

AIRMIC LECTURE

Institute of Directors,
Pall Mall, London

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29 January 2003

Certainty In An Uncertain World

In August 1883, Queen Victoria wrote to her granddaughter, Princess Victoria of Hesse. Her letter contained the following advice:

“I would earnestly warn you against trying to find out the reason for and explanation of everything ... To try and find out the reason for everything is very dangerous and leads to nothing but disappointment and dissatisfaction, unsettling your mind and in the end making you miserable”.

This is gloomy news for those of us involved in the world of insurance, who spend our days calculating the chance of something happening. If Queen Victoria was right, we are destined to be disappointed, dissatisfied and downright miserable.

But I am not – far from it. If you wanted to sum up my mood and that of Lloyd's, I would do it in three words – confidence, confidence, confidence.

This evening I would like to explain why, why I think our industry – and Lloyd's in particular – can look ahead with confidence in what is a troubled and uncertain world.

I also want to explain how we need to face up to the challenges and grasp the opportunities that now lie before us.

Let me begin with two questions: how does insurance benefit the world – and why does our industry matter? In the to-ing and fro-ing of debate on the issues that confront all of us who are involved in the insurance industry, people tend to lose sight of the answers to these critical questions.

The word “risk” is derived from the early Italian, “risicare”, to dare. From crossing the road to sending men to the Moon, we act according to the risks we dare to take. And as our industry becomes more and more sophisticated, it is easy to forget how people behaved and perceived the world before those risks could be quantified.

For example, in 1662 a Londoner called John Graunt published a work whose title, *Natural and Political Observations made upon the Bills of Mortality* – hardly sets the pulse racing does it? But it is a groundbreaking book. In it, Graunt ventures into the barely-chartered waters of using mortality statistics to predict the chance of Londoners catching various illnesses. In his own words:

“Whereas many persons live in great fear and apprehension of some of the more formidable and notorious diseases, I shall set down how many died of each disease; the respective numbers, being compared with the total [number of deaths], those people may the better understand the hazard they are in.”

“The hazard they are in.” Being able to calculate hazard has fascinated people before and since Graunt trawled through his statistics. And our success at doing so has, quite literally, changed the world.

Consider just one short period in our history. In 1692, England was, once again, at war with France. It needed money. So the House of Commons issued a million pounds of annuities. The National Debt was born.

Three years later, Edward Lloyd began to publish his List, cataloguing the arrivals and departures of ships. This information sparked the growth of an insurance industry that lowered the barriers to undertaking risky enterprises – as well as, according to one history, house-breaking, highway robbery, death by gin drinking, the death of horses and even “assurance of female chastity”.

Such insurance fostered invention and innovation – creativity – the hallmark of Lloyd’s today. As Peter Bernstein wrote in his book *Against the Gods*, “without a command of probability theory and other instruments of risk management, engineers could never have designed the great bridges that span our widest rivers, homes would still be heated by fireplaces or parlour stoves, electric power utilities would not exist, polio would still be maiming children, no airplanes would fly and space travel would be just a dream”.

Insurance has helped to drive forward the wheels of progress thanks to our industry’s ability to be flexible – to adapt to customers’ needs and to rise to challenges. Lloyd’s built its reputation on being a genuine and secure marketplace where a customer can find cover for almost any risk, and where, if the worst should happen, Lloyd’s pays the claim. Over hundreds of years it developed into a global brand, a trusted name found in every large port, protecting businesses and individuals from the wild winds of fate.

In the 1980s and 90s that reputation faced severe tests and it suffered. Disasters rolled in thick and fast and it seemed as if Lady Luck no longer smiled on Lloyd’s. Newspaper articles from exactly a decade ago have a common theme: losses at Lloyd’s; bankruptcies among Names; a market reeling. One headline summed it up: “Nightmare for Lloyd’s”.

Just over a year ago, the natural disasters and catastrophes, and the years of financial losses were compounded and capped by one shattering man-made event. The repercussions and reverberations of the appalling attack on September 11 are with us today.

It was the biggest single loss in our 315-year history. Commentators and analysts suggested we were staring into the abyss, we were reeling, we would close and break our historic pledge that we always pay valid claims.

