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The Future Role of Lloyd's of London

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Summary: This session discusses the future role of Lloyd's of London in the reinsurance market. The way Lloyd's works and its past difficulties will be reviewed, but emphasis will be placed on how it has adapted for future reinsurance needs. An update of Lloyd's current issues and its 1997 makeup will be covered. The attendees will learn how Lloyd's of London will operate and fit into the accident and health reinsurance market of the future.

Mr. Erik J. Rasmussen: I'm a senior marketing manager for Allianz Life Insurance Company of North America. I manage our group reinsurance area. Colin is the active underwriter for Syndicate 1206 at Lloyd's of London. He's also the director of the Owen and Wilby Underwriting Agency. He has been involved in the Lloyd's market since 1967. Roger Smith is the senior vice president of Accident and Health Reinsurance of Aon Worldwide. Prior to joining Aon in Chicago, Roger spent ten years as a broker in the London market.

Mr. Roger K. Smith: As some of you may know, access to Lloyd's underwriters is only through a Lloyd's broker. The result is an exclusive relationship that often leads to misunderstandings and some jealousies. Many people see the Lloyd's

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broker as a protected species, because to get to a Lloyd's underwriter, assuming you want to do that, you have to go through a Lloyd's broker. Is this in the best interest of Lloyd's? In light of some of Lloyd's recent troubles, you may think that isn't the case. So what exactly does a Lloyd's broker do?

These rather grandiose titles sum up the four main functions of the Lloyd's broker: a business producer, an administrator, a mediator, and a regulator. The business producer is the role that you most commonly expect from the broker, one that everybody would understand. Traditionally the brokers scout out the land, establish contact with the client, return to London, sit down with the underwriter, negotiate the rates, terms, and conditions of placement, and in general export the expertise of Lloyd's underwriters. The broker was the marketing department of Lloyd's for many years.

The administrator. Probably not many people are aware that the broker plays a significant role drafting the contracts, such as insurance policies or reinsurance contract wordings. These are prepared by the broker and approved by the clients and the underwriter alike. The broker is primarily responsible for premium collection and for claim payment. Those processes are initiated and handled through the broker, as is the file maintenance. These are important roles performed by the Lloyd's broker. As Colin will illustrate when he gets into the structure of Lloyd's, Lloyd's is a market made up of many different syndicates, each representing its own company. For the broker, taking on these roles helps reduce the administrative burden for individual syndicates. So it's very much a shared responsibility.

A broker is a mediator. Having brought the business into Lloyd's in the first place, and having satisfied both client and underwriter that this is a good piece of business, it's quite important to be able to renew it. The broker's role is to keep the client apprised of developments within the market and to negotiate suitable renewal terms. Most people on the reinsurance side believe that their biggest chance of continued profit is through their renewals. So it's a significant role.

All too often in the current environment, as soon as a dispute arises we have resource to the legal fraternity, who are more expensive than brokers. Many times the broker through being a middleman, or buffer, can get parties either to come to a compromise settlement or else to see that there's a better way out of the situation than a lawsuit. So that's the mediator role.

Next, the broker as regulator. This may come as something of a surprise, but brokers do sit on many of the regulatory committees within Lloyd's and have representation on their council of Lloyd's. There is, in fact, a broker's code of conduct (quite a weighty term), but it's expected that the brokers live up to that code of conduct, and there are currently provisions that if people misbehave, they can be either fined or, in fact, disbarred. The broker also contributes to setting standards for developing new areas of business, such as new areas in terms of new products. They also look for ways for Lloyd's looking to export its expertise around the world. The broker helps explain to the new clients how business is done, what is expected of them in terms of premium payment, and the kind of client Lloyd's is generally looking for. That has had a particular relevance in some of the African and the Eastern Bloc countries, where insurance is something of a different business from what it is in the U.S.

Next, I would like to go into the unique strengths of the broker-underwriter relationship. Lloyd's is perhaps most famous, on a positive note, for its ability to underwrite esoteric risks, from the famous body parts of film stars and celebrities to catastrophe risks—basically anything that doesn't fall in a standard underwriting box. That's where Lloyd's has excelled over many years. The relationship between the broker and the underwriter is done on a face-to-face basis. Those of you who have visited Lloyd's will have noticed the rather antiquated process of standing in line to see an underwriter. After you get face to face with the underwriter and exchange information and ideas, you hope we reach a decision. Over the years that has been the appeal of clients' going through the Lloyd's system. Once they've made the great broker understand exactly what they want, they get a decision from the underwriter almost instantaneously. It doesn't have to be referred to committees and get lost in internal workings.

One of the strengths is with the broker's having taken on much of the administrative burden; it helps reduce the overall expenses of the Lloyd's system. Again, that's a shared expense, and a shared duty. It really is a unique relationship between the Lloyd's broker and the Lloyd's underwriter. There have been perceived weaknesses of the Lloyd's broker-underwriter relationship, a perception from those outside the market that the broker is naturally driven more by underwriters at Lloyd's and acting in their interest than in the clients' interest—obviously, because a broker is remunerated by business that he places in Lloyd's. Again, I think that's just a misconception, and not an actual fact. Any broker knows that if he doesn't do a worthwhile job for his client, he doesn't get the business.

