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## A BUSINESS SURVIVAL STORY

by Jerry Theodorou and Stephan Christiansen

PHOTOS: SHUTTERSTOCK

# LLOYD'S

In the latter part of the 20th century, the venerable London-based insurer faced a stark choice: evolve or die. Several decades later, much has changed. But not everything.

THE RETURN OF THE LLOYD'S INSURANCE MARKET from several near-death experiences in the past two decades perfectly illustrates the observation by 19th-century German philosopher Friedrich Nietzsche that whatever doesn't kill you makes you stronger. By almost any measure, Lloyd's has emerged not only alive, but healthier. An examination of the winning elements underlying Lloyd's transformation reveals a deft combination of change and continuity.

The challenges that Lloyd's faced were daunting. First there was financial exposure to U.S. asbestos losses in the 1980s, bringing €15 billion (more than £12.65 billion, or more than \$20 billion) of toxic assets to London's doorstep. Damage from the asbestos liabilities was characterized by Lloyd's chairman, Lord Peter Levene, in a 2009 speech to the Insurance Institute of Dublin as a "near-death experience." A firestorm of litigation from outraged, bankrupted Lloyd's investors followed in the wake of the asbestos losses. The lawsuits clogged British courts for a decade and severely tarnished the Lloyd's reputation. Next came the notorious LMX (London Market Excess) reinsurance spirals, triggered by the 1988 Piper Alpha oil rig explosion in the North Sea. Lloyd's susceptibility to damage from U.S. catastrophe risk was shown again with the Sept. 11 tragedy.

While Lloyd's was confronting challenges from the outside in the form of crippling catastrophe losses, it also was engaging in a protracted process on the inside to transform itself into a modern, relevant source of global specialty insurance expertise and capacity. Three historical weaknesses of the Lloyd's market were the focus of this reform process:

- Dangerously disparate performance levels across syndicates;
- Lack of transparency compounded by idiosyncratic reporting;
- Historical vulnerability to catastrophe losses from an acute concentration of exposure and insufficient diversification.

These weaknesses were addressed by introducing pervasive changes to areas of the market's structure and operation, while at the same time sustaining Lloyd's inherent core strengths. The new elements included tightening business management controls, implementing catastrophe management, and modifying capital structure. At the same time, Lloyd's continues to maintain a preference for underwriting profit over investment returns, to preserve its historical mix of business, and to retain its wide global scope.

### Changing Business Management

The mutualization of the Lloyd's market through a central fund, to which all market participants (syndicates) contribute, means

that strong syndicates occasionally are called upon to shore up the market weakness caused by poorly performing syndicates. The \$5 billion in Lloyd's Sept. 11 losses caused its management to heighten oversight of syndicate business management to minimize the chances of large cash calls at the central fund bringing down the entire market from catastrophes or uncontrolled, unsound underwriting.

The new administrative structure designed to protect Lloyd's from the deleterious effects of underperforming individual syndicates was the Franchise Management Board, set up in 2003. The board introduced the concept that Lloyd's value was in its brand name. Lloyd's was akin to a franchiser, and the individual syndicates operating in the Lloyd's market were akin to franchisees. The franchisees would be required to operate in prescribed prudent ways to protect the Lloyd's brand and reputation. This was somewhat of a departure from the past, when competition among syndicates was rife and coordinating action across syndicates was like herding cats.

Participants in the Lloyd's market today are accountable to Lloyd's through centrally approved annual business plans that prospectively specify the nature and volume of business to be written. Accountability on a lower level is maintained through regular rate measurement and monitoring to flag deviation from prudent rates for the class of business. This monitoring is done for all business in the Lloyd's market—across syndicates

## Exotic Risks at Lloyd's

Lloyd's has underwritten the following risks:

- The smile of America  
Ferrara, star of the TV show "Ugly Betty"



## Lloyds CONTINUED

and across time within individual syndicates. A recent outgrowth of this effort was the November 2010 publication of *Lloyd's Premium Rate Index: A Guide to Historical Premium Rate Movements*, which shows the rate trends in the market for nine classes of business from 1993 to 2009.

The management of the franchise board, renamed the Performance Management Directorate (PMD) in 2010, has the authority to address deviations from approved plans that have the capacity to damage the market. According to the 2002 Chairman's Strategy Group consultation document that led to the formation of the PMD, if a syndicate doesn't improve underperformance, the PMD may "conduct detailed and invasive review of the syndicate; limit underwriting for the rest of the year and the subsequent year on a particular line of business; require the syndicate to purchase additional reinsurance to cover the overexposure," and, ultimately, "remove the franchisee from the franchisor." Because the PMD oversees syndicate underwriting to maximize the profitability of the overall market, it has been dubbed the "underwriter of the Central Fund."

