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The Revitalized Lloyd's of London

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Moderator: ANDREW S. NIEDZIELSKI
Panelist: ERIK J. RASMUSSEN
Recorder: ANDREW S. NIEDZIELSKI

Summary: The reorganization of Lloyd's of London has revitalized this venerable organization. It has both a new capital and governing structure.

Mr. Andrew S. Niedzielski: I'm an actuary and director of product development research for CIGNA Reinsurance in Bloomfield, Connecticut. Several months ago, I was provided with the unique opportunity by my employer to investigate the possibility of CIGNA Reinsurance developing a corporate capital syndicate at Lloyd's of London. I jumped at the opportunity, although, as I've since come to learn, I knew very little about Lloyd's, and of the little that I knew, most of it was wrong. The first thing I was wrong about was my assumption that Lloyd's is an insurance company. In the months that followed, I've cleared up many of my own misconceptions and learned about an organization that impacts insurance and reinsurance business in virtually every corner of the globe, including the U.S. I also learned about an organization that has undergone tremendous difficulties, struggling for its very survival, and which is undergoing tremendous change. I'm extremely fortunate to have Erik Rasmussen on the panel with me. Erik is an ASA, and a member of the AAA. He's senior marketing manager for Allianz Life Insurance Company of North America where he's responsible for group reinsurance on both the ceded and assumed side. Erik also established North American London Underwriters (NALU), Allianz Life's corporate capital vehicle at Lloyd's. As such, Erik is well versed when it comes to Lloyd's.

What Erik and I hope to accomplish in this session is to provide you with some basic background regarding Lloyd's. Perhaps we'll clear up some of your own misconceptions and discuss some events and changes that have taken place at Lloyd's as a result of these events. We'll also talk about Lloyd's involvement in the U.S. marketplace.

Mr. Erik J. Rasmussen: I'd like to give you some background on Lloyd's and clear up some of the misconceptions. I'm going to touch a little bit on Equitas, the reconstruction and renewal program that Lloyd's recently completed. Then Andy is going to get into much more detail than I will. Hopefully, it will be educational. That is the main thing.

The first thing is Lloyd's is a market and not a company. It is not an insurance company. It is really a conglomeration of underwriting syndicates that can take risk. The syndicate is led by an active underwriter. The active underwriter, along with the staff that he or she has, will make the decisions about risks. The capital for that was traditionally provided by individuals and now, over the last three or four years, it has switched to a mix between individuals and corporate capital.

Lloyd's has been operational for over 300 years. It started in a coffee shop in London run by someone named Edward Lloyd. A group of wealthy merchants were looking to insure cargo that was going across the Atlantic to the U.S. They formed the original syndicate. They had groups of people that were backing it up to provide insurance coverage, and part of that structure is what has led to some of the unique things about Lloyd's and what it is doing right now. One of things that's unique is the three-year accounting cycle. Three hundred years ago, it took three years for a ship to leave England, make its way to the U.S. and then come back. Then they'd have word whether that ship actually made it or not and whether there was an insurance loss.

It is an annual venture, which means that each year each syndicate must get the capital backing that it needs. While it still has a continuous cycle of finding capital providers, with the advent of corporate capital the syndicates becoming less dependent on that. Lloyd's writes half of the international business in the London market and sets the rates for two-thirds of that business. The London market has grown over the last several years. It has companies outside of Lloyd's that are functioning, but Lloyd's still plays a prominent role. More then 6% of the worlds reinsurance is placed at Lloyd's. So they're a significant player in the world market.

The market, in 1997, had a capacity of over ten billion pounds. Individual names were over five billion pounds and corporate capital was just under five billion pounds. As we move into 1998, the expectation is that corporate capital will become the dominant player. I've heard estimates of in the range of 60% or higher for 1998. So you're seeing a real transition from that traditional individual to corporate capital. Some of that is individuals that have incorporated; some of it is just really the worldwide influx of insurers into that market.

Some 167 syndicates are active with an average capacity of 60 million pounds. The meaning of capacity there is a little bit different than what it means here. Capacity is the amount of premium that can be written by the syndicate. They have the ability to write on average 60 million pounds worth of premium, or, as a market, Lloyd's can write up to ten billion pounds of premium.

There are 207 Lloyd's registered and regulated brokering companies. We'll get into the structure later, in terms of how risk gets into the market. The Lloyd's broker plays a key role in that process. In fact, the only way to access Lloyd's is through that Lloyd's broker.

The chain of security has really changed over the last couple of years. They're tightening things up, and they have really put together a four-stage process. The security that backs Lloyd's is taken care of.

I'd like to explain a premium trust fund. When a Lloyd's syndicate writes business, and when they begin to receive premium, the premium isn't disbursed to the people providing the capital backing. It's put into a premium trust fund. That premium trust fund sits there through the three years of that accounting cycle and is used to pay claims and other expenses that the syndicate may have. It also accrues interest. That trust fund, at the end of the three-year cycle, when they close that underwriting year, is what is then distributed to the names. One of the things that's probably important to touch on about that process is what really happens at the end of that three-year cycle. Before that money is distributed, there's a transaction called reinsurance to close. Reinsurance to close is the process by which the individual syndicate can close an underwriting year and make the disbursements to the names on there. That process includes a reserve exercise that looks at really the incurred but not reported (IBNR) that are necessary for the runout of that business. That reserve then would be transferred to a subsequent underwriting year of a syndicate.

