

An introduction to corporate participation at Lloyd's

New edition

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Introduction

Lloyd's of London is perhaps the most famous insurance brand in the world. Yet for those not actively involved in the market, its structure and methods of doing business have until recent years largely remained a mystery. After three centuries of operation (with its capital being provided by individuals with unlimited liability, and its governance being not unlike a private club), it has been undergoing a radical re-organisation, which began in 1993.

More than 90% of the market's total capacity is now being provided by corporate investors (so called '*corporate capital*'). Investment has come predominantly from insurance and reinsurance companies, and institutional and other investors, based principally in Bermuda, the United States and the United Kingdom.

The purpose of this guidance note is to explain why Lloyd's may be attractive to both passive and strategic investors, provide a brief introduction to Lloyd's and describe some of the methods of corporate participation at Lloyd's.

We have extensive experience of all the matters set out in this guidance note. In particular, we have been advising the members' agents – as a group – on the introduction of LLPs to Lloyd's.

What does Lloyd's offer?

- Access to some of the best underwriting talent in the world.
- Access to international reinsurance business which comes to Lloyd's as the pre-eminent market for such business.
- Access to the Lloyd's brand name and the ability to offer policies with Lloyd's.
- The benefit of Lloyd's A+ (strong) (Standard & Poor's), A (excellent) (A.M.Best) and A+ (strong) (Fitch Ratings) security ratings.
- Access to Lloyd's licences enabling business to be written in over 60 domestic insurance, and a further eight reinsurance, markets across the world.
- A regulatory process which can approve a new entrant to the Lloyd's market quickly.
- Access to Lloyd's reputation for the consistent payment of valid claims, despite the scale of losses in the past.
- Low cost of entry.

How to invest or participate in Lloyd's

Passive investment

- Invest in one of the Lloyd's groups whose shares are listed with the London Stock Exchange.
- Join Lloyd's as a corporate member of Lloyd's and participate with the help of a Lloyd's members' agent on a spread portfolio of syndicates, to achieve a balanced portfolio spread over the Lloyd's market.
- Alternatively, concentrate on a few syndicates - or even just one - managed by one or a small number of managing agents or writing a particular class of business.

Strategic investment

- Passive investment may also be strategic. Insurance or reinsurance companies in other countries may participate on syndicates at Lloyd's to improve their overall mix of business or to obtain exposure to specialised classes of business which they do not have the expertise to write – or which is not normally shown to the investor.
- Establish a new managing agency, and syndicate, in conjunction with a Lloyd's underwriter with an established reputation. Lloyd's is an entrepreneurial environment and such people or teams are there to be found.
- Establish a new syndicate with an existing managing agent, who will run it for you and will help to recruit the underwriter to underwrite the business for you.

- A new syndicate could write business similar to that already being written in the Lloyd's market, though it would need to demonstrate that it will be bringing new business to Lloyd's and is not relying on taking business away from other syndicates. Alternatively it might be set up to underwrite business which is very specialised to the investor, and allowing it to access more readily other sources of business through the Lloyd's market. The syndicate would need the specific approval of Lloyd's (and there might well be serious policy considerations for certain classes of business).

Such an arrangement might, for instance, be ideal for carrying on the following types of activity:

- Underwriting business in a foreign jurisdiction, where the investor might not otherwise be able to underwrite the business concerned.
- Underwriting where the ability to obtain reinsurance protection in the market is fundamental to the underwriting.
- The underwriting of risks normally sold by a bank or building society, as an ancillary, and even branded, part of their service. It might be possible for the bank or building society to establish a syndicate to underwrite the insurance either taking the whole risk itself or sharing it with others. Similarly a retailer could participate in insurance sold by it, for instance in relation to extended warranties.

Background to the Lloyd's market

From its origins more than 300 years ago, the Lloyd's market has now changed beyond all recognition. One of the most significant changes was the decision in 1993 to allow companies to participate directly as members of Lloyd's for the first time, beginning with the 1994 year of account. In the 2007 year of account corporate capital contributed almost £15 billion of capacity.

