# A STRUCTURAL ANALYSIS OF LLOYD'S OF LONDON

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Robert Long
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# Abstract

Lloyd's is analysed within the framework provided by Kay (1995) on 'distinctive capabilities' - architecture, innovation and reputation. An examination of Lloyd's reveals that a dominant feature of the Society is cooperation between syndicates which occurs via a method of trading - the subscription system - and as a consequence of the rulings of the Council of Lloyd's.

Lloyd's has a reputation for innovation and entrepreneurism. This research argues that this is a direct result of four distinctive aspects of its architecture - syndicates are entrepreneurial organisations, the subscription system of risk placement, the unique capital base of unlimited liability Names and the presence of the Central Fund. The research reveals that Lloyd's is centered on the primacy of underwriting and that the existence of the Central Fund encourages new syndicates to form. The dynamic of a Lloyd's syndicate is that of a small business - a small number of people working towards a common goal. Moreover the unique capital base, composed entirely of individuals, does not have a voice in the day-to-day underwriting affairs of the syndicates. This allows underwriters complete freedom to underwrite and to change underwriting policy if opportunities arise. The subscription system of risk placement encourages innovative underwriting and ensures information flows between underwriters.

This author suggests that the introduction of a new capital base, limited liability incorporated investors, may stifle the entrepreneurial nature of Lloyd's underwriters and pose a threat to the subscription system of risk placement. These investors are purchasing Managing Agents, the management structure of syndicates, as well as investing in syndicates. This research suggests that this new capital base challenges the appropriateness of the current regulatory structure and well as posing a threat to the continued existence of the Central Fund. This author recommends that Lloyd's should abandon self-regulation and should instead be regulated by the Department of Trade and Industry. Furthermore, this author suggests that the Market Board and Regulatory Board should be replaced by a Business Development Board.

## Introduction and Overview of Thesis.

### In. 1 Subject matter of thesis

The subject matter of this thesis is Lloyd's of London, the international insurance and reinsurance market. The aim of the research is to analyse Lloyd's within the framework provided by John Kay (1995) on distinctive capabilities, namely architecture, reputation and innovation, and from this analysis gain an insight into the possible future implications resulting from the admission of incorporated capital to support the underwriting function. Much attention is paid to the structure of Lloyd's and the nature of the change in this structure due to the admission of a new capital base. The thesis is thus positioned in the area of organisational structure. Arising from the examination of Lloyd's and through interviews with underwriters, brokers, capital providers and Members' Agents, various hypotheses are made as to the future direction of Lloyd's.

The subject matter of this thesis is challenging and very broad. Lloyd's was not founded by one single person in a similar way to a firm, but has its origins in the gatherings of shipping merchants who congregated in coffee houses in seventeenth century London. Lloyd's is, arguably, the most famous name in insurance and it is also the oldest; the Society celebrated its 300th anniversary in 1988. To understand the Lloyd's of today it is necessary to see from whence it came and to understand its history. The present underwriters in the Room are the inheritors of a 300 year-old tradition. Indeed, Lloyd's is still steeped in tradition, even though many of its operations are extensively computerised. The Lutine Bell, the symbol of Lloyd's, stands in a rostrum at the centre of the trading floor. Corporation staff, called waiters, who work in the Room wear frock coats, reminiscent of their forebears who served coffee to the merchants who gathered in London's Stuart coffee houses. Underwriters sit at desks known as boxes which are modelled on the seats from Edward Lloyd's coffee house. Major shipping losses are recorded in the loss book by a clerk using a quill pen. These traditions might seem out of place in a modern insurance operation, but they are reminders of the rich heritage that the current Lloyd's has from its past.

This thesis covers a wide area of study; it is of necessity broad because Lloyd's is a sprawling organisation and to describe the structure and to evaluate the change in this structure it is necessary to look at all aspects of its operations.

**In. 2 Methodology**

The theoretical underpinning of the thesis comes from the work by John Kay (1995) on distinctive capabilities. Kay argues that firms may gain competitive advantage by possessing a distinctive capability - some feature of its relationships which other firms lack and cannot readily be replicated. He states that there are three sources of distinctive capability - architecture, innovation and reputation. Kay also states that some firms gain competitive advantage, not through the possession of a distinctive capability, but by having a strategic asset. Kay's work is qualitative; it provides a framework for an analysis of an entity; it deals in concepts and ideas rather than prescriptive formulae. Kay thus provides a conceptual framework for the analysis of an organisation - ideal for an amorphous entity such as Lloyd's.

The first of Kay's sources of distinctive capability is architecture. Architecture is the network of relational contracts within, or around, the firm. Firms may establish relationships with their employees (internal architecture), with their suppliers or customers (external architecture) or among a group of firms engaged in related activities (networks). Reputation is the second source of distinctive capability. Reputation is a mechanism through which firms convey information to the consumer. Reputation is important in insurance because the nature of the product is difficult for consumers to assess without specialist knowledge. The final source of distinctive capability is innovation. Innovation may be defined as producing new products or re-selling a current product in a different way to competitors. The essence of a distinctive capability is that it is a unique attribute of the firm and thus difficult to replicate by a competitor.

Kay recognises that a firm may have a competitive advantage over others based not on distinctive capabilities but on its dominance or position within the market, i.e. the firm possesses a strategic asset. Kay states that there are three main types: where a firm has a monopoly in a market, where the incumbent firm in the market has incurred substantial sunk costs and where the firm benefits from market restrictions - the product of licences and regulation. This author does not believe that Lloyd's possesses a strategic asset in the terms suggested by Kay. However, it could be argued that Kay's three distinctive capabilities are themselves strategic assets.

Kay states that the first part of the strategy-making process for a firm must be the identification of its distinctive capabilities. The next task is to match these to appropriate markets in order to gain sustainable competitive advantage. It is not the purpose of this thesis to develop a strategy for Lloyd's. Indeed, Lloyd's *cannot* have a single strategy, as the conclusions of this thesis will show, as it is a collection of individual business units, syndicates, each of which will have a different strategy. For instance, the strategy of a U.K. motor syndicate will be different from the strategy adopted by a non-marine syndicate writing mainly catastrophe excess of loss reinsurance. Moreover, Lloyd's as a whole, i.e. the Society of Lloyd's, is governed by a body which cannot implement a single strategy for the whole of Lloyd's. The purpose of this research is to examine the distinctive capabilities of Lloyd's as a whole, rather than the attributes of individual syndicates.

