December 2006

Lloyd's Update: A New Era Beckons

Developments at Lloyd's over the last six months point to a strengthening of the market's competitive position. The news is rightly dominated by the announcement that, subject to various approvals, Berkshire Hathaway is to provide substantial extra reinsurance protection for Equitas in 2007, as a prelude to a planned assumption of the liabilities in 2009. This agreement is viewed positively by the rating agencies, and its key elements are covered in this briefing, together with the likely implications for the ongoing market. We also provide an overview of Lloyd's interim results, highlight recent corporate activity and look ahead to assess the likely shape of the market in 2007.

The Equitas Transaction

Lloyd's Chairman, Lord Levene: "This agreement marks a significant milestone for Lloyd's. It enables us to close a chapter in Lloyd's history and move forward."

Berkshire Hathaway Chairman, Warren Buffett: "Putting Berkshire Hathaway's Gibraltar-like strength behind the remaining problems – which will take many decades to resolve – eliminates any remaining worries for all concerned."

Standard & Poor's: "…we recognise that, based upon what has been disclosed to date, it may remove any realistic potential for reserve inadequacy at Equitas to undermine confidence in Lloyd's – in particular among clients, brokers and capital providers."

The deal between Equitas and Berkshire Hathaway was announced on 20 October 2006. It is planned that the transaction will occur in two phases:

Phase 1 (expected to complete before 31 March 2007)

National Indemnity Company (NIC) will provide reinsurance cover to Equitas of US$5.7bn over and above the 31 March 2006 reserves (US$8.7bn), less adjustment for payments and recoveries since that date. The premium payable to NIC will be:

i. all of Equitas' assets less £172m; and
ii. a contribution of £72m from the Corporation of Lloyd's.

In this phase, the staff and operations of Equitas and the management of the run-off will pass to an English subsidiary of Berkshire Hathaway.

Phase 2 (expected to complete before the end of 2009)

Equitas will seek approval of the High Court to novate all the liabilities of Reinsured Names into Equitas or a subsidiary of Berkshire Hathaway, by way of a Part VII transfer under the Financial Services and Markets Act 2000. If such a business transfer occurs before the end of 2009, NIC will provide up to US$1.3bn of additional reinsurance cover for a further premium of up to £40m. At the time of any such business transfer, or on 31 December 2009 if a transfer has not occurred, Lloyd's will provide a further contribution of £18m.

Completion is subject to various conditions, including approvals which must be obtained before 31 March 2007 from the Financial Services Authority, regulatory authorities in the United States and the Equitas Trustees. Both contributions from Lloyd's will be drawn from the Central Fund and are subject to approval by an Extraordinary General Meeting of the current membership of Lloyd's.

Implications

Standard & Poor's: "Successfully allaying concerns about legacy issues could help the market regain its position as the preferred European destination for businesses considering expansion overseas."

It is recognised that only upon successful completion of Phase 2 will Reinsured Names, and hence Lloyd's, have achieved finality. However, news of the agreement has had an immediate impact on the market's competitive position, mainly because exposure to Equitas has been a consistent drag on Lloyd's financial strength ratings. Standard & Poor's and Fitch Ratings assigned a positive outlook to their 'A' ratings on the day of the announcement, offering the possibility that both will upgrade by one notch to 'A+' upon successful completion of Phase 1. The response of A.M. Best has been more measured, the agency saying only that the potential impact was "viewed positively."

Without the shadow of Equitas, existing competitive strengths should come into starker relief (particularly with progress now being made on business process reform), which in turn should make Lloyd's franchisees more attractive to existing capital providers and to organisations seeking to diversify. It is also possible that further consolidation will be spurred within the market itself.

For underlying policyholders, completion of both phases of the transaction will provide the benefit of up to an additional US$7bn of reinsurance cover. It remains to be seen whether the approach to the management of the run-off will change and the eventual resting place for these liabilities is also yet to be determined.

Lloyd's 2006 Interim Results

On 27 September 2006, Lloyd's released unaudited pro forma financial statements for the first half of 2006. The strong underlying performance of recent years has continued. Relative to the same period in 2005, interim profit was virtually unchanged at £1.35bn, a 20 percent improvement in underwriting profit being offset by a smaller contribution from investment income. The result was said to be a combination of good underwriting conditions and the market's continual focus on underwriting discipline. Given the benign hurricane season, there is now a good chance that Lloyd's will produce a record profit for 2006 as a whole.

