THE RISK MANAGEMENT FORUM - MONTE CARLO 1993

"INSURER SECURITY"

BY

MICHAEL PAYNE

My subject today is one of paramount importance to all ~~layers~~ buyers of insurance and reinsurance the world over - indeed it has always been so, but never more than in today's exceptionally difficult conditions.

We have now experienced three consecutive years of unprecedented losses on a scale never before experienced in Lloyd's 304 year history - and of course it will not surprise you that the main theme of my paper will be to concentrate on Lloyd's, where I have just completed my 45th year. But there are many wider issues than Lloyd's on its own and I will deal with these briefly before I go into the more specific details relative to the security of our market and its future role (logo slide).

PART ONE - HISTORICAL PROBLEMS

Broadly speaking the current trend which does not show any sign of diminishing is that we are heading rapidly towards a capacity crisis which is likely to reach its peak during the forthcoming renewal season at the end of this year. Whilst it may be felt that this is just part of the normal cyclical pattern to which we have become accustomed over the years, let my say that I do believe this one will be far more profound and prolonged than at any time in the past four and half decades which is the exact period of time that I have been involved in underwriting at Lloyd's. I must stress that I do not believe at all that this capacity problem will be confined solely to the Lloyd's Market as in fact we are in a fairly healthy position in that respect as I will be demonstrating to you later on.

The principal problems arise from the very sudden and dramatic reversal of capacity during the past twelve months and especially during the calendar year 1993.

Looking at the London Market alone, there have been some very significant withdrawals in that quite apart from the financial collapse of one major reinsurer, many others have withdrawn from the Market altogether. This includes many well known Names who have been prominent players in the London Market for many years. I believe that they have not only gone but that they have gone for good and this will create a vacuum which undoubtedly will result in a very dramatic upstream in the direct writing cycle.

Whilst this is clearly desirable, in order to restore the confidence of shareholders, Underwriting Members of Lloyd's and the buyers of our products, we must not allow a repetition of the years that followed a similar situation in 1986/87.

At that time, there was an equally sudden withdrawal of capacity mainly from the USA and this caused major problems for many buyers and risk managers who were left with incomplete layers of cover, particularly in the liability sector which has been my main interest for the whole time that I have been underwriting.

All this coincided with a much tougher approach from the professional reinsurance market and for a very short period of time, some of the less scrupulous insurers and reinsurers were taking full advantage of that situation by imposing premium and rate increases which were not wholly justified either by the nature of the business or by its loss experience. This is possibly one reason why that very difficult period was followed by capacity flooding back into the Market, particularly from the USA, with the most inevitable results that rates plummeted downwards again to an unprecedented low level where they have remained until comparatively recently.

What we need to do now is to ensure that there is no repetition of that phenomenon and that we establish world wide a stable and secure market without any of the over reaction that has taken place during the last ten years. There can be no doubt that these violent swings affect our credibility and for the unfortunate risk manager, he or she will not know where the capacity is coming from or how much it is going to cost from one year to the next, if we allow that situation to continue.

Of course the whole problem was made far worse for the property catastrophe market by reason of the fact that there were so many catastrophes both of natural and unnatural origin in the years of depressed rates, that the effect was most dramatic indeed. All these disasters have of course been very well chronicled and I do not need to go into any detail here other than to make the obvious comment that they all took place within a very short space of time and they all cost a very great deal of money. Indeed the full impact of such disasters as "Hurricanes Hugo" and "Andrew", "Typhoon Mireille", "CAT90A" being the North European windstorms in early 1990 and the other many unprecedented disasters are still being calculated and it will still be some time before the full impact is known.

Quite apart from the withdrawal of capacity from London by established reinsurers who are still trading elsewhere, there have been many failures around the world and indeed it is probably not well publicised that something in excess of 300 US insurers have filed for bankruptcy in the past two years. There have been others domiciled in London, Europe and many other parts of the world which have ceased trading and it is unlikely that any recovery can be made from any of them. This has in itself caused an additional problem for the Lloyd's Market as a new phenomenon has emerged as a fairly regular item in syndicate accounts, namely ~~mainly~~ that of "bad debt" arising from reinsurance failures. Clearly this has made all underwriters and syndicate managers ever more alert to the need to satisfy themselves totally that the security is 100% in every respect and hence there have been many moves to establish procedures both independently and in-house in order to ensure that this is the case for the future.