There are two accepted approaches to empirical study in management. The first method is a cross-sectional approach where a large number of firms are studied and data collected or a time series analysis of data, often financial data, for a single firm or a group of firms. Hypotheses are tested against the data using statistical techniques. This method is not appropriate for this author's research as Lloyd's is a single corporate entity and neither does this thesis seek to analyse time series data on Lloyd's. The second method is a behavioural study where an in-depth analysis of a single firm, or a small group of firms, is undertaken over a period of time. This longitudinal approach examines the processes within the firm and charts the development of the firm over time. The purpose of this author's research is not to examine the processes within Lloyd's, but primarily to investigate its structure and the evolution of the structure following the admission of a new capital base. From this examination this author predicts the future structure of Lloyd's and makes recommendations for structural changes.

Such a research agenda requires an appreciation of the history of Lloyd's and knowledge of why and how it has evolved into the organisation it is today. Furthermore, the research requires the input of members of the Lloyd's community in order to test this author's hypotheses as well as gaining insight into Lloyd's and its structure as well as the forces that are influencing changes in the structure. The author's initial approach was a pilot study whereby a questionnaire was sent out to twenty underwriters. Only ten per cent were returned - a disappointing response. Given the low percentage of responses and through the author contacting some of those who had not responded, the impression gained was that there was a reluctance to divulge confidential information and opinions on a written questionnaire. Consequently, this method of approach was abandoned.

A new method was thus needed, so the author decided that instead of asking for a questionnaire to be filled in, to ask members of the Lloyd's community if they would be interviewed. The advantage of holding interviews is that senior personnel can be reached who might otherwise pass a questionnaire to a junior member of staff. Whilst a questionnaire can be produced, copied and mailed to many people, interviews are much more time-consuming and thus fewer people can be contacted over a given period of time. However, the scope for discussion and the generation of new ideas is, arguably, greater in an interview than in a questionnaire.

there is little reason to consider that the interviewees were unrepresentative of their peers in their particular segment of the Lloyd's market.

This author is employed as an underwriter for a non-marine syndicate and much information was gleaned from this author's observations on the way Lloyd's operates.

**In. 3 Sources of information**

The main source of statistical information is the Lloyd's Planning Department and their annual publication "Statistics Relating to Lloyd's". This work is an extension of the historical statistics produced by Doody (1979) from 1950 to 1977. Information on the company market has been gained through LIRMA and the ABI and their associated publications. There is little information in academic journals due to a lack of research connected with Lloyd's and also the unavailability of statistics and information to those who are not actively involved in the Society. Much of the material from which this thesis is built has been derived from articles in the insurance and reinsurance press and through interviews with members of the Lloyd's community.

**In. 4 Overview of thesis**

The main work of the thesis is divided into seven chapters, with the eighth chapter being a conclusion.

***Chapter one: Overview and Statistics.***

This chapter describes the business underwritten at Lloyd's and an assessment is made as to the position of Lloyd's within the London market and the world market. This chapter also describes the operation of Lloyd's and briefly outlines the history of the Society. The chapter ends with a note on the constituents of the London insurance and reinsurance market.

*Chapter two: Studies on Lloyd's.*

This chapter outlines the literature published about Lloyd's, focusing on the reports that have been commissioned by Lloyd's, as these are primary sources that have influenced the development of the Society.

*Chapter three: The architecture of Lloyd's and the capital base.*

This chapter examines the nature of the structure or architecture of Lloyd's, Kay's first source of distinctive capability. This chapter pays particular attention to the capital base and an analysis is made of the change in the structure of Lloyd's as a result of the introduction of a new capital base - limited liability incorporated capital. The role of the Lloyd's broker is discussed and the influence of information technology on this role is evaluated.

*Chapter four: Two Structural Models: The Porter Model and the Market-Hierarchy-Network Model.*

In this chapter an analysis is made of both the insurance and reinsurance markets and the position of Lloyd's within each of these markets using the framework provided by Michael Porter (1980). The Market-Hierarchy-Network model is discussed and the structures existing within Lloyd's are presented within the context of this model.

*Chapter five: The nature of cooperation within Lloyd's.*

This chapter examines a particular feature of the architecture of Lloyd's, namely cooperation between syndicates. An analysis of the nature of this cooperation is made and the threats to its continuance with the introduction of incorporated capital are discussed and a simple two-dimensional model of Lloyd's is proposed.

*Chapter six: Innovation, entrepreneurism and Lloyd's.*

Innovation is the second of Kay's sources of distinctive capability. The nature of innovation and entrepreneurism in Lloyd's is assessed and the threat to such innovation with the introduction of incorporated capital is discussed.

*Chapter seven: The reputation of Lloyd's.*

Reputation is the third of Kay's sources of distinctive capability. The nature of the reputation of Lloyd's and the ownership of the reputation are discussed.

*Chapter eight: Conclusions and recommendations.*

The conclusion discusses the main findings of this research and makes recommendations as to future structure of Lloyd's.

**In. 5 Contribution to knowledge and recommendations for further research.**

Many of the writings on Lloyd's have sought to describe the history of the Society e.g. Gibb (1957), Cockerell (1984), Brown (1987). There have been books written on the profitability of Lloyd's e.g. Raphael (1994), Mantle (1992) and Lloyd's has been the subject of several reports at the instigation of the Lloyd's Council. These reports, such as those prepared by the Neill and Fisher working parties, have mainly focussed on the regulatory arrangements at Lloyd's. There is thus a gap in the literature for a study in the structure of Lloyd's. This thesis represents the first attempt to describe the structure of Lloyd's in terms of its trading units, the syndicates, and the threats to the change in the structure due to the admission of a new capital base.

The thesis arguably raises more questions than it purports to answer, but the fact that these issues, such as the threat to entrepreneurism with the introduction of incorporated capital, have been identified is, arguably, a conclusion in itself.

Further research is needed to explore the implications of information technology on the distribution of insurance and reinsurance in general and the role of the broker in particular. Perhaps the most revealing research would be to re-write this thesis in ten years' time in order to explore whether the conclusions reached have indeed come to fruition.