In 2003 the Franchise Board replaced the Lloyd's Regulatory Board and the Lloyd's Market Board. Under the franchise framework Lloyd's is the franchisor and the managing agents are the franchisees. Each of the Lloyd's businesses are independent but operate within the franchise framework.

The Franchise Board is responsible for the general management of the franchise but day-to-day operations are delegated to the Executive Team. The commercial and supervisory framework is set by the Franchise Board and then applied to the individual franchisees. Through a set of principles, the Principles of Relationship, the franchisor and franchisees owe duties and obligations to each other which sets the framework within which the franchise operates.

Underwriting at Lloyd's

The structure and administration of Lloyd's is unique. Regulation stemmed in recent years from the Lloyd's Act 1982, which established the Council of Lloyd's as the governing body. The Council appoints and oversees the performance of the Franchise Board. The Council and other professionals operating in the market are now subject to external regulation by the Financial Services Authority, a body established by the government.

At an underwriting level, business is accepted through syndicates (87 in 2009), which generally comprise a group of members, either corporate or individual or a mixture of both, each of which is managed by a managing agent. Some syndicates have only one corporate member.

Individual members

Prior to the advent of corporate capital, only individuals were permitted to be members of Lloyd's (so-called '*Names*'). Although Names underwrite by participating on syndicates together (alongside other limited or unlimited liability members of Lloyd's), they are only responsible for their own share of any losses that arise. However, Lloyd's no longer admits new Names. Traditionally, the amount of capital provided to support the underwriting capacity of Names has been lower than that for corporate members. However, these ratios have now been aligned.

Limited Liability Partnerships

Lloyd's allowed limited liability partnerships (LLPs) to participate as corporate members at Lloyd's with effect from the 2007 underwriting year. LLPs are bodies corporate, and so separate legal entities conferring limited liability upon their members, which have the structure – and tax transparency – of partnerships.

Structure of a Lloyd's syndicate

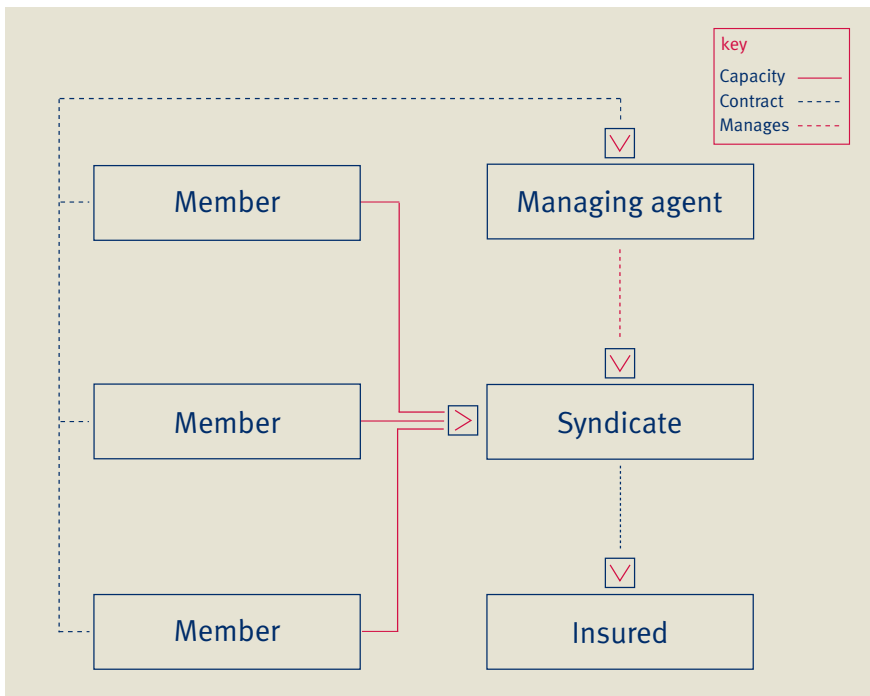
The salient features of a Lloyd's syndicate are as follows:

