

# RatingsDirect®

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## Lloyd's

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SACP* Assessments				SACP*		Support		Ratings	
<b>Anchor</b>	<b>a+</b>	<b>Modifiers</b>	<b>0</b>	<b>a+</b>		<b>0</b>		<b>Financial Strength Rating</b>	
<b>Business Risk</b>		<b>ERM and Management</b>	<b>0</b>	<b>Liquidity</b>	<b>0</b>	<b>Group Support</b>	<b>0</b>	<b>A+/Negative/--</b>	
<b>Very Strong</b>		<b>Holistic Analysis</b>	<b>0</b>	<b>Sovereign Risk</b>	<b>0</b>	<b>Gov't Support</b>	<b>0</b>	<b>Holding Company Rating</b>	
<b>Financial Risk</b>								<b>A+/Negative/--</b>	
<b>Moderately Strong</b>									

\*Stand-alone credit profile.  
See Ratings Detail for a complete list of rated entities and ratings covered by this report.

## Major Rating Factors

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>Strong brand name and worldwide recognition in the non-life insurance sector.</li> <li>Diverse product and geographic range.</li> </ul>	<ul style="list-style-type: none"> <li>Current capital position as measured by our risk-based model remains at levels that are not supportive of the rating level.</li> <li>Market's underlying operating performance continues to weaken.</li> </ul>

## Rationale

Our rating on Lloyd's reflects its unique position in the insurance sector and the strength of its competitive position, particularly in the reinsurance and specialty markets. The market's current level of capital adequacy per our risk-based model, and its weakening underlying performance in recent years, currently offset these factors.

The London-based Lloyd's insurance market is a major participant in specialty commercial insurance and reinsurance worldwide. Lloyd's wrote gross premiums in 2017 of £33.6 billion (2016: £29.9 billion) across a diverse range of classes, predominantly via broker distribution.

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, Lloyd's still sources about two-thirds of its income from North America and the U.K. About one-quarter of the net premium written relates to property catastrophe business. Lloyd's currently operates in more than 25 countries and has established offices in Singapore, Japan, China, Canada, Brazil, India, Belgium, and the United Arab Emirates.

**Outlook: Negative**

The negative outlook reflects our uncertainty as to whether Lloyd's will be able to rebuild its capital position so it returns to a surplus above the 'AAA' level in our model by year-end 2020. Our base-case scenario sees Lloyd's operating performance improving in 2018-2020 recording combined ratios close to 95%.

**Upside scenario**

We could revise our outlook to stable if the market manages to remain attractive to its members and restores its capital position to the 'AAA' level in our model through strong earnings in 2018-2020.

**Downside scenario**

We could lower our ratings by one notch if Lloyd's is not able to restore its capital position to the 'AAA' level in our model by the end of 2020, either through further major losses or weaker earnings.

**Base-Case Scenario****Macroeconomic Assumptions**

- Continued interest rate increases globally, led by further hikes in the U.S., should feed into slowly improving yields for insurers.
- Economic growth in developed markets to improve, but remain sluggish, lagging growth in developing markets.

**Company-Specific Assumptions**

- We expect modest rate improvements in the global reinsurance sector (0%-5%) for 2018. However, in the absence of any major catastrophes in 2018-2019, we believe pricing in 2019 and 2020 will at best remain stable.
- We include a catastrophe load of 9% in our forecast combined ratios.

## Key Metrics

	2019F	2018F	2017	2016	2015	2014
GPW (mil. £)	>35,000	>35,000	33,591	29,862	26,690	25,283
Combined ratio (nonlife; %)	95.0	95.0	114.0	97.9	90.0	88.4
Net income (mil. £)	>2,000	>2,000	(2,001)	2,107	2,122	3,161
Net investment yield (%)	2.0	2.0	2.1	1.7	1.3	1.7
Return on revenue (%)	~10.0	~10.0	(8.8)	7.9	11.7	15.0

GPW--Gross premium written.

## Business Risk Profile: Very Strong

In our opinion, Lloyd's benefits from its unique brand, the attraction of being the world's largest subscription market, and its large geographic footprint from which it distributes its wide product offering. The expense of doing business at Lloyd's, along with the tough market conditions the market faces in virtually all its lines of business, somewhat offsets these strengths.

