Article Title: ARCHIVE | Criteria | Insurance | Specialty: Lloyd's Syndicate Assessment Methodology Revised In Light Of Lloyd's Market's Move To Annual Accounting Data: (EDITOR'S NOTE: — This article has been superseded by "Lloyd's Syndicate Assessment Methodology," published March 28, 2013.) This article provides a further update to the criteria used by Standard & Poor's Ratings Services to evaluate Lloyd's syndicates' business continuity characteristics in the form of Lloyd's Syndicate Assessments (LSAs). This latest update focuses on the impact on analysis of recent changes to reporting and accounting within Lloyd's (Lloyd's or the Market; A/Stable); in particular, the move from three-year fund to annual U.K. GAAP accounting. Lloyd's is a globally respected insurance marketplace where capital providers accept insurance risk on a strictly several basis through syndicates in return for insurance premiums. The financial risks to these capital providers are partially mutualized through the Lloyd's Central Fund, to which all underwriting members contribute. Because of the presence of the Central Fund, and the powers vested in the Council of Lloyd's to manage this fund, Standard & Poor's has been able to assign an insurer financial strength rating (FSR) to the Lloyd's Market, which applies currently and prospectively to each policy issued by Lloyd's from the 1993 year of account onward. Standard & Poor's does not believe that, under the Market's current legal and regulatory structure, FSRs on syndicates are appropriate. This view reflects the fact that syndicates are groupings of one or more capital providers, managed on their behalf by a managing agent, and are not legal entities in themselves. Furthermore, regulatory action is the arbiter of default with regard to FSRs and, due to the mutualization of Lloyd's through the Central Fund, regulatory action resulting from concerns as to ability to meet claims would be Marketwide, not syndicate specific. With these issues in mind, in order to meet the insurance and capital markets' need for a more specific view on syndicates, Standard & Poor's offers an opinion on a syndicate's business continuity characteristics in the form of an LSA. LSAs evaluate the relative dependency of syndicates on Lloyd's infrastructure and the Central Fund, reflecting their ability to offer business continuity to policyholders. LSAs rely on both qualitative and quantitative analysis and are assigned according to the following scale: Where an assessment is based purely upon publicly available information, the LSA carries a 'pi' subscript. Standard & Poor's considers that all syndicates are dependent on Lloyd's to a greater or lesser extent. A syndicate assigned an LSA of '5' is considered to have "very low dependency" and strong business continuity characteristics, which Standard & Poor's views as positive, whereas an LSA of '1' indicates "very high dependency" and weak business continuity characteristics, which are viewed as negative. LSAs have been welcomed both by syndicate clients and brokers who wish to ensure that continuity of relationships is maintained over the life of the policy and claims period. Standard & Poor's has assigned an LSA to all syndicates currently trading at Lloyd's that have sufficient relevant data to support a meaningful review. Typically, Standard & Poor's requires financial results from at least three closed underwriting years before assigning an LSA on a 'pi' basis. LSAs are updated regularly through the year, notably after each syndicate quarterly return data release from the Market. Standard & Poor's may also revise an LSA in response to other emerging information. Public Information ('pi') LSA Methodology The starting point for all LSA analysis is the result generated by the 'pi' LSA model. Where an LSA is assigned on an interactive basis, additional and confidential information gained through discussion with syndicate management supplements the initial 'pi' analysis. From Jan. 1, 2005, the main financial reporting regime for the Lloyd's Market moved from a three-year fund to an annual accounting basis, adopting U.K. GAAP. With this change, Standard & Poor's has shifted its prime analytical focus to the annual accounted information disclosed by each syndicate. Three-year fund-accounted information, where disclosed, is still reviewed as part of analytic due diligence, and syndicate three-year fund-accounted track records remain extremely relevant, especially during this transitional period. However, the change in focus was necessary in order to: Ensure analytical consistency. Not all syndicates have produced three-year fund accounts for year-end 2005, whereas all have produced these on an annual accounted basis. Enhance the comparability of Lloyd's syndicates with insurance operations outside of the Market. Changes in reporting have also been reflected within an updated 'pi' LSA model, as follows: The calculation of some ratios within the model has been altered to reflect the manner in which syndicate information is now presented; Some existing ratios have been excluded from the updated model because the data upon which they were based are no longer available; and New ratios have been added to enhance the analysis. Standard & Poor's has ensured consistency within the LSA product through extensive testing and calibration of the updated model and through the committee process. The latter has been particularly important considering the huge volatility in performance seen at many syndicates between the reported 2005 figures (affected as they were by a very severe North Atlantic hurricane season) and 2004 comparatives (also affected by hurricane activity, but to a much lesser extent). The updated 'pi' LSA model continues to have seven heads of analysis that carry set weightings (see table). 