

## **Speech to the NAIC**

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### **“Lloyds--Challenges and Opportunities in Today's Environment”**

#### **Introduction**

Those of us in the risk business are naturally wary of appearing complacent. However, I am pleased to report that there is a genuine mood of confidence at Lloyd's at the moment. The market is once again profitable. We are driving through a series of changes to make sure that profitability can be sustained. And we are aggressively marketing the strengths of our business in key global markets.

But let me not pretend for one moment that we have not travelled a hard road over the past decade, to get to where we are now.

Had I been standing here, addressing you ten years ago, I think I could have been excused for suffering from depression and severe headaches.

Between 1988 and 1992, Lloyd's of London had made a loss of over \$12 billion<sup>1</sup>.

Newspaper headlines screamed about the “nightmare” at Lloyd's. The management's attention was devoted to survival rather than progress.

But ten years on, Lloyd's has achieved a remarkable transformation. We are in excellent shape. And in profit. We have emerged stronger, through undergoing a process of constant re-evaluation, learning and self-improvement.

Today, I would like to explain the progress that Lloyd's made during the 1990's, the reforms we have been implementing and are still making, and what this means for us here in the United States, which is such a critical market for us.

#### **The Problems of the early 1990s**

But before I do so, a brief bit of background.

Lloyd's, as many of you will know, is not a company. It is a marketplace, where people insure and reinsure pretty much anything – from satellites to oil rigs. Today, Lloyd's operates in over 100 markets around the world, 90 per cent of the Dow Jones companies have policies at Lloyd's – as do 96 per cent of the FTSE 100, the world's top ten banks, the world's top 10 pharmaceutical companies and the world's top 5 petroleum companies all insure through Lloyds<sup>2</sup>. In the US, we venture where few other insurers dare, insuring risks and businesses that are vital to the US economy. Doctors at risk from being sued for negligence. Airplanes. Satellites. Ocean Liners. Power Plants. Oil Rigs. Construction projects that are, by their very nature, highly dangerous. And, since 9/11, we have been

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<sup>1</sup> Loss after personal expenses before tax: £8,133m. page 17 Standard and Poor's Rating of the Lloyd's Market, October 1997

<sup>2</sup> FTSE 100, Dow Jones I.A., Fortune Global 500 and Lloyd's statistics Nov. 2002

providing greater security for your industry, covering US transport, oil and aviation business against the risk of terrorism attacks as they trade around the globe. We are, if you like, pouring oil into the engine of America's economy, to help ensure that it continues to roar.

We also play a significant role in supporting the US insurance industry itself. Lloyd's writes about \$3 billion of reinsurance premium per annum<sup>3</sup>. As a result of our market's traditional reinsurance support for the U.S. industry, we now provide \$7.9 billion<sup>4</sup> of balance sheet credit to US insurers.

It has taken centuries for Lloyd's to achieve this. In the three hundred plus years that Lloyd's has operated, our business has built a reputation based on innovation, creativity and expertise. Above all, it has been rooted in Lloyd's track record in paying claims: What other institution can claim to have supported the American economy to such an extent throughout its good and bad times.

So what about the recent history? A decade or so ago, all of Lloyd's capital was provided by what we call "Names", most of whom were wealthy private individuals. These individuals could face unlimited liability for paying claims.

During the late 1970s and 1980s, there had been relatively few major catastrophes in the world, which made being a Name appear a relatively safe and easy way of making a good return on capital. But then, in the late 1980s, things went wrong – a series of unprecedented catastrophes struck across the globe – many of them insured at Lloyd's.

In London, if you find yourself waiting for a bus for a long time, a common observation is "just you wait. No buses for an hour. Then four buses all come along together". In the late 1980s and early 1990s, Lloyd's suffered from something similar.

After years of there being very few sizeable catastrophes, there was suddenly a string of them. The UK was hit by a major storm. The Piper Alpha oil rig blew up in the North Sea. The Exxon Valdez ran aground in Prince William Sound. Hurricane Hugo hit the States, followed by major storms in Europe, Typhoon Mirielle in Japan and then Hurricane Andrew here<sup>5</sup>. The insured loss for these events totalled almost \$38 billion<sup>6</sup>.

