1 London Market Update and Lloyd's Internship Program

Speech delivered by Andrew Beazley, chief executive, Beazley Group, plc, at Houston Marine Insurance Seminar, September 20, 2005

Good morning.

Insurers and reinsurers bear a heavy responsibility, on which their own survival and, often, that of their clients depends. It's what I call being wise *before* the event.

Over the past two weeks we've heard from many practitioners of that much easier art – being wise *after* the event. I don't want to add to their number this morning. Instead I want to talk to you about some of the ways in which we in the London market are seeking to be wise before the event. We're making some good progress. As a result, I think we're better prepared today to support our clients through a market-changing event such as hurricane Katrina than we would have been in the past. And I'd like to talk about that progress.

But I also think we have much further to go, both in the London market and in the insurance industry as a whole. I believe there's still scope for us to be much wiser *before* the event. I think that Katrina gives us some pointers here, and I'd like to talk a little about that too.

All in all it's a story of change – changes accomplished; changes in prospect; and new changes that we need to consider. But before I conclude today I will also say a few words about the internship program that Lloyd's chairman Peter Levene announced here last year. And that's a slightly different story. Because alongside the change, there are some business values that remain constant. And the Lloyd's internship program, which is all about sharing experience and expertise with a new generation of insurance professionals, represents some of those constant business values.

There's one other constant business value that I think is very important at a time like this. It's one that has been much talked about in the past two weeks. It's stability. And that's something that we at Beazley and I know many of my friends and colleagues in London care passionately about. We have been, and we intend to continue to be, a stable market for our US clients – on the south coast, on the west coast, on the east coast and at all points in between. We are not simply an opportunistic market of last resort. We know that ours is a relationship business. I think that those of you who are in the marine and energy market have always known that, but it sometimes takes an event on the scale of the 1906 San Francisco earthquake or Hurricane Katrina to make that more widely understood.

But our stability is, paradoxically, shored up and secured by our willingness to change. And we've entered a phase of dramatic change in the Lloyd's market which I think is qualitatively different from the momentous changes we saw in the 1990s. Then, the big changes related to our capital base – the replacement of capital from private individuals with corporate capital. And it has to be said that this change was largely forced upon Lloyd’s because of the scale of the losses many syndicates suffered and the way in which the supply of traditional, private capital consequently dried up.

We’ve come a long way since then and I am pleased to say that most of the change we’re now seeing is not being forced on Lloyd’s. It’s coming at our instigation. In so far as you can ever control your destiny in insurance, we at Lloyd’s today are captaining our own ship. And I think that the course we’ve charted was relevant to our state of preparedness on August 29 when Hurricane Katrina made landfall on the Gulf coast.

Some of the changes in our market are being initiated at the Lloyd’s and London market level, although with the full support of operators in the market. And others are being driven by Lloyd’s businesses themselves. Altogether, they fall under five headings:

- First, a fundamental change in the relationship between Lloyd’s centrally, represented by the Lloyd’s Franchise Board and the Franchise Performance Directorate, and the Lloyd’s marketplace, comprising the managing agencies.
- Second, new capital adequacy standards that are much better calibrated to the full range of risks being assumed in our market.
- Third, the role that technology and standardized, market-wide processes are now playing in enhancing customer service in areas such as the rapid issuance of policy documentation and contract certainty.
- Fourth, major investments in another key element of customer service, which is enhanced claims management.
- And fifth, developments in the distribution strategy of a number of Lloyd’s businesses, which are designed to broaden our access to attractive business opportunities, particularly here in the United States.

So let’s start with the Franchise Board. One of the biggest changes at Lloyd’s in recent years has come in the relationship between the businesses that make up the market and Lloyd’s centrally. A few years ago a number of people started thinking in a fresh way about this relationship, and about the balance of privileges and responsibilities of being a business at Lloyd’s. The word “franchise” began to be bandied about – Lloyd’s being the franchisor and our businesses being the Lloyd’s franchisees. I think this was a very positive development – not least because the franchisor-franchisee arrangement is well understood in the wider world. We at Lloyd’s have had an unfortunate habit of developing unique structures and practices, like the reinsurance to close and the annual venture, which were hard for others to understand. But the franchisor-franchisee concept was familiar and straightforward.

