Insurance

BACKGROUND TO THE INSURANCE MARKETS

History

> *But ships are but boards, sailors but men: there be land rats and water rats, water-thieves and land-thieves, I mean pirates: and then there is the peril of waters, winds and rocks.*
> (*The Merchant of Venice,* Act I, Scene III)

Shylock is quite right and Antonio is soon to discover that an insurance premium is cheaper than a pound of flesh any day! While the history of insurance is lost in the mists of time, our modern history surely begins with marine insurance.

Ship owners would meet with rich merchants who would agree to jointly pay for any losses for a share of the premiums. A contract was drawn up and merchants added their name at the bottom. As they wrote underneath the text, they were *underwriters*. Apart from this, a group of ship owners might agree to raise a levy on all members and share losses between them. This principle continues today with the so-called 'P&I' club (see below).

Meetings in London for business took place in coffee houses. In 1688 we have the first mention of Edward Lloyd's coffee house in Tower Street. They moved to Lombard Street in 1691. Then, as now, information was power and, in 1734, they began a publication, *Lloyd's List*, which gave shipping information and also some financial data. It is still published today.

The insurance world in those days was as full of scandals as the world of stocks and shares. Just as the Stock Exchange was set up to bring respectability and rules so, in 1769, one Thomas Fielding set up a new organisation meeting in Pope's Head Alley and, in 1771, drew up a document setting up a ruling committee. A move to the Royal Exchange building in 1774 was followed in 1781 by the first constitution of Lloyd's. These were the early origins of the famous Lloyd's of London, of which more later.

Even earlier than Edward Lloyd's coffee house, the Fire Office Company was set up in 1680. The Amicable followed in 1706 and the London Assurance and the Royal Exchange Assurance in 1720.

The basic idea of insurance is the *sharing of risk*. Experience may suggest that, of an insurance population of buildings, 2% will have a fire in a given year. Dividing the anticipated claims by the numbers seeking insurance gives us the *premium* to be paid. Those who haven't had a fire have contributed to a pool to pay for those who have, while buying protection in case they were the unfortunate ones.

The Insurance Market

The biggest markets in the world by total premium income are the US, Japan, the UK, France and Germany. Premiums in the US in 2005 were $1143 billion, Japan $476 billion, UK $300 billion, France $222 billion and Germany $197 billion. The premiums for Western Europe as a whole totalled $1241 billion, of which the UK, France and Germany contributed 58%.

There are clear differences between life and non-life business. Over the whole world, total life premiums were $1973 billion and non-life $1452 billion. Non-life business is 62% of the market in the US, 40% in Europe, but only 20% in Japan. Taking life business only, Europe is the biggest market in the world, followed by the US.

Another way of looking at it is by market penetration, that is, as a percentage of GDP. Here, countries like South Korea, Taiwan and South Africa come out well. Of the industrialised countries, the largest by this measure are the UK, Switzerland, Japan and Ireland. The potential in the fast growing countries of China and India can be seen by the low penetration – only about 3% in each case. (Figures from Swiss Re *Sigma* publication July 2006.)

The main characteristic of the UK insurance companies is the international flavour of the business. This is discussed under the heading 'The London Market' later in this chapter.

Table 1 *World's largest insurance companies*

Company		*Premiums 2004 $bn*
AIG	USA	66.8
Met Life	USA	58.7
Axa	France	58.4
Allianz	Germany	56.2
ING	Netherlands	49.9
Generali	Italy	49.9
Nippon Life	Japan	45.5
Aegon	Benelux	42.0
Aviva	UK	37.6
Great Western Life	Canada	34.0

Sources: Swiss Re *Sigma* publication No. 1/2006

Assurance/Insurance

Assurance is the cover for events which are certain. Since death comes to us all, life insurance (strictly speaking, 'death insurance'!) is providing cover for an event which is certain, only the timing being open to doubt. The study of the relevant statistics and laws of probability by a profession called *actuaries* leads to an accurate estimate as to how many of an insured population will die in a given year. As a result, it would be very unlikely that the claims would exceed the premiums. In other words, the company expects to make an *underwriting* profit. In addition, premiums are paid in advance and will be invested prior to any money being paid out. The second source of profit is thus the return on the investments. Ironically, interest rate risk will be more than mortality risk! Finally, people take out a life policy and perhaps do not change this for the whole of their life. As a result, the business is stable and can invest for the long-term. The nature of this business is such that it is natural for them also to invest funds to provide pensions in the longer-term. We, thus, talk of the 'life and pensions business'.

The industry has been ingenious in working out variations on the theme of a simple life policy. One variation is *term assurance*. The life cover is for a given number of years such as 10 years. As death is no longer certain, the policy is cheaper. We can have heavier protection for a vulnerable period (a young family) than later.

Endowment policies add the element of investment. Life cover is provided up to the age of, say, 50 and if death has not taken place a sum of money is guaranteed. Often the 'life' element is only 10% of the premiums or even less.

Living assurance is a new type that has become popular in the US. This policy will pay out on the diagnosis of serious diseases such as cancer, heart disease, and so on.

Life policies can be with or without *profits*. The with-profits policy declares bonuses annually (*reversionary*) and at termination.

A variation on this theme, which has become popular in many countries (US/Canada/UK/France), is to link the policy to mutual fund performance (*unit-linked)*, as the fund is usually divided into units (see Chapter 7).

Insurance is providing cover for events which may or may not happen: for example, theft, fire, accident, storms, and so on. Judging the probability of these events is much more difficult than judging the incidence of death and frequently claims exceed premiums – an underwriting loss. In recessions, for example, the incidence of arson mysteriously increases!