- On a yearly basis, a member (corporate or otherwise) agrees to provide an amount of underwriting capacity to the syndicate which, when aggregated with the capacity of all the other members on the syndicate, forms the syndicate's capacity for that year. Usually members spread their total underwriting capacity over various syndicates. That capacity must be supported by the deposit of funds at Lloyd's (FAL). The amount of FAL dictates the member's underwriting capacity. Members also contribute to the New Central Fund, which is available, at the discretion of the Council of Lloyd's, to meet policyholders' claims.
- Members are generally advised on their syndicate participation by a members' agent (who also manages their overall participation at Lloyd's). Members' agents also advise corporate members who do not have an in-house capability.
- Until 1995 syndicate participations were allocated without payment. In 1995 a system of syndicate participation auctions was initiated, partly to allow members on syndicates to receive value for their participations, and partly to make access to syndicates easier and more transparent.
- Each syndicate is managed by a managing agent which employs the underwriter and his team. In turn, the underwriter and his team deal with the daily running of the syndicate – the acceptance of risks, placing of reinsurance and payment of claims.
- A syndicate's year of account runs for a calendar year with risks being underwritten for inception during that year on behalf of members who have agreed to participate on the syndicate for the year in question. Usually, a syndicate closes the account for each year's underwriting as at 31 December of its third year by reinsurance, as referred to below, following which any profit or loss is declared.

- A syndicate reforms on a yearly basis. In return for a premium, the members for a particular year of account will generally reinsure the outstanding liabilities of the syndicate members of the immediately preceding year of account as at the end of the third year of the year of account in question. This is known as the reinsurance to close (RITC). In practice the majority of the closing year members are also members of the reinsuring year. However, while underwriting year accounts remain open for at least three years, from 1 January 2005 managing agents also prepare syndicate annual accounts which comply with the UK Companies Act 1985.

In its simplest form the structure can be illustrated as follows:

diagram 1 – syndicate



Corporate structures

These fall into three basic categories, spread, dedicated and integrated vehicles.

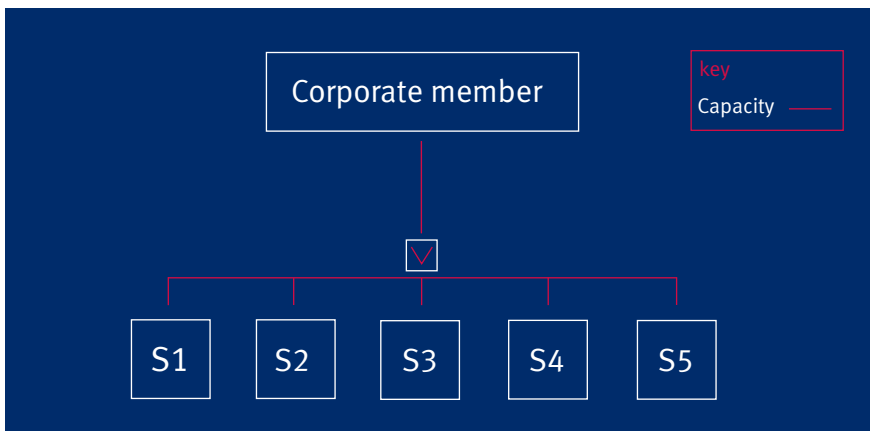
Spread vehicle

This was the first form of corporate capital admitted in 1994. The normal structure is a corporate member (or a number of corporate members with a common holding company, which itself may be listed on an investment exchange) which participates on a broad range of syndicates managed by different managing agents.