We view Lloyd's brand and reputation as a key differentiator for the rating. The availability of one-stop shopping for various niche and standard products, the expertise of Lloyd's underwriters, and the strong face-to-face culture have led to policyholder and broker loyalty that we view as a competitive strength.

Lloyd's enjoys a leading position in the global re/insurance market, consistently ranking among the top five global reinsurers, and it has been the leading excess and surplus writer in the U.S. since 2011. The Lloyd's market is also the leading reinsurer for global marine business. However, a significant majority of Lloyd's income (65%) comes from the U.S., Canada, and the U.K., which are particularly credit-sensitive markets compared with those in continental Europe.

The cost of doing business at Lloyd's somewhat constrains our assessment of the market's competitive position. Lloyd's expense ratio is significantly higher than that of peers (39.5% in 2017, compared with a simple sector average closer to 35%). This is driven in part by high acquisition costs (the top six global brokers provide 50% of Lloyd's business) but also by Lloyd's dependence on coverholders who produce close to 30% of Lloyd's premium. Lloyd's management is working on changing its operating model to address this issue through introducing initiatives such as electronic placement and simplifying claims handling. While we believe these programs have been more successful than previous attempts to modernize the market, there remains a significant amount of work to do to ensure the market can improve its competitiveness.

The growing amount of alternative capital in the wider re/insurance market also poses a threat to Lloyd's profitability via increased competition and pressure on pricing. Prior to the 2018 renewals, risk-adjusted rate adequacy in the reinsurance fell consistently in 2012-2017. Natural catastrophes in 2017, including the hurricanes Harvey, Irma, and Maria (HIM), have led to some rate increases in 2018 renewals so far, but our expectation is that, without a significant

catastrophe in 2018, rates could fall again in 2019.

In our base-case scenario we expect that Lloyd's will grow its premium base in 2018 by about 5%, largely due to rate increases following the HIM losses in 2017. However, our expectation is that in 2019-2020, premium will increase by only 1%-2% in constant currency terms.

## Financial Risk Profile: Moderately Strong

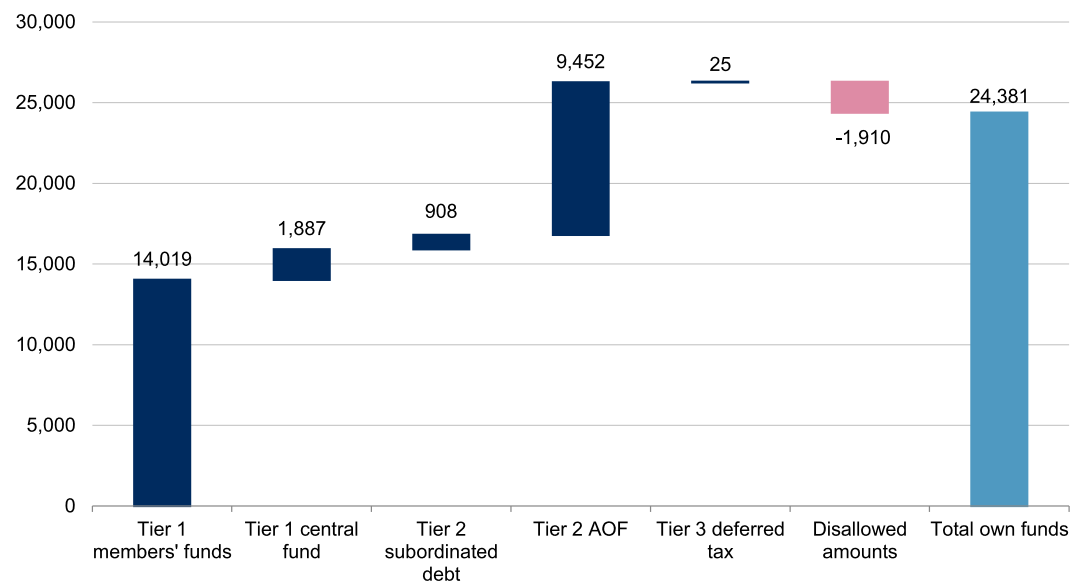
We base our assessment of Lloyd's financial risk profile on our expectation that the market's capital position will return to a surplus of capital at a 'AAA' level (per our capital model) by 2020. We also expect that Lloyd's operating performance will improve in 2018-2020 so that it will record combined ratios close to 95% (in the absence of any significant catastrophes).

