

## Introduction

Good morning ladies and gentleman, and thank you Mr. Chairman for that kind introduction.

This morning I'm here to share some thoughts about our industry – the insurance.

It is the job of insurance to reduce or remove risk. And that's something today's businesses need. In a world where new risks seem to be created or plucked out of thin air every day, businesses must be able to reduce their risks – otherwise in a society post-September 11, post-anthrax, post Enron, post-Worldcom, post-Anderson, no one will every want to invest or take a risk again.

And that's the challenge before the insurance industry today.

How do we respond to a situation where our customers want us, but one in which all our thinking and planning was turned on its head? How do we respond to a world that looks the same, in which people continue to go about their daily business, their *ordinary lives* as we insist on calling them, but a world which feels tangibly different...a world in which a new mood now prevails.

The world is different – we now need to behave differently. How differently? Well to try to give you some of the answers, I want to cover three main points this morning.

I want to take a critical look at some of the trends and pressures affecting the US and world markets over a year on from 9/11. You'll be familiar with many of these individually, but it's when we look at them collectively – when we see the pattern they form – that it becomes clear we're now operating in uncharted – and perhaps dangerous – waters. All of this, I believe, has a great deal of impact on our current thinking about the so-called 'insurance cycle'.

Next, I want to put forward the response which I believe we need to make as an industry to this new insurance environment.

Finally, I want to share with you how Lloyd's of London is taking control of its own destiny and will no longer allow external forces such as the insurance cycle to drive it in a direction it no longer wishes to travel.

So let's begin by looking at the state of the insurance industry and the economy post 9/11 and think about what all of this means for the insurance cycle.

Where do we start? Well, let's start with the bad news.

It's a sad fact, but by whatever measure you wish to use, collectively as managers of shareholders' capital, we have done a pretty poor job - the insurance industry has performed abysmally.

Did you know that since 1980, the US P&C industry has collectively lost \$439 billion in its underwriting? Did you know that our industry has managed to under-perform consistently in relation to other industries?

The only positive spin I can put on this is that clearly we must be tremendously good salespeople, because people keep giving us money. As the graph shows, over the last 10 years we have consistently failed to meet our cost of capital requirements. Our industry's cost of capital is 12% – in other words, we need to achieve a 12% return on investment in order to retain and attract capital. And we're not doing that – not by a long way.

Since 1991, the US industry's rate of return has fallen well short, averaging just 5.3%.. Even before 9/11, the US market was under-performing. And with a return of just over 3% for the first half of 2002, it isn't even in the ball-park. Yet, perversely, investors are still putting capital into the insurance industry. Just take a look at what's happened since 9/11. Experts tells us that over \$40 billion of new capital has come into our industry. Yet still we keep getting it wrong.

The symptoms of our bad financial management are clear for all to see.

*Falling reserves are one sign.*

After what I've just told you, it shouldn't come as a great surprise that the insurance industry's surpluses are being depleted – but the scale of that depletion gives rise for real concern. The surplus for the worldwide P&C industry fell by \$90 billion in 2001 – and is expected to do the same in 2002. That means a drop of over a quarter in the industry's global capacity. That's a huge drop in such a short time.

In the US market alone, reserves have fallen by \$36 billion already in 2002.

*The action of the major financial rating agencies also shows trouble brewing.*

The role of rating agencies has grown in importance over the last decade. That means that the impact of action they have taken over recent months is more significant than ever.

This year, for the second consecutive year, the number of securely rated companies – that's B+ and higher – decreased. Also for the second consecutive year, AM Best issued more downgrades than upgrades.

In addition, we have all witnessed the rating agency actions against a number of major reinsurers in the last month.

Now, all of this is pretty grim I'm sure you'll agree. Yet the very strange thing is, that immediately post 9/11, over \$40 billion of new capacity in the global insurance industry was created. How? By people and businesses being prepared to invest in us. Now why, you might ask, would those businesses want to invest in an industry whose performance has been so unremittingly dire – and is arguably still in intensive care?

The answer can be found on a graph that's on the desk of almost every senior executive in our industry. That graph illustrates the rise and fall of premium prices – what you and I know as the insurance cycle. And right now, the line on that graph is heading upwards – steeply upwards. The insurance cycle appears to have turned. The combined effects of the trough of the late 90s and the huge losses associated with 9/11 have kicked –started premium pricing into overdrive.

So when we look at that graph – on our desks and our office walls – many of us see that rising line as our salvation. The cycle, we say, has turned. We can look forward to maybe two, three, perhaps even four years of profitable underwriting conditions.