Advantages

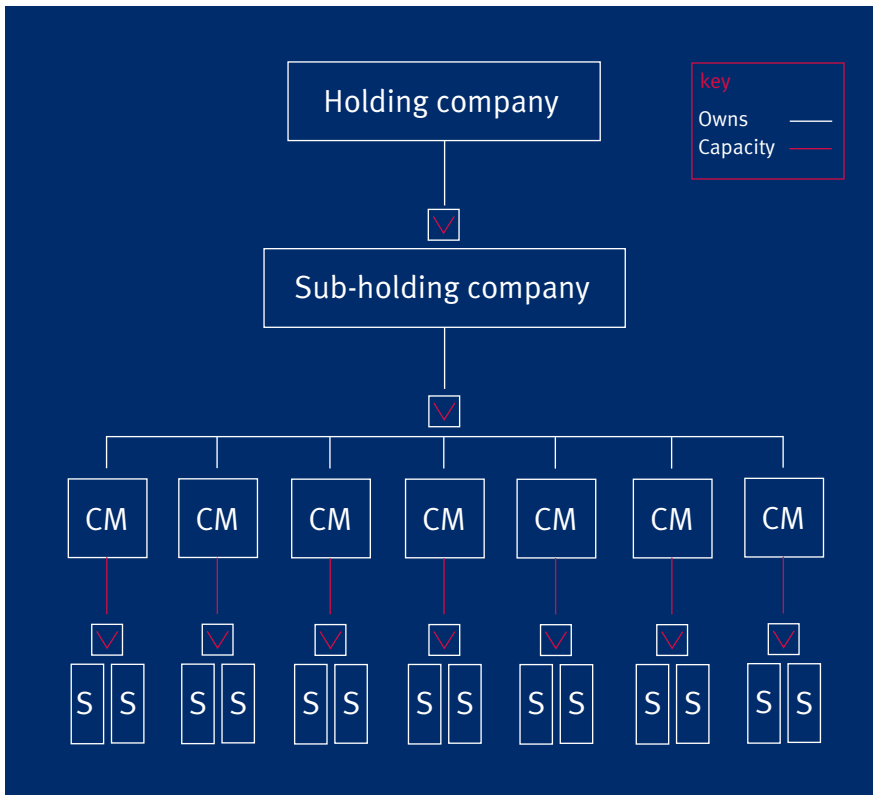
- The corporate member's risk is spread and diversified, in much the same manner as a traditional individual Name.

diagram 2a – spread vehicle (private)



- A structure (involving five or more corporate member subsidiaries writing on a spread basis) was originally devised to allow vehicles to qualify as investment trusts or investment companies under the rules of the London Stock Exchange, and to obtain an immediate listing, without the usual requirement for a three year track record. However, this track record is not required for a listing on the London Stock Exchange's subsidiary exchange, the Alternative Investment Market (AIM).

diagram 2b – spread vehicle (listed on the London Stock Exchange)



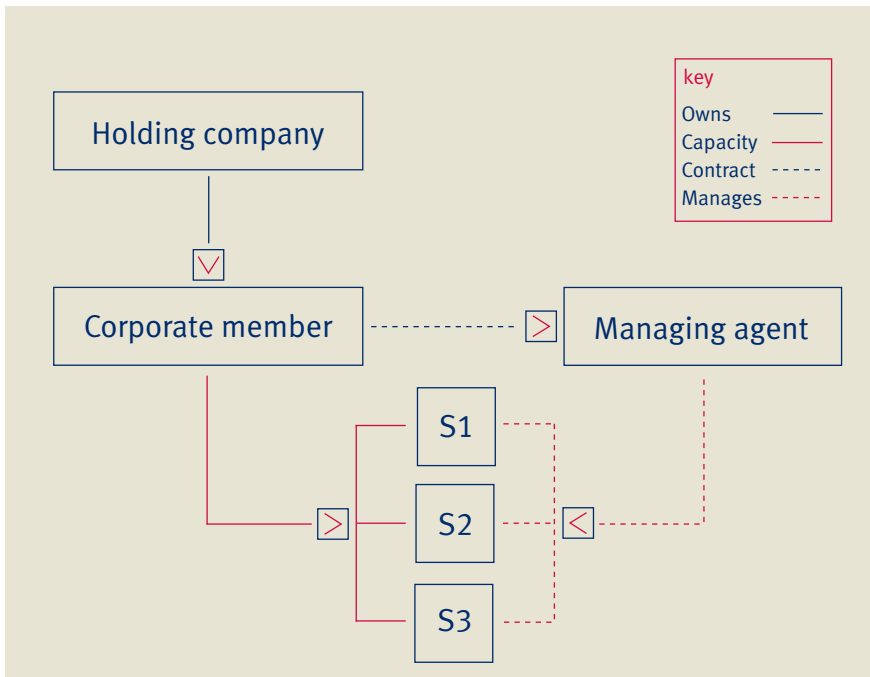
Disadvantages

- The nature of the investment is passive, with the member (and its shareholders) having no control or influence over the managing agent or the business written.

