

**Speech to ILLCA
Saxon Riley
Milan
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Introduction

Good morning. I would like to reiterate the welcome that my colleague Enrico has already extended to you.

We are delighted to see so many of you here today and the attendance only serves to emphasise the strength of the relationship between our two markets.

From the outset, I would also like to extend Lloyd's thanks to the other speakers for agreeing to share their expertise today, and in particular to Stuart Shipperlee of AM Best for agreeing to share his thoughts from a rating agency perspective. But first, it falls to me to give the view from London. Much of significance has happened to affect the insurance markets in Europe and worldwide since this time last year. There has also been, and will continue to be, a great deal going on at Lloyd's that I am sure you would like to know about, and I hope to cover some of the main developments this morning.

Just over a year ago, my colleague James Sutherland addressed this same conference less than a week after the tragic events of September 11th. He said, and I quote, "Lloyd's can

manage the financial impact of the US attacks.” Despite the fact that September 11th became the costliest tragedy ever, not just for Lloyd’s, but for the entire global insurance industry, that statement remains true one year on. So, that is where I will start this morning. Next, I will look in more detail at the shape of Lloyd’s in 2002, and discuss what we have been doing to adapt to the current market conditions and to plan for the future.

September 11th: impact on Lloyd’s

The events of September 11th 2001 affected all of us at Lloyd’s in a profound and personal way – whether as insurance industry professionals or personally as citizens. They have forced all of us to re-evaluate our priorities in both our personal and professional lives.

Firstly, some figures. Lloyd’s faced wide exposure, not only to aircraft hull but also extensive business interruption and property damage. We have a substantial involvement with American Airlines, United Airlines and the World Trade Centre complex. Lloyd’s share of the loss, at US\$3 billion net, is greater than that of even the largest US domestic insurance company.

Again, as so often before in our history, speculation mounted. On the back of unacceptably poor financial performance during the soft market, there was controversy as to whether Lloyd’s could weather the storm.

The answer is a firm yes.

Lloyd's has already effectively pre-paid the loss. We moved over US\$5 billion to the US trust funds within six months of the tragedy to meet American regulatory requirements. No other insurer has done this. Indeed, one might question whether any other insurer would be capable of doing so.

Since Lloyd's initial estimates, our net and gross estimates have not materially altered, and at this point, Lloyd's has paid the equivalent of almost \$1.45 billion in September 11th-related claims¹.

Analysis of Lloyd's reinsurance arrangements also shows positive indications. Lloyd's has to make more than 259 reinsurance recoveries - approximately 35% of these are due from the five largest insurance groups in the world and 92% of Lloyd's reinsurance for the September 11th events is held with carriers rated A and above.

I think it's important to put Lloyd's figures into context. Despite the large losses related to September 11th and our unacceptable financial performance during the soft market, our overall 2001 results are highly comparable with those of our peers. Our 2001 combined ratio of 140% sits comfortably with 143% for the US reinsurance market and 129% for the European reinsurance industry.

¹ XChanging Report 17 Sep 2002

Following our assessment of the financial impact, we took rapid action to strengthen Lloyd's central assets. In particular, we will raise Lloyd's central cash assets in the Central Fund - the mutualised fund that provides a cushion of security for the market should all its other assets be exhausted - to \$1 billion by December 2003.

So where does all of that leave Lloyd's in 2002? I believe that current conditions put us in a stronger position than for some considerable time. Let's look at market conditions today and look at some of the key health indicators for Lloyd's.

Since September 11, we have seen dramatic change within the global insurance markets. Firstly and perhaps most obviously, we have seen significant price increases. These have varied from business to business but we are looking at something like 40% on average. This slide gives the view of Lloyd's underwriters when we surveyed them after this year's January renewals.

Under normal circumstances, it would have taken around two years for rates to reach this point in the insurance cycle. However, in the main, these are very necessary changes in order to preserve a healthy, robust industry able to meet its future obligations.

Of course, pricing is only one part of the equation. The tightening of terms and conditions is at least as important in the re-evaluation of underwriting. One obvious outcome is the application of terrorism exclusions to commercial risks, where it is now difficult to quantify exposure and where it would be irresponsible to give blanket coverage in these circumstances.