There are allegations too of incestuous dealings. During the 1980s a significant amount of business recycled around within the Lloyd's market, the so-called LMX spiral. Instances of that took place, and the brokers played as large a role in that as the underwriters. As we talk about the future of Lloyd's, we hope that is all but eliminated.

Lloyd's brokers have to realize they cannot be all things to all people. The Lloyd's market isn't designed for every piece of insurance or reinsurance business there is, and the broker needs to concentrate on the strengths of Lloyd's, not just on putting business in. There's also criticism that the Lloyd's broker has been somewhat insular, clinging to the 300 years of history and all the mystique that goes with Lloyd's and unlimited liability. Again, it's probably a reasonable criticism over the last decade.

So we have been through a rough patch. The important issue to come out of that is not necessarily exactly what happened (that has been documented both accurately and inaccurately) Lloyd's and the Lloyd's broker must have a future. Lessons have to be learned, one of the most important that the buck definitely has to stop somewhere. If through churning of reinsurance people think they're actually avoiding a loss that doesn't happen, a loss doesn't go away. And there is a collective responsibility. If the Lloyd's broker doesn't act responsibly, he won't have a market to place business in.

Reinsurance must disperse risk and not concentrate it. This harks back to the London market business. For reinsurance to work properly it is the spreading of the risk among a number of people who take a risk position. It's not churning it and concentrating that risk among a few people who don't really have the risk position. Lloyd's is not a volume market. It cannot trade competitively against large multiline insurance companies, who have an ability to write insurance and reinsurance business and count their profit as the investment income on it. Lloyd's cannot do that. It is regulated by the premium income it writes, and the margins that it is looking for are not met in the volume business.

The broker has to come to terms with the concept of limited liability as opposed to unlimited liability. For many years we rather glibly told clients that the security behind Lloyd's was unlimited. And it is a rather mythical thing to stand behind. Quite frankly, I think now that we've been through the problems and Lloyd's has the ability to show its balance sheet, it stands in a much better state as far as clients are concerned. People are more interested in exactly what the paid-up capital is and what the reserves are. We have had to modify the way that we sell the security. The broker has to recognize his place and the place of Lloyd's in the world market. Now a Lloyd's broker isn't restricted to placing business in Lloyd's. He has the best of both worlds, and he can access anyone else in the world who will deal with a broker. So it's just a question of balancing the business that is suitable for Lloyd's, (where Lloyd's is suitable for some clients), and utilizing other markets where that's not always the case.

So what is the future role of the Lloyd's broker? Well, I may be stating the obvious, but it is important for Lloyd's to continue to play to the strengths of the traditional broker-underwriter relationship: face-to-face dealing. If the client has an insurance or reinsurance problem to solve, he or she can get an instant decision from the broker who has the ability to sit down with the underwriter and get that decision.

Obviously in the world today, the broker has a role as a communicator. The flow of information is more critical in today's environment than it ever has been. The broker is going to become more of a specialist than ever. As a communicator—we touched on this a bit before—security is a substantial issue in the current market, in part because where Lloyd's is concerned, much of the press that it got through its recent troubles undermined a good deal of the current confidence in the security of the market. It's vital that the broker have an understanding of the paper security of Lloyd's, as well as some of the other intangible aspects of security. Some of those intangibles include the fact that security is not just the balance sheet, defined by who you've been doing business with. Do they understand the risks that they're taking, and whether that entity plans on being around for a period of time. It's all well and good to place a piece of business today that in five years has a claim. If the people you placed it with have gone, or the company that you placed it with wasn't really aware that the people you placed were this kind of business, you will have all kinds of problems. So there is much more to security than just the balance sheet.

It's important to communicate the risk information. We are becoming more and more obsessed with data as more becomes available. Electronic communication—Lotus Notes, electronic mail—mean that kind of information can be easily transferred, so the broker has a duty to make sure he can supply the information that enables the underwriting process to be more precise and more accurate. I'm calling that specific risk information, as well as the background information that the broker plays a substantial role in collating, whether it be the geological or geographic information as far as property risks are concerned. We do not have a substantial input on size-making activities as well as geographical spreads of people for the property insurance market. Politics obviously have more implications for areas of the world other than the U.S., and socioeconomic information is significant in the health care market. It's important for Lloyd's to keep pace with its competitors and its clients. It should know exactly what is going on in the world, and what developments are taking place in the world of reinsurance.

Next let me touch on the broker as specialist. We're accepting as a given that Lloyd's isn't so much a volume market. It's probably fair to say that as far as the U.S. is concerned, Lloyd's traditionally has written a substantial book of insurance business on a surplus lines basis from the U.S. Its difficulties, and the greatly increased appetite in the U.S. to write that kind of business itself means that it's more difficult for Lloyd's to compete on the insurance side. More business comes into Lloyd's from the U.S. through reinsurance. So for the broker to enable his underwriters to compete favorably, he has to develop some in-depth knowledge of what's happening in the market, and he has to understand the regulatory issues. I think this applies to any broker-underwriter relationship. Again, using the health care market as an example, the ability of somebody to make some profit out of writing either the insurance or reinsurance will depend on an understanding of the implications of the regulatory changes as they occur. The brokers are also involved in a pre-underwriting process. The client is really paying the large broker for his knowledge of the market, (the 170-odd syndicates), and his ability to understand what the client wants, and to direct a client toward the appropriate underwriting syndicate.