Dedicated vehicle

Typically, this involves establishing a single corporate member which participates on one or more syndicates managed by a single managing agent (or managing agent group).

diagram 3 – dedicated vehicle



Advantages

- It allows a corporate investor to back the skills of a particular underwriter or managing agent and to participate in a class or particular classes of business.

Disadvantages

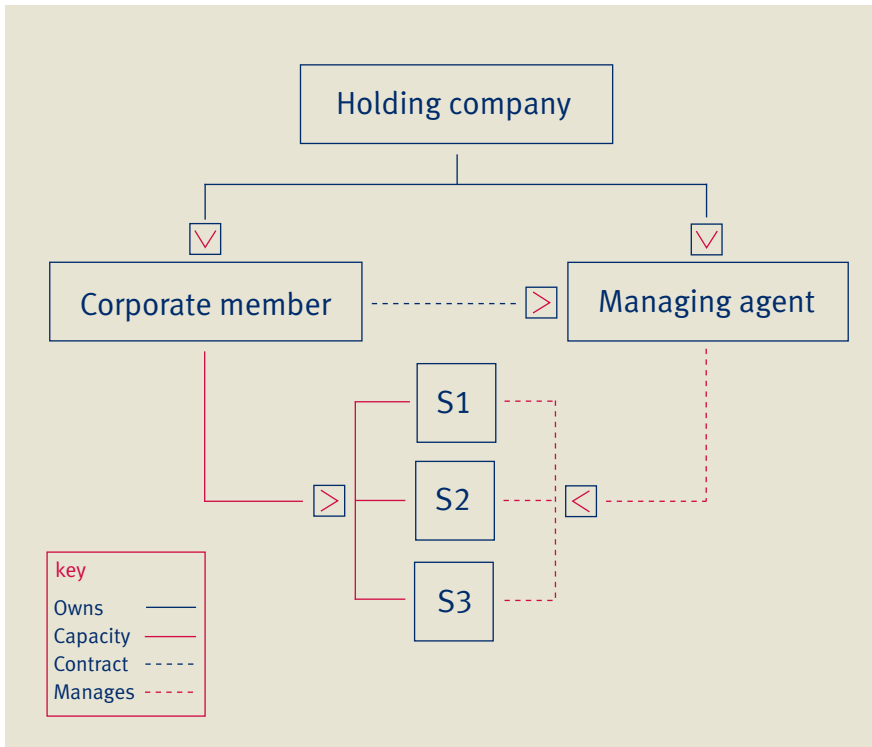
- The underwriting is concentrated on either one syndicate or a group of syndicates managed by one managing agent. Hence, there is less diversity of risk. Further, the member will not have direct control of the business, as this is the responsibility of the managing agent.

Integrated vehicle

This term is used to describe a group which comprises both a managing agent and also a corporate member underwriting on one or more of the syndicates managed by the managing agent. Lloyd's regulations prevent the functions of these two companies being combined into one company. Like an insurance company, this group combines both underwriting and capital but because other members participate on the syndicate they must continue to operate in the usual way, being subject to RITC and other regulations imposed by Lloyd's.

Generally, as part of the franchise process at Lloyd's, consents will be needed to establish managing agents and corporate members, the nature and range of which will depend on the chosen structure. In certain cases, particularly where an insurance carrier is involved, Lloyd's will take an interest in parties which it regards as having a controlling interest in the activities of the new corporate member or group. FSA authorisation is also necessary for the managing agent.

diagram 4 – integrated vehicle



Lloyd's charges

Lloyd's reviews its charges each year. It has introduced 'user pays' charges, whereby services actually used are paid for by the member. In many instances, the charges for these services were previously incorporated in higher centralised charges.

Application fees (for 2009)

- New corporate member £25,000 (VAT not currently chargeable).
- New managing agency £100,000 (VAT not currently chargeable).
- New syndicate £50,000 (VAT not currently chargeable).