Or can we?

My view: no we can't. Because if we think like this – if we continue to look at our industry in terms of hard markets followed by soft markets – we are sowing the seeds of our own downfall. We need to change our mindset.

What I'm trying to explain to you, is that I believe that are a number of factors at play now that either we have never seen before, or we have never seen this combination of factors before. Let me give you some examples.

*Firstly, the investment environment*

In recent years, the insurance industry's exposure to the stock markets has grown enormously. In the four years up to 2000, US insurers' equity investment grew from 7.9 to 9.5% of their assets. The exposure is even higher amongst continental European insurers.

Now 9.5% of total assets doesn't sound like a huge amount. But when you're talking about a stock market trapped in a downward spiral fuelled by anxiety and a series of major corporate scandals, it becomes a very real problem. In fact, insurers have had to realise nearly \$1 billion in capital losses during the first quarter of this year. Stocks and bond yields sank even further during the second and third quarters.

*The next new factor to consider: look at what is happening to claims costs.*

My point is that the costs of claims in all these areas is spiralling exponentially and often retrospectively. Let me give you some figures.

The cost of the US tort system, currently estimated at \$198 billion per annum, is set to rise to \$298 billion by 2005. That's a staggering 51% increase over three years.

How many of you are aware that, in medical malpractice, the average award almost trebled to \$3.5 million between 1994 and 2000?

For product liability, the growth was even greater – from under \$2 million to almost \$7 million over the same period.

Look also at cats. The cost of catastrophes has been demonstrating a worryingly similar trend. The graph says it far better than I can.

*Next, the increasing speed with which investment markets react to opportunities.*

We've all witnessed the number of new start-ups post 9/11. Most of us have been pretty surprised by the speed at which they were up and running. Ten years ago, who would have believed you if you predicted that approximately 50% of new capital entering our industry post 9/11 would be up and running in just over two months? That's an amazing change for us to be dealing with.

*Another significant factor – a distribution system like we've never seen before.*

The last seven years have seen major structural changes in the distribution system, plus changes to the transparency of the system. Global networks underpinned by advances in information technology have stripped away the mystique of the value chain. Now, unless you add value, you're no longer a player.

*Customer sophistication has increased markedly.*

Customers are no longer 'the dumb jocks', the Jane Does, the Three Stooges. They are highly sophisticated beings who've spent their entire lives in the most consumer-driven society our planet has ever seen. In our industry, our customers are using the very latest risk modelling techniques to assess whether traditional insurance is the most cost-effective means of risk transfer for them. That's something we need to be very aware of.

So, let's pause for a breather and recap. What I've tried to show you is that we are working in an industry that is still in the financial intensive care ward. The world we're operating in has changed. There are factors involved here we have never experienced before – at least certainly not in this combination. There have, I believe, been very significant shifts in the dynamics of our industry. Collectively we no longer have the luxury of a solid financial cushion to ignore these changes and commit financial suicide.

Hoping that a couple of years of hard market conditions will save us is about as effective as a man lost in the desert trusting a mirage.

A new situation demands a new response from our industry. And that response is to challenge the very notion of the cycle itself. And we do that by sticking to one simple, yet hugely important principle – a principle that should be the No 1 deliverable enshrined on the heart of every underwriting manager:

Make a sustainable underwriting profit year on year. If not get out of the the game. In fact some of the best analysis I seen recently suggest that the industry must write at a combined ratio of 90% - 90% should be the norm, and not the exception that happens by accident at the very peak of a cycle

Sounds radical? That we should be trying to operate in an environment where we can make a reasonable profit?

If you'd said this to most insurance executives two year ago, they would have had the men in white coats cart you off to the local funny farm. Indeed, there are still some managers today who continue to think like this. They are wrong – utterly wrong – and it is highly dangerous for our long term prospects. These are the managers who are not simply reacting to the insurance cycle, they are creating it.

Indulge me for a moment if you can. In the scenario I've just spelled out to you – the 90% combined ratio – we would live in a world where attractive returns would guarantee a steady stream of capital. Brokers would reap the rewards of a far more stable and financially secure market, where they wouldn't have to explain to their customers on a regular basis why prices for the same risk fluctuate by 1000% and in extreme cases, coverage is just not available. Likewise, customers could get on with running their own businesses knowing that they can transfer their risks in a predictable manner at a predictable cost – and they would know the person they paid their premium to would still be around in five years time when they present their claim.