At times, too, premiums are driven down to uneconomic levels due to fierce competition. The industry is cyclical. It is not difficult to start up in insurance and, when profits are good, firms are attracted in until the extra competition produces losses. Firms then depart until profits rise again and the whole cycle starts once more. The 1980s and early 1990s were a very bad period for insurance, exacerbated by an extraordinary series of disasters – hurricanes, the Exxon Valdez spillage, and so on. Heavy losses were made, but then things settled down a little. Profits rose once

again, new entrants came in and there was overcapacity in the industry, premiums fell and things were difficult, leading to a new spate of mergers. The events of 11 September 2001 changed things again. Premiums increased considerably and we moved to a new phase in the cycle. Equally, the losses of 2005 due to the tsunami and hurricanes like Katrina have sent premiums up again.

The possibility of underwriting loss means that a good profit from the investment of the premiums is essential since this may be the only profit there is. To make matters worse, premiums are specifically renewed annually and the insured party may look around and decide to switch to another company, leading to less certainty regarding future income.

The investment policy of the insurance company, therefore, has to pay much more attention to liquidity than the investment policy of companies in life and pensions.

As a result of the two sides of the business – assurance and insurance – we find companies which do assurance only, insurance only and companies which are in both markets, called *composites*.

As well as public companies with shareholders, it is very common to find companies which are not public companies but are owned jointly by the policy holders. These are called *mutuals* and this is very common across all the Western markets, especially for life companies.

Regulation

The importance of insurance, and the fact that it is often bought by members of the general public, means that it is an industry which is closely regulated. The collapse of the Vehicle and General Company in the UK in 1971, for example, left 800 000 motorists uninsured overnight!

In the US, regulations are made by both the central government and the states themselves. In the UK, regulation is from the Financial Services Authority, in France from the Direction des Assurances and in Germany from a body called the BAV. In Japan, insurance is now controlled by the Financial Supervisory Agency, set up in 1998.

Where countries have regulatory bodies, their objectives are similar – namely to promote efficient, orderly and fair markets and to help consumers achieve a fair deal. These objectives are aimed at providing confidence in the market to encourage the concept of individual responsibility for one's family and future.

Regulations may cover general supervision, licensing, solvency ratios, accountancy practices and annual returns. They will also cover the question of compulsory insurance, such as third party motor insurance, public liability and so on.

Solvency ratio is similar to the concept of capital ratio in banking (see Chapter 2). In banking it was, in essence, a prudent relationship between capital and lending. In insurance, it is a prudent relationship between capital (shareholders' equity plus reserves) and premiums. Money spent buying *reinsurance* from others can usually

be deducted from the premiums (up to a maximum figure), thus allowing the insurer to take more business. The rules are complicated and alternative calculations are often possible. Each country tends to have different rules but the EU single market regulations are imposing common minimum standards. Liquidity is important and the regulations may demand that part of the capital must be held as a *minimum guarantee fund*. In the US, if claims arise from risks written in London, they must be covered by a letter of credit.

Distribution

The question of the distribution channel for selling personal insurance is very important. Essentially, insurance is a 'distress purchase'; few people have life insurance or pension provision as top of desired purchases. Similarly, motor and house insurance in more advanced countries is mandated by government or lenders. Thus there is an old adage that 'insurance is sold and not bought'. This results in distribution being extremely important in this market. It has led to insurers linking with banks to use them as a channel for selling policies (see Chapter 4) and banks buying or starting insurance companies.

Typical distribution channels are:

- ❏ Tied agents
- ❏ Direct sales staff
- ❏ Independent financial advisers (IFA)
- ❏ Part-time agents
- ❏ Brokers
- ❏ Telephone-based.

Tied agents are usually self-employed and sell only the policies of one company – Allianz, for example, has 43 000. They are also very common in France, where there are about 80 000.

A direct sales force is often employed, especially in assurance. In Japan, much of insurance is sold by a unique sales force of 'insurance ladies'.

Independent financial advisers will make recommendations from a range of products. They may charge a fee for their advice or simply take a commission on the policy offered from the company concerned. In the latter case, the possibility of bias towards high commission policies may lead to the 'independence' of IFAs being questioned. The UK has struggled with this problem in recent years and regulations forced IFAs to register with a 'Self-Regulatory Organisation' (SRO) and declare their commission on the recommended policy. Another rule called 'polarisation' ruled out combining the roles of IFA and tied agent in any way. For example, a bank manager might act as agent for the bank's mutual funds but act as adviser in other matters. This is not permitted. A seller of mutual funds and life policies must inform the prospective buyer in writing whether their status is that

of IFA or tied agent. However, the Financial Services Authority has been looking at the possibility of altering the rules on polarisation, and from 2004 the strict division between independent advisers and tied agents was abolished. Firms are able to continue to describe themselves as tied agents provided that they offer the customer the option of paying a fee for the advice they give. Advisers are required to disclose a menu of charges and fees prior to a sale.

Part-time agents are usually solicitors and estate agents who will handle personal assurance and insurance on a casual basis and take commission. However, from 1 January 2006, all selling insurance as a sideline in the UK must register with the Financial Services Authority – this complies with the EU's Insurance Mediation Directive. If they do not register, they are not covered by the financial services compensation scheme.

Brokers are very common in the US, the UK and the Netherlands and occupy a strong position in Latin America and South East Asia. The large brokers typically serve corporate clients with complex and large exposures. They help clients determine their exposures, structure their insurance programmes, and negotiate rates, terms and conditions. In addition, they provide multiple services along the insurance value chain, for example, with consulting arms for pensions and employee benefits. Smaller brokers handle personal lines and small commercial risks. Much of it, like motor and household, is not particularly lucrative. For the broker it is the contact from which they hope to sell more profitable life and pensions business. This phenomenon is termed 'cross-selling' and is becoming increasingly important to company profitability.

Corporations with large commercial and industrial risk rely on the expertise of insurance brokers to provide adequately priced coverage and risk management services. Terrorism, rising medical costs and increased litigation (for example, concerning asbestos) have made life much more difficult.

The industry is highly concentrated. Marsh and McLennon and Aon account for over 50% of the industry's brokerage levels. The world's top brokers can be seen in Table 2. For the UK, Jardine Lloyd Thompson is the biggest broker.