Annual fees (in 2009)

- Members' subscriptions – 0.5% of written premiums. This is to be collected in two instalments, in January and in June, to be adjusted in April 2011 to reflect the actual written premiums.
- Central Fund contribution – 0.5% of written premiums. New corporate members pay 2% for each of the first three years of operation.
- Syndicate loans to the New Central Fund– Lloyd's has no intention to collect any loans for 2009.
- Callable Central Fund (predecessor to the New Central Fund) contribution – up to 3% of a member's syndicate premium limit in respect of each syndicate.

A managing agency will also be subject to Franchise Performance Risk Management Charges as part of a 'user pays' system. These are currently:

- a flat fee of £11,350 per syndicate managed
- a flat fee dependent on the managing agent's written premium (as determined by pre-set bands), ranging from £15,950 for written premium of up to £50m and £335,250 for written premium in excess of £500m
- a percentage levy (ranging from 0.1607% down to 0.0203%) on amounts of written premium in excess of the minimum amount of written premium in the relevant band.

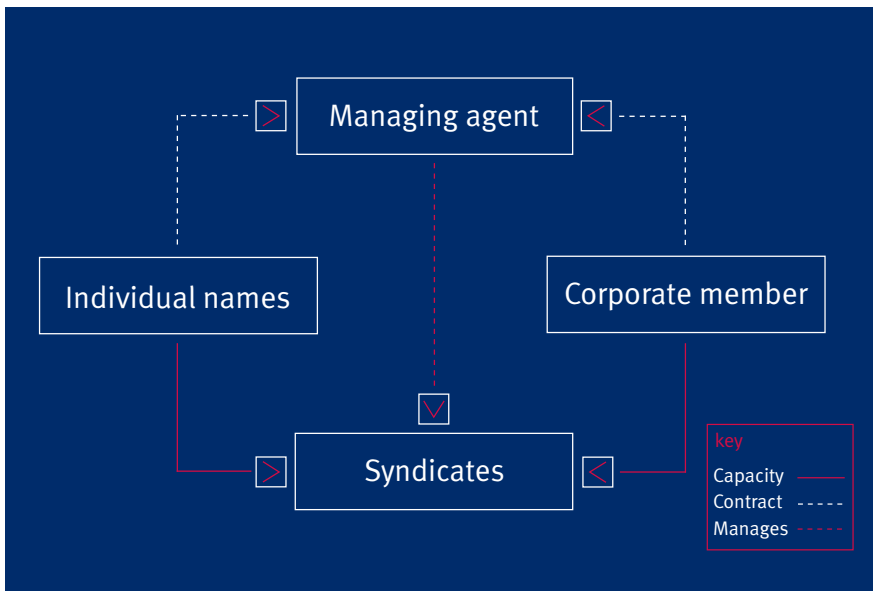
Types of syndicate

There are three different types of syndicate on which a corporate member can participate:

Mixed syndicates

The members of the syndicate are both corporate and individual members. Generally, spread vehicles write on these syndicates alongside individual Names. Most managing agents have co-ordinated the establishment of dedicated vehicles to underwrite on the managing agents' syndicate or syndicates, normally participating alongside other syndicate members.