The broker as facilitator is increasingly involved in compliance issues. Again, this fits in with the regulatory atmosphere. As Lloyd's tries to develop new products, it's important that it's done legally. Also, the broker is increasingly utilizing our internal actuaries. That's something that's maybe not as traditional as many of the other services, but it's an important contribution that we can make.

I should also mention distribution of the expertise and the underwriting products that Lloyd's generates and the various peripheral services. In short, these are run-off services that brokers need to provide as we go forward and as the insurance world changes.

Mr. Rasmussen: I would like to give you some background on Lloyd's: on how it's structured and how it's changing, and also talk a bit about Equitas, which is the entity that has been formed by Lloyd's to handle the back year runoff. Roger touched on it earlier, and it's important to remember Lloyd's is a market, not a company. What that means is, it's a series of syndicates that operate autonomously and underwrite business and function separately under the umbrella of Lloyd's. Lloyd's has put together a shared infrastructure to handle the administration, but each of these entities is separate. Lloyd's has a history, 300 years of innovative underwriting, that has been the key to their past success and the key to their future success. Lloyd's has always been able to underwrite the unique risk.

It is an annual venture, which means that each year the syndicate has to get the financial backing necessary to underwrite business. Traditionally, they have obtained that through the individual names, and more recently through corporate members. But on an annual basis that has to be renewed.

Lloyd's writes half of the international business in the London market and sets the rate for two-thirds of that business. That tells you the presence they have and the fact that the two-thirds, where they're setting the lead terms, is critical to their importance. It also has more than a 6% share of the world reinsurance market.

In 1997, the total capacity for Lloyd's is over ten billion pounds. It is important to define capacity. Capacity is the total premium that Lloyd's can write. Individual names accounted for 5.8 billion pounds of that capacity, with corporate names now up to 4.5 billion pounds. There are 167 syndicates with an average of 60 million pounds of capacity, and there are 207 Lloyd's-registered-and-regulated brokerage companies.

I would like to discuss the chain of security and how the financial backing works. You have the individual and corporate members who provide financial backing. The premiums for each syndicate are put into premium trust funds, where they remain through the three-year accounting cycle. Lloyd's operates on a three-year accounting cycle for an underwriting year. So they'll write business in 1997, and through 1998, and in 1999 it will run its course. And then in the first part of the year 2000, for this underwriting year, they will close that underwriting year and then make a distribution to the names at that point. The individual names put funds at Lloyd's (FALs), with a risk-based capital ratio between 20% and 30% of their premium limits. The individual members have unlimited liability. Their personal assets are used to back that, and the phrase that has been used to describe this is, they're backing Lloyd's down to their last cuff link.

On the corporate side, FALs are deposited with a risk-based capital ratio between 50% and 200%. The risk-based capital level is determined by Lloyd's and is based on the volatility of the business the syndicates have supported to underwrite. The corporate members have a couple of different means by which they can put up the funds. They do have a corridor of a half million pounds that has to be put up in narrow securities, either U.S., U.K., or Canadian government securities. Above that corridor a wider range of securities including publicly traded stocks and bonds as well as letters of credit can be used. The corporate member has limited liability, limited to their FALs. If either the corporate or individual members are unable to fulfill their obligations, Lloyd's has created a central fund, much like the state guarantee fund in the U.S., to pay those losses. In the history of Lloyd's they have paid the entire amount of every legitimate claim. That has been a key strength in their history.

Next, I will describe the structure of the market. In the middle, you have the syndicates that are operated by managing agencies to write insurance and reinsurance policies. The syndicates have capital backing on the individual and corporate names. Then you have the initial policyholder, the insured using the Lloyd's broker to get to the syndicate.

There are four market segments in Lloyd's. First is aviation, which includes commercial, general, product aviation, and satellites. The hull and liability area is the major part of what's there. Motor is another segment, which is standard automobile coverage for U.K. residents, as well as fleet and specialty car coverage. Third is marine, which is hull, cargo, transport, and marine structures. And then the nonmarine segment is really the personal accident segment of the market, as well as employee and professional liability and specialty coverages.

I would like to give some background on the growth of corporate members. In 1994 corporate members were first allowed to participate in Lloyd's 25 vehicles, of which 24 were spread vehicles and one was a dedicated vehicle. Spread means that they're participating on a number of syndicates. Dedicated means participating on only one syndicate, or the syndicates in one managing agency. Dedicated vehicles have grown from one in 1994 to 48 in 1997. This is due to a change in Lloyd's regulations that allow corporations to buy managing agencies. This has led to insurance companies' buying the managing agency and providing all the backing for the syndicate through a corporate vehicle.

The types of corporate vehicles include spread and dedicated vehicles, as well as mixed, parallel, and stand-alone corporate syndicates. In some instances, parallel corporate syndicates have been formed alongside existing syndicates, to allow corporate backing support on an underwriter they are interested in when they are unable to get backing on the syndicate. The underwriter then will take a line for each of the two syndicates—the traditional syndicate and the corporate parallel syndicate.

There are two different types of investments by corporate names. There is a passive investment, which is where a corporate member selects a syndicate and backs them but has no direct involvement. And then there is a strategic investment, where there is control of investment in the managing agent. Currently, 45 managing agencies have a corporate investment, so it's becoming a larger part of what's being done. The corporate name, on an annual basis, makes a 1.5% contribution of capacity to the central fund.