### Changing Catastrophe Management

The events that shook Lloyd's to its foundations several times from the 1960s to 2001 were U.S. catastrophe losses. The worst results for Lloyd's since the 1940s were in 1966 (from the previous year's Hurricane Betsy), 1988 to 1990 (the Piper Alpha explosion and the LMX spiral, Hurricane Hugo, and the Loma Prieta earthquake), and 1998 to 2001 (asbestos-related litigation and Sept. 11).

For most of its more than 300-year history, Lloyd's insured marine risks in which the maximum loss from one event was limited to the value of one ship or its cargo. Events like Hurricane Betsy in 1965, which was termed "the first billion-dollar storm," seemed to catch Lloyd's by surprise. Subsequent catastrophes also saw Lloyd's experiencing worse results than other insurers because its underwriters' tacit maximum



Bruce Springsteen's voice



The beard of Macy's professional Santa Claus, Brady White

foreseeable loss (MFL) calculations didn't adequately contemplate the potential for risk accumulation.

The implementation of the PMD in 2003, and the

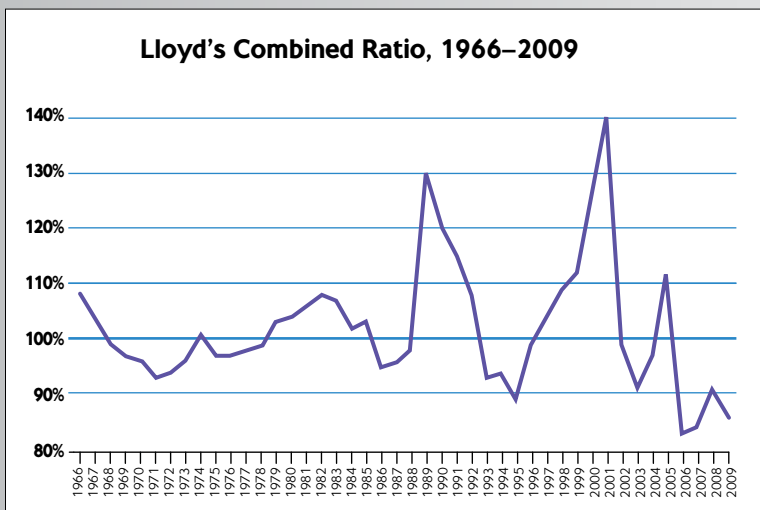
consequent realization of the dangers of Lloyd's overexposure to outsize catastrophe losses, was accompanied by a more concerted focus on catastrophe management. Catastrophe exposure is one of the nine areas for which specified guidelines for franchisees are spelled out in the Chairman's Strategy Group consultation document (see Page 38). The specific guidelines regarding catastrophe management stipulate that:

- Catastrophe exposure should be analyzed using tools or methods that are approved by the franchiser
- Each franchisee should manage to a minimum return period agreed to by the franchiser
- The maximum gross exposure to a single Lloyd's specified realistic disaster scenario (RDS) event for a syndicate is up to 75 percent of syndicate capacity, and the maximum net exposure to a single RDS event is 20 percent of syndicate capacity.

Although disaster scenarios were discussed in Lloyd's bulletins in the 1990s, they lacked the degree of rigor put into place following 2003. Lloyd's results in 2008, the year of hurricanes Ike and Gustav, demonstrate the impact of more effective catastrophe management. In 2008 the combined ratio for the Lloyd's market was 91 percent, compared with 105 percent for the entire U.S. property/casualty insurance industry.

### Changing Capital Structure

Capital and underwriting at Lloyd's historically have been separated. Syndicates underwrote business backed by outside individual capital providers, known as "names." The advent of corporate capital in 1993 coincided with sharp reductions in the participation of individual names, many of whom suffered severe financial reverses as a result of the asbestos-related losses. Corporate



SOURCE: CONNING RESEARCH & CONSULTING ANALYSIS, STATISTICS RELATING TO LLOYD'S



The nose of vintner Ilja Gort



Moviegoers from the risk of death from laughing too much

PHOTOS: SHUTTERSTOCK

capital provides greater continuity of capital for underwriters, and supports the writing of longer-term exposures. It often is accompanied by higher standards of professionalism and accountability.

The majority of Lloyd's capital base today is drawn from corporate entities. The same corporate backers also control the underwriting in syndicates they manage. Thus, the historical division between underwriting and capital has been erased for the most part, and capital is now aligned with underwriting syndicates. Lloyd's historical financial accounting on the basis of an annual venture meant that the capital base was re-created every year. This was the underpinning of Lloyd's vaunted "flexible capital" advantage. Even with the arrival of corporate capital, some level of flexible capital remains at Lloyd's as syndicates are able to increase or decrease prospective underwriting capacity as conditions warrant. Syndicates continue to increase or decrease their capacity annually in accordance with the market.