Anyway this took concrete shape in the formation of the Lloyd’s Franchise Board at the beginning of 2003. One of the crucial roles of the Board is to review, and if necessary, challenge the syndicate business plans submitted by Lloyd’s managing agencies. And the great benefit of this process is ***not*** that it keeps all of us on our toes – because really the competition does that – but that it enables Lloyd's to identify those syndicates that lack robust plans or that do not employ adequate risk management procedures. And it can – and has – put syndicates into run-off if they don't measure up.

Now hypotheticals are as difficult to analyze in insurance as they are in other walks of life. But many of us – myself included - believe that Lloyd's would not have absorbed catastrophe claims of $2.3 billion from four US hurricanes last year and still walked away with a pretax profit of $2.6 billion without the work of the Franchise Board. And by the same token, the work of the Franchise Board has made our market as a whole better equipped to absorb the losses from Katrina. As you know Lloyd's has set a preliminary estimate of net losses for the market at £1.4 billion, or $2.55 billion.

Don't get me wrong: there have always been very talented underwriters at Lloyd's who've been able to make profits in challenging markets. But the difference today is that Lloyd's, through the Franchise Board, is much better equipped to stop the less talented underwriters who can pose a threat both to the market's financial health and to its reputation.

Another important change in this context is the move to what is known as individual capital assessment, or ICA. This is the application to the London insurance market of the work on capital adequacy for financial institutions that is enshrined in the Basel Accord and various European Union directives. As many of you will know, the European Union moves in a very deliberative way, so while we wait for the second EU solvency directive, which will apply to insurers and reinsurers, the UK regulator, the Financial Services Authority, has set insurer capital requirements that are twice - or in some cases more than twice - the current EU minimum levels.

Now this might look like a case of change being imposed upon Lloyd's from the outside. But really it's not. Lloyd's has worked very closely with the FSA to develop capital adequacy standards that are robust and appropriate to the market's needs and structure. Like the capital adequacy rules governing banks and other financial institutions, they will cover credits, assets, liquidity and operational risk as well as underwriting risk.

And we're getting some external validation of the progress that we've been making. Last year AM Best raised its rating of the Lloyd's market from A- to A, at a time when it was downgrading many other insurers and reinsurers. AM Best has cited the individual capital adequacy standards regime that the FSA is bringing in as a development that will reduce the exposure of Lloyd's central resources. So, again, that speaks well of our ability to withstand current and future catastrophic losses.

Of course the proof of the pudding is in the eating. AM Best expects that over the coming years there will be continuing reductions in Lloyd's underwriting capacity, following the 8.7% drop that has already occurred between 2004 and 2005. That will now of course depend in part on changes to the premium rating environment that will ensue from this year's hurricane season. But leaving this aside, there should be no more writing premium for premium's sake at Lloyd's – or so we hope and expect.

Now I'd like to move away from capital adequacy and look at some of the other changes we're instigating, which are just as important. A lot of them relate to business processes. At the front end, we're pursuing ways to automate many activities, while retaining the essential expertise of our underwriters - and indeed making the market more widely available to more clients.

There are a number of initiatives aimed at creating a more efficient market and provide "contract certainty", by which we mean raising standards and changing processes to ensure that the full contract terms, including wordings, are agreed before the inception of the policy. This will need the full support of the broker chain and clients to achieve our goals. Decisions will need to be made well before inception.

One such initiative is Kinnect, which aims to create an electronic slip for the London market, allowing the exchange of structured electronic data and providing an electronic placing system for syndicated business. This should reduce the costs associated with duplication and manual keying of information. And in broader terms more comprehensive data should aid decision making and ensure more efficient use of capital.
Kinnect currently has the support of 60% of the Lloyd's market and Marsh and Willis have played pivotal roles in developing the brokers' requirements and locking down the process.

