

Operating Company Covered

By This Report

Financial Strength Rating

Local Currency

A+/Stable/—

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Lloyd's

Major Rating Factors

Strengths:

- Strong competitive position.
- Strong operating performance.
- Strong capitalization.
- Strong financial flexibility.

Weaknesses:

- Relatively high utilization of reinsurance and letters of credit for capital support.
- Inherent operating performance volatility.

Rationale

The insurer financial strength rating on the Lloyd's insurance market (Lloyd's or the Market) reflects Standard & Poor's Ratings Services' view of Lloyd's strong competitive position, strong operating performance, strong capitalization, 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 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, 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 to the Market in recent years. This has contributed to Lloyd's operating with a near-record level of capacity in 2011, virtually flat from 2010. This is not all positive in our view, since operating margins are under downward

pressure in many of Lloyd's business lines, which will in turn continue to demand strong oversight from the Performance Management Directorate.

Lloyd's prospective operating performance is expected to remain strong overall, but it continues to face some challenges that we believe will result in lower profitability in 2011 and 2012 compared with recent years, namely continued depressed pricing in many major lines, prolonged periods of low investment returns, and the expected reduction in reserve surpluses from prior years. 2010 operating results were strong, albeit down from record highs in 2009. The Market posted a pretax profit of £2.2 billion in 2010 (2009: £3.9 billion) and strong, though suppressed, operating statistics, including a combined ratio of 93.3% and 11.2% return on revenue (ROR), compared with 86.1% and 20.3% in 2009. However, catastrophe losses in 2010 were slightly above the average level incurred by Lloyd's since 2001, while 2009 was substantially below average. On the other hand, reserve releases continued to drive profitability in 2010, comprising 89% of the Market's underwriting result, up from around 40% in 2009—a trend we do not consider to be sustainable.

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 £4.4 billion in loss reserves since 2005, and equivalent to 3%-4% of opening loss provisions in the past four years. 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 £6.8 billion or 49% of members' funds at Lloyd's in 2010—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. Also, considering nearly 90% of these facilities are provided by 10 banks, there is some concentration risk.

Lloyd's financial flexibility is strong. The diversity of Lloyd's capital providers represents a unique strength for the Market. In addition to the strong flow of high quality new applicants, financial flexibility is also reinforced by Equitas' \$7 billion reinsurance deal with National Indemnity Co. (NICO; AA+/Negative/—) and the declining trend of annual undertakings given to insolvent members. Solvency deficits amounted to just £123 million in 2010, down from £482 million in 2005.

Outlook

Our outlook on Lloyd's is stable.

Negative pricing trends have abated in most lines during 2011. However, prices remain soft in many segments, and when coupled with low forecast investment returns we believe this could suppress the Market's earnings. Lloyd's estimates that the first-quarter catastrophes resulted in \$3.8 billion in losses for the Market; we believe these events will add around 20% to Lloyd's 2011 combined ratio. This suggests to us that a combined ratio for the full year of 105% is achievable if there are no additional catastrophes during the year and reserve releases continue at the same rate, but more likely it will be higher given the historically active hurricane season that takes place in the third quarter.

We expect the impact of prior-year releases on the Market's overall performance in 2011 to be slightly more, if not the same compared with 2010 as market participants look to offset catastrophe losses and low investment returns in the first half of the year. However, over the longer term, we view the level of reserve releases seen in recent years as unsustainable, and consider that their positive impact on earnings will diminish in coming years.

Lloyd's central assets for solvency of £3.0 billion at year-end 2010 are over £1.2 billion in excess of its minimum economic target. However, given the continued uncertainty in capital requirements from the Solvency II standard formula, we would not expect Lloyd's to reduce the amount of the Central Fund or contributions to it in the short term. Nor do we expect Lloyd's to adjust the 35% uplift that is applied to each member's Individual Capital Assessment (ICA).

Lloyd's has submitted a pre-application for internal model approval to the U.K.'s Financial Services Authority (FSA), and we recognize that Lloyd's has worked very hard towards successful Solvency II implementation. However, model approval is not yet assured, and we believe that due to its mix of business, Lloyd's is particularly exposed to certain current capital charges under the current standard formula proposals (as tested under QIS 5).

A positive rating action in the short term is not likely in our view. This is due to ongoing uncertainty around the pricing environment in many of Lloyd's major lines of business, the possibility of a resumption of rate declines, and thus the diminishing profit margins in many lines. In addition, while we recognize that Lloyd's appears to be progressing toward obtaining internal model approval for Solvency II purposes, the lack of certainty in this area presents a hurdle to the rating given the Market's vulnerability to severely increased capital requirements.

Ultimately, positive rating action would be conditional on the impact of Solvency II being neutral relative to peers, Lloyd's main capital providers remaining committed to the Market as they invest in separate operating platforms, and Lloyd's upholding strong operating performance relative to peers. The likelihood of negative rating action is similarly low, but would be driven by a wide exodus of capital providers should they incur capital requirements or costs of doing business that abate the profitability of doing business in the market; by operating performance returning to levels seen prior to 2002, reflecting poor management of a softening underwriting cycle; or by the occurrence of a major catastrophe loss.

Corporate Profile: Significant Participant In Worldwide Markets

The London-based Lloyd's insurance market is a major participant in specialty commercial insurance and reinsurance markets worldwide. Lloyd's wrote gross premiums in 2010 of £22.6 billion across a diverse range of classes, predominantly via broker distribution (see table 1). This represented growth of 3% over 2009. Lloyd's ranked as the fifth-largest reinsurer in 2010, according to our global survey.

Table 1

<i>Lloyd's/Main Business Classes By Gross Premiums Written</i>										
	—2010—		—2009—		—2008—		—2007—		—2006—	
	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)
Reinsurance	8,389	37	7,993	36	6,299	35	5,455	33	5,560	34
Casualty	4,397	19	4,320	20	3,762	21	3,364	21	3,572	22
Property	4,908	22	4,954	23	3,971	22	3,809	23	3,638	22
Marine	1,671	7	1,606	7	1,334	7	1,226	8	1,153	7
Energy	1,419	6	1,371	6	1,150	6	1,019	6	1,125	7
Motor	1103	5	1118	5	939	5	983	6	923	6
Aviation	642	3	551	3	481	3	464	3	393	2
Life	63	0	60	0	49	0	46	0	50	0
Total	22,592	100	21,973	100	17,985	100	16,366	100	16,414	100

As at Jan. 1, 2011, there were 92 syndicates (including 5 special purpose syndicates) trading at Lloyd's, supported by 57 managing agencies. These figures include those managing agents and syndicates that are only authorized to underwrite reinsurance to close (RITC) contracts.