For example, let's say syndicate A is functioning for the 1995 underwriting year. In the first part of 1998, it will do a calculation of what its projected liability is for the runout of the business it wrote in that year. It will take that reserve and transfer it to the 1996 underwriting year. The liability will go there, and the same thing will happen in subsequent years. When there are questions about that process, questions about the business that's in there or if there is some piece of business for which it's going to be hard to find a good reserve number, it has the option of keeping a syndicate year open. You might hear somebody talk about open years at

Lloyd's. There might be a syndicate that decides that for the 1994 underwriting year, it is going to keep it open until it has a degree of certainty about making an appropriate reserve calculation.

Let's go back then to the chain of security. The second chain is funds at Lloyd's. Each name at Lloyd's is required to make a deposit of funds that is put on deposit at Lloyd's. The percentage of capacity varies between the individual names and the corporate names. If there are actual funds that have been on deposit in the event that the losses exceed the premium trust fund, then they will begin to draw down on those assets that are set up to support underwriting. The individual names have to put up between 20% and 30% of the capacity that they committed.

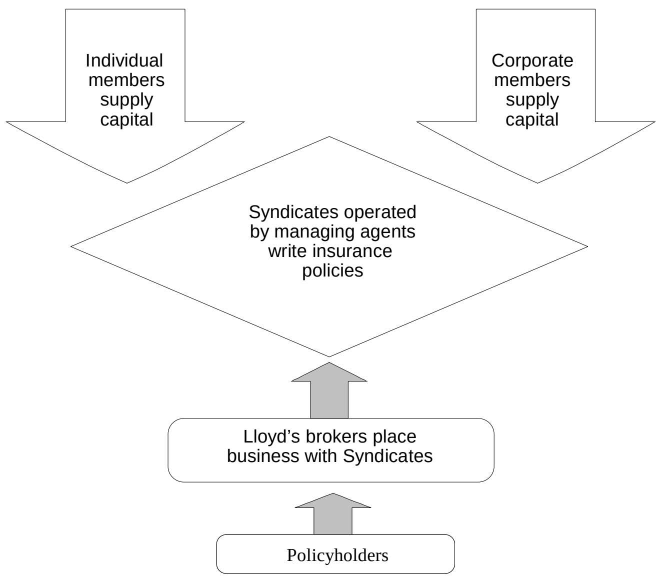
For corporate names, the minimum is 50%, but the range is as high as 200%, depending on the syndicates that they support. I'll have a little more detail on that later. Lloyd's does a risk-based capital (RBC) calculation that looks at the C–2 risk. It requires funds to be placed on deposit in order to support that.

The third link is members' other assets, and by *members*, I mean individual members. Individual members have unlimited liability. That means once the premium trust fund has been exhausted, the funds at Lloyd's have been exhausted, you can then begin drawing down their personal assets. Many people have heard the term, down to their last cuff links. That is true of the individual names at Lloyd's. They are at risk down to really their last pair of cuff links. There are many people that, through the period of 1988–92, when there were a lot of losses, lost their home and other assets because of the writings that they did through Lloyd's.

The fourth link, when those assets are exhausted, is the central fund. Each of the individual members make a contribution as well as the corporate capital member. Individual names deposit 0.6% which will eventually be increased to match the corporate capital deposit of 1.5%, of their capacity that is going into the central fund. The Lloyd's central fund works in a similar fashion to the state guaranty funds. The important thing about the chain of security is the fact that Lloyd's has always paid all legitimate claims. It has never defaulted on any claim, and I think that's one of the things that the people at Lloyd's are particularly proud of in their history. Despite the troubles they've had over the last several years, they have made good on every claim, in every instance.

Chart 1 shows the structure at Lloyd's. In the middle of the diagram is the syndicate. The syndicate has the ability to write insurance and reinsurance policies and is operated by a managing agent. The managing agent is the one that provides the back room and the infrastructure necessary for that syndicate to do business. The top part shows the individual names and the corporate names providing the capital they need. The bottom part is the policyholder going to a Lloyd's broker, who then will place the business with the syndicate. As I said, the only way to access Lloyd's is through a Lloyd's broker. As a result, brokers play a key role in this process.

CHART 1
THE STRUCTURE



Lloyd's can be broken down into four main market segments. The first is aviation, which includes commercial, general, and product aviation. Lloyd's is also involved in satellite coverage. The motor side of it is U.K. motor business. I believe Lloyd's is the largest provider of auto insurance in the U.K. It provides standard, fleet, and specialty car coverage.

The third segment is marine business: hull, cargo, transport, marine structures. Again, it is covering the shipping and the offshore oil rig portion of the business. Finally, there is the nonmarine segment, which is really kind of the catch-all of what's being done there. There is life, accident and health (A&H), employer and professional liability, and other specialty coverages.