Commercial business remains strong, but personal business is in decline as people are going directly to the insurer or using the Internet to find the best price. The banks have also moved into insurance, as we saw in Chapter 4. In London, for example, 80% of large commercial business is still broker-based but the percentage of personal lines business is less than 30%, compared to 70% in 1990 (figures from Swiss Re *Sigma* publication No. 2/2004).

There is also a type of distribution called *industrial*, branch or IB. This involves calling door to door to collect premiums in cash over the lifetime the policy remains in force. The term was used in the 19th century as it was regarded as insurance for people employed in the factories. In the UK, the Prudential was famous for its industrial sales force, giving rise to a cliché, 'the man from the Pru'.

Today this business is hardly sold, as most people now have bank accounts from which to pay premiums. However, in-force policies will continue until 2040 in the

UK. As the collection is high, insurers are encouraging these policies to be 'paid up' – a term whereby the insurer pays the outstanding premiums, as they are cheaper than the cost of collection, and the policy holder receives the maturity payment as if the policy had gone full term The percentage cost of premiums collected was much higher than for other types of business. It suited some policy holders who manage their lives on a week-to-week cash basis! For others, sadly, loneliness is a factor. There will be someone to talk to each week even if it's only the person from the insurance company. Many companies have abandoned this type of business. The UK Prudential gave up taking new policies from January 1995, at which time it employed 8000 people visiting 1.6 million homes. It finally abandoned this business in 2001.

Table 2 *The world's leading insurance brokers*

Company
Marsh & McLennan
Aon
Willis Group
Arthur J Gallagher
Acordia
HLF Group
Jardine Lloyd Thompson
Alexander Forbes
Hilb, Rogal and Hamilton
Brown & Brown

Sources: Swiss Re *Sigma* publication No. 2/2004.

Lastly, mention should be made of the fact that company pension schemes (where they exist) usually provide life assurance cover automatically wrapped within the pension arrangement.

Telephone-based, as a way of cutting costs, is becoming very common. In the UK, this was pioneered by Direct Line, a subsidiary of the Royal Bank of Scotland, which now has three million motor policies, the largest private sector insurer in this market. They have now set up Línea Directa in Spain using Bankinter and similar bodies in Italy, Germany and Japan. Other insurance companies such as Axa and Zurich have followed suit as well as others in the UK.

Self-Insurance

As insurance is essentially a spreading of risk, the rising premiums in some market sectors have led to a growth in *self-insurance*. For example, municipal authorities with their common interests might form their own pool of premiums, especially for public and employers' liability.

For a single entity, a large multinational company, for example, self-insurance might simply involve putting aside an amount of money each year into a fund to build up a sum to meet given insurance risks. This could apply if the company felt that it was a much better risk than the general insured population of firms for a given risk and was paying excessive premiums as a result. It also saves on insurance commission and expenses.

Sometimes several large multinationals in the same industry will join together. Thus, Astra Zeneca, GSK and others have set up 'Pharmaceutical Insurance Ltd' in Bermuda to cover claims for property damage and business interruption. Oil and gas companies and international telecommunications firms have taken similar action.

Brokers have seen an opportunity here and have set up consultancy arms. They can advise clients on setting up self-insurance vehicles and even help establish them.

In marine insurance, an association of ship owners will organise mutual aid for risks not covered under a marine hull policy. Each member will contribute to a pool to cover losses up to a given sum. Above this sum, reinsurance will be used (see below). These associations are known as *Protection and Indemnity Associations* or P&I clubs. There are 39 in the London market.

Captives Another type of self-insurance exists where large companies set up an in-house insurance 'captive' to assess the risks across the business and place insurance policies directly with providers. This essentially cuts out the middle man. This has been increasingly common with the growth in multinational businesses with property estates around the world, while tens of thousands of employed staff make it worthwhile to manage insurance risk internally.

REINSURANCE

Definitions

Reinsurance is the form of insurance by which an insurance company can transfer to another company all or part of its liability for claims of a given type. This reduces the risk that excessive claims could seriously weaken the company.

The company transferring the risk is the *reinsured* and is also known as the *ceding* company. The company accepting the risk is the *reinsurer*.

The reinsurer may themselves pass on some of the risk to another company – this is a *retrocession* contract.

The reinsured company now has protection against excessive claims or a large accumulation of claims and can write more business than if it was standing 100% of the loss.

The amount of business it can take is limited by the solvency margin. The reinsured company can deduct premiums due to reinsurers when calculating this (although EU regulations restrict this to 50%).

Generally, reinsurance is divided into *proportional* and *non-proportional*. Top reinsurers are shown in Table 3.

Table 3 Top reinsurers by net premiums written, 2004

Company
Swiss Re / GE
Munich Re
Berkshire Hathaway Re
Hanover Re
Lloyd's
Allianz Re
Everest Re
XL Re
Partner Re

Source: S&P *Global Reinsurance Highlights*, 2005.

Proportional and Non-Proportional Reinsurance

Proportional The reinsurer takes an agreed share of the risks ceded in return for the same share of the premiums less a *reinsurance commission*. This latter is to offset commission paid to intermediaries and also the expenses incurred.

Q*uota share reinsurance* Here the reinsurer takes an agreed proportion of all insurances of a given type written by the ceding company.

Surplus reinsurance This occurs where the original insurer cedes the whole contract to a treaty where the original insurer bears some risk and the reinsurers the rest. Occasional risks, not covered by the treaty, may be reinsured on a *facultative* basis.

Non-proportional The reinsurers contribute to losses in excess of a given figure in return for a premium. This may be *excess of loss* or *excess of loss ratio*.

Excess of loss Here the reinsurers agree to pay any loss in excess of a given figure up to a maximum stated amount. This may be on a *per risk* basis (that is specific to, say, a ship or building) or on an *event basis* (for example, a hurricane, and often called *catastrophe* cover). It is typically written in layers according to the risk of a 'hit'.

