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Lloyd's and the London Insurance

Market: An Overview

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19.1 U.K. INSURANCE MARKET CONTEXT

19.1.1 Market Size and Structure

Nobel Prize winning economist Kenneth Arrow stated that the world would be a better place if we could insure against future possibility. This would enable more risk taking, creating a source of economic progression. As one of the largest insurance markets in the world, the U.K. insurance market has a pivotal role in the growth of this economic progression that Arrow speaks of.

It is in within the overall context of a highly mature and developed U.K. insurance industry that we must approach the particular features of the London market. The U.K. market is currently the largest in Europe and the third largest in the world after the United States and Japan (Association of British Insurers (ABI 2005, AXCO 2005). U.K. premiums per capita are the second highest of any country, after Switzerland, and insurance penetration (the ratio of insurance premiums to gross domestic product), at 14.2 percent, is second only to South Africa (International Financial Services London, 2004).

In studying the London market, it is also important to bear in mind the size of the United Kingdom as a non-life insurance market. According to the ABI, U.K. non-life market premiums were almost \$90 billion in 2003.³⁴⁶ Further, over the four years 1999 to 2003, the non-life market grew much faster than the long-term (life insurance) market, yielding an overall growth rate of 15 percent over the period.

The international flavor of the U.K. insurance industry is also a clue to understanding the London market better. Its international nature is confirmed by the fact that the United Kingdom accounts for 8.4 percent of worldwide premium income, and some \$12 billion of British export sales (ABI 2005). Overseas insurers also have a notably high presence in the U.K. market, due in part to its relative size and its regulatory openness, among other factors.

³⁴⁶ Exchange rate used is US\$1.92 = £1 at year end 2004 unless otherwise stated.

19.1.2 Market Distribution

Because the London insurance market is, by and large, an intermediated market, it is important to appreciate the overall distribution structure of the U.K. industry. The U.K. insurance market is, in distribution terms, one of the most sophisticated in the world, with a wide and increasing variety of channels available. Traditionally, brokers have played a key role in the U.K. insurance market, often a greater role than in many other European markets, acting as intermediaries in the placing of insurance business for their clients, negotiating price, and designing risk programs for their clients.

It is estimated that 80 to 85 percent of U.K. commercial lines business is distributed by brokers; however, brokers' share of the personal lines market is considerably lower and has fallen significantly in recent years due to the rise of direct selling, Internet distribution, bancassurance, and sales through affinity groups including "high street" supermarkets.³⁴⁷ The structure of the U.K. broking sector and the role of the intermediary have changed over the last decade. In particular, brokers have had to adapt and extend their range of services offered to include consultancy services such as risk management advice and control services, the development of new financial products for the management of risk, claims consultancy, and employee benefits consulting. As has happened with general insurance companies, the broking sector has become highly concentrated in recent years.

19.1.3 Regulation

The London market's character has also been significantly influenced by the approach taken by the U.K. supervisory authorities over the years. In the past, regulation of the insurance market in the United Kingdom was fragmented. However, the Financial Services Authority (FSA) was formed in 2001. The FSA is an independent nongovernmental body, given statutory powers by the Financial Services and Markets Act 2000, and is a company limited by guarantee and financed by the financial services industry. The U.K. Treasury appoints the FSA Board, which consists of a chairman, a chief executive officer, three managing directors, and 10 nonexecutive directors, and this board sets overall FSA policy. The FSA describes its mission as follows:

In January 2000 we set out our proposed approach to regulation in *A New Regulator for the New Millennium*. We stated that our overriding aim was "to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal". Our approach is based on a clear statement of the realistic aims and limits of regulation; it recognises the proper responsibilities of consumers and of firms' own management, as well as the impossibility and undesirability of removing all risk and failure from the financial system (FSA 2005).

Prior to the establishment of the FSA, the United Kingdom had experienced some insurance market failures, most notably that of Independent Insurance. This company was a leading underwriter of commercial business, and in particular

³⁴⁷ Estimates vary. This is based on ABI data (2005) and AXCO data (2005).

employers' liability business, before going into liquidation in 2001. Many have commented since that the new regime and risk-based capital requirements put in place by the FSA have significantly raised regulatory standards in the United Kingdom. At the same time, the regulator's approach means that the United Kingdom retains its reputation for a "liberal attitude" and "stable environment," which have been identified as critical factors for an international market (Herve-Bazin 1994). In contrast to the United States, rates and forms are not regulated in the United Kingdom, and as part of the European Union (EU), the United Kingdom benefits from what is essentially free trade in commercial lines insurance with other EU member states. Taken together, these conditions create an excellent insurance infrastructure and a mature insurance market for both domestic and international risks, and overall close to a quarter of U.K. insurance companies' net premiums come from overseas business including from subsidiaries overseas (International Financial Services London 2004).

19.2 THE LONDON MARKET

19.2.1 Introduction

The London market plays a unique role within the United Kingdom's insurance industry, well summarized as follows almost a decade ago:

The London Insurance Market is a distinct, separate part of the UK insurance and reinsurance industry centred on the City of London. It comprises insurance and reinsurance companies, Lloyd's syndicates, and brokers who handle most of the business. While there is no watertight definition of the market, there is general agreement that the core of its activity is the conduct of internationally traded insurance and reinsurance and reinsurance business, which would include the very large risks of UK companies and multinationals. The business is almost exclusively non-life...with an...emphasis on high exposure risks (Jim Bannister Limited 1999).