Technical Account Summary

	As at June 30, 2006	As at June 30, 2005	As at Dec. 31, 2005
Gross premiums written	£9,966m	£8,395m	£14,982m
Net premiums written	£7,560m	£6,467m	£11,770m
Net premiums earned	£6,067m	£5,576m	£11,785m
Net claims incurred	£3,288m	£3,161m	£9,505m
Net operating expenses	£1,927m	£1,707m	£3,668m
Net profit/(loss) before tax	£1,351m	£1,377m	(£103m)
Combined ratio	86.0%	87.3%	111.8%

Source: Lloyd's

Gross premiums written rose by 19 percent in the first half of the year, driven by rising rates on US catastrophe-exposed classes, the largest increase being in property treaty.

The limited availability and increased cost of reinsurance and retrocession cover for catastrophe exposures in the US resulted in significant reconfiguring of protections, including greater use of industry loss warranty products. The period was characterised by a marked emphasis on reducing direct and assumed reinsurance aggregates and managing the point at which policies attached, in the face of higher retentions, curtailment of sideways cover and generally less broad protection.

Ultimate net claims estimates for the 2005 hurricanes rose by £208m (or 6 percent) to £3,517m during the period. In aggregate, however, prior accident years reported a small surplus, with no additional underwriting losses falling to insolvent members supported by the Central Fund.

Balance Sheet Summary

	As at June 30, 2006	As at June 30, 2005	As at Dec. 31, 2005
Cash and investments	£32,317m	£30,998m	£33,568m
Reinsurers' share of outstanding claims	£11,631m	£9,348m	£14,450m
Reinsurers' share of unearned premiums	£1,715m	£1,441m	£696m
Debtors	£9,689m	£8,557m	£8,167m
Other assets	£3,797m	£3,450m	£3,172m
Total assets	£59,149m	£53,794m	£60,053m
Provisions for outstanding claims	£33,839m	£29,492m	£37,719m
Provisions for unearned premiums	£9,089m	£8,389m	£6,829m
Other liabilities	£4,656m	£3,937m	£4,513m
Total liabilities	£47,584m	£41,818m	£49,061m
Member's funds at Lloyd's	£11,121m	£9,749m	£10,206m
Member's balances	(£957m)	£1,045m	(£408m)
Central reserves	£899m	£685m	£693m
Subordinated loan notes	£502m	£497m	£501m
Net resources	£11,565m	£11,976m	£10,992m

Source: Lloyd’s

The balance sheet strengthened in the first half of 2006. The total paid out on 2005 hurricane claims had reached £4bn by the end of June, bringing the reinsurance recoverables balance down by 20 percent. Funds at Lloyd’s, central reserves and net resources have all increased since the end of 2005. The Central Fund has grown by 17 percent to £784m over this period, based on the doubling of members’ contributions and a lower charge for claims in respect of insolvent members, offset by lower investment returns.

2006 Corporate Activity at Lloyd’s

After several relatively quiet years, the level of corporate activity at Lloyd’s has greatly increased during 2006. Only the most significant developments are highlighted here.

Catlin to acquire Wellington

Standard & Poor’s: “…the transaction provides clear scale and diversification benefits to Catlin and will enable it to leverage the competitive strengths of…Lloyd’s…while benefiting from Bermuda’s lower tax rate.”

On 30 October 2006, Catlin Group Ltd made a recommended cash and shares offer for Wellington Underwriting plc at a 25 percent premium to the pre-announcement share price, valuing the group at around £600m. Subject to regulatory and other approvals, the acquisition is expected to complete by the end of December, at which point Wellington shareholders will own 34 percent of the combined entity. Separately, Wellington has sought permission to cease Syndicate 2020 at the year-end and move its group capital behind Syndicate 2003 for the 2007 year of account, its application being backed by a recommended compensation offer to Names. A ruling from Lloyd’s is expected “early in December.” Cessation is conditional upon the offer being declared unconditional in all respects, so there is still a remote possibility that Syndicate 2020 will trade into 2007.

