporation, reviewing each syndicate's ICA and applying an uplift based upon the syndicate's business proposal. The capital is held in trust as readily realisable assets. Letters of Credit (LOCs) continue to represent a significant proportion of assets within FAL (53% at end-2011). Fitch notes that the largest providers of LOC facilities have remained constant through the credit crisis.

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

Central Assets at Lloyd's are the third level of security, 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 at end-2011 was GBP2.4bn, with 83% of the portfolio 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 both the FAL and Central Fund asset levels.

Figure 22

Reserve Adequacy – Prior-Year Reserve Movement

pp movement in combined ratio	2007	2008	2009	2010	2011	Fitch's expectation
Reinsurance	-4.6	-12.1	-5.8	-9.5	-7.5	Continued caution regarding the level of surplus that will be generated by prior underwriting years. Of the seven classes, the future development of the casualty and motor reserves will receive the greatest scrutiny.
Property	-6.0	-6.5	-3.4	-6.7	-6.0	
Casualty	-9.1	-8.8	-8.3	-4.5	-1.8	
Marine	-7.6	-7.8	-7.4	-7.5	-7.8	
Energy	-3.9	-8.2	-6.2	-18.3	-9.7	
Motor	-6.4	-1.3	3.9	36.7	-1.7	
Aviation	-18.3	-23.7	-16.6	-24.5	-26.5	

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

Prior-Year Surplus Generated by All Classes

- Motor development stabilises
- Level of casualty surplus decreases
- Reserving position has greatly improved following Equitas

This trend was driven by favourable claims experiences across all of the main classes of business at Lloyd's, which resulted in a 6.5pp% improvement in the calendar-year combined ratio (2010: 5.9%). Fitch will closely monitor developments across the casualty and motor classes, with the agency believing that it is here that the greatest near-term uncertainty resides.

Motor Development Stabilises

Following significant strengthening in 2010, equivalent to 36.7pp, a modest 1.7pp surplus was achieved in 2011. Fitch remains cautious as to how this class will perform over the next few years, with the adequate control of claims costs being viewed as the key factor in determining future profitability.

Level of Casualty Surplus Decreases

The challenging outlook for this major class was highlighted by the reduced level of surplus achieved in 2011, equivalent to 1.8pp (2010: 4.5pp). While the ultimate level of claims arising from the financial crisis remains unclear, the agency views strengthening efforts positively, although it remains cautious about future development.

Reserving Position Has Greatly Improved Following Equitas

The reserving position of Lloyd's has improved significantly since 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 1997 has reduced the volatility of the reserving position of Lloyd's, as the proportion of long-tailed liabilities has significantly diminished.

Reinsurance, Risk Mitigation and Catastrophe Risk

Increased Reinsurance Recoverables; Credit Quality of Reinsurers is Good

- Falling external reinsurance utilisation rate

The major claims incurred through 2011 served to increase net reinsurance recoverables, which at end-2011 stood at GBP11bn (+19.6%), although this remains significantly down from a peak of GBP14.5bn at the end of 2001 following the 11 September 2001 terrorist attacks in the US. Fitch regards the reinsurance recoverables as generally high-quality, with 95% of counterparties rated 'A' or above.

Falling External Reinsurance Utilisation Rate

Each syndicate is required to make its own reinsurance arrangements. Across the market, the "external" reinsurance utilisation rate is 18% (2010: 18%). Reinsurance within the market between syndicates is excluded from this ratio.

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 being considered core.

Notching

The unique corporate structure of Lloyd's, being 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. The regulatory environment in the United Kingdom is considered to be strong.

Notching Summary

Society of Lloyd's

- The Society's IDR is linked to the IFS Rating assigned to Lloyd's of London. The Society has no legal liability for the insurance liabilities of members other than where it has issued an undertaking. The undertakings are liabilities of the Society and constitute unsecured obligations of the Society ranking pari passu with its other senior unsecured liabilities. Thus, Fitch has aligned the IDR of the Society with the implied IDR of Lloyd's of London.

IFS Ratings

- Due to the existence of policyholder priority, a baseline recovery assumption of Good applies to the IFS Rating, and standard notching from the implied IDR was used.
- The insurance policies issued by Lloyd's of London 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 of London.

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

Figure 22
Hybrids Treatment

Hybrid	Amount	CAR Fitch (%)	CAR Reg override (%)	FLR Debt (%)
Sub debt	GBP300m	0	100	100
Sub debt	EUR253m	0	100	100
Sub perpetual	GBP419m	0	100	100

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. It includes both the "Old" Central Fund and the New Central Fund.

Corporation of Lloyd's

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 on a worldwide basis 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's agreement. These services and duties include advising the member on which syndicates he should participate in, the level of participation on such syndicates and liaising with the member's managing agents.

Service Company

A service company coverholder (referred to in the Code simply as a "service company") is an approved coverholder that Lloyd's has agreed can be classified as a service company by reason of it being 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.