diagram 5 – mixed syndicate

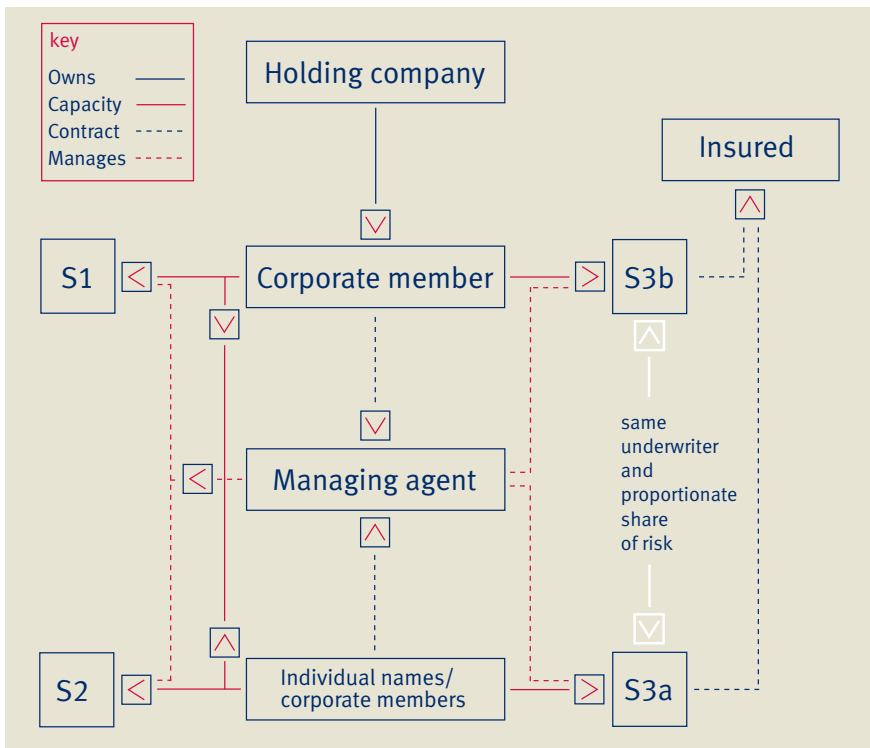


Parallel syndicates

This is where a corporate member participates as the sole member on a syndicate specifically set up to operate alongside one or several existing mixed syndicates participating in all the same risks on a proportionate basis. For most purposes it is treated as if it were part of the main syndicate, eg in placing reinsurance protection and writing RITC of the previous year's syndicate.

In the diagram below the corporate member participates alone on a syndicate which operates in parallel to the syndicates on which the individual members participate.

diagram 6 – parallel syndicate



Stand-alone corporate syndicates

This is a syndicate which has a single corporate member and which does not write in parallel with any existing syndicate. In essence, this syndicate underwrites solely for its own account and does not track an existing Lloyd's syndicate. A stand-alone syndicate is supported by only one underwriting member which interfaces with only one source of capital rather than a collection of underwriting members with varying amounts of capital. Generally Lloyd's will not allow a stand-alone syndicate to be established unless it can demonstrate that it is bringing new business to the market. It will require its own underwriter, unlike a parallel syndicate, which takes a proportion of the risks underwritten on the main syndicate.

diagram 7a – stand-alone syndicate (basic structure)

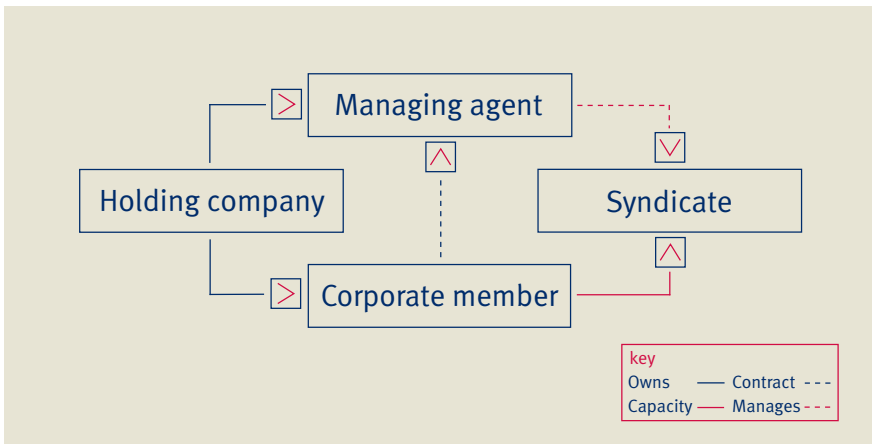
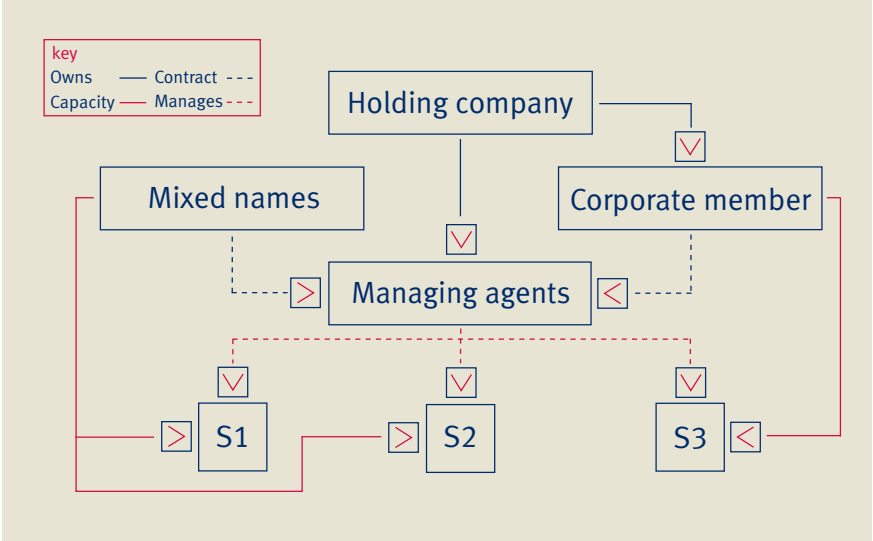