With the change to corporate capital, Lloyd's has created a mechanism where existing individual names can convert to corporate membership, or at a minimum, convert to limited liability. Eventually, all of Lloyd's backing will be on a limited liability basis.

Reconstruction and renewal is the process that Lloyd's went through that led to the formation of Equitas. First, I would like to describe the problems that led to the formation of Equitas. Lloyd's experienced pretax losses of 7.9 billion on net premium of 25.3 billion pounds between 1988 and 1992. It also came up against investor expectations that were unprepared for the losses faced by the individual names. There was a huge growth in the 1980s in individual names in Lloyd's, and a number of people saw this as a way to earn a quick buck and did not realize really what the two obligations were. This led to some of the legal issues surrounded by action group names that were formed against syndicates. There was also an extreme concentration of losses. One of the things that has been a weakness in the Lloyd's market at times is keeping that loss within the market, and allowing it to spiral around rather than using reinsurance as a vehicle to spread the risk to outside sources.

Major losses that contributed to it were in asbestos, pollution, and health hazard claims. We've all heard much about that. There were disasters, natural or otherwise: the Piper Alpha explosion, the Exxon Valdez, hurricanes Hugo, Mireille, and Andrew—all contributed to large property losses, combined with the claims working through the LMX spiral process, which focused the concentration of business in the market rather than spreading.

The key elements of reconstruction and renewal include the formation of Equitas, to take on all the liabilities of 1992 and prior years. It also includes a settlement to the names for the 1992 and prior years of 3.2 billion pounds. A new central fund and a firebreak have been established to separate the old Lloyd's from the new Lloyd's. Equitas was funded initially with 14.7 billion pounds of reserves to handle the obligations for that runout of 1992 and prior business.

Now the good news is the results. For 1993, the market profit of just over one billion pounds was a 12.3% return on capacity. Projected profits for 1994 and 1995 are at similar levels. I think that's a sign of the fact that the market changed and got smarter in what it was doing, and now it is once again a strong market and ready to trade forward.

From the Floor: What happens to the remaining liabilities for the 1993 year when it is closed?

Mr. Rasmussen: At the end of the third year of the accounting cycle, a portfolio transfer is done. This transaction is called reinsurance to close.

Mr. Colin M. Owen: I don't have a crystal ball, and I'm not clairvoyant. If I did and if I were, there probably wouldn't be a need for actuaries in our industry. I'm glad

I'm not because it gives me an opportunity to enjoy the considerable actuarial support that we obtain from your industry.

The future of Lloyd's is an interesting subject. As you've seen and heard from what Erik and Roger have said, we have had to come a long way to overcome the problems of our recent past. What I'm about to say are my own thoughts, my own opinions, and not those officially of Lloyd's.

A perception of the future is incomplete without an understanding of the past. We really did begin in a coffeehouse. There really was an Edward Lloyd. And that coffeehouse was just down the road from where we are now trading in the City of London. The story began in 1688, 309 years ago, when a group of rich merchants assembled to drink coffee. They had to be rich because coffee was expensive. And somehow or other, somebody came in, and they shared out between them the risk of a voyage across the seas to the West Indies or somewhere. And at that moment they laid down principles that have lasted ever since. First, as I said, they were rich merchants who had earned their money in another trade. They were using those assets to support a second business, insurance risk taken. Second, they were individuals; individuals then as now had unlimited personal liability. It was a good business. It developed at the Lloyd's coffeehouse, it went on very successfully, and things happened that set the pattern ever after.

First, syndicates were formed. Groups of those rich merchants appointed one of their members to take the business on their behalf—but still as individuals, each with his own part and not one for another. Second, the transaction of business was undertaken by brokers, middlemen, intermediaries, and Lloyd's brokers, because they went in and out of Lloyd's coffeehouse.

Lloyd's had become a national institution, still only involved in the insurance of marine risks but under a formalized constitution. In 1774 John Julius Augestein was the driving force behind the move of establishing Lloyd's in his own home, the Royal Exchange in London, and writing the rules. The syndicated system became established, and in 1871, Lloyd's active parliament established Lloyd's as a self-regulated organization and set the tone for today's market. What followed was the emergence of professional underwriters, still only underwriting marine risks. With no marine emerging in the 1880s and 1890s, Lloyd's continued to prosper, through the involvement of a gentleman named Cuthbert Heath.

Then, in 1906, there was a big breakthrough, and out of bad came good. The 1906 San Francisco earthquake was a very considerable boost to Lloyd's; its status here in the U.S. became established and something happened of which we are extremely proud. Erik has mentioned that no policyholder who has had a valid policy has ever not been paid his claim. Even through our recent, very difficult period all valid claims were paid. That was true at the time of the San Francisco earthquake. Cuthbert Heath, who by then was the chairman of Lloyd's, gave instructions to pay all claims and quickly. That established Lloyd's reputation here in the U.S. because others sadly went out of business because of the scale of the loss. It gave a huge boost to the development of business here in North America, and the Lloyd's brand name was becoming global.