These catastrophes came as the costs began to escalate for asbestos and pollution losses arising under policies stretching back decades. The uncertainties of these losses, and the legal disputes surrounding them, meant that syndicates could not close their accounts and offer members "finality" or a final reckoning of their liabilities. Petrol was poured on the flames by certain Lloyd's syndicates providing retrospective reinsurance, with very large limits, to insurance companies for losses of this type.

Worse still, reinsurers at Lloyd's had become increasingly distanced from the original risk, thanks to the degree of inter-syndicate excess of loss retrocession, which was created by the soft market conditions at that time.

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<sup>3</sup> Insure report LEG 720, 2002 gross premiums.

<sup>4</sup> Market Reporting, Q2 2003 - US CRTF reporting packs.

<sup>5</sup> Page 17 Standard and Poor's Rating of the Lloyd's Market, October 1997

<sup>6</sup> Best's Special Report, Initial Best's Rating of Lloyd's October 1997, Section 6, page 1.

Sadly, many of our 30,000 plus members faced severe losses. The extent of their liabilities was unclear. An avalanche of legal disputes threatened to clog up the entire English legal system. Lloyd's was facing the abyss.

## **Reconstruction and Renewal**

But, we did not plunge headlong into the darkness. We adopted a strategy which did not just rebuild Lloyd's, but put it on a more stable footing. Internally, we called this R and R, which an American audience might think denotes a relaxed, laid-back, typically British attitude to a crisis, but actually stands for Reconstruction and Renewal and was the most rigorous turnaround of a business achieved during the 1990s

R and R, which began in 1994, had to cope with the complexity of our marketplace. There are run-off companies, advisers, service companies, members' agents, managing agents, corporate members, syndicates, brokers, approved correspondents and underwriting members. Overall, there are about 20,000<sup>7</sup> entities that are part of the market.

Juggling with this complexity, we addressed the clear needs of the moment. That began by assessing our liabilities. We completed the most extensive actuarial exercise that Lloyd's and probably any insurer had ever undertaken. In fact, most of the world's leading actuarial firms were heavily engaged in this effort. This meant that we had to confront the full extent of the market's issues, including asbestos and pollution, in a detail which frankly many others have yet to do.

This exercise helped us to create Equitas. Equitas is a separately capitalised reinsurance vehicle, which was created to reinsure the liabilities of the market incurred up to and including 1992. Since its creation, and despite reserve strengthening that caused a modest decrease in solvency margin over the last year, Equitas has, nevertheless, increased its solvency margin from 5.6% in 1996 to 8.7% in 2003<sup>8</sup>.

R&R enabled us to reach agreement with those Names who wanted to achieve finality to the extent of their liabilities. Almost 95 per cent<sup>9</sup> of our 30,000 plus members agreed to accept this and move on. The majority of others have accepted since then.

During this time, other changes were introduced. Corporate capital was introduced in 1994 and has steadily increased ever since. It now accounts for 87%<sup>10</sup> of the market. It has a geographical diverse base with 32%<sup>11</sup> being provided by US and Bermudian companies. Respected names like AIG, Berkshire Hathaway, St Paul, Liberty Mutual, Munich Re, General Re to name a few<sup>12</sup>.

That's good news. No one wants to be heavily reliant on one source of capital. Furthermore, capital markets and professional management exact strong commercial discipline on our marketplace.

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<sup>7</sup> Lloyd's Regulatory Report for 1996 and Regulatory Plan 1997

<sup>8</sup> Equitas Press Release EQ 39, 11 June 2003

<sup>9</sup> Lloyd's Annual Report 1996, page 2.

<sup>10</sup> 2003 Lloyd's MSU Capacity and Membership Statistics 1996 - 2003

<sup>11</sup> Syndicate Business Plans – 2003 Year of Account

<sup>12</sup> 2003 Lloyd's MSU Capacity and Membership Statistics 1996 - 2003

But these changes, and the problems which provoked them, required a new, more rigorous regulatory approach. At the time, responsibility for that lay at the door of Lloyd's itself. We carried responsibility for regulating the market, and it was up to us to ensure that the crisis of the early 1990s would not happen again.