In short, it all means a return to the basics, a more disciplined approach to rating and greater attention at individual risk level. And, unsurprisingly, it comes in tandem with tighter scrutiny of the financials by the boards of our capital providers. In view of the losses of the recent past, this more scientific approach is very welcome. However, it does make for a different decision-making process than we might have become used to in the soft market.

This new approach to risk has also brought opportunities. We have seen a return to the concept of payback for improvements to risk management practice. In the soft cycle, it was virtually impossible to discount an already low rate. Now, as insurers and clients work together, there is an opportunity to encourage and reward best practice risk management techniques. So, intermediaries can now sell risk management advice to clients. And, as risks which do not aggregate or correlate are currently most attractive to the market, it is increasingly important to examine ways of creating risk separation and looking at risk in different ways.

Lloyd's global position

In terms of premium volume, Lloyd's ranks as the 2nd largest insurer and 7th largest reinsurer in the world². 93% of Dow Jones Industrial Average companies and 91% of FTSE100 companies have policies at Lloyd's³. The fact that so many of the world's largest and high profile corporations insure at Lloyd's is a testament to their confidence in both our wide range of insurance products and financial strength. Our global spread remains second to none, and we maintain licences in over 60 territories worldwide.

² Source: S&P

³ Source: Fortune 500/ FTSE100/ Dow Jones

And right now, we are experiencing some of the best underwriting conditions in recent memory. We predict a strong return to profit for 2002, in the absence of any exceptional losses. Our underwriters expect rate increases to continue during the rest of the year, especially for marine and reinsurance risks. In the non-marine sector too, rates are expected to rise further, especially in those lines affected by September 11th or where there have been market withdrawals.

Against this background, we are experiencing considerable growth in our business volumes. For the last quarter of 2001 and first quarter of 2002, Lloyd's premium volume was up 62% on a year before.

However, we need to be realistic and acknowledge that there will be greater appetite for certain types of risk and lines of business than others in these harder market conditions. The impact of September 11th has been highest in the US, where there have been massive withdrawals within the domestic market, so rate increases elsewhere are correspondingly smaller, potentially making US risks more attractive to underwrite. That is a gross generalisation of course and despite what I have said, our profile in Europe continues to grow. Last year, our income from the EU rose to 2.3 billion euros. And of this, 320 million is Italian business, making Italy our seventh most important overseas market⁴.

Syndicate trends

⁴ Italian and European premium figures from Lloyd's Italian office

Lloyd's continues to operate as a varied and vibrant market place. There are now 88 syndicates managed by 49 separate companies, known as managing agents. Since the late 1990s we have seen both a fall in the number of syndicates as they consolidate, and a strong trend towards corporate capital, often dedicated capital where a corporate investor's capacity is aligned to a particular business or syndicate – we call this the integrated Lloyd's vehicle or ILV. We expect these trends to continue.

Distribution

As a broker, I'm delighted that Lloyd's has always been a broker market and - importantly - intermediaries remain the key to our distribution strategy. Since January last year, those broker firms located outside London which meet our strict standards can apply to become accredited to deal directly with Lloyd's underwriters, just like London-based firms. So, we now have 149 firms of Lloyd's brokers in London and worldwide, of which 32 have been accredited under the new arrangements since last year. Many of the newly accredited brokers are located outside the UK. Two, Mondialbrokers and WBA are actually based here in Italy and we are seeing continued interest from European brokers and expect that this number will grow.

Of course, many underwriters also continue to work with coverholders worldwide, across a wide range of programmes, under binding authority arrangements. Over the last few years, we have tended to see a reduction in the numbers of these arrangements as underwriters are forced to make difficult decisions about how to utilise capacity and guarantee profit in the changing market conditions. This applies to Europe as much as elsewhere. However, where such arrangements prove profitable for capital providers, and where they continue to be

efficient in servicing local clients' needs, many of these long-standing and successful relationships continue to be nurtured, and there are xx of them in Italy.

Capital flow

Recent activity with regard to flow of capital into Lloyd's also backs up the view of a healthy market. Whilst premium volumes make a good short-term indicator for performance, in many ways, measuring the change in capacity provides a good gauge of our investment community's confidence in Lloyd's future in the longer term.

Firstly, Lloyd's has expanded by 20% over the last two years. That means that, at the start of 2002, the market was larger than ever, with a capacity of over \$18 billion⁵, and international investors such as Berkshire Hathaway, Liberty Mutual and Munich Re all increasing their commitment to Lloyd's for the current year. We also saw AIG injecting capital into Lloyd's for the first time.