Excess of loss ratio Here the excess of claims over an agreed loss ratio is reinsured. The loss ratio is the ratio of claims to premiums. For example, a reinsurer might cover 90% of losses above a loss ratio of 75% to a maximum of 110%. Suppose the premium income was $10m. A 75% loss ratio would arise for claims of $7.5m. A 110% loss ratio arises with claims of $11m. The difference is $3.5m. A reinsured might agree to cover 90% of this figure, leaving the reinsurer to bear some of the loss (an important principle).

Financial Reinsurance

This has three key features:

- A ceiling on the liability for the reinsurer
- A recognition of the time value of money
- A sharing of profits through premium rebates.

The first policies were the *time and distance* policies of Lloyd's syndicates in the 1970s. The reinsurer undertook to meet a number of future claim payments. The reinsured undertook to pay a premium equal to the net present value (that is, the discounted value) of the above payments. The reinsurer, in a tax haven, would make a profit by reinvesting the premium at a higher rate of interest than that used in the discounting calculation.

The reinsured was left with no responsibility for the correct investment of the premium and might still benefit from a rate of return it could not achieve by itself. There was no transfer of risk and the arrangement was purely financial.

Today's financial reinsurance contracts do involve a transfer of risk, for example, timing risk, that is, that claims payments may be made earlier than expected. They might also agree to cover a sum higher than that implied by the premium (*finite risk*).

Financial insurance contracts can be:

- *Retrospective* – the schedule of future payments is guaranteed in respect of business already written
- *Prospective* – providing cover for future losses on business currently being written
- *Loss portfolio transfer* – a transfer of liability for losses from policies already written up to a maximum figure.

The Reinsurance Market

Lloyd's (to be discussed below) covers reinsurance, as do many insurance companies. Reinsurance is, however, a specialist international business rather dominated by specialist companies like Swiss Re and Munich Re, the world's two biggest. The German and Swiss firms are helped by being allowed to build up catastrophe reserves

which can be offset against tax. In the US, high general catastrophe reserves are allowed – the tax position is much more favourable than in the UK.

As in most financial markets, consolidation has taken place. The US General Re, the world's third biggest, took a majority holding in Cologne Re, but was itself acquired by Berkshire Hathaway in 1998. Swiss Re bought Life Re (US) and Munich Re bought American Re. Then, in 2005, Swiss Re acquired GE Reinsurance and became the world's biggest – see Table 3 for the top names.

Reinsurance brokers also operate internationally and play a very important role in non-proportional reinsurance and also in handling unusual risks. Reinsurance broking is especially strong in the UK. The biggest in the US are Towers, Perrin and John B Collins and in the UK, Benfield and BMS.

Financial reinsurance is a growing area and Zurich Insurance is probably the largest specialist. Its subsidiary is Centre Re and it has bought the Pinnacle company in Bermuda, which has underwritten many reinsurance policies for Lloyd's. Bermuda is the centre for financial reinsurance due to its tax-free status.

The banks have also become involved in financial reinsurance and Bankers Trust have set up a subsidiary to handle this in Jersey (Channel Islands). JP Morgan and Marsh & McLennan have set up a joint venture catastrophe insurer based in Bermuda.

The excess of loss market was particularly badly hit by a string of disasters in the 1980s and early 1990s. This includes Hurricanes Gilbert, Hugo and Andrew; the Philips Petroleum explosion; the Piper Alpha oil rig disaster; the San Francisco earthquake; the Los Angeles riots; the Exxon Valdez oil spill; and the storms in Southern England in October 1987 and January 1990.

This spate of catastrophes even led the Chicago Board to set up futures and options for 'catastrophe insurance' and then catastrophe bonds. They are issues backed by a pool of insurance policies and designed to spread the risk. They offer a high yield and the possibility of a loss of some or all capital. An interesting example is the issue by Tokyo Fire and Marine of $100 million 10 year bonds in November 1997. They are based on the risk of losses if Tokyo is struck by an earthquake. Swiss Re estimate that the value of catastrophe bonds has risen from $700 million to $5 billion today.

The US derivatives exchanges have also seen the rise of 'weather derivatives'. Swiss Re estimate that these have a notional value in excess of $5 billion. Chicago Mercantile Exchange contracts cover 29 cities worldwide. There are some very specific risks – for example, the number of days' frost at Amsterdam airport.

The above deals bring giant insurers into competition with investment bankers. Swiss Re and others have set up capital market divisions and investment bankers, like Goldman Sachs, have set up insurance arms.

The years 2004 and 2005 saw further disasters like the South East Asian tsunami and the US hurricanes, like Katrina. As a result, the demand for catastrophe insurance has grown enormously and reinsurance prices have gone up. As capital must be held to counterbalance risk, by mid-2006, some reinsurers were having to seek more outside capital. *Retrocession* – the reinsurance that reinsurers buy, has also

risen. The UK reinsurance broker, Benfields, estimate that the whole season will cost the global market $80 billion (£48 billion) of which reinsurers will pay $30 billion (£18 billion).

THE LONDON MARKET

What people refer to as 'The London Market' consists of:

- Lloyd's
- The International Underwriting Association (IUA).

The IUA was itself formed in 1998 from a merger of the marine insurance body, The Institute of London Underwriters, and the corresponding organisation for non-marine insurance, The London Insurance and Reinsurance Association. The IUA has 117 members.

The London market enjoys a unique status in the insurance industry as the most important trading centre for risks from all over the world. It is a concentration of the biggest providers of insurance in one place, with brokers (160) as agents, the insurance companies (some 200) and Lloyd's syndicates as providers. Some 40% of aviation premiums world-wide and 60% of premiums for offshore oil and gas rigs are collected here. Apart from the Lloyd's brokers and IUA insurers, there are 39 P&I clubs specialising in the insurance of ships and cargo (for P&I see under Self-Insurance).