Taken together, the London market employs around 40,000 insurance professionals within the so-called Square Mile of offices in the City of London, accounting for 1.2 percent of national gross domestic product and ranking as the world leader for large, complex, or unusual specialist commercial risks, with an estimated 10 to 15 percent share for large industrial risks overall, and a considerably higher share of specific specialist sectors, as highlighted later (International Financial Services London 2004). However, the London market does not, in general, underwrite much life business. Total London market premiums grew steadily throughout the late 1990s, reaching an estimated \$45 to 50 billion by 2004.³⁴⁸

Insurance and reinsurance coverage within the London market is provided by a number of key groups, each distinct but often working together:

Lloyd's insurance market. Discussed in detail below, which is estimated to account for over half of London market business.

³⁴⁸ This is an estimate based on a total London market premium figure of £25 billion for 2002 (IFSL 2004, p. 17) and two years of subsequent premium growth.

London company market. London is the only market in the world where the world's 20 largest insurance and reinsurance companies all have offices, whether headquarters, branch, or representative offices. In total, over 100 companies are estimated to have a London operation, the purpose often being to access and underwrite the international business that the market sees.

The London company market is represented by the International Underwriting Association of London (IUA), and their members are headquartered in 40 countries around the world, according to the Corporation of London. The IUA is the world's largest representative organization for international and wholesale insurance and reinsurance companies. It is both a trade association, representing its members' interests internationally, and a market association supporting the business environment in London.

IUA membership is available at ordinary, affiliate, and associate levels. Ordinary members enjoy full membership status, while the affiliate category comprises companies in run-off and service providers to full membership companies. Associate membership is the most limited form of membership for non-London based companies. A list of the 42 ordinary members, at September 2005, is provided in Table 19.1.

It is difficult to give definitive premium statistics for the London company market, due in part to the different processing and accounting treatments adopted by different member companies. However, it is generally reckoned that the London company market accounts for less than half of the total London market premiums, and the business mix is similar to that experienced by Lloyd's. The IUA also indicated in April 2004 that premium figures had been increasing for the past three years (International Underwriting Association 2004).

The London company market shares a common processing bureau with Lloyd's, and the two sectors cooperate on a number of processes and other related initiatives. The general thrust of these initiatives is to improve efficiency and drive down the cost of processing within the London market. Further details and current updates on these initiatives can be found on their respective web sites.

19.2.2 Protection and Indemnity (P&I) Clubs

P&I clubs are insurance associations of shipowners and charterers who operate on a mutual basis. They originated in order to underwrite liability risks not covered by marine policies usually available in the insurance market. Of the world's marine insurance markets, London is the largest for P&I clubs, with about 70 percent of such global business directed through London (International Financial Services London 2004).

Table 19.1. IUA Membership, September 2005: List of Ordinary Members

Ace European Group (was ACE Insurance SA-NV)
Alea London Limited
Allianz Cornhill Insurance Plc (was Cornhill Insurance plc)
Allianz Marine & Aviation Versicherung AG (<i>was AGF Marine Aviation Transport</i>)
Arch Insurance Company (Europe) Ltd
Aspen Insurance UK Limited
Assicurazioni Generali S.p.A. (UK Branch)
AXA Corporate Solutions Assurances SA
AXA Corporate Solutions SA
Chubb Insurance Company of Europe
CNA Insurance (Europe) Company Limited (<i>now incorporating Maritime Insurance Company Limited</i>)
Ecclesiastical Insurance Office plc
Endurance Worldwide Insurance Limited
Everest Reinsurance Company (UK Branch)
FARADAY Reinsurance Company Limited
Federal Insurance Company
GE Frankona Reinsurance Limited
GE Frankona Ruckversicherungs Aktiengesellschaft
GE Specialty Insurance (UK) Limited
Global Aerospace Underwriting Managers (GAUM)
Great Lakes Reinsurance (UK) Plc
Groupama Transport
Hannover Re
Houston Casualty Company London
International Insurance Company of Hannover Limited
Liberty Mutual Insurance Europe Limited
Markel International Insurance Company Limited
Munich Reinsurance Company
New Hampshire Insurance Company
New India Assurance Company Limited
QBE International Insurance Limited
QBE Reinsurance (Europe) Ltd
Royal & Sun Alliance Insurance plc
SCOR UK Company Limited
Sirius International Insurance Corporation (publ)
SR International Business Insurance Company Limited
Swiss Reinsurance Company UK Limited
Tokio Marine Europe Insurance Limited (TMEI)
Tokio Marine Global
XL Re Ltd
Zurich Insurance Company
Zurich Specialties London Limited

Source: International Underwriting Association (2005).

19.2.3 London Market Brokers

Almost all risks underwritten within the London market are intermediated, and brokers therefore also make up a key part of the London insurance market. The majority of the world's largest insurance broking firms have a significant presence in London. One commentator (Jim Bannister Limited 1999) has attempted to group them as follows:

- Major global brokers who have a significant share of the London market and global business
- Multiniche brokers based in London but with sizeable operations outside the London market
- London-based wholesale brokers who specialize in placing business from other non-Lloyd's brokers
- Many smaller and specialist niche brokers

In addition to these participants are many firms of specialist insurance lawyers, loss adjusters, actuaries, consultants, and other insurance experts who complete the hub of insurance expertise.

19.2.4 London as an International Insurance Market

The available literature on international markets is quite limited; however, one of the best surveys was prepared in 1994 by Eric Herve-Bazin of AXA for the French insurance association. It was well researched, involving several months visiting insurance centers in Europe, North America, and Asia. The survey produced a long list of requirements for a successful international center as follows:

- Political stability
- Geographical location
- Quality transportation
- Developed communications systems
- Highly qualified personnel
- Office space at competitive prices
- Multilingualism
- Stable legal and regulatory environment
- Liberal attitude by authority
- Quality family life
- Appropriate time zone
- Strong foreign presence

He also added a number of secondary advantages, ranging from a developed financial center to a strong currency, and emphasized the need for strong international "network" links to potential sources of business.