Lloyd's has very wide geographic coverage, with specific trading rights to write insurance business in over 75 jurisdictions and the ability to write reinsurance in over 200 countries and territories. Nevertheless, a significant majority of income (63% in 2010) continues to be sourced from North America and the U.K. About one quarter of the net premium written relates to property catastrophe business.

Competitive Position: Unique Brand, Subscription Market, Mutuality And Licensing Provide Key Advantages

Lloyd's competitive position is very strong, supported by its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance/reinsurance market, and policyholder loyalty. This position has been further enhanced in recent years by a combination of Lloyd's improved financial strength, the successful completion of Equitas' deal with NICO and improving London market business processes which aim to make Lloyd's more competitive. The attractiveness of Lloyd's as an operating platform is evidenced by the continual flow of new entrants to the Market in recent years either directly or through the acquisition of an existing operation. This has contributed to Lloyd's operating with a near-record level of capacity in 2011, virtually flat compared with 2010. This is not all positive in our view, since operating margins are under downward pressure in many of Lloyd's business lines, which will in turn continue to demand strong oversight from the Performance Management Directorate.

Lloyd's draws significant competitive strength from its unique brand. Built over centuries, the brand is recognized globally and is often viewed as a key positive attribute among insurance buyers. Although the brand may not regain the position it had before the Market's near demise during the mid-1990s, Lloyd's underwriters are still recognized as possessing a number of positive traits. These include a strong track record of timely settlement, particularly following major loss events, and their willingness and ability to offer innovative underwriting solutions to their clients.

Lloyd's is the world's largest subscription insurance market. Lloyd's has endorsed the European Federation of Insurance Intermediaries' (BIPAR) principles, which seems to have resulted in fewer changes to the subscription market than was initially feared. Although Lloyd's managing agents operate as independent businesses, the size and diversity of underwriting capacity within the Market allows it to compete with the largest global (re)insurance groups. This diversity provides Lloyd's with a valuable competitive advantage in that it enables buyers and brokers to diversify risk placement in a single marketplace.

Lloyd's retains a critical mass of relevant underwriting, claims and broking expertise, and support services, remaining the cornerstone of diverse specialist underwriting niches, such as marine, energy, aviation, and certain nonmarine classes. This will, in our view, preserve London's status as a leading marketplace; however, the proliferation of new regional hubs and the trend towards local placements presents Lloyd's with several challenges. Nearly than 80% of participants at Lloyd's now have access to alternative platforms, and several of the large traditional capacity providers are investing heavily in their non-Lloyd's operations, thereby reducing their reliance on Lloyd's. This is, in our view due to several factors; Lloyd's does not have the same licensing advantages outside of the U.S. surplus lines

market; Lloyd's has an array of capital providers whose interests are not always aligned; and local requirements often mean additional operational and regulatory complexity for Lloyd's. The Market's resilience is evident, however, from the way it withstood Bermuda's emergence as a major competitor, and it continues to extend its global reach, notably through market development activities in over 25 countries and the establishment of Lloyd's offices in Singapore, Japan, China, Canada, Brazil (where it is the second-largest reinsurer), and most recently in Russia.

The features of business typically underwritten at Lloyd's include: complexity; large monetary exposure levels; and a high-severity, low-frequency profile of risk. It has accentuated this risk in recent years, capitalizing on well-priced U.S. catastrophe business. The resultant underwriting portfolio, although diverse, is positioned toward a highly credit-sensitive clientele. A significant majority of Lloyd's income (63%) is sourced from the U.S., Canada and the U.K., which are particularly credit-sensitive markets compared with those in Continental Europe. Lloyd's underweight position in Europe is in our view a competitive disadvantage relative to some peers, which we believe is difficult to redress. We acknowledge that operating margins have more recently tended to be lower in Europe, but there is some diversification benefit to be gained, and Solvency II may provide growth opportunities in the future.

Lloyd's predominantly sources its business through brokers—the most credit-sensitive distribution channel—and remains highly dependent on the top three large international broking groups (50% in 2010). About a third of Lloyd's business is also underwritten on a delegated authority basis. This is a higher risk underwriting model, particularly so when pricing and terms and conditions are under pressure.

Owing to the credit-sensitive nature of its key stakeholders, confidence in Lloyd's among these constituencies is extremely important, hence the value placed by Standard & Poor's on the deal concluded between Equitas and NICO in 2006. Phase II of the NICO transaction was completed effective June 30, 2009. As a result, Equitas and relevant policyholders now benefit from the full \$7 billion of reinsurance cover provided under this arrangement (in addition to Equitas' reserves). The U.K. High Court approved the insurance business transfer of the members' liabilities in respect of 1992 and prior non-life business written at Lloyd's to Equitas Insurance Limited, a newly formed FSA-authorized insurance company within the Equitas Group. This transfer relieves the members and former members concerned from those liabilities under English law and the law of every other state within the EEA. Standard & Poor's believes the Equitas/NICO deal renders as highly remote the potential for reserve inadequacy at Equitas. We also believe the deal alleviates risk of potential damage to the Market's competitive position that could result from a loss of confidence in Lloyd's due to such reserve inadequacy.

The London market's business administrative processes have historically been a drag on Lloyd's competitive position. In being less efficient than those of global market peers, they reduced London's relative attractiveness to policyholders in terms of service quality and cost. Since 2006, Lloyd's has embarked on a fairly ambitious business process reform agenda, focused on introducing common data standards, improving the process and speed of premium and claims payments, and hopefully removing the residual frictional costs associated with trading at Lloyd's.

Management And Corporate Strategy:

Management

As expected within a marketplace, the quality and sophistication of management varies. The Corporation has established a strong track record in relation to its prime goal of protecting, but in reality improving, the Lloyd's franchise, both in a financial and competitiveness sense. The success of this can be measured in the continual flow of high quality new applicants to the market. The more recent success of the Corporation is evidence of the effectiveness of increasingly robust performance, risk-monitoring processes, tools, and benchmarks against which managing agents are assessed. Part of the credit for the enhanced effectiveness of the Corporation in positively influencing Market behaviour must, in our view, be attributed to the Performance Management Directorate (PMD), which established an impressive track record in enforcing market underwriting discipline. We have noted few major changes, such as improving market oversight, enhancing minimum standards, transforming the claims process, and providing better access to more business through increased transparency and information on delegated authority initiatives. The PMD has put more emphasis on, and monitoring against, Syndicates' business plans. The business plan steering group has increased its size and scope and now conducts quarterly monitoring meetings and provides more analysis on cross cycle and segmental performance for managing agents.