I want to go into a little bit about corporate membership and more details in terms of the structure. As I mentioned earlier, corporate membership started in 1994 with Lloyd's. It has grown significantly over the four-year period from 1.6 billion pounds of capacity in 1994 to 4.5 billion pounds of capacity in 1997. There are two types of vehicles within that structure: spread and dedicated vehicles. The spread vehicles would be the way the individual names at Lloyd's have operated. It would be a vehicle that participates in a multiple syndicate across multiple market segments. When they set up the corporate capital, things were geared much more favorably towards people that had spread vehicles. When you're doing the RBC calculation, for instance, the more syndicates that you're involved in, the better. They were looking for a minimum of five syndicates, and they wanted those five syndicates to be separate managing agencies. If there were less than five syndicates, meaning less than five managing agencies, there were debits against your RBC, which pushed the numbers higher. They were also looking for diversification across market segments, which made it an interesting process. When we began our corporate capital vehicle in 1995, we wanted to be focused on the nonmarine market. We were penalized to begin with, with the RBC number of 65%, because of the fact that we weren't spread across market segments, and we didn't have what they were looking for.

The dedicated vehicles are ones that are focused probably on one syndicate or maybe multiple syndicates of one managing agency. You've really seen that number take off as two things have happened. Lloyd's has relaxed its RBC requirements in terms of the necessity for the spread. But also, companies have bought into the managing agents in Lloyd's market and taken an ownership interest there and only want to back the syndicates that are part of that managing agency. Of the 48 dedicated corporate names in 1997, I'm willing to guess that the vast majority of those have ownership interest in a managing agency.

Let's talk a little bit more about the types of the vehicles. We talked about the spread versus dedicated. There is also mixed, parallel and stand-alone corporate syndicates. The mixed syndicate is similar to the spread. However, the parallel or stand-alone corporate syndicates are different. The parallel would be one where an existing syndicate forms a parallel syndicate, so the underwriter would be taking risk. Every time it took a risk, it would sign for Syndicate A and Syndicate B. Syndicate B was set up with the sole purpose of having a new corporate membership become part of the backing of that. It is taking the same identical risk, taking similar lines, but it's just making sure that the corporate name is getting a line on what it is doing without disrupting the individual names that have backed them over a period of time.

Then there's the stand-alone corporate vehicle, which is really where the corporation has come in and bought the managing agency. It has really bought out the capacity. You can buy capacity now through an auction process. The corporation can buy out the capacity of the people that were on there and make it a corporate vehicle.

Let's discuss passive and strategic investments. In the passive investment, somebody doesn't have that involvement in the managing agency. In the strategic investment, people have control, or at least an investment in that managing agency. They do have it noted here that 44 managing agents have corporate investments at this point. That's a number that continues to expand and grow

Let's discuss corporate members. The conditions of membership mentioned a little bit earlier were a 50% minimum RBC level. Those funds from that 50% RBC level are on deposit at Lloyd's and support a limited liability entity. When you become a corporate name of Lloyd's, you don't do it using your corporate name. I'll use our situation as an example. Allianz Life is not the corporate name at Lloyd's. We have formed a wholly-owned subsidiary that is a limited liability company, and it serves as the corporate name. The name is North American London Underwriters. The real distinction between the corporate name and the individual name is the limited liability versus unlimited liability. I mentioned the 1.5% contribution to the central fund earlier. There is a process by which existing individual members can convert to corporate membership. The main advantage is the unlimited versus limited liability. The disadvantages are the higher deposit into the central fund and the higher RBC level. So Lloyd's is working on equalizing that process and, over time, there probably won't be any more unlimited liability, and there will probably be no difference in the central fund deposits.

Let's touch on reconstruction and renewal. I think a lot of people have heard or read in different publications about what's going on with Lloyd's and the process that led to reconstruction and renewal. There were a couple of different reasons. First, there were pre-tax losses of 7.9 billion pounds on net premiums of 25.3 billion pounds between 1988 and 1992. Investors were unprepared for this. You had an influx in the mid-1980s of a large number of individual names that were new to the marketplace. These names had probably overextended themselves to become part of Lloyd's, but had heard about and were tempted by the returns that others were getting.

There were also extreme losses. Those losses include asbestos and health hazard claims, that came in at that period of time. Some disasters were the Piper Alpha explosion, which is a offshore oil rig. There was the Exxon Valdez oil spill and hurricanes Hugo, Mireille, and Andrew.

Another reason for reconstruction was the LMX spiral, which is really a concentration of losses in the market instead of spreading those catastrophic losses. Allow me to use an example to explain a spiral. Let's say Syndicate A buys its reinsurance protection from Syndicate B. And Syndicate B buys its reinsurance protection from Syndicate C, who then buys its reinsurance protection from

Syndicate A. What happens is they keep passing those claims amongst themselves, instead of taking those claims and spreading them outside of Lloyd's to other entities. And that concentration of claims causes a huge cash-flow problem and keeps that loss concentrated in the market.

So Lloyd's looked at the situation and decided that if they were going to go forward, they needed to make some serious changes, and they needed to do it very quickly. Andy will give more details of this. The key elements was the formation of an entity called, Equitas Reinsurance Limited. Equitas is an entity that is providing reinsurance of all liabilities allocated to 1992 and prior years. It takes into account some of the runoff of those things that are significant.

There was a settlement offer made to the names for the 1992 prior liabilities of 3.2 billion pounds. There was also the establishment of a new central fund, a firebreak to separate the old Lloyd's from the new Lloyd's. That was considered key in terms of the marketplace, and in terms of comfort and interest that people had if they were to buy reinsurance from Lloyd's. It separated the two entities. Equitas Reinsurance Limited was funded with the premium of 14.7 billion pounds, in order to support its operation.