Within a couple of years, we had embarked upon a programme of strengthening the regulatory framework at Lloyd's. Throughout the mid to late 1990's, we introduced a number of measures, of which I would like to highlight the most significant.

The most significant change began in 1995 with our development of the Risk Based Capital system. This aimed to calculate the appropriate level of funds held by each underwriting member [not syndicate] at Lloyd's by calculating a Lloyd's market average assessment of risk. This is done by analysing a number of factors including the business by reference to the risk codes underwritten by that member's syndicates on which the member participates and the historical experience of those risk codes. In short it attempts to capitalise both underwriting risk and reserving risk. Since it began, other factors have been added to it – such as underwriters' experience and qualifications, reinsurance gearing, and reliance on 100% – rather than shared – lines of business. We have also used R.B.C. analysis at member level to indirectly increase capital support requirements for syndicates whose operations are believed to entail a higher level of risk for the market as a whole.

Next, a set of core principles of behaviour for under-writing agents was introduced, followed by more thorough registration requirements for all those working in the Lloyd's marketplace. By 1997, over 4,300<sup>13</sup> individuals had been registered. Over time we have used this registration process to review the performance of active underwriters. In 2001 alone we reviewed 51<sup>14</sup> underwriters, whom we believed to be underperforming. The vigour of our review is demonstrated by the fact that, of the 51 underwriters targeted in 2001, only 4<sup>15</sup> remained as active underwriters. These new procedures have had their desired affect, as the number of underwriters who have had to be targeted for review has decreased steadily.

Third, regulators began a programme of on-site reviews of all underwriting agents, and numerous syndicates and other businesses, to examine their controls and operating procedures. In 2001 and 2002, we conducted over 60<sup>16</sup> operational reviews of managing agents.

Fourth, we improved the degree of supervision over syndicates' loss reserves, by insisting upon independent actuarial sign-off on annual solvency reserves from 1997. This includes separate actuarial sign-off on syndicates' gross reserves on all US trust funds.

Fifth, we introduced a new solvency regime and rules in 1997, before moving to a continuous solvency monitoring process in 2001.

Sixth, we built up the Society's central resources, including the Central Fund, which more than doubled between 1996 and 2002<sup>17</sup>.

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<sup>13</sup> Lloyd's Regulatory Plan for 1998 and Regulatory Report for 1997.

<sup>14</sup> Market Supervision at Lloyd's. Key Facts 2000-2001 and Priorities for 2002.

<sup>15</sup> Market Supervision at Lloyd's. Key Facts 2000-2001 and Priorities for 2002.

<sup>16</sup> Market Supervision at Lloyd's. Key Facts 2000-2001 and Priorities for 2002

<sup>17</sup> Standard & Poors Rating of the Lloyd's Market – September 2002

Seventh, and finally, we improved the disaster planning process and assessment of market aggregate risk by requiring syndicates to undertake Realistic Disaster Scenarios, in which businesses calculate the financial impact of major catastrophes.

We have your organisation, NAIC, to thank for keeping a watchful eye on the progress of these reforms. You conducted on site reviews of the Lloyd's market in 1994, 1998 and 1999. By 1999, you reported that "the Chain of Security"- especially the Risk Based Capital and the Solvency Models – had been strengthened. Furthermore, NAIC observed that "the oversight and monitoring conducted by Regulatory compares favourably to regulatory efforts in the United States". In your eyes, we were in a "much-improved" position to detect and mitigate potential losses".<sup>18</sup>

Finally, running parallel to these reforms, was a fundamental change to the way in which Lloyd's was regulated. At the end of the 1990s, the UK Government supported our wish to end self-regulation, and make the regulation of Lloyd's the responsibility of the new Financial Services Authority, or FSA.

This change was finally achieved in December 2001. At that point, the FSA assumed full regulatory responsibilities for the oversight of Lloyds. Significant effort between 1999 and 2001 was devoted to establishing the practicalities of the ongoing relationship and ensuring compliance with the FSA's requirements. It is gratifying to note that the FSA has chosen to demonstrate its confidence in Lloyd's supervisory capabilities by delegating a significant portion of the required monitoring work to Lloyd's.

