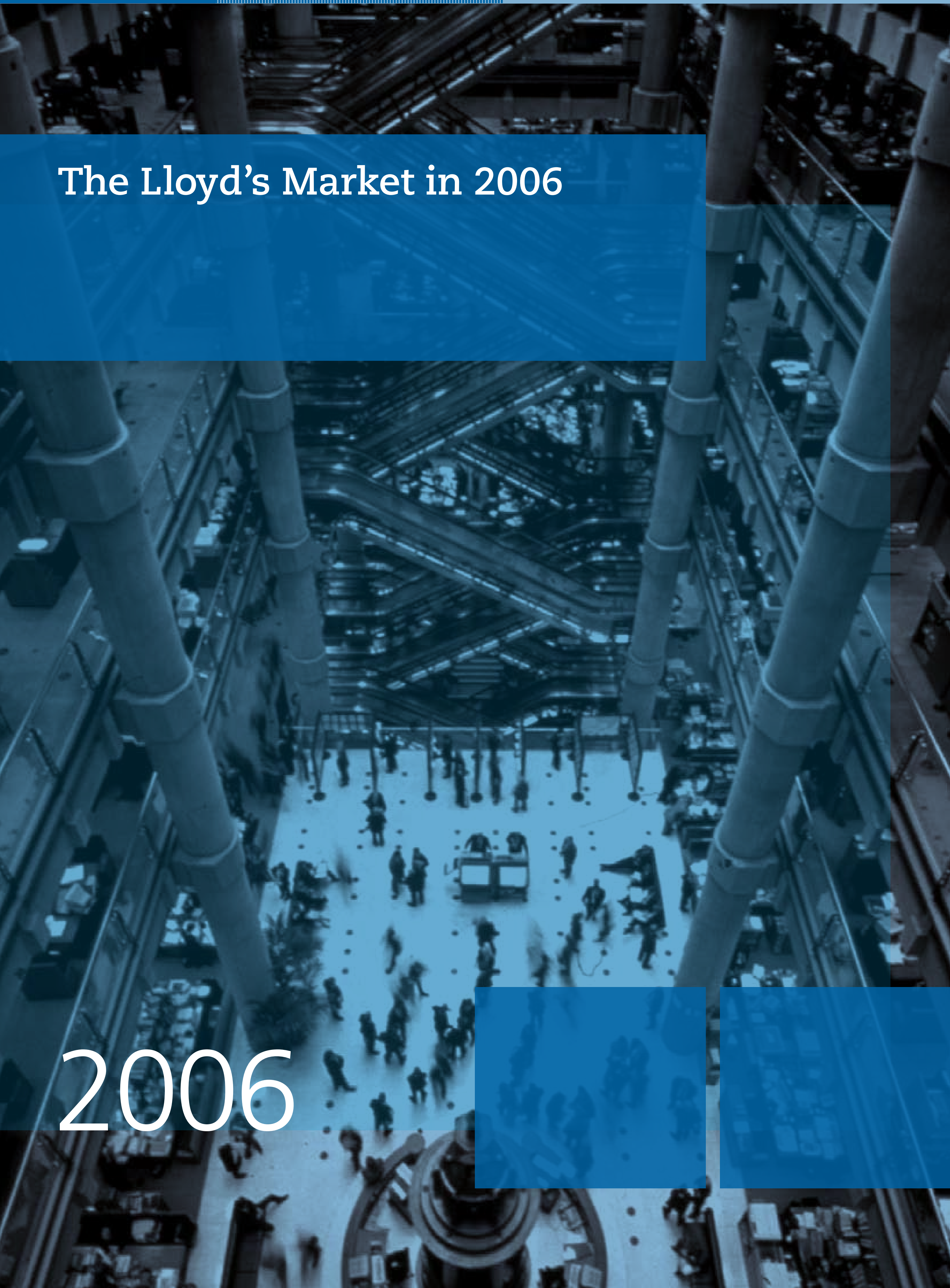
GUY CARPENTER

The Lloyd's Market in 2006



2006

The Lloyd's Market in 2006

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Introduction

GEOFFREY I K BROMLEY
PRESIDENT
Non-Americas Operations

Guy Carpenter & Company Ltd is pleased to present its fourth annual review of the Lloyd's Market.

The insurance industry was severely tested by a second year of unprecedented natural catastrophes in 2005. Six of the ten largest insured losses in US history occurred in the last two years. Hurricane Katrina in particular, which at US$45bn was twice as costly as any previous event, has had major repercussions on the reinsurance market. Financial strength ratings have been pressured across the industry, downgrades have been commonplace and many carriers with significant property catastrophe books have had to act quickly to shore up their balance sheets.

Against this backdrop, Lloyd's has proved to be a strong and stable partner for our clients. Enhanced risk management and three successive years of significant profit left the market well placed to absorb the substantial claims that were inevitable given Lloyd's specialty and US focus. Net hurricane losses of £3.3bn pushed the market into a relatively small overall loss of £103m and all syndicates have been able to trade forward without calls on the Central Fund. Capital providers have committed £1.2bn of new funds for 2006 and mutually held central assets have increased. Crucially, the market has maintained its 'A' ratings with stable outlook from Standard & Poor's, AM Best and Fitch Ratings, thereby confirming its resilience.

The impact of Katrina is still being felt in the current shortage of capacity for US catastrophe exposures in peak zones, driven by underwriters' risk reassessment and major alterations to catastrophe models and rating agency methodologies. The franchise model has proven successful in the difficult trading environment of 2005 but the real challenge for Lloyd's is 2006 and beyond. Can Lloyd's maintain and indeed further develop a leadership role in the global marketplace? Process changes are imperative and are receiving high priority. It is, however, the market's ability to respond positively to the needs of clients within an appropriately robust and sustainable business model that will determine future success. Change is becoming a mantra at Lloyd's and, with a further active hurricane season predicted for 2006, we believe that Lloyd's recent record and proven ability to adapt to new circumstances should provide strong comfort for existing and potential policyholders alike.

Guy Carpenter & Company Ltd would like to recognise and thank Lloyd's for its extensive assistance in providing data and research material for this report.

Executive Summary

The underlying performance of Lloyd's remained strong in 2005, aided by improved risk management, but net losses of £3.3bn from Hurricanes Katrina, Rita and Wilma (KRW) pushed the market into a small overall loss of £103m.

The combined ratio stood at 111.8% in 2005, including 28.1 points of KRW losses, which compared favourably with reinsurers based in the US and Bermuda. All non-catastrophe exposed lines, including casualty, marine, motor and aviation, remained profitable.

The KRW claims are substantial, but every syndicate has been able to trade through these losses and the impact on the Central Fund is expected to be negligible.

Under International Financial Reporting Standards (IFRS), mutually held central assets have increased by 5.9% to £1.266bn, comprising the Central Fund (£670m), the net assets of the Corporation of Lloyd's (£95m) and subordinated debt (£501m).

The resilience of Lloyd's has been demonstrated in the market's ability to maintain its 'A' ratings with stable outlook from Standard & Poor's, AM Best and Fitch Ratings, despite successive years of record insured natural catastrophe losses.

In the wake of KRW, capital providers committed £1.2bn (US$2bn) of new money to the market, boosting Funds at Lloyd's (FAL) by 6% to £10.2bn and market capacity for 2006 by 8% to £14.8bn.

Corporate capital accounts for 90.3% of 2006 market capacity, with the remaining 9.7% supplied by 1,497 high net worth individuals (Names) writing on an unlimited liability basis.

In November 2005, the market's already strong trading position was enhanced by the granting of a reinsurance licence to establish an onshore operation in China. Lloyd's is also expected to establish a representative office in India during 2006.

The market's infrastructure and showing of business, coupled with the capital advantages flowing from partial mutualisation, have ensured that the vast majority of capital providers remain committed to Lloyd's.

Nevertheless, Lloyd's has recognised the growing competitive threat from offshore domiciles such as Bermuda. In January 2006, plans designed to develop the market into 'The Optimal Platform' for specialist and large property and casualty risks over the next three years, were published.

Progress on business reform has been slow, but there are signs that the arrival of new CEO Richard Ward, continued pressure from the FSA on contract certainty and the emergence of the 'G6' group (Amlin, Beazley, Catlin, Hiscox, Kiln and Wellington) as a force for change are building momentum.

Risk management at Lloyd's is beginning to bite. The increased stresses of the 2006 US Windstorm Realistic Disaster Scenarios (RDSs), coupled with the reduced availability of reinsurance, are believed to be pressuring current appetite for US catastrophe-exposed business.

Lloyd's is in the process of implementing a new capital-setting framework based on the FSA's Individual Capital Adequacy Standards (ICAS) regime for the UK market, which is expected to align capital more closely with risk. The Franchise Board has signalled that capital levels for catastrophe-exposed business will increase for the 2007 year of account.

2005 Market Results

The Pro Forma Financial Statements (PFFS) are prepared so that the financial results of Lloyd's and its members taken together, as well as their net assets, can be compared with general insurance companies. The profit and loss account aggregates syndicate underwriting results, a notional investment return on members' assets held as FAL and the results of the Society of Lloyd's. The balance sheet aggregates the assets held at syndicate level, members' assets held as FAL and the central resources of the Society, and therefore reflects all the links in the Lloyd's chain of security.

2005 Profit and Loss Account

The underlying performance of Lloyd's remained strong in 2005 but, given the risk profile of the market, it was inevitable that the events of the second half would take a heavy toll on the overall results. After three years of significant profit, the market was obliged to report a pre-tax deficit of £103m for 2005, after net incurred hurricane losses of £3.309bn (2004: £1.333bn). This can be regarded as a creditable result in the circumstances – clearly a very substantial level of profit would have been reported had 2005 been a 'normal' loss year. However, like the rest of the industry, Lloyd's is now having to come to terms with the fact that elevated levels of insured losses from natural catastrophes may be the new reality.

PROFIT AND LOSS ACCOUNT SUMMARY 2000–2005

Source: Lloyd's

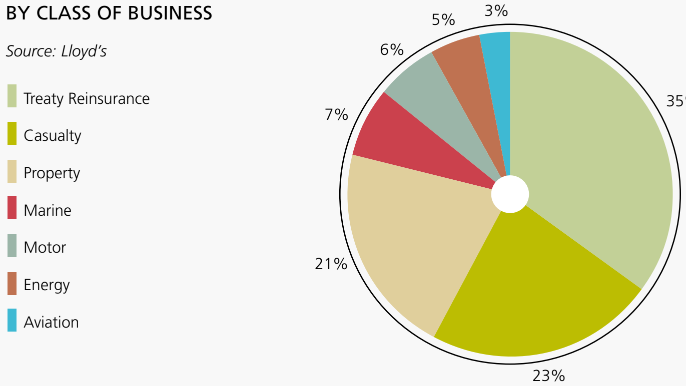
£m	2000	2001	2002	2003	2004	2005
Gross Written Premium	12,641	16,112	16,203	16,422	14,614	14,982
Net Written Premium	9,017	11,072	11,160	12,250	11,734	11,770
Net Earned Premium	8,338	9,888	10,669	11,711	11,797	11,785
Net Claims Incurred	(7,816)	(10,332)	(6,652)	(6,697)	(7,646)	(9,505)
Net Operating Expenses	(2,630)	(3,541)	(3,872)	(3,922)	(3,755)	(3,668)
Underwriting Result	**(2,108)**	**(3,985)**	**145**	**1,092**	**396**	**(1,388)**
Investment Return	1,128	1,098	902	1,020	1,167	1,498
Other Expenses	(231)	(223)	(213)	(220)	(196)	(213)
Pro Forma Pre-Tax Result	**(1,211)**	**(3,110)**	**834**	**1,892**	**1,367**	**(103)**

Underwriting Performance

Market capacity fell by 9% to £13.722bn going into 2005. Underwriting conditions remained favourable for all major lines in the first half, with terms and conditions holding relatively stable but varying degrees of rate softening noted particularly on very large property risks, onshore energy and airline business. Some casualty classes were also under pressure, including financial institutions and certain general and professional liability lines (primarily non-US). Gross written premium fell by 15% to £8.395bn over this period, as the market responded with discipline to the increasingly competitive environment. However, the total for the full year was up by 2.5%, reflecting patchy rate hardening and the addition of some £400m of reinstatement premium in the wake of the US hurricanes. The proportion of premium ceded to reinsurers increased from 19.7% in 2004 to 21.4% in 2005, with the result that net written premium was virtually unchanged.