I'd like to discuss the thoughts of underwriters that we're dealing with and the key issues that they're facing. The first is the U.S. dollar funding. As part of the processes that went through reconstruction renewal, there was some restructuring of trust funds in the U.S. There was a formation of the Lloyd's Dollar Trust Fund (LDTF) and that was to support reinsurance and surplus lines activity in the U.S. The insurance business that Lloyd's does in the U.S. is on a surplus lines basis which really encompasses all the business that's being done in the U.S. This is a deposit that is made and held in the state of New York, but it's not a working fund, so the calculation of it can be very difficult for the syndicates and it presents a cash-flow problem. They have to put up deposits into this fund and maintain them. They have to pay out claims and the expenses outside of those funds. Those funds over the three-year period get released, but on the front end the deposit is large, it becomes very difficult from a cash-flow standpoint.

Deposits match the outstanding losses of gross reinsurance, so they have to look at it from the standpoint of gross, not net. If they buy reinsurance protection that would help offset that, that does not help their situation from the trust fund basis because they have to put up that full gross deposit, which is even more of a difficult restriction over here. So I imagine there's a quarterly calculation and adjustment. There's regulatory reporting at the syndicate level. What that means is that, at the syndicate level, that information by Lloyd's is reported to New York state. That means they're making sure that each syndicate meets its requirements on it's own.

The LDTF is for new business. The Lloyd's American Trust Fund (LATF) is for policies beginning prior to August 1, 1995. That trust fund had much less stringent requirements, and obviously created a much more favorable situation for people.

What are the keys to the future success? What are the things that Lloyd's needs to do to maintain their position in the market and continue to grow business? It must seek new markets versus old friends. I'll show you the breakdown of business worldwide. Lloyd's has been very dependent on U.S. business. This market is very difficult and very competitive. With all the issues that they have, particularly with regard to trust fund requirements, they need to look for new markets and new opportunities that provide a more favorable opportunity to make a return. They need to live off their tradition and their innovation. They've always been an innovative reinsurer or an insurer, and they come up with greater risk. Andy was eluding to some of the things that they have gotten involved in before. They need to continue to trade off that reputation and tradition that has been established.

Another key will be improving and maintaining that reputation worldwide. The press has reported a lot of negative things, but the press tends to look for negative things rather than focus on the positive things. They need to trade off their strengths and continue to get that message out to people.

Lloyd's must continue to maximize it's global franchise, and that's related to seeking new markets. As an organization, Lloyd's must continue to find ways to do business in places other than the U.S., and it must trade on that name and that reputation. Serving customer needs is a standard one for anybody who's in business. But they need to continue to provide good prices, sound policies, and make good on claims on a timely basis.

Lloyd's must meet the expectation of capital. It's world has changed. It has many educated and active capital providers. These providers are also more demanding. They need to meet the expectations of those investors and continue to get better at what they do in order to do that.

Lloyd's must also satisfy the needs of its employees. That market is changing. Many people at Lloyd's have seen a lot of change in the last three or four years, and they continue to help grow and educate those people, so they can do more as they're being asked to do more.

What are the fundamentals that will get Lloyd's to success? It must compete sensibly. It might have to avoid some business and make sure that things are adequately priced and find a niche area where they can compete. It must reserve properly. People will argue that some of the problems from 1988 and 1992 were related to reserving. That means probably greater opportunity for the actuarial profession in that market than there has been.

Offering first class security is the key to be able to trade off that strong Lloyd's name and make sure that it's reputation is not tarnished. Growing appropriately means finding the right segments, the right business, and the right places to grow. Two other fundamentals of success are behaving professionally and conducting business profitably. I did a session on Lloyd's in the spring with an underwriter, Colin Owen. He said, "When I sit down with people, whether it be an insurance market that we're dealing with as a reinsurer or whether it be a broker, I'm not afraid to tell them that my job is to make a profit for the people that are investing in me." Sometimes people are afraid to admit what their real focus is. Lloyd's underwriters are focused on that more that ever and more than willing to say to people, "I'm looking for a way to do this business profitably, or I'm not going to do it. My sole purpose is to do things profitably."

What are some changes we can expect in the future? Given the trend that's going on, given what's changing in the marketplace, given what Lloyd's is doing to encourage it, there's a high probability that, over the next several years, it will be at 100% of corporate capital. I think it's a trend that's inevitable. Regulation by the Department of Trade and Industry (DTI) would mean the end of self regulation. Currently Lloyd's is not regulated by any authority within the U.K. It is a self-regulated organization. It does have a large structure of regulatory bodies. But the time has come for Lloyd's to be accountable to somebody outside the organization, and I think you're seeing that movement. You may see that move as early as the first part of 1998.

You might see a move to a U.S. statutory accounting cycle or something that we're more familiar with. As your capital base changes to corporate capital, I think there's an impetus to do that. On the other hand, because of the tradition and the way the business is written on that three-year accounting cycle, it will be a difficult transition. They have other issues to tackle besides that one. I mean it's not as simple as just saying, "OK, we're going to have a more permanent capital structure. Now we're going to do single-year accounting." They have systems that are geared towards three-year accounting, and processes that are all set up that way. There would have to be a huge infrastructure change before they could do that. I think there are bigger fish to fry at this point. So the probability is that this is more of a long-term change than a short-term one.

