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First, a question: 'Is Lloyd's worth reforming?' My answer is a resounding 'Yes'. Lloyd's is the world's leading market place for specialist insurance and reinsurance and reform will ensure we maintain that position. A few statistics might help:

- 96% of FTSE 100 have policies at Lloyd's, together with
- 90% of the Dow Jones
- the world's top 10 banks
- the world's top 10 pharmaceutical companies
- the world's top 5 petroleum companies[i]

The business of the market is buoyant. This year, so far, our premium is 25% higher than a year ago[ii]. Our capacity to write premium for next year will be at record levels when we announce it later this month. One commentator has already predicted a figure of £14 billion, which would be 14% more than last year and 39% more than 2000[iii]. In GAAP terms, our gross premium for 2002 will be well in excess of $25 billion[iv].

The capital base of the market is regenerating and increasing. Quietly – but eloquent testimony to the resilience and attractiveness of the market – upwards of $8 billion of capital[v] has been injected into the market in the last two years. The market capitalisation of the UK quoted Lloyd's companies is nearly 50% higher than it was on 10 September 2001[vi]. By contrast the aggregate of the rest of the industry is lower.

The Lloyd's market had the resources and financial flexibility to lodge $5 billion in trust funds in the United States to fund our gross liabilities relating to 11 September, and has already paid around $2.5 billion of 11 September claims[vii].

Clearly, then, the Lloyd's market has something going for it. A brand that has endured through centuries of risk taking and some well canvassed problems and controversy in recent decades. An ability for entrepreneurial businesses to plug into a network of licences to trade around the world. A commitment to and 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.

I have dwelt on these points because the resilience, commercial importance and competitive reality of Lloyd's are real yet fundamentally under-appreciated. Indeed, in the early 1990s and in the aftermath of the tragedy on 11 September last year, there were those who confidently predicted Lloyd's demise.

Instead Lloyd's is very much alive and kicking, at a time when the industry as a whole has a number of problems.

This is partly because our balance sheet is not exposed to falling equity values in the same way as the industry. Only 5% of the market's assets are in equities, compared with at least two or three times that number for the rest of the industry[viii].

Part of it is because we were obliged, as a result of the litigation of the early 1990s, to confront the issues of asbestosis and environmental liability through the creation of Equitas in 1996, an actuarial exercise of unprecedented scale and scope. Others are now finding that they have to increase their reserves, and are doing so incrementally.

Part of it is because we at least started to confront and report the disappointing reality of how bad underwriting conditions were from 1997-2000 earlier than much of the industry. We took a lot of criticism, but now we are seeing that others are having to make significant additions to reserves to reflect the poor results of those years that were not reported at the time.

As a result of these factors, the shrinking asset values and encroachment of past year underwriting issues on current results that we are seeing across the industry – and which will, I believe, sustain the current up cycle – are much less of a problem for Lloyd's.

I have also dwelt on this evidence of Lloyd's remarkable vitality to give you a sense of the assets that Lloyd's has under its collective care. Brand name, reputation, licences to trade, underwriting and broking expertise resulting in a continuing ability to attract capital. Those assets are enormously valuable and require active attention. In today's business environment the price of assets is eternal vigilance, and eternal vigilance means a willingness to change and a strong capacity for self-criticism.

That is why reform is so important for Lloyd's. We have to look beyond the circumstances of the moment, to do the right things so that we maximise the future value of those precious assets. What does self-criticism tell us?

First, that the overall financial performance of the market was poor between 1997 and 2001. Never mind that others have, it turns out, performed badly too. Moreover, in footballing parlance, our performance has been a game of two halves. Our best businesses have generated world class performance. 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, 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-criticism. 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 have developed a number of initiatives which tackle issues of business process.

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. For the avoidance of doubt, the transition does not mean a lock stock and barrel cessation of all previous activities labelled *regulation*.

Firstly, the term *regulation* has always meant more in a Lloyd's than in a non-Lloyd's context. Any society of members has its own rules to police and enforce.