But when we announced our capacity for 2002 last December, we also predicted that we would see further significant announcements from major investors as the year progressed. That's a prediction which has proven right.

At Lloyd's, a request to increase capacity is called a pre-emption. Since the start of this year, pre-emptions to the value of \$450 million have been authorised, pushing up our capacity to \$18.5 billion.

Further pre-emptions for this year are already in the pipeline. In some respects, an unapproved pre-emption at Lloyd's is rather like a wish-list. I want to tell you about this not to give you definite figures, but to give you an idea of just how many people wish to increase their underwriting at Lloyd's. If approved, the new pre-emptions will bring capacity up to almost \$19.4 billion by the end of 2002.

Whereas other insurers may feel compelled to raise capital through rights issues of new shares, businesses at Lloyd's may have greater flexibility and are employing a variety of means. This includes qualifying quota share reinsurance arrangements, private equity, and injection of additional capital by trade investors. Given the current uncertainty in the stock markets, this choice of different routes can only be beneficial. In addition, as a substantial element of Lloyd's assets is held in liquid form, Lloyd's may be less impacted by a downturn in share prices than some other insurers.

Market businesses are also now in the process of applying to increase their capacities for 2003. Again, this is a wish list – but it's a wish list that is getting bigger every year. Initial indications based on these requests suggest Lloyd's could achieve a capacity of \$20-21 billion next year. Now that prediction comes with a significant health warning. Firstly, the requests may not be approved by Lloyd's as the market's supervisor. And second, it is not our intention to allow the market to be flooded with so much capital that a soft market is created. Indeed, we are very wary of that. However, these figures I've just given you provide an indication of the appetite for investment in Lloyd's that is building up.

⁵ Lloyd's Global Results 2001

Reform of Lloyd's

But despite the good news stories of our first 314 years of existence, Lloyd's is not complacent. Over the past 18 months, I have been leading a team which has spent a great amount of time developing a set of proposals designed to transform Lloyd's into a modern, transparent and profitable marketplace.

I want to spend the last part of my presentation this morning focusing on these proposals, which are radical, but sensible. Everyone involved in this market, from investors to policyholders, wants to do business in a competitive and disciplined environment. No one wants a repeat of the substantial losses we have had in recent years. Standing still has never been an option.

At the heart of these changes is the creation of a franchise, a new partnership between the businesses in the market and Lloyd's, which runs the market. The franchise proposals seek to improve market profitability. In the past, a minority of poor performers have run up damaging losses, and we all paid a heavy price. The proposals allow us as the future franchisor to monitor and guide the franchisees – the businesses in the market.

We are, by instinct, facilitators, and will help underperforming businesses to change. Where there is no change, and where business failure threatens the market's security and profitability, our responsibility must be to intervene decisively. In extreme cases, we will have powers ultimately to eject those failing businesses. The overwhelming majority of market businesses want us to take on that role.

Lloyd's regulatory activity with regard to poor performance has already been stepped up. Pre-emptive action is being taken to identify the poor performers – the bottom quartile of syndicates is constantly monitored and gross incurred losses are now monitored across all years to identify problems early. Only 4 underwriters from the bottom quartile of syndicates in 1998/9 remain active in 2002⁶.

Equally important are our proposals on annual accounting which seek to improve our transparency, increasing the ability of clients and investors to compare our financial performance with that of our peers.

Thirdly, in a market that accepts greater and more demanding risk than most others, new unlimited liability members are not an option. Lloyd's will admit no new unlimited liability members after this year.

During our consultation process, we've heard a great deal about the structure of the market and the views of our investors – be they private individuals or international insurers. What we've not heard so much about are the views of our policyholders.

As a broker, I know what policyholders – our customers – want. They want the absolute security that comes from knowing that when they make a valid claim, it will be paid – and paid promptly. They want to know their insurer is financially secure and has the resilience to deal with situations like September 11. And increasingly since September 11, policyholders

⁶ Lloyd's Market Analysis department June 2002

want to know that they are dealing with expert underwriters who understand their businesses and the risks they face.

The changes we are about to implement at Lloyd's are changes which I believe will be welcomed by our customers.