The Corporation has an array of tools, enhanced by the implementation of the PMD Return in 2010, which monitors syndicates' planned, expected, and actual performance and helps to identify under-performing businesses at an early stage with the requisite authority to impose sanctions where warranted. These may include capital loadings, business plan restrictions, and requesting changes to the management team. Lloyd's has recently demonstrated its ability and willingness to impose such restrictions.

The Financial Services Authority (FSA) has ultimate responsibility for the regulation of the Market. Although the FSA's working relationship with the Franchise Board means that the Corporation effectively performs many of the regulator's duties, the FSA inspects and is actively engaged with individual managing agents and has imposed additional measures, beyond those suggested by Lloyd's, where problems have been identified.

Despite its improved effectiveness, the Corporation's remit remains somewhat limited. It can take necessary action to protect the Central Fund, Lloyd's reputation, brand, and ratings—hence, for example, the introduction from 2007 of underwriting, claims, and risk management principles and minimum standards (which were enhanced in 2011). Nevertheless, while considering the above, the Corporation is constrained from promoting or undertaking activity that could be considered anti-competitive. In addition, it is understood within the Market that the Corporation is not expected to be a micromanager of managing agents, therefore the oversight it provides is designed to be robust without being overbearing. That said, in our view the requirements under Solvency II are demanding, more so given Lloyd's application for internal model approval, and require major improvements to risk management across the Market. Lloyd's has been forceful in preparing the Market for Solvency II, engaging its participants by creating a series of working groups, workstreams, and dry runs, through regular dialogue and the publishing of advice, gap analyses, and benchmarking the level of preparedness of individual managing agencies. A small number of managing agents are struggling to implement the new requirements according to Lloyd's timetable. If Managing Agents are unable to

make good the gaps in progress, this has unknown consequences for Lloyd's since it is mandating at least partial internal model approval for all participants so as not to prejudice the Corporation's application. However, we do note the improvement in agents' Solvency II preparedness, as measured by Lloyd's internal rating system.

Strategy

During 2011, Lloyd's has made progress against its three-year strategic plan announced in February 2010. The Corporation's stated priorities are unchanged; to preserve and enhance the competitiveness of Lloyd's in terms of accessing and transacting efficiently with(in) the market, ensuring Lloyd's is not disadvantaged by changing regulation, especially Solvency II, and continuing to promote and enforce strong risk and performance management within the market. Success is evidenced by strong operating results in the face of an above-average catastrophe year for the market, continued interest in the Market from new capital providers, obtaining access to new business in new markets such as China, Brazil, and Russia, and continued progress towards the successful implementation of Solvency II. Lloyd's acknowledged its reliance on the U.S. and certain brokers for business, and increased weighting to more volatile lines of business, but considers them to be part of its success and has no plans to shift focus.

Additional short-term priorities inevitably include process reform. The move to electronic claims files and accounting submissions have impressively cut processing times. Progress with electronic messaging (The Exchange) has been slow, but improved as of late. All managing agents and 28 brokers (representing 85% of Market premium) are now connected, and cumulative message volume has doubled since the beginning of the year to over 300,000, growing by an average of 23% per month. Other initiatives such as claims transformation aimed at improving claims handling, and the administration of coverholders has been centralized through the Atlas platform, which allows agents to monitor coverholder details, audits, approval, and compliance information. Lloyd's considered various optimal systems solutions as part of its strategic review, such as a central clearing function, but ultimately determined that the current program of improvements was adequate, probably after feedback from the Market that there was still much to deliver on and within budget. Lloyd's does not intend to turn itself into an electronic trading platform, however, which might in the future be to the advantage of competing marketplaces.

Enterprise Risk Management: Continuous Enhancement Remains A Key Priority For Lloyd's

Standard & Poor's considers the quality of the Lloyd's enterprise risk management (ERM) to be adequate with strong risk controls, which is supportive of the rating. Standard & Poor's believes that it is unlikely that Lloyd's will experience losses outside its risk tolerances. The factors supporting the overall assessment are adequate and improving risk management culture, strategic risk management, and strong risk controls overall, namely underwriting, reserving, and emerging risk controls.

For our ERM assessment we have considered the central fund as a provider of protection to the Market and have assessed the risk controls and strategic risk management with this in mind. This ERM assessment is not a reflection of the ERM capabilities of the participants in the Lloyd's Market.

ERM is of high importance. The Market operates in numerous complex business lines, many of which have the potential to demonstrate extreme volatility. Individual syndicates have historically

performed with significantly varying degrees of success. Centrally, Lloyd's continues to make considerable progress on ERM and further enhancements are planned. In Standard & Poor's view, the frequency and effectiveness of the interaction between the risk management team and the other directorates continues to improve. Separately, we do note the variability of the ERM capabilities evident among managing agents continues to vary throughout the market.

We view the Market's catastrophe risk controls and risk models as strong. However, we have not yet undertaken a full review of Lloyd's risk models.

We have assessed strategic risk management as adequate; however, the Corporation is constrained by law from promoting activity that optimizes Market profitability at the expense of competition. Therefore, the Corporation cannot directly intervene to ensure the Market is able to optimize its RAROC (risk-adjusted return on capital), so we have not considered the strategic risk management of the underlying syndicates in this assessment.

We believe that the proposed developments, especially in the risk appetite framework, will have positive implications on our assessment. The development of the risk appetite framework and the resulting communication of quantitative tolerances should allow a more aligned and transparent risk strategy, which may facilitate a broader use of risk in strategic decision making. Therefore, these improvements could result in an increase in assessment of the ERM capabilities of the Corporation in the foreseeable future.

Accounting: Various Accounting Conventions Considered

Standard & Poor's analysis of Lloyd's relies on data provided under a number of accounting conventions, including fully audited three-year fund and U.K. generally accepted accounting principles (GAAP) accounting for syndicates, audited financial statements for the Society and unaudited pro forma financial statements for the Market. The latter, while externally reviewed by auditors, are unaudited and are generated to present Lloyd's aggregated results on a basis that is broadly comparable with results for general insurance companies.

The key adjustments made within Standard & Poor's risk-based capital model from published financial statements are: recognition of loss-reserve discount and total adjusted capital. The latter has been derived in the capital model after applying adjustments for: (1) loss and unearned premium reserve discounting; (2) a 100% write-down of deferred acquisition costs; (3) and full hybrid equity credit given to the subordinated loan notes and perpetual subordinated capital securities issued by The Society of Lloyd's in 2004 and 2007, respectively.