Electronic trading might be a possibility in the future. There has been a lot of discussion within the market of brokers about being able to send the slips and deal with the risk electronically instead of having to go to Lloyd's and stand in line and wait to see the underwriter. I think there's a low probability of that because that business is so geared towards the relationship and the face-to-face contact. The underwriters I talked to value the opportunity to sit down face-to-face with the broker and have that direct conversation with them. I think they will resist that. So I think the probability of that happening is low.

There might be changes in the type of syndicates. I think you're going to see more and more syndicates become specialist syndicates, or single-market segment syndicate. For instance, you might see a syndicate that's just focused on the personal accident business, instead of having bits and pieces of property coverage. That will be driven by the corporate capital backing. They're going to want more of a focus and more specialization. Another one is the generalist or composite syndicate. A generalist would be the one that has that broad spread. And you've seen it in some of the bigger managing agents. They've taken multiple syndicates, and they've merged them into one jumbo syndicate because they think that gives them the opportunity to trade better in the world market, when they have the ability to write 400 million pounds of capacity, instead of having five entities that can do 80 million pounds each. I think you'll see some of that continue, but I think the corporate backing will slow that trend as we go forward.

Where is Lloyd's going to have growth? Where are the opportunities to have growth in the market? The U.S. will have medium growth and it will continue to need to do some things in the U.S. I think the trend will be to grow away from this market a little bit. The U.K. and Europe will have high growth. There's a lot more focus on getting involved there, particularly on the continent where it hasn't been prevalent before. Asia and the Pacific has medium growth and part of that is not because of Lloyd's lack of desire, but because of some of the cultural issues that will be raised from being over there. Lloyd's has just opened an office in Japan, and I think you'll see them to try to make significant effort there, but it will be difficult.

South America will have medium growth. I think that's partially because there are a lot of people in North American that are looking at South America as a growth market. I think we've seen growth in Lloyd's business in South Africa, as an example. We continue to see emerging markets. India is another area that is an emerging market. There's a lot of discussion about the business there and the potential to do some things.

What have all these changes meant? What have all these things done? And 1993 and 1994 were largely successful years. There was over a billion pounds of profit in each of those years. 1995 and 1996 are years during which there was a downturn in that projection. Obviously the results are still satisfactory from the eyes of most of Lloyd's investors. 1995 and 1996 were soft markets. Hopefully, things are starting to firm up. I would think if you were to ask me what 1997 will bring, I would say that it would probably be something more like 1996 than 1993. So once Lloyd's got passed the 1988 and 1992 losses, it has made some corrections and taken advantage of their position in the market. With that I'll turn it back to Andy.

Mr. Niedzielski: In his presentation, Erik touched on the reconstruction and renewal process and the three main points of that proposal. I'm going to talk about the underpinnings of that reconstruction and renewal process. Successful development and implementation of this process was quite simply an issue of survival for Lloyd's. They were faced with names in bankruptcy or on the verge of bankruptcy or on the verge of losing their homes. These names were faced with the prospect of finding out just what unlimited liability really meant.

Erik touched on the three keys. The first one was reinsuring the old liabilities from 1992 and prior years and getting them away from the ongoing market. The second point was the settlement offer for names. This would be an opportunity for names to have closure at Lloyd's, but at the same time, it would need to be an incentive for these names to want to accept the proposal. If Lloyd's simply came to them and said, "These are your liabilities. Pay up," it would not be enough. Third, they needed to creative the firebreak between the old market and the ongoing market in order to provide comfort for policyholders, as well as to attract capital to the marketplace.

So the first step was the creation of a reinsurance company, which would come to be known as Equitas, and again, Erik talked a bit about this. It was authorized by the Department of Trade and Industry (DTI) in March 1996. It was funded with a premium of 14.7 billion pounds that was meant to cover both claims that would need to be paid, as well as the ongoing operating costs of Equitas. You can imagine how big a structure would be needed to handle all these claim payouts over the 20, 30, or more than 40 years over which claims would need to be paid. In fact, the present value of the operating costs has been estimated at about 1.2 billion pounds. Probably the most important item associated with Equitas was the idea of a proportionate cover provision. This was done at the request of the DTI. What a proportionate cover provision allows Equitas to do is to have an alternative to insolvent liquidation. In the event that it became apparent that Equitas wouldn't have enough funds to meet all of its obligations, it could turn to this proportionate cover. It would determine what percentage of its outstanding liabilities it thinks it could cover. It could choose to pay at this reduced rate (lower than 100%), rather than be forced into bankruptcy by the creditors. So this was a critical item.

A key to Equitas was valuing the liabilities. Again a major undertaking, due to the nature of the liabilities. It began in late 1993 and spanned a 2.5-year process. It initially focused on liabilities that were related to the 1985 and prior underwriting years, and then was later amended to include 1992 and prior years. The reason for choosing 1985 was not arbitrary. 1985 marked an important change in claims wording for U.S. policies. In 1985, it changed from an occurrence basis to a claims-made basis.

The asbestos, pollution, and health hazard risks ended up accounting for 40% of the total liabilities, and that was on a discounted basis. Finally, there was an actuarial review performed, although what was performed was a review of the process and not the accuracy of the data or the calculations involved in determining those liabilities.