However, it should be noted that it is not just the actual failures that are causing the problems, it is the difficulty in extracting payment of claims from those companies that have withdrawn from the Market but still continue to trade. Once you have stopped trading there is no cashflow and consequently their delay in meeting in full valid claims has become more and more pronounced, and this is another aspect of security which I have constantly felt should be given more attention.

Financial security is one aspect which is clear to everybody and our standards must improve in this respect, but also the other factor is security of intent that is to say the willingness of insurers and reinsurers to meet claims promptly.

I am sure that I do not need to remind you that in all of the 300 plus years of history, Lloyd's has never failed to meet in full any valid claim and the same situation still applies to claims which were having to be met by syndicates in run-off - even if it means effecting cash borrowings in advance of reinsurers failure to pay either on time or at all.

Nevertheless, Lloyd's is still able and willing to pay and that is the message which I bring to you since it is clear that with losses aggregating something in excess of £5billion sterling over the past three years, this has placed a considerable strain on our resources. However, those resources ~~are still~~ remain more than adequate to meet liabilities and I do not think there are many other markets which could be in that position after such a dramatic sequence of events.

Certainly we do have our problems and many of the extremely badly hit Names have formed themselves into Action Groups who are going through a legal process to determine how much they can recover of their losses from the agents who put them on the syndicates which have cost them so much money, also the agents who controlled those syndicates, the auditors and indeed anyone else who happened to be "in the frame". It is anticipated, however, that such of these actions that are valid will be settled by negotiations before the year-end. This would have a most beneficial effect on the Membership which still provides our fundamental capital base.

As will be well known, the 'Names' are in fact the Members of Lloyd's who have supported their involvement in each syndicate by a proportion of their individual capital wealth and it is important to note that this factor should be put in a proper prospective.

By this, I refer to the fact that the disastrous losses which have cost the Names throughout the Market over £5billion have been predominantly concentrated on a comparatively small number of syndicates. For example, in the 1988 and 1989 year of account, the total amount of loss was just over £2.7 billion to the entire Market constituted ~~contributed~~ by a total number of approximately 400 syndicates though only four of that number managed to create between them over 50% of the aggregated losses to the Market.

As far as the 1990 account is concerned (and bear in mind that our accounts are closed three years in arrears, therefore the 1990 account has only just been closed) we are looking at a further loss of approximately £3.1 million which brings us to the total aggregated figure over the three years of £5.8 billion with the prospect of a further loss to come in 1991 of much lesser severity.

However, again, it is a comparatively small number of syndicates that have created the problem and indeed over the whole three year period there are a total of approximately ten syndicates which have brought about 45% of the aggregated loss figure.

Therefore, it is a minority of Names who have been very severely hit, some to the point where they can no longer continue, though no Name to date has been forced into bankruptcy. If they cannot pay (or indeed some of them will not, pending the outcome of legal action) then the losses are earmarked against the Central Guarantee Fund so that no valid claim goes unpaid. This vital factor provides a very valid comparison with the position in other sectors of the Market, i.e., insolvent insurers in the US and elsewhere who are simply unable to meet their commitments, therefore the policy holder or the reinsured is left without any protection.

Nonetheless there is no doubt that 1990 reached an all time low as far as Lloyd's is concerned but we feel it has provided a turning point for Lloyd's fortunes. Although the loss was indeed very significant, it is important to know that a considerable proportion of it was accounted for by deterioration in earlier years of account which have been reinsured into the 1990 year. It is estimated that this feature contributed £1.1 billion Slide (1) towards the loss which incidentally also contains a considerable element of what we call 'double counting'. This amounts to something in excess of £600 million on the 1990 account alone and it refers to a situation where the same claim counts twice or maybe even three times against the Name in question who has to meet the loss. It occurs simply because the original claim is met in the first place and that in turn may give rise to a claim by the Name in question against his agent who in turn claims against the errors and omissions underwriters who can in some instances be the same syndicates as those of course who sustained the loss in the first place. Although this feature is there, the majority of the errors and omissions claims are set against other syndicates in the Market but it does make the overall loss that much the greater even though one claim will be offset by the other ultimately. This is yet a further indication of the strength of Lloyd's reserves to which I will be referring in a moment.