Over 2016 and 2017, Lloyd's capital adequacy per our model fell to a level significantly below our 'AAA' requirement. The causes of the deterioration included premium growth, higher catastrophe risk, and the HIM losses of 2017. However, management has sought to address the issue through raising capital and taking steps to improve the quality of capital.

Immediately following the HIM losses, management instructed the market to recapitalize, and by year-end, it had raised roughly £3 billion of capital. This capital increase largely offset the major claims of 2017 and funded 2018 underwriting. The recapitalization brought Lloyd's Solvency II ratio back to 144% (the same level it was at year-end 2016). Management will also improve the market's capital position by reducing the market's dependence on letters of credit (LOCs) as a form of capital. At year-end 2017, £9.4 billion of Lloyd's capital base comprised LOCs. This dependence impacts our assessment of Lloyd's quality of capital. Solvency II rules only allow 50% of an entity's solvency capital requirement to comprise this type of funds, hence £1.9 billion of LOCs are disallowed as capital (and therefore receive no equity credit in our model). Management has insisted on a reduced portion of capital backed by LOCs in underwriters' future business plans. As a result, by 2020, we expect there will no longer be a disallowance. It is our belief that these management actions and an improvement in operating performance will result in Lloyd's returning to a surplus of capital at our 'AAA' level by the end of 2020.

**Chart 1****Lloyd's -- Market Solvency II Capital Breakdown**

(Mil. £)



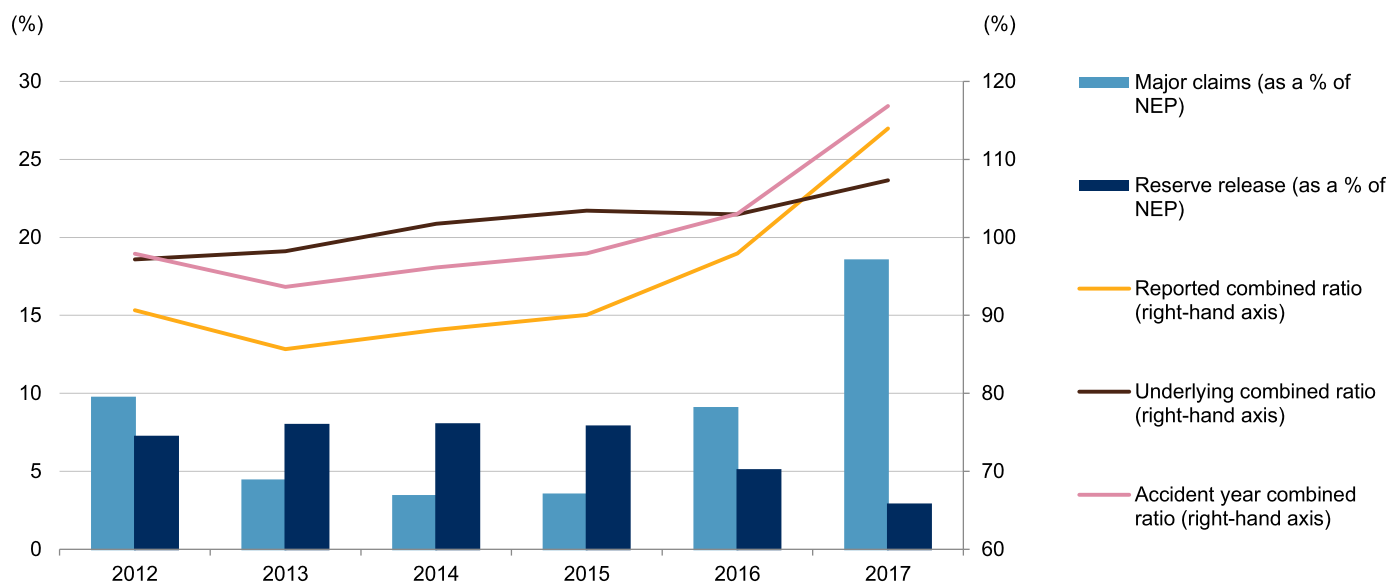
AOF--Ancillary own funds.