Operating Performance: Strong, But Headline Numbers Obscure Weakening Prospects

Table 2

<i>Lloyd's/Operating Performance</i>					
<i>(Mil. £)</i>	<i>2010</i>	<i>2009</i>	<i>2008</i>	<i>2007</i>	<i>2006</i>
Total gross premiums written	22,592	21,973	17,985	16,366	16,414
Annual change (%)	2.8	22.2	9.9	(0.3)	9.6
Total net premiums written	17,656	17,218	14,217	13,256	13,201
Annual change (%)	2.5	21.1	7.2	0.4	12.2
Total revenue¶]	17,976	18,069	14,339	14,320	13,645

Table 2

Lloyd's/Operating Performance (cont. 'd)					
(Mil. £)	2010	2009	2008	2007	2006
Annual change (%)	(0.5)	26.0	0.1	4.9	9.2
Profit before tax	2,195	3,868	1,899	3,846.0	3,662
Annual change (%)	(43.3)	103.7	(50.6)	5.0	(3,655)
ROR [§] * (%)	11.2	20.3	12.1	23.2	22.7
Net loss ratio (%)	58.6	51.6	61.4	50.0	49.0
Net expense ratio (%)	34.7	34.5	29.9	34.0	34.1
Net combined ratio (%)	93.3	86.1	91.3	84.0	83.1
Accident-year combined ratio (%)	99.2	91.7	100.5	90.5	85.2

*Restated. †|Net premiums earned plus allocated investment income. §Balance on the technical account for general business/Total revenue. N.A.—Not available.

Lloyd's prospective operating performance is expected to remain strong overall, but it continues to face some challenges that we believe will result in lower profitability in 2011 and 2012 compared with recent years.

The Market posted strong operating results in 2010, although down from 2009's record performance. Pretax profit in 2010 was £2.2 billion, compared with £3.9 billion in 2009. Operating statistics were strong, although reflective of catastrophe activity that was above average for the Market in the last decade (10 percentage points of the combined ratio). Lloyd's reported a combined ratio of 93.3% in 2010, and a ROR of 11.2%, compared with 86.1% and 20.3% ROR excluding investment gains, and a 2.6% total investment return. This represents a continued strong level of performance in a challenging operating environment in absolute terms and relative to peers. However, reserve releases continued to drive profitability in 2010, comprising almost 90% of the Market's underwriting result, up from around 40% in 2009, a trend we do not consider to be sustainable.

The accident-year combined ratio excluding U.S. windstorm activity, which gives a reasonable indication of attritional claims for Lloyd's, has remained flat over the period 2007-2010, at just above 90%, which we view as encouraging. In fact, if we were to normalize the combined ratio for an average catastrophe year (10 points of the combined ratio versus the actual 12.7 experienced in 2010), and excluding any profit emergence from prior underwriting years and foreign exchange effects, the combined ratio would be 96.5% in 2010, compared with 97.3% in 2009. This gives us an indication of the underlying profitability of the Market's business. Implicit within our analysis is an expectation that the impact of prior-year reserve releases on the Market's overall performance will diminish. This does not seem to be the case, however, looking at the 2011 interims for the listed Lloyd's vehicles.

Table 3

Breakdown Of Combined Ratio		
	2009	2010
Accident-year combined ratio	87.3	86.5
Impact of nonmonetary items	2.3	0
Impact of U.S. hurricanes	2.1	12.7
Prior year movements	5.6	5.9
Reported calendar year combined ratio	86.1	93.3

Analysis of Lloyd's underwriting performance reveals that prior-year releases accounted for almost 89% of the underwriting profit for 2010. Due to a slightly above-average catastrophe year, property insurance and reinsurance only generated marginal underwriting profits for the current accident year. However, they contributed 24% and 8% of 2010 accident-year result, respectively. Casualty insurance returned to an accident-year loss, as in 2008 and 2007, following a small accident-year profit in 2009. It continued to experience strong positive gains on prior years, however, accounting for 15% of total reserve releases in 2010. Reserve releases, which lowered the overall combined ratio by 5.9 percentage points in 2010, came from all major segments except motor in 2010, as in 2009. In fact, the motor line has generated losses in each of the last five accident years, with 2010 experiencing a loss of £150 million in the current accident year, and reserve strengthening of £370 million on prior years. .