There is increasing cooperation between Lloyd's and the IUA to strengthen the appeal of the London market. There is a common standard slip and common terms, the 'General Underwriting Agreement' (GUA). In addition, there is now a common service company. Lloyd's own Policy Signing Office has merged with Xchanging and the equivalent IUA body to form 'Inssure'.

Lloyd's has always been particularly strong in international marine insurance and the time has come to consider this important body.

LLOYD'S

Organisation

Lloyd's of London is a special case and merits special treatment. The Corporation of Lloyd's (formed in the 1771 reorganisation) does not itself insure anyone. The council of Lloyd's lays down the regulations for members' financial status, provides premises and general central support services. The insurance itself is provided by individual members called *names*.

There are at present about 1625 names and they used to risk their personal wealth

in providing insurance underwriting as they had unlimited liability. The theory is that, with unlimited liability, people will behave more prudently. The problem is, that with 1625 names and only 62 professional underwriters actually doing the work, controlling their actions is difficult. Much of the debate in Lloyd's over the last 20 years has turned on the question of giving the names more control, especially when it is borne in mind that in 1988 there were over 30 000 names! Most people will have read of individuals in Lloyd's having all their personal wealth destroyed (it even featured in a hugely praised play on Broadway and London's West End – *Amy's View*). This was because Lloyd's lost £8bn between 1988 and 1992 and, in these circumstances, unlimited liability became a personal disaster. Why did the names take such a risk? It was because, historically, it had been very profitable with generous tax concessions … or, if you want to be harsh, because of greed. New names nowadays do have limited liability – they cannot lose more than the capital they put up.

The actual underwriting is carried out by professional underwriters organised into 62 *syndicates* (in 1980, there were 437). Each syndicate is run by a *managing agency*, of which there are 45. As is often the case, they are dominated by the biggest (Ace, Limit, Amlin, Wellington) and the top 10 manage 50% of the capacity.

Originally the syndicate ran for a year and was then reorganised. The accounts for that year were published three years later. For example, the accounts for 1997 were published in 2000. This allowed time for claims to be made and settled. Even then, there may still be potential further claims, so these were reinsured so that the books could be closed – *reinsurance to close*. More recently, Lloyd's has made a move to one year accounting and we discuss this later.

Each name is looked after by a member's *agent* and they advise the members on the rules, risks and which syndicates to join. There are 20 agents.

Lloyd's will use brokers but only those who are the *Lloyd's brokers* (some 160). They have to be able to distribute premiums to several syndicates and collect payment of claims from several syndicates. There are also some direct sales, especially for motor insurance.

To facilitate dealings between underwriters and brokers, there is a central service provider, *Inssure*. This not only handles the distribution of money for premiums and claims but will also prepare the wordings of policies and check them.

The names must have personal disposable wealth of £350 000. They will deposit 40% of their maximum premium capacity. If the capacity is £1 million, they will deposit £400 000. At this level, the risk will probably be spread over some 10–15 syndicates.

The big attraction for the aristocracy and wealthy sports and pop stars has always been the threefold opportunity for income:

- The investment revenue from the deposit
- The investment income from the premiums
- The share of underwriting profit.

In addition, the attitude of the tax authorities in previous years was not as strict as it is today.

In June 2005, CBS Private Capital, a members' agent, launched a fund to give the public access for a minimum of £50 000. The government has also approved in principle a new vehicle for private investors – a limited liability partnership. This was expected to be available some time in 2006. Members will be able to offset losses for tax purposes and maintain control of underwriting decisions. Profits will be treated as earned income and thus can be used for pension contributions.

The names contribute 2% of premiums to a central fund for the protection of the insured and can themselves insure against excessive claims (although this has become more difficult and costly in recent years).

Lloyd's is run from the £160m Richard Rogers building which was opened in 1986. At the heart is the *room*. This is the area where underwriters sit on uncomfortable desks called 'boxes' and are visited by brokers seeking cover for particular risks. A broker gets agreement from a prominent underwriter (the 'lead underwriter') first – this is a *line* which is expressed as a percentage of the total risk. They then visit other underwriters (who will probably follow this example from one of their eminent colleagues) until they have enough 'lines' to cover the policy. Sometimes they may cover more than the required total to spread the risk further – say to 125%. In this case, each underwriter is scaled back ('signed down'). So, an original 5% would be scaled down to 4%. However, an original percentage is never 'scaled up' and there may be no change if there is an initial agreement for a 'line to stand'.

In the room is the famous Lutine Bell. This was salvaged by Lloyd's from *HMS Lutine* during the Napoleonic wars. In the days when communications were not as good as today, one ring was bad news (a delayed ship was lost) and two rings was good news (the delayed ship had arrived safely in harbour). It is now rung on ceremonial occasions only. The bell was rung when the Queen opened the building in 1986. In view of the many scandals which surrounded Lloyd's at the time, one wit asked whether it would be one ring or two! It was also rung on 4 September 1998, when the Department of Trade and Industry approved the market's recovery plan – the Equitas vehicle (see below).

Lloyd's is run by the Lloyd's Council of 18 members – active names, non-active names, corporate members, the chairman and chief executive and six others nominated from outside. There used to be a regulatory board and a market board, but these were replaced by the new franchise board in 2003.

Lloyds has appointed Richard Ward, formerly of the International Petroleum Exchange, as chief executive to succeed Nick Prettejohn; the chairman is Lord Levene of Portsoken.

Lloyd's is a major centre for world reinsurance, of key importance for aviation insurance and marine insurance, and has pioneered policies for new risks such as AIDS and computer fraud. It has also always specialised in unusual risks such as multiple births, a famous film star's legs (Betty Grable, many years ago) and the world's largest cigar! Its reputation in the US was enormously enhanced by its

prompt settlement following the 1906 San Francisco earthquake, in contrast to many other insurers.