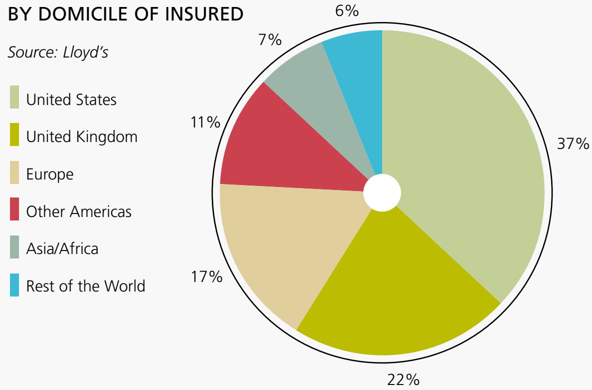
2005 GROSS WRITTEN PREMIUM BY CLASS OF BUSINESS

Source: Lloyd's



2005 GROSS WRITTEN PREMIUM BY DOMICILE OF INSURED

Source: Lloyd's



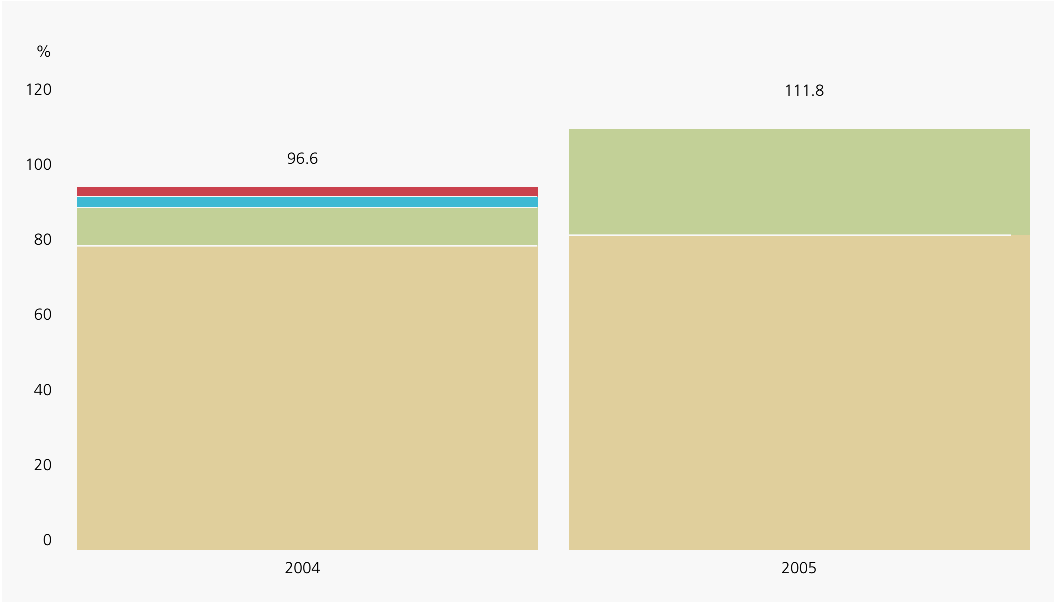
Lloyd's overall combined ratio rose from 96.6% in 2004 to 111.8% in 2005, including 28.1 points of net hurricane claims, which compared favourably with reinsurers based in the US and Bermuda. The accident year combined ratios demonstrate strong underlying profitability, but the market has had to accept its share of the unprecedented insured natural catastrophe losses of the last two years. Swiss Re has estimated these at US$45bn in 2004 and US$78bn in 2005, with Hurricanes Katrina, Rita and Wilma accounting for US$65bn of the latter *(source: sigma No.2/2006)*. As at 31 December, 2005, gross hurricane losses to the market were reserved at £8.767bn, stemming mainly from surplus lines property insurance, offshore energy insurance and property per risk and catastrophe reinsurance. Net losses totalled £3.309bn (a £359m increase on the first estimate issued in November 2005), split Katrina £2.209bn, Rita £602m and Wilma £498m. The outwards reinsurance asset in respect of the hurricanes stood at £5.458bn, of which 93% was due from risk-bearers rated 'A-' or better.

Lloyd's has positioned itself as a specialist insurer and reinsurer to the US market and it is therefore no surprise that these losses are substantial. The positives are that every syndicate has been able to trade through these events and that the impact on the Central Fund has been negligible (a small loss has been sustained from old multi-year energy policies). This is clear evidence of both the progress achieved at the centre in recent years and the scale and diversification benefits now accruing to the major established players.

LLOYD'S COMBINED RATIO BREAKDOWN 2004–2005

- Prior Year Reserve Movements
- Central Fund Insurance Settlement
- US Hurricanes
- Accident Year ex US Hurricanes

Source: Lloyd's



Adverse reserve development on prior years has not been a major issue for the market in recent times, for three main reasons:

- all pre-1993 non-life liabilities now fall to Equitas;
- exposure to general liability business written on an occurrence form is relatively modest;
- reserve integrity continues to benefit from the requirement for all syndicates to obtain actuarial certification of their closed and open year reserves.

Casualty reserves were strengthened by around £300m during 2005, relating mainly to US professional liability business written over the period 1998 to 2001, the Enron, WorldCom and IPO laddering actions featuring prominently. However, this was fully offset by reserve redundancies on short-tail business written over the period 2002 to 2003, resulting in a small net release overall of £14m.

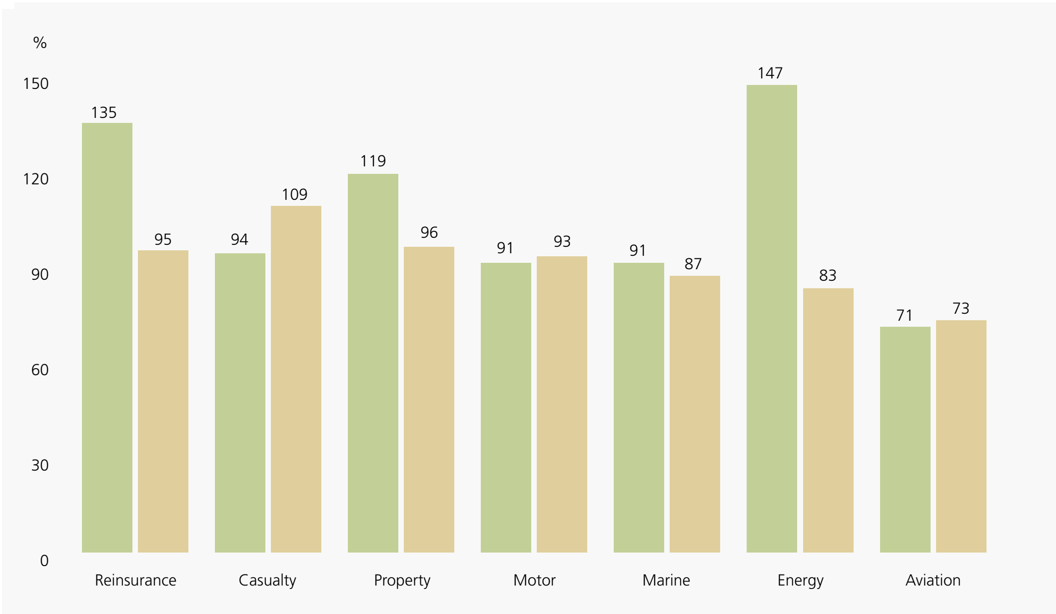
Excluding exchange movements, net operating expenses represented 33.6% of net earned premium in 2005, unchanged on the previous year. Net acquisition costs rose by 4% to £2.913bn, while administrative expenses fell by 11.2% to £1.052bn.

All non-catastrophe exposed lines, including casualty, marine, motor and aviation, remained profitable in 2005. Brief commentary on the loss-making classes – reinsurance, energy and direct property – follows.

2005 CALENDAR YEAR
COMBINED RATIOS BY CLASS

2004
2005

Source: Lloyd's



Reinsurance
Treaty reinsurance accounted for 35% of the Lloyd's total book in 2005, a significant increase from 29% in 2004. Gross written premium rose by 23% to £5.261bn, the largest class being property non-proportional per risk and catastrophe excess of loss reinsurance, with only a limited amount of retrocessional business being written. A large proportion is cover for US insurance and reinsurance companies. As a leader of property, marine and energy business, Lloyd's sustained a significant loss of £1.307bn from this account in 2005, based on a combined ratio of 135%.

Energy
Offshore energy business has always formed the larger part of the Lloyd's energy portfolio and a significant proportion of this is located in the Gulf of Mexico. Gross written premium stood at £804m in 2005 and a loss of £238m was sustained, based on a combined ratio of 147%.

Direct Property
Gross premium fell slightly to £3.199bn in 2005, with the US the biggest market by far. This sector suffered a loss of £457m, based on a combined ratio of 119%, business written under binding authorities being a significant contributor.

Investment Performance

The investment return in the non-technical account is divided into three parts. The first is based on assets held by syndicates in their Premiums Trust Funds. The second is based on assets held in trust as FAL – a notional investment return is calculated based on indices yields on each type of asset held. This is the equivalent of insurance companies generating investment return on the capital held to support underwriting. The third is based on mutually held assets, including the Central Fund.

Overall returns in 2005 were constrained by the market's relatively conservative investment policy; equities accounted for only 4.2% of invested assets at the year-end. The total yield was maintained at 4.1% in 2005.

2005 Balance Sheet

The balance sheet has strengthened significantly since the end of 2001, accompanied by a doubling of the investment portfolio over the past five years. Liquidity is good across the market as a whole, although certain syndicates with heavy hurricane losses have faced short-term strains associated with the need to fully collateralise gross reinsurance liabilities in the US.

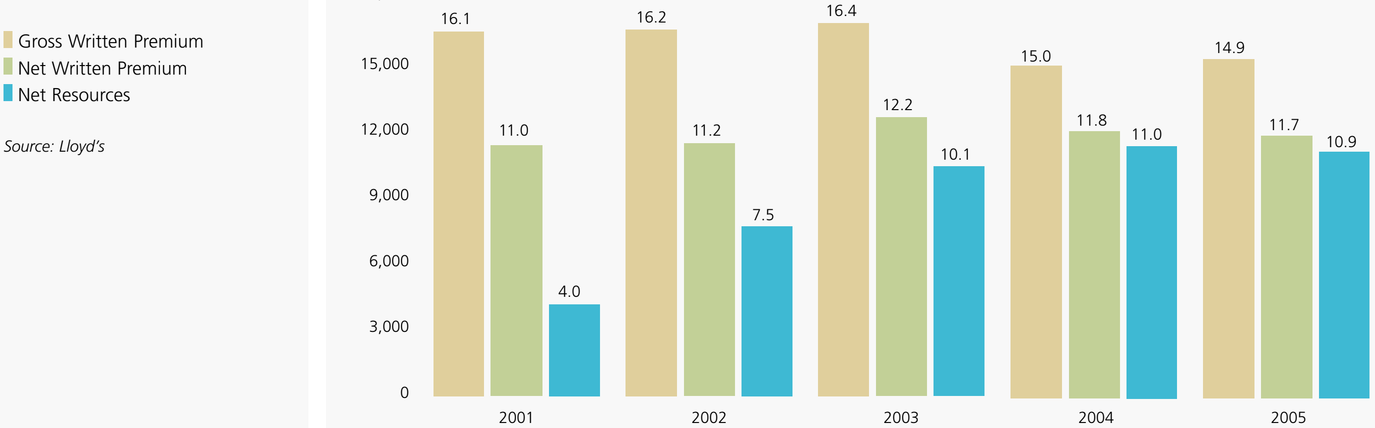
LLOYD'S BALANCE SHEET SUMMARY 2000–2006

Source: Lloyd's

£m	2000	2001	2002	2003	2004	2005
Cash and Investments	16,597	20,296	24,512	27,893	31,412	35,012
Reinsurance Recoverables	10,351	15,864	13,693	11,180	10,550	15,146
Other Assets	8,023	10,253	11,091	9,830	9,203	9,895
Total Assets	**34,971**	**46,413**	**49,296**	**48,903**	**51,165**	**60,053**
Gross Technical Provisions	26,799	37,788	37,090	35,093	35,629	44,548
Other Liabilities	3,442	4,116	4,697	3,665	3,367	4,513
Total Liabilities	**30,241**	**41,904**	**41,787**	**38,758**	**38,996**	**49,061**
Net Resources	**4,730**	**4,509**	**7,509**	**10,145**	**12,169**	**10,992**

Net resources – total assets less policyholder and other liabilities – is Lloyd's closest proxy to shareholders' funds. The total contracted by 10% to £10.992bn during 2005, primarily due to the release of profit to members. It is important to recognise that the bulk of these funds operate on a several liability basis. Operating leverage was high in the wake of the US terrorist attacks, but the significant strengthening of net resources since 2001 has left Lloyd's in a much better position to manage the events of 2005. This is clearly demonstrated by looking at the levels of market premium against net resources over the past five years.

LLOYD'S UNDERWRITING LEVERAGE 2001–2005



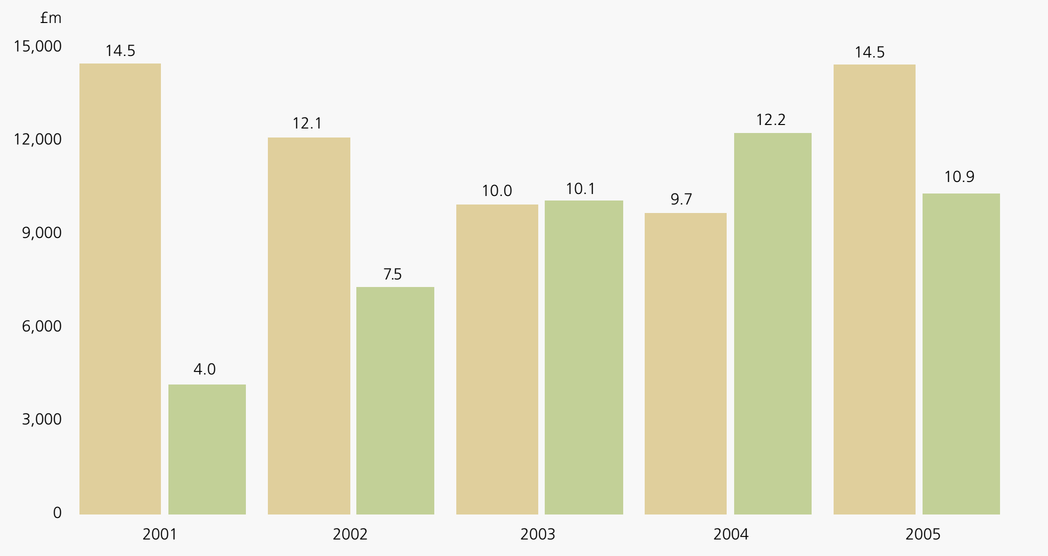
Source: Lloyd's

Reinsurance recoverables on outstanding claims fell by a third in the three years following the US terrorist attacks, but increased by £4.772bn to £14.450bn during 2005 as a result of the US hurricanes. Lloyd's reports that 92% of the total outwards reinsurance asset was rated 'A-' or better at the year-end.

