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Lloyd's

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Lloyd's

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

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

Major Rating Factors

Strengths

- Strong brand name and worldwide recognition in the non-life insurance sector.
- Diverse product and geographic range.

Weaknesses

- Current capital position as measured by our risk-based model remains at levels not commensurate with the rating level.
- The market's underlying operating performance continues to weaken.

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 such that 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 (loss and expense) 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 were 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, absent 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	2018 H1	2017	2016	2015	2014
GPW (mil. £)	>35,000	>35,000	19,338	33,591	29,862	26,690	25,283
Combined ratio (non-life; %)	95.0	95.0	95.5	114.0	97.9	90.0	88.4
Net income (mil. £)	>2,000	>2,000	588.0	(2,001.0)	2,107.0	2,122.0	3,161.0
Financial leverage	<5	<5	2.7	2.9	3.2	3.3	3.5
Fixed-charge coverage	>30	>30	30.5*	(41.6)	35.2	46.5	53.1

*Estimate. F--Forecast. H1--First half. 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. Lloyd's 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 by 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 increasing 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. Before the 2018 renewals, risk-adjusted rate adequacy in the reinsurance market fell consistently in 2012-2017. Natural catastrophes in 2017--including 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 expand 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

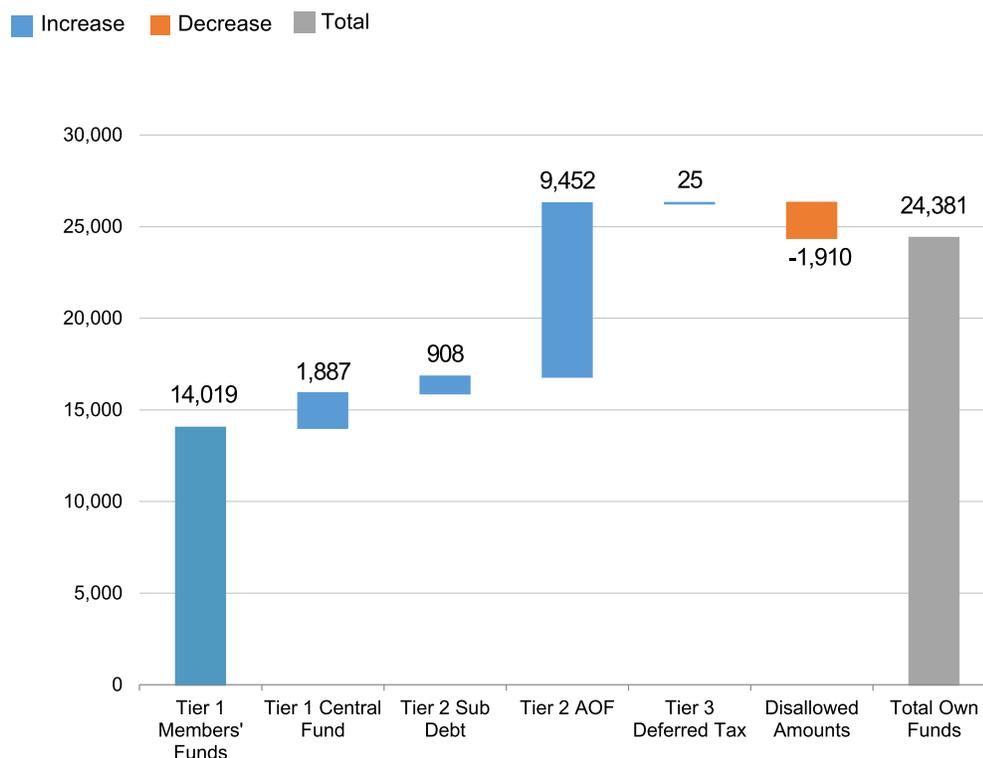
We base our assessment of Lloyd's financial risk profile on our expectation that the market's capital position will return to a surplus of capital at a 'AAA' level (per our capital model) by 2020. We also expect that Lloyd's operating performance will improve in 2018-2020 so that it will record combined ratios close to 95% (absent 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 on what we consider a softer form of capital is reflected in our capital and earning assessment. 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 SII Capital Breakdown