Chart 1

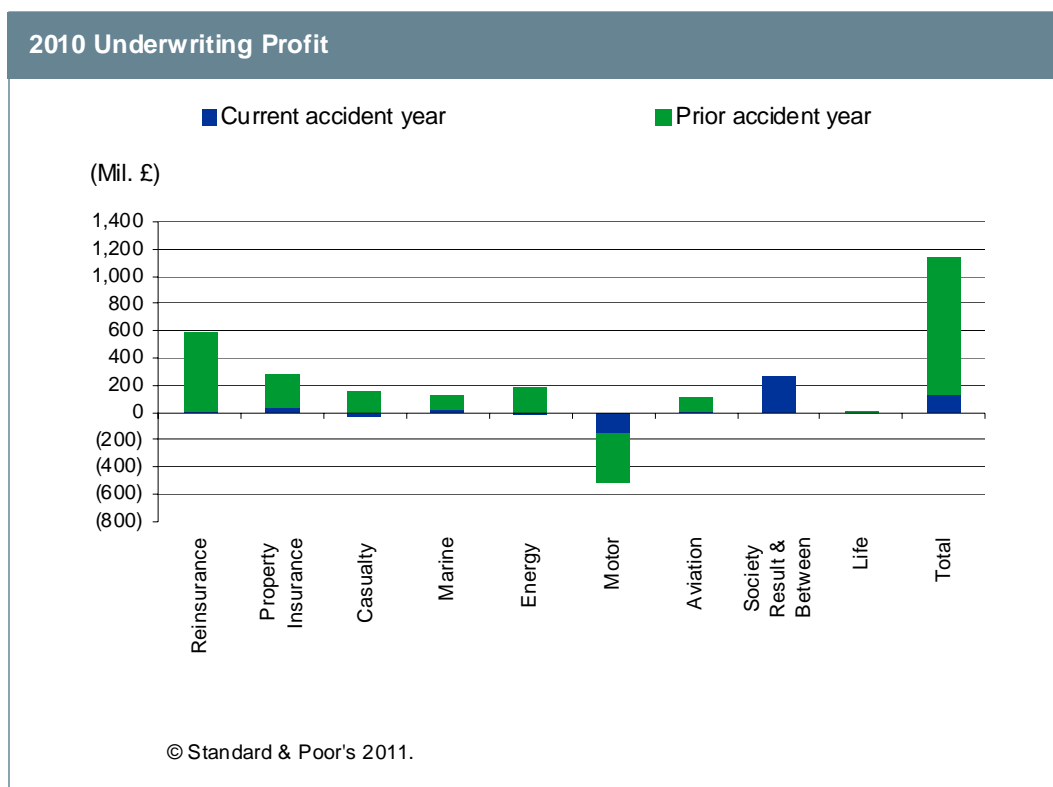


Chart 2

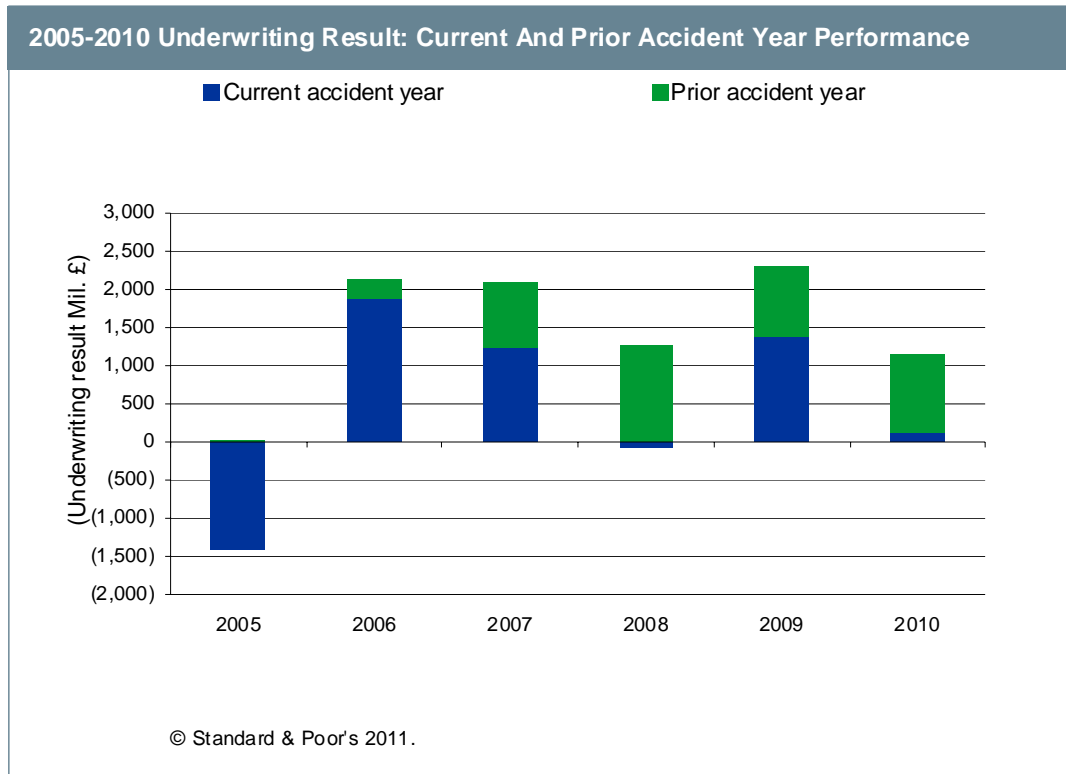


Chart 3

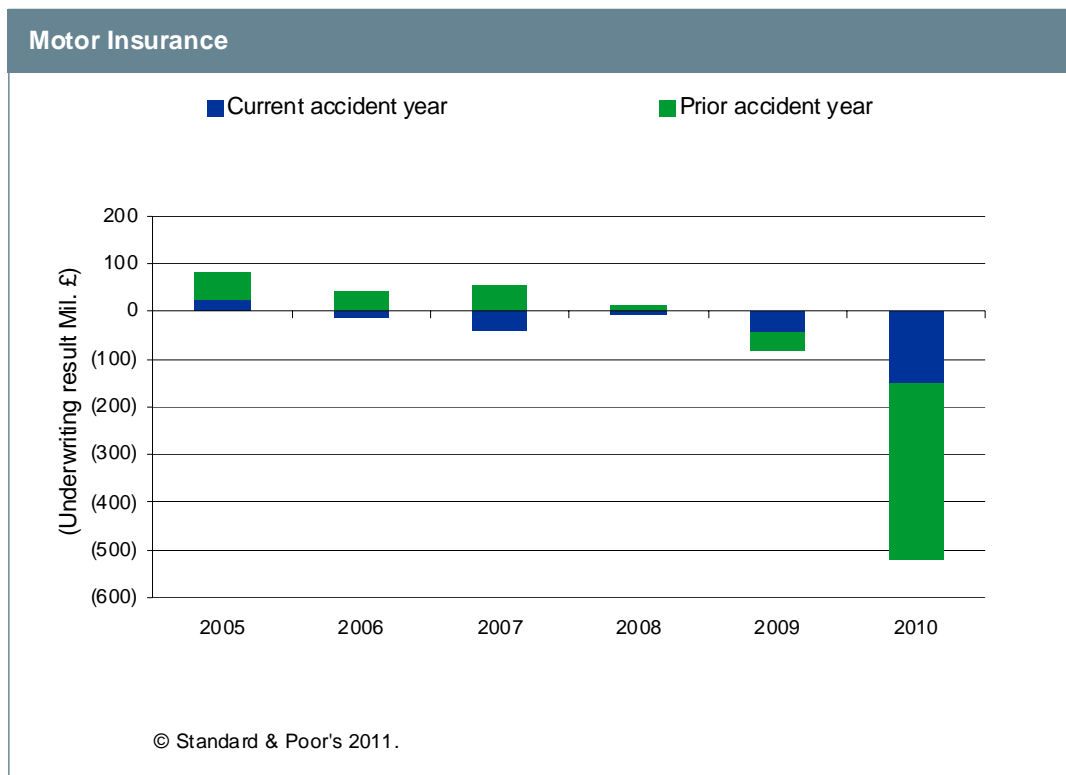
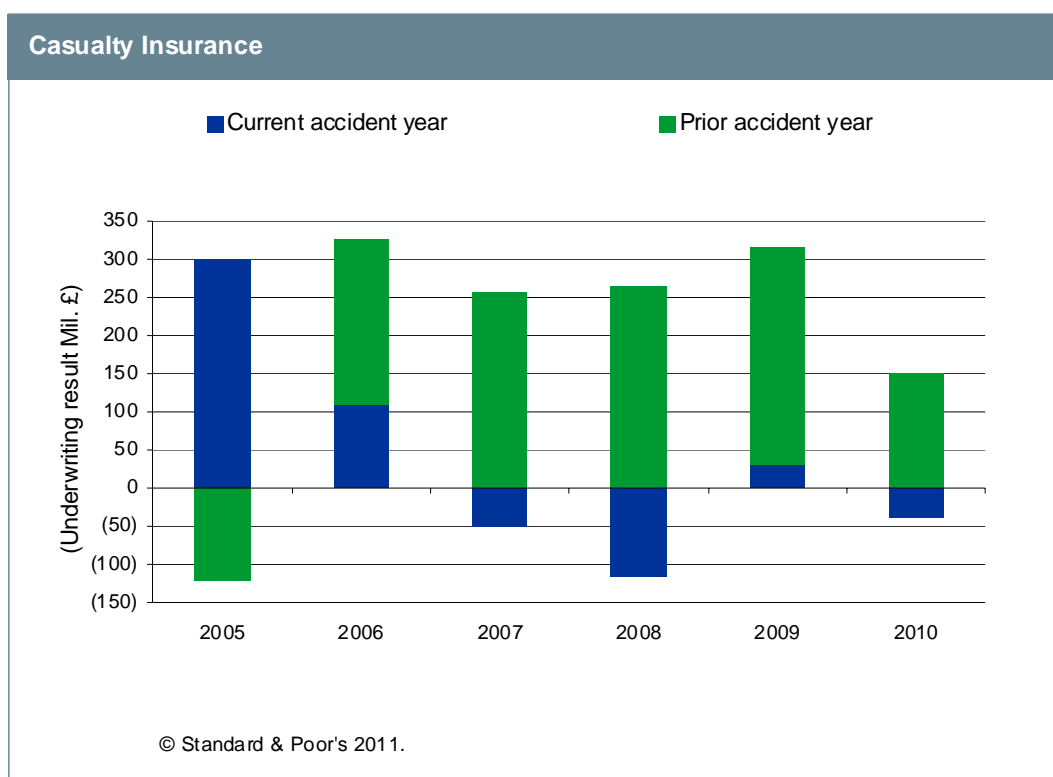