LLOYD'S REINSURANCE LEVERAGE 2001–2006

Reinsurance Recoverables
Net Resources

Source: Lloyd's



Trends in Lloyd's Capacity

Underwriting at Lloyd's is conducted by the membership. The amount of premium each member can write in any one year, net of brokerage, is governed centrally and is a function of the proposed book of business and the amount of capital deposited, with credit given for diversification. By allocating their capital support, the members govern the amount of business that each syndicate can write each year – the syndicate capacity. The total capacity of the Lloyd's market in any given year is the aggregate capacity of all syndicates for that year.

Capacity Development 2005–2006

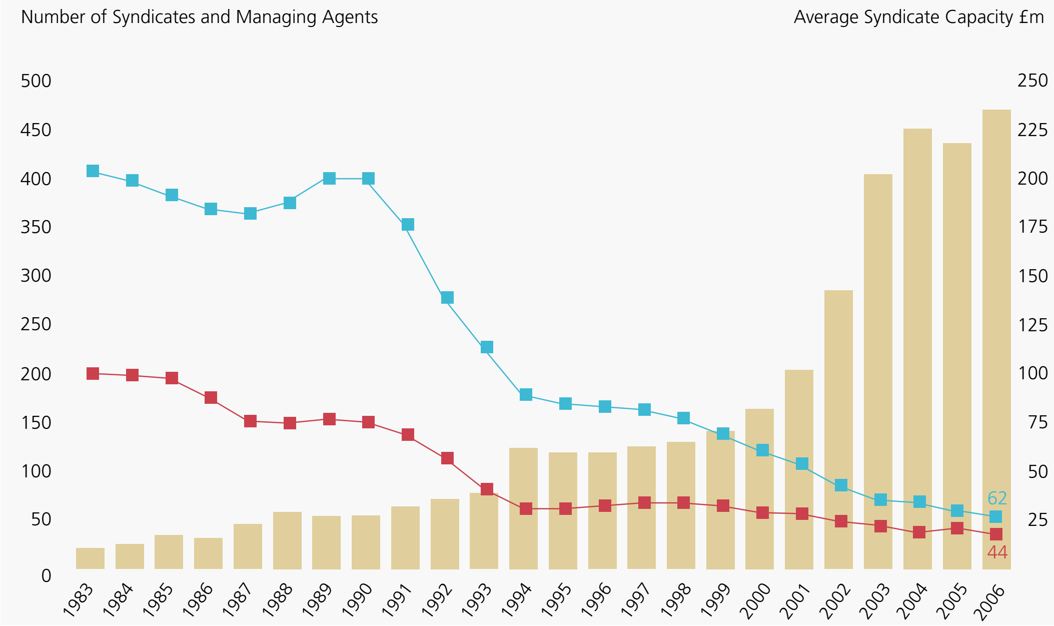
The first set of syndicate business plans for 2006 was submitted to Lloyd's prior to the onset of the hurricanes. Under the watchful eye of the Franchise Performance Directorate, these aggregated to an overall reduction in market capacity of 7%, reflecting discipline in the face of rate softening in most classes. However, as the insured losses mounted, the market again demonstrated its ability to respond quickly to changing market conditions. In view of the improved outlook for rates, capital providers chose to commit a further £1.2bn (US$2bn) of new funds to Lloyd's, with the result that the market began 2006 with capacity of almost £14.8bn, an 8% increase relative to the opening capacity for 2005. This represented a capacity upswing of around £2bn, relative to the initial business plans.

After a period of consolidation, the number of syndicates and managing agents remained unchanged for 2006, at 62 and 44 respectively, while average syndicate capacity rose by 8% to £239m.

LLOYD'S SYNDICATE TRENDS

Number of Syndicates
Number of Managing Agents
Average Syndicate Capacity

Source: Lloyd's

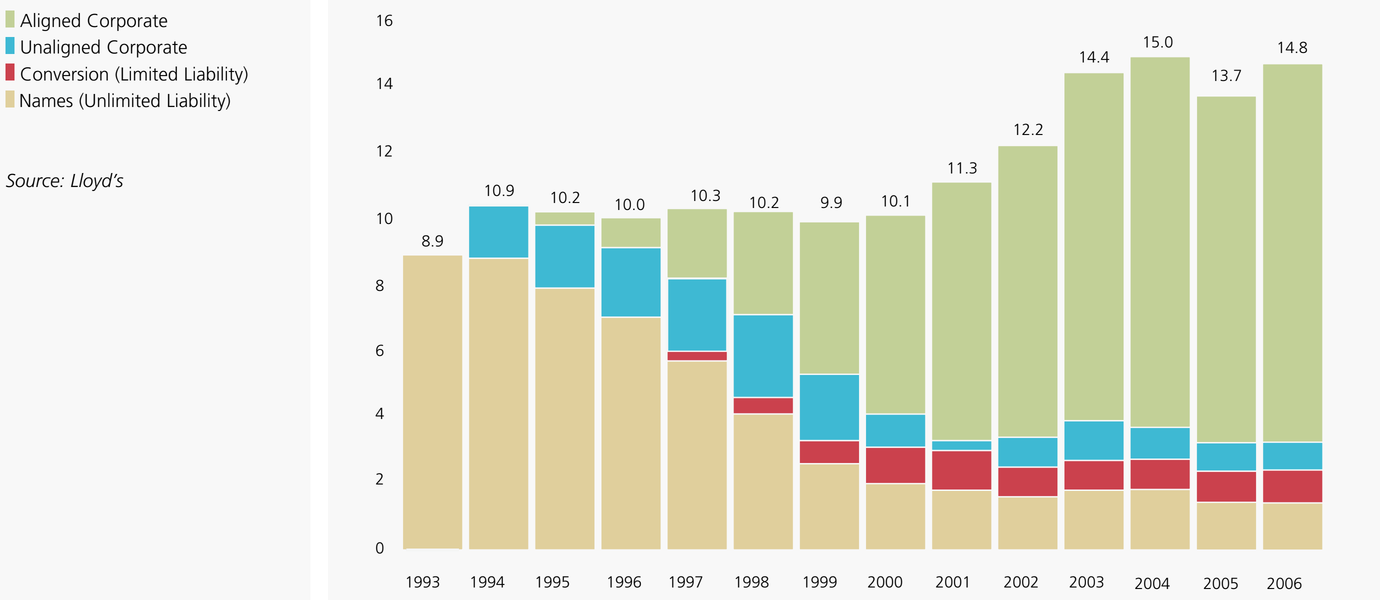


Capital Alignment

Where a corporate member and a managing agent of a syndicate are owned by the same company or part of the same corporate group, that capital provider is described as an 'aligned' member. Individual members and some corporate members have no ownership links with managing agents, often participate on a number of syndicates on a third-party basis and are described as 'unaligned' members.

For 2006, 714 members writing on a limited liability basis provide 90.3% of the market's capacity, up from 89.5% in 2005. Aligned capacity has continued to increase and now represents 77.8% of the total, up from 76.2% in 2005. The remaining 1,497 active Names – high net worth individuals writing on an unlimited liability basis – provide 9.7% of the market's capacity, down from 10.5% in 2005. Lloyd's continues to encourage voluntary conversion to limited liability underwriting and moves to enable Names to convert to limited liability partnership status in 2007 are expected to hasten this process.

PROFILE OF LLOYD'S CAPITAL PROVISION 1993–2006



Source: Lloyd's

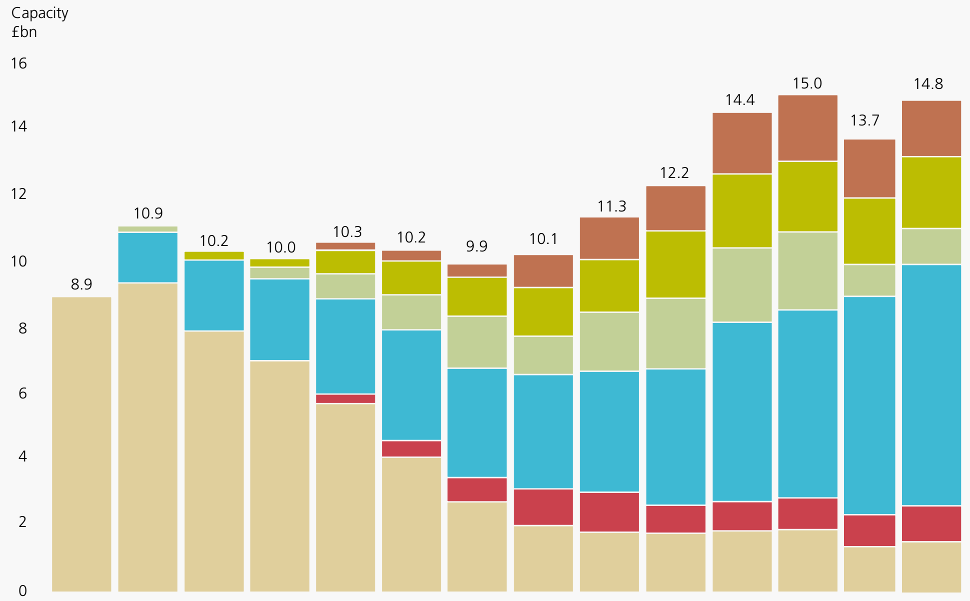
Sources of Capital

The capital base in 2006 remained diverse, with the 20 largest capital providers supplying 65% of the market's capacity, up from 64% in 2005, and no one capital provider supplying more than 6.8% of the total.

SOURCES OF LLOYD'S CAPACITY 1993–2006

- Worldwide Insurance Industry
- US Insurance Industry
- Bermudian Insurance Industry
- UK Listed and Other Corporate
- Conversion Capital
- Names (Unlimited Liability)

Source: Lloyd's



Members have a right of tenure for the capacity on the syndicates they support and are required to indicate their intentions as to their future support in advance of each underwriting year. Members may increase their participation ('pre-empt') if a syndicate's managing agent indicates that additional capacity is required, or decrease it ('de-empt'). Rights of tenure may be transferred bilaterally or in annual 'capacity auctions' organised by Lloyd's.

The Lloyd's Franchise

Since 1 December 2001, the Financial Services Authority (FSA) has been responsible for the regulation of the Lloyd's market under the Financial Services and Markets Act 2000. Simultaneously, an internal governing body, the Council of Lloyd's, continues to retain statutory responsibility for management and supervision of the market under the Lloyd's Act 1982. Since the introduction of the franchise model in 2003, the day-to-day running of the market has been overseen by the Franchise Board.

FSA Regulatory Requirements

The Society of Lloyd's and the individual managing agents are considered by the FSA to manage all of the significant prudential risks that affect Lloyd's policyholders. Accordingly, the FSA applies prudential requirements to the Society and managing agents on the basis of whichever of the two is best placed to control the relevant risk.

Regulation of Managing Agents

Regulatory oversight occurs at the managing agency level in respect of the insurance business carried on through each managed syndicate. The FSA requires each managing agent to:

- establish and maintain appropriate controls over risks affecting insurance business carried on through syndicates, including credit risk and market risk, within limits that are substantially the same as those for insurance companies;
- assess the capital needed to support the insurance business carried on through each managed syndicate.

Compliance is assessed through the same risk assessment framework applied to other regulated firms and partly through on-site visits. Areas considered by the FSA include the overall business strategy, the nature and permanence of capital support, the risk portfolio and underwriting systems and controls.

Regulation of Lloyd's

Regulatory oversight occurs at Lloyd's centrally in respect of the insurance business of each member, or the resources that it holds in support of the members' business. The FSA requires Lloyd's to:

- establish and maintain appropriate control over the risks affecting funds held and managed centrally, including managing risk within appropriate limits;
- assess the capital needs of each member, taking into account the capital needed to support the insurance business carried on through each syndicate, as assessed by managing agents.

The responsibility for capital-setting falls to Lloyd's, because managing agents do not have an aggregate view across the market. In particular, Lloyd's centrally takes account of members' participations on more than one syndicate, assets held outside syndicates and the liabilities to which central assets are exposed.

Corporate Governance

The 18 appointees to the Council of Lloyd's include six internal and six external members, all of whom are directly elected by the Lloyd's membership, usually for a term of three years. Six further members are nominated by the Council, with the approval of the Governor of the Bank of England. All Council members are also approved by the FSA. The Council has wide-ranging powers, which allow it to manage and supervise the affairs of the Society, borrow money or apply levies to members in order to raise funds to use as central assets, and apply central assets to meet members' liabilities.

In practice, the Council operates principally through the Franchise Board, which has 11 members. The Chairman of Lloyd's (Lord Levene), the Chief Executive Officer (Richard Ward), the Director of Finance and Risk Management (Luke Savage) and the Franchise Performance Director (Rolf Tolle) are joined by four external and three internal non-executive members. The Franchise Board has set the Franchise Goal, which is: "To create and maintain a commercial environment at Lloyd's in which the long-term return to all capital providers is maximised." This recognises the fact that most major trade investors now have a choice of trading platform and it is for this reason that much of the Franchise Board's effort is focused on minimising the costs of mutuality.

The role of the Franchise Board encompasses three core streams of activity – Franchise performance, risk management and capital management.