We at Beazley are supporters of Kinnect, but we have also been making some significant technology investments of our own. And of course that's a big part of the story of today's London scene. In addition to the major projects involving multiple players in the market, individual Lloyd's businesses have been making significant changes of their own. And one of the reasons we can do this is that the scale of our businesses are now much larger. There has been huge consolidation in our marketplace. There are now 62 syndicates trading at Lloyd's, down from more than 400 a few years ago. Many of our businesses, Beazley included, are quoted on the stock exchange. So we have the resources to make major strategic investments.

At Beazley, we have been developing an electronic platform called BeazleyTrade. This incorporates rating engines and processes that will enable us to transact larger volumes of small business faster and provide ease of access to the broker market. One of the challenges Lloyd's has faced, as many of you will know, is getting policies to our clients in a reasonable timescale. With BeazleyTrade, that becomes a thing of the past: brokers will receive a Beazley policy as soon as the risk is bound.

The story of the Lloyd's market and the adoption of new and more efficient technology has not always been an edifying one. The very real challenges of the subscription market mean the convoy has all too often gone at the speed of the slowest ship. But that is changing; and Kinnect and BeazleyTrade are both evidence for the change.

Also changing is the way we think about and manage claims. This is the fourth of the major developments I mentioned earlier. Claims management has not historically always had the attention it should have had at Lloyd's, where underwriting has been the primary focus. Four hundred and fifty thousand claims are processed every year in our market. There is enormous potential for value creation through more efficient claims management. A recent study by Lloyd's, supported by McKinsey, suggested that more than 5% of Lloyd's claims costs – or nearly $1 billion per year – could be saved by improved claims management.
I think it's important to recognize that this isn't a zero sum game. There are benefits all round. Valid claims get paid faster, which is good for clients and the brokers who represent them. Reinsurers look for transparent and consistent claims management practices on the part of their reinsureds – that is a precondition for strong, long term reinsurance relationships under which reinsurance claims are paid quickly and cover continues to be available even in difficult markets. And of course for our investors, more efficient claims management translates over time into savings that boost the bottom line.

Now we need to keep talk of automation and efficiency in context. Most of the business in which Lloyd's specializes, including marine and energy, is a relationship business. There will always be "grey areas" when complex claims are submitted and underwriters will need to retain a measure of discretion. Nevertheless, consistent claims management standards and procedures will over time benefit all parties – not least brokers and insureds who will enjoy more stable coverage from insurers that manage their claims effectively. The client and broker goodwill that comes with fair and timely claims settlement will ultimately support new business along with client retention.

That is why I am a strong supporter of the claims management principles and minimum standards introduced by the Lloyd's Franchise Board last year. The work that Lloyd's has done on claims, with the help of McKinsey, highlighted the importance of effective peer review and supported the formulation of the revised procedures which have been agreed across the market. Much effort and time has also been devoted to bringing claims management fully into the electronic age with the electronic claims files project, which will hopefully end the Dickensian sight of individuals carting around piles of paper files.

Finally, managing agents have been investing in their own claims management teams. We at Beazley have been in the forefront of this. Earlier this year we hired David Marock from McKinsey to lead the claims team for our specialty lines division, which is the largest segment of our account. He has an excellent market-wide perspective because he led the claims strategy project with Lloyd's.
One of the areas where we think there is scope for a much more efficient and much less silo'd approach is in the relationship between claims management and underwriting. We team claims specialists with underwriters to ensure that pricing and policy wordings benefit from what we learn through claims management. For example, more accurate reserving enables better pricing, and experience gained in managing individual claims aids the development of more appropriate policy wordings.

Two other things we've been thinking about very hard at Beazley – and I know others at Lloyd's have been thinking about too – are distribution and the overall balance of our portfolio. The two are of course allied because, if we don't get the right distribution, we won't get the spread of business we are looking for. And, if you look across the Lloyd's market, you'll find a number of firms that are looking to broaden their access and provide a more localized service for brokers. Here in the United States, Wellington, Hiscox and Catlin are three Lloyd's businesses that, in one way or another, have established a local presence to help them underwrite US business of various kinds.