It is perhaps appropriate to mention at this time that my own syndicate, Michael Payne and Others, had a significant involvement in the agents' errors and omissions cover but after making full provision of this and additional high provisions for personal Stop Loss reinsurance which we also wrote, we still came out with a very positive result for 1990 as indeed we have for the past five years. I am very happy indeed to tell you that our profit in the 1990 year of account was by far the highest of any syndicate in Lloyd's in monetary terms. There were in fact 110 syndicates out of a total of 380 trading of 1990 which did manage to make a profit in that year of account, albeit in most cases, a very small one. This profit indeed totalled only £170 million from those syndicates which give you a fair indication of the fact that the bulk of the Market was in a loss situation though, I stress again, that it was only a very small minority of syndicates which caused the major problem.

So to summarise the position of the last three years trading, the combination of a number of factors has led us into a situation where we need to institute even better control that has been the case in the past and we have therefore adopted a 'Business Plan' which was promulgated by Lloyd's Council earlier this year. Much of the Plan has already been implemented, and the remainder is under active consideration at the present time. I refer to this in the next section of my paper.

Conclusion

Having attempted to sketch for you some of the features that have brought us to the present situation, I will conclude this part of my paper with a summary of the major contributing factors:-

- Over capacity causing rates to drop to a non-viable level.

- An escalation of attritional claims in the wake of an unprecedented number of occurrences world-wide of a catastrophic nature.

- The disastrous effect on a few syndicates of the notorious "LMX spiral".

- The need to constantly top up reserves set aside for back year deterioration brought about almost entirely by asbestosis and pollution claims from the USA, some of which relate to "occurrences" which took place over 100 years ago.
- A significant number, though still a small minority of Names being placed on a number of syndicates with a high degree of exposure to the foregoing.

PART TWO - LLOYD'S SECURITY

SLIDE (2)

So now the time is opportune to give you a little more up-dated detail as to how Lloyd's has been able to withstand the heaviest succession of losss at any time in its entire history.

In order to do this, it is necessary for you to understand the chain of security that lies behind every policy Slide (3). This slide demonstrates the structure of the funding, yet does not show the full picture. Starting at the top, we have the "Premiums Trust Funds" - these being funds held in trust for the Names, derived from premiums received by the Syndicate. In effect, these funds are the first call for payment of claims and are of course invested on behalf of the Names to produce the maximum benefit in terms of interest and capital growth as at 31/12/1992, the last completed audit date, these funds stand at a total of £16,165 billion sterling.

Next comes the deposit lodged at Lloyd's by each Names to enable him or her to trade - equivalent to 30% of the total allocated premium income to that Name over all syndicates in which the Name has a participation. Lloyd's has the right to draw down on any deposit where the Name has not paid the relevant proportion of the loss. This totals £4,496 billion.

After that comes the confirmed personal wealth of the Names in liquid assets of not less than £250,000 and on top of that is an unlimited liability for all the Names' assets in excess of the minimum, currently standing at £1.88 billion.

Then there is the Central Fund which totalled £1,147 billion at 31/12/1992 and whilst a proportion of this fund may have been earmarked for losses not yet funded by individual Names, there is a further "top-up" from this year's levy. There remains a healthy surplus in this fund despite the calls made upon it.

Finally there are other corporation assets totalling £251 million, all of which produce a total asset base of £24,438 billion against provisions for future liabilities of £18,347 billion leaving a healthy surplus of over £6 billion.