Herve-Bazin concluded that only London qualified as an international insurance center according to all of the above criteria. He also specifically mentioned its strong ties with the United States as a positive factor. A decade later, while various other

financial and insurance locations have continued to emerge and develop, London has nevertheless retained its preeminence as the world's international insurance center. The two lines of business where the London market is most prominent are discussed further below.

Marine, Aviation, and Transport Market

The London market, and in particular Lloyd's, is regarded as the leading global center for marine, aviation, and transport insurance and reinsurance. The London market's share of the global marine market is estimated at up to 19 percent. Having backed and secured the fortunes of mariners and merchants on the high seas for over 300 years, Lloyd's in particular continues to lead a significant proportion of the world's marine business, underwriting \$1.8 billion dollars in marine premiums in 2003 alone (Asia Insurance Review 2004; Tolle 2005). Lloyd's heritage and expertise in the sector is further demonstrated by the existence of around 350 Lloyd's agents spread across every major global port. Their presence provides valuable specialist surveying and adjusting services throughout the world.

In recent years, the global marine market has been intensively competitive, particularly the hull sector. Profits in the early 1990s ebbed in the face of high loss events until 2001, when things finally began to improve from an extremely low starting point. Too many losses in 2002 crippled the sector further, with the hull sector on its sixth consecutive annual loss, leading to a general call for a return to sanity based on profitable underwriting.³⁴⁹ In 2003, Lloyd's did see marginally better hull results, but the pricing and coverage conditions were still far from levels capable of supporting consistent profits.

The cargo and marine liability sectors, where Lloyd's is also a major player, have returned a more consistent performance over time, although once again there continue to be concerns about pricing adequacy, and cargo profits for 2005 have been adversely impacted by hurricane damage in the American Gulf. In the future, exchange of technical data and greater transparency of results should help the marine market move toward the need to underwrite at the right price to allow underwriters to make sustainable profits.

The London market's share of aviation business is even higher than that of marine, standing at around 39 percent (IFSL 2004). However, the aviation sector is not immune to the cyclical pressures and increased competition in recent years. Notwithstanding, the global aviation insurance market continues to grow in spite of increased potential problems with security, from \$51.3 billion in 2003 to \$56.7 billion in 2004, an increase of 12 percent. Passenger numbers have also increased, rising from 197 million to 229 million in 2004, an increase of 17 percent (*Insurance Day* 2005).

London Market Reinsurance Sector

The London market's share of nonmarine treaty reinsurance has remained relatively stable in recent years, at around 5 to 10 percent, and London is estimated to account for a full quarter of the world's internationally available reinsurance (IFSL 2004;

³⁴⁹ Publicly expressed at the IUMI Conference, 2003.

Swiss Re 2004). Lloyd's alone is ranked as the world's fifth largest reinsurer (Standard & Poor's 2004a).

After over three centuries of experience of dealing with risk, the expertise, underwriting skill, and knowledge residing within the London market for specialist reinsurance needs is certainly extensive. Like their direct counterparts, reinsurance risks, whether facultative or treaty business, local or international, reach the London market exclusively through intermediaries. The leader may choose to accept the entire risk on behalf of his syndicate or company, but in most cases, especially with large reinsurance treaties or facultative placements, the risk will be greater than the syndicate or company wishes to bear alone. When that happens, other syndicates and companies are invited to take a share of the risk, spreading the risk throughout the wider London market, and beyond. This unique subscription system allows individual syndicates and company market insurers to combine their capital and compete with the largest of the world's reinsurers, yet retain the responsiveness and short decision-making hierarchy which ensure that underwriters are able to provide clients with individual attention.

Current conditions suggest a stabilizing global reinsurance market after years of poor results. Positive factors often cited include high current accident year profitability and a trend in superior quality underwriting control and analysis. Some offsetting factors include concerns about continued undesirable development in U.S. casualty lines, capital depletion following two record windstorm seasons, and ongoing concern about the ability of reinsurers to maintain underwriting discipline throughout the insurance cycle.

19.3 LLOYD'S BACKGROUND AND HISTORY

19.3.1 Early History

Founded in 1688, Lloyd's is the world's oldest and best known insurance market. Lloyd's first existed as a coffee house owned by a man called Edward Lloyd who encouraged ships' captains, merchants, ship owners, and others with an interest in overseas trade to visit his establishment. Within a short period of time, Lloyd's had gained a strong reputation for trustworthy shipping news, ensuring that Lloyd's became the popular place for obtaining information on all things related to marine trade and the risks that accompanied it.

In the seventeenth century, the growing importance of such trade led to demand for ship and cargo insurance, a natural extension of this sharing of information. Business in those days was conducted very informally, and a merchant with a ship to insure would ask a "broker" to take the risk from one wealthy merchant to another seeking insurance cover. Each merchant would take a portion of the risk, and the broker would visit several merchants until the risk was completely covered. The broker's skill lay chiefly in ensuring that policies were underwritten only by people who could meet their share of a claim, if need be, to the full extent of their personal fortunes. This was the process that became known as underwriting.

In 1769, a number of the more serious players at Lloyd's broke away and set up a rival, more professionally organized establishment. This "New Lloyd's Coffee

House" eventually became too small, so a committee was elected and 79 merchants, underwriters, and brokers each paid £100 into the Bank of England for new premises. In 1774, rooms were leased in the Royal Exchange and, no longer a coffee house, the modern Lloyd's was born.

19.3.2 A Period of Rapid Growth

Over the next century, the society of underwriters at Lloyd's evolved further. Membership was regulated, and the elected committee was given increased authority. A process of formal investment into the Lloyd's market began, and those who invested in the market were called Names, sole capital providers for the market. Lloyd's then took another step forward in 1871 with the incorporation of Lloyd's by Act of Parliament. The Lloyd's Act 1871 gave Lloyd's a formal legal basis, allowing it to acquire property and make by-laws backed with the full authority of Parliament, establishing Lloyd's as a unique business institution, a status it maintains today. The Lloyd's market grew steadily thereafter, both in terms of financial size and product range. Lloyd's first began to diversify from its marine history in 1887, underwriting property risks for the first time, which was considered a controversial innovation at the time.