### Keeping the Investment Strategy

Before the infusion of corporate capital into the Lloyd's market in 1993, individual names invested in Lloyd's for the underwriting risk rather than for the investment risk. Land-rich private individuals would pledge their landholdings as capital to back syndicate underwriting. To the extent such individual investors had cash and sought investment gains, they could participate in the financial markets directly. They were in Lloyd's for the underwriting risk—and their investments were conservative. Lloyd's annual venture system, under which syndicates recapitalized every year, also contributed to investment in conservative, liquid, short-term instruments. Investors could opt to exit syndicates annually when making their decisions as to where to commit capital. When annual GAAP accounting was introduced in 2005 to increase accounting transparency and encourage corporate capital, the annual venture became less of a factor.

Lloyd's assets continue to be invested conservatively today. More conservatively, in fact, than the three components of U.S. insurers' investment returns: policyholder's surplus, unearned premium reserves, and loss reserves. In a direct comparison

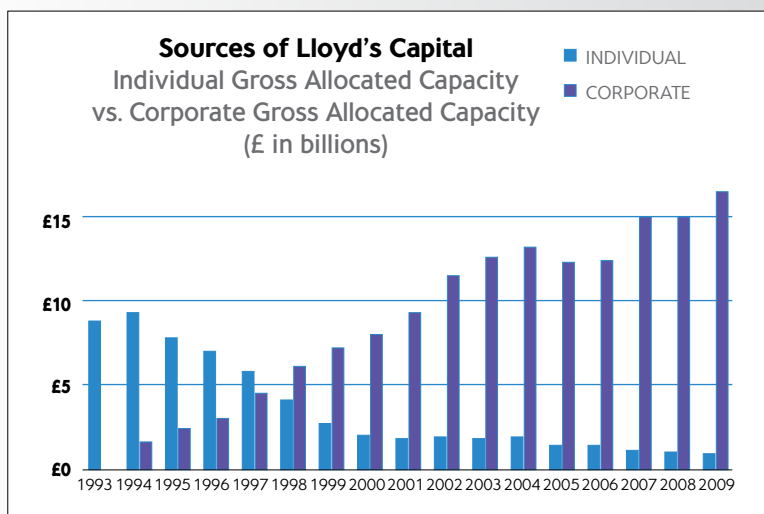
(see chart, below), U.S. property-casualty insurers invest a significantly higher percentage of assets in riskier vehicles, such as equities and alternative investments. Lloyd's invests a correspondingly higher proportion of assets in cash.

Two principal factors contributing to the perpetuation of Lloyd's conservative investment approach are regulation and the nature of the middle wall of Lloyd's three-tiered capital fortress.

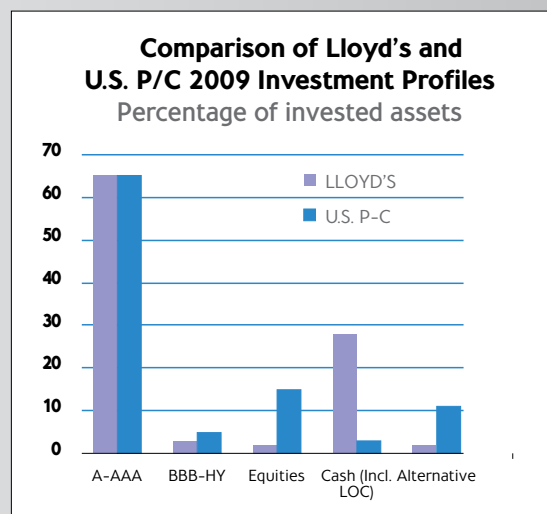
The Financial Services Authority (FSA), which regulates all providers of financial services in the U.K., has been Lloyd's external regulator since the passage of the Financial Services and Markets Act in 2000. The FSA stipulates that Lloyd's investments be of appropriate safety, yield, maturity, and marketability. In practice, investment managers responsible for investing Lloyd's premium trust fund assets operate under guidelines that favor short-duration corporate bonds rated single A or better. The Lloyd's investment guidelines typically are far more conservative than those guiding investments of U.S. insurers.