So if this is such a blindingly simple solution to our problems, the obvious question is: why aren't we all doing it now? My answer: we're in the wrong mindset. Too many of us believe that the insurance cycle dictates market conditions. Prices rise and fall, and we just go along for the ride. That is the wrong approach. If we are to turn this industry around, we need to take control. And we can only do that if we reject our industry's self-limiting beliefs and trust in our own good judgement.

And that is exactly what we at Lloyd's are doing.

So finally this morning, I want to explain to you how we at Lloyd's are trying to do exactly what I've been speaking about – how we are setting out to challenge the cycle so we are, so to speak, driving the bus rather than being trapped in the back seat careering down the freeway at 100 mph.

In the press over the last couple of months, you will have seen stories about how Lloyd's is setting out to reform itself – to modernise at a basic structural level and reinvent itself as a modern, transparent, profitable market – not easy some might say for a 17<sup>th</sup> century coffee shop. But that's exactly what we are doing. And that's how we are taking control of the cycle.

Back in September, our members gave their overwhelming approval for a programme of reforms that have taken us over a year to create and refine. At the heart of the reforms is the creation of a new Lloyd's franchise – a franchise that is a partnership between the businesses in the market and Lloyd's, which runs it.

This franchise concept will firstly address the issue of market profitability. In the past, a minority of poor performers have run up damaging losses, and we all paid a heavy price. Maybe we have been guilty of accepting a degree of inevitability about our performance given the particular stage of the insurance cycle. A soft cycle equals losses. But does it have too? In fact, a number of leading Lloyd's businesses were making healthy returns during the last three years. The proposals allow us as the future franchisor to monitor and guide the franchisees – the businesses in our market, the Lloyd's syndicates.

What we want to do is ensure that the great dramas associated with Lloyd's financial performance in recent years – both the highs and the lows – will be much better managed. That management will manifest itself in many different ways including in a new business planning process – one that's far more proactive than anything Lloyd's has engaged in before – and the creation of a new role for Lloyd's centrally. In the past our primary focus has been a regulatory one. Therefore when problems have happened, it's been our job to find the solution. The structure we operated under pushed us into a more reactive role. But now we're changing that structure. Under the franchise arrangement, we will act more as facilitators, encouraging higher standards of performance from our businesses, and assisting them wherever possible to achieve them.

In addition, these reforms allow us the opportunity to improve our level of transparency – and that's something you've said you want to see happen time and time again. One of the ways we're doing that is by moving from our old system of three-year accounting, to the system you all know and recognise: annual accounting. This will allow us to track the performance of our businesses much better, and will let investors see – and understand – our results more quickly. Brokers and customers will also be able to understand us better, and compare us more readily with our competitors.

So that's what we at Lloyd's are doing to challenge the cycle. We are making major structural changes to our business in order to give us the maximum amount of control possible.

To draw this to a close, what I want to urge you to do... is to think, while you go through your meetings at this conference over the next couple of days, whether you want to take control of the insurance cycle...or whether you want to stay a passenger.

At Lloyd's we know that being a passenger is a recipe for financial suicide. And that's why we making the changes which will allow us to drive that bus forward...in the direction we want to go, not the direction dictated to us.

Our thinking and behaviour must change if the insurance industry is to be a stable, secure industry for our policyholders and shareholders of the future. If those who lead our industry are not prepared to do so, then how can we expect others to follow our advice?

Today, I've tried to explain to you why I think we're facing a unique situation in our industry – and why our old reliance on the benevolence or not of the insurance cycle can no longer be tolerated. I've also spelled out my belief that unless we make a sustainable underwriting profit over the long term and make the structural and behavioural changes that will allow us to do it, we are condemning ourselves to the same inevitable results – an unstable, financially ailing industry, with unhappy shareholders, dissatisfied customers and despairing brokers.

That's not the sort of industry I want to be working in. I'm sure the same is true for you.

So to close, and in order to spur you on your way, I just want to share a thought on change.

The renowned writer Lewis Grizzard wrote that life is like a dog sled team. If you aren't the lead dog, the scenery never changes. And he's dead right. Being a leader of change isn't ever easy. But for those of us who see change everywhere – in our markets, in our businesses, in our shareholders' demands, in fact right across the spectrum – we can either lead, or simply follow. For those that just follow, the scenery truly never changes. Indeed, that scenery will be the constant up and down of the insurance cycle.

But for those that lead, and take those first few steps, the rewards for us all will be great.

Thank you.