The trend toward growth and innovation continued throughout the twentieth century. As a result, Lloyd's is home to some of the most skilled and experienced insurance specialists in the world and has led the industry in creating new areas of coverage over the last 50 years, such as kidnap and ransom, space and aviation, cyber-liability, specialist policies for satellites, contingency coverage for large international and national sporting events, and terrorist threats.

19.3.3 Recent History

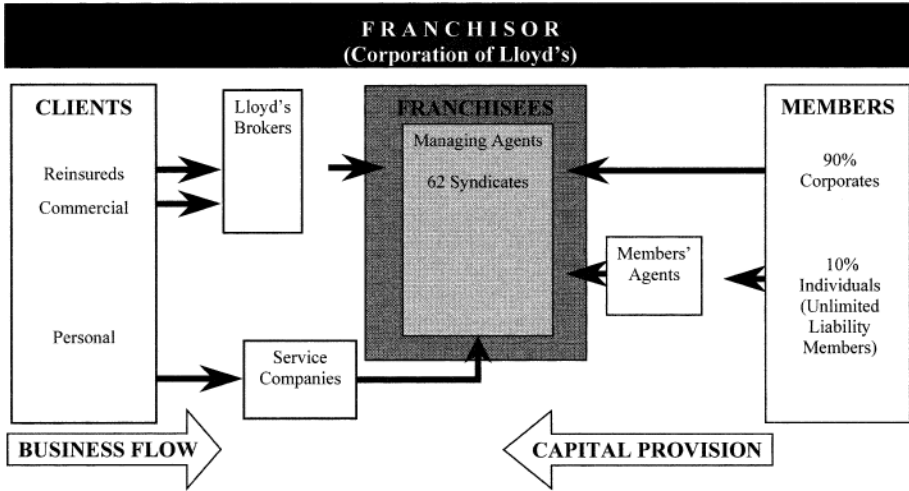
However, in the mid-1980s and the early 1990s, the Lloyd's insurance market suffered an unprecedented wave of losses due to events including the Piper Alpha oil spill, Hurricane Andrew, and mounting asbestos claims. With the market in a state of financial uncertainty, Lloyd's implemented a Reconstruction and Renewal Plan in 1996 aimed at rebuilding the market. The Plan involved the establishment of a reinsurance company called Equitas to allow members of Lloyd's to run off their 1992 and prior year liabilities, while allowing current and future members of Lloyd's to trade forward. The Plan succeeded, securing support from the vast majority of Lloyd's members. Equitas is a completely separate entity from Lloyd's.³⁵⁰

19.4 LLOYD'S: A MARKET, NOT A COMPANY

Today, Lloyd's is probably the world's best known insurance brand, but it is not always well understood. This is because Lloyd's is an insurance market, and not an insurance company. Lloyd's is very different to the coffee shop of its origins, but it

³⁵⁰ A.M. Best comments briefly upon Equitas in its rating rationale of the Lloyd's market in A.M. Best (2005b).

still operates using the same principles. It is best represented diagrammatically as shown in Figure 19.1.



Source: Members Services Unit, Admissions, Nov. 2003; Broker Services, Nov. 2003; Lloyd's Global Results 2002, May 2003

Figure 19.1. How the Lloyd's Market Works

19.4.1 Underwriting

The market comprises a number of underwriting businesses called syndicates. Working for the individual syndicates, underwriters accept risks on their behalf from the community of London market brokers. The number of syndicates operating within the Lloyd's market has varied widely over time, reaching a peak of 437 in 1980 (Statistics Relating to Lloyd's, Syndicate section, 2001). Since then, consolidation has taken place within Lloyd's, as elsewhere in the insurance markets, and the number of syndicates has decreased while syndicate size and strength has conversely increased, and market structure has become more efficient. In 2005, there are 62 syndicates operating within the Lloyd's market, of different shapes and sizes, and each with its own specialties and expertise (Lloyd's 2005b). Each syndicate is in turn managed by a managing agent, also known as a Franchisee under the Lloyd's structure. A number of managing agents manage more than one syndicate.

Given that Lloyd's is a marketplace, different underwriters, working for different syndicates, will sometimes compete on price and terms and conditions to win business and the lead role in underwriting the risk, a practice that has traditionally encouraged a flexible and innovative approach and ensures that a competitive spirit remains alive within Lloyd's. The broker may need to visit a number of syndicates in order to cover the risk: frequently, larger risks are divided between more than one syndicate in the market, with each syndicate taking a percentage of the risk, usually at the same price and terms as the lead underwriter

who assumes the first portion of the risk. This is known as the subscription market. In any circumstance, the underwriter works with the broker and calculates a premium based on the likelihood of the risk occurring, using a mixture of scientific and actuarial modeling tools and a degree of intuition based on specialist and detailed knowledge of what are often highly specialized areas.

Lloyd's has long been viewed as being at the leading edge of the specialist insurance market. Lloyd's is known as a place for "firsts": the first reinsurance, aviation, motor, and satellite policies were all underwritten at Lloyd's during the nineteenth and twentieth centuries, and it continues to lead the development of innovative insurance products today, such as insurance policies to protect businesses against computer hacking attacks, and coverage for intangible assets, including intellectual property risks. See Table 19.2 for a breakdown of the lines of business within Lloyd's.