We have achieved that position despite the accepted fact that Lloyd's establishes reserves on a more conservative basis than any of our competitors on either side of the Atlantic **Slide (4)**. Whilst this does not demonstrate the position at 31/12/1992, due to delay in collating comparative figures from all sources, I am assured that we remain in a most satisfactory position. This **Slide (5)**, compiled to show the A.M. Best rating in the U.S. demonstrates the satisfactory movement on reserves compared with the "normal" range of up to 25% on this test. Despite the unprecedented level of deterioration on old years, we remain well within acceptable limits. It should also be noted that the potential liabilities arising from pollution in the U.S.A are all reserved fully on a conservative basis, including a large measure of IBNR. I do not believe that any U.S domestic insurer reserves on a similar basis for this contingency, the majority only providing for attorney's fees until the individual case actually reaches the court.

Despite this quite unique approach, Lloyd's remains well in excess of the minimum solvency requirement established by the D.T.I in the U.K. and the next **Slide (6)** demonstrates how we compared at 31.12.91. We can only wonder where the U.S Market would be, were it to reserve on the same basis. Chapter II may be the only answer!

So we are not only well and truly reserved but we are still very solvent. Have no fear or doubt - Lloyd's will not only comfortably survive the present critical situation, but we will emerge as a leaner and stronger market with the highest quality standards that can be achieved anywhere. There can be no doubt that we have learned some hard lessons in the past 3 years - and the various causes of these have been or will be eliminated totally.

Just look at our performance over the past 40 years **Slide (7)** which demonstrates clearly that we have outperformed our competitors in both the U.K. and the U.S. consistently over the years, though in the bad years we have not done as well, for example Hurricane "Betsy" in 1965 hit us harder, as has been the case in 1989/90. But overall, it is an impressive record and it should leave no room for doubt that, with incorporation of our Business Plan, we shall do much better in the future.

PART THREE - LLOYD'S CAPACITY IN THE FUTURE

Although my brief for this talk should be confirmed to solvency issues, I feel that in the same context you should be aware of our future plans for both capacity and solvency.

After all Lloyd's remains central to London (and therefore to international markets), ~~and~~ demonstrated in **Slide (8)** as not only do we write 50% but we lead at least 66% of all London business **Slide (9)**. We intend to improve on this by enhancing both standards and our competitive advantages with particular emphasis on our traditional strengths e.g.,

- Flexible and responsive product development.

- Direct right of access to the decision makers thus establishing a positive link between the buyer and the ultimate risk taker.

- High variables with low fixed costs.

- An unequalled range of talent and expertise.

- A tradition of high quality service which will be much improved by the introduction of highly geared electronic technique.

As for capacity to write business, we can now look forward to a level of capacity for 1994 roughly equivalent to that available to us in 1993, around £8.8 billion, of which possibly £800 million - £1 billion will be Corporate Capital - a new feature to Lloyd's. Since publication of the Business Plan, the individual Members have responded in the most positive manner. The majority who are still able to do so have increased their commitment, some who had suspended their underwriting have returned and new Names are coming in.

So, from 1994, we shall see some changes with the introduction of a "mixed" capital base of incorporated members and individual unlimited liability Names, though the latter will undoubtedly remain the key capital **Slides (10 & 11)**. Corporate entities throughout U.K, Europe and U.S.A. have displayed an ever-increasing volume of interest in Lloyd's, even though they will have increased responsibilities to the Central Fund and by way of the ratio of deposit to premium **Slide (12)**. This new feature plus increasing participation from individual Members should see us back up to at least £10 billion or more by 1995.

Consolidation of capacity and syndicate numbers leads inevitably to fewer, larger syndicates (**Slide (13)**) and therefore: (**Slide (14)**)

- Economies of Scale
- A more stable long-term capital base
- Greater capacity for successful underwriters and
- a "leaner, fitter Lloyd's".

We have a "New Deal" for you, with a much improved and more attractive Market backed by uncompromising security. That is what you need and that is what we will give you.

In conclusion, may I offer no apology if my talk today has centred on Lloyd's - my Market for 45 years, and as you may have noticed, I am intensely proud of it. We came here to talk about security and you will find none better than that which has seen us through the most difficult period ever known. As to the rest of the market, I am sure that there any many who feel the same way, but I am neither sufficiently qualified or informed to make an appropriate comment - I leave that to those directly concerned. but always, please remember that security of intent is every bit as important as financial security.

It has been a privilege and a pleasure to address you today and I thank you for your attention (LOGO).