'pi' LSA Model: Heads Of Analysis --WEIGHTING (%)-- UPDATED MODEL PREVIOUS MODEL Underwriting profile 15 10 Investments and liquidity 10 10 Reinsurance 15 15 Operating performance 25 25 Reserves 15 15 Capital 10 10 Ownership* 10 15 *Previously ownership and management. Within the updated model, however, the weighting associated with the underwriting profile has been increased to 15%, whereas that relating to ownership (previously ownership and management) has been reduced to 10%. The renaming of ownership and management and reduction in weighting reflects the fact that the accuracy of operating performance forecasting is no longer taken into account. This was used as an indicator of management quality in a 'pi' context and was assessed by comparing the record of closed underwriting-year results with published forecasts previously released for those same years. Forecasting accuracy in conjunction with the forecasts themselves also provided a lead indicator of operating performance. Forecasts are much less relevant than in the past, however, since their impact is already reflected in the annual financial statements. The increase to the underwriting profile weighting reflects Standard & Poor's desire to maintain the previous balance between historical and prospective information within the LSA analysis. Underwriting profile remains one of the more leading indicators within the 'pi' model. Increasing its overall weighting offsets somewhat the element of prospective view lost with the removal of the forecasting accuracy assessment. The updated factors and weightings applied have been determined by Standard & Poor's using both its analysis of Lloyd's past syndicate business continuity and factors that, in our opinion, contribute to the overall financial strength of the Market. Underwriting profile (model weighting 15%) This part of the analysis examines a syndicate's revenue-generating ability and the likely performance characteristics of its book of business. Factors considered include: Syndicate capacity. Generally, the larger the operation, the greater is assumed to be its profile within the Market and visibility with brokers and clients. Portfolio diversification. This is measured by the diversity of a syndicate's gross premiums written by business class. The greater the diversity, the lower is assumed to be the syndicate's potential exposure to specific sector underperformance and volatility. Industry risk. A measure determined by Lloyd's earnings track record and pricing volatility per business class, applied to an individual syndicate's business mix. Lloyd's syndicates segment the premium income of their portfolios into a number of standard classes (for example, accident and health, fire and other damage to property, motor, and reinsurance). Investments and liquidity (model weighting 10%) This assesses the quality of a syndicate's assets, the allocation of its investments, its liquidity in relation to the mix of business underwritten, its investment performance, and its exposure to investment market fluctuations. Key ratios examined within this section include: Insurance debtor ratio (total insurance debts arising out of direct insurance and reinsurance operations/{total adjusted assets + members' balances + estimated funds at Lloyd's {FAL}}). This ratio considers the quality of credit control at the syndicate and can indicate potential liquidity issues. Estimated FAL are included within the denominator of this ratio as they are a potential source of additional liquidity. FAL are deposited by capital providers to back their Lloyd's underwriting. Throughout the 'pi' LSA model, the ratio of FAL deposited by capital providers is consistently set at 50% of syndicate capacity. This proxy is used for the actual amount unless otherwise disclosed in the public domain. Previously, the FAL proxy ratio was 60%. It has been reduced in this model update to reflect the potential within Lloyd's for reduced FAL requirements with the introduction of the Individual Capital Adequacy Standards (ICAS) regime by the U.K. regulator, the Financial Services Authority. Liquidity ratio ({equities + bonds + cash + participation in investment pools + deposits with credit institutions + overseas deposits + FAL proxy}/{net outstanding claims provision + non-life deferred acquisition costs {DAC} + net unearned premium provisions}). This ratio examines a syndicate's liquidity by considering its ability to respond quickly to operational cash calls. Again, estimated FAL are included within the numerator as they are a potential source of additional liquidity. Investment return ({investment income excluding gains/losses + {4% x FAL proxy}}/{average investments + cash + average amount of FAL proxy}). This represents the results of a syndicate's asset management policy. It indicates the level of contribution of regular investment income (that is, dividends and coupon payments) available to overall operating performance. Standard & Poor's excludes from this measure investment gains or losses, recognizing their relative unpredictability, but includes a fixed return on FAL (currently 4%). Investment sensitivity ratio ({equities + bonds + FAL proxy}/{members' balances + FAL proxy}). This ratio measures the sensitivity of capital (members' balances + FAL proxy) to potential changes in the market value of listed investments. Reinsurance (model weighting 15%) This seeks to assess the dependence of a syndicate upon ceded reinsurance--that is, third-party capital over which it has little or no control. Business risk is created if the presence of economically available reinsurance is a prerequisite for the portfolio underwritten by a syndicate to be profitable on a net basis. Credit and liquidity risk is also generated through reinsurer dependency, based upon both the willingness and ability of reinsurers to reimburse ceded losses