The FSA's statutory objectives include maintaining market confidence, promotion of the public understanding of the financial system, and providing appropriate protection of consumers. We see the activities we undertake as market supervisors as complementing the FSA's regulatory objectives. Together, we have changed and continue to change the supervision of Lloyd's. For example, from January 1<sup>st</sup> 2004 we will be required to comply with the Solvency 1 Directive as implemented by FSA rules. And from 2005, the FSA will be introducing new enhanced capital requirements and individual capital assessments for Lloyd's and for the rest of the industry.

So, by becoming our regulator, the FSA has brought added scrutiny to the Lloyd's marketplace. It has stitched our regulation into the overall regulation of financial services in the UK. All this has been good news for our businesses, and our clients who trust their insurance programs to Lloyd's.

By 2001, therefore, the way Lloyd's operated and was regulated was undergoing major change. Many of these reforms had begun to bite. We were facing the most significant change to our regulation for generations. We could have sat back and thought "enough is enough". But we didn't. Why?

One reason and perhaps the main- reason for us continuing our programme of evolution was that the global insurance market was suffering from one of the worst periods of under pricing in its history. And like many other insurers, as it now turns out, Lloyd's did perform unacceptably badly in the late 1990s. This was mainly thanks to the tail of underperformance of a few of our businesses. They dragged down the others, both in terms of our reputation

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<sup>18</sup> NAIC 1999 Review, page 448.

and the cost to our financial structure. Their exposure meant the contributions to the Central Fund – which is the backstop to cover policies at Lloyd’s – had to increase. This hit everyone, good and bad performers alike. In 1999, at a time when the US industry lost a staggering \$24 billion<sup>19</sup> in underwriting, quite interestingly, some Lloyd’s business made an adequate underwriting return. In fact the top quartile returned a underwriting profit of 1%<sup>20</sup> but the bottom quartile lost an equally staggering 60%<sup>21</sup>.

It was clear to us that such divergence of performance is not acceptable or sustainable. So more change was needed. We embarked upon another bout of re-evaluation under the leadership of our late Chairman, Sax Riley and CEO, Nick Prettejohn. These reforms were agreed by our membership in September 2002.

## **Recent Reforms**

The more recent programme of reforms has three prongs. First, the introduction of the concept of the franchise, and its supervision. Second, changes to the capital at Lloyd’s. Third, improved transparency, especially the introduction of annual accounting. Let me spell out what each of these prongs – this trident of advancement – will mean.

I’ll start with the most important of the changes: the concept of the franchise. This is rooted in the simple truth that businesses at Lloyd’s share collective assets – the brand and reputation of the market, and the membership of this marketplace. Those assets need protection and safeguarding. Businesses therefore need to show that they have met required safeguards and will contribute to the overall success of the Franchise.

Consequently, Lloyd’s is now the franchisor of the businesses – or as they are known franchisees – who operate in our marketplace. We now set and enforce underwriting standards across the whole market to complement the work we have already undertaken in enforcing capital requirements and operational control standards. This added role clearly goes beyond the traditional role of a regulator.

To make this become a reality, we have done two specific things. We have created a Franchise Performance Directorate, and we have improved the Risk Management Framework. Both merit some detail.

The task of the Franchise Performance Directorate is to coach, nurture, and supervise the performance of businesses in the market.

It has published a set of guidelines which it expects franchisees – businesses – to satisfy. These guidelines set best practice parameters for Lloyd’s businesses and have been developed after reviewing the reasons for past failures or poor historical performance. These include guidelines about line size, use of reinsurance and catastrophic risk exposure.

Also, it has developed the business planning process for syndicates and it monitors the performance of each franchisee against its business plan. These quarterly reviews of each business’s plan check how the business is actually performing. In particular, the Directorate

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<sup>19</sup> Annualized estimate based on first 9 months of 2002 data. Source: A. M. Best, Insurance Information Institute at Jan. 2003

<sup>20</sup> Global Results 2001, page 8

<sup>21</sup> Market and Analysis Dept.(DM/BMT Oct. 2003)

analyses underwriting risk, reserving risk, gross line size, catastrophic risk, reinsurance leverage and security, capacity and growth.