These reforms will bring a transparency to our business that it has lacked previously. This may have added to the mystique of Lloyd's, but businesses today need to offer a great deal more than simply mystique.

Efficiency – another factor we have on occasion been guilty of lacking. From the policyholder's perspective, efficiency means speedy processing of policies, rapid payment of claims. Our proposals, combined with the modernisation now taking place across the entire London insurance market, will ensure much greater efficiency.

And profitability – should that matter to a policyholder? Yes, absolutely. Profitability means an insurer with secure reserves, an insurer with a strong balance sheet and the ability to take risks.

The proposals for reform were voted through by our membership just two weeks ago. The vote results demonstrated a market overwhelmingly in favour of change.

With almost 80% backing for these reforms, we got a decisive mandate to implement the proposals. We must now follow that mandate. And so the first stage of our work has

concluded. The second stage – implementation – is already underway, and at the heart of it are three key new individuals I would like to tell you about.

First, we have just appointed an implementation director, whose role it is to ensure that we start putting the reforms into practice and push the process of change forward.

Second, we are currently in the process of recruiting a *Franchise Performance Director*. Reporting to the new Franchise Board, this individual will lead the drive to raise business standards and spot business problems before they damage the market.

Third, Lord Peter Levene will assume the Chairmanship of Lloyd's when I retire at the end of the year. It is the first time in its history that Lloyd's has appointed an external Chairman, and the significance of that fact should not be underestimated as an indicator that we are striving to become a more open, commercially-driven marketplace. Peter has had a distinguished career in both the public and private sectors in the UK. He has also served on a number of occasions as Special Advisor to the Government. I believe that he has much to contribute to the Lloyd's of tomorrow.

I believe that a reformed Lloyd's will be a truly customer-focused Lloyd's. With the creation of the Lloyd's franchise, the great dramas associated with Lloyd's financial performance in recent years – both the highs and the lows – will be much better managed. That can only mean fewer issues in the market itself, and therefore more resources to be focused on product development, claims management and overall customer care. In addition, policyholders need

to be confident in their insurer and we know from the past that a Lloyd's torn by internal tensions will not inspire confidence.

In closing, I believe we have all emerged robustly from a very difficult year – and that firmly includes Lloyd's.

- The marketplace for risk has changed radically since September 11th in terms of pricing and terms and conditions. A more disciplined approach to underwriting has emerged.
- As an industry, we have emerged robustly from the tragedy and that firmly includes Lloyd's.
- Our 1,300 underwriters and 88 separate businesses continue to display unrivalled diversity and expertise. We remain committed to the Italian market and continue both to lead many Italian risk programmes and to protect Italian insurance companies' portfolios through reinsurance coverage.
- Current conditions mean that we fully expect a strong return to profitability for 2002. and in current market conditions are taking a new approach to risk appetite, capacity available, and the need to structure programmes.
- We remain a broker market, continuing to work closely in partnership with thousands of European intermediaries, and have begun to accredit those Italian firms as Lloyd's

brokers who meet our high standards and who wish to have direct access to our underwriters.

- Strong investor confidence and further capacity increases mean we will continue to be well-placed to handle large risks, and we are forecasting a record capacity of over \$20 billion for 2003.
- And lastly, we look forward to the implementation of a radical new set of proposals intended to make Lloyd's a modern, transparent and profitable leader in the 21st century insurance market.

If one thing is clear, it is that in today's insurance environment we must be ready and willing to respond and change. I would like to leave you with two thoughts about change, thoughts from two very different men. Mahatma Gandhi had wise words about many things; about change he said we must become the change we want to see. This resonates for me, in the context of insurance, and in particular the context of Lloyd's. For if the insurance industry wants change, we must first change ourselves and our own businesses.

On a lighter, but hopefully equally resonant note, Lewis Grizzard, the writer and wit, once wrote that life is like a dog sled team. If you aren't the lead dog, the scenery never changes. He's dead right! Being a leader of change isn't always easy, it is never cheap, and it is often unsuccessful. But for those of us who see change everywhere, in our markets, in our business environment, in our shareholders' demands, across the spectrum – we can lead, or simply react. For those that just react, the scenery truly never changes. But for those that lead, take

the brave steps, make managing change a core competence, and steel themselves for fundamental changes of self-image, exciting, bold new landscapes lie ahead.

Thank you for listening,