

Houston Marine Insurance Seminar

“Shaping the London Coffee House for its Next 300 Years”

[TITLE SLIDE 1]

Mr Chairman, ladies and gentlemen, thank you for the kind invitation to speak to you today. It is about 5 years since I was last in Houston, although I was scheduled to speak at this Seminar last year. My plans, both professional and personal – like many of yours – were redrawn after the events of September 11, but my colleague, Peter Allen, kindly agreed to deputise for me and, I hope, was able to give you a perspective on some of the changes then underway at Lloyd’s.

I shall leave it to experts speaking later during the Seminar to provide a detailed perspective on the marine and energy insurance industry with which Lloyd’s is so closely associated. My presentation today will focus on telling you about Lloyd’s plans for the future. But first let me set out a little background.

[slide 2: A never-ending story of change ...]

The first known reference to Lloyd’s was in 1688 when Edward Lloyd ran a coffee house in the City of London. Lloyd himself was not involved in underwriting but ran the establishment in which ships captains, merchants and wealthy individuals gathered to transact rudimentary forms of marine insurance. In idle moments, I often wonder whether Lloyd’s salty patrons of 300 years ago would

have been an easier constituency to deal with than today's policyholders, brokers and capital providers !

The next 304 years saw many changes at Lloyd's as it moved between premises in the City of London. For example, the market was incorporated by Act of Parliament in 1871, Cuthbert Heath introduced the first excess of loss reinsurance contract in 1907 – the year of the great San Francisco earthquake – and, as lawyers sought out new ways to make money, Lloyd's pioneered Directors' & Officers' insurance in 1934 as US businesses looked to insure their newly discovered exposures.

A decade ago Lloyd's published "A Route Forward" – commonly known as the Task Force Report - which proposed a range of radical changes, including the establishment of rights of participation on syndicates for members of Lloyd's and the notion of value associated with those participations.

With hindsight, perhaps the most important recommendation of the Task Force was the introduction of corporate capital that would underwrite on a limited-liability basis. The admission of corporate members has brought with it profound changes in the market over the last 9 years.

I'm sure you are all aware of the impact on the market of the huge losses of the late 80s and early 90s that lead to the Reconstruction & Renewal programme involving a Settlement Offer to Names and the establishment of Equitas as an independent reinsurance company into which all the non-life liabilities of Lloyd's members prior to 1993 were reinsured.

In a few slides from now I shall talk about the consequences of September 11 on Lloyd's and will then spend some time explaining the work of The Chairman's Strategy Group – or CSG – whose reforms were approved at a specially-convened EGM just 10 days ago.

Let's leave Lloyd's history there and turn our attention to more recent times.

[slide 3: One year ago]

My next slide shows just 3 of the very large number of bearish statements that were made about Lloyd's in the weeks and months following September 11 – I'm sure you recognise the sentiments as there were many commentators – especially in the US - predicting doom and gloom for the grand old lady of Lime Street at that time.

We were determined not to publish numbers until we felt comfortable that they were representative of the true aggregate position of all the businesses in the market. Perhaps surprisingly, information available to us immediately on September 11 on the combined financial impact on Lloyd's of a mid-air collision between two wide-body passenger aircraft and a major Los Angeles earthquake still represents a good approximation to the scale of our WTC loss. Anyway, I am pleased to tell you that since September 11 last year more than \$2.1bn of new money has flowed into Lloyd's and the market is currently as buoyant as many underwriters can remember during their careers. To paraphrase Mark Twain, reports of the death of Lloyd's seem to have been exaggerated.

[slide 4: Market structure 2002]

You may be familiar with this next slide showing a schematic representation of the Lloyd's market in 2002 and so I will talk to it only briefly.

Our client base is spread throughout the world and Lloyd's is licensed to transact insurance in more than 60 countries.

The US market itself now represents 38% of our total business volume, consolidating its status as our largest single market, and Lloyd's is now the largest surplus lines insurer. In the first quarter of 2002, business in US dollars accounted for 62% of all premiums written at Lloyd's.