diagram 7b – stand-alone syndicate (developed structure)



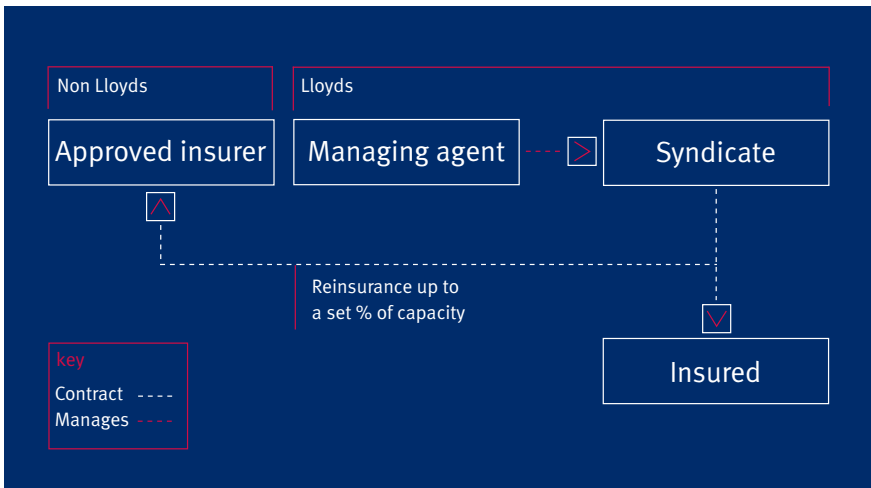
Participation without establishing a corporate member

There are various ways in which Lloyd's allows participation from outside the market. These arrangements are also, in part, regulated by Lloyd's.

Syndicate qualifying quota share reinsurance

A qualifying quota share reinsurance of a syndicate by a reinsurer approved by Lloyd's qualifies, within certain parameters, as a reduction from the syndicate's written premium. This effectively allows the syndicate to increase the business which it underwrites without having to find additional capacity from members.

diagram 8 – syndicate qualifying quota share reinsurance



To qualify, the reinsurance must, amongst other things:

- be with a reinsurer approved by Lloyd's
- not exceed a specified percentage of syndicate capacity (Lloyd's may be willing to increase this on a case by case basis)

Consortium arrangements

Consortia between syndicates and insurance companies have been a common feature for some years. In an arrangement of this kind, a Lloyd's managing agent may act as underwriting agent for one or more Lloyd's syndicates as well as one or more insurance companies. However, the underwriting agent need not be the managing agent but, as is often the case, can be owned by the consortium members in their proportionate shares. Participation in such arrangements is by reference to a fixed percentage of each risk.

Since participating insurance companies are effectively writing direct business, they will need to be authorised in the jurisdiction where business is being written (and in some jurisdictions sold) and, in this instance, cannot rely on the Lloyd's licences, in contrast to quota share arrangements.

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