Performance Management

By 2003, it was recognised that the performance of Lloyd's had become increasingly volatile since the mid-1980s and that returns were uncompetitive across the cycle. Of particular concern was the fact that the strong performance of some businesses was being over-shadowed by the results of the bottom quartile, which were dragging down the whole market. There was a clear need to raise and maintain underwriting standards across Lloyd's, in order to enhance the market's sustainable profitability and financial strength. This task fell to the Franchise Performance Directorate (FPD) under Rolf Tolle and is tackled principally by way of an extensive business planning and result monitoring regime. Recent results suggest the FPD is having a positive impact, with Lord Levene commenting in his annual statement that the value of its work had now been clearly proven.

Beginning in the month of June with a preliminary forecast, all active syndicates are required to submit detailed business plans for the following year to the FPD, recognising certain underwriting guidelines laid down by the Franchise Board:

- Profitability by Product Line – there should be a reasonable expectation of making a gross underwriting profit on each line of business every year;
- Catastrophe Exposure Management – the maximum gross and net exposures to a single Realistic Disaster Scenario (RDS) are 75% and 20% of syndicate capacity respectively;
- Reinsurer Selection – each Managing Agent should have an approved reinsurer selection process;
- Gross Line Size – the maximum gross line size that a syndicate should have on an individual risk is 10% of capacity;
- Reinsurance Leverage – each syndicate should retain a net minimum amount of 10% exposure of each risk;
- Multi-year Policies – should either have matching reinsurance cover or be limited to the agreed maximum net exposure to the class of business as set out in the syndicate's business plan.

Any managing agent wishing to operate outside the guidelines is required to justify its position and obtain approval. With a third successive year of major windstorms predicted, and given the current reduction in retrocessional capacity and underwriters' reinsurance protection, the FPD is currently heavily focused on exposure management and underwriting for gross profit.

Business plans are usually finalised and agreed by the end of October and syndicate performance is then monitored by the FPD on a quarterly basis. More than 400 meetings were held with managing agents during 2005. These reviews include loss ratio performance benchmarking, which acts as an effective early warning for under-performance. The FPD's approach is primarily facilitative, but if a managing agent does not respond to concerns raised, the Franchise Board will take appropriate action, which may result in business restrictions or, ultimately, the withdrawal of a managing agent's permission to operate at Lloyd's.

The FPD is additionally responsible for implementing claims management 'best practice', co-ordinating the market's response to major losses, overseeing relationships with the market's leading reinsurers and ensuring the effective management of open years and syndicates that have ceased trading.

Open Year Management

Closure of a syndicate and the release of supporting capital can only occur once all outstanding and incurred but not reported claims are reinsured into a successor syndicate through the reinsurance to close (RITC) mechanism. If a managing agent is unable to agree a RITC premium that is acceptable to, or maintains equity between, members, then that year remains open (also termed a run-off year of account). This usually occurs when there is material uncertainty over the reserves and/or no successor syndicate. Run-off years of active syndicates and all years of syndicates that have ceased trading completely are subject to quarterly monitoring, as Lloyd's is keen to facilitate prompt and economic closure. However, progress on this front has been slow, due to factors such as:

- the absence of a significant RITC market (capital requirements for writers of RITC are being examined to see if an effective market can be stimulated);
- RITC premium quotations being rejected as too high;
- liabilities being too uncertain to allow RITC quotation.

A partial solution may have emerged towards the end of May 2006, when it was announced that Life Syndicate 0982, which ceased trading in 2001, had become the first syndicate to successfully transfer assets and liabilities in run-off to a company outside Lloyd's, giving closure to capital backers. This was achieved by way of a Part VII transfer under the Financial Services and Markets Act 2000, which requires the approval of policyholders, the FSA and the courts. The deal was complex and took two years to put together. To avoid regulatory concerns in the US, such transfers are expected to be contained to personal lines business involving UK and European policyholders.

Risk Management at Lloyd's

The Franchisor is required to set the market supervision framework in accordance with FSA requirements, while the corporate governance of Franchisees (managing agents) is the responsibility of each individual entity. Strong risk management disciplines are viewed as essential to enhancing business performance and safeguarding overall Franchise value. Extensive risk management reviews are undertaken on registration and alongside ongoing performance management reviews, to address the risks faced by individual businesses and the risks that each business poses to the Franchise.

Realistic Disaster Scenarios

RDSs are used to evaluate catastrophe exposure and are an increasingly important component of the risk management framework. The output is used as part of the Lloyd's capital-setting regime, in assessing compliance with the underwriting guidelines and in identifying potential over-reliance on individual reinsurers. Through aggregating losses from particular events, the overall risk exposure of the market can also be assessed, which links into the capitalisation of Lloyd's.

There are currently nine generic (and optional) scenarios utilised mainly for analysing syndicate level exposures and nine specific (and compulsory) event-based scenarios utilised mainly for analysing market level exposures. Lloyd's reviews the specifications and parameters of each scenario on an annual basis. This review is undertaken by a central Exposure Management team, in conjunction with a 'Market Experts Group' of managing agent representatives and working closely with the leading catastrophe modelling agencies. Two new events were introduced for 2005, namely a US$65bn Gulf of Mexico Windstorm (which is said to have had a positive impact on the market's overall exposure to Hurricane Katrina) and Japanese Typhoon.

REALISTIC DISASTER SCENARIOS

Source: Lloyd's

Optional	Compulsory	
Marine Event	Two Events	(US$65bn + US$30bn)
Loss of Major Complex	Florida Windstorm	(US$100bn)
Aviation Collision	California Earthquake	(US$65bn)
Major Risk Loss	New Madrid Earthquake	(US$40bn)
Satellite Risks	European Windstorm	(US$30bn)
Liability Risks	Japanese Earthquake	(US$50bn)
Political Risks	Terrorism	
Alternative RDS: A	Gulf of Mexico Windstorm	(US$100bn)
Alternative RDS: B	Japanese Typhoon	(US$14bn)

For 2006, three noteworthy revisions have been implemented in respect of the windstorm-based scenarios, to reflect 2005 experience and to incorporate demand and storm surge more explicitly:

- the Two Event scenario now comprises a North-East US windstorm with a total industry loss of US$65bn, followed in quick succession by a Carolinas windstorm generating a total industry loss of US$30bn. This replaces the previous scenario, which envisaged Hurricane Andrew followed by the Northridge Earthquake, with a total industry loss of US$20bn for each event;
- the total industry loss for the Florida Windstorm scenario has been increased to US$100bn from US$70bn;
- the total industry loss for the Gulf of Mexico Windstorm scenario has been increased to US$100bn from US$65bn.

All managing agents are required to complete a minimum of 11 scenarios for each syndicate. Optional scenarios that result in both a gross loss of less than 10% and a net loss of less than 3% of 2006 capacity need not be included. Inactive syndicates with live exposures are subject to the same reporting requirements as active syndicates. The deadline for submission of all RDS returns for 2006 was 9 June, with all loss calculations based on live exposures and unutilised reinsurance protections in place at 1 April 2006. The increased stresses of the 2006 US Windstorm scenarios, coupled with the reduced availability of reinsurance, are believed to be pressuring current appetite for US catastrophe-exposed business, as syndicates look to keep their net exposures within the 20% of capacity limit stipulated by the Franchise Board's underwriting guidelines.

Capital Management

Lloyd's activities in this area are currently centred on the transition towards a new regime for member capital-setting, which is integrated with the FSA's wider Individual Capital Adequacy Standards (ICAS) approach (see Appendix 3, page 32) and the continuing drive to keep the costs of mutuality to a minimum.

Lloyd's began a review of its future capitalisation in 2003, which concluded that central assets should be strengthened in order to enhance the long-term financial strength and competitive position of the market. In an effort to improve capital efficiency, it was decided to introduce 'syndicate loans' from 2005, as a means of partly funding contributions to the Central Fund. The payment of interest and repayment of the principal is at the discretion of the Council, with the latter normally taking place on a three-year rolling basis, upon closure of the relevant year of account. Lloyd's also decided to raise funds externally through the capital markets for the first time, issuing just over £500m of subordinated debt in November 2004. A recent similar exercise drawing on the extensive work done in support of the Society's Individual Capital Assessment (which defines the level of capital resources required to withstand a 1-in-200 year event over a one-year time frame), concluded that the target level for central solvency assets should be around £1.7bn. The total currently stands at just over £1.8bn.

The recent development of the charging structure for the underwriting membership is shown in the following table.

CENTRAL CHARGES AT LLOYD'S

Source: Lloyd's

% of Capacity	2003	2004	2005	2006
Members' Subscriptions	0.25	0.50	0.50	0.50
Premium Levy	2.00	-	-	-
Central Fund Contributions	1.00	1.25	0.50	1.00
Syndicate Loans	-	-	0.75	0.75
Total Charges	**3.25**	**1.75**	**1.75**	**2.25**

For 2006, members' subscriptions and syndicate loan rates remain at 2005 levels, whilst Central Fund contributions have doubled to 1%. This is to make good the £226m shortfall stemming from the unfavourable outcome of last year's Central Fund insurance policy arbitration and to maintain an appropriate balance between central asset components. New corporate members underwriting on new syndicates are required to contribute to the Central Fund at a rate of 2.5% of capacity for their first three years of operations at Lloyd's.

Competitive Positioning

Lloyd's competitive position is strong, supported by its powerful global brand, a unique licence network, strong market-wide security ratings and proven capital provider and policyholder loyalty. The market covers business from more than 200 countries and territories worldwide and continues to be the sixth largest global reinsurer and second largest surplus lines insurer in the US. The willingness to take on difficult risks and the ability to respond quickly to client needs are generally regarded as Lloyd's strongest source of competitive advantage.

Lloyd's Strengths

The London market has retained its critical mass of underwriting and broking expertise, as well as vital support services, allowing the historical flow of attractive business in diverse specialist underwriting niches such as marine, energy, aviation and certain non-marine classes to continue, despite increased overseas competition.

Lloyd's has very wide geographical coverage, with specific licences to write insurance business in 75 territories and the ability to write reinsurance in many more. The market's trading position was strengthened still further in November 2005, with the granting of a reinsurance licence to establish an onshore operation in China. Lloyd's has long been active in an offshore capacity, but the new status will enable it to reinsure local currency business, which represents almost 90% of the current market. Agreement has also been reached to establish a representative office in India during 2006.

The wide showing of business gives new underwriters the opportunity to build a diversified book of business quickly. These strengths, coupled with the capital advantages associated with the partial mutualisation of the market, have ensured that the vast majority of capital providers remain committed to Lloyd's, despite the increasing number of groups having diverse operating platforms – typically subsidiaries in the UK and/or Bermuda.

The Competitive Challenge

Despite its strengths, Lloyd's is facing a growing competitive threat, principally from Bermuda, but also from Asian financial centres, which are keen to attract clients who have traditionally looked to London. Certainly Bermuda continues to attract the lion's share of new capital raised in the wake of major industry losses, based on its tax advantages and less onerous regulatory regime. Around a dozen new companies formed on the island towards the end of 2005, backed by US$9bn of capital. Existing Bermuda players raised an additional US$8bn, principally to plug holes in their balance sheets, but also to fund further growth. Standard & Poor's recently stated that gross written premium reported by Bermuda-based insurers and reinsurers had increased to US$46bn in 2005 from about US$17bn in 2001. By contrast, gross written premium at Lloyd's fell by 7% over this period.

Bermuda lacks the franchise, infrastructure and concentration of expertise that Lloyd's is able to offer and will always find it difficult to accommodate business involving extensive claims activity. However, Lloyd's capital benefits do not outweigh the tax advantages of offshore centres and, for that reason, Bermuda is likely to continue gaining market share in certain more commoditised lines of business, such as property catastrophe. Much has been made of the decision of leading Lloyd's operations such as Amlin, Hiscox and Catlin to establish Bermudian subsidiaries. However, these organisations have achieved a scale – through successfully trading at Lloyd's – that allows them to diversify opportunistically and, to an extent, this is viewed as natural progression. Importantly for Lloyd's, it is clear that these groups remain committed to the market, with both Amlin and Hiscox supporting significant capacity increases for 2006.

The desire for a more level playing field has led to recent calls, supported by Lloyd's, for changes to the UK tax environment. The FSA has also announced that it will accelerate the authorisation process for start-ups at times of market stress and that it is investigating how insurers and reinsurers could use special purpose vehicles in London, possibly to create the so-called 'sidecars' that have been so popular in Bermuda post Katrina.

Lloyd's Response – The Optimal Platform

Lloyd's accepts that it cannot rely on external events and must have a clear and compelling offer to succeed in an environment where capital and business are becoming more transient. The concept of the Optimal Platform has therefore been developed to provide strategic direction for the market over the next three years. This continuation of recent market initiatives recognises that:

- businesses operating in the market are larger and more sophisticated than ever before;
- a material element of capital is provided by major insurers with other options/platforms outside Lloyd's;
- listed vehicles are focused on developing platforms/opportunities outside Lloyd's for hedging/portfolio management purposes;
- individuals now supply less than 20% of the capital base;
- business is more concentrated in the hands of fewer, larger brokers – the top ten accounted for 70% of the market's gross written premium in 2005, up from 54% in 1994.

The strategic plan, published in January 2006, was developed with considerable input from the market and sets out a clear goal for Lloyd's to be the platform of choice for insurance and reinsurance buyers and sellers to access and trade both specialist and large property and casualty risks. It envisages a package of benefits in return for the costs of operating at Lloyd's, including:

- a clear and transparent performance framework that supports the achievement of superior operating returns through recognising the specific characteristics of each Franchisee;
- capital advantages – a capital framework, in which the benefits of mutuality demonstrably outweigh the costs, that cannot readily be duplicated outside Lloyd's. Mutual assets are expected to cost less than 1% of gross written premium across the insurance cycle;
- a secure, highly rated market – insurer financial strength ratings of at least 'A' from Standard & Poor's, AM Best and Fitch Ratings;
- outstanding market access – cost-effective, easy access to the world's major markets, supported by a global brand and licence network;
- efficient business processes – a framework of standards for business processes that enables firms to deliver services to customers at a cost and level of risk comparable with other platforms and that offsets the inherent costs of a subscription market.