Second, 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, quite apart from 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. Grossly oversimplifying, the period from the mid 1990s saw us steadily update and refine our regulatory management, consistent with much of what appears in the 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. That is a big – and I will employ an overused word – cultural change, as well as a practical one.

When you couple changes to our own structure and objectives with the output of the Tiner Report it is clear that 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. 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. We charged a group of practitioners to come up with a list of those factors, and some guidelines to reflect them. The central themes of these guidelines include underwriting profit, avoidance of over reliance on reinsurance and excessive catastrophe exposure, and management of line size relative to capital.

The guidelines are what they say they are: guidelines. But they are guidelines that 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 and also service issues, a topic to which I shall return later.

The fundamental issues of risk management and operational control will also be addressed in this single plan which, at individual business level, will be the primary vehicle for managing the franchise. 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 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 1980s and early 1990s.

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. Balancing the prudential with the commercial is the critical and perennial challenge for all financial institutions. Division of responsibility does not necessarily create balance. 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.

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. The Board and Executive will be advised by two groups – one to give a regular, critical and free thinking view on underwriting trends and risks (the Underwriting Advisory Committee) and the other to give independent advice on difficult issues and decisions that affect individual businesses with the Market (the Market Supervision Advisory Committee).

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 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 – the very fact of being a market place of individual, expert underwriting businesses accountable to their own investors being paramount amongst those strengths. 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 three-year accounting system, in contrast to most of the rest of the industry. The three-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 down cycle from 1997-2000 earlier and rather more openly – at least because we have had to do it explicitly over a three year period – than many others in the industry.

However, three-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 three-year accounts for 1999. The result was – largely as a result of the tragedy of 11 September – a loss of £3.1 billion[ix]. But put in the context 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.

It is worth noting that annual accounting has other consequences beyond transparency, for instance the ability to recognise current and historic underwriting returns sooner than under three-year accounting. This leads to wider issues about our capital structure and an important point needs to be made: the reforms voted through in September were designed to improve the outlook for all capital providers to the Lloyd's market.

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 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. 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.

Outside observers are quick to say that the industry has been slow to embrace technology. I am not so sure about this verdict. The industry as callow adolescent has been ineffective rather than simply slow in its attempts to embrace.

And in reality, 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 that is critical.

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. We are working actively with a number of major broking houses, underwriters and industry systems providers to progress this initiative. 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.

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 and 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 January 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. In my view, 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. The LMP slip is an important step, one which we have to achieve. Then the debate can and must move on to examine other aspects of the business process, for instance the use of claims repositories. 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.

So, Lloyd's is engaged in a process of meaningful and challenging reform, learning from the past and looking to the future. We are doing so to ensure our competitiveness, to respond to the needs of policyholders. A financially strong and profitable market will continue to deliver the security that policyholders require. A transparent market will enhance confidence and understanding. And only a modern market can deliver the cost and service levels which policyholders will increasingly demand from the whole industry.

We are engaged in reform at a time when trading conditions are extremely strong. We are doing so at a time when the market has shown remarkable resilience and has met the terrible challenge of 11 September. We have shown the ability to be self-critical and to initiate change. We must now implement change thoroughly and relentlessly. The combination of real reform and the enduring commercial strength of the market is a powerful one. The prize for success is continuing policyholder loyalty and a brand name for the next 300 years.

ENDS

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[i] FTSE, Xchanging Ins-Sure Services, Dow Jones, Fortune Global 500
[ii] Lloyd's Market Reporting and Analysis
[iii] Lloyd's Market Reporting and Analysis
[iv] Lloyd's Market Reporting and Analysis
[v] Lloyd's Members Services Unit
[vi] Lloyd's Market Reporting and Analysis
[vii] Lloyd's Office for September 11
[viii] Lloyd's Market Reporting and Analysis
[ix] Lloyd's Global Report and Accounts 2001