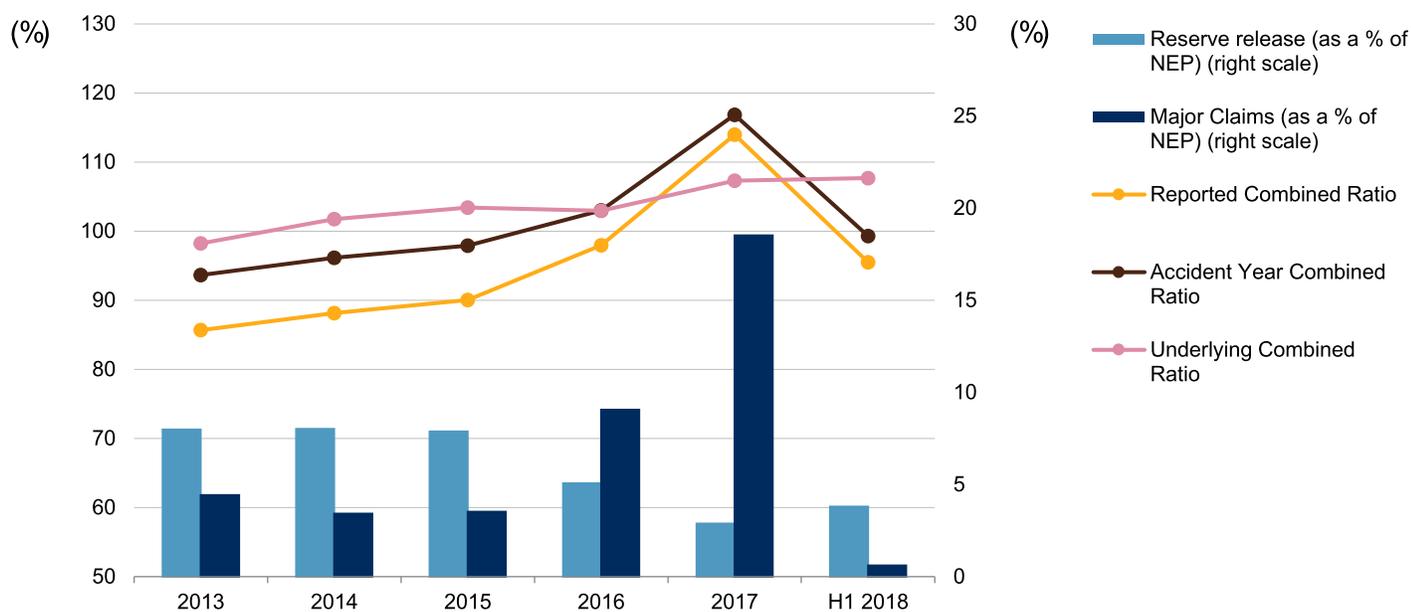


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Like many of its reinsurance peers, Lloyd's recorded a loss in 2017, primarily as a result of the HIM losses (Lloyd's recorded £4.5 billion of major claims in the year, compared with £2 billion in 2016). A combined ratio of 114% in 2017 brought the 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 waning, having fallen to 3% in 2017 from 8% in 2013.

Chart 2

Lloyd's Market Underlying Performance



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We expect Lloyd's to improve its operating performance in 2018-2020 as a 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. At half-year 2018, the market's combined ratio improved to 95.5% reflecting a quiet first half of the year in terms of catastrophes with just £73 million of major claims. While the second half of the year has had more catastrophe events to date (including Hurricanes Florence and Michael), we still expect the market to record a combined ratio close to 95%.

Other Assessments

Enterprise Risk Management

We view positively Lloyd's risk controls and its strategic and emerging risk management of this highly complex marketplace. We believe that enterprise risk management (ERM) is highly important to Lloyd's' operations, and that Lloyd's is unlikely to experience losses outside its risk tolerances.

We view negatively, however, Lloyd's' appetite for, and ability to limit, risk-taking on the part of the syndicates. Last year, we revised downward 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 Lloyd's' risk appetite at the start of 2018, we will 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 providing protection to the market and have assessed the risk controls and strategic risk management with this in mind. This ERM assessment does not reflect 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 note, however, that Lloyd's itself has seen significant turnover in its senior management. Both the CEO and CFO 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 the executive level.

We view positively 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

Related Research

Ratings Detail (As Of October 26, 2018)

Operating Company Covered By This Report

Lloyd's

Financial Strength Rating

Local Currency

A+/Negative/--

Domicile

United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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