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Like many of its reinsurance peers, Lloyd's recorded a loss in 2017, primarily as a result of the HIM losses (Lloyd's recorded £4.5 billion of major claims in the year, compared with £2 billion in 2016). A combined ratio of 114% in 2017 brought Lloyd's' rolling five-year average combined ratio to a reasonably profitable 95%. However, while this average reflects the market's sub-100% headline combined ratios, its underlying underwriting performance (excluding prior year reserve releases and assuming a blanket catastrophe load of 9%) weakened in the period 2012-2017 and has been unprofitable since 2014. A period of below-average catastrophic events and significant reserve releases have masked a deterioration in attritional losses due to pressures on pricing as described earlier. The chart below also shows that the benefit of reserve releases (which have averaged 6% over the past five years) may be on the wane, having fallen to 3% in 2017 from 8% in 2013.

Chart 2

## Lloyd's -- Market Underlying Performance



NEP--Net earned premium. Accident year combined ratio excludes reserve releases from prior years. Underlying combined ratio excludes both the impact of reserve releases and actual major claims, and adds a 9% catastrophe load.

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Our expectation is that Lloyd's will improve its operating performance in 2018-2020. We expect this development will be the result of the increase in rates we have observed in early 2018 and a reduction in the market's expense ratio reflecting some output of the modernization program described earlier. Assuming a 9% catastrophe load, we expect Lloyd's will record combined ratios close to 95% in 2018-2020, resulting in annual profits before tax in excess of £2 billion.

## Other Assessments

### Enterprise Risk Management

We have a positive view of Lloyd's risk controls and its strategic and emerging risk management of this highly complex marketplace. We believe that enterprise risk management (ERM) is of high importance to Lloyd's operations, and that it is unlikely that Lloyd's will experience losses outside its risk tolerances.

We are concerned, however, at Lloyd's appetite for, and ability to limit, risk-taking on the part of the syndicates. Last year, we revised down our assessment of risk management culture (a subfactor of ERM) to neutral following growth in Lloyd's consolidated catastrophe risk exposure. While the market's catastrophe risk exposure came back to within risk appetite at the start of 2018, we maintain our risk management culture score at neutral until we see a longer track

record of management maintaining risks within appetite.

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.

### **Management & Governance**

Our positive view of the market's management and governance reflects the significant expertise and experience of the Lloyd's managing agents and the market's overall governance. We do note, however, that Lloyd's itself has seen significant turnover in its senior management. Both the CEO and CFO have announced their intended departure from Lloyd's in the past 12 months. We believe that Lloyd's will be able to find suitable replacements, either externally or internally, but will monitor the situation to ensure Lloyd's retains the appropriate level of experience and expertise at executive level.

We hold a positive view of Lloyd's robust strategic planning process, which its performance management and finance directorates have established and improved in recent years. The initiatives implemented include a stringent business planning process and benchmarking exercises, and have fueled significant improvements in performance standards and measurement. We have not identified any governance deficiencies in our assessment.

### **Liquidity**

Lloyd's premium income flow provides readily available liquidity. The market also has a highly liquid asset portfolio that contains more than £56 billion in marketable securities. The entire Lloyd's chain of security could be liquidated in 90 days. We also credit the market's ability to call on members for capital injections throughout the year and withhold profits in order to ensure claims are paid as a positive factor for its liquidity assessment.

## **Related Criteria**

- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Criteria - Financial Institutions - Banks: Assumptions: Clarification Of The Equity Content Categories Used For Bank



And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

### Ratings Detail (As Of August 6, 2018)

#### Holding Company: The Society of Lloyd's

Issuer Credit Rating

*Local Currency*

A+/Negative/--

Junior Subordinated

A-

Subordinated

A-

#### Operating Company Covered By This Report

##### Lloyd's

Financial Strength Rating

*Local Currency*

A+/Negative/--

#### Related Entities

##### Lloyd's Insurance Co. S.A.

Financial Strength Rating

*Local Currency*

A+/Negative/--

#### Domicile

United Kingdom

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