Chart 4



Negative reinsurance pricing trends have continued through 2010, although declines have abated in most lines during 2011. However, when these softer prices are coupled with low forecast investment returns, we believe this could suppress the Market's earnings. For example, Lloyd's total investment return of £1.3 billion in 2010 was down from the £1.8 billion received in 2009, and persistently low interest rates meant that the net investment yield weakened to 2.6% (2009: 2.5%). The efficacy of Lloyd's cycle management is expected to be an increasingly key driver of its earnings in the longer term. Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded prior to 2002. Nevertheless, earnings volatility will remain a feature given the nature of the short-tail and specialty business lines that continue to represent Lloyd's core business.

Notably, catastrophe losses incurred to June 30, 2011 are estimated to be the highest level of first-half losses incurred by the industry, and already equivalent to 1.5x the losses incurred in all of 2010. Lloyd's has released estimates for the three large first-quarter 2011 catastrophe events; the Japan Earthquake (\$1.9 billion), the second New Zealand earthquake (\$1.2 billion), and the Australian floods (\$0.7 billion). There remains a lot of uncertainty in these loss figures in the market, so it is unclear how these figures might develop in the near future. Taken together, these events are expected to add around 20% to Lloyd's 2011 combined ratio. This suggests to us that a combined ratio for the full year of 105% is achievable if there are no additional catastrophes during the year and reserve releases continue at the same rate, but more likely it will be higher given that the third quarter is the most active quarter for hurricane formation and loss.

Investments: Conservative Investment Stance Pays Off

Table 4

Lloyd's/Investment Split					
(%)	2010	2009	2008	2007	2006
Bonds and other fixed-interest securities*	60	58	57	56	55
Equities and other variable-interest securities	12	11	10	12	11
Cash and bank deposits	18	20	21	20	23
Loans and private placements	10	11	12	12	12
Other investments	0	0	0	0	0
Total investments	100	100	100	100	100

*Pre-2004 includes members' funds at Lloyd's.

Lloyd's investments are very strong. The Market has historically pursued a conservative investment strategy, and this has partially insulated it from the extreme volatility seen in global financial markets. Invested assets can be separated into three groupings; those backing the members fund's at Lloyd's (FAL), premium trust funds (PTF), and Central assets (including the Central Fund).

PTF's account for £32.3 billion of the total £48.5 billion of investments, and are invested primarily in high quality bonds and cash. Including LOCs, just over one-third (31%) of syndicate investments (Funds at Lloyd's (FALs) and premium trust funds (PTFs)) were invested in government and related securities. Bond credit quality has remained stable in 2010, with 'AAA/AA' rated bonds representing 69% of the portfolio, compared with 70% in 2009, and the average portfolio rating was still 'AA', with £1.2 billion of securities rated 'BBB' or below (7% of the portfolio). The portfolio duration is about two years, shorter than the three-year liability profile. Only 4% of assets are held in hedge funds or equities.

The Central Fund's investment policy has always been somewhat more aggressive. Given the intended long-term nature of the Central Fund, this approach is understandable. The Corporation could almost double the amount of risk assumed and stay within its value at risk limit, but we think this is unlikely. At Dec. 31, 2010, 16% of investments were held in equities and hedge funds and 3% in high-yield or emerging markets bonds. The remainder was held in high quality bonds and cash. Just over half (51%) of the bond portfolio consisted of sovereign or government guaranteed debt, with 42% of this amount held in gilts or debt guaranteed by the U.K. government. Lloyd's currency matches its subordinated debt securities, hence the higher proportion of Sterling and Euro assets than those held by the syndicates.

Liquidity: Strong, Supported By Highly Liquid Invested Assets

Lloyd's liquidity is strong, supported by a substantial £12.2 billion cash position, high-quality bond portfolio, and substantial credit facilities in place to support capital and short-term liquidity requirements. Operating cashflow was £1.7 billion in 2010 (2009: negative £0.7 billion), partly as claims payments for the 2009 year were low due to a benign cat season. We expect operating cash flow to be negative in 2011 and 2012 as the Market pays out claims on the 2010 and 2011 catastrophes. Liquidity needs are significantly influenced by U.S. situs trust fund requirements, including Lloyd's 100% collateral requirements as an accredited reinsurer in the U.S. While we note that some states, namely Florida and New York, have amended their collateral requirements for foreign reinsurers, we

do not expect this to have a material beneficial impact on Lloyd's business until a more significant number of states follow suit.