The acquisition will create a major international specialty property and casualty insurer, with gross premiums of approximately US$2.4bn and net assets of US$1.9bn. Catlin will become the largest underwriting operation at Lloyd's – Syndicate 2003 will have stamp capacity of up to £1.3bn – and will have a strong platform to accelerate the development of its US business. Catlin's senior management will continue to lead the enlarged group in their current roles, with key Wellington executives being integrated into the team.

Canopius to acquire Creechurch

On 24 October 2006, it was announced that Canopius Group Ltd was acquiring Creechurch Holdings Ltd, the manager of Syndicates 1607 and 3786 (combined 2006 capacity: £90m), which specialise in marine and energy, personal accident and UK liability and professional indemnity insurance. For the 2007 year, all Creechurch business will be written through Canopius Syndicate 4444.

Cathedral – change of ownership

On 2 November 2006, it was announced that UK private equity fund Alchemy Investment Plan (AIP) had made a recommended cash offer of 140p a share for Cathedral Capital plc, valuing the group at £113m. The sale remains subject to regulatory and shareholder approval. The existing management team will be left to run the business, which is expected to continue substantially unchanged. Cathedral represents Alchemy's first move into the insurance sector and this is one of the most significant investments by a private equity firm in a Lloyd's business.

Hiscox – change of domicile and new 'sidecar'

Hiscox plc has received shareholder approval for a corporate reorganisation which will see the introduction of a new Bermuda-domiciled holding company for the group, Hiscox Ltd. Subject to the High Court sanctioning the necessary scheme of arrangement at a hearing on 11 December 2006, it is expected that shares in Hiscox Ltd will be admitted to trading on the London Stock Exchange on the following day. This follows a similar reorganisation at Omega Underwriting Holdings plc, which saw the establishment of Omega Insurance Holdings Ltd as the group's new Bermudian holding company, with effect from 9 November 2006.

On 1 December 2006, Hiscox plc announced the launch of the first Lloyd's syndicate sidecar. In order to take advantage of strong underwriting opportunities, particularly in US catastrophe risks, Syndicate 0033 has entered into a quota share reinsurance arrangement with Panther Re Bermuda Ltd, a US$360m Bermuda reinsurance company newly formed by WL Ross & Co. Under this agreement, Panther Re will assume a 40 percent pro rate share of Syndicate 0033's property catastrophe reinsurance business for the 2007 underwriting year, with a similar share to be agreed for 2008. The financing behind Panther Re comprises US$144m of equity and US$216m of term loans, the net proceeds being placed in trust for Syndicate 0033 as security for the reinsurance.

IAG to acquire Equity

In another sign of the growing attractiveness of Lloyd's players, it was announced on 4 December 2006 that Insurance Australia Group would acquire motor insurer Equity Insurance Group (formerly Cox), the manager of Syndicate 0218, for £570m. The transaction is expected to complete in the first quarter of 2007, subject to regulatory approval. This represents IAG's second foray into the Lloyd's Market, following their acquisition of the Alba Group (the backer of Syndicate 4455) in June 2006.

Syndicate Activity 2006 – 2007

At the beginning of 2006, there were 62 active syndicates operating at Lloyd's and the capital supplied by investors was sufficient to allow £14.8bn of gross premium to be written (net of commissions). These active syndicates were overseen by 44 managing agents.

New Capacity in 2006

There has been substantial growth in the level of interest in establishing new syndicates at Lloyd's over the last year. Three new ventures were formed during 2006:

New Syndicate	Pseudonym	Active Underwriter	Managing Agent	2006 Capacity	Capital Backer
1919	CVS	Chris Hancock	Marlborough	£15m	C.V. Starr
3334	SCS	Peter Nash	Argenta	£8m	Sportscover
4455	MBM	Moray Martin	Whittington	£8.6m	IAG

In addition, Aviation Syndicate 5555 has been established as an internal trading division of Limit Syndicate 2999. Several existing operations also increased their capacity mid-year, in order to take advantage of perceived underwriting opportunities. Together, these developments have lifted 2006 market capacity to in excess of £15bn.