Instead, Lloyd's moved to pay claims arising from this enormous event. We have now paid over \$2.5 billion of claims for 9/11¹. This is a tribute to the powerful, commercial and financial strength of the Lloyd's market. It sent a powerful message around the world. Lloyd's is secure. Lloyd's is certainty in an uncertain world.

How have we achieved this?

Well before 9/11 happened, Lloyd's had confronted the difficult issues which had led to the years of losses. In response it came forward with a radical reform and modernisation plan for the market.

Thanks to this, we are in a good position to benefit from the strong trading environment. Far from losing out to new competitors, we have attracted new business. Direct premium has risen by 29%, re-insurance premium has risen by 25%². Meanwhile, our capital base has not dwindled. Quite the opposite. Our capacity has increased to £14.4 billion³ – a record in our history.

Let me put our success in context. While the market cap of FTSE 250 has fallen by more than 30 per cent since September 2001⁴, the market capitalisation of Lloyd's UK quoted businesses is around 50 per cent higher⁵ today than it was then. While the financial markets enter a period of almost unprecedented turmoil, Lloyd's is not simply a small beam of light – it's a beacon.

¹ Office for September 11, January 2003

² Xchanging Ins-sure services, January 2003

³ MSU (Member's Services Unit), January 2003

⁴ www.ft.com

⁵ Lloyd's market reporting and analysis, September 2002

And these facts need to be set against the global nature of the Lloyd's marketplace. 96 per cent of the FTSE 100 have policies at Lloyd's⁶, as do 93% of the Dow Jones⁷, the world's top ten banks, the world's top 10 pharmaceutical companies and the world's top 5 petroleum refining companies⁸. Edward Lloyd's coffee shop still performs its role as a supporter of enterprise, as a dynamo for innovation and invention, but on a world-wide scale.

So the gloom has gone. The headlines are changing. "Lloyd's poised for record business". "Good times roll on for Lloyd's".

This matters because what people read and hear is a part of what shapes their faith and trust in our market. To change that, we had to change the way Lloyd's does its business.

Change is never easy. It takes courage and foresight. And it is often more painful the older an organisation is. But although Lloyd's is more than three hundred years old, the history of our market is one of constant change. Our reputation rests on our flexibility, our ingenuity and entrepreneurial spirit. Lloyd's strength is that it is a genuine market in which innovation sparkles, not an organisational behemoth that suffocates fresh thinking.

So we have had a cool, hard and critical look at the way Lloyd's operates, and have acted to raise standards of performance. The foundations of our reforms are now firmly in place. Let me sketch out three of them.

Byzantine accounting practices are going. To many outsiders, viewing Lloyd's through its three-year accounting system was like looking through an out-of-focus camera. Transparency and focus breeds trust, which is essential to our industry. So we are moving to annual accounting.

⁶ FTSE 100 & Dow Jones IA/Fortune Global 500, Lloyd's Statistics, November 2002

⁷ Xchanging, 2003

⁸ FTSE 100 & Dow Jones IA/Fortune Global 500, Lloyd's Statistics, November 2002

Second, we are going to be tougher on those businesses which trade in our market. Those businesses effectively use a franchise, the assets that underpin the Lloyd's brand – our name, our reputation and our network of international trading licences. In future, each underwriting business will sign an agreement to abide by a range of standards and guidelines, so that we can protect our brand.

The franchise concept should inject more financial stability into the market, which in turn should result in sustained profitability in the long term. Where once Lloyd's could only take action after a syndicate had got into problems, now a Franchise Board will be able to take action before problems materialise and harm the financial performance of the market as a whole. This marks a sea-change in Lloyd's thinking and will begin a new era in the market's performance.

Our third change is that, over time, we intend to move away from unlimited liability. This can be achieved in a couple of ways. First, not admitting new unlimited liability members. Second, working to ensure that those members with unlimited liability do not lose out when they change to limited liability.

These reforms mean that Lloyd's is on the cusp of a dynamic and exciting future in what the Chinese, in their typically modest and delightful way, might describe as “interesting times”.