Capitalization: Strong Adequacy And Quality

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. Strong profits continue to emerge on prior-year loss reserves in aggregate; however, we expect this trend to progressively diminish following 2011. The syndicates' high reliance on LOCs to support their FAL and collateral requirements, and on reinsurance capacity to support their underwriting, is a detraction.

Capital adequacy

Capital adequacy is considered to be very strong. Analysis of our capital model indicates extremely strong capital adequacy at year-end 2010, albeit certain structural aspects of the Market are not easily captured. Lloyd's central assets for solvency purposes—£3.0 billion at year-end 2010, have more than doubled since 2005. Part of this reflects the issuance of subordinated debt in 2004 and 2007, of which £930 million was outstanding at year-end 2010. Lloyd's is required to hold central assets in excess of any solvency deficits at individual syndicates. This shortfall amounted to just £123 million in 2010, down from £482 million in 2005. Lloyd's minimum surplus target is £1.7 billion. In spite of the current excess, both in relation to Lloyd's solvency test and relative to The Society of Lloyd's 2011 ICA, we do not expect Lloyd's to reduce the amount of the Central Fund or contributions to it in the short term. Nor do we expect Lloyd's to adjust the 35% uplift that is applied to each member's ICA.

Lloyd's has submitted a pre-application for internal model approval to the U.K.'s FSA, and we recognize that Lloyd's has worked very hard towards successful Solvency II implementation. However, model approval is not yet assured, and we believe that due to its mix of business, Lloyd's is particularly exposed to certain current capital charges under the current standard formula proposals (as tested under QIS 5). For example, the proposed formulaic approach and calibration of non-EU and reinsurance catastrophe exposures presents a particular problem for Lloyd's due to its large proportion of U.S. catastrophe business. In addition, any capital held in nondomestic assets incur a currency risk charge under the current proposal, and Lloyd's holds a large proportion of capital in dollar-denominated assets (to back potential U.S. liabilities). Under the current proposals, adoption of the standard model formula could result in capital increases that could significantly challenge Lloyd's business model.

We therefore believe that Lloyd's will adopt a conservative stance in the interim. Lloyd's also has the option to redeem one of its hybrids in 2014. Fixed charge coverage at The Society of Lloyd's of 7.7x in 2010 (2009: 3.9x) was consistent with the assigned debt ratings.

Quality of capital

Quality of capital is strong. Our analysis is based on the consolidation of the syndicates' annual accounts, the members' FAL, and the Society of Lloyd's, so there is no inclusion of intangible assets or leverage that may reside at the capital providers', where capital quality may be weaker.

Members' FAL is provided for either by depositing assets with Lloyd's, or through the provision of LOCs. In 2010, LOCs accounted for £6.8 billion, or 41% of the total £13.8 billion FAL (in addition

Members Balances represent surplus assets at Syndicate level of £2.9bn). Under the latest Solvency II proposals, Tier 1 capital must comprise 50% of regulatory capital. LOCs are eligible as Tier 2 capital only. While Lloyd's currently meets that requirement, 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. Further, considering nearly 90% of these LOC facilities were provided by 10 banks, there is some concentration risk at the Corporation level.

Loss reserves

Strong profits continued to emerge on most prior underwriting years and classes of business during 2010. The total amount released was £1.0 billion, up slightly from £0.9 in 2009. In aggregate, Lloyd's has released £4.4 billion since 2005, and equivalent to 3%-4% of opening loss provisions in the last three years. Despite this, IBNR levels have been maintained at 40%-45% of total loss reserves. Standard & Poor's expects such releases to diminish but persist for the continuing Market after 2011, particularly in respect of the 2002-2006 years of account. There were some areas of deterioration, such as U.K. motor, and non-trade credit insurance which performed poorly during the financial crisis, but Lloyd's main classes continued to see positive run-off. This included casualty insurance, which has developed positively since 2006, and casualty reinsurance, similarly in the last three years. It is worth noting that the market as a whole has revised its loss picks upwards, albeit very marginally, for both the 2008 and 2009 accident years.