A detailed internal Franchisor implementation plan has been drawn up, with reporting deadlines to the Franchise Board. The published document identifies key milestones, involving periodic progress reports to key stakeholders. The strategic direction and relevance of the plan will be re-evaluated annually in the context of external trends. With the support and commitment of all those working within the market, the successful achievement of the Optimal Platform could go a long way towards protecting Lloyd's long-term competitive position. The new Chief Executive Officer, Richard Ward, who joined in April 2006, is expected to be an effective force in driving this programme. He has a track record of building consensus and managing change, having previously overseen conversion to fully electronic trading at the London-based International Petroleum Exchange.

Business Process Reform

For capital providers, there is an additional cost associated with the subscription market, which the Franchise Board is anxious to minimise. It is also recognised that successful reform of business processes should improve client service and thereby heighten the market's attractiveness to policyholders.

The London Market Principles initiative was launched as long ago as 1999, in an effort to coordinate business process modernisation. Progress has been much slower than originally anticipated, reflecting the complexity of the issues being tackled, the large number of parties involved and the voluntary nature of participation. The Market Reform Group (MRG) headed by the Chief Executive Officer of Brit Insurance Holdings plc, Dane Douetil, is now responsible for setting strategy and driving reform.

Attempts by Lloyd's to deliver a market-wide electronic data transfer system covering risk placement and endorsement ceased in January 2006 with the closure of Kinnect, after an outlay exceeding £70m. Rather than build the central infrastructure itself, the Franchisor will now encourage and support the development of electronic trading platforms, business-to-business systems and the use of data transfer standards among Franchisees. Once commonly agreed standards have been set, Lloyd's will concentrate on measuring performance and enforcement. Such market-driven solutions are likely to lead to a significant change in the role of Xchanging Ins-Sure Services (XIS) and Xchanging Claims Services (XCS), with their offerings becoming increasingly optional.

The most notable initiative thus far involves the 'G6' – Hiscox, Amlin, Beazley, Catlin, Kiln and Wellington – who represent combined capacity of £4.6bn, or around a third of the market total. This group formed towards the end of 2005, with the aim of working with brokers to develop data standards for the market. It has embarked on an ambitious two-phase project. Phase 1, which has now been completed, has seen the development of data transfer on a 'peer-to-peer' basis between brokers and managing agents, not only bringing into line information required for slips, but also providing a platform which supports the feeding of this data directly into back office systems. A database of wordings has also been transferred to the Lloyd's Market Association (LMA) as part of the drive to contract certainty. At the beginning of April 2006, it was announced that the leading brokers had agreed to pilot the new ACORD data standards. Phase 2, which is targeted to complete by the end of 2006, will see the standardisation of claims management systems.

Contract Certainty

The London market is under pressure from the FSA to deliver demonstrable progress on contract certainty by the end of 2006. Under the MRG definition, this is "achieved by the complete and final agreement of all terms (including signed-down lines) between the insured and insurers before inception." The LMP Slip has created a standard framework that ensures all placing and risk information is set out in an unambiguous and structured way and has recently been widened to include Binding Authority and Lineslip business. This allowed London to achieve 65% contract certainty by the end of 2005 and the market is expected to meet the MRG's target of 85% by the end of 2006.

Richard Ward has described business process reform as a clear priority and is already pushing for the early implementation of a new approach to the contract documentation process, in an effort to improve efficiency and client service. Lloyd's proposes to:

- publish a simple set of checks which must be completed before the contract is entered into;
- allow each managing agent to perform the checks itself or to place reliance on the leader or a suitable service provider;
- facilitate immediate issuance of the contract, at a minimum to produce and issue a client copy within 30 days;
- allow managing agents and brokers to agree on the branding of the client copy, provided it includes agreed Lloyd's branding.

Managing agents will be responsible for implementing this approach, supported by tools such as model wordings, and will need to measure and report compliance to Lloyd's through existing risk management reviews. This marks a significant change, as currently brokers make the checks with the co-operation of XIS. The initiative has the support of the LMA, which has set a target operational date of August, as well as the G6 insurers.

Claims Management

Recognising that the market's brand reputation with clients relies upon consistently effective claims management, Lloyd's introduced a set of Claims Management Principles in July 2005. Minimum standards relating to claim reserving, the selection and management of external experts and the measurement of claims management performance were introduced immediately, with further standards to be introduced over the next two years. A new service agreement with XCS commenced on 1 July 2005 and a new Lloyd's Claims Scheme was introduced with effect from 1 April 2006. Lloyd's is also developing an infrastructure using electronic claim files and document repositories.

Lloyd's Status in the US

In terms of National Association of Insurance Commissions (NAIC) regulatory status, Lloyd's is a 'licensed insurer' in Kentucky and Illinois. It is an 'eligible excess and surplus lines writer' in all states except Kentucky and an 'accredited' or 'trusteed' reinsurer in all states. In line with all other alien reinsurers, Lloyd's is required to hold collateral in the US equating to 100% of gross reinsurance liabilities. In Lloyd's case, this is done on a syndicate-by-syndicate basis, by way of the Credit for Reinsurance Trust Funds (CRTFs), with reserving supported by quarterly reports and annual actuarial certification of liabilities. By contrast, US reinsurers are able to fund their US liabilities on a net basis, taking credit for reinsurance purchased and only posting collateral in states where they are not licensed. It is only when losses have been paid directly from syndicate resources that the associated funds are released from the CRTFs back to the UK, meaning that Lloyd's must, in effect, 'double-fund' its US reinsurance claims.

US syndicate-level trust funds can and will only be accessed if a member's Funds at Lloyd's, as supplemented by the Central Fund, ever prove to be inadequate to pay losses in the regular course of business. This is because, in order to claim against the syndicate-level trust fund, a claimant must have a valid claim which has been the subject of a final judgment and which has not been paid. This has never happened. Were it ever to be the case that the assets in the syndicate-level trust funds were inadequate to pay all mature claims in full, then policyholders affected would be entitled to draw down the reinsurance component of the market-wide Joint Asset Trust Funds.

Lloyd's and other European reinsurers have been lobbying hard for many years to change the US collateralisation rules, which are regarded as discriminatory because they are based on geographic domicile rather than financial strength. It is hoped that the recent adoption of the EU Reinsurance Directive and moves towards the Solvency II regime should alleviate lingering US regulatory concerns. The NAIC itself has estimated the annual cost to foreign reinsurers of maintaining collateral at US$500m.

Hopes of a change in the rules for foreign reinsurers reached an all-time high at the beginning of March 2006, when the NAIC executive committee directed its Reinsurance Task Force (RTF) to come up with a list of alternatives by the end of 2006. Options under consideration include creating a collateral pooling mechanism and beginning to reduce collateral based on ratings assigned to approved carriers on a 'white list'. The RTF was also asked to conduct discussions with international regulators and, in particular, look at approaches that "take account of a reinsurer's financial strength, regardless of domicile." The new sense of urgency to reach a consensus on the issue is driven largely by external pressure, including from the EU and US federal interests.

Capital Structure and Solvency

"Standard & Poor's risk-based capital model indicates strong capital adequacy at Lloyd's."
(Rating of the Lloyd's Market – February 2006)

Legal Framework

Underwriting at Lloyd's is conducted by the membership, which participates through involvement in one or more syndicates. Members have the legal obligation to policyholders, but delegate management and control of their insurance business to managing agents who act on their behalf. Lloyd's syndicates have no legal personality and are merely the vehicles through which members underwrite.

Capital is supplied to syndicates on the basis of an annual venture, with continuing support from providers needing affirmation each year. Syndicates form at the beginning of each underwriting year and close once the result is determined, usually three years later. Closure occurs once all outstanding and incurred but not reported claims are reinsured into a successor syndicate through the RITC mechanism. All underwriting members trade on a several liability basis, meaning that they receive profits or bear losses in proportion to their share in the syndicate for each underwriting year of account. The aggregate resources of Lloyd's therefore do not represent the funds available to pay a policyholder's claims. The security offered by a particular policy relates to the specific resources supporting the syndicate(s) underwriting the risk and the resources of the Central Fund as a last resort.

Individual members continuing to operate on an unlimited liability basis are liable for their underwriting losses to the full extent of their wealth. Corporate members writing on a limited liability basis are also liable to the full extent of their resources, although their only financial assets tend to be their FAL. Shareholders have their liability limited to the extent of their investment in the corporate member.

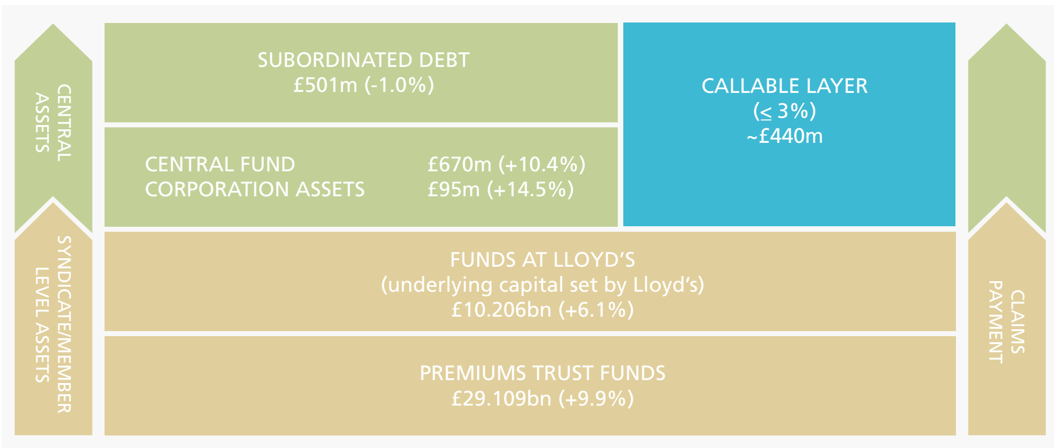
The Chain of Security

The great majority of claims are paid from the Premiums Trust Funds (PTFs), which form the first link in the Lloyd's chain of security. The capital deposited at Lloyd's by the membership in support of their underwriting forms the second link. Both the PTFs and FAL operate on a several liability basis, with each member's resources only available to meet their share of claims. The third link represents assets available to meet the liabilities of any member on a mutual basis. The chain of security supports non-life policies written for the 1993 and subsequent years of account and all life business. At 31 December 1995, all pre-1993 non-life Lloyd's business was reinsured into Equitas, a separate UK licensed insurance company (see Appendix 4, page 34).

LLOYD'S CAPITAL BASE AT 31 DECEMBER 2005

Several Assets
Mutual Assets
Contingent

Source: Lloyd's



Premiums Trust Funds

To protect the interests of policyholders, all premiums and other monies receivable in connection with members' underwriting business are initially paid into year of account specific PTFs, held at syndicate level under the trusteeship of directors or officers of Lloyd's managing agents. Payments from these funds (to which strict investment rules apply) may only be made to meet permitted trust outgoings, such as claims, reinsurance premiums, underwriting expenses and overseas regulatory deposits. There are separate PTFs for life and non-life business. There is a further segregation in that a number of PTFs, though maintained in London, are exclusively available to support certain overseas underwriting of members. The Lloyd's Dollar Trust Funds (LDTFs) receive premiums in respect of US denominated non-life business underwritten or incepting after 1 August 1995. The Lloyd's Canadian Trust Funds (LCTFs) are held in respect of Canadian situs business and the 'Lloyd's Asia' trust funds are held in respect of business written by members through service companies in Singapore.

PTFs are also used to fund overseas regulatory deposits. US regulations require separate dollar trust funds to be held in New York to support reinsurance and surplus lines business for US policyholders – the Credit for Reinsurance Trust Funds (CRTFs), the Surplus Lines Trust Funds (SLTFs) and the Joint Asset Trust Funds (JATFs). These deposits are available to meet judgment debts of a member whose PTFs are inadequate, even after replenishment from other links in the chain of security. Underwriters also maintain regulatory deposit trust funds in Australia and South Africa.

Meeting Deficits

Members are obliged, by the terms of the underwriting agreements with their managing agents, to ensure that there are sufficient funds in the PTFs for the syndicate to meet all claims and other expenses. Where a shortfall is identified, managing agents must either make a 'cash call' on syndicate members or arrange alternative financing. Cash calls are met by members from their own resources or if necessary from their FAL or, at the Council's discretion, from the Central Fund.

Releasing Profits

The move to annual accounting has been accompanied by changes that accelerate the distribution of profits from Lloyd's. From 2006, managing agents can transfer open year profits determined at the year-end from PTFs to members' Personal Reserve Funds (PRFs), subject to confirmation that they have no liquidity or other concerns. Any profit not applied to meet cash calls and/or loss payments may be used towards meeting members' capital requirements and will be available for release to members subject to a 'Release Test', which ensures that only funds in excess of required capital are released.

Funds at Lloyd's

All members are required to provide security in the form of FAL, in advance, to support the business they propose to underwrite. FAL is inter-available across underwriting years and typically comprises amounts required to support the previous two open syndicate years and the current/forthcoming active year. Thus, during the 'Coming into Line' process in November 2006, each member's FAL will have to be sufficient to cover any net deficit on the 2004 and 2005 underwriting years for all syndicates on which the member participated (as determined by actuarial review at 31 December 2005), as well as meeting that member's Lloyd's determined capital requirement for 2007.

