The Future of Lloyd's
A speech by Nick Prettejohn, Chief Executive, Lloyd's
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"The Future of Lloyd's"

I have the privilege to be Chief Executive of an institution which occasions more speculation and punditry than any other in the industry. Let me give you my thoughts about the future. In doing so, I should stress that I share and not just for compliance reasons the healthy intellectual scepticism that shies away from adamant prediction born of spuriously confident 5 year plans – the well worn path to fields of rusty tractors and condemnations of bad harvests. And my grounding in empiricism will lead me to spend some critical – in both senses of the word – time observing the present, and the past, Lloyd's.

But I will start with the vision. It was this vision that the membership endorsed in September, when 80% of our capacity voted in favour of reform.

"We will be the leading specialist insurance market place. Our businesses are independent and operate within a franchise: committed to delivering consistent underwriting profit, benefiting from a common rating and mutual security and attracting the highest quality management and underwriting talent".

Like all good vision statements, this is a simple statement, containing some powerful words chosen after long debate.

Just to single out a few. Lloyd's is a genuine market place of, yes, independent businesses. Different businesses. Owned by different people. Writing different lines of business. Small. Responsive. Short lines of decision making. Offering choice. Choice that is valued by policyholders and brokers. 93% of the Dow Jones[1]. The world's top 10 banks. The world's top 10 pharmaceutical companies. The world's top 5 petroleum companies.[2]

Offering the opportunity to entrepreneurial businesses to plug into a network of licences to trade around the world. A commitment to and an unprecedented ability to work with brokers to produce solutions to client problems. Access to underwriting decision makers, access that is valued by brokers and clients.
"Underwriting profit".

[1] Source: Dow Jones, Xchanging Ins-sure Services Dec 2002
[2] Source: Fortune Global 500, Xchanging Ins-sure services Dec 2002

A focus on underwriting profit because that is the only way to deliver competitive levels of shareholder value. A realistic focus because the best businesses in our industry, and crucially, the best businesses within Lloyd's, have demonstrated an ability to deliver underwriting profit even through the full insurance cycle. By contrast, our industry as a whole has failed abjectly to deliver underwriting profit and hence the shareholder value.

"Common security". The underpinning of brand, the single policy and the licence to trade. A common security that binds the market place into a single commercial promise. A common security whose cost is demonstrably less than the benefit it confers.

"Management and underwriting talent". People drive success. The business model has to be attractive to the best people, not anathema. The best underwriters to be innovative, flexible, creative. The best management to exercise proper control, without the gratuitous burdens of excessive cost or bureaucracy.

This vision leads, then, to some clear objectives:

- to make Lloyd's the preferred market of choice for policyholders, brokers, underwriters and capital.
- to create and maintain a commercial environment at Lloyd's in which the long term return to all capital providers is maximised.
- to create a disciplined market place of well managed businesses.

A modern, transparent and profitable market.

So, there is the vision.

What about the here and now?

I am speaking after a year in which Lloyd's has demonstrated quite extraordinary resilience and vitality.

Twelve months ago there were those who were confidently predicting the demise of Lloyd's, in the aftermath of the appalling tragedy of September 11th, when businesses connected to Lloyd's lost many family members, friends and colleagues, and the Market suffered the greatest single loss in our history.

First there were short-term financial risks. The requirement to fund our reinsurance liabilities in the United States at 100% of gross liability, taking no credit even for the retrocession provided by the US regulated entities. We fulfilled that requirement, placing $5 billion in our US Trust Funds, and have already paid out $2.5 billion of claims[3]. And our gross and net estimates of September 11th liability have shown considerable stability during 2002. We were asked several questions by the tragedy of September 11th and have shown the resources, financial flexibility and discipline to answer them.

Second, there were commercial doubts. Would Lloyd's benefit from the improved rating environment, or would we lose out to existing and new competitors?

Premium has risen 25% so far this year. Our reinsurance premium – the subject of some particular punditry has risen 25% and remains about half of our total business.

And our experience of premium rates and terms and conditions continues to improve. So, Lloyd's has met the competitive challenge of the last 12 months in the eyes of brokers and policyholders. This strong premium performance combined with a relatively low level of catastrophe experience and claims activity means the prospects for our 2002 year appear, at this stage to be very promising.