in a timely manner. Syndicates rarely identify in the public domain their reinsurers by name, nor do they disclose the structure of reinsurance protections. (Previously, syndicates used to consistently disclose the amount of reinsurance purchased from other Lloyd's syndicates.) The following ratios can, however, indicate where reinsurance overdependence may be an issue: Premium retention ratio (net premiums written/gross premiums written). This can indicate a syndicate's dependence on reinsurers and the potential scope of cover purchased by highlighting the amount of premium paid for reinsurance protection from the gross amount received by the syndicate. Loss retention ratio ({net claims paid + net change in provisions for outstanding claims}/{gross claims paid + gross change in provisions for outstanding claims}). If this ratio is consistently materially lower than the premium retention ratio, it indicates a potential excessive reliance upon reinsurer support for the generation of underwriting profits. The continuous provision of this support cannot be taken for granted. Operating performance (model weighting 25%) Operating performance is a reflection of how well a syndicate's underwriting profile is exploited--over the long term, a strong underwriting profile should be reflected in equally strong earnings--and is key to sustaining continued investor interest and participation in a syndicate (and therefore key to the syndicate's sustainability and business continuity). The importance of this head of analysis is indicated by the fact that it receives the highest weighting from Standard & Poor's in the 'pi' LSA model. Key ratios reviewed include: Combined ratio ({net claims incurred + net operating expenses}/net premiums earned). A ratio of less than 100% implies a syndicate is technically profitable. The volatility of this ratio is considered separately. A highly variable combined ratio that regularly exceeds 100% by a wide margin is not considered to be a positive attribute for syndicate business continuity. Standard & Poor's also separately analyzes movement in, and the size of, the component parts of the combined ratio (namely the loss and expense ratios), as well as the influence of large loss events on performance. Reserve movement/net premiums earned. This indicates the impact of reserve adjustments on the reported combined ratio, in addition to highlighting the profitability or otherwise of the current year's underwriting. ROR ({underwriting result + investment income excl. gains or losses + {4% x FAL proxy}}/{net premiums earned + investment income excl. gains or losses + {4% x FAL proxy}}). This ratio factors in the benefit of investment income to the syndicate's bottom line. This benefit would normally be expected to be greater for syndicates focusing on longer tail classes (namely liability) than for those focusing on shorter tail lines (namely property). This reflects a syndicate's ability to generate higher absolute amounts of investment income due to the longer period elapsing between premiums being received by the syndicate and claims being paid. Reserves (model weighting 15%) It is essential to form a view on the adequacy of the level of a syndicate's reserves, both absolutely and relative to the underlying level of the syndicate's underwriting activity. Syndicates are required to disclose material reserve movements in their report and accounts, and over time a track record of reserve adequacy can be established. Key ratios reviewed include: Reserves/risk ({net outstanding claims provision + non-life DAC + net unearned premium provisions}/net premiums written). This ratio indicates the total level of technical resources available to the syndicate to meet prospective claims generated from current underwriting. The net premiums written figure is used in this ratio as a proxy for the level of underwriting risk being assumed by the syndicate. Reserves/capital ({net outstanding claims provision + non-life DAC + net unearned premium provisions}/{members' balances + FAL proxy}). This ratio considers the level of leverage posed by syndicate reserves, and therefore indicates the sensitivity of a syndicate's capital to underreserving. Prior-year underwriting result/reinsurance to close (RITC) brought forward.

This ratio is generated from information contained within three-year fund accounts. These are still produced by some syndicates in parallel with annual accounts, and support the distribution of profits from individual underwriting years of account. It is expected that reliance on this ratio will be phased out over time, along with three-year fund accounts. The accumulated track record of the ratio's movement is still considered within the analysis. The RITC brought forward represents the funding level identified as being required to settle risks outstanding on closed years of account. Not only can consistently negative ratios point toward inadequate reserving levels and processes, they can also suggest that the accuracy ascribed to forecast results for current, pure underwriting years should be questioned. Capital (model weighting 10%) Standard & Poor's recognizes that the U.K. regulator's ICAS methodology mainly drives the level of capital supporting each syndicate. For trading syndicates, the outcome is binary in nature--either sufficient capital is provided or it is not. Therefore, this section of analysis is given less weighting than would ordinarily be the case for FSRs. Two main ratios are considered: Solvency measure ({members' balances + FAL proxy}/net premiums written). This ratio considers the level of leverage posed by syndicate net underwriting, and indicates the sensitivity of a syndicate's capital to underwriting underperformance. Reinsurance recoverable leverage (reinsurers' share of claims outstanding/{members' balances + FAL