Early Problems

From the late 1960s onwards, the operation of Lloyd's began to attract increasing criticism. The accounting information was weak (and prevented names from realising the true facts); managing agencies shared profits but not losses; some syndicates were exceeding premium limits; periodically huge losses arose; and finally, the ownership of managing agencies by brokers led to conflicts of interest.

Most of these problems were addressed by the Lloyd's Act of Parliament, passed in mid-1982 and becoming law in January 1983.

Before it even became law, Lloyd's was hit by massive scandals involving illegal transfers of money to offshore companies abroad. These transfers resulted in heavy losses, most of which had to be met by a special fund set up at Lloyd's. They led to a further change in which the outside members of the Lloyd's Council (nominated by the Bank of England) and nominations of the non-working names were to be in a majority. This was implemented in 1987.

Commercial Problems

The problems that hit Lloyd's in the late 1980s and early 1990s were commercial problems, partly due to poor underwriting rather than fraud.

The names had, of course, unlimited liability and began to find themselves facing huge losses, in many cases involving personal ruin.

This was particularly true in the excess of loss market (LMX). Here one syndicate reinsures the losses of another or of a company outside the Lloyd's market. At first, syndicates specialising in excess of loss were very profitable and attracted new and undercapitalised names. The old minimum wealth level of £100 000 had been kept at this figure for far too long and was only raised to £250 000 in 1990 (and today is £350 000). Gooda Walker syndicate 290 went from underwriting capacity of £6.2m in 1982 to £69.4m in 1989. As the string of catastrophes occurred, to which we have already referred, names faced huge losses. Accusations began to be made that 'insiders' only put money into the safest syndicates and that some agents packed innocent names onto weak syndicates as cannon fodder. The insiders put their money into safe syndicates, known as 'baby' or 'preferred' syndicates. In particular, there had been excessive passing on of reinsurance risks from one syndicate to another.

Members of the Oakley Vaughan syndicates brought a unique court case against the Corporation of Lloyd's itself, claiming that it had failed in its duty to protect the names. In June 1992, the High Court came to a decision. It was decided that Lloyd's had a duty to regulate the market and act fairly, but no specific duty of care to the names.

Another problem was caused by huge payments for compensation as a result of litigation arising in the US. The cases concerned pollution and asbestosis. In some cases, the law was even changed with retrospective effect. The uncertainties this created led to a large number of years' accounts being left 'open' – a highly undesirable state of affairs. Normally, the accounts were closed after 3 years by 'reinsurance to close'. If the value of potential claims is so uncertain that they cannot be reinsured, the accounts are left open. The names then faced unlimited future claims on their resources.

The Rowland Report David Rowland, Chairman of Sedgwicks, was asked to head a task force and produce a report on how Lloyd's could be a safer place for the names and respond to the latest difficulties.

Rowland made his report in January 1992. After allowing time for discussion of its revolutionary proposals, he then produced a firm business plan in April 1993.

The key elements of the Rowland proposals were:

1 Corporate members with limited liability to be admitted in 1994.
2 The formation of a new reinsurance company called Equitas, to which all the claims for earlier losses not yet settled would be transferred; this would enable a cap to be placed on names' losses.
3 A system like unit trusts to be set up to allow names to put money into a 'pool' of multiple syndicates.
4 The size of the Council to be reduced to make it more effective.

We must remember that the essence of Lloyd's had always been that of private members with unlimited liability. The admission of corporates with limited liability was a revolutionary change. Many new corporates were set up to trade at Lloyd's, usually via a quoted investment trust, spreading investment over a range of syndicates. Some larger investment trusts have bought underwriters and some underwriters have bought capacity on their own syndicates. For example, one of the largest corporate capital providers, Angerstein, has merged with one of the largest managing agencies, Murray Lawrence. Today, limited liability members provide 89% of the capacity at Lloyd's. (As well as corporates, individual names can change to a form of limited liability.) Outsiders also bought in to Lloyd's – General Re bought managing agency D.P. Mann, and Bermuda-based Ace has bought Charman Underwriting.

The second part of the above plan was the proposal to concentrate all old business into one new company and cap names' losses. All losses not settled up to 1992 were to be transferred to Equitas, but the names had to agree. The offer was put to 34 000 names who were affected. It was approved by 90% of the names by 30 August 1996, when the offer went unconditional. The DTI then gave the go-ahead for the Equitas plan and on 4 September David Rowland, now Lloyd's chairman, rang the Lutine bell – not twice, but three times! Clearly, the hope was that the nightmare was over, although Equitas is not a guaranteed solution and was forced to increase its resrves by £128 million ($213 million) in 2005 to cover asbestos-related claims.

The plan put a cap on names' losses prior to 1993 and enabled an out-of-court settlement of claims. In addition, a new 'auction' system enabled names to sell places on syndicates to others. These schemes, together with a pooling system for syndicates which operates like a unit trust, finally paved the way for the new Lloyd's into the 21st century.

In April 2006, Lloyd's reported a loss for 2005 of some £103 million ($170 million) due to the hurricanes in the US. This was the first loss since 2001 and followed good profits in 2002–04. Ironically, there was great pride in the 2004 profit after the worst year ever for catastrophe losses. Obviously, no-one imagined that 2005 would be even worse. However, the impact on the central fund was expected to be minimal. Lloyds expected to increase its capacity in 2006 to £14.7 billion ($24.5 billion) as opposed to £13.7 billion ($22.8 billion) in 2005.

In January 2002, the 'Chairman's Strategy Group' (CSG), acting on behalf of the Council with consultants Bain and Co., put forward some far-reaching reform proposals. The CSG was set up with a specific objective, which was to determine 'the future vision and strategy for Lloyd's which will maximise the wealth of capital providers to Lloyd's over the next ten years'. The key proposals were:

- ❑ Lloyd's to move to a formal franchise structure, with Lloyd's as franchiser and managing agents as franchisees, under a new relationship defined in a set of 'Franchise Principles'.
- ❑ The existing regulatory and market boards to be replaced by a new franchise board.
- ❑ Full annual accounting on the basis of the EU's new International Accounting Standard to be implemented from January 2005.
- ❑ A new mechanism for third party capital called the 'Single Reinsurance Syndicate' to be created.
- ❑ No new names to be admitted to the market from 1 January 2003.
- ❑ Existing names with limited liability to cease trading as such from 1 January 2005.