Thirdly there were doubts a year ago about our capital base. Would Lloyd's attract capital or would the capital base dwindle? Most commentators see our capacity to write premium as a measure of the health of the capital base. It's a crude statistic but it does tell a straightforward story. Twelve months ago, even in the immediate aftermath of September 11th, our capacity hit record levels. It has crept up further during the last year. Today I can reveal that our first official estimate of capacity for 2003 has reached £14.25 billion, or around $21.5 billion. A new record, and one which clearly demonstrates that we have been successful in attracting new capital. Indeed nearly $9 billion of capital has been injected into the Lloyd's market over the last 2 years. A telling statistic is that the market capitalisation of Lloyd's UK quoted businesses is around 50% higher today than in September last year.

Lloyd's has a diverse capital base and there is ample evidence from all constituencies of the resilience of that capital. Our insurance company members have increased their capital, and so have private individuals.

[3] CAT01G report

And, an important point, our capital is much less exposed to the equity markets than that of our competitors – 5% of all investable assets versus 2 or 3 times that level for the rest of the industry. Lloyd's has, then, picked up the gauntlets thrown down by the capital markets and the investment community.

This performance has been a demonstration of powerful commercial and financial strength, in defiance of the predictions of a number of pessimistic observers. It is testimony to the features of the market that I described earlier, the unique features of a genuine and enduring market place.

But our resilient and promising present must be replicated in the future. We need sustained performance. Nor must it blind us to the lessons of the past, or distract us from the need for real and far reaching reform. In today's business environment, no franchise or brand has the luxury of even a milli-second for complacency or relaxation. Rather the capacity for constant self analysis – identifying the need for change – is a source of competitive strength, and a relish for necessary change, however gut wrenching the prospect, is the hall mark of success.

Change is a challenge for any organisation. For a 300 year old institution like Lloyd's, it is both difficult and a way of life. No institution can endure for 300 years without changing. Equally, all advocates of change must recognise what the change is for: to preserve the many assets that make the effort of change worthwhile.

In our case, any change must be measured against some simple criteria. Is it preserving or enhancing the attractiveness of the market place to brokers and policyholders? Is it creating a sustainable environment in which skilled entrepreneurial underwriters and high quality capital will chose to unite? All advocates of the status quo, or opponents of change, must judge their reluctance to do things differently by the same criteria.

At Lloyd's, we are in the middle of a change process. We have been through a stage – a bout, even – of self analysis, the work of the Chairman's Strategy Group being the primary example, but also the work we have done with the rest of our colleagues in the London Market to look at the business process.

The lessons of the self analysis are clear and uncompromising.

First, that the performance of the market was unacceptably poor between 1997 and 2001. We were not alone in that poor performance, as it turns out. There has been a veritable parade of recognition around the industry that, yes, the late 90's really were profoundly unprofitable years. We at least started to admit how bad they were some time ago – and were roundly criticised at the time for our results. Now we are being joined by many others. But what made our overall market performance so frustrating was that our best businesses delivered excellent – world class – performance.

By contrast, our worst businesses have generated substantial losses that have cancelled out the good performance. Such bipolarity is not sustainable. The cost of the mutual element of our financial structure, measured by contributions to the Central Fund, which is increased by the poor performance of the few, must be kept to a level which is competitive for the many. This is particularly important given that Lloyd's businesses increasingly have a choice as to where they operate.

Second, we have been difficult to understand, not least because of an accounting system that has many merits to the cognoscenti, but affords little transparency to the general insurance – let alone broader financial – community.

Third, we share a business process with the rest of the London market and much of the international insurance industry that requires urgent overhaul because it is, simply, inefficient.

So much for the self analysis. What about the willingness to change? Well, in September we put a package of reforms to our membership to address the first two issues, and we received an 80% vote in favour of reform. And on the third, we are actively working on a number of initiatives which tackle the vital issues of business process that must be addressed to make ours an efficient market for the future.

Let me take you through some of the key elements of the reforms. Firstly, the franchise reforms which address the issue of performance. The word "franchise" recognises that Lloyd's businesses share in the collective assets that I discussed earlier

- brand and reputation
- international licences
- membership of a unique market place

as well as the collectively held financial assets that underpin them, notably the Central Fund.

The "franchise" concept further recognises that looking at these assets through an exclusively or predominately regulatory lens and acting accordingly will not maximise the value of the assets.

So the franchise reforms are about making a transition from being a regulator to being something different: the manager of a franchise.

The manager of a mutual market place must – like any unitary financial institution – enforce sensible prudential risk management and business conduct disciplines across the businesses who make up the market. It must do this for sound commercial reasons. Never mind its statutory responsibilities to its members or its regulator.

To that end, the market manager and regulator share, albeit from different starting points, a virtual identity of interest.