The year has also seen some changes in terms of the managing agents operating within the market. In April, Whittington Underwriting Management Ltd was launched to oversee start-up Alba Syndicate 4455. In May, SVB Syndicates Ltd (the manager of Syndicates 1007 and 2147) changed its name to Novae Syndicates Ltd. In September, Abacus Syndicates Ltd (the manager of Syndicates 2525 and 2526) was renamed Imagine Syndicate Management Ltd, and responsibility for the management of Syndicates 1400 and 0994 was transferred to this entity from Danish Re Syndicates Ltd and Imagine Underwriting Ltd, respectively. The net effect of these changes is a reduction in the number of active Lloyd's managing agents to 43.

Opening Capacity for 2007

The syndicate and market capacity figures for 2007 are still subject to change. The most significant developments for the year ahead are the announcements that, subject to regulatory and other approvals, Catlin is to acquire Wellington and Canopius is to acquire Creechurch. If these deals complete as intended, they will result in significant growth in capacity at Syndicates 2003 and 4444, while Syndicates 2020, 1607 and 3786 will cease to accept new business.

At least two new operations will begin trading from 1 January 2007:

New Syndicate	Pseudonym	Active Underwriter	Managing Agent	2007 Capacity	Capital Backer
3820	HDU	Patrick Gage	Hardy	£65m	Hardy
4242	ICM	Greg Butler	Chaucer	£75.5m	Various

However, there are also two mergers taking place. Syndicate 0994 will be absorbed by Syndicate 1400 and Syndicate 1007 will be absorbed by Syndicate 2147, which will then be renumbered as Syndicate 2007. These changes mean that Lloyd's is expected to begin the new underwriting year with 62 active syndicates, the same number with which it began 2006. However, a number of other new entrants are known to be "in the pipeline."

It is expected that Wellington Underwriting Agencies Ltd and Creechurch Underwriting Ltd will no longer appear as managers of active syndicates in 2007. However, their places will be taken by Mitsui Sumitomo Insurance Underwriting at Lloyd's Ltd and Pembroke Managing Agency Ltd, new managers of Syndicates 3210 and 4000 respectively (previously Chaucer), which will leave the overall number unchanged at 43.