Table 19.2. Lloyd's Business Split by Category, 2004

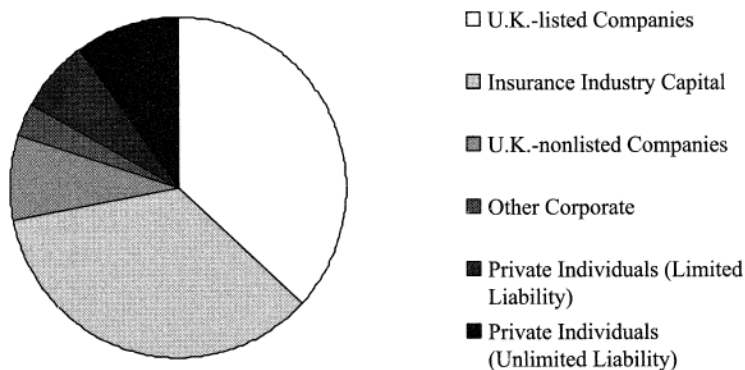
Line of Business	Percent
Reinsurance	30
Casualty	26
Property	22
Motor	7
Marine	7
Energy	5
Aviation	3

Source: Lloyd's (2005b), p. 12.

19.4.2 Capital Provision

Capital providers to Lloyd's are traditionally known as members. They accept insurance business through syndicates on a several basis for their own profit or loss (in other words, members of Lloyd's are not jointly responsible for each other's losses). The membership of Lloyd's is currently made up of companies that operate with limited liability and individuals who continue to operate with unlimited liability. Individual members tend to support a number of syndicates, whereas some corporate members only underwrite through a single syndicate. Figure 19.2 shows Lloyd's capital provision for 2005.

In recent years, corporate membership has grown rapidly; currently, around 90 percent of Lloyd's market capacity is provided by corporate, limited liability capital (Lloyd's 2005b). American, British, and Bermudian insurance companies provide the largest tranches of capital, with the remainder coming from other overseas companies and individual Names that have converted to limited liability by forming limited companies (Lloyd's Member Services Unit 2005). It is no longer possible for new members to enter Lloyd's on an unlimited liability basis; thus, all new members of Lloyd's do so on a limited liability basis.



Source: Lloyd's (2005b), p. 9.

Figure 19.2. Lloyd's Capital Provision 2005 (Percent of total)

Each member of Lloyd's is required to demonstrate its ability to support its total Lloyd's underwriting business by holding sufficient capital. In particular, members are required to hold funds in trust at Lloyd's as security for the policyholders and to support a member's overall underwriting activities. The amount is related to a member's premium income limit, in accordance with the ratios laid down by the Council of Lloyd's. The administration of these funds is subject to the various trust deeds and regulatory requirements. The funds must be in a form approved by the Council of Lloyd's and be maintained in value. The amount of funds required from members will vary, depending on the perceived level of risk in the business that they underwrite. Thus Lloyd's operates what is known as a "risk-based capital," or RBC, system. In the past, Lloyd's RBC system was a rule-driven system based on market average performance. Implementation of the new Individual Capital Assessments regime at Lloyd's will enable Lloyd's to align capital with risk in a more efficient manner.

19.4.3 Intermediaries

The Lloyd's market is also made up of Lloyd's brokers. A Lloyd's broker is a partnership or corporate body permitted by the Council of Lloyd's to bring insurance business to Lloyd's on behalf of its clients. In order to become a Lloyd's broker, the intermediary must go through an application and approval process, with criteria based upon levels of professionalism, integrity, and customer service. Lloyd's positively welcomes applications from brokers, in the United Kingdom or overseas, who want direct access to the Lloyd's market.

The number of Lloyd's brokers has remained relatively constant over the past 50 years, and there are currently over 160 firms of Lloyd's brokers working with the Lloyd's market (Lloyd's 2005a). The brokers act on behalf of clients who are seeking to cover their risks by arranging insurance with underwriters. The brokers have a thorough understanding of the Lloyd's market, and, like the underwriters, many specialize in finding insurance for particular risks. Brokers use their specialist knowledge of the insurance available in the market to choose the best syndicate and

negotiate competitive prices for their clients. Brokers add value to the underwriting process for their clients by representing their interests, achieving the best value for money, ensuring the quality of the coverage offered meets the client's need, and doing the best to find the most competitive price.

Sometimes Lloyd's managing agents develop particular working arrangements with intermediaries whereby brokers are given delegated authority to underwrite locally on their behalf. Such arrangements usually apply only for particular categories of risk up to a certain size, and in practice tend to involve personal lines and smaller commercial lines policies. Managing agents may also establish service companies in particular locations in order to improve the sourcing and servicing of local business.

19.4.4 Franchisor

The Corporation of Lloyd's, also known as the Franchisor, provides the franchise or platform from which Lloyd's businesses can operate. An administrative body of the Lloyd's market, the Corporation itself does not provide insurance. Rather, it provides the infrastructure for underwriters and brokers to do business and to support the market in its commercial aims. Where authority is delegated by the FSA, the Corporation also acts in a supervisory capacity to ensure that the market operates efficiently and effectively and that those involved meet certain standards.

19.4.5 Infrastructure

In recent years, the Lloyd's market has begun to invest in modern infrastructure systems for processing the millions of risk its deals with every year. Certain classes of insurance, including fine art and cargo, can now be bought on-line from Lloyd's syndicates. Lloyd's own web site, www.lloyds.com, allows insurance professionals from all over the world to find information on the market, underwriters, and brokers. More recently, Lloyd's has invested heavily in a new technology platform, Kinnect, which is designed to transform the traditional risk placement process and make processing of business more efficient. In addition, Lloyd's has been leading the call for change in the London market in respect of improving contract certainty and standards of business processing generally, with several important initiatives currently underway. Lloyd's and the IUA cooperate on such business processing reform initiatives, and the latest developments are available from their respective web sites.