# Chapter One: Overview and Statistics

## 1.0 Introduction

This chapter gives an overview of Lloyd's of London - its business practices and a selection of terminology which it is necessary to define. This chapter gives a summary of the workings of Lloyd's and discusses some statistics relating to Lloyd's - the growth of Lloyd's, the type of business underwritten and its geographical provenance. Lloyd's share of the UK insurance market is discussed and an estimate given of Lloyd's share of the global insurance market.

## 1.1 An historical perspective

During the late seventeenth century there was an expansion in England's overseas trade. Before 1650 English overseas trade had largely consisted of the exchange of woolen cloth for other manufactures, wine, and foodstuffs, including grain. During the latter half of the seventeenth century tobacco and sugar (and later tea, coffee and chocolate) were important export commodities for England. This transformation of the commodity structure of England's overseas trade was brought about by the establishment and development of the Atlantic colonies and by trading ventures to the Far East and Africa, such as the East India Company. Davis (1962) estimates that the total tonnage of English merchant shipping rose from 115,000 tons in 1629 to 340,000 tons in 1686 and then levelled off to 323,000 tons in 1702. The growth of long trade routes and a more diversified trading pattern stimulated the growth of marine insurance and credit facilities in London. These were often adaptations of practices used in Amsterdam, but increasingly London insurance underwriters, who met at Edward

Lloyd's coffee shop in the City, captured business from their Dutch rivals. Coward (1994) suggests that the period of English neutrality from 1674 to 1689, when the Dutch remained at war with France, was a vital one in the progress of English overseas trade. During this period, English merchants overtook the Dutch in the colonial slave trade and the European carrying trade, with the result that London was well on the path of becoming the centre of the commercial world.

### 1.2 An overview of Lloyd's

The Lloyd's insurance market is a place where the business of insurance and reinsurance is transacted between those who are seeking insurance - the insured or reinsured - and others who are prepared to offer insurance coverage - the capital providers.

The growth of Lloyd's from Edward Lloyd's seventeenth century coffee house to a major international insurance and reinsurance market has been well documented (Cockerell,1984; Gibb, 1957) and it is not the purpose of this thesis to dwell on the history of Lloyd's. Lloyd's is not an insurance company nor does it itself issue insurance policies. Prior to 1994 Lloyd's consisted entirely of individuals, known as underwriting members or Names who transacted the business of insurance with unlimited liability "each for his own part and not one for another". Insurance is contracted on the basis that each Name is liable to the full extent of his wealth for the share of the risk he accepts ("down to his last shirt button" as the traditional saying is in Lloyd's). Whilst risks are normally shared between Names, liability is several and not joint, with "each underwriting member (acting) for his own part and not one for the other" (Lloyd's Act 1982). A Name is treated in English law as a sole trader and thus has unlimited liability.

From 1st January 1994 incorporated investors could join Lloyd's and, as these are limited liability companies, the shareholders are liable only to the extent of the value of their shareholding.

Lloyd's is constituted under various Acts of Parliament, thus reflecting the fundamental differences between Lloyd's underwriters and corporate or mutual associations. The Lloyd's Act 1871 gave Lloyd's its legal foundation, incorporating principles that had been previously accepted by the Underwriters on a voluntary basis. The Act conferred on the elected governing Committee the powers to enforce the rules and principles that were previously adhered to on a voluntary basis. The Act incorporated the Underwriting Members of Lloyd's into the Society and Corporation of Lloyd's and made provision for a Committee of Members to manage the affairs of the Society.

Subsequent legislation was enacted in 1888, 1911, 1925, 1951 and 1982. The Lloyd's Act 1982 established a Council of Lloyd's to manage and regulate the Society's affairs with wider powers of self-regulation than the Committee had previously possessed.

### 1.3 Lloyd's Accounting System

A three year accounting system is followed by all Lloyd's Underwriters. Under the system, the underwriting results of the members are stated by "year of account". A new "year of account" commences on 1st January of each year and remains open for a period of three years. During that period, all premiums received and claims paid in respect of the policies signed during the first calendar year of the "year of account" are attributed to that year of account. All premiums are held in trust and none can be distributed until after the expiration of the third calendar year of a year of account. At the end of the three year period the underwriter will calculate a reserve (known as the "reinsurance to close") based on the known and unknown liabilities of the year of account. Once the reinsurance to close is established, the year of account can close and the reinsurance to close is transferred in full to underwriting members participating in the same syndicate for the subsequent "year of account". For example, a new syndicate which started in 1996 will close its first year of account at 31st December 1998. The reinsurance to close will be transferred to the 1997 year of account. The 1997 year of account closes on 31st December 1999 and the reinsurance to close is calculated on the reserve required in respect of known and unknown liabilities for both the 1996 and 1997 year of account. Consequently the older a syndicate becomes the larger the reinsurance to close should become because there are an increasing number of closed years for which a reserve has to be calculated. The three year accounting system is designed to ensure that when a year of account is closed, written premiums have matured, return premiums have been accounted for, a large proportion of the claims have been settled, and a realistic assessment of outstanding claims and IBNR (incurred but not reported claims) can be attained.

### 1.4 The course of business at Lloyd's.

The business of insurance at Lloyd's is conducted via the interaction between Lloyd's underwriters and Lloyd's brokers. All insurance business is brought to underwriters through brokers who are regulated by the Council of Lloyd's, and are known as "Lloyd's Brokers". As of 1st January 1996 there were 211 registered Lloyd's Brokers.

The underwriting members of Lloyd's are subject to stringent financial requirements which are prescribed by Acts of Parliament and the Council of Lloyd's and are intended to ensure that the security afforded by Lloyd's is of the highest order. Prior to joining Lloyd's, each prospective member must prove that he has a minimum level of wealth (qualifying means). With the exception of those members who actually work at Lloyd's, members are required to establish minimum qualifying means on joining of £250,000. Only certain assets which are readily realisable qualify for inclusion as means. The combined qualifying means assets on 31st December 1995 were £6,758 million. Since the object of establishing qualifying means is to demonstrate a minimum level of wealth, it may reasonably be inferred that the actual wealth of members exceeds this figure by a substantial amount.

Each underwriting member is required to deposit a minimum sum of £25,000 at Lloyd's. In the majority of cases, however, considerably more is demanded as Names often underwrite more than the minimum. The exact amount will vary depending on each member's underwriting limit but an external member will be required to deposit 30% of his underwriting limit in his Lloyd's deposit. As at 31st December 1995, members' deposits amounted to £4,696 million.