FAL assets are held in trust for the protection of policyholders, either as compulsory Lloyd's Deposits (95% of the total) or voluntary Personal/Special Reserves, and must be readily realisable. Under the terms of the premiums trust deeds, these funds are available to meet syndicate cash calls. Letters of credit and bank guarantees are admissible as capital – one of the principal advantages for capital providers of operating at Lloyd's – and these accounted for 55% of FAL assets as at 31 December 2005.

Capital requirements are determined under the capital-setting regime of Lloyd's, following a detailed review of business plans (see Appendix 3, page 32). For 2007, most members will continue to be subject to a minimum capital requirement of 40% of their overall premium limit.

Those members writing predominantly (85%) EU motor business will effectively be subject to a minimum capital requirement of 25%, a significant relaxation of the rules that may result in the attraction to the market of additional personal lines business.

Mutual Central Assets

Mutually held central assets, comprising the Central Fund and the net assets of the Corporation of Lloyd's, are assets of the Society of Lloyd's, a legal entity distinct from the underwriting membership, and are available at the discretion of the Council of Lloyd's to cover the underwriting liabilities of any member unable to meet its obligations.

DEVELOPMENT OF CENTRAL ASSETS 2004–2005

Source: Lloyd's

£m	2004	2005
Central Fund at 1 January	**528**	**607**
Contributions from Members	191	70
Syndicate Loans	-	104
Claims and Provisions	(126)	(224)
Net Investment Income	33	87
Other (mainly tax)	(19)	26
Central Fund at 31 December	**607**	**670**
Corporation Net Assets	83	95
Subordinated Debt Issue	506	501
Central Assets under IFRS	**1,196**	**1,266**

The Central Fund is financed by the membership. For 2006, non-refundable contributions doubled to 1% of capacity, principally to make up the £226m shortfall stemming from the unfavourable outcome of the Central Fund insurance policy arbitration. Members are also continuing to contribute 0.75% of capacity by way of subordinated loans (see page 15). In addition the Society issued just over £500m of subordinated debt in November 2004, the proceeds of which were used to enhance Lloyd's central assets for solvency and capital purposes. Documentation supporting these notes explicitly subordinates them to the payment of the insurance liabilities of Lloyd's members. The other assets of the Corporation can be made available, at the Council's discretion, to meet underwriting liabilities as a last resort.

Also included in the chain of security is the callable layer of up to 3% of members' capacity, funded directly from PTFs, which is payable at the discretion of the Council. Further calls can be made, but only with the consent of members in a general meeting.

Annual undertakings to insolvent members are approved by the Council, normally in April of each year, based on the anticipated cash flow requirements of those members in the following 12 months. New undertakings totalled £217m in 2005 and payments made in respect of such undertakings during the year totalled £146m, of which £76m related to a former Goshawk corporate member and £40m related to former Alleghany corporate members. Unutilised undertakings at 31 December 2005 totalled £164m. By 31 March 2006, this balance had been reduced to £4.8m by the payment of claims of £47m and the expiry of undertakings totalling £112m. On 5 April 2006, the latter were reinstated and a further £63m of new undertakings were given, which will be reflected as a charge in the 2006 income statement.

Solvency Testing at Lloyd's

The managing agent of each syndicate is required to estimate and provide for all current and future liabilities for each year of account. These liabilities are subject to a statement of actuarial opinion (there were no qualified reports at 31 December 2005). All members have an obligation to keep sufficient funds in trust to meet their liabilities and to satisfy any request for funds in respect of audited losses or future liabilities. Lloyd's requires each member to report on its underwriting position each year as part of its 'Annual Solvency Test'.

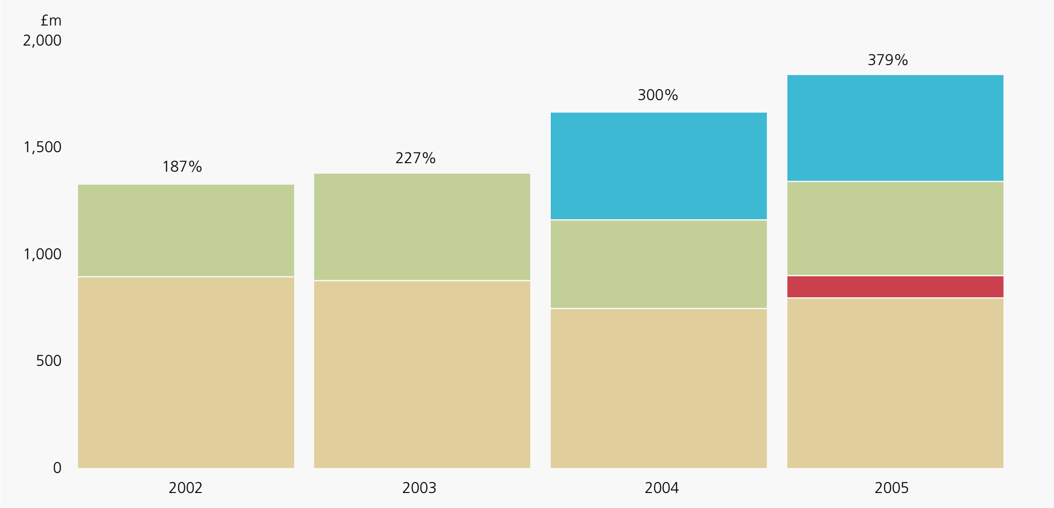
The first part of the solvency test is conducted at member level and requires each to have sufficient assets – held in PTFs, overseas regulatory deposits and FAL – to cover their underwriting liabilities and an additional solvency margin. The latter is calculated separately for each member, determined essentially as the greater of 16% of total annual premium income or 23% of average claims incurred over a three-year period. Premiums and claims in respect of certain types of liability business have their value increased by 50% for the purposes of this calculation. Where a member's assets are not sufficient to cover the aggregate of their underwriting liabilities and solvency margin, the member has a solvency shortfall. The second part of the test requires that the net central assets of the Society must be sufficient to cover the aggregate of all members' shortfalls calculated at the solvency test date. For these purposes, central assets include the effective callable layer (that part not attributed to members with a solvency shortfall).

Central assets for solvency purposes rose by 10.5% to £1.838bn in 2005, the latter being an estimate of the amount that was due to be finalised in June 2006 for submission to the FSA. The components are the net assets of the Society at 31 December 2005 (£765m), the subordinated loan notes (£501m), callable Central Fund contributions (£439m) and other solvency adjustments (£133m). On an unaudited basis, the estimated regulatory solvency ratio (calculated as central assets for solvency divided by members' solvency deficits) improved to 379% at 31 December 2005, from 300% previously, reflecting Lloyd's enhanced capital position.

LLOYD'S SOLVENCY RATIOS 2002–2005

Subordinated Debt
Callable Layer
Syndicate Loans
Corporation & Central Fund Assets

Source: Lloyd's



Lloyd's is required to maintain solvency on a continuous basis and the solvency position of each member is monitored on a regular basis. Where it is apparent that a member has insufficient assets in trust to meet its underwriting liabilities and solvency margin, Lloyd's will take action in order to protect policyholders. This will result in the member having to cease underwriting unless new funds are provided.

Lloyd's and the Rating Agencies

Market Ratings

Lloyd's financial strength ratings have exhibited great stability since they were first assigned in October 1997, a period which has seen wholesale downgrades across the reinsurance sector. More recently, this resilience has been demonstrated in the market's ability to maintain its 'A' ratings with stable outlook from Standard & Poor's, AM Best and Fitch Ratings, despite successive years of record insured natural catastrophe losses. This is particularly important for Lloyd's because a significant majority of income continues to be sourced from the highly credit-sensitive US and UK markets.

Standard & Poor's (S&P)

The initial market rating of 'A+' was downgraded by one notch to 'A' in the wake of the US terrorist attacks. On 9 September 2005, this rating was placed on CreditWatch with negative implications, reflecting uncertainty over the scale of the impact of Hurricane Katrina on Lloyd's. On 12 December 2005, the rating was affirmed with stable outlook, following a meeting with management.

AM Best

The initial market rating of 'A' was downgraded by one notch to 'A-' in the wake of the US terrorist attacks. However, the rating returned to 'A' with stable outlook in August 2004, reflecting the market's improving prospective capitalisation, strong operating performance, its global reach and improvements in risk management. The rating was last affirmed on 27 July 2005, although AM Best did comment on 15 September 2005 that Lloyd's initial estimate of its Katrina losses was not outside expectations and that the market's overall capitalisation position was believed to remain supportive of the rating.

Fitch Ratings

Fitch assessed the Lloyd's market on a public information basis only until September 2004. The relationship then became interactive and the rating was upgraded by one notch to 'A', reflecting improved capitalisation, the market's ability to attract and retain capital, improved risk controls and recent strong earnings. On 15 September 2005, Fitch indicated that the Lloyd's provisional estimate of net Katrina losses was within current rating expectations. On 20 December 2005, the rating was affirmed with stable outlook, following publication of updated hurricane loss estimates.

Syndicate Ratings/Rankings

The market ratings remain the principal measure of financial strength to be applied to those underwriting at Lloyd's, but several rating agencies separately provide syndicate-specific analysis. Widely varying approaches have resulted in as many as six different types of ratings or rankings being assigned to individual syndicates operating at Lloyd's in 2006. Some are unsolicited and effectively based only on publicly available information, while others are fee-based and involve interactive relationships. Individual syndicate analysis can add some value to the reinsurance-buying decision-making process, but it is dangerous to place undue reliance on these products without having some understanding of the widely varying underlying methodologies. It is worth noting that none of these offerings are endorsed by Lloyd's.

Any ratings or rankings assigned to individual syndicates can be found in Appendix 1, see page 28.

Standard & Poor's

Generally speaking, S&P's insurer financial strength ratings are made by reference to the likelihood of regulatory default. The agency does not believe that syndicate-specific financial strength ratings are meaningful, as the effective mutualisation of all market risks through the Central Fund means that the defaulting entity would be the Lloyd's market as a whole, rather than individual syndicates or their members. However, S&P has published assessments that differentiate between syndicates, not just in terms of pure credit quality, but also in terms of likely syndicate continuity.

Lloyd's Syndicate Assessments (LSAs)
The LSA product, which was introduced in September 2002, evaluates syndicate continuity characteristics based on the relative dependency of syndicates on Lloyd's infrastructure and the Central Fund. Most are assessed using purely public domain qualitative and quantitative information and these LSAs carry a 'pi' subscript. However, nine of the 46 LSAs assigned are now based on interactive relationships with management, allowing more detailed evaluation. S&P does not evaluate syndicates that have reported fewer than three closed years of account, syndicates that have undergone substantial recent restructuring or syndicates in run-off.

Lloyd's Corporate Member Guarantees
S&P is able to assign financial strength ratings to Lloyd's corporate members in cases where an acceptable guarantee has been provided by another rated entity. On this basis, the sole capital backers to Syndicate 3210 (MSI Corporate Capital Ltd) and Syndicate 1414 (Ascot Corporate Name Ltd) are rated 'AA-' and 'AA+', respectively.

AM Best
AM Best believes that meaningful financial strength ratings *can* be assigned to individual syndicates, on the basis that some have capital strength characteristics in their own right capable of supporting a rating at or above the floor level of the market rating. An interactive product was launched in November 2001, based on a combination of quantitative and qualitative standards, the fundamental areas of analysis being the same as those employed for a traditional AM Best rating, i.e. capital strength, operating performance and business profile. These ratings are directly comparable with the companies market and follow the normal rating scale, but are differentiated with an 's' modifier. There are 18 active ratings in effect as at July 2006. The take-up has generally been from syndicates writing significant volumes of US business, who wish to differentiate themselves in the market. However, only one of these ratings now exceeds the level of the market rating (Ascot Syndicate 1414 at 'A+').

Moody's Investor Service
Moody's syndicate analysis comprises two different sorts of rating.

Syndicate Performance Ratings (SPRs)
SPRs reflect Moody's view of the potential future performance of an individual syndicate over the insurance cycle, relative to other Lloyd's syndicates, based on currently known factors. They do not attempt to assess the security underlying Lloyd's policies. Instead they aim to address policyholder continuity, on the basis that only syndicates that are profitable over the cycle are likely to retain capital support and thus continue trading over the medium to long term. The ratings are forward-looking, using historical data and, in most cases, input from management.

Syndicate Insurance Financial Strength Ratings (IFSRs)
Moody's introduced fee-based interactive syndicate financial strength ratings in 2000 but, as at June 2006, only four were in effect. The IFSRs are credit ratings, taking into account syndicate earnings, FAL and any benefits from the Central Fund where applicable, and are directly comparable with Moody's ratings on other insurance operations worldwide.