Those business plans inject a degree of supervision into the plans of each syndicate before the start of the underwriting year. Underpinning our thinking are three core principles. First, good businesses do not endlessly try to increase market share. Second, good businesses do not rely on reinsurance when the market is tough, but they always try to make a gross underwriting profit. Third, good businesses are cautious – they do not expose their capital with a large exposure to a specific catastrophe risk, or excessive line size<sup>22</sup>

This body aims to set a target level of expected profitability for the market over the insurance cycle.

If a franchisee under-performs, Lloyd's may review its operations in depth. It may have limits placed on its ability to underwrite particular lines of business. It may be required to purchase additional reinsurance to cover-exposure to a particular risk disaster. And, ultimately, its franchise may be withdrawn. These measures have one simple aim: to erase that tail of underperformance that drags down the rest of the marketplace.

So much for the Franchise Performance Directorate. The second way in which we are bolstering the franchise concept is by continuing our central programme of operational risk reviews. We have also introduced a revised risk management framework for the Franchise and are working closely with agents to enhance their own risk management systems and controls.

Firstly, the backbone of capital setting, the RBC formula continues to be continually refined and reviewed to allow for differences in the operating risk characteristics of individual businesses.

The capital of each separate member is set using the risk based capital model and partly by planning for different scenarios of major disasters or catastrophes. There are seventeen of these realistic disaster scenarios. For example, USA windstorm, a major marine event, a loss of major complex in the North Sea, an aviation collision, a major risk loss, the loss of a number of satellites in a space storm or a major terrorist attack.

Added to this, we place great emphasis on ensuring that franchisees comply with a continuous solvency regime. Further we have encouraged and cajoled franchisees to improve their own attention to risk management issues by continuing our central programme of risk reviews.

Why are we putting much time and effort into these new structures? Because analysis of past business failures both inside and outside of Lloyd's show a very clear correlation between these risks and underwriting and managerial performance. In each case, they found that the cause was management or governance.

But the avoidance of failure is just one reason to entice businesses to change. The most powerful commercial driver should be the prospect of greater underwriting profit. For the reality is that, in recent years, our industry has been bad at making a profit from underwriting. For too long, businesses have buttressed their bottom lines with returns on

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<sup>22</sup> Franchise Performance Directorate Guidelines 2002

investment. After the collapse in equities, businesses are now in a new era in which they cannot rely on investments to salvage their performance (although I would add that, unlike others in the industry, underwriters' investments in equities has always been quite limited due in part to Lloyd's conservative rules on permissible investments). They need to improve their underwriting profit. Hence the need for better management.

So what difference is all this making? Well the screws are beginning to tighten on under-performers. As a result of our actions, one business has stopped underwriting and three other businesses have temporarily ceased underwriting until our concerns are rectified<sup>23</sup>. These are not, then, just empty threats. They are backed by action.

So much for the concept of the franchise, the first prong of the new programme of reform. What of the second – changes to the capital at Lloyd's?

As I said, we have already moved away from the over-reliance we had on private capital, to create a market that is more diversified, and less reliant on capital supplied exclusively by individuals.

Over the last two years, capital has flooded into Lloyd's. The market now has a capacity of £14.4 billion<sup>24</sup> or \$23 billion<sup>24</sup> - an all time high. Over the last two years approximately \$9 billion<sup>25</sup> of new money has flowed into Lloyd's. Since the start of this year, all newcomers to the market have limited liability, and the UK Government has changed the tax regime so that holders of unlimited liability can more easily change to limited liability.

The final and third prong of the new changes has been the move to annual accounting. Historically, Lloyd's has produced its accounts on a 3 year basis. Many aficionados wax lyrical about its technical merits. They say it produces a relentless and relatively accurate focus of underwriting performance. Undoubtedly, it forced us to confront the horrors of the last down cycle with a clarity and openness than many others in the history are just beginning to do.