One of the fundamental features of Lloyd's is that each member must accept and fully understand that he has unlimited liability; thus each member is liable to meet his underwriting losses to the full extent of his wealth. A member's underwriting capacity is administered by a Members' Agent who will advise a member with which syndicates to place his capacity. Members' Agents often require that members establish additional underwriting reserves with them which usually take the form of personal reserves, and are held in the names of trustees, whose consent must be obtained before funds may be released for any purpose other than meeting underwriting liabilities. The Members' Agent may suggest that the member hold a special reserve as well. Both the personal and special reserves are available to support a member's underwriting.

Insurance business can only be presented at Lloyd's by approved Lloyd's brokers. Once the broker receives instructions from his client (the insured), he prepares a "slip". This will set out the type of insurance, the sum insured, the period of insurance, the location where applicable, and various clauses applicable to the particular type of insurance. Most insurance at Lloyd's is transacted by the physical attendance of the broker at the underwriter's "box" in Lloyd's. Certain underwriters are recognised as market leaders in particular classes of insurance, for instance the Cassidy syndicate at Lloyd's is known as a market leader for kidnap and ransom insurance and syndicate 435 (D.P. Mann and others) is known as a lead for US liability business. It will be to one of these "leads" that the broker approaches in order to obtain a quote for his client. The leader will decide the price required for the insurance and/or any terms, conditions or warranties and will underwrite a certain percentage of the risk. The broker will offer the underwriter's quote to his client and, if acceptable, he will then go around the appropriate market until he has secured additional lines making up one hundred per cent of the risk that he is seeking to have underwritten. Having placed the risk in this manner, the Lloyd's broker is then under a duty to prepare the insurance policy on the appropriate form on which the insurance has been placed, and the broker then submits the slip and the policy to the Lloyd's Policy Signing Office (LPSO).

The insurance slip is the complete and final contract fixing the terms upon which the insurance cover has been granted. The slip is a legally binding document and reference may be made to it for the purposes of ascertaining the parties' intentions in preparing the policy (Ionides v Pacific Insurance Co (1871) L.R.6 Q.B. 674). It is specifically provided for in the Marine Insurance Act 1906 that where there is a policy issued by underwriters, reference may still be made to the slip, and the Court is given power to rectify a policy so as to make it correspond with the terms expressed in the slip.

### 1.5 Central resources of Lloyd's

Individual underwriting members are liable for their own underwriting commitments. However, should the assets held on their behalf at Lloyd's or their personal resources prove insufficient to meet their liabilities, the resources held centrally by Lloyd's are available to meet their obligations. These central resources comprise the Central Fund to which all members contribute by way of an annual levy on their overall premium income, and the assets of the Corporation of Lloyd's.

The Central Fund was established to protect the policyholder and not the underwriting member; it is not an asset of the Corporation of Lloyd's. The Central Fund was constituted in 1927 for the purpose of meeting the underwriting liability of any Lloyd's member in the event that the assets constituting his premium trust funds, underwriting reserves, personal wealth and Lloyd's deposit prove insufficient to discharge his underwriting liabilities. As at 31st December 1995, the net value of the Central Fund was £541 million and the assets of the Corporation of Lloyd's totalled £245 million.

**1.6 Technical Reserves at Lloyd's**

The technical reserves (loss reserves) of a syndicate, which are broadly comparable to those of an insurance company, comprise: (1) the reinsurance to close (loss provisions) in respect of the closing year and all preceding years; and (2) the provision for estimated future liability on the two open years (IBNR - incurred but not reported claims). The assets supporting the technical reserves include the underwriting balances which must be held in trust in a form acceptable to the Department of Trade. These assets are available for the payment of claims, expenses and other outgoings of the members.

Whilst the underwriting balances are largely used to meet underwriting payments, they produce investment earnings to increase the funds available. It is not until all underwriting payments have been made and provision made for outstanding liabilities, that the underwriting profit, if any, may be released to underwriting members. At 31st December 1995, the value of assets encompassing the total underwriting balances of Lloyd's members was £19,686 million. The assets were in the form of cash and investments (including the American and Canadian Trust Funds held in New York and Toronto, respectively, totalling approximately $12,214 million and Can$951 million) plus the amounts due for payment by Lloyd's brokers through the Central Accounting System.

The total declared resources of the underwriting members of Lloyd's, either in the form of assets held in trust at Lloyd's, or representing their means certified to Lloyd's at 31st December 1995 were £27,326 million. Given that the Names' financial resources will exceed their deposits, this figure represents a conservative valuation of the resources of members.

### 1.7 Statistics relating to Lloyd's.

The first major publication on Lloyd's statistics was "Lloyd's of London: A Detailed Analysis of Results 1950 - 1977" by Doody (1979). Doody analysed the Global Returns submitted annually by the Corporation of Lloyd's to the Department of Trade and Industry over the period 1950 to 1977. Doody (1979) described the growth of the membership of Lloyd's and the development of premiums and claims over the period 1950 to 1977. However, his figures did not extract the reinsurance to close figure from the premium, so it is difficult to evaluate how the premium income has actually developed. The reinsurance to close figure has been extracted by the Lloyd's Planning Department in their annual publication "Statistics Relating to Lloyd's". The figures in "Statistics Relating to Lloyd's" are extracted from the annual returns that syndicates make to the Department of Trade and Industry, together with information that the syndicate has to disclose to the Corporation of Lloyd's - such as stamp capacity, number of supporting Members' Agents and the types and numbers of members comprising each syndicate.

## 1.8 The capacity of Lloyd's, the number of syndicates, net premium income and profitability

When an insurance or reinsurance contract is underwritten at Lloyd's, the premium is collected by the broker from the insured or reinsured. The policy is then sent to the Lloyd's Policy Signing Office in Chatham, Kent to be "signed", i.e. allocated a signing number and date. The LPSO debit the premium from the broker and credit the syndicates who have underwritten the contract. Each insurance or reinsurance contract at Lloyd's is allocated a unique signing number and date. This enables the LPSO to identify and track the contract.