Appendices

Syndicate	Pseudonym	Underwriter	Managing Agent	Largest Capital Provider in 2006	Stamp Capacity (£m)		Result to Capacity (%)*		Combined Ratio (%)**		Moody's	S&P	Financial Strength Ratings	
					2006	2005	2005	2004	2005	2004	Perf Rating	LSA Ranking	Moody's	AM Best
0033	HIS	RC Watson	Hiscox	Hiscox (73%)	833	775	-3.8	6.2	110.2	93.9	A-	-	-	A s Stable
0044	JDB	C Ray	Canopius	Talisman (86%)	3	3	4.9	16.1	94.8	72.6	B-	2pi	-	-
0218	EMP	J Josiah/K Charlton	Equity	Equity (64%)	401	433	9.0	12.8	97.4	93.5	B+	3pi	-	-
0260	KGM	C Hart	KGM	Perseverance (65%)	43	40	11.8	15.4	102.5	89.7	B-	2pi	-	-
0308	KLS	C Toomey	Kiln	Kiln (51%)	13	10	-23.9	9.9	139.7	91.0	B-	2pi	-	-
0318	MSP	M Pritchard	Beaufort	Beaufort (45%)	159	159	5.1	6.2	95.8	92.6	B	3pi	-	-
0382	PWH	AJ Walker	Hardy	Hardy (91%)	110	100	8.4	2.7	96.3	95.0	B+	4pi	-	A s Stable
0386	DAC	D Constable	Limit	QBE (69%)	340	425	49.1	25.9	62.2	81.5	A-	5 Stable	-	-
0435	FDY	M Rayner/P Ceurvorst	Faraday	Berkshire Hathaway (100%)	325	300	-23.0	-8.5	143.1	122.0	B	2pi	-	-
0457	WTK	D Hoare/O Crabtree	Munich Re	Munich Re (100%)	260	190	-5.6	14.0	108.6	81.6	B	3pi	-	-
0510	KLN	Robert Chase	Kiln	Kiln (47%)	625	546	-7.6	11.4	112.6	87.3	A-	4pi	-	A s Stable
0557	KCS	A Carrier	Kiln	Argenta Private (48%)	55	48	-24.9	18.3	163.4	66.2	A-	3pi	-	-
0566	STN	J Parry	Incidental – see Syndicate 2999		-	-	-	-	-	-	-	-	-	-
0570	ATR	KW Wilkins	Atrium	Argenta Private (27%)	150	150	2.2	16.6	105.7	86.1	A-	3pi	-	A s Stable
0609	AUW	CE Dandridge	Atrium	Argenta Private (28%)	215	215	-18.0	18.4	136.0	79.4	A	3pi	-	A s Stable
0623	AFB	AF Beazley	Beazley	Hampden Private (43%)	183	220	7.8	9.1	100.7	89.4	A-	4pi	-	A s Stable
0626	IRK	IR King	Incidental – see Syndicate 0033		-	-	-	-	-	-	-	-	-	-
0727	SAM	MJ Meacock	Meacock	CBS Private (46%)	72	72	-3.6	15.3	108.0	82.2	B	2pi	-	-
0779	CDL	BJ Jackson	Jubilee	Argenta Private (34%)	38	36	5.0	9.5	99.1	88.0	B+	3pi	-	-
0780	ADV	L Tunnicliffe	Advent	Advent (80%)	153	153	-90.8	3.8	205.8	99.2	B-	2- Negative	-	-
0807	SDM	SD Mathers	Kiln	Argenta Private (25%)	110	100	-15.2	4.7	117.5	94.2	B	3pi	-	-
0958	GSC	JD Robinson	Omega	Argenta Private (30%)	249	225	6.0	7.4	96.8	90.5	B	3pi	-	A s Stable
0994	SIM	MIC Simmonds	Imagine	Imagine (100%)	40	40	-8.5	-23.6	126.8	118.2	C+	1pi	-	-
1007	NVA	JLJ Butcher	Novae	Novae (82%)	120	151	12.4	8.0	90.7	89.7	B	2 Stable	A3 Stable	A s Stable
1036	COF	C O'Farrell	Incidental – see Syndicate 2999		-	-	-	-	-	-	-	-	-	-
1084	CSL	BP Bartell	Chaucer	Chaucer (100%)	450	400	-7.3	-0.6	112.1	102.3	B+	3 Stable	-	A s Stable
1176	MGD	M Dawson	Chaucer	Chaucer (54%)	23	18	15.5	21.2	88.2	59.8	B+	3pi	-	-
1183	TAL	CNR Atkin	Talbot	Talbot (100%)	307	282	-1.3	11.3	106.4	84.0	B+	3pi	-	-
1200	ROC	LJ Rock	Heritage	Heritage (61%)	180	150	-9.4	13.1	111.2	79.8	-	-	-	-
1206	GER	GM Halpin	Gerling	Gerling (100%)	60	60	-4.1	-8.5	109.7	110.5	B-	1pi	-	-
1209	XL	P Drake	XL	XL (100%)	230	288	-7.7	8.0	128.2	87.8	B+	-	-	-
1218	ODY	SL Gordon	Newline	Odyssey (100%)	100	145	8.0	20.5	87.8	92.6	-	2pi	-	-
1221	MLM	R Bardwell	Navigators	Navigators (100%)	113	135	-1.7	7.3	107.7	85.1	B	3pi	-	-
1225	AES	P Thorpe-Apps	AEGIS	AEGIS (100%)	207	165	-9.3	7.9	114.4	91.5	-	3pi	-	A s Stable

* UK GAAP annually accounted result against stamp capacity

** Net losses incurred plus commissions plus administrative expenses against net earned premium

All ratings/rankings stated as at 7 July 2006 and subject to subsequent change. Syndicates designated as 'incidental' operate as sub-syndicates of the designated 'parent' syndicate, the underlying security being identical.

Syndicate	Pseudonym	Underwriter	Managing Agent	Largest Capital Provider in 2006	Stamp Capacity (£m)		Result to Capacity (%)*		Combined Ratio (%)**		Moody's	S&P	Financial Strength Ratings	
					2006	2005	2005	2004	2005	2004	Perf Rating	LSA Ranking	Moody's	AM Best
1231	FRW	JS Wilkinson	Jubilee	Jubilee (100%)	55	51	11.4	20.7	95.2	75.1	-	-	-	-
1301	BGT	PJ Gage	Chaucer	CLAL (100%)	55	55	7.8	3.0	94.7	95.5	-	-	-	-
1400	DRE	M Petzold	Danish Re	Imagine (100%)	100	50	-32.1	-7.8	155.0	114.0	-	1pi	-	-
1414	RTH	MRD Reith	Ascot	AIG (99%)	550	410	-21.1	34.1	132.8	63.7	-	-	-	A+ s Stable
1607	JHA	J Thomas	Creechurch	Converium (41%)	49	50	-15.2	-12.8	162.4	122.9	-	1pi	-	-
1861	BRM	L Allen	Marlborough	Berkshire Hathaway (100%)	50	60	-47.0	10.0	148.3	93.0	-	-	-	-
1886	QBE	J Neal	Incidental – see Syndicate 2999		-	-	-	-	-	-	-	-	-	-
1952	JJS	J Cashen	Incidental – see Syndicate 1231		-	-	-	-	-	-	-	-	-	
1965	AMS	R Yeo	Argenta	Temasek (100%)	16	17	-3.7	-	132.5	-	-	-	-	-
2000	HAR	M Harrington	Incidental – see Syndicate 2999		-	-	-	-	-	-	-	-	-	-
2001	AML	AW Holt	Amlin	Amlin (100%)	1000	850	18.6	14.1	89.2	84.4	A- Positive	4 Stable	A1 Stable	A s Stable
2003	SJC	N Burkinshaw	Catlin	Catlin (100%)	450	500	-13.2	10.1	117.0	90.9	B+	4- Stable	-	A s Stable
2010	MMX	JC Hamblin	Cathedral	Cathedral (54%)	250	200	6.8	14.6	93.0	76.3	-	3pi	-	A s Stable
2020	WEL	T Burrows	Wellington	Wellington (67%)	800	730	-11.6	9.1	121.5	92.6	A-	3pi	A2 Stable	A s Stable
2121	HYL	J Hyland	Argenta	Argenta Private (91%)	90	76	-54.2	-3.5	175.0	107.4	-	1pi	-	-
2147	NVA	A Hicks	Novae	Novae (100%)	240	286	8.5	8.9	93.9	89.0	B	2 Stable	A3 Stable	A s Stable
2468	MFM	SP Lotter	Marketform	Converium (41%)	100	100	8.3	8.9	97.1	93.5	-	2pi	-	-
2488	AGM	R Pryce	ACE	ACE (100%)	350	400	-18.6	7.7	124.8	97.7	A-	-		-
2525	DLP	DL Pratt	Abacus	CBS Private (70%)	50	44	29.2	0.2	80.8	104.6	-	2pi	-	-
2526	AGD	AG Dore	Abacus	CBS Private (47%)	32	28	16.6	-0.4	81.8	102.3	-	-	-	-
2623	AFB	AF Beazley	Beazley	Beazley (100%)	647	522	-1.6	5.2	106.8	94.7	A-	3pi	-	A s Stable
2791	MAP	DES Shipley	MAP	MAP (30%)	400	326	-0.2	15.9	104.2	85.9	-	3pi	-	-
2987	BRT	MA Sibthorpe	Brit	Brit (100%)	500	500	-2.3	6.5	107.2	95.6	B	3pi	-	-
2999	QBE	P Grove	Limit	QBE (100%)	660	550	-5.6	9.7	116.3	88.4	B	3+ Stable	-	-
3000	MKL	G Albanese	Markel	Markel (100%)	145	145	14.9	22.5	101.4	96.4	B+	3pi	-	A s Stable
3210	MIT	D Warren	Chaucer	Mitsui Sumitomo (100%)	300	300	8.4	13.2	95.0	86.0	B+	-	-	-
3245	LAW	M Lawrence	Heritage	Heritage (62%)	49	58	7.8	4.5	90.2	94.2	-	-	-	-
3786	TAK	S Gargrave	Creechurch	SALAMA (100%)	41	-	-	-	-	-	-	-	-	-
4000	QNT	M Wheeler	Chaucer	Quanta (100%)	82	80	-4.8	-	126.2	-	-	-	-	-
4040	ILM	D Burniston	Illium	Houston Casualty (56%)	54	70	1.0	-5	100.7	129.9	-	-	-	-
4444	CNP	J Giordano	Canopius	Talisman (42%)	300	240	-6.4	-2.6	107.4	105.2	B-	2+ Stable	-	-
4472	LIB	TRC Corfield	Liberty	Liberty Mutual (100%)	912	716	-60.8	-0.7	205.8	105.4	B	2pi	-	-
5000	SPL	MP Hudson	St Paul	St. Paul Travelers (100%)	250	240	-13.7	-7.2	123.6	121.1	-	1pi	-	-
5820	CDG	BJ Jackson	Jubilee	Jubilee (100%)	44	38.5	-1.8	-	105.4	-	-	-	-	-

* UK GAAP annually accounted result against stamp capacity
** Net losses incurred plus commissions plus administrative expenses against net earned premium
All ratings/rankings stated as at 7 July 2006 and subject to subsequent change. Syndicates designated as 'incidental' operate as sub-syndicates of the designated 'parent' syndicate, the underlying security being identical.

20 LARGEST SYNDICATES BY 2006 CAPACITY

Source: Lloyd's

Managing Agent	Syndicate Number	2006 Capacity £m	2005 Capacity £m	Variance %
Amlin	2001	1,000	850	17.6
Liberty	4472	912	716	27.4
Hiscox	0033	833	775	7.5
Beazley	0623/2623	830	742	11.9
Wellington	2020	800	730	9.6
Limit	2999	660	550	20.0
Kiln	0510	625	546	14.5
Ascot	1414	550	410	34.1
Brit	2987	500	500	-
Chaucer	1084	450	400	12.5
Catlin	2003	450	500	(10.0)
Equity	0218	401	433	(7.4)
MAP	2971	400	326	22.7
ACE	2488	350	400	(12.5)
Limit	0386	340	425	(20.0)
Faraday	0435	325	300	8.3
Talbot	1183	307	282	9.9
Mitsui	3210	300	300	-
Canopius	4444	300	240	25.0
Munich Re	0457	260	190	36.8

20 LARGEST DIRECT CAPITAL PROVIDERS

Source: Lloyd's

Capital Provider	2006 Corporate Member Capacity £m	Capacity Growth vs 1 January 2005 (%)	2006 Market Share (%)
Amlin	1,000	17.6	6.8
Liberty	912	27.4	6.2
QBE (Limit)	895	6.5	6.1
Beazley	653	23.6	4.4
Hiscox	604	9.8	4.1
AIG (Ascot)	550	34.1	3.7
Wellington	533	10.6	3.6
Brit	500	0.0	3.4
Chaucer	462	14.9	3.1
Catlin	450	(10.0)	3.0
Berkshire Hathaway	375	4.2	2.5
Kiln	353	26.4	2.4
ACE	350	(12.5)	2.4
Novae (formerly SVB)	338	(17.4)	2.3
Talbot	307	8.9	2.1
Mitsui Sumitomo	300	0.0	2.0
Canopius (Englefield)	288	18.7	1.9
Munich Re	260	36.8	1.8
Equity Insurance Group	257	(5.6)	1.7
St Paul Travelers	250	2.1	1.7
Top 20	**£9.6bn**	-	**65.2%**

20 LARGEST MANAGING AGENTS

Source: Lloyd's

Managing Agent	2006 Capacity £m	Capacity Growth vs 1 January 2005 (%)	2006 Market Share (%)
Amlin	1,000	17.6	6.8
Limit (QBE)	1,000	2.6	6.8
Liberty	912	27.4	6.2
Chaucer	910	6.6	6.2
Hiscox	833	7.5	5.6
Beazley	830	11.8	5.6
Kiln	803	14.1	5.4
Wellington	800	9.6	5.4
Ascot (AIG)	550	34.1	3.7
Brit	500	0.0	3.4
Catlin	450	(10.0)	3.0
Equity Insurance Group (Cox)	401	(7.5)	2.7
MAP	400	22.7	2.7
Atrium	365	0.0	2.5
Novae (formerly SVB)	360	(17.6)	2.4
ACE	350	(12.5)	2.4
Faraday (Berkshire Hathaway)	325	8.3	2.2
Talbot	307	8.9	2.1
Canopius	303	24.7	2.0
Munich Re	260	36.8	1.8
Top 20	**£11.7bn**	-	**78.9%**

Syndicate Activity

Cessations at 31 December 2005

- Syndicate 1923 managed by Imagine.
- Syndicate 2800 managed by Danish Re.