By the 1980s consumerism brought about investor protection and reforms to the financial services sector. Many were calling for Lloyd's to be the subject of external regulation. Lord Fisher was appointed by Lloyd's to conduct a review, and his report modernized the market. It brought about divestment at Lloyd's, which separated the ownership of the producers of business, the brokers, from the ownership of the risk takers, and the underwriters. Lord Fisher's reports, even though they brought about considerable change, reaffirmed Lloyd's as a self-regulated organization. Lloyd's enjoyed a great heritage, but what went wrong?

The period 1988–92 was characterized by trading losses. I give the total in pounds because it sounds substantially less than $13 billion if you measure it against the annual premium. It is roughly losing one year's written premium at Lloyd's, around eight or nine billion pounds. So we lost the equivalent of one year's premium in a five-year run. This was no worse than other insurance markets at that time, but that's still a great deal of money, and that was made all the worse by the losses being concentrated in a small number of syndicates, where the losses were disproportionately high. It brought about the need for the reconstruction and renewal program.

Let me just briefly explain the Lloyd's system for those of you who are not familiar with it. The boxes are still called underwriting boxes, harkening back to the theme of the coffeehouse. The static boxes are where the underwriters sit. We trade on four floors. The marine tradition has dictated that the ground floor remains the showpiece, and that floor is dedicated to the marine market. Fifteen thousand people a day at peak periods pass through Lloyd's. It's a magnificent place, and a wonderful institution.

When the Lloyd's market was only available to individuals and names as investors, those names agreed to take shares in syndicates. The accumulated total of those shares enabled the underwriters, the active underwriter and his team, to write a premium and accept the commensurate liability of that premium generated for that syndicate. The premium was equal to the total of the shares, the money that the names had committed. Now, unlike if you're a shareholder in an insurance company, where the worst that can happen is that you lose the value of the shares that you have purchased, at Lloyd's you have unlimited liability. You are responsible for your proportion of the total losses of that syndicate. Erik's comment about down to the last cuff link has really happened. In simple terms, when you become a member of Lloyd's, when you become a name, you are committing yourself to unlimited liability.

Now, that couldn't be the basis on which the Lloyd's of the future could trade. We needed new capital and corporate capital was introduced. The new form of capital was allowed to trade on a new basis with limited liability. Those new names came in alongside those names who still continue to trade with unlimited liability, and unlimited liability still remains. It represents approximately 56% of the current capacity at Lloyd's; 5.8 billion pounds is still through individual capacity in two forms: (1) bespoke capacity, in which the individual name chooses the syndicate that he supports, and (2) a members' agent pooling arrangement (MAPA) in which the members' agent acts as your investment manager. They pool together shares and syndicates to give a spread vehicle. MAPA capacity represents about 3.6 of the 5.8 billion, leaving 2.2 billion of the bespoke capacity. Unlimited liability remains, and there are many who are extremely keen to continue to trade that way. There are tax advantages in doing so and other advantages as well. I won't go into all that; it's far too complicated.

The important thing is that it is now knowledgeable capacity that understands the business it is in, and names understand that the key duty of capital is to support risk and to pay claims—a comment that also applies to the new investors. That capital is driven by hard-nosed investment people who recognize that those syndicates are still trading at Lloyd's, and that's down from 410 syndicates at its peak. Most of the remaining syndicates traded profitably through an entire period of losses at Lloyd's. Some of them made losses, but those losses were within a proportion of what might be expected by a properly run business. They are the people who attracted the new capital, and they are the future.

A recent change is that the names now have value in their investment—they own that capacity. There is a regular auction system now, and the second annual capacity auctions took place in 1996, when a combined total of 1.4 billion pounds of the 1997 capacity was auctioned, realizing 34.6 million pounds. The value in the capacity at Lloyd's is new. There have been many broker mergers. There are currently 301 Lloyd's brokers, and that's an ever-declining number. We are still an annual venture. That means each syndicate reforms itself every year, attracts new capital, and has to reform itself. But we still live by the three-year accounting method, where we close our years at the end of the period. The 1997 year trades all the way through 1998 and 1999 to enable all of the claims to come through for a proper evaluation of reserves to be established.

My own job at Syndicate 1206 is as a specialist, accident, and health underwriter. We're slightly different from the norm at Lloyd's now in that we are 94% corporate and only 6% traditional names. The U.S. features strongly in my syndicate. We have Allianz Life and the investment vehicle that they've created, together with Duncanson & Holt, part of the UNUM group. They are risk-aware capital, professional risk takers and money that I personally welcome because many names were becoming shell shocked and risk adverse through the troubles that we've recently experienced.

The underwriter is the ultimate risk taker. On the floor at Lloyd's, the broker comes to the ultimate risk taker, to the ultimate decision maker, and looks him in the eye and trades face to face. The marketplace is changing: there's a move toward niche players and specialist underwriting, developing the relationships with brokers, cover holders, and clients.