The capacity of a syndicate is the maximum gross premium, i.e. before deductions for outwards reinsurance premiums, in any one year of account that a syndicate can accept. Thus a syndicate with a capacity of £70 million for a given year of account can have a gross premium income of £70 million for that year. Premiums are credited to syndicates in three currencies - Sterling, U.S. dollars and Canadian dollars. To determine how much of a syndicate's capacity has been utilised these three currencies are converted to sterling at rates of exchange specified by Lloyd's - the premium income monitoring (PIM) rates of exchange. These rates are published by Lloyd's at the beginning of a calendar year and are constant for that year. A syndicate has to make quarterly returns to Lloyd's in order for the Solvency Department to check that the syndicate is not writing in excess of its capacity. This check ensures that sufficient assets uphold the liabilities accepted by the syndicate.

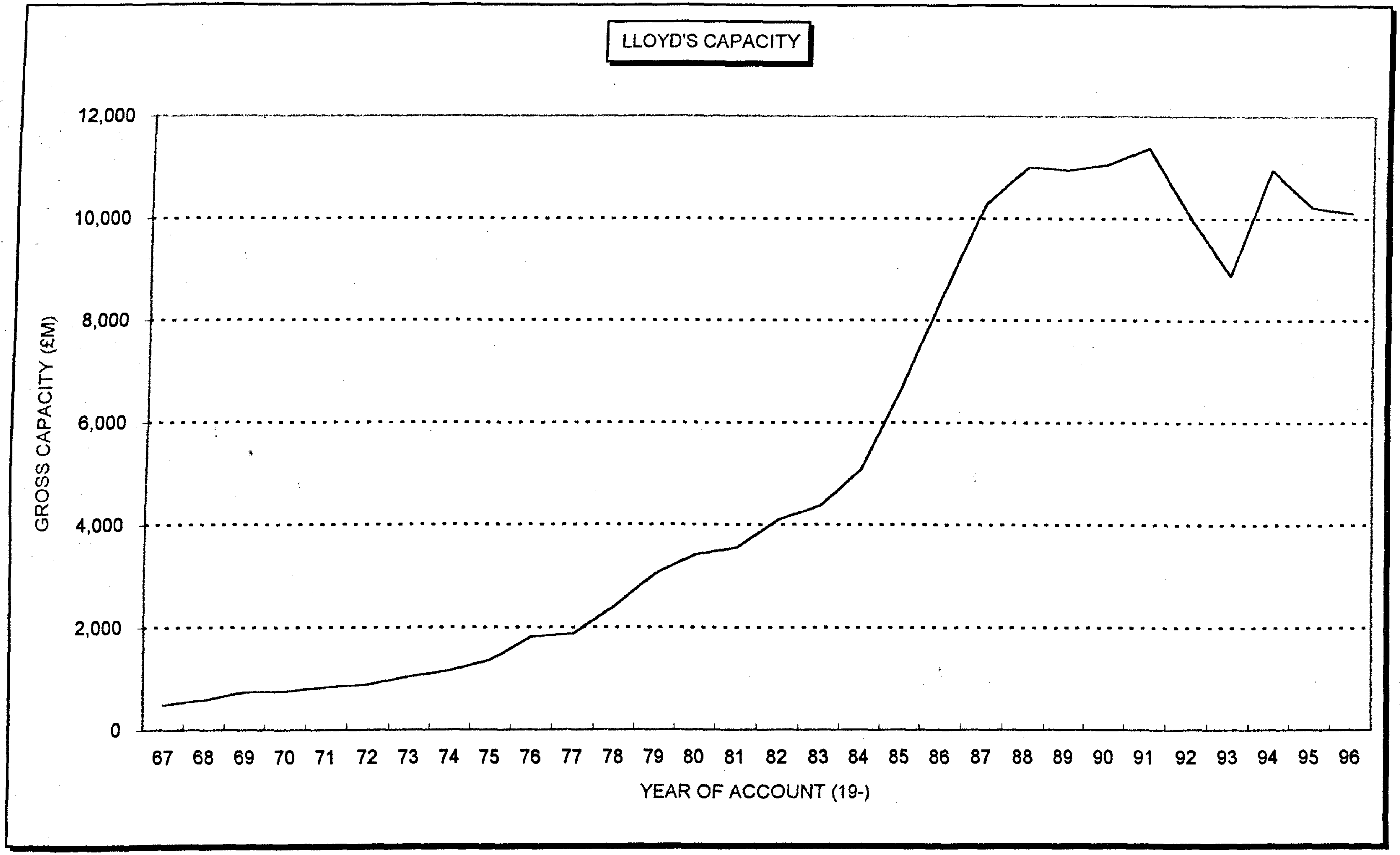



Figure 1.1: The Capacity of Lloyd's. (Source: Statistics Relating to Lloyd's, 1996)

The graph (Fig 1.1) shows the growth in Lloyd's capacity from 1967 to 1996. The graph may be divided into four sections: (1) from 1967 to 1977, (2) from 1977 to 1984, (3) from 1984 to 1987 and (4) from 1987 to 1996. From 1967 to 1977 capacity at Lloyd's grew by almost three and three-quarters from £503 million to £1,882 million, an average growth of £137.9 million per year. From 1977 to 1984 capacity grew at a faster rate, an average of £458.3 million per year. During this period capacity more than doubled from £1,882 million in 1977 to £5,090 million in 1984. In the four years from 1984 to 1987 the capacity of Lloyd's more than doubled from £5,090 million in 1984 to £10,290 million in 1987 an average increase in capacity of £1,733 million per year. The rate of growth of capacity slowed between 1987 and 1991 to an average increase of £273 million per year. Capacity peaked at £11,382 million for the 1991 year of account which represents just over a 10% increase on 1987. Capacity dropped from £10,046 in 1992 to £8,878 for 1993 although recovering to £9,994 for the 1996 year of account. The 1996 capacity comprises £6,950 million from traditional Names and £3,044 million from corporate members.