You may be interested to know that Lloyd's writes over \$1bn of premiums in Texas which, if the state were a country, would rank it 4th on the list of Lloyd's largest premiums written, after only the remainder of the US, the UK and Canada.

There are around 3,300 members providing capital to the market in 2002. Among the 132 corporates are many household names such as The St Paul, ACE, XL, QBE, Markel, AIG, Munich Re and Swiss Re. The individual membership comprises around 2,500 unlimited-liability members and 700 members have converted from unlimited- to limited-liability status.

Lloyd's today comprises 86 syndicates managed by 49 managing agencies. Average syndicate capacity now exceeds \$200m compared with \$14m 20 years ago and \$120m only two years ago.

About one-third of the market trades as Integrated Lloyd's Vehicles – or ILVs – where ownership of underwriting capital and managing agent is identical. All policies issued by all syndicates at Lloyd's carry an AM Best A- and an S&P A rating.

[slide 5: Profile of capital provision 1993-2002]

The changing nature of the Lloyd's capital base is shown in this next slide. The trends are, I think, clear enough. In 2002, 79% of market capacity is provided by corporate members – remember there were no corporate members 9 years ago. Names and Names conversion capital now support 14% and 7% of capacity, respectively. US and Bermudan insurers, 18% and 17%, respectively. Other insurance capital from outside the US and Bermuda, 11%. The largest component of capacity, 33%, is provided by investors from outside the industry who participate either through the UK stock exchange in listed vehicles such as Amlin, Wellington and Hiscox or via private-equity arrangements.

This chart also shows the growth in market capacity over the last three years. Lloyd's 2002 capacity of a little over \$18bn is the highest in the market's history and looks set to increase yet further next year.

So, as you can see, the complexion of the Lloyd's market is unrecognisable from that of a decade ago, and the issues associated with governing the marketplace have changed dramatically. Many of our capital providers are sophisticated players in the insurance industry in their own right – some with larger premium bases than Lloyd's itself!

[slide 6: Top 10 capital providers]

This chart shows our top 10 capital providers in 2002 who represent between them about 45% of total market capacity. ACE heads up the membership league table by size providing around 7% of Lloyd's capacity. Berkshire Hathaway via its Gen Re and National Indemnity subsidiaries is the only other capital provider north of the \$1bn mark.

[slide 7: Lloyd's – recent capital announcements]

I mentioned earlier the inflows of capital to the market since 9/11. These headlines cover just a sample of the many capital raising activities that I believe represent a key barometer of confidence in our market. With ever-increasing capital mobility – not just within our industry but between industries and jurisdictions – nothing can be taken for granted. You can gauge current investor sentiment toward Lloyd's from the following statistics.

[slide 8: Increased commitment from a variety of capital sources]

More than \$7bn of new money has entered the market over the last two years. These funds have been used to pay claims, establish syndicate reserves and statutory funding requirements and to expand underwriting capacity.

About a \$1bn of additional underwriting capacity has been created since the beginning of this year through a variety of mechanisms. Just last week, for example, Hiscox announced it was raising \$160m to take advantage of current trading conditions. New private equity support has been provided to Catlin, Kiln and others and trade investors such as Berkshire Hathaway and AIG have injected significant additional funds to grow their respective involvements at Lloyd's.

In addition to this extra capital provision, more than \$1.5bn of qualifying quota share reinsurance capacity has been authorised or is in the pipeline for authorisation. These arrangements permit syndicates to write premium in excess of their capacity up a maximum increase of 30%. A wide range of high-quality reinsurers is involved in supporting these arrangements.

[slide 9: Market Security: chain of security]

The Lloyd's chain of security is probably familiar to many of you and so I don't intend to spend much time explaining it today. The chain comprises the 4 "links" as shown on the slide.

[click x 4]

With the exception of the Central Fund – about which I shall say more in a moment – each link in the chain was significantly stronger at the end of 2001 than at the end of the previous year. The new capital which I have just been talking about – much of which has entered the market during 2002 and so is not included in the figures on the slide - has been injected into the Funds at Lloyd's link where required capital is determined using the Lloyd's risk

based capital model which the rating agencies – who should know - tell us is among the best capital-setting tools in use in the industry.