But the transition from regulator to franchise manager is an important one. It is in many ways a logical extension of the direction in which we have been moving over the past few years. The period from the mid 90's saw us steadily update and refine our regulatory management, consistent with much of what appears in the UK Financial Services Authority's recently published vision of insurance regulation : the focus on risk and the implementation of a risk based capital system, the focus on the identification, documentation and conduct of key business activities, and an emphasis on senior management responsibilities. This progress was all in the context of Lloyd's as a self-regulated market. Then in 1997 we reviewed our regulatory status and – ourselves – stated the case for being externally regulated. That externally regulated status finally came about December 2001, although we had begun to prepare for that position over the previous couple of years as the FSA came into being.

Thus Lloyd's itself is now a regulated entity – the Society of Lloyd's, through the Corporation, is regulated in the same way that the businesses in the market have been and are regulated. And going forward, the FSA and Lloyd's need to look at the arrangements under which the FSA has delegated some of its activities to Lloyd's. That is a welcome process of examination that has begun and will continue over the coming months. Clarity of responsibility and avoidance of unnecessary duplication will be guiding principles in this process. Lloyd's businesses must not be gratuitously disadvantaged versus their competitors, which means finding a sensible way of achieving prudential and commercial control within a transparently fair regulatory environment, consistent with the responsibilities of all the parties involved: FSA, Lloyd's collectively, and Lloyd's businesses individually.

So what does being a "franchise manager" mean in practical terms?

I will pick out two things in particular. The first is a more active role for Lloyd's in agreeing and enforcing underwriting standards across the market, to set alongside the standards of conduct, operational control, and capital requirements that are already enforced.

This active role does not mean micro-management of underwriting by the centre of Lloyd's, as some fear. Central micro-management is neither feasible nor desirable at market level. Management of underwriting remains unambiguously the responsibility – and the competitive raison d'être – of the individual businesses in the market.

What it does mean is recognition that there are some common factors between the most successful underwriting businesses in the market, and between the least successful.

Analysis of the second half of the 90's teaches some stark lessons.

- Do not write for market share. Our best performing businesses often shrank their businesses during the late 90's; our worst performers typically grew.

- Make a gross underwriting profit; do not rely on reinsurance habitually to bail you out.

- Do not over expose your capital with either excessive line size or excessive assumption of particular catastrophe risk.

Not complicated lessons, but in many ways all the more challenging for their simplicity. These lessons have been translated into guidelines which we expect businesses to honour unless they make a convincing case to the contrary. And since they represent good practice, they can and must be enforced with vigour and confidence in the majority of situations. Each business will prepare an annual business plan showing how it will perform versus the guidelines. And each business will have a dialogue with a new Lloyd's function – the franchise performance function – around the underwriting content of the plan. That will be a dialogue that covers underwriting, risk management, operational control and service issues – the latter a topic to which I shall return later.

This single plan will be the primary vehicle for managing the franchise at individual business level. The plan represents a major opportunity to rationalise and improve the relationship between the centre of Lloyd's and the market. Above all, no one should underestimate the importance of the plan process, or the guidelines, or the determination with which we will seek to ensure that the lessons of the past are applied.

The success of these measures will be best judged when premium rating conditions begin to turn downwards. And while it is a demonstration of health today that our capacity is increasing, it could well be that a strong inclination to grow, and indeed an indication to shrink, will be a measure of true health when the cycle turns. Both our business plan discussions and our risk based capital model will bolster the Market's thought process when that time comes.

The second aspect of the franchise proposals to discuss is governance. The Council of Lloyd's has been, and will remain, the ultimate governing body of the Society. Under the Lloyd's Act it has certain responsibilities that it cannot shed. But historically it has discharged many of its responsibilities through a labyrinthine collection of committees. In particular, the 1993 Business Plan recommended a split between a "Market Board" and a "Regulatory Board". This was perfectly justifiable given the issues and concerns of the late 80's and early 90's.

However it has become increasingly apparent that a single board is required to take a holistic view of the major strategic, risk management and operating decisions of the Society. Thus under the franchise proposals a Franchise Board will be created.

The Council will retain ultimate authority to remove the Franchise Board and to hire and fire the Chairman and Chief Executive. It will also – because it has to – retain the power to make and amend bylaws.

But the Franchise Board will have substantial delegated power from Council to run the Franchise. It will be much smaller than Council – 11 members rather than 18. The proportion of genuinely independent non-executive members be higher – 4 out of 11, in contrast to 5 out of 18 on Council, 1 out of 16 on the Market Board and 4 out of 15 on the Regulatory Board. The Board will be chaired by the chairman of Lloyd's, Lord Levene who is for the first time at least in living memory a distinguished outsider, not from the market. That in itself is a sign of Lloyd's determination to change.