The graph of the number of members of Lloyd's (Fig 1.2) follows the pattern of the growth in capacity. Figure 1.2 shows the number of active members of Lloyd's for each year of account. It therefore excludes those members who are on open years of account - members who are unable to leave Lloyd's because the syndicate has been unable to close. There was a great increase in the number of Names during the period from the late 1970s to the late 1980s. Membership peaked at over 32,000 for the 1988 year of account but then dramatically fell away at an average rate of over 2,300 per year. It is interesting in the period 1988 to 1991 the membership dropped from 32,433 to 26,539 -

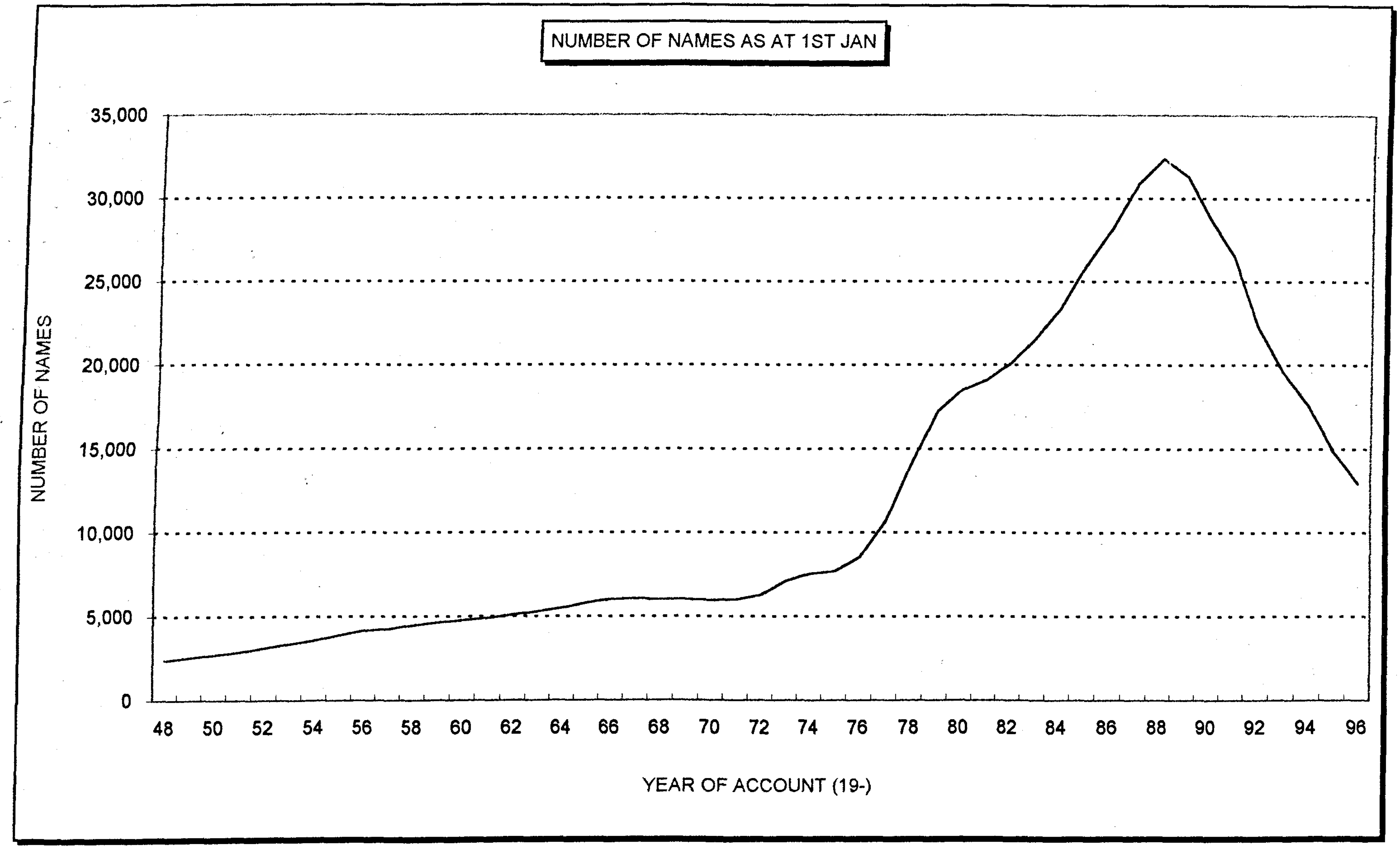



Fig 1.2: Number of Names as at 1st January. (Source: Membership Department, Corporation of Lloyd's)

a decrease of 18%; however, the capacity of Lloyd's increased over that period from £11,018 million to £11,382 an increase of 3%. The drop in the number of Names may be explained by the significant losses experienced by some syndicates, but the increase in capacity suggests that those members who did not leave Lloyd's were increasing their overall premium income limits.

Figure 1.3 (a) below shows the profit or loss paid to Names over the period 1950 to 1992 and the percentage "pay-out" to Names. Names' profits are described by Members' Agents as a percentage "pay-out" of their capacity i.e. the monetary amount of profit (or loss) divided by the Name's capacity on the syndicate.

From 1950 to 1987 Lloyd's continuously declared a profit to Names apart from small losses for the years 1964, 1965 and 1966 due to Hurricane Betsy. For the 1988 to 1992 years of account Lloyd's has made enormous losses totalling £8,729 million. From 1950 to 1987, a period of 38 years Lloyd's paid out to Names a total of £4,005.3 million. The pre-tax profit or loss to Names over years of account 1950 to 1992 is shown on the graph in figure 1.3 (b). The loss making years are due to a combination of large natural disasters during the period 1988 to 1992 and also numerous asbestosis and pollution claims on old years of accounts. The losses have caused many Names to leave Lloyd's from 1988 onwards as is seen by the graph in Figure 1.2.

It is interesting to look at the column entitled "Percentage Pay-out" in Figure 1.3 (a). The percentage pay-out is the pre-tax profit divided by the capacity of the market. Lloyd's has rarely paid out more than 10% profit on capacity. Indeed, the Society has only paid out 10% or more for four years of account during the 24 years from 1967 to 1990. The Lloyd's Business Plan (1993) states: "We aim to achieve a pre-tax return of 10% on underwriting capacity over the underwriting cycle" (Page 12 Section 1.16). Given the historic picture of the profitability of Lloyd's, this seems to be an ambitious target.