In spite of everything commentators are saying about the “good times” at Lloyd's, we are not, never have been, and never will be complacent. We have to continue to develop the financial flexibility and discipline to meet unforeseen and colossal challenges. Our world faces new risks which we need to confront.

Terrorism is one. The events of September 11 prompted some commentators to claim that the nature of risk has changed forever. Professor Frank Furedi wrote a paper¹, sponsored by AIRMIC and Lloyd's, in which he challenged this assertion.

His argument is that the attacks have created the spectre of “intentional risk” – the threat of actions with the specific intention of causing damage or disruption. In today’s risk averse culture, we have reacted to this by planning for the very worst disaster scenarios. We are being told to think and prepare for the unthinkable – itself increasing our sense of vulnerability and changing how we behave. This, in Professor Furedi’s eyes, can result in western organisations rewarding terrorists, by spreading fear and panic. Instead, he argues that we need to look afresh at how to pool risk in light of this new brand of terrorism. Otherwise, our economic ability to take risks, to innovate, will be sapped.

I don’t agree with some of this analysis. Governments are right to prepare for the worst but also hope for the best. The extremism we witnessed on September 11 does mean that some aspects of how we live have to change – such as greater security in public transport, and so on.

However, Professor Furedi hits the nail on the head in one respect. To defeat the terrorist, to refuse to be terrorised, our industry needs to think of ways in which businesses can continue to operate in the face of intentional risk.

We cannot afford to lose sight of the role that insurance plays. As David Gamble has said, insurance both rebuilds and enables.

The first role – the re-builder – is well known. After a catastrophe, insurers foot the bill for recreating or compensating for what has been destroyed. As I said, we are meeting billions of dollars of claims arising from the attacks of 9/11. In practice, that means that we are helping our friends in New York to re-build their lives and the dynamic area of Lower Manhattan.

The second role is the one I referred to earlier on: we drive the wheels of progress. When people invest in a venture – whether it be physical assets or currency – they often prefer not to be exposed to all the risks associated with it. If they lack that insurance, or it is insufficient, then the scale and number of investments is likely to fall over time.

So our industry needs to think of new ways to cover these risks. The problem, which some experts have highlighted, is the sudden “shocks” – such as terrorist outrages or unexpected epidemics – that our industry might confront. We need to ask ourselves whether we can do more to prepare for such unforeseen calamities. Have we examined and experimented with new ways of pooling risk? Have we the skills we need to manage this new uncertainty?

The death and destruction caused by terrorism is horrific, but the fickle hand of nature can be just as terrifying.

In the US, insurance losses from natural disasters have increased 15-fold since 1960. And things are going to get worse. By 2050, mega-catastrophes, which used to occur every 100 years, are predicted to happen once every 25. The UN predicts that losses will then be 900 per cent higher than they are todayⁱⁱ.

In this uncertain world, one thing is clear. The very kernel of insurance is to spread losses throughout the community on the basis of solidarity. Be it 9/11 or natural disasters, the lesson for all of us is this: to foot colossal bills, we need strong, financially secure insurers.

So let me be honest: in the medium term, our industry will need to pass back the high burdens of claims onto the insured. If we don't do that, how can fulfil our role as the enabler and re-builder? If there is inadequate cover, insurance companies will go to the wall, and then everyone suffers.

In the long-term, the changing nature of risk will test our inventiveness and creativity to the full. It is not our role to confront the sources of these new risks – be they man-made or natural - to society. But as the enabler, it falls to us to give people peace of mind to cover these risks so that they can continue to innovate, create and invest. We are better placed than anyone else to develop the solutions to these new challenges. We have the

creativity and diversity, the knowledge and expertise, the financial strength and security to deliver.

We shall continue to “try to find out the reason for and explanation of everything”, despite Queen Victoria’s advice. Lloyd’s, despite 9/11, is in fine form to do so. In an uncertain world, we can be certain of that.

NOTES

i *Refusing to be terrorised: Managing risk after September 11th*, by Professor Frank Furedi, University of Kent. A Global Futures Production, sponsored by Lloyd’s and AIRMIC, 2002, page 20.

ii *Global Climate change threatens the insurance industry*, The Environmental News Network, August 27th 2002.