proxy}). This ratio examines the quality of a syndicate's capital by examining its exposure to reinsurers' ability and willingness to pay claims. Following the hurricane experience of 2005, this is currently a significant issue for many syndicates. Ownership (model weighting 10%) For ownership, analysis focuses on a single area of qualitative assessment--namely, the financial flexibility available to a syndicate through its relationship with its principal capital backer ("owner"). In situations where a syndicate is ultimately backed by an insurance group already benefiting from a Standard & Poor's FSR, the strength of the group/syndicate relationship is considered in light of Standard & Poor's insurance group rating methodology. The Lloyd's operation, represented by the syndicate, is designated core, strategically important, or nonstrategic to the wider group. Analytical adjustment Analysts and LSA committees at all times have the ability to override modeled results where it is felt that the modeled output is not adequately reflective of the information that is available in the public domain. An example may be the incorporation of a prudent underwriting loss loading to reflect the potential impact of a large loss event reported in the public domain but not yet reflected in financials. Interactive LSA Methodology Standard & Poor's interactive LSAs are prepared at the request of the syndicate's management. Key differences from the 'pi' approach include the incorporation within the analysis of dialogue with management and extensive confidential information. Interactive LSAs therefore allow Standard & Poor's to offer a more prospective view on a syndicate's business continuity characteristics. The 'pi' subscript is removed from the interactive LSA. In addition, to recognize the added depth that full interaction brings to the analysis, the LSA scale includes notches (that is, pluses and minuses), which enhance differentiation between the syndicates. Interactive assessments also carry outlooks (positive, stable, or negative) and can be placed on Watch (positive, developing, or negative). The risk categories considered in an interactive assessment are the same as those of the 'pi' assessment. The criteria that are applied are drawn largely from Standard & Poor's criteria for rating property/casualty insurance companies*. The following gives some examples of how the 'pi' assessment is built upon and transformed into an interactive assessment. Underwriting profile When a syndicate is analyzed on an interactive basis, the underwriting profile section is in effect replaced with an analysis of competitive position that is comparable with that undertaken on insurance companies as part of FSR analysis. Key points considered include: Product diversification, Geographic diversification, Market advantages and market share, Barriers to market entry, The nature and cost of distribution, The potential threat of new entrants into the market, The threat of substitute products or services, The sector's competitiveness and volatility, and The bargaining power of insurance buyers and suppliers. Reinsurance The historical performance of the reinsurance program as reflected in financials is supplemented by, for example, an investigation of the syndicate's current reinsurance protection strategy in relation to gross exposures assumed, disclosure of the identity of the syndicate's reinsurers, and discussion on the credit control of reinsurer debt. Reserves Syndicate reserving practices and resources are considered in detail, as is the performance of reserves on a class-by-class and aggregate basis. Ownership The greater level of information disclosure through the interactive process allows Standard & Poor's to consider more fully the syndicate's relationships with its principal capital providers, the overall operational performance that capital providers expect, and the extent to which the syndicate's continued participation at Lloyd's is likely. Financial flexibility--that is, the ability of the syndicate to raise finance from its "parent" either to fund expansion or underwriting losses as required--is a subset of this analysis. Outlook A Standard & Poor's LSA outlook assesses the potential direction of an assessment over the intermediate term (typically up to two years). In determining an outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An outlook is not necessarily a precursor of an assessment change or future CreditWatch action. A positive outlook means that an assessment may be raised. A negative outlook means that an assessment may be lowered. A stable outlook means that an assessment is not likely to change. Watch A Watch listing focuses on identifiable events and short-term trends (within 90 days) that cause assessments to be placed under special surveillance by Standard & Poor's analytical staff. These may include mergers, recapitalizations, regulatory action, or anticipated operating developments. Assessments appear on Watch when such an event or a deviation from an expected trend occurs and additional information is necessary to evaluate the current assessment. A Watch listing does not mean, however, that an assessment change is inevitable. Furthermore, assessment changes may occur without the assessments having first appeared on Watch. A positive Watch listing means that an assessment may be raised. A negative Watch listing means an assessment may be lowered. A developing Watch listing means that an assessment may be raised, lowered, or affirmed. Note *"Insurance Ratings Criteria: Property/Casualty Edition" is in PDF format and can be found on RatingsDirect. Click on "Criteria" and scroll down to "Insurance." Related Criteria And Research Insurance Criteria: Lloyd's Syndicate Assessments, June 30, 2005 Insurance Criteria: Lloyd's Syndicate Assessments (Update), Dec. 15, 2005