| **Year of Account** | **Gross capacity (£m)** | **Pre-tax profit/loss to Names (£m)** | **Percentage pay-out** |
|---|---|---|---|
| 1967 | 503 | 2.2 | 0.44 |
| 1968 | 592 | 38.5 | 6.50 |
| 1969 | 741 | 55.1 | 7.44 |
| 1970 | 761 | 63.0 | 8.28 |
| 1971 | 839 | 71.4 | 8.51 |
| 1972 | 891 | 89.1 | 10.00 |
| 1973 | 1,045 | 113.1 | 10.82 |
| 1974 | 1,162 | 97.1 | 8.36 |
| 1975 | 1,365 | 142.0 | 10.40 |
| 1976 | 1,828 | 126.1 | 6.90 |
| 1977 | 1,882 | 141.4 | 7.51 |
| 1978 | 2,417 | 198.6 | 8.22 |
| 1979 | 3,049 | 229.0 | 7.51 |
| 1980 | 3,415 | 352.7 | 10.33 |
| 1981 | 3,562 | 248.3 | 6.97 |
| 1982 | 4,111 | 161.7 | 3.93 |
| 1983 | 4,381 | 119.6 | 2.73 |
| 1984 | 5,090 | 278.2 | 5.47 |
| 1985 | 6,682 | 195.5 | 2.93 |
| 1986 | 8,511 | 649.4 | 7.63 |
| 1987 | 10,290 | 509.1 | 4.95 |
| 1988 | 11,018 | -509.8 | -4.63 |
| 1989 | 10,956 | -2,063.2 | -18.83 |
| 1990 | 11,070 | -2,319.1 | -20.95 |
| 1991 | 11,382 | -2,047.8 | -17.99 |
| 1992 | 10,046 | -1,192.9 | -11.87 |
| 1993 | 8,878 | 225.20 | 2.54 |

Figure 1.3(a): The profitability of Lloyd's (Source: Global Accounts, Statistics Relating to Lloyd's)

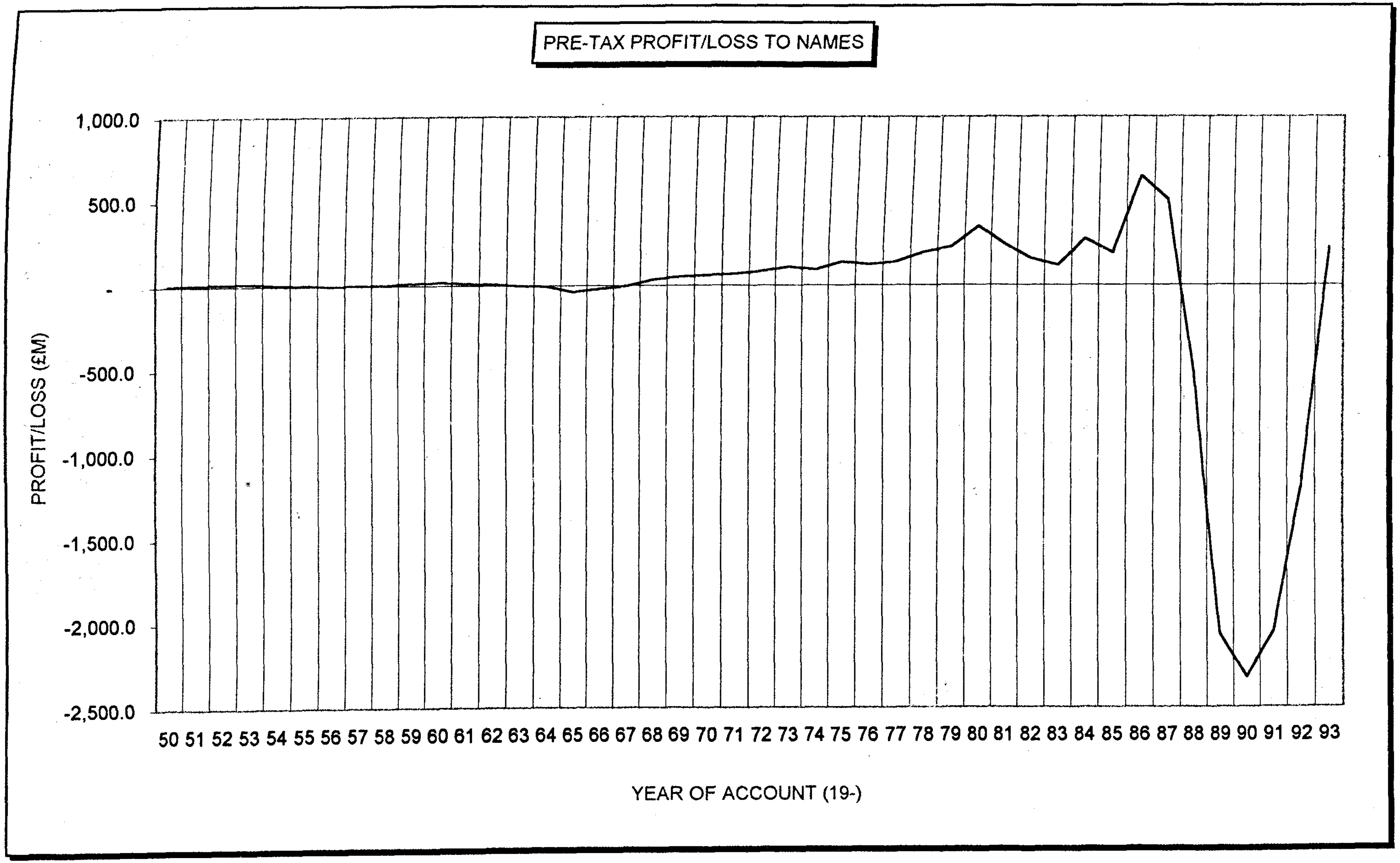



Figure 1.3(b): Profitability of Lloyd's. (Source: Global Accounts; Statistics Relating to Lloyd's, 1996)

The graph in figure 1.4 shows that from 1967 to 1980 there was an overall increase in the number of syndicates from 237 to 437. The capacity of Lloyd's increased over this period from £503 million to £3,415 million. The average size of syndicate increased from £2.1 million to £7.8 million over the same period. From 1980 to 1987 the number of syndicates decreased at a mean average rate of just over ten per year. There was a slight increase in the number of syndicates from 1987 to 1990. However, there has been a dramatic decrease in syndicate numbers since 1990, from 401 in 1990 to 167 in 1996 as a result of the loss experience of Lloyd's over the same period. Capacity has, however, remained relatively static, thus suggesting that those syndicates that have not ceased trading have increased in size either through merger or through raising new capital. The distribution of syndicates by size is shown below in figure 1.5 which shows that in 1990 there were fifteen syndicates with a stamp capacity of over £100 million, but by 1994 the number of syndicates with a capacity of over £100 million had doubled. The mean average syndicate capacity in 1990 was £27.6 million whereas in 1994 this had increased to £60.9 million.