Lloyd's held an extraordinary AGM on 13 September 2002, and the CSG proposals were passed by an 80% majority. Although opposed by many names, the votes were weighted by underwriting capacity, which counted against them.

In November 2002, Lloyd's unveiled membership of its new franchise board, which started work in the beginning of 2003. It was led by Lloyd's new chairman, Lord Levene. This new franchise board has tough powers to scrutinise the business plans of the market's underwriting syndicates as well as managing agents. Syndicates can be forced to put up more capital and to accept strict guidelines on the insurance portfolio. Nick Prettejohn, the then chief executive, took the unusual step of naming syndicates who had drawn on the central fund, ultimately used to pay compensation when a syndicate can't pay.

In late 2005, Lloyd's announced yet another strategic plan – 'Building the Optimal

Platform'. This time, the 3 year plan is a radical overhaul to tackle the increasing competition from rival centres, such as Bermuda. According to Benfields, the reinsurance broker, some $7.4 billion (£4.4 billion) of new capital was raised in late 2005 by nine new Bermudan companies, but no new vehicles chose Lloyd's. Indeed, two of Lloyd's biggest insurers, Hiscox and Amlin, have set up new operations in Bermuda. Hedge funds also like Bermuda as it is tax-friendly and it is easy to get in and out.

Referring to the plan, Lord Levene, the Lloyd's chairman, said, 'We operate in a fiercely competitive market and we cannot afford to stand still.' Key objectives are:

- ❑ A review of how capital is raised each year
- ❑ To make it easier for businesses across the globe to access Lloyd's policies
- ❑ To match the capital required from each insurer to their performance instead of to a set figure
- ❑ The setting of clear performance standards and an increase in efficiency in day-to-day dealings
- ❑ A wider representation for Lloyd's in the world's most important insurance market.

In spite of current problems, Lloyd's still has unique strengths:

- ❑ Underwriting skills – exotic risks that normal insurers will not touch
- ❑ Security – premium trust funds of £21.8 billion ($36.3 billion), capital requirements of members – £9.6 billion ($16 billion), member's assets not held at Lloyd's but declared of £220 million ($366 million) and, finally, the central fund of £556 million ($926 million).
- ❑ Global reach – Lloyd's is licensed to do business in 60 countries.

THE MARKET TODAY

General

The third edition of this book (2000) laid much emphasis on the spate of *takeovers*, *mergers* and *alliances* that had taken place in the previous three years. This activity seems to have settled down. The equity market decline between 2000 and 2002 led to a slowdown. Life insurance was hit by capital losses, especially in Europe. This led to a slowdown in mergers and acquisitions activity. One interesting move in the period since 2002 is the sale by Citigroup of Travelers Property and Casualty Unit to St Paul, finalised in April 2004, and the announced sale of Travelers Life and Annuity to Metropolitan Life. The Nordic region's biggest insurer, Old Mutual,

merged with the UK's Scandia early in 2006 and Axa agreed to buy Winterthur from Crédit Suisse. A significant move in the world of reinsurance was the acquisition of GE Reinsurance by Swiss Re in 2005, which now becomes the world's biggest reinsurer with total premiums of $32 billion (£19 billion), passing their rival, Munich Re, which has total premiums of $28.9 billion (£17.3 billion).

Financial engineering This has increasingly become more important. One area is that of credit derivatives, where many insurers have entered this market. This is a way of insuring against, for example, bond issues defaulting. This is explained in Chapter 14. Insurance companies have also learned how to reduce the cost of capital by issuing bonds secured against a stream of premiums – asset-backed securities (see Chapter 6). At the end of 2005, for example, we saw Axa issue a €200 million ($242 million, £145 million) bond backed by its motor insurance portfolio. At much the same time, Swiss Re issued its second asset-backed bond to the value of $370 million (£252 million). Jacques Algrain, Chief Executive of Swiss Re, has noted that, whereas underwriters and actuaries had dominated the industry, financial engineering had become essential to future success – 'The industry is going through a major transformation and awakening. There is increasing use of the capital markets wherever possible.'

Emerging markets Meanwhile, emerging countries are beginning on the route to new prosperity. Brazil, Russia, India and China, the so called BRIC countries, have become significant world-wide economies in recent years. India and China, for example, qualified as two of the top ten world-wide economies in 2005. With this prosperity comes the desire for luxury goods, savings and investments. Thus many of the world's largest insurers have begun operations in these emerging countries. Prudential of the UK has been one of the more aggressive, with 2005 income from Asia at 34% of the total. This was less than 2% ten years earlier.

Regulation The growth in regulation has continued in recent years as market confidence has suffered. In Shakespeare's *Othello*, Cassio cries, '*O. I have lost my reputation! I have the immortal part of myself, and what remains is bestial.*' He knew that image is everything and is extremely difficult to recover.

Against this background, there have been regulatory moves for more transparency in insurance with Spitzer and Sarbanes-Oxley (SOX) regulation and – on a global basis – Basel II and IAS (International Accounting Standard) aimed at ensuring capital reserves are adequate to cover all types of risk in financial markets including insurance.

Non-Life

The sharp escalation in judicial awards and the introduction of stricter legal standards in several jurisdictions, including the US, have led to a new emphasis on what is known as *liability insurance.* This comprises the following – commercial general liability, product liability, professional indemnity, directors' liability, product recall, personal liability and motor liability. Commercial firms have had to pay far greater

attention to this type of insurance, with the rise in strength of the consumer lobby everywhere and potentially ruinous court awards. At the same time, it represents an opportunity for the insurance industry. It is also picking up in many of the emerging economies.