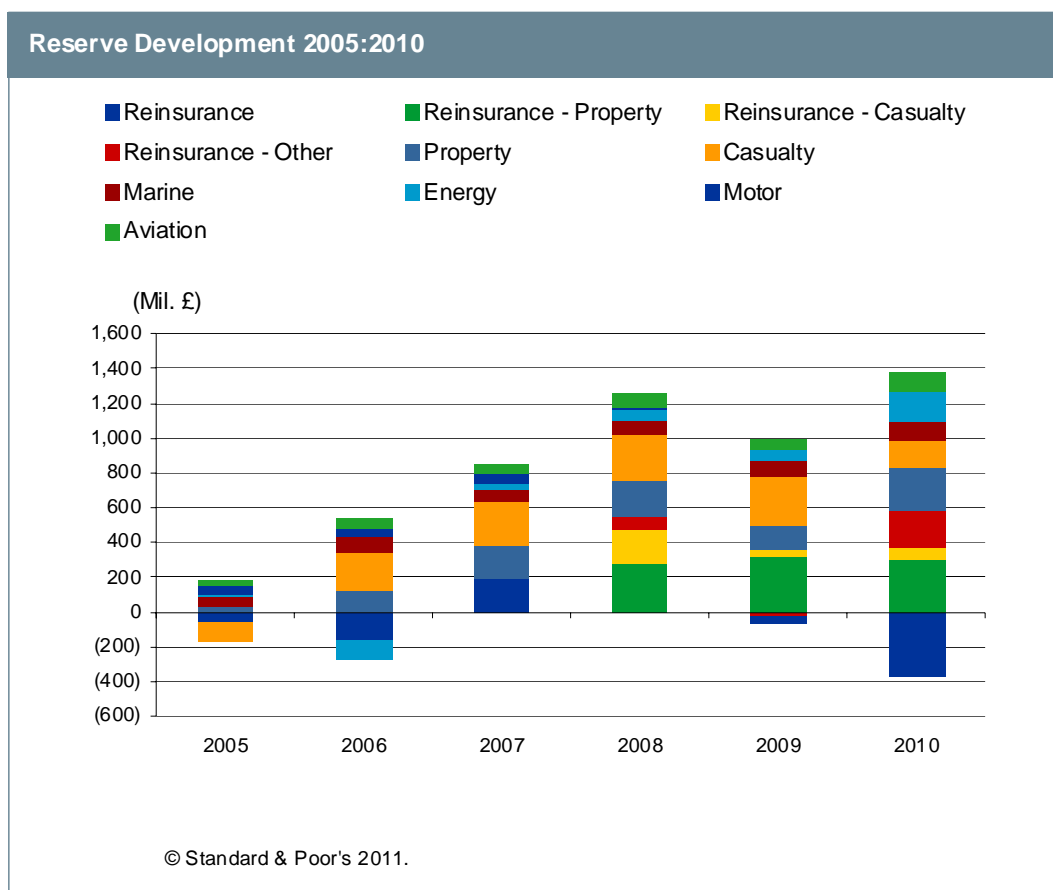
Table 5

Lloyd's/Reserving Track Record*					
(%)	2010	2009	2008	2007	2006
Calendar-year net combined ratio	93.3	86.1	91.3	84.0	83.1
Accident-year combined ratio	99.2	91.7	100.5	90.5	85.2
Prior-year reserve movement combined ratio points	(5.9)	(5.6)	(9.2)	(6.5)	(2.1)
Run-off years' reserve movements (mil. £)	108.0	97.0	39.0	(48.0)	(3.0)
Continuing Market reserve movements (mil. £)	908.0	837.0	1,226.0	904.0	273.0

*Data on pro forma annual accounting basis. N.A.—Not available.

The reported position of run-off years of account continues to improve. At financial year-end 2010, there were eight syndicates with 10 open underwriting years (i.e. not closed after three years as is normal), amounting to gross reserves of £1.0 billion. This compares to equivalent figures of 48, 102, and £7.0 billion in 2005, respectively. 2010 also saw a further net release of reserves held in respect of run-off liabilities of £108 million, (2009: £97 million).

Chart 5



Reinsurance

The proportion of reinsurance Lloyd's cedes as a percentage of gross premiums written now appears to have stabilized at around 20%, but remains high relative to that of peers. As a result, the Market's competitive position and future earnings remain relatively dependent on the continuing supply of adequate reinsurance capacity. Despite this, we believe Corporation and managing agents' activity has ensured that the Market's reinsurance protection is broadly adequate and closely monitored. Following 2008 catastrophe losses, Lloyd's saw a 41% increase in its reinsurance asset at Dec. 31, 2008. This fell back to £9.2 billion, or 54% of reported capital (including hybrids) in 2010. Although in our opinion the overall quality of the asset was and remains strong, any sharp increase potentially leaves the Market exposed to reinsurer dispute and default following major loss events in the future.

Table 6

Lloyd's/Reinsurance Usage					
(Mii. £)	2010	2009	2008	2007	2006
Total gross premiums written	22,592	21,973	17,985	16,366	16,414
Total reinsurance ceded	4,936	4,755	3,768	3,110	3,213
Total net premiums written	17,656	17,218	14,217	13,256	13,201
Reinsurance ceded as % of gross premiums written	21.8	21.6	21.0	19.0	19.6
Reinsurers' share of claims outstanding*	8,779	8,484	10,504	7,449	9,259
Capital and reserves	18,191	18,163	14,182	13,449	12,836
Reinsurers' share of claims outstanding as % of capital and reserves¶	48.3	46.7	74.1	55.4	72.1

*Excludes intersyndicate reinsurance.

Financial Flexibility: Diversity Of Capital Providers Positively Differentiates

Lloyd's financial flexibility is strong, being principally derived from capital providers' continued support. The diversity of Lloyd's capital providers represents a unique strength for the Market. Our view of Lloyd's financial flexibility is also reinforced by the completion of Phase II of Equitas' \$7 billion reinsurance deal with NICO, the declining trend of annual undertakings given to insolvent Names, and the positive momentum that continues to surround the Market, which makes Lloyd's an attractive platform for an increasingly diverse range of capital providers.

Table 7

Lloyd's/Capital Requirements And Sources	
Capital requirements	Capital sources
Member/syndicate level	
Underwriting losses	Premium trust funds
Increases in capacity	Members' funds
Changes to ICA/ECA requirements	Cash calls
Liquidity requirements	Outward reinsurance
	Short-term bank facilities
	Parental guarantees
Market level	
Member solvency shortfalls	Central Fund and Corporation assets
Corporation liabilities	Central Fund subordinated loans
	Callable layer
	Centrally raised hybrid equity
	Membership levies

ICA—Individual capital assessment. ECA—Economic capital assessment.

Sources

Capital is supplied on the basis of an annual venture, with continuing support from providers needing affirmation each year. As a result, capital providers' continued support, in terms of both willingness and ability, directly or indirectly underpins the majority of Lloyd's capital sources. The longevity of any Lloyd's investment will ultimately depend on factors such as: the attractiveness of underwriting

conditions; the Lloyd's platform enabling operations to outperform those outside of the Market; the effectiveness of the Corporation in minimizing the cost of mutuality, particularly by reducing any strain on the Central Fund; and regulatory costs (in terms of compliance and the amount of capital held).

In part because some Lloyd's managing agents are not in a position to operate meaningfully outside the Market, but largely due to the competitive advantages conveyed by the market outlined earlier, we expect the majority of current capital providers to remain committed to Lloyd's in the short-to-medium term. Nevertheless, there is a divergent trend between new entrants at Lloyd's, many of which are international groups that are seeking to extend the number of operating platforms and exploit Lloyd's global licenses, and the large, more established Lloyd's capital providers who are expanding in global (re)insurance markets independent of their Lloyd's operations.

Continued diversity within Lloyd's capital base will remain important. Standard & Poor's believes that mutualization would be weakened were underwriting capacity supplied by too few capital providers or if any one provider were to represent too great a proportion of the Market. Concentration of capacity among a few industry investors would mean less incentive to support the Market in the event of a call for extra funds because this could be construed as supporting a competitor.

Needs

Capital needs declined following Equitas' conclusion of its reinsurance transaction with NICO. Previously, Standard & Poor's had felt that capital providers could be required to support a shortfall scenario at Equitas. In addition, reflecting reducing negative reserve movements in aggregate, annual undertakings given to insolvent members continue to fall. Capital requirements under Solvency II represent an area of uncertainty, however.

Ratings Detail (As Of 19-Sep-2011)*	
Operating Company Covered By This Report	
Lloyd's	
Financial Strength Rating	
Local Currency	A+/Stable/—
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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