Our traditional system clearly has many merits. We cannot ignore the fact, however, that it is unique to Lloyd's and is somewhat complex in structure and application. Our desire to be transparent and comparable to other industry participants is clearly disadvantaged by it. Therefore we have committed to implement an annual accounting system to Lloyd's business from 1<sup>st</sup> January 2005. This has been made possible by recent amendments to the EU Directive, which previously contained provisions constraining such a move by Lloyd's. This should bring a number of benefits. For example, a single profit and loss account; presentation of premium income before the deduction of acquisition costs; recognition of premium income on an earned basis apportioned over policy periods; and annually reported adjustments on back years being fed through to the profit and loss account; and finally, much more detailed balance sheet reports including gross and net technical provisions.

Meanwhile, we have introduced in the last couple of years an additional reporting by syndicates on an annual accounting basis. These show how well Lloyd's is performing: last year, our combined ratio of 98.6 %<sup>26</sup> was commendable, and shows how we can outperform

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<sup>23</sup> Risk Management, (SM/BMT Oct 2003).

<sup>24</sup> Lloyd's Members Services Unit. Based on an exchange rate of £1 = \$1.61 as at Dec 31 2002

<sup>25</sup> Finance, Risk Management and Operations

<sup>26</sup> Global Results 2002, page 11.

our peers. The comparable figures for the US P&C Index was 107.2%<sup>27</sup>, US Reinsurers was 121.3%<sup>28</sup> and European Reinsurers 105.1%.<sup>29</sup>

### **September 11<sup>th</sup> – A challenge for the new system**

So in summary that describes the road we have taken over the past decade to improve and strengthen Lloyd's. However, our progress has not deterred some from saying that we face disaster. And those voices were at fever pitch in the days after September 11<sup>th</sup>.

It came as no surprise to us that on September 11<sup>th</sup> we faced the greatest single loss in our three hundred year plus history. Nor was it a surprise that we bore the largest share of the claims. These facts merely reflect the extent and scale of the business we do in the United States.

But it came as surprise to many that we managed not only to survive but to thrive. So far, we have already paid out \$4.2 billion<sup>30</sup> in September 11-related gross claims. And we are still paying out.

Furthermore, the horrific event showed the benefits of planning for realistic disaster scenarios. Within 48 hours, the entire market had completed a detailed questionnaire which meant that, within ten days, we had an excellent estimate of our exposure. Indeed, the gross loss today is within 6 %<sup>31</sup> of the original estimates, which reflects the success of our modelling and the improvements in discipline in our market.

Finally, I would like to highlight the time we were given by NAIC's leadership, the members of the Surplus Lines and Reinsurance Task Forces and leading regulators in a number of individual states. The NAIC and other regulators from around the globe played a truly important role at a particularly challenging time for the global economy. It demonstrated the value of mutual recognition, global dialogue and, above all, the value of careful and thoughtful analysis. We should all feel proud about the way in which the global regulatory community responded in the weeks and months after that great tragedy.

### **Lloyd's: the leading specialist insurance marketplace**

However, although we survived this challenge, I hope that I have demonstrated that at Lloyd's we are not complacent. Yes, we have made progress, but we know that there is always more we can do to achieve our vision.

That vision is very simple.

We will be the leading specialist insurance marketplace. 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.

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<sup>27</sup> Insurance Information Institute 2002

<sup>28</sup> Reinsurance Association of America 2002 figures

<sup>29</sup> CSFB 2002 figures

<sup>30</sup> Source: Xchanging Claims Services report, 5<sup>th</sup> August 2003

<sup>31</sup> Run-off, Reinsurance & Claims (responsible for now responsible for WTC figs ) Oct 2003

This will require continued improvement. If we want to continue to offer insurance in the United States and grow around the world, we cannot stop thinking of ways to manage and supervise our marketplace better, to raise standards and improve performance.

This is a vision that, ten years ago, someone from Lloyd's would consider to be a very distant dream. Today, as I hope I have shown, we are well on the way to making it a reality.

Thank you for listening.