Council will establish for the Franchise Board a goal and set of guiding principles. Council will monitor the board's performance versus those principles through the mechanism of the Compliance Committee.

In turn, the Franchise Board will hold the Executive accountable for carrying out the policy of the Board.

This represents a significant reduction in the number of Committees and a healthy clarity of responsibility, accountability and decision making.

Implementation of the franchise proposals is well under way. We have already announced the non-executives for the Franchise Board, which will meet first in the New Year. Those non-executives will bring a strong combination of insurance expertise and insights from elsewhere that will greatly enhance the management of the franchise. All of the businesses have produced the first version of new style business plans, and the dialogue has begun on the basis of those plans, with meaningful action already being taken at individual business level as a result of that dialogue.

That then, is a summary of the franchise proposals. The proposals are designed to improve the profitability of the market. They recognise the underlying strengths of the market. But at the same time the franchise proposals recognise the responsibility we have to preserve and enhance the precious collective assets that all Lloyd's businesses share.

The reforms that were endorsed in September sought to make the market profitable; they also sought to create a modern and transparent market place.

The most important reform here is the transformation of our accounting system. Traditionally we have had a 3-year accounting system, in contrast to most of the rest of the industry. The 3-year system has some genuine virtues. If properly applied it forces a prolonged and harsh focus on the underwriting performance of a given year of underwriting. Hence we have confronted the financial consequences of the underwriting downcycle from 1997-2000 earlier and rather more openly - at least because we have had to do it explicitly over a 3 year period - than many others in the industry.

However, 3 year accounting is the real tennis of financial reporting. Its devotees swear by it, but no one else understands it. A business that has to explain the methodology behind its reporting before it can explain the numbers themselves is at a disadvantage. We believe it is vital to be transparent and comparable. Therefore we have committed to move to an annual accounting system, in tandem with the implementation of International Accounting Standards within the European Union, or – if that process is delayed – ahead of it.

As a tangible demonstration of our commitment, this spring we published our 2001 annually accounted results at the same time as our traditional 3 year accounts for 1999. The result was – largely as a result of the tragedy of September 11^{th} – a loss of £3.1 billion.[4] But put in the context

[4] CAT01G report

of our competitors – since annual accounting allows us to compare our combined ratio with that of the industry – our performance appeared to be in line with many of our peers.

The reforms voted through in September were designed to improve the outlook for all capital providers to the Lloyd's market. The diversity of sources of capital represented by the Lloyd's capital base is a competitive strength, and over reliance on any one generic source of capital would be a relative weakness.

The reforms did however signal an important change – the intent to move the market, over time, to an all limited liability basis.

This can be achieved by a couple of means: first, not admitting new unlimited liability members from 2003 and second, working with the UK government to change the tax regime so that unlimited liability members do not lose out when they change to limited liability. These initiatives, if successful, should naturally result in an all limited liability market – limited liability capital sourced from insurance companies, the public and private equity markets, and from private individuals. We believe that the risk profile of the global speciality insurance and reinsurance business makes this change desirable and inevitable.

The reforms that were voted through in September mark, then, a major transformation. Real practical steps to create a modern transparent and profitable market place – by changing behaviours, structures and measurement of performance.

There is a third area of reform that was not centre stage in September, but is equally necessary and fundamental. That is the area of business process reform.

People often talk – quite rightly – about the need to reduce the cost of doing business at Lloyd's.

For Lloyd's to be a sustainable, competitive environment, the cost of doing business at Lloyd's rather than any other location must be demonstrably lower than the benefits. Reforms to underwriting practice that I discussed earlier can have a direct impact on that calculation. Less reinsurance leverage, less concentrated exposure, higher quality controls should all translate into lower losses, lower calls on the Central Fund and hence lower Central Fund contributions and premium levy rates. But however successful these underwriting reforms are in reducing central fund related expenses, and that is a critical objective the fundamental structural expense issue for Lloyd's and London is frictional cost.

Lloyd's, the London Market, the insurance industry as a whole, have a business process that needs urgent and if necessary uncomfortable change. Frictional costs are simply too high, driven by multiple data entry and lack of contractual clarity. Not only are frictional costs too high, but movements of cash and documentation are too slow. This is not a zero-sum game between the different parties involved in the insurance transactions: these are issues of equal interest and value to brokers their clients, and to underwriters.

This is not primarily an issue of technology. It is an issue of behaviour. It is about the underlying way in which business is done.