You can also see the very small exposure to equities throughout the chain – even the Central Fund, which is currently invested about 30% in equities, has only fallen a few percent in value during 2002.

In order to strengthen the Central Fund post 9/11, we took the decision to increase the premium levy – a kind of tax on written premiums – to 2% in addition to maintaining the Central Fund contribution rate at 1% of capacity. This has enabled us to grow our central assets from the \$545m shown on the slide for year-end 2001 to around \$900m today.

[slide 10: Central fund growth]

The Central Fund itself stands at around \$700m today and we remain confident in our projections for a Central Fund in excess of \$1bn by the end of next year.

Clearly, however, such a level of central costs for market businesses is undesirable in the longer term and so, over the next few months, we shall be reassessing the optimum level and structure of central resources. This is a very important project for us as our current Central Fund Insurance, providing \$750m of protection, expires at the end of 2003.

[slide 11: Impact of September 11 on global insurance industry]

Let me now move on to present a few slides on the impact of 9/11 on Lloyd's. September 11 brought the insurance industry the largest and most complex loss ever experienced. Commentators believe that it has been responsible for removing up to \$100 billion of capital from our industry. Lloyd's faced wide exposure, including for the aircraft involved in the tragedy and property on the ground destroyed in the attacks, as you might expect with a business so closely linked with the US economy.

Lloyd's share of the loss, both gross and net, is greater than that of any single domestic or overseas insurance company.

Our current estimates of market-level loss, excluding intra-market exposures between syndicates, are a gross loss of \$8.9bn and a net loss of \$2.9bn. About one-third of the loss is direct and about two-thirds reinsurance. The determination of these estimates has been subject to a number of levels of independent review, including year-end actuarial sign-off. Clearly, however, certainty will take many years.

Careful analysis of Lloyd's reinsurance arrangements also shows positive signs. There are more than 250 reinsurance companies from which Lloyd's has to make recoveries. Approximately 35% of these are due from the five largest insurance groups in the world and more than 90% of Lloyd's reinsurance for the September 11 events is held with carriers rated A and above.

[slide 12: September 11 – gross development (ex ISR)]

Since Lloyd's initial estimates, our net and gross loss estimates have not materially altered, with any changes

reflecting the reduced aviation and increased property notifications.

At this point, Lloyd's has paid over \$1.5 billion in claims. IBNR stands at a little under 20% of the projected ultimate loss.

In order to address market-level claims issues we have a special 9/11 team in place reporting directly to the Chairman of Lloyd's.

[slide 13: September 11 vs major cats]

You may find the development comparison shown on this next slide interesting. The chart plots, quarter-by-quarter post event, the incurred development of various major cats – 2 aviation and 2 property – the 9/11 development is then superimposed in dark blue. You can see that 9/11 is developing in a way that is consistent with the other events, although I think the very different nature of 9/11 from the other cats means we can take little more than broad comfort from this.

[slide 14: US situs funding]

Lloyd's has already effectively pre-paid the 9/11 loss. Lloyd's moved well over US\$5bn to the US trust funds within just over six months of the tragedy to meet your regulatory requirements.

No other insurer has done this. Indeed, we might question whether many other insurers would be capable of doing so. Lloyd's now holds some \$8.7 billion of assets in trust for US reinsurance and \$2.5 billion of assets in trust for US surplus lines policyholders. When you add in the LATF, which relates to business written before August 1995, we have a total of almost \$12.5bn held in regulatory deposits in the US.

It is worth mentioning that US regulatory requirements mean that these assets cannot normally be used to pay claims. All 9/11 claims are separately paid from funds in London, meaning that the US funds act as added security for US policyholders rather than as working funds.

[slide 15: Trend in Market financial performance]

Let's now turn briefly to look at the Market's financial performance.

