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Rating Lloyd's Syndicates

A.M. Best's rating criteria for Lloyd's syndicates address factors specific to individual syndicates and not already covered by A.M. Best's well-established insurance rating methodology. Syndicate ratings are assigned through the application of A.M. Best's interactive rating process. They should be regarded as a complementary analytical service to A.M. Best's rating on the overall Lloyd's market and should be considered only in this context.

Financial strength ratings provide A.M. Best's view as to the ability of a rated organisation to meet policyholder obligations. The market rating is the "floor" of security for all policies written at Lloyd's. The existence of the market rating reflects the "chain of security" and, in particular, the role of the Central Fund, which partially mutualises capital at a market level. This ensures that each syndicate is backed by capital consistent with a financial strength rating of at least that of the Lloyd's market. A policyholder exposed to a syndicate with a financial strength profile weaker than the market would still have market-level security, given the Central Fund's role as a guarantee fund. However, A.M. Best believes that the specific characteristics of some syndicates could be consistent with a financial strength rating at or above the level of the market rating and that this is a valuable perspective for policyholders, brokers and others with a vital interest in security at Lloyd's.

The relationship between the Lloyd's market rating and the syndicate ratings is demonstrated by the fact that an amendment to the market rating would automatically trigger a review of all syndicate ratings, as these cannot be viewed in isolation from the market as a whole. However, this would not necessarily mean that any given rating would change. That would depend on the basis for the change in the Lloyd's rating and the syndicate-specific characteristics that support the syndicate's rating.

A specialised analytical team assesses each syndicate according to A.M. Best's traditional key ratings factors – capital strength, operating performance and business profile – after which A.M. Best is in a position to assign a rating. An "s" modifier, e.g. A+ s, differentiates ratings on individual syndicates from the overall market's rating.

Key Rating Factors

Capital Strength

A.M. Best evaluates a syndicate's financial strength and flexibility by looking at leverage, capital structure, reinsurance, asset quality, reserves and liquidity. However, most of the standard measures of balance sheet strength can only be analysed at the whole market level, the syndicate's balance sheet information being of limited use for measuring capital strength. This is because the capital backing a syndicate is held at the member level, in the form of funds at Lloyd's (FAL), and is fungible across all of a member's syndicate participations. There is therefore no capital shown in the syndicate's balance sheet; moreover, syndicates do not retain profits and there is no policyholders' surplus. Consequently, Best's Capital Adequacy Ratio (BCAR model) cannot be used. Capital adequacy is addressed largely through assessment of the

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application at Lloyd's of the Individual Capital Adequacy Standards (ICAS) methodology, required by the U.K. regulator, the Financial Services Authority (FSA). This forms a key part of A.M. Best's analysis for the Lloyd's rating. Lloyd's as a whole and individual syndicates are required to produce an Individual Capital Assessment (ICA). Additionally, A.M. Best uses some syndicate-specific indicators and ratios, insofar as they affect operating resilience.

a) Leverage: Standard indicators of operating, financial and asset leverage are considered at the Lloyd's market level. In addition, A.M. Best assesses characteristics pertaining to the syndicate itself, including the extent of reliance on reinsurance and associated credit exposure; the size of technical reserves – particularly the reinsurance to close ("RITC") – relative to capacity and premiums; and the degree of asset risk attaching to the syndicate's premiums trust fund investments. The following are the main ratios employed in A.M. Best's assessment of leverage at the syndicate level:

- Gross Premiums Written/Capacity
- Net Premiums Written/Capacity
- Net Premiums Written/Gross Premiums Written
- RITC Brought Forward/Capacity
- RITC Brought Forward/Net Premiums Written
- Gross RITC/Net RITC

b) Capital Structure: A syndicate's capital structure influences financial strength when the syndicate is backed largely or entirely by "integrated" capital through an integrated Lloyd's vehicle ("ILV") – i.e. where the same group owns the managing agency and the capital backing the syndicate. ILVs can provide their syndicates with financial flexibility, including capital infusions and, in some cases, additional sources of cash flow from other operations. A.M. Best therefore reviews the ILV's capital structure to determine whether the finances are sound and unencumbered. For example, the existence of debt and other financial instruments could reduce the quality of an ILV's capital structure and might place

a drag on its ability to provide future capital to a syndicate. In addition, A.M. Best reviews any non-insurance operations of the holding company for their potential impact on the financial condition of insurance operations.

c) Reinsurance: A.M. Best analyses the quality and appropriateness of a syndicate's reinsurance programme insofar as it affects prospective operating performance and how that, in turn, could affect the ability to retain and attract capital. Each syndicate's gross and net Realistic Disaster Scenarios are also reviewed, partly to assess the efficacy of reinsurance