19.4.6 Financial Information

Lloyd's derives considerable strength from being a market, but the manner in which it structures its finances and conducts its businesses can be difficult to understand if compared to a standard insurance company. In the past, financial analysts have commented that Lloyd's tends to outperform the rest of the insurance industry over the course of the insurance cycle (HSBC 2000).

All Lloyd's syndicates benefit from Lloyd's central resources, including the Lloyd's brand, its network of global licences, and the Central Fund. One of the

unique competitive strengths of Lloyd's, the funds that make up the Central Fund are derived from a small percentage of each syndicate's annual income. The Central Fund is designed to operate as a fund of last resort at the discretion of the Council of Lloyd's, to meet any valid claim that cannot be met by the resources of any member syndicate. All Lloyd's policies are ultimately backed by this common security, and it was worth \$1.1 billion dollars at the end of 2004 (Lloyd's 2004b). It is impossible to say that the central resources will never be exposed because of poor underwriting, but the operating environment is designed specifically to avoid such problems. Since Reconstruction & Renewal, systems have been enhanced dramatically, enabling Lloyd's to monitor risk at both the syndicate and market levels. According to Standard and Poor's (2004b), "management is very strong and independently minded and the lessons of the recent past have been well learned."

For 2004, Lloyd's recorded \$2.6 billion in reported annual profit. This is more than 2002's reported profit of \$1.6 billion but less than 2003's annual reported profit of \$3.6 billion—largely as a result of Florida hurricane losses (Lloyd's 2004b). Lloyd's combined ratio of 96.9 percent for 2004 compares favorably with an estimated average of 98.7 percent for U.S. property and casualty insurers, 106.1 percent for U.S. reinsurers, and 98.2 percent for European insurers and reinsurers. Financial ratings agencies Standard & Poor's and A.M. Best currently rate Lloyd's A (Strong) and A (Excellent), respectively.

19.4.7 The September 11, 2001 Terrorist Attacks

The terrorist attacks of September 11, 2001, created the largest-ever loss for Lloyd's to date. Lloyd's loss proved to be larger than that of any other insurer or reinsurer, highlighting its role as an integral part of the U.S. market. The majority of the loss was caused by property and aviation claims, and over 60 percent related to coverage granted by Lloyd's syndicates under reinsurance treaties. In fact, 10 U.S. insurance groups account for over 50 percent of Lloyd's reinsurance exposure to the event (Lloyd's 2004a). Lloyd's has paid out around \$5 billion in claims for the tragedy of 9/11 to date (Lloyd's 2004a). Despite the magnitude of its exposure, the Lloyd's market has not only survived, but has emerged strongly. Its ability to withstand the event is testament to the diversity of its capital base and to its financial security. At the same time, Lloyd's franchise system aims to improve the market's financial performance over the longer term, by generating more consistent results and long-term profitability.

19.5 LLOYD'S GLOBAL IMPACT

Although it is synonymous with the City of London, Lloyd's is a truly global organization, attracting businesses and capital from around the world (see Table 19.3). More than two-thirds of its business comes from overseas and the Lloyd's market conducts business in more than 200 countries and territories and has offices and staff in over 25 countries (Lloyd's Worldwide Markets 2005).

Table 19.3. Lloyd's Business Geographic Split, 2004

Region	Percent of Total
United States	34
United Kingdom	24
Europe	18
Americas	11
Asia/Africa	7
Rest	6

Source: Lloyd's (2005b), p. 12.

Of course, since Lloyd's began, entire national economies and insurance industries have grown up in the developing world, and new types of insurance have been pioneered, many by Lloyd's itself. Today, Lloyd's underwrites a huge range of international business risks and projects, including oil rigs, underground transport networks, airlines, and the world's top four manufacturers of personal computers. Over 94 percent of the companies listed on the main U.K. stock exchange, the FTSE 100, have policies at Lloyd's, and insurance capital from all over the world invest in, and operate businesses at, Lloyd's (Lloyd's 2004c). These include, among others, well-known insurers and reinsurers such as Munich Re (Germany), Mitsui (Japan), AIG (United States), and ACE (Bermuda) (Lloyd's Commercial Directorate and Member Services Unit 2005).

19.5.1 Lloyd's in Europe

Today, Lloyd's provides coverage for a wide range of European industrial risks outside of the United Kingdom. In reinsurance, too, Lloyd's plays an important role, supporting the balance sheets of many of Europe's largest insurance companies. The continental Western European market represents 23 percent of global non-life premiums, making it the second largest in the world; it accounted for 18 percent of Lloyd's total business in 2004 (AXCO and Lloyd's Market Reporting 2004). Overall, Europe's risk environment is changing rapidly, and the Lloyd's market is serious about playing a leading role in its future.

19.5.2 Lloyd's in Asia

Asia has also experienced tremendous economic growth, which is impacting the insurance industry lately and is currently especially strong in Northeast Asia—although the Asian economy is becoming increasingly integrated, and the benefits of economic success are therefore being felt throughout the whole region.

This reflects the gradual change in the global economy with a definitive shift in the economic center of gravity toward the east. Many of the 62 syndicates in the Lloyd's market have particular expertise and knowledge in the Asian market. The market's first purely Asian syndicate was established in 2005, writing marine and associated risks. The Lloyd's market provides insurance companies in Asia with

access to a unique pool of underwriting expertise and talent. Lloyd's is able to support the development of insurance markets in the region by providing technical knowledge, specialist expertise, and insurance education to the market. Lloyd's is also a firm supporter of liberalizing markets in the region, and as China and India open up in particular, Lloyd's believes that it will have considerable expertise to share with these markets.