Each syndicate is run by a managing agency, and it's the managing agency's responsibility to employ the underwriter and his team. I, for instance, have a team of 24 people absolutely dedicated to the syndicate's role. Some of them trade at Lloyd's, on the box, and some of them are committed back to the back office. The Lloyd's marketplace is made up of leaders and followers. The leaders are those who negotiate the terms with the brokers and fix the rates that have been established by the rating methodology that they're going to use. They set the strategy, and they accept risk. They're responsible for the monitoring of the risk, the control of the risk, and for the claims payment on the risk. Leading business is not the only risk task. As the active underwriter, one of my many responsibilities is to set the reserves at the period of time when we close the syndicate and create what we call a reinsurance to close—a portfolio transfer into the next year to enable that syndicate to close its liabilities forward. This is actually where some of the problems in the past were experienced because small premiums were charged for what later produced very substantial losses as those closings were all put forward year after year. Inadequate reserves were created, and suddenly the losses had to be paid with inadequate premiums that were charged in the past and inadequate reserves that were rolled forward, with considerable losses at today's values.

The reinsurance-to-close function is performed for a syndicate that is closing its underwriting year and is paying out a profit. If that exercise cannot be done, if it's not possible to adequately calculate the known outstanding and the incurred but not reported, a separate function is performed—reinsurance for estimated future liability. That means the syndicate creates a reserve, and that reserve remains with that year of account, which remains open. You've heard about open years at Lloyd's: this is exactly what happens. You create a fund, and each year you recalculate the reserve that's required for the estimate of future liabilities. That fund needs to be topped up, until it is possible to close that year by adequately calculating the reserves that are required. Of course, we use the actuarial services substantially during this exercise.

We're going through a period of great change, and we cannot allow ourselves to drift back into the past and the old habits of the past. And we would not be allowed to. The current period at Lloyd's is characterized by significant regulation. Each syndicate now is required to produce a business plan, which is a voluminous document that contains the overall strategy of the syndicate: its risk acceptance methods, monitoring disciplines, and controlled plans. Good business practices are strictly regulated at Lloyd's to ensure compliance through the Lloyd's council, the Lloyd's market board, the Lloyd's regulatory board, and the corporation of Lloyd's generally, who have a very significant management structure. They're all necessarily doing their bit to ensure the future will be successful.

Lloyd's has had some tough negotiations with the regulators here in North America to satisfy them that the past is behind us. For instance, we have agreed to a new method of establishing trust funds—and this is at the syndicate level here in North America—to demonstrate our ability to pay claims. These are separate trust funds for U.S. reinsurance business and surplus lines business. These are deposits and not working funds, meaning that we have to pay out claims in addition to establishing a reserve, until such time as the calculation of the amount of money needed in the fund to meet future claim liabilities allows an adjustment that releases some of the funds back to the syndicate. This enables each syndicate to be assessed for its own solvency instead of the old practice of Lloyd's globally satisfying solvency over here in the U.S. A separate Lloyd's dollar trust fund has been established, in which the balance of the dollar premiums are held, while the Lloyd's American trust fund remains enforced, to continue to support policies accepted prior to August 1995. The plan is that as liabilities on risk accepted prior to 1995 decline, the Lloyd's American trust fund will be growing. And they're growing at a very significant rate. For instance, in my syndicate's first year of trading, 1996, the rate of deposit that we had to make to this new Lloyd's dollar trust fund was 74 cents on the dollar on average. It's quite onerous, leaving us 26 cents to run our business and pay our claims. It's a necessary evil because that was the basis on which Lloyd's was allowed to continue fighting here.

So what are the future changes we should expect to see or anticipate for future generations? Will we see 100% corporate capital? I think this is a high possibility. Part of me is almost wishing it, in that I welcome the risk-aware capital as opposed to some of the traditional names, who, I mentioned earlier, were becoming risk adverse. Of course, some of that corporate capital that I'm saying might become 100% of the capital at Lloyd's may come from the very individuals who today want limited liability, since they may incorporate themselves with limited liability corporations.

Will we be regulated by the Department of Trade and Industry? I think this is very likely. It's interesting to note that since I prepared these notes, Lloyd's itself only last week issued a press release that recommends that the accounts at Lloyd's should be subject to accountability to an external body as a respect of its regulatory responsibilities. Furthermore, it was announced only on Wednesday of this week that the new Chancellor of the Exchange for the newly elected British Parliament wants to create a new super-watchdog with responsibility for, among other things, the supervision of the Lloyd's insurance market. I quote, "it was to bring the regulation of banking securities and insurance together under one roof." There were too many regulatory bodies each trying to do their bit, to regulate the financial services sector.

Will we see Lloyd's as one public company? Or will we see a small series of smaller insurance companies operating under Lloyd's regulation? And what are the regulatory implications? I think and hope that's a low risk. Who knows what the regulatory implications would be.

Will we see statutory accounting as in the U.S.? I think we're definitely moving toward that. We're familiar with the statutory reporting that has to be completed by companies over here, and that whole trade and methodology is moving very much toward the way that statutory accounting applies to companies here.

Will we see a change in the distribution channels, removing the need for a broker or intermediary? I don't think so; in fact, I hope not. I feel the broker is most definitely value added. In particular, will there be dealings on the world insurance network or the Internet? I'm sure in this ever-changing world there is an inevitability of an ever-increasing trading volume on the Internet, but probably not for the esoteric risk that regularly challenges Lloyd's underwriters. Will we see direct electronic dealing or on-screen trading? Again, I'm sure that there's much business that can be effectively and efficiently conducted in this way. But again, it's probably not at Lloyd's, where I feel the face-to-face negotiation is still very important, where you can look the other fellow in the eye and see what he is thinking.