2007 Indicative Syndicate Capacity (Subject to Change)

Syndicate	Pseudonym	Active Underwriter	Managing Agent for 2007	Current Capacity £m	2007 Indicated Capacity £m	Change %	Notes
0033	HIS	RC Watson	Hiscox	833	875	5%	
0044	JDB	C Ray	Canopius	3	2	-40%	
0218	EMP	J Josiah/K Charlton	Equity	401	421	5%	
0260	KGM	C Hart	KGM	43	50	16%	
0308	KLS	C Toomey	Kiln	13	15	15%	
0318	MSP	M Pritchard	Beaufort	159	199	25%	
0382	PWH	AJ Walker	Hardy	110	110	-	
0386	DAC	D Constable	Limit	340	340	-	
0435	FDY	M Rayner/P Ceurvorst	Faraday	325	325	-	
0457	WTK	D Hoare/O Crabtree	Munich Re	260	260	-	
0510	KLN	Robert Chase	Kiln	625	735	18%	
0557	KCS	A Carrier	Kiln	55	120	119%	
0570	ATR	KW Wilkins	Atrium	150	125	-17%	
0609	AUW	CE Dandridge	Atrium	215	215	-	
0623	AFB	AF Beazley	Beazley	183	190	4%	Operates in conjunction with Syn 2623
0727	SAM	MJ Meacock	Meacock	72	74	2%	
0779	CDL	BJ Jackson	Jubilee	38	38	-	
0780	ADV	L Tunnicliffe	Advent	153	153	-	
0807	SDM	SD Mathers	Kiln	110	135	23%	
0958	GSC	JD Robinson	Omega	249	249	-	
0994	SIM	MIC Simmonds	Imagine	40	0	-100%	Merging into Syn 1400 for 2007
1007	NVA	JLJ Butcher	Novae	120	0	-100%	Merging into Syn 2007 for 2007
1084	CSL	BP Bartell	Chaucer	450	485	8%	
1176	MGD	M Dawson	Chaucer	23	28	22%	
1183	TAL	CNR Atkin	Talbot	307	310	1%	
1200	ROC	N Jones	Heritage	215	260	21%	£35m mid-year pre-emption
1206	GER	GM Halpin	Gerling	60	60	-	
1209	XL	D O'Donohoe	XL	230	230	-	
1218	ODY	SL Gordon	Newline	100	85	-15%	
1221	MLM	R Bardwell	Navigators	123	140	14%	£10m mid-year pre-emption
1225	AES	P Thorpe-Apps	AEGIS	207	221	7%	
1231	FRW	JS Wilkinson	Jubilee	55	46	-16%	
1301	BGT	tba	Chaucer	65	65	-	£10m mid-year pre-emption
1400	DRE	M Petzold	Imagine	100	125	25%	Formerly Danish Re; absorbing Syn 0994 for 2007
1414	RTH	MRD Reith	Ascot	550	625	14%	
1607	JHA	J Thomas	Creechurch	49	0	-100%	Subject to acquisition of Creechurch by Canopius
1861	BRM	L Allen	Marlborough	120	120	-	£70m mid-year pre-emption
1919	CVS	C Hancock	Marlborough	15	70	367%	Established during 2006
1965	YEO	R Yeo	Argenta	16	16	-	
2001	AML	AW Holt	Amlin	1,000	1,000	-	
2003	SJC	N Burkinshaw	Catlin	480	1,300	171%	2006 +£30m; 2007 subject to Wellington acquisition
2007	NVA	A Hicks	Novae	240	360	50%	Previously Syn 2147; absorbing Syn 1007 for 2007
2010	MMX	JC Hamblin	Cathedral	250	300	20%	
2020	WEL	D Ibeson	Wellington	800	0	-100%	Subject to acquisition of Wellington by Catlin
2121	HYL	P Hunt	Argenta	90	92	2%	
2468	MFM	SP Lotter	Marketform	100	100	-	
2488	AGM	R Pryce	ACE	370	400	8%	£20m mid-year pre-emption
2525	DLP	DL Pratt	Imagine	50	42	-16%	Previously Abacus
2526	AGD	AG Dore	Imagine	32	32	-	Previously Abacus
2623	AFB	AF Beazley	Beazley	647	670	4%	Operates in conjunction with Syn 0623
2791	MAP	DES Shipley	MAP	400	460	15%	
2987	BRT	MA Sibthorpe	Brit	500	525	5%	
2999	QBE	P Grove	Limit	660	780	18%	Includes £85m of new aviation capacity
3000	MKL	G Albanese	Markel	160	160	-	£15m mid-year pre-emption
3210	MIT	D Warren	Mitsui Sumitomo	300	340	13%	Previously managed by Chaucer
3245	LAW	M Lawrence	Heritage	49	55	11%	
3334	SCS	P Nash	Argenta	8	15	88%	Established during 2006
3786	TAK	S Gargrave	Creechurch	41	0	-100%	Subject to acquisition of Creechurch by Canopius
3820	HDU	PJ Gage	Hardy	-	65	New	Focusing on property D&F and treaty
4000	MHW	M Wheeler	Pembroke	82	73	-11%	Previously managed by Chaucer
4040	ILM	D Burniston	Illium	54	54	-	
4242	ICM	G Butler	Chaucer	-	76	New	Focusing on SME insurance in US cat-exposed regions
4444	CNP	J Giordano	Canopius	300	450	50%	Subject to acquisition of Creechurch by Canopius
4455	MBM	M Martin	Whittington	9	24	185%	Established during 2006
4472	LIB	T Corfield	Liberty	912	725	-21%	
5000	SPL	S Eccles	St Paul Travelers	250	260	4%	
5820	CDG	BJ Jackson	Jubilee	44	44	-	
		Capacity totals to December 8, 2006		15,010	15919	6%	

Notes:
Syndicate 0626 operates as an internal trading division of Syndicate 0033
Syndicate 1952 operates as an internal trading division of Syndicate 1231
Syndicates 0566, 1036, 1886, 2000 and 5555 operate as internal trading divisions of Syndicate 2999

Who to Contact

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