19.5.3 Lloyd's in North America

However, Lloyd's modern character is undoubtedly founded upon a long history of innovation in North America. Lloyd's underwriters have been writing business in the United States for more than 150 years. By 1840, the United States was already an important source of marine business for Lloyd's underwriters. By 1900, with the aid of an array of attractive new products, Lloyd's had become a major force in non-marine insurance as well. In the early years of the twentieth century, Lloyd's supported the rapid development of the U.S. economy by underwriting a wide range of risks, both directly and as a provider of reinsurance in support of domestic insurance companies. In these years, the most popular line of business offered by Lloyd's was fire insurance. Many of the companies that purchased fire coverage were also attracted to an additional form of protection recently pioneered at Lloyd's: loss of profits, or consequential loss insurance. But it was the 1906 San Francisco earthquake and its aftermath that did the most to establish Lloyd's reputation in the United States. The earthquake and fire that followed it destroyed 28,000 homes and cost insurers \$180 million (Lloyd's 1998). Lloyd's, unlike some domestic insurance companies, paid claims swiftly and without dispute. But just as important in the long run was the way Lloyd's underwriters responded to the opportunities the disaster created. Other Lloyd's innovations also proved attractive to North American businesses. Jewelers protected their stocks with jewelers' block insurance. Bankers covered their securities and liabilities with bankers' blanket bond policies. A new generation of art collectors also sought coverage for their precious acquisitions at Lloyd's. The bond between U.S. insurance coverage and Lloyd's was strengthening at a rapid pace.

Today, Lloyd's role in the world's largest insurance market is greater than ever with more than a third of Lloyd's business generated in the United States. Approximately 93 percent of the companies that make up the Dow Jones Industrial Average have policies with Lloyd's. Lloyd's business underwritten in the U.S. insurance market totaled approximately \$8.3 billion in 2003, followed by the United Kingdom, Canada, and Bermuda. Hence, Lloyd's continues to shape the agenda for the North American markets (Lloyd's 2004c).

19.6 CURRENT CHALLENGES FOR THE U.K. INSURANCE INDUSTRY

19.6.1 Managing the Insurance Cycle

It is well known that underwriting results in the non-life insurance market have tended to follow a cyclical pattern over time, with a wide variation in profitability from year to year (see Table 19.4). This pattern, known as the “insurance cycle” or “underwriting cycle,” creates uncertainty for both shareholders and capital providers in the insurance industry (who expect a stable and adequate return on investment) and for clients (who see both availability and pricing of insurance change dramatically over the cycle).

Table 19.4. Lloyd's Market
Underwriting Capacity, 1993 to 2005

Year	US\$ bn
1995	19.6
1996	19.2
1997	19.8
1998	19.6
1999	19.0
2000	19.4
2001	21.7
2002	23.4
2003	27.6
2004	28.8
2005	26.3

Source: Lloyd's (2005b), p. 8.

Taking the U.S. property-casualty industry as a measure, the insurance industry has recorded an underwriting profit in only one of the past 25 years, which was 2004 (Insurance Information Institute 2005). Traditionally, insurers have tried to compensate for poor underwriting performance with investment income derived from investing their assets on the stock markets. However, given current global economic conditions that are generating sustained lower investment returns, this has become much more difficult, and Lloyd's believes that it is imperative for insurers to focus on achieving a profit from their underwriting activities alone. Given a simultaneous apparent upward trend in insurance losses in recent years, Lloyd's is convinced that the need for underwriters to manage the insurance cycle is now greater than ever.

As A.M. Best stated in its recent report on the 2005 European renewal season, “Forthcoming renewals throughout 2005 and the first quarter of 2006 will be decisive” (A.M. Best 2005a). Performance management therefore remains one of Lloyd’s key themes for the future, because it is from here on that the pressure is likely to build and test underwriters’ and management’s resolve. In 2005, Lloyd’s paid particular attention to direct and facultative property, aviation, energy, non-U.S. professional indemnity lines where it has seen the strongest signs of softening in terms and conditions.

Of course, it is important not to generalize. At this point in the cycle, the reinsurance market has exhibited more underwriting discipline than the direct market, which is encouraging, and any softening is often from a high level. However, barring any major catastrophes, underwriters must expect further pressure on pricing and conditions in the short to medium term. Reinsurers still believe there is a significant margin in the business. Competition will continue to be high. The only way to counter this pressure is for the market—and the reinsurers in particular—to remain disciplined and restrained. At Lloyd’s, the 2005 business planning cycle proved its determination to take action where it is needed. Few of the plans submitted by the businesses in the Lloyd’s market were approved without some degree of challenge or further consultation with the Franchise Performance team, and the fact that Lloyd’s market’s underwriting capacity is down 9 percent in 2005 reflects the market’s disciplined approach to current market conditions (Lloyd’s 2005c). This approach will continue in coming years; Lloyd’s focus is on working with the businesses in the market, to ensure that they have the tools and robust processes in place which they need in order to manage the cycle, and to expose and reverse underperformance.

19.6.2 Business Processing

Lloyd’s also believes that, within the commercial insurance market, the processing of insurance business needs radical improvement. Recent events in the global market have proved that improved contract certainty, including final policy wordings fully agreed between all the participants, is critical to the future of the insurance industry. For this reason, Lloyd’s is working (often in conjunction with the rest of the London market) to deliver a program of business processing reform.

Lloyd’s has mandated a standard form of slip for recording deals done in the London market, for the first time in over three centuries. Used properly, it helps ensure that important features of the contract are documented in a more uniform way and are clear from the start. The use of this slip by market businesses is improving month by month.

Lloyd’s also recognizes that, in order to improve standards, brokers and underwriters must exchange reliable data and agree on contract details in a secure and transparent way. Lloyd’s is therefore sponsoring the Kinnect electronic platform to drive this change using efficient modern technology. The insurance industry owes it to its customers as well as to itself to ensure that coverage is fully agreed and clearly documented right from the start.