A.M. Best Company Methodology

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purchased. The ICA requirement applied to syndicates will reflect to some extent Lloyd's view as to the quality of reinsurance, because review of syndicate ICAs is delegated to Lloyd's by the FSA. Beyond this, consideration of a syndicate's reinsurance programme in the context of current capital strength may have shortcomings, since the capital backing the syndicate (FAL) is held at the member level.

d) Reserves: This element in A.M. Best's assessment of individual syndicates is considered largely in relation to prospective operating performance rather than capital strength. Again, this reflects the fungibility of capital held at the member level.

e) Asset Quality: A.M. Best's analysis of asset quality is derived mainly from the overall market rating, taking into account all the assets held as FAL. Assets held in the premiums trust funds are held at syndicate level and are analysed to determine how they affect a syndicate's liquidity.

f) Liquidity: The limitations inherent in syndicates' balance sheets mean that the standard indicators of liquidity are not strictly applicable. Therefore, A.M. Best focuses on a syndicate's operating cash flows and any other contingent funding facilities in place to cover deficits.

Operating Performance

In addition to the impact of reinsurance and reserve quality mentioned above, A.M. Best measures the operating performance of a syndicate by evaluating the following three areas: profitability, revenue and quality of management.

a) Profitability: With the introduction of annual accounting, A.M. Best largely analyses syndicates' profitability using similar ratios against gross and net premiums written to those used with an insurance company, as follows:

- Gross Loss Ratio
- Net Loss Ratio
- Expense Ratio
- Combined Ratio

- Net Investment Income/NPW
- Result after Personal Expenses/NPW
- Pure Year Underwriting Result/NPW

A.M. Best also analyses syndicates' profitability by measuring traditional indicators against capacity.

b) Revenue Composition: A.M. Best applies its standard analysis of revenues.

c) Management Experience and Objectives: As with any company, management is a critical factor in a syndicate's long-term financial strength. A.M. Best considers the management team's experience and background, together with the key managerial and operational procedures employed. In particular, A.M. Best considers the management team's approach to risk management and control, as A.M. Best believes that enterprise risk management – establishing a risk-aware culture and using sophisticated tools to identify and measure risk and risk correlations – is an increasingly important component of that framework.

Business Profile

The business profile of a Lloyd's syndicate represents the amalgamation of all core activities in which a syndicate is engaged. In the context of Lloyd's, it is evident that all syndicates depend on, and are part of, the business profile of Lloyd's as a whole. Therefore, any weakening of Lloyd's business position will act as a drag on an individual syndicate's rating. However, the particular characteristics that distinguish one syndicate from another and from the insurance industry as a whole can offset this to some extent. These characteristics are the main drivers of A.M. Best's analysis of the business profile of Lloyd's syndicates.

Potential Scenarios for Syndicates Rated Above Market Level

At the end of the interactive process and the assessment of the above key rating factors, A.M. Best believes two scenarios could emerge under which an individual syndicate could be assigned a rating above that of the market:

I.) The syndicate is backed by a capital provider that, in A.M. Best's opinion, offers a higher level of financial strength than the market and is fully committed to supporting the syndicate beyond the member's limited liability obligations and before recourse to Lloyd's Central Fund. A.M. Best undertakes a detailed analysis of the capital provider's commitment. A.M. Best would also have to be satisfied that the capital provider would not cease underwriting at Lloyd's under adverse circumstances not related to its own syndicate's performance, such as an additional Central Fund levy. Eligibility for a rating enhancement due to capital backing also may be affected if the corporate member participates in other syndicates, since capital held at member level is fungible across all syndicates in which the member participates.

II.) The business profile and/or operating performance of a syndicate are in line with the characteristics of insurers with higher ratings. As with an insurance company, these two factors are key, leading indicators of a syndicate's ability to retain and attract capital and thereby support long-term financial strength.

The two scenarios are not mutually exclusive. An individual syndicate may achieve a rating above the level of the market through one or both scenarios.

A.M. Best's rating methodology for Lloyd's syndicates, as for all other ratings, is based on a combination of quantitative and qualitative standards, and the fundamental areas of analysis are the same as those employed for a traditional Best's Rating. Direct quantitative comparisons with traditional insurance companies' financials are not strictly possible because of Lloyd's unique capital structure. Therefore, results from a syndicate's quantitative analysis are compared with other syndicates and insurance companies of a comparable size and business mix, to the extent possible.

In A.M. Best's quantitative analysis, for the latest open years of account, A.M. Best will use data from the syndicate quarterly monitoring returns (QMR) when voluntarily provided by the syndicates. These reports, although technically unaudited, are Lloyd's regulatory returns. When using these data, A.M. Best also takes into account the syndicate's track record in producing reliable QMR data.



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