Life and Pensions

Across most of the Western world, life and pensions business has become a significant political issue. State pensions schemes mostly operate on a 'pay as you go' basis, where today's payroll deductions fund today's pensioners. This was fine until the demographic changes slowed population growth. In the UK, for example, in the 1950s there were nine working people for every pensioner. Today the ratio is three to one and declining. Furthermore, life expectancy has increased dramatically. These two factors together create a massive burden for future generations. Without fundamental reforms, most Western countries face ruin.

The way out of the problem, however, also has political ramifications. States have only a limited number of choices: increase tax, extend the retirement age or make some kind of saving compulsory. The latter has been introduced in Australia, for example. In Europe the problem is at its most acute in Germany. French and Italian state pensions are very generous, some at 70% of final salary.

Clearly, going to the polls on a ticket of increased taxation or forced savings will be unpopular. Thus the problem continues to be deferred, only exacerbating it. On the good news side, this should eventually result in opportunities for life and pensions providers.

There are, nevertheless, some particular problems in the UK. New regulations have insisted on a more precise match between future assets and liabilities. It is difficult to be precise about the future value of equities and this has led many insurance and pension funds to move out of equities and into bonds. This has sent bond prices up and yields down, making matching assets less effective and leading to more purchases of bonds – which lowers yields … it's a self-perpetuating problem. Gross yield on UK gilts, which was 4.5% at the beginning of 2005, had fallen to 3.7% at the end. The real yield on index-linked 50 year gilts (a popular choice) had fallen to 0.5% or less. Many with-profit funds promise a minimum annual growth of 4% – now a considerable challenge. One can, perhaps, be forgiven for thinking that a mass exodus from equities in favour of these low yielding assets is an act of collective folly.

EU REGULATION

While some progress has been made with EU directives on general insurance, progress with life assurance has been very slow. However, in June 1992, two key directives were finally passed – the Third Non-Life Insurance Directive and the

Third Life Assurance Directive. These became law on 1 July 1994. From this date, insurers need only be authorised once, in their own country. This is the same 'single passport' idea that will apply in banking. However, marketing and selling practices will still be regulated by the country in which the insurance is sold. For example, cold calling is banned in Denmark and Germany.

There will still, of course, be problems with foreign insurers, especially at the retail level – language, distance, law and local support. Will policy holders wish to pursue a case in a foreign court? Following a European Court decision in 1992, it was ruled that a German, living in Belgium, could not claim tax relief from the Belgian government on insurance policies he was buying in Germany. For this and other reasons, the chairman of Allianz said in October 1995 that the single market in insurance was a 'myth'! What was needed first was harmonisation of legal, tax and social security systems.

The Bureau Européen des Unions des Consommateurs produced a report on comparative premiums in the life market. Using 100 as the cheapest cover, they produced the following figures:

Ireland	100
UK	102
Germany	118
France	151
Portugal	345

There is clearly scope for more competition!

SUMMARY

The biggest insurance markets in the world are in the US, followed by Japan, UK, France and Germany.

Assurance is cover for events which are certain (death). *Insurance* is cover for events which may or may not happen (accident, fire, catastrophe).

Offering insurance protection is *underwriting*.

Some companies do assurance only, some insurance only, and some (called *composites*) do both.

The equivalent of capital ratio in banking is *solvency ratio*.

The distribution of the insurance product is a key issue with the possibility of agents, direct sales staff, independent financial advisers, part-time agents, brokers and telephone selling.

Sometimes a large multinational or a group with similar interests will cover their own insurance – *self-insurance*.

Reinsurance occurs when the underwriter spreads the risk with other insurers or specialist reinsurers. There are various terms used such as *proportional*, *non-proportional*, *quota*, *share*, *surplus* and *excess of loss*.

A reinsurer may offer to reinvest premiums to provide future cover. This is *financial reinsurance*.

There are reinsurance companies, reinsurance brokers and a large reinsurance market at Lloyd's of London.

The so-called *London market* consists of *Lloyd's* and the *International Underwriting Association of London* (IUA).

Lloyd's of London is an organisation of individual members called *names* who offer insurance. They used to have unlimited liability which led to heavy losses and this has now been changed. The actual underwriting is carried out through *syndicates* and syndicates are run by *managing agencies*. Names are advised by *members' agents*.

Syndicates accounts may be terminated by *reinsurance to close*.

Lloyd's uses *Lloyds's brokers* and a central service provider, *Inssure*.

Lloyd's has faced increasing problems in the last 20 years. These have arisen from alleged fraud, careless underwriting, a disregard for the names' interests, huge claims due to pollution cases in the US and a string of natural catastrophes. This has all led to names facing huge losses.

In 1994, Lloyd's reorganised on the following lines:

- ❏ Allowing corporate membership with unlimited liability
- ❏ Setting up a system like unit trusts to pool money across syndicates
- ❏ Reorganising the Lloyd's Council
- ❏ Forming a new reinsurance vehicle called Equitas to which all claims up to the end of 1992 have been transferred; this will set a cap on names' losses.

In September 2002, Lloyd's agreed further changes:

- ❏ A formal franchise structure with a new franchise board to be set up
- ❏ Full annual accounting to be implemented from January 2005
- ❏ No new names to be admitted to the market from January 2003.

Lloyd's is preparing a new plan, 'Building the Optimal Platform', to meet the fierce competitive challenge from Bermuda.

Current issues affecting the market include the greater use of financial engineering, the prospects in emerging markets, increasing regulation and the massive challenge facing the life and pensions market due to demographics. In the UK, due to new regulations calling for a more precise match between future assets and liabilities, insurance companies have been selling equities and buying long-dated bonds.

The EU has passed the Third Non-Life Insurance Directive and the Third Life Assurance Directive. These provide the single passport concept that we have seen in banking but the results have been less than dramatic.