New Syndicates for 2006

- Limit Non-Marine Liability Syndicate 1886, operating as an incidental of umbrella Syndicate 2999.
- Takaful Syndicate 3786, managed by Creechurch and backed by SALAMA.
- Alba Syndicate 4455, backed by Insurance Australia Group – the first multi-line syndicate dedicated to Asian business – began trading in June 2006 with capacity of £8.6m.

Proposed Start-Ups Subject to Lloyd's/Capital Approval

- In May 2006, it was reported that Limit had submitted a provisional business plan to Lloyd's backing the creation of a new aviation syndicate under Emilio Di Silvio. The syndicate is expected to begin trading on 1 October 2006.
- In June 2006, it was announced that Heritage was looking to establish Personal Accident Syndicate 3200 mid-year, with expected capacity of £50m. The syndicate will not trade beyond 2006 and the business will be combined with Syndicate 1200 for 2007.
- In June 2006, it was announced that Hardy would be launching a new Non-Marine Syndicate for 2007 with capacity of up to £75m, under Patrick Gage, the current Active Underwriter of Syndicate 1301.

Appendix 3

Capital Setting at Lloyd's

With effect from 1 January 2005, the FSA introduced the Individual Capital Adequacy Standards (ICAS) regime for UK non-life insurers, as a forerunner to the implementation of the Solvency II proposals, which are likely to be implemented across the European Union from 2010. This regime also applies to Lloyd's, with certain limited exceptions reflecting the market's unique structure. Three key objectives are to ensure that senior management is focused on risk management, that there is a link between risk and capital-setting and that this is demonstrated through clear documentation of all prudential risks, processes and controls.

Individual Capital Assessments (ICAs)

Managing Agent Responsibilities

Under the ICAS regime, managing agents are required to carry out regular assessments of the amount of capital that is adequate for the size and nature of each managed syndicate. All potential risks must be considered, including insurance risk, credit risk, market risk, liquidity risk, group risk and operational risk. For 2007, the ICA must provide for all losses, modelled to ultimate, arising after 1 January 2007 on the syndicate's 2006 and prior years of account at a 99.5% confidence level, or higher where agreed with Lloyd's. This includes primarily the risk that claims reserves as at 31 December 2006 prove to be inadequate.

Lloyd's Responsibilities

The FSA delegates the task of reviewing and agreeing syndicate ICAs to the Lloyd's Market Risk and Reserving Unit, being content to review managing agency output on a sample basis. This recognises that the responsibility Lloyd's has for setting member capital requirements is fundamental to its role of ensuring that central assets are adequate, are not exposed to undue risk and represent tangible protection for policyholders.

Provisional ICAs are submitted to Lloyd's in June of each year, along with the first set of Syndicate Business Forecasts for the following year. Lloyd's is responsible for ensuring that syndicate ICAs are at an adequate level and dialogue with managing agents will be ongoing throughout the months of July and August, until the final full ICAs are agreed and submitted with the formal Syndicate Business Plans in September. It should be stressed that managing agents are at all times accountable to the FSA for their compliance with the rules and that, should any ICA outcome be considered unsatisfactory, the FSA has the power to issue Individual Capital Guidance (ICG) as to how much additional capital is required. To date, this has not been necessary.

Lloyd's is also required to conduct an ICA for the market as a whole, which is the level of capital resources required to withstand a 1-in-200-year event over a one-year time frame. The calculation is based on the same six risk categories, the capital available to meet these risks being provided by net central resources. The output of the Lloyd's ICA is discussed with the FSA and is either agreed or subject to ICG.

Economic Capital Assessments (ECAs)

The ICA figures represent the minimum regulatory capital required by the FSA. Lloyd's also assesses the level of economic capital required to protect the Franchise against unexpected losses, such that the market's underwriting liabilities can be met and Lloyd's financial strength ratings maintained. For 2006, Lloyd's applied a broad-brush 35% economic capital uplift to all syndicate ICAs. For 2007, the capital loading will vary between syndicates, depending on the tail and catastrophe risk. It is expected that the uplift will range between 30% and 40% and average out at 35% across the market.

For 2006, which was regarded as a transitional year, it was agreed that syndicate-level ECAs would not differ by more than 15% either way from the capital requirements calculated under the previous market average based regime. For 2007, this capital corridor will be widened to 20%, subject to syndicate-level capital being at least as high as the syndicate ICA itself.

Future Development of Lloyd's ICAS Model

The goal at Lloyd's is to develop a regime whereby capital for each member or syndicate is based on the unique risk characteristics of the business, rather than market average assumptions. The improved alignment of capital with risk should help to protect central assets, boost returns on capital and enhance policyholder security.

Going forward, Lloyd's is expected to set higher overall capital levels to meet its Optimal Platform objectives. Bearing in mind the impact of the 2005 hurricanes on rating agency models, the Franchise Board has expressed its firm opinion that capital levels for catastrophe-exposed business will increase for the 2007 year of account. New ICA guidance issued in March 2006 indicates that syndicate ICAs will move to a three-year model for 2008, with syndicate-specific data used to assess both frequency and severity of loss (including total value at risk for economic uplift). The possibility of moving to differential Central Fund contributions is also being considered.

Coming Into Line (CIL) and Member Recapitalisation

The free funds available to a member to meet its capital requirements may fall below the required level for two reasons. Firstly, due to increases in syndicate ICAs following a material change to the risk profile of the business and, secondly, from erosion of funds due to losses. In either case, the timetable for recapitalisation and any intervention by Lloyd's will depend on the extent of the shortfall.

CIL is a procedure undertaken in June and November each year, which requires members to demonstrate that they have sufficient eligible assets to meet their current underwriting liabilities and to support future underwriting. Lloyd's has powers to require members to meet their ECAs at all times, but will normally permit recapitalisation in accordance with this biannual timetable, provided that members' free funds remain above their ICA. Where a member's funds fall below their ICA level, Lloyd's would expect members to inject additional capital outside of the normal CIL timetable. Where there is material exposure to the Central Fund and policyholder security, underwriting restrictions or other measures may be imposed to mitigate the risks until capital is lodged at Lloyd's. In accordance with the continuous solvency regime, where a member's free funds fall below the level of regulatory solvency (underwriting losses plus the required minimum margin), the existing powers to immediately suspend underwriting or take any other measures deemed appropriate by Lloyd's may be used.

The mid-year CIL position for all active members has been calculated using data as at 28 April 2006. Members were notified of any shortfalls at the end of May 2006 and were required to make these good by the end of June 2006. The Franchise Board has agreed that half-year interim results should be recognised for capital setting within the November CIL exercise and for September Release Test purposes. In view of the nature and seasonal exposure of much of Lloyd's business and the limited scope of the external verification (a review by syndicate auditors, rather than a full audit), any credit will be restricted to 10% of the ECA and will be subject to cancellation in the event of a major catastrophe. Where an active member is entitled to a surplus FAL release as a result of the interim results, it is expected that any release request takes into consideration the member's CIL requirement – a surplus capital release should not be followed by provision of additional assets for CIL. The CIL process relating to the 2007 year of account requires that any ECA shortfalls be funded in full by 29 November 2006, with sanctions otherwise imposed.

The current annual timetable is driven by the annual venture, a wide operational review of which will be undertaken by the end of 2006, as part of the drive towards the Optimal Platform.

Appendix 4 Equitas – Review of the Past 12 Months

Overview

Equitas' results continue to be important in the overall context of the Lloyd's market, not least because all of the major rating agencies view continuing exposure to Equitas as a significant negative rating factor. The main potential exposure of the continuing market to a failure at Equitas is through the Joint Asset Trust Funds (JATFs) established by Lloyd's to support business written in the US. In the majority of conceivable shortfall scenarios, Lloyd's would be very likely to replenish the JATFs to maintain access to the US market, perhaps by way of a loan or levy on the current membership. However, unless finality was achieved, even this outcome would undermine confidence in the market among clients, brokers and capital providers.

It is generally recognised that Equitas has done a good job of running off Lloyd's 1992 and prior non-life liabilities. Since inception in 1996, Equitas has settled claims of over £17bn (cutting undiscounted liabilities by 71%), realised £7bn of reinsurance asset, generated investment returns of £908m in excess of the unwinding of the reserve discount and reduced the annual cost of running the business from £243m to £72m. However, Equitas has also had to increase gross discounted reserves by £1.6bn over this period, mainly relating to US asbestos liabilities. The reserves now contain a much higher proportion of asbestos, pollution and health exposures than was the case when the company was originally established, leading to increased levels of uncertainty. Asbestos continues to be the greatest single threat facing Equitas, accounting for around 53% of gross discounted reserves. While Equitas continues to seek resolution of the largest and most volatile claims, and has had considerable success in this regard, the risk of severe adverse developments is likely to remain for many years.

Latest Financial Results

The financial statements for the year ending 31 March 2006 have again received a qualified audit opinion, relating to the uncertainties associated with reserve provisioning.

EQUITAS PROFIT AND LOSS ACCOUNT SUMMARY

Source: Equitas Group

£m	31 March 2006	31 March 2005
Gross Claims Paid	(744)	(1,030)
Reinsurers' Share	190	209
Net Claims Paid	**(554)**	**(821)**
Change in Net Claims Provision	322	707
Claims Incurred, Net of Reinsurance	**(232)**	**(114)**
Other Technical Charges	25	(3)
Balance on the Technical Account	**(207)**	**(117)**
Investment Income	194	190
Realised Gains	53	63
Unrealised Gains	(58)	(120)
Investment Return	**189**	**133**
RESULT FOR THE YEAR	**(18)**	**16**

EQUITAS BALANCE SHEET SUMMARY

Source: Equitas Group

Assets £m	31 March 2006	31 March 2005
Financial Investments	4,137	4,087
Financial Reinsurances	28	32
Reinsurers' Share of Outstanding Claims	360	514
Reinsurance Debtors	264	317
Other Assets	77	81
TOTAL ASSETS	**4,866**	**5,031**
Liabilities £m	**31 March 2006**	**31 March 2005**
Gross Claims Outstanding	4,176	4,406
Reinsurance Creditors	202	112
Other Creditors	30	37
Shareholders' Funds (Retained Surplus)	**458**	**476**
TOTAL LIABILITIES	**4,866**	**5,031**

The results for the year to 31 March 2006 appear broadly neutral for the financial position of Equitas. Gross paid claims fell by 28% to £744m, including settlement of 32 direct asbestos claims and 16 direct pollution claims. Good progress was again made in reinsurance collection, with one third of the asset that existed at the beginning of the year being realised, driven in part by commutations with 86 reinsurers. In the aggregate, those settlements produced contribution to surplus of £81m. The group's investments also performed well during the year, the overall return exceeding the unwinding of the reserve discount by £88m. Within gross paid claims, operating costs fell by 11% to £72m, reflecting a fall in headcount from 387 to 312.

These positive developments were offset by £128m of additions to gross discounted asbestos reserves, primarily as a result of greater than expected claim notifications from US insurers. Equitas also needed to increase pollution reserves for the first time since March 1999, owing to adverse development in a small number of cases. The net effect was an £18m reduction in retained surplus to £458m and a slight decline in the solvency margin to 12.0% from the high point of 12.2% last year. The opening solvency margin in 1996 was 5.6%.

Equities represented 6.8% of the market value of the investment portfolio. Government issues accounted for 71% of the bond portfolio and the remainder was rated A or better. Approximately 50% of the surplus is held in US dollar assets. Technical provisions are discounted to reflect the time value of money. For the year under review, the discount rate has increased from 4.1% to 4.3%, as a direct result of rising bond yields. Even with all the settlements achieved over the past year, net liabilities were only reduced by 2% to £3.8bn. The reduction would have been more like 8%, but for the effect of exchange rate movements. Virtually all of the liabilities are matched by currency and, although there is some exposure, Equitas considers foreign exchange risk to be low.

Asbestos

Since April 2001, Equitas has completed 46 major direct asbestos settlements involving the payment of over £1.8bn and completed commutations that extinguish more than £550m in undiscounted asbestos liabilities. Equitas had another year of success in this area, assisted by what it termed growing intolerance for the submission or payment of illegitimate claims. Of the top 25 direct claims identified a year ago, 12 have been settled. Progress in commuting reinsurance liabilities with US insurers has been slower, possibly hindered by uncertainty over the passage of the Fairness in Asbestos Injury Resolution (FAIR) Act and Equitas is seeking to do more to convince other companies of the mutual benefits of commutation.

GROSS DISCOUNTED ASBESTOS RESERVES

Source: Equitas Group

	£m
Reserve at 1 April 2005	2,314
Payments and Commuted Liability	(465)
Reassessment of Reserves	128
Unwinding of the Discount	66
Exchange	167
Reserve at 31 March 2006	2,210

At 31 March 2006, gross undiscounted asbestos reserves were unchanged on the previous year at £3.4bn. On a discounted basis, these reserves totalled £2.2bn as at 31 March 2006, down from £2.3bn previously. Non-US asbestos reserves have remained relatively stable and represent approximately 13% of the total.

Researched and written by
Mike Van Slooten
Senior Vice President

Market Information Department
Guy Carpenter and Company Ltd.

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For further information,
please contact your local
Guy Carpenter office or visit our
website at: www.guycarp.com

Guy Carpenter & Company Ltd.
Tower Place
London
EC3R 5BU

Tel: +44 (0)20 7357 1000

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