Will we see different types of syndicates at Lloyd's, concentrated on specialist and niche areas? Yes, most definitely. Will we see general composite syndicates? I think there is a medium risk of that. Since there is a considerable number of others that do that already, Lloyd's should concentrate on a slightly more unusual risk. That's what we built our reputation doing.

What markets will we see the future trading being conducted in? Definitely trading will continue to develop with our U.S. connections, so long as regulation doesn't stifle it. The U.K. and Europe are also a high probability. Obviously, we must cultivate business with our European partners. There is a moderate chance of trading in Asia and the Pacific Rim. We have a long way to go to understand and be accepted by Asian cultures, but we are opening the doors, as can be seen by the recent innovations to establish a permanent trading license with Japan. The other Americas—again, there is a medium likelihood, and, again, understanding of their cultures is necessary. We must also look to new horizons.

How will we achieve all these things? Whatever happens, the following fundamental issues will continue to occupy center stage in the future. We must develop or seek new markets versus old friends, particularly here in the U.S. Just because we've been doing business in a particular way for many years doesn't mean we can't do it differently and better. We must maintain Lloyd's tradition and innovation by maintaining what Lloyd's was famous for because our reputation has been tarnished. By continuing to maximize Lloyd's global franchise, we have a substantial network of licenses worldwide. Lloyd's currently transacts business in more than a hundred countries. We must remember we're in the service industry by better serving clients' needs on policies and claims, and we must meet the expectations in that capital by giving a good return on investment.

We must satisfy the needs of our employees. In these difficult times we must recognize and reward the efforts of those who have given their best by competing sensibly. There is no future in buying market share, and, yes, of course, that does happen. By reserving properly, we must learn from some of the mistakes of the past, by offering first-class security, which we always have done. I see no reason for that to change. In fact, I think the current changes have reinforced the security at Lloyd's. I don't think people really understood the mysterious way that members of Lloyd's have always had this unlimited liability, especially the American people. The concept of unlimited liability is something that most people struggle to grasp. We need to be highly professional. Sir David Rowland, the chairman of Lloyd's, in his recent speeches pulls no punches about the incompetence that was allowed to drift into Lloyd's. It's not for me to comment on the competence or incompetence, but Sir David was most damning about some of the idiotic things that were done that caused the problems of the past. As I said earlier, those syndicates that are trading today have mostly traded through the darker days. It was professionalism that saw them through, and that must continue. We must conduct our business profitably. We should not be ashamed to broadcast the fact that we are in business to make a profit.

I, like all my other underwriting colleagues at Lloyd's, need to perform well as individuals, as a separate trading unit, and as successful businesses, so that, collectively, we all can do our best for that institution to which we owe our livelihoods. We must ensure our ability to trade in the way that we do in the insurance market known as Lloyd's of London.

Mr. Rasmussen: One additional point: the active underwriter in each syndicate has been one of those individual names. Colin is an individual name on the syndicate he backs. If you want to talk about risk taking, that's true risk taking. The decisions he makes day in and day out impact him personally on a financial basis. I think that's also a strength of the market.

Mr. Owen: It's not just a common thing. Lloyd's requires the active underwriter to have his money where his mouth is. If I'm expected to commit others, they need to see that I've committed myself. Apart from it being my livelihood, I'm required to invest personally in my own syndicate. I am a name writing 350,000 pounds at Lloyd's, and I have 300,000 pounds on my own syndicate. It is a commitment that I have to make. The size of it isn't dictated; the fact that I must be a name is.

From the Floor: I was wondering if the advent of capacity, that's limited liability in effect, leverages the liability of the remaining capacity that has unlimited liability, or is there some mechanism dealing with that? And if there isn't, it would seem that after a certain point, the remaining capacity with unlimited liability would have an intolerable risk. For example, if you had a syndicate with 50/50 limited/unlimited capacity, and you had 110 million of losses on 100 million of premium, does that ten million in excess all inure to the half with the unlimited liability?

Mr. Rasmussen: It would depend on the gearing, and it would depend on the deposits. You would need a loss much larger than that 10% of both to make the limited liability go away. If you have a huge catastrophic loss, and if you go through a period like they went through from 1988 to 1992, yes, there is potential negative impact on the individual name. But it would have to be something dramatic like that, not in the normal course of business.

Mr. Owen: That's why Lloyd's has done an exercise to create the increased gearing for the corporate names. The gearing required for individual members is 20–30% for its risk-based capital, whereas for the corporate member, it's a minimum of 50%. In addition, the contribution into the Lloyd's central fund is greater for the corporate vehicle than it is for the private individual. Again, that's because of the possibility that the unlimited line could have greater ultimate loss than the limited liability investor. The FALs and the contribution into the central fund at Lloyd's is greater for limited liability capital. It's more expensive to join, and that was what I sort of touched on when I said that there were definite tax advantages for the individuals, and other advantages as well. The levies at Lloyd's have been quite onerous lately, and they've been more onerous for the new corporate capital that has come in. They wanted to join the club, so to speak, and they've had to pay a premium for doing so. But your point is valid, and the risk does remain, that if there were another catastrophic period, the unlimited name could find himself disadvantaged. But he always had that risk. Nothing changes there. It's only the limited capacity that has come in that is actually trading differently.

Mr. Rasmussen: And when Colin touched on the central fund contribution, the corporate side is 1.5%, and for the individual name it's 0.6%. So there is a significant difference between that contribution level.