The profitable years of '93 to '96 have been followed by a period of sustained loss. In 1999 Lloyd's lost \$2.4bn, in 2000 and 2001 it is forecast to lose \$2.2bn and \$1.9bn, respectively. Not a very pretty picture ! As someone who always looks for silver linings, I take some comfort from the fact that 2001 might have only been slightly loss making in the absence of the 9/11 loss.

The graph shows the residual account in profit but this is as a result of rate hardening post September last year.

Ahead of coming here, I asked for data on the performance of the principal energy classes over recent

years to see whether they had added to our woes or ameliorated them. It may be less of a surprise to you than it was to me, but over the years 1998 to 2000 on-shore energy generated gross loss ratios – not combined ratios – for Lloyd’s of between 230% and 380% of premiums. The offshore classes were only slightly better with some loss ratios well north of 200%. If anyone here had a role in generating those results, I’d be grateful if they could make themselves known to me during the coffee break !

[slide 16: Lloyd’s vs industry combined ratios]

Overall, however, despite the large losses related to 9/11, our 2001 results compare reasonably favourably with our peer group. The Lloyd’s 2001 pure-year loss of \$4.5bn on an annually-accounted basis represents a combined ratio of 140% which reduces to 129% if you look just at businesses that continued into 2002.

This compares to 143% for the US reinsurance market and 129% for the European reinsurance industry. Many of our industry peers in both the direct and reinsurance markets would have been happy with those statistics.

[slide 17: Market supervision: quartile performance (1999 a/c)]

In order to lead into my discussion of the reforms to be implemented following the work of the Chairman’s Strategy Group I’d like just to pause for a moment to dissect our financial performance a little further. I’ll use

the 1999 results as an example, but other years would show similar effects.

Although the 1999 account lost about 14% on capacity, the best 25% - or quartile - of syndicates just about managed to make a profit even though the insurance cycle was at its nadir for many classes of business.

The bottom quartile, however, managed to achieve losses averaging almost 45% of their capacity. This corresponded to over half of the total market loss.

[slide 18: Best vs worst quartile performance (Average return on FAL 1995-99)]

As part of the research undertaken by Bain & Co. supporting the CSG, other quartile-based analysis was carried out. This slide shows that, for the period 1995 to 1999, the best businesses generated ROEs in excess of 10% whilst the worst businesses had negative ROEs of 14%.

[slide 19: Best vs worst quartile performance (Average Gross Loss Ratio 1995-99)]

A similar picture is seen for gross loss ratios.

[slide 20: Best vs worst quartile performance (Average Net Premium CAGR 1995-99)]

My final example shows compound annual growth rate in net premiums over the same period. The best businesses at Lloyd's shrank on average by 8% during this period of

severe downturn in the cycle, while the worst businesses continued to grow.

[slide 21: Objectives of the CSG]

This polarisation in performance between the market's best and worst businesses and the drag the latter have had on the market as a whole was one of the factors that lead to the formation of the CSG in 2001.

The stated objectives of the CSG are set out on this slide and I will leave you to read them for yourselves.

Achieving these goals is vital if we are to avoid the destructive influences of the past – there may be no more chances.

[slide 22: Vision for Lloyd's]

The CSG set out a vision for Lloyd's:

"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”

The reforms fall into 2 main categories: those that relate to the Franchise of Lloyd’s which involve the way in which the market operates, and those that relate to the capital structure of the market. They are summarised on this slide, but I will take you through them in more detail in the following slides.

At the EGM held 10 days ago these reforms were voted on by the membership. An 80% vote in favour gave us a decisive mandate to proceed with implementation.

[slide 23: Franchise reforms: proposed structure]

As I said earlier, our financial performance has simply not been good enough and we have to do something about it NOW. Our best businesses deliver world class financial performance. The market as a whole delivers unacceptable performance. That must change.

That is why we are proposing changes to the way we organise ourselves to deal with the market performance.

People have talked about the Franchise of Lloyd’s for some time. The CSG reforms seek to make that colloquial concept more formal.