The second factor contributing to Lloyd's preference for underwriting rather than investment risk is the nature of its Funds at Lloyd's (FAL) investments. FAL are the middle level of security in the Lloyd's market (with the top and most liquid being premium trust funds, and the deepest layer—at which the mutuality of the Lloyd's market exists—being its Central Fund). FAL account for almost a third of Lloyd's £45 billion in invested assets, and consist largely of cash and letters of credit. The ability to use letters of credit to back FAL contributes to the "flexible capital" advantage enjoyed by Lloyd's that attracts so many investors to the market. Just as the landed gentry of old could pledge their landholdings as assets to back syndicate underwriting, corporate investors today can furnish letters of credit to back their FAL. A result, however, of this form of capital, especially in the current environment where the yield on cash investment is virtually nil, is that there is almost no return on this investment.

The restrictions and limitations on Lloyd's investments mean that the responsibility to produce favorable returns rests on underwriters. This has not translated into pressure on other Lloyd's investments to compensate by generating higher returns.



SOURCE: LLOYD'S



SOURCE: LLOYD'S, CONNING RESEARCH & CONSULTING ANALYSIS



The tongue of Costa Coffee's chief taster, Gennaro Pellicia

## Lloyd's CONTINUED

### Keeping the Mix of Business

The “business philosophy” that characterizes Lloyd's is a long-term, cross-cycle approach to the market, one that opportunistically seeks high-margin business in low-frequency/high-severity specialty lines. A substantial component of Lloyd's business mix accordingly consists of reinsurance, energy, and property and casualty lines. These four lines accounted for 82.5 percent of Lloyd's premium in 2009. Lloyd's also has kept true to its historical origins as a marine insurer, writing \$5.3 billion in marine (including energy) gross written premium in 2009, compared to \$3.6 billion written in the entire U.S. reported market for ocean marine (including energy).

Lloyd's has retained its reputation for insuring exotic risks other underwriters would be hard pressed to touch. An example of Lloyd's willingness to insure unusual risks is its coverage of the presidential inauguration ceremony in 1965 for Lyndon Johnson against cancellation for any reason whatsoever (see below). More current exotic risks written by Lloyd's underwriters include the smile of America Ferrara, star of the now-canceled TV show “Ugly Betty,” and the raspy voice of singer Bruce Springsteen.

Writing such a business mix requires adroit underwriters who are experienced enough to recognize opportunities in a hard market or post-loss environment. At the same time, they must possess sufficient business skills and discipline to walk away from underpriced business, or be resolute in their walkaway price. The focus within the Lloyd's market on training and development of underwriters supports using such a business strategy.

### Keeping the Global Scope

The damage to Lloyd's from the crises of the 1980s and 1990s—and the concomitant emergence of

Bermuda during this period—caused Lloyd's to risk some of its reputation and its premium to the island insurance hub. With available capacity and expertise resident in platforms outside the Lloyd's market, Lloyd's increasingly has touted its worldwide reach as a “unique selling point” (British rendering of “value proposition”). The globalization of commerce has meant that insurers with global capabilities are better equipped to satisfy client insurance needs that transcend national borders. Lloyd's licenses in 80 countries allow small syndicates to push beyond their reach and operate in countries where, lacking the Lloyd's marque, they would be in a much less competitive position.

### A Tale of Business Survival

Reform at Lloyd's has spanned an entire generation. It began in 1966 when the Lord Cromer Report attempted to confront the issue of declining membership. The investigation uncovered governance weaknesses allowing self-dealing. Conflicts of interest continued amid a string of underwriting scandals, until the Fisher Report of 1980 advised that self-regulation was not adequate to control market excesses. The Lloyd's Act 1980 introduced outside directors on the Lloyd's Council, but practices at Lloyd's were so embedded that these reform measures could not protect Lloyd's from damage caused by the U.S. liability crisis and natural catastrophes. The reconstruction and renewal plan of 1996 walled off Lloyd's from pre-1992 liabilities, and the PMD began to institutionalize sound business management.

The process of Lloyd's long rehabilitation ultimately is a business survival story. Like the best survival stories, it reveals a difficult process that required enormous amounts of dedication and sacrifice, and an unwavering gaze at a brighter future. □

## House Rules

Areas with specified guidelines for Lloyd's franchisees spelled out in the 2002 Chairman's Strategy Group consultation document are:

- Catastrophe exposure
- Profitability by product line
- Reinsurer selection
- Gross line size
- Reinsurance leverage
- Multiyear policies
- Overall market dominance by franchisee
- Dealings with brokers
- Service standards.

Broker slip for Lloyd's cancellation coverage of the 1965 U.S. presidential inauguration.

IMAGE COURTESY OF THE CORPORATION OF LLOYD'S

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### Resources

*Lloyd's Premium Rate Index: A Guide to Historical Premium Rate Movements* <http://bit.ly/hc6RRZ>

Chairman's speech at Lloyd's 2002 extraordinary general meeting <http://bit.ly/gTU5G7>

Chairman's 2009 speech to the Insurance Institute of Dublin <http://bit.ly/gzCIkn>

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