A second important step in the reconstruction renewal process was funding the settlement offer. Again, the names needed a financial incentive to accept the settlement. Lloyd's managed to collect roughly 3.2 billion pounds from various parties involved in Lloyd's to help defray the costs that the names would otherwise have. Going briefly down the list, existing members contributed based on the fact that, as Erik showed, 1993, 1994, and 1995 underwriting years were very successful. As a result, they agreed to contribute 1.5% of their stamp capacity to fund the settlement offer.

Managing agents also agreed to contribute to the settlement offer as did members' agents. Members' agents are those folks who provided advice to prospective names. They helped them determine what syndicates to participate in and what the level of participation should be. Errors and omissions insurers contributed close to 800 million pounds. Auditors who prepare syndicate financials contributed to the settlement offer. Brokers who placed the risks contributed monies. Lloyd's itself contributed through the sale of various assets, most notably its existing Lloyd's building, which it sold and now leased back. Finally, the ongoing market is contributing to the settlement offer. Lloyd's secured a 200 million pound loan, and that is being repaid through assessments against the ongoing market of 1.1% of their gross premium writings. Based on projections of gross premium writings they expect to pay that off in roughly five years.

You might ask, as I did, why would all these parties be so willing to ante up such large amounts of money to help fund the settlement offer? In one word, the answer is, litigation. The names weren't about to sit back quietly and take their lumps. When these tremendous losses surfaced, they sued anyone and everyone associated with Lloyd's in and outside the U.K., including the U.S. Remember, as a result of this reinsurance-to-close process that Erik described earlier, a lot of the names inherited losses that originally occurred many years before they ever even signed on with Lloyd's. So some of them may have had reason for anger.

The settlement offer would hopefully help both sides. Names would have reduced liabilities from what they would otherwise be required to pay. They could avoid having to go through prolonged litigation without the assurance that they were going to win. The other parties that I mentioned that anted up money to the settlement offer would avoid cost of litigation and potential losses of that litigation. So they had a vested interest in making the settlement offer work, as well.

I'd like to give you an idea of some of the litigation that was going on. Suits were filed against managing agencies for closure of syndicate years at inadequate premiums. This is the reinsurance-to-close process. It's the managing agency that was responsible for setting the appropriate premium to cover those outstanding liabilities and transfer them to the following underwriting year. Needless to say, when it turned out that they were grossly underreserved, lawsuits came out of that. The managing agency is also responsible for the hiring of the underwriters and the syndicate staff. As a result of that, negligent underwriting suits were brought against the managing agencies.

Members' agents who were responsible for providing advice to the names regarding what syndicates to participate in were sued because they were presumably giving bad advice. Auditors were sued because they were the ones preparing the syndicate accounts and again, as a result of the liabilities and the reserving, things were understated.

Brokers were sued for negligent placing of business and intentionally not disclosing everything they might have disclosed about a particular risk they were placing. Lloyd's itself was sued for failure to control and regulate all the different folks that I just described to you. And they were also sued, primarily by U.S. investors, for breach of security laws. These investors alleged that certain aspects of the names' participation in Lloyd's constituted securities. As a result, they were offered and sold these securities in violation of U.S. law. Finally, Citibank was responsible for administering the various trust funds at Lloyd's and was sued for improper administration.

What would ramifications of acceptance of the settlement offer be? From the names' standpoint, they would agree to pay their finality bill, which would be less than what they would have been required to pay if the settlement offer and the $3.2 billion of funds weren't created. The names would also agree to waive all claims, meaning litigation by them, in respect of their 1992 and prior business. On the other hand, Lloyd's would agree to waive central fund debts related to their 1992 and prior business. The name would be free to cease membership at Lloyd's, and this was not just a technicality. By ceasing membership they would no longer be liable for any future assessments by Lloyd's. And Lloyd's finally would agree to make no further demands on the names in respect of their 1992 and prior business. This proposal was sent out by Lloyd's in the summer of 1996. The results were that 95% of the names agreed to this settlement offer. As a result, the reconstruction and renewal plan was able to proceed.

A big question for the names is, is finality really final? According to Lloyd's, the payment of the finality bill represented a full and final discharge of the names' obligations to the society. I'd like to read a quote from the settlement offer itself: "it is not within the power of Lloyd's to grant names an absolute release from their liabilities to policyholders." What that simple statement means is that if Equitas ever becomes insolvent or goes into proportionate cover, the original names for those syndicate years would have the ultimate liability to pay. In fact, the DTI recently informed all former names that "they are to be tracked for the rest of their lives by Equitas. Failure to inform Equitas of a change of address could result in a fine of up to $5,000 pounds." So Big Brother will be watching them for the rest of their lives.

The third key to reconstruction and renewal was this idea of creating a firebreak between old Lloyd's and new Lloyd's. The Equitas solution does a good job of creating this; however, it's not foolproof. There are potential holes in the firebreak. The first one relates to special central fund assessments. The new central fund was specifically set up with a prohibition against paying claims that are related to business reinsured into Equitas. However, a majority vote by the members, and that vote would be weighted by capacity, could allow the central fund to be used for purposes of covering Equitas claims.