I have talked about the central assets that constitute the franchise – the licences to trade around the world, the Central Fund, and, of course, let’s not forget the brand name. Those assets are underpinned by our system of

financial security and the Central Fund. But the value of the franchise is most directly impacted by our standards of behaviour and service, the attractiveness of our trading environment to underwriters, brokers and policyholders, and fundamentally by performance.

Historically, Lloyd's has operated much more like a regulator than the owner of a commercial franchise. Lloyd's has only got involved with businesses in the market in situations where they are causing, or have caused, damage to the franchise.

Experience suggests that we need to play a much more active role. Not in any way to compromise our essential market place characteristics, but to raise the commercial standards of performance in the market.

Thus Lloyd's centrally, collectively, will be the franchisor and the business in the market franchisees. Under this new structure, each franchisee will be accountable to the franchisor, but also, obviously, still responsible to its shareholders.

A set of franchise principles will be established to include minimum service standards, target ROEs, and an active process of business-plan approval and performance monitoring will be introduced. We will impose strategic and operating disciplines on the market to create a framework - a set of guidelines - within which the franchisees will be obliged to operate.

As franchisor we will provide the strategic framework, brand management, and support for Lloyd's global licence network, mutual security and security ratings. We will provide effective supervision of the market while at the same time establishing a performance culture that will be pervasive throughout the market. We will not hesitate to

intervene where we identify that the standards of the franchise are threatened.

This is a very different role from the one Lloyd's has traditionally adopted. It will require some new skills in our central team. And it will require a new governance structure. Management of the Lloyd's franchise is best achieved by a commercially minded board, rather than a representative council, as at present.

These are major changes for us. They will require detailed practical work to implement. Most of all they will require a cultural change, which I believe will be widely embraced within the market.

[slide 24: Franchise reforms: sample guidelines]

The guidelines I have just referred to will govern profitability by product line, limits on catastrophe exposure, reinsurer selection, limits on reinsurance leverage, maximum gross line size, limits on multi-year policies, dealings with brokers and standards of service. Each franchisee will be expected to operate within the specified guidelines unless discussed and agreed otherwise in advance with the franchisor. Examples of these guidelines are shown on this slide.

The obvious challenge will be to do a better job of managing the market for profitability without stifling the creative and independent underwriting for which Lloyd's is renowned.

[slide 25: Franchise reforms: business plan steps to improve performance]

Each business plan that is approved by Lloyd's will allow a reasonable degree of flexibility.

Wider operating parameters will be applied for more experienced and successful syndicates.

Ideally, we will deal with underperformance by identifying it as early as possible through the quarterly monitoring process and through regular review and discussion.

The initial approach will be facilitative, working with the franchisee management to improve performance.

If this facilitative approach does not work, however, the franchisor can and will take corrective action, including possible expulsion.

[slide 26: Capital reforms: annual accounting]

Aside from Lloyd's poor financial performance over recent years we have experienced a number of structural problems. Our structure has been built up over 300 years, with the pace of development, like that of the rest of the world, peculiarly accelerated into the last 10 and 5-year periods. As a result, we are difficult to understand – complexity can be an art form at Lloyd's.

In the old days, being arcane was a source of competitive advantage. It added to the mystique and snob value. But not today. We at Lloyd's derive no benefit from being complicated – our complexity is a disincentive to investors and policyholders, who need to understand the entities they do business with quickly, so that they can focus on their competitive choice.

There are many aspects to our structure that we need to address. Let me focus briefly on two we are proposing to change, and one we are not.

The first source of our complexity is our accounting system. We operate with three-year accounts. Devotees of the system will assure you it is a great discipline. Well, if it is a great discipline, then it is a shame that so few people can understand the numbers that it produces. And I'm not so sure it is an unambiguously great discipline anyway. For some, it provides an opportunity to postpone the evil day when they have to face up to the grim task of assessing how profitable (or not) the business is that they are currently underwriting.

We propose to move to annual accounting – I perhaps hesitate to say GAAP accounting, in a Post Enron era. We have already started this migration process by requiring the market to produce audited annual accounts parallel to their three-year accounts. Going forward, we will work with our regulatory authorities in UK to replace the old system entirely – we anticipate that this can be achieved by the beginning of 2005.