19.6.3 Rising Catastrophe Trends

Finally, recent catastrophe events will intensify the debate on global warming, with the rate of natural disasters expected to grow further as temperatures rise. In recent years, a number of important and credible studies have raised a question about the link between global warming and the rise in natural disasters around the world. Research shows that the 10 hottest years on record have all occurred since 1990, and while scientists say it is not yet possible to link recent record storm seasons directly to global warming, the debate is increasing. From an insurer's perspective, the facts are certainly dramatic enough: 2004 was the most expensive year for natural catastrophes ever, with around \$50 billion of insured losses, driven by the unprecedented string of hurricanes that pounded the United States and Caribbean, and the worst typhoon season ever recorded in Japan.³⁵¹

Looking forward, the signs are that things are going to get even worse. The Intergovernmental Panel on Climate Change, a group including hundreds of leading scientists from around the world, says that extreme events will increase further. As a result of climate change, insurance markets may well be forced to look again at how they model, plan for, and manage weather related losses. Global warming is undoubtedly a debate in which the insurance industry must become more involved as its contribution has the potential to make a significant impact to future business performance.³⁵²

19.7 CONCLUSION

As one of the world's largest and most sophisticated insurance markets, the United Kingdom makes a significant contribution to the global financial services sector. In particular, the international focus of the London market means that the U.K. insurance industry plays a pivotal role in helping the global economy manage its business risk. All business involves risk, and as the economy becomes ever more complex and interlinked, business owners will increasingly need access to appropriate, internationally available insurance solutions to help them manage it. At the heart of the London market, with a 300-year history of paying valid claims and an innovative approach to risk, is Lloyd's. Unlike any other insurer or reinsurer, Lloyd's is a market and not a company. Its underwriters interact daily with intermediaries in London and around the world on some of the largest, most complex, and most difficult international risks. With a strong recent financial performance and commercially focused structure, Lloyd's plays a strong and leading role in the development of the London and global markets. The current challenges facing the U.K. industry are managing the insurance cycle, reforming the industry's business processing, and engaging in the debate on global warming.

³⁵¹ Swiss Re (2004), plus estimate of \$10 billion for tsunami insured losses.

³⁵² A useful insurance industry study on the subject is "Opportunities and Risks of Climate Change," published by Swiss Re and available on its web site.

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19.9 USEFUL WEB SITES

- **www.abi.org.uk**, Association of British Insurers
- **www.airmic.com**, British Risk Managers Association
- **www.biba.org.uk**, British Insurance Brokers Association

- **www.cbi.org.uk**, Confederation of British Industry—the voice of business
- **www.cii.co.uk**, Chartered Institute of Insurers
- **www.ifsl.org**, International Financial Services London—a trade association
- **www.iii.org**, Insurance Information Institute—U.S. information resource
- **www.insuranceday.com**, *Insurance Day*—daily insurance newspaper
- **www.iaa.co.uk**, Association of International Underwriters of London—London market
- **www.lloyds.com**, Lloyd's insurance market
- **www.swissre.com**, Swiss Re—reinsurance company

19.10 LEXICON

ABI: Association of British Insurers.

Capacity: A measure of company or market size. The ability to underwrite insurance premiums based on capital provided.

Central Fund: A fund of last resort and the final part of Lloyd's chain of security for policyholders.

Combined ratio: A measure of an insurer's underwriting profitability based on the ratio of the net incurred claims plus net operating expenses to net earned premiums. A combined ratio of 100 percent represents the break-even point. A ratio of over 100 percent represents an underwriting loss, while a ratio of under 100 percent represents an underwriting profit.

Commercial property insurance: Property insurance for businesses rather than homeowners.

Council of Lloyd's: The governing body for the Lloyd's market.

Cyber-liability: Liability specifically created by the advent of e-commerce and the Internet.

Domestic property insurance: Insurance for homeowners rather than businesses.

Equitas: The corporate entity into which the general business insurance liabilities of Lloyd's Syndicates allocated to the 1992 and prior years of account have been reinsured.

EU: European Union.

Franchisee (of Lloyd's): Managing agents that manage syndicates.

Franchisor (of Lloyd's): The Corporation of Lloyd's, which manages the Lloyd's Franchise on behalf of managing agents, who are the Franchisees.

FSA: Financial Services Authority, the U.K. regulator of the insurance industry.

Hardening: The increase in insurance pricing and tightening of rates and terms that takes place as part of the insurance cycle.

ICAs: Individual Capital Assessments. Method of calculating risk-based capital requirements.

Insurance cycle: Underwriting results in the non-life insurance market are notoriously inconsistent and have tended to follow a cyclical pattern over time, with a wide variation in profitability from year to year. This pattern is known as the “insurance cycle” or “underwriting cycle.”

Insurance penetration: The ratio of premiums collected to gross domestic product expressed as a percentage.

IUA: International Underwriting Association of London, also known as the London company market.

Long-term market: Includes life and annuities insurance; individual, group, and occupational pensions; and income protection insurance.

MAT: Marine, aviation, and transportation business.

Members (of Lloyd’s): Capital providers.

Motor: Known as automobile in U.S. English.

Non-life market: Also known as general insurance. Excludes all long-term insurance.

P&I club: Protection and Indemnity Club; a mutual insurer usually focused on marine liability business.

R&R: Lloyd’s Reconstruction & Renewal, which took place in 1996 to secure the market’s future following unprecedented losses.

Softening: The decrease in insurance pricing and relaxation of rates and terms that takes place as part of the insurance cycle.

Subscription market: Large risks may be covered by more than one insurer within the London market. The process by which the risk is shared among syndicates and/or company market insurers is called subscription.

Syndicate: A group of underwriting members at Lloyd’s.