Second, the Society of Lloyd's itself has several liabilities that are not syndicate liabilities, but are, in fact, the corporation of Lloyd's liabilities. Lioncover Limited and Centrewrite Limited are a couple of reinsurance companies that were established to take over the liabilities of some Lloyd's syndicates that had gone bad. And they have an unlimited indemnity from the Society of Lloyd's in case there are not enough funds to meet all the liabilities that they need to cover.

There's also litigation still pending against the Society of Lloyd's from those names who chose not to accept the settlement offer. Lloyd's also built a hardship scheme into its plan, so that for certain names who qualified (if Equitas was unable to pay those claims), Lloyd's would pick up the difference. Finally, there's the issue of overseas trust funds. The U.S. happens to be the largest trust fund. These funds could potentially be used to pay for claims that are in Equitas, if Equitas does not have enough money to cover them.

Finally, I want to talk about Lloyd's participation in the U.S. This participation can primarily take one of four basic forms. First, Lloyd's participates as a licensed insurer in some states, where they actually submit and file policy forms for approval with the State Insurance Department. Lloyd's can also be a surplus or excess lines insurer as any other insurer can. This pertains primarily to business that the licensed market declines to support. Typically it involves more complicated types of risks or jumbo capacity risks. Third, Lloyd's also participates in exempt business lines. The biggest examples of that in most states in the U.S. are aviation and marine business. And finally, Lloyd's can participate as an approved reinsurer, assuming they comply with the various state regulations for reinsurance.

I also wanted to give you a sense of the magnitude of Lloyd's involvement in the U.S. Lloyd's wrote close to $4 billion in what's called, U.S. situs business in 1995. And related to Equitas, roughly $12 billion is currently being held in U.S. trust funds in support of these U.S. situs liabilities that are related to Equitas claims.

I also wanted to talk briefly about some recent developments at Lloyd's. Lloyd's has gone through some significant changes recently. One is, it now has a new name. It is no longer Lloyd's of London; it is simply, Lloyd's. The "of London" was dropped in an effort to recognize Lloyd's worldwide presence. Lloyd's is far from just a London insurer or reinsurer.

Lloyd's also recently named a new chairman, Max Taylor, who's a leading insurance broker in the London market. He has been named to replace, Sir David Roland at year end. Sir David Rowland is credited with saving Lloyd's as the pioneer of the reconstruction and renewal plan. And finally, and probably most importantly, for the first time in its history, Lloyd's has received claims-paying ratings from both Best's and Standard and Poor's. Best's issued an A, its excellent grade rating, and Standard and Poor's issued an A+, which is in its good range. These ratings apply to Lloyd's in total rather then the individual syndicates. This is a result of the security chain that Erik talked about with its final underpinning being the central fund.

Through the reconstruction and renewal plan, Lloyd's has managed to survive the biggest storm of its life; however, Lloyd's is by no means in the clear now. Only time will tell whether Equitas is indeed sufficiently funded to meet its obligations and what financial impact, if any, Equitas will have on the ongoing market. What strikes me is that, despite the tremendous problems, Lloyd's has successfully managed to attract new capital to the market. As Standard and Poor's (S&Ps) stated in the October 15, edition of *Credit Week*, "Lloyd's is probably the strongest brand name and licensed network in worldwide insurance and reinsurance. Given the severe stress and near demise of the market suffered before reconstruction and renewal, client loyalty has proved exceptionally strong. Although widespread client defection might have been expected in these circumstances, this did not happen."

Thus, there are some key items weighing in favor of Lloyd's. At the same time, as Erik pointed out, market conditions continue to tighten, which will impact earnings going forward. I suppose the ultimate question will be, will the past come back to haunt the future?

Mr. Kevin M. Law: I'm curious as to the source of the funding for the Equitas reinsurance premium of 14.7 billion pounds. Where did those funds come from?

Mr. Rasmussen: Of the 3.2 billion pounds that was the contribution made by members, brokers, and others, the remainder of it was reserves that were held by various syndicates for their liabilities. It was what they had projected. Andy talked about the exercise that went through. Each syndicate had their reserves reviewed by representatives. In some instances, they were told they had to strengthen their reserves, and in some instances they were told that they could release some of their reserves. Then those reserves were transferred to Equitas to support the ongoing process.

Mr. William J. Bugg, Jr.: Does the managing agent determine the premiums that are charged?

Mr. Rasmussen: No, the underwriter for each syndicate makes that determination. The managing agent is the one that manages that underwriter, helps in terms of putting together the business plan, provides the infrastructure in terms of the back room, and handles the premium and claim processing.

Mr. Donald A. McIsaac: It seems to me there are two issues of risk that have to be carefully considered. The first is the risk for those percentage of names who did not agree to the settlement or who did not send in their part of the contribution or whatever. I'd like to have a sense of how numerous they are. Second, it seems to me that there's a serious risk or problem with respect to this Equitas reserving. In other words, an attempt was made to determine the present value of all outstanding future liabilities. And that's a fairly difficult thing to do for older business where they've closed accounts. What safeguards are in place or what are the confidence limits on that amount of money? What is the risk, as you both have said, that sometime that could become a problem. They could find themselves short and they would have to revert to this proportional settlement. I guess it is kind of like a liquidation process. Can you comment on that?