This move will not only address complexity and comparability, but will permit annual profit distribution and reduce the workload and costs associated with managing agents having to account on a GAAP basis to their capital providers – perhaps here in the US – whilst still having to prepare 3-year accounts for Lloyd's.

[slide 27: Capital reforms: move to limited liability underwriting]

The second source of complexity is the way in which capital is provided to the market. It used to be straightforward. Capital came from individuals – Names – who provided it with unlimited liability. Down to the last cufflink, and regrettably those cufflinks were reached in the early 1990s.

Then along came along so called “Corporate Capital”. To begin with it mimicked Names capital in that it backed many businesses or syndicates – it was spread capital.

But soon Corporate Capital was backing single businesses, though not many at first. Capital came from all kinds of sources – the insurance industry, public markets and private equity.

So what we have today is the hybrid market I discussed earlier. But the structure and rules are still fundamentally based around the 14% of unlimited-liability members. We still have an annual venture – capital is reconstituted annually. No funds are provided for working capital purposes – hence the need for what we call “cash calls” – a normal part of doing business at Lloyd’s, but often wrongly and emotively portrayed.

And the relationship between capital providers and the businesses they support is governed by agency law – a notoriously onerous regime. If you ever drop a book on English agency law on your foot, you may not survive to cry for help!

I could spend a long time describing the CSG’s work on capital structure to you, but your capacity not to be bored rigid by me, no doubt already under strain, would be tested too far. The reforms emanating from this work have proved highly emotive and have been the subject of much heated debate – both private and public – so it is important for you to understand the main points. These are:

- no new unlimited liability members will be admitted after this year. The basic argument

here is that we feel it is inappropriate for global specialty risks to be underwritten on a unlimited-liability basis, especially in view of the risk profile of our industry post 9/11. Contrary to what some would have you believe, this debate is not a case of one form of capital against another. The Lloyd's market rightly celebrates its diversity of capital sources. But there is a critical difference between having diverse sources of capital (a good thing) and having diverse types of capital (a force for gratuitous complexity).

- the greatest impediment to conversion to limited-liability status right now is the problem of carrying forward the tax losses of these members. To address this we are currently working with the UK taxation authorities.
- many members who wish to exit Lloyd's are trapped by their participations on open years, some as early as 1993. We have instructed a major broker to identify reinsurance solutions to allow these years to close and the members to resign from Lloyd's.
- finally, we will continue to facilitate, where desired, the movement of capital providers to fully aligned status. Lloyd's will also facilitate the development of new forms of investment, including on a non-membership basis.

I said there were two aspects of our structure we needed to change – capital and accounting. I said there was a third we would not. That is our mutualised financial structure, and the existence of the Central Fund.

Lloyd's is a market place composed of many businesses – 86 syndicates this year. Owned by different people. Writing different lines of business. Small. Responsive. With short lines of decision making. Offering choice.

Yes, there is great value in being a market. There is even greater value if you achieve financial scale and single access to global licenses and a strong umbrella brand.

[slide 28: Lloyd's: the world's leading specialist insurance marketplace]

So let me conclude by summarising my vision for Lloyd's.

We will continue to be the world's leading specialist insurance marketplace. A marketplace which has a roll call of the best businesses in the industry.

- Businesses owned by the leaders in the international insurance and reinsurance marketplace.
- Businesses that are independent Lloyd's vehicles.
- Businesses that are backed by high quality capital from public and private equity markets, individuals and corporations.

A marketplace that retains and builds on its global reputation for being at the forefront of innovation, risk taking and entrepreneurship in the insurance industry.

And, through implementation of the CSG reforms, a market redefined:

- setting high for standards itself:

- high standards of financial performance
- high standards of service performance

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

A market that is a magnet for talent:

- underwriting talent
- managerial talent
- broking talent

A market that is passionate about performance.

[END SLIDE 29]

Thank you for listening and, Mr Chairman, if we have time, I shall be happy to take any questions.

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