Of course technology can support and accelerate change to behaviour in a very powerful way. For instance, Lloyd's is investing in a project – Blue Mountain – which aims to create connectivity between the myriad different systems in the market and the industry to enable single data entry and see through processing to become a reality. In this, we are working actively with a number of major broking houses, underwriters and industry systems providers. In particular the project is making good progress to develop interfaces with systems used widely in the broking and underwriting communities. This represents a pragmatic technology solution that will enable businesses to change their processes, rather than prescribe one particular way of doing business. As such it stands a better chance of success than many previous attempts, and deserves widespread support. Someone has to deliver a solution to the problems created by multiple systems, processes and data entry. Lloyd's is well positioned to be central to the effort.

Lloyd's is also a partner in the joint venture with the London Company Market and Xchanging, Ins-Sure, to create a single back office for the London Market; and a partner with Xchanging in creating Xchanging Claims Services, to provide value added claims management and processing expertise. And we are participating in a benchmarking programme with the London brokers to measure progress towards change.

These are all important developments and represent significant investments in technology and business process change. But they will only bear ultimate fruit if people across the market change the way we do things.

Together with our broking underwriter colleagues across the London Market we have been working on a programme to achieve that significant behavioural change – London Market Principles or LMP. At the heart of LMP is a new slip structure, the key documentation that drives the transaction. This new structure brings greater clarity and hence efficiency to the whole ensuing process. Recently the brokers have announced a target of 70% of 1/1 renewals to be agreed using the LMP slip structure. This is an ambitious and welcome target because the LMP slip is the essential starting point for basic reform of the business process.

How then can the franchise reforms help make this process reform happen?

I talked earlier about setting franchise guidelines for underwriting. It will also be important to set franchise guidelines for business process and service delivery. The long term reputation, competitiveness and attractiveness of the franchise depend as much on the cost of doing business and the quality of service as they do on underwriting, since cost and service are in the direct interest of the policyholder. There is clearly a debate to be had about means and ends – do you set guidelines that specify what levels of service delivery – do you set guidelines for how to achieve those levels? The right answer is probably both, and the balance between the "what" and the "how" approaches may need to change over time.

But whatever the right balance might be between means and ends, process issues will be high on the agenda of the Franchise Board, and an obvious place to start the discussion will be the LMP slip. I will repeat my recently expressed view that the Franchise Board should consider setting a timetable for mandatory use of the LMP slip once the market take-up of the slip has reached a sensible critical mass.

Because if the market is adopting process reform, then the Franchise Board has a responsibility to accelerate that process. We need urgently to progress a programme of change that addresses the entirety of our business process, from placing of the risk through to payment of claims. The Franchise Board can and must play an active part in promoting that programme.

Lloyd's is, then, engaged in a process of meaningful and challenging reform. We are seeking to eliminate those elements of underwriting and risk management practice which have destroyed value in the past. We are investing time, energy and money to address the inefficiencies of London's business process. These reforms – if implemented vigorously and embraced wholeheartedly – should result in lower costs of doing business and improved profitability for the market as a whole.

Let me return, finally, to where I started out and to our objectives. Lloyd's as the preferred market of choice for policyholders, brokers, underwriters and capital. A commercial environment in which the long term return to all capital providers is maximised. A disciplined market place of well managed businesses.

In today's world, businesses and capital have a choice. They will chose the operating platform that deliver the most benefit relative to the cost. There will always be reasons why individual businesses make particular choices, and why particular locations have particular advantages at a point in time. And given the diversity of businesses that have invested in Lloyd's, it will not be possible to please everyone all of the time. But we have to be sure that we are doing everything we can to liberate the real competitive strength of the Lloyd's market and the Lloyd's platform, and to eliminate ruthlessly the weaknesses.

Success in that mission will ensure a thriving market place for the future.

A market place which has a roll call of the best businesses in our industry.

- businesses owned by the leaders in the international insurance and reinsurance market.

- businesses that are independent Lloyd's vehicles.

- businesses that are backed by high quality limited liability capital from the public and private equity markets, individuals and corporations.

A market place that sets and achieves high standards for underwriting performance.

A market place that is open and intelligible, comparable to competitors.

A market place that adopts the behaviour and technology required to achieve business process efficiency.

A market place where the structure delivers demonstrable benefits to policyholders and to those businesses who chose to participate in it.

A market place that is a magnet for talent: underwriting, broking and managerial talent.

Lloyd's has shown remarkable resilience. The vitality of the market today is testimony to its enduring competitive strength. Competitive strength that is recognised by policyholders and investors, and demonstrated by a robust flow of business and capital into the market.

The combination of enduring competitive strength and tough, thoughtful, reform, unerringly implemented, will be a powerful one. The market is seizing the opportunity today and building the opportunity for the future. It is an exciting prospect.