At Beazley we've taken quite a radical approach to this. Last year, we bought an admitted U.S. property and casualty insurance company, Omaha Property & Casualty. The company has now been renamed Beazley Insurance Company and, through it, we're licensed to write admitted business in all 50 states.

So what does this mean for us and for Lloyd's? Well for us it means that we want to access clients for our products who have not traditionally come to Lloyd's for a couple of reasons. First, because they want to buy from the US admitted market and Lloyd's is only admitted in Illinois and Kentucky. And second because they are small and mid sized customers whose risks may be uneconomical to place in London because of the distribution chain.

The key word for us is flexibility. We can now write business on both an admitted and surplus lines basis throughout the United States. We have our underwriters in London with exceptional expertise and experience in the large risks. And we've been hiring some equally experienced and skilled underwriters in the US who will be focusing on small and mid sized clients for our specialty lines and cargo products. In Florida and other hurricane-prone states we recently started writing high value homeowners business on a surplus lines basis.

We think this makes sense because it will give us a balanced portfolio. And we think that there are things that we can bring to the local US commercial lines market that derive from our Lloyd's experience and reputation. We are entrepreneurial, our underwriting is highly responsive to our clients' needs, and we are a stable partner for our clients and our brokers. We believe all those qualities really matter.

But we are not complacent. We know that there are some respects in which Lloyd's has not excelled over the years. We know that it has not always been the easiest market for brokers to work with. So a big part of our focus in the U.S. is to make our operations here as user-friendly for brokers as possible. And this means being, wherever possible, a local presence.

So that's a pretty rapid retrospective on what we've been doing, both in the London market and at Beazley. What else *should* we be doing? I think an historic event on the scale of Hurricane Katrina should encourage us to think really hard about how our industry measures up – the whole property casualty insurance industry, not just London – and how it could do better.

You can approach this from a number of angles, but I'd like to make one quite specific suggestion. It relates to the way in which we rate risks and comes back to what I said at the beginning about being wise before the event. We should ask ourselves: Are we really taking into account and giving due weight to all the rating factors that matter?

Let me give you an example. A great deal of discussion has focused in recent weeks on the role and performance of the Federal Emergency Management Agency, FEMA. Was its planning robust? Did it follow its own plan? Did the fact that it had been absorbed into the Department of Homeland Security reduce its influence and impair its performance? Was it adequately funded?
Big questions and clearly a big part of the political debate here in the U.S. I don't have the answers and I don't intend to step into the political debate. But these are questions that we as insurers should still be asking ourselves. And, switching from the past to the future tense, they're questions we should be asking ourselves *before* the next hurricane hits. Because critical decisions on what risks we can write, and what risks we can't, will ride upon the answers, as may millions if not billions of dollars in potential claims. And I think it would be complacent of us to say, those are imponderables that can't and shouldn't affect the way we rate natural catastrophe risks. They may be difficult questions to answer, but the reality is that when it comes to a major catastrophe of this kind, we the insurance community, city government, state government and federal government are all in the same boat. The way *each* of us performs will affect the outcome for *all* of us.

This interdependence is also linked to the question of insurability. At times such as this, it is natural that the insurability of catastrophe losses should reemerge as an issue for our industry and for society at large. I think it is important to remember that catastrophic events such as hurricane Katrina are not fundamentally uninsurable. It may be the case that, this year and last, a combination of high sea temperatures in the tropical North Atlantic and faster than normal trade winds has made hurricanes more likely. And it is unquestionably the case that property concentrations and values in areas exposed to these hurricanes have risen and continue to rise as more and more people seek to live in coastal regions. But neither of these developments makes the risk impossible to quantify and therefore insure. They just make it more costly to insure and the size of exposures difficult for the domestic and world markets to digest.