Mr. Daniel L. Wolak: Erik, let me ask you a question in regard to the actuarial role with Lloyd's of London. It seems like with the Lloyd's of London situation, you would look to have a situation created where you have an eligible underwriter who is at risk. From the actuarial side, though, it wouldn't seem like Lloyd's of London has much data analyzed from an actuarial side. How would you compare that to sort of the normal, traditional arrangement of a U.S. reinsurer or Allianz reinsurer, where there might be more data provided back to the actuarial side of the house? What do you see as the pros and cons in the role of the actuary in regard to Lloyd's of London or the need for the role of the actuary in the Lloyd's of London marketplace?

Mr. Rasmussen: First, with regard to your point about the data, it's certainly a different class of business in many ways. In many ways, it's a very similar class of business. One of the things that Colin's syndicate does, for instance, is self-funded medical programs in the U.S., which is the same as what our company does. So the actuarial side of it can be very similar there. He also does some unique risks where it's hard to measure, hard to quantify, and difficult for the actuary to try to quantify it. I've been dealing in the Lloyd's market for three-and-a-half years now, and we're beginning to see more involvement from the actuaries in that marketplace in terms of reserve setting. As Colin indicated, he sets the reserves right now. There is more actuarial involvement though, and I think as you go forward and get into a U.S. GAAP-type accounting methodology on a single-year accounting basis, which I think is looming in the short term, there's going to be a greater and greater role, and a greater and greater need, for actuarial support and services for the syndicate.

Mr. Owen: I agree, and I must emphasize that we use actuarial services substantially for our writing basis. Erik mentioned the medical business. Our rating methodology breaks the whole U.S. down into various zip codes. An actuarial model is very helpful in establishing the rate that we use for that. We also have a need for an actuarial assessment for our reserves in the reinsurance-to-close exercise. It's such a public exercise now. Although I'm ultimately responsible for setting reserves for my syndicate, I have to look at them in every way, and we have substantial actuarial input and accounting advice before we establish any reserve. It's required again by Lloyd's.

Ms. Theresa M. Resnick: Has the presence of limited liability changed the rates? And as more corporate money is backing the syndicates, will rates continue to change?

Mr. Owen: I don't think it's the limited liability that has changed the rates; it's the providers of the limited liability who are far more professional, and far more aware. I use the phrase "hard-nosed investment people." They've chosen very carefully to come into Lloyd's and have chosen very carefully the syndicates they're backing within Lloyd's. They expect, and quite rightly so, a proper return on investment. They're not interfering, but they're making their presence felt and ensuring that we are aware of the bigger picture of what's going on in the world. Allianz can act as eyes and ears for us over here, and we have our own intelligence network. We get constant feedback. You've seen the considerable roles that the broker plays. It would be easy for brokers to mislead. Some would say perhaps that they have a vested interest in doing that. They do not. But it could be construed that way if something went wrong, if we placed reliance on the broker's information or wrong decision. But having the feedback and corporate backing that is aware of what's going on in the market is invaluable. They've not had a direct influence on the rates, but of course, they are aware and professional people with knowledge, and are going to influence the way that we do our business.

Mr. Rasmussen: My perspective comes from not only the corporate backing side of Lloyd's, but also from operating in the market in the reinsurance side both as a buyer and seller of reinsurance. Corporate backing has, like Colin said, brought more professional backing to what's done, but it's not changing the rates.

From the Floor: When the reinsurance-to-close transaction occurs for the 1994 underwriting year, where are the reserves transferred to?

Mr. Rasmussen: Into the 1995 underwriting year. And as Colin alluded to, part of the problem that happened from 1988 to 1992 was that the reinsurance-to-close reserves were understated and the liabilities were pushed forward unknowingly.

Mr. Owen: Simply put, the reinsurance-to-close function requires the active underwriter, and all the support services that he can use for this function, to evaluate whether the current reserves are adequate to pay the known outstanding claims. Once we are satisfied, our auditors are satisfied, and everybody who has to be satisfied is satisfied that the reserves are adequate; the transfer takes place in the form of a premium to close. It's a reinsurance risk premium that's charged to the current group of names. They pay that premium forward to the 1995 group of names, who accept the liability incoming. This enables us to close the 1994 year and discharge all our liabilities to the 1994 year. The 1995 names are required to accept the incoming risk. Now, if we get that wrong, that running forward mechanism creates a loss for the ultimate names. They do such a thorough exercise now that, I cannot see where we can get it wrong going forward. I'm sure there will be some mistakes made. But I always find it very easy. This is probably where one hesitates. I always find it a very easy function, because the accident and the health market sells a benefits policy. We're not subject to the whims of the law. We only sell benefit policies. When this happens, that's what we pay. It's a stated benefit, and there's not any way it can be increased. So it's very difficult for me to underestimate the outstanding reserve that's required, because it's a lump sum. It's a benefit, and it's just a question of addressing all the benefits. We're selling the more complex liability business that's written, like the pollution area has had losses that have gone forward.

From the Floor: Can the reinsurance-to-close create a windfall for the names assuming the risk?

Mr. Owen: Yes, that can indeed happen. When they went through the exercise to close 1992 and in prior years into Equitas, a number of syndicates had reserves released to them due to redundancies.