Mr. Rasmussen: Regarding the first part of that question, roughly 5% of the names did not agree to the reconstruction and renewal plan. I don't know what that is number wise. Regarding the liabilities in Equitas, obviously there are difficult liabilities to measure, as any property and casualty company realizes and recognizes. It will take many, many years before anybody knows for sure whether they'll be sufficient or not. Public information is somewhat limited on the details of the reserving process. My understanding is that the reserving process was done on a best-estimate basis, and they then added a 15% margin in those reserves for conservatism.

From the Floor: Are a lot of them liability type, professional liability or product liabilities?

Mr. Niedzielski: Most of the liabilities are the asbestos, environmental hazards, and those types of risk. That's the majority of the exposure that Equitas has, but it also includes professional indemnity as well as other types.

Mr. Rasmussen: We should probably add that Lloyd's is actively pursuing the 5% of the people that did not send their check in and did not accept through legal means to have them make their contribution. The other thing that I think is critical in terms of Equitas's survival is that 1.2 billion pounds were assumed for the operational standpoint. Any operational efficiencies that they can bring to the process will help them. And there are some operational efficiencies that can become part of the process by having the multiple syndicates from those. Having the whole market really be in one spot will help them. Because of my involvement in the workings of Lloyd's, Equitas has fully taken advantage of that and it continues to process as if there are still a bunch of individual entities underneath there. But as they start transitioning to take advantage of some of that, that will help off set some of that 1.2 billion pounds for the operational portion of it. Hopefully, it will provide even more margin for them going forward.

Mr. Niedzielski: If I could, I'd like to add one more comment to that, too. Lloyd's has one thing going in its favor, in terms of that small percentage of names who have not agreed to the settlement offer. Legally those names are bound by a "pay now, sue later" philosophy. They are required to pay their obligations to Lloyd's now, and then sue in courts for recovery later. So to the extent that cash becomes an issue or litigation gets dragged on for many years, that will put a lot of pressure on some of these names.

Mr. Bugg: Erik, you were talking about the corporate members and how that number has grown. You speak of vehicles or the number of corporate members. You also spoke of the different types of corporate members. You got the spread and dedicated, and then you mentioned mixed, parallel, and stand-alone. Could you go over that once more?

Mr. Rasmussen: Sure. The mixed syndicate would be a syndicate that has both individual and corporate names. If they wanted a parallel syndicate, Syndicate 555, based on the naming convention that they use or the numbering convention that they use, they would have a parallel corporate syndicate, 1,555. The underwriter for those two syndicates would be the same person. They'd write the same mix of business, but the supporters of 555, as an example, would be the individual names that had been there for many years. And the supporters of 1,555 might be just one corporate capital vehicle or multiple corporate capital vehicle. But it's just solely corporate capital backing as a parallel vehicle. The stand-alone corporate is the one that has been formed that is really just a new syndicate. It has all corporate capital backing, and none of the traditional means as part of what they're doing.

From the Floor: I think these names with unlimited liability sounds really frightening. Do they basically get policies on themselves to capitate that excess of loss so that they aren't hung out to dry, so they can end the year personally?

Mr. Rasmussen: Yes, they can buy personal stop-loss protection through some of these different vehicles. Andy mentioned Centrewrite as an entity. What Centrewrite does is go out to individuals who have syndicates with open years. For instance, one of the underwriters we deal with has kept the 1993 underwriting year open because of unusual circumstances around this year. That underwriting year remains open. Recently Centrewrite has approached all the names that are on that 1993 underwriting year and said, "For *X* number of pounds in premium, we will take on your liability." You can close that year and go forward. There are a variety of different options. The second option that we talked about is really on the back end of the front end. They can buy a personal stop-loss or some sort of personal protection.

Mr. Niedzielski: Ironically during these poor performing years, most of the personal stop-loss policies were insured through Lloyd's Syndicates. So it became very incestuous.

Mr. Rasmussen: Andy was talking about the contributions to Equitas by errors and omission (E&O) insurers in there. Some of those E&O insurers were Lloyd's Syndicates. So again, there was still some of this incestuous part of it.

Mr. Bugg: How many syndicates are there?

Mr. Rasmussen: Currently, there are probably somewhere between 160 and 170 syndicates, and they may fluctuate a little bit, depending on creation of parallel syndicates or corporate vehicles. It's somewhere in that range. At the height there were probably 450 syndicates. So when you go back to that 1990, 1991, or 1992 period, there were almost three times as many as there currently are.

Mr. Bugg: Now if you have a risk that you want to look to Lloyd's for protection, as I understand, you have to find a broker to deal with. Is that correct? If one were interested in participating as a name, how would one go about that?

Mr. Rasmussen: There are difficulties now in the U.S. because of some of the issues there, and Andy eluded to one of the claims against Lloyd's was about the fact that, being a name, Lloyd's was being offered as a securities protection instead of more of a riskier proposition than that. So I think there's a moratorium on U.S. names, in terms of the ability to join. In the U.K., the process would be to select a members' agent, of which there are many. Go in and discuss the ramifications of becoming a name. Their job should be to educate you in terms of the ups and downs. That's part of the reason why there were claims made against them. Did they do a proper job of educating those people explaining that? They'll assist in terms of the syndicate selection and making those decisions, in terms of what syndicates you're going to back.

The other difficulty with the U.S. names was the ability to access those types of people. I know people who are names we deal with in London. Quite frequently, we go visit their managing agent in their office and go through figures. There really are no extensions of those operations here in the U.S. The approach is a little bit disjointed.