History, both in my country and here in the United States, shows that there is a role for government to play in providing coverage where, genuinely, none is available – as was the case for some terrorism risks after 9/11 – or where the cost is prohibitive and the option of self-insurance is not viable. The insurance industry also has a clear interest in supporting reforms and education programs that help businesses and communities prepare for catastrophes, and help those same businesses and communities recover quickly after a catastrophe strikes. And it's here – in forward planning and efficient disaster recovery – that government can play its most valuable role – and incidentally help keep the cost of insurance down.

It's really a virtuous circle. Take business interruption insurance. If, following a hurricane, a business can be back on its feet days or weeks earlier than would otherwise be the case, that is good for insurers because their business interruption claims will be lower. And it's good for the business because its premiums will be lower. Instinctively, my preference would be for government to focus most of its efforts in this area, rather than setting up new catastrophe insurance funds – although I recognize that these may sometimes be needed.
Now before I conclude I'd like to say a few words about the Lloyd's internship program. As I mentioned earlier, this is less about change and more about continuity. The idea is that we should help continue and cement the very strong relationship that Lloyd's already has with the Texas insurance market by offering three month internships to young insurance professionals from Texas, beginning next spring.

For 2006 we will select one individual to spend three months in the Lloyd's market – and in subsequent years we will take two candidates. On the program interns will learn first hand how our market works by spending time with underwriters and brokers and developing relationships and contacts across the market. The program, including travel and accommodation, will be fully funded by the Lloyd's market. There has been widespread support for this initiative, Munich Re, Amlin and Willis amongst others have already confirmed their interest in participating in the program. I hope it goes without saying that we at Beazley are also strong supporters.

For those of you who are interested in learning more, full application details can be obtained from the organizing committee of this year's seminar. Prospective candidates must be employed by a broker or underwriter in Texas and have a minimum of one, and a maximum of eight years' experience in the marine or energy fields. Candidates will also have to submit a short essay as part of the application process. The deadline for this year's applications is 31st October.

Returning to what is inevitably the major topic of conversation and debate at this event, it is clear that – whatever the final figure - Katrina will prove a loss of enormous scale. The impact on the lives of people in her path is ever apparent – including here in Houston. I believe the realization of her destructive power is yet to be fully appreciated by many in the financial markets. The insurance sector will experience some turmoil as we approach the end of the fourth quarter. Rates will increase since premium levels have, in many instances, proved wholly inadequate. Boards of insurers and reinsurers alike will be reassessing their exposures using the new information gathered from this disaster, which will show higher values of loss than expected and the shortcomings of modeled scenarios. They will also be reassessing their risk appetite. In the aftermath of 9/11, the government stepped in to contain future exposure to the insurance industry. This was after an insured loss of some $20 billion. The current scenario is totally different. With four Florida hurricanes in 2004 bringing insured losses of $25.5 billion, followed by Katrina with insured losses estimated between $40 - $60 billion and the rest of the season to go, there are difficult questions to answer about the future. What now is the possible scale of "the big one"? What is the likelihood of repeating catastrophes of this size? What is the acceptable exposure of shareholders funds to such risk? And what return should shareholders derive from the risk taken? One must therefore expect changes in cost and availability of cover.

Now is the time for reflection as the scale of the losses emerge. In some areas, such as energy, underwriters will need a complete reevaluation of their exposures and of the premiums needed to take on such risk. Be under no illusion, this loss will test the appetite of many, but Lloyd's will be there, at the right price. Underwriters at Lloyd's will not "run for the hills". Our history has been one of creating capacity for risk, as evidenced by the growth of our writings for terrorism since the tragedy of 9/11. Nevertheless, we need to know how much risk we are taking on and be paid adequately for such risk.

As I hope I have made clear this morning, I think we are better equipped to manage our exposures – including our exposures to the most severe natural and man-made catastrophes – than in the past. We've embraced some important changes at Lloyd's. We're not like the Sicilian author Lampedusa who famously said that everything must change so that everything can stay the same. But we are perhaps saying that many things must change so that one big thing can stay the same. And that big thing is London's continuing role as a provider of stable insurance and reinsurance coverage in which, at times like this, our clients and brokers can place their trust. We think that's a prize worth making some changes for.

Thank you.