During the period 1989 to 1994 there have been numerous mergers and takeovers among underwriting agencies. One example is the underwriting agency A.J. Archer, which acquired the Kellett Group late in 1992 for £1.3 million plus an amount contingent upon the profits of Kellett's agency business through 1995. In July 1993, Archer acquired Castle Underwriting for £5.2 million. The Castle acquisition increased Archer's 1993 capacity (for all the syndicates it manages) from £201 million to £389 million and its members' agency business from 145 to 745 names. One of the benefits that Archer anticipates is consolidation of administrative and service functions into one

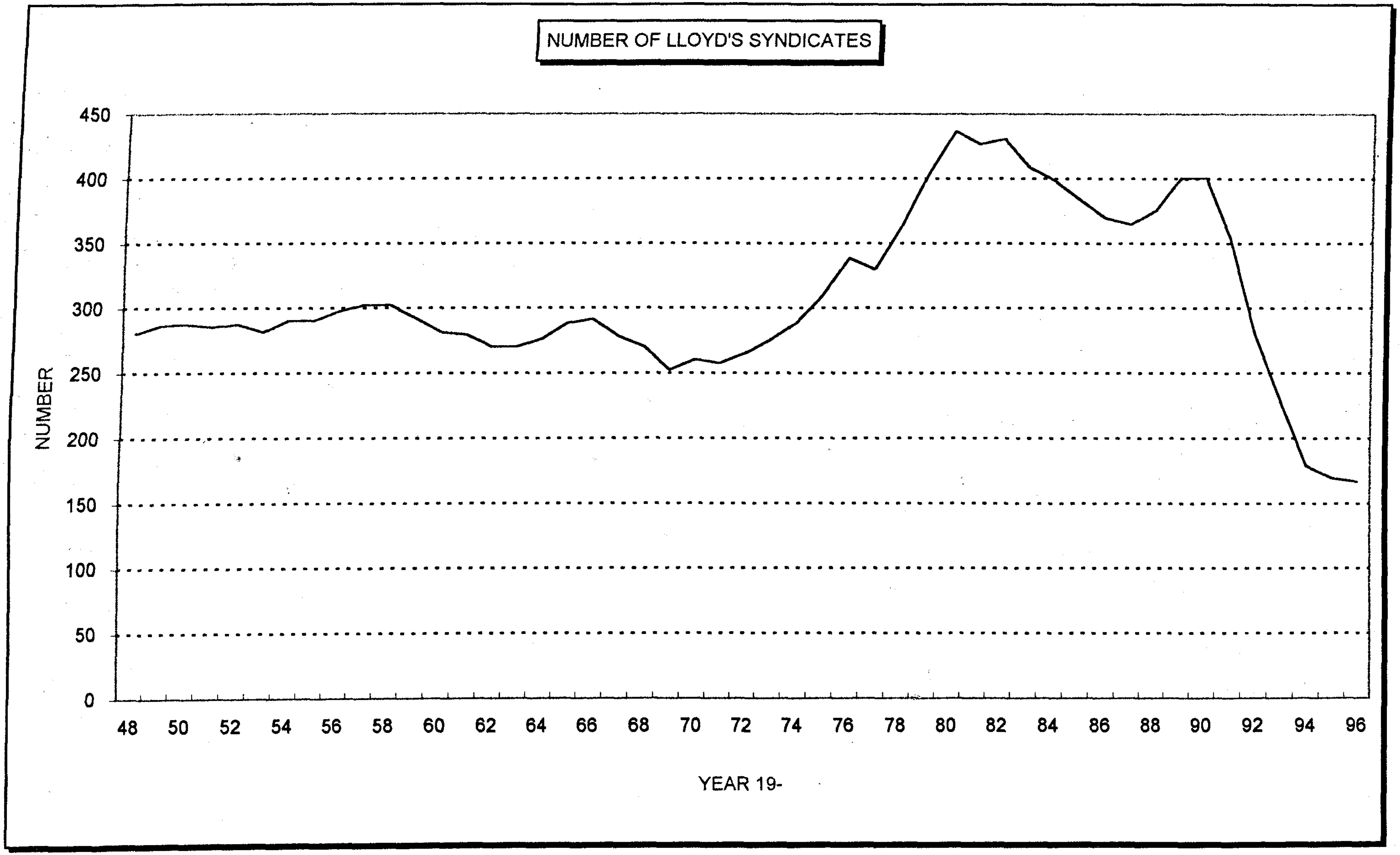



Figure 1.4: The number of Lloyd's syndicates from 1948 to 1996. (Source: Membership Department, Corporation of Lloyd's)

organisation. These benefits however did not come without a further price: Archer announced a pre-tax loss of £0.8 million for the year ending September 1993 (compared with a profit of £1.2 million in the previous year), in part due to restructuring.

| **Syndicate size £ million** | **Year of Account 1986** | **1990** | **1994** |
|---|---|---|---|
| 0-19.99 | 254 | 209 | 31 |
| 20-39.99 | 53 | 102 | 45 |
| 40-59.99 | 12 | 32 | 41 |
| 60-79.99 | 10 | 18 | 24 |
| 80-99.99 | 7 | 10 | 8 |
| 100-119.99 | 1 | 7 | 8 |
| 120-139.99 | 0 | 2 | 8 |
| 140-159.99 | 2 | 2 | 2 |
| 160-179.99 | 0 | 2 | 1 |
| 180-199.99 | 2 | 1 | 4 |
| 200+ | 0 | 1 | 7 |
| Total no of synds | 341 | 386 | 179 |
| Total capacity of Lloyd's (£m) | 8,511 | 11,070 | 10,954 |
| Average capacity of a Syndicate (£ million) | 24.96 | 28.68 | 61.20 |

Figure 1.5. Distribution of syndicates by size. Source: Chatset figures 1986, 1990, 1994.

Figure 1.6 is a graph of Lloyd's net premium income. Net premium income is defined as gross premium income less the amount for reinsurance to close and reinsurance ceded. This shows that the net premium income has increased over time, although it decreased for the 1993 year of account. The rate of increase was very dramatic from 1978 onwards which reflects the growth in capacity of the market over this period. A more revealing graph is Figure 1.7 which shows net premium income as a percentage of gross capacity i.e. capacity utilisation. From 1967 to 1993 year of account there has been a gradual trend towards a lower utilisation of capacity. This suggests that the rate of increase in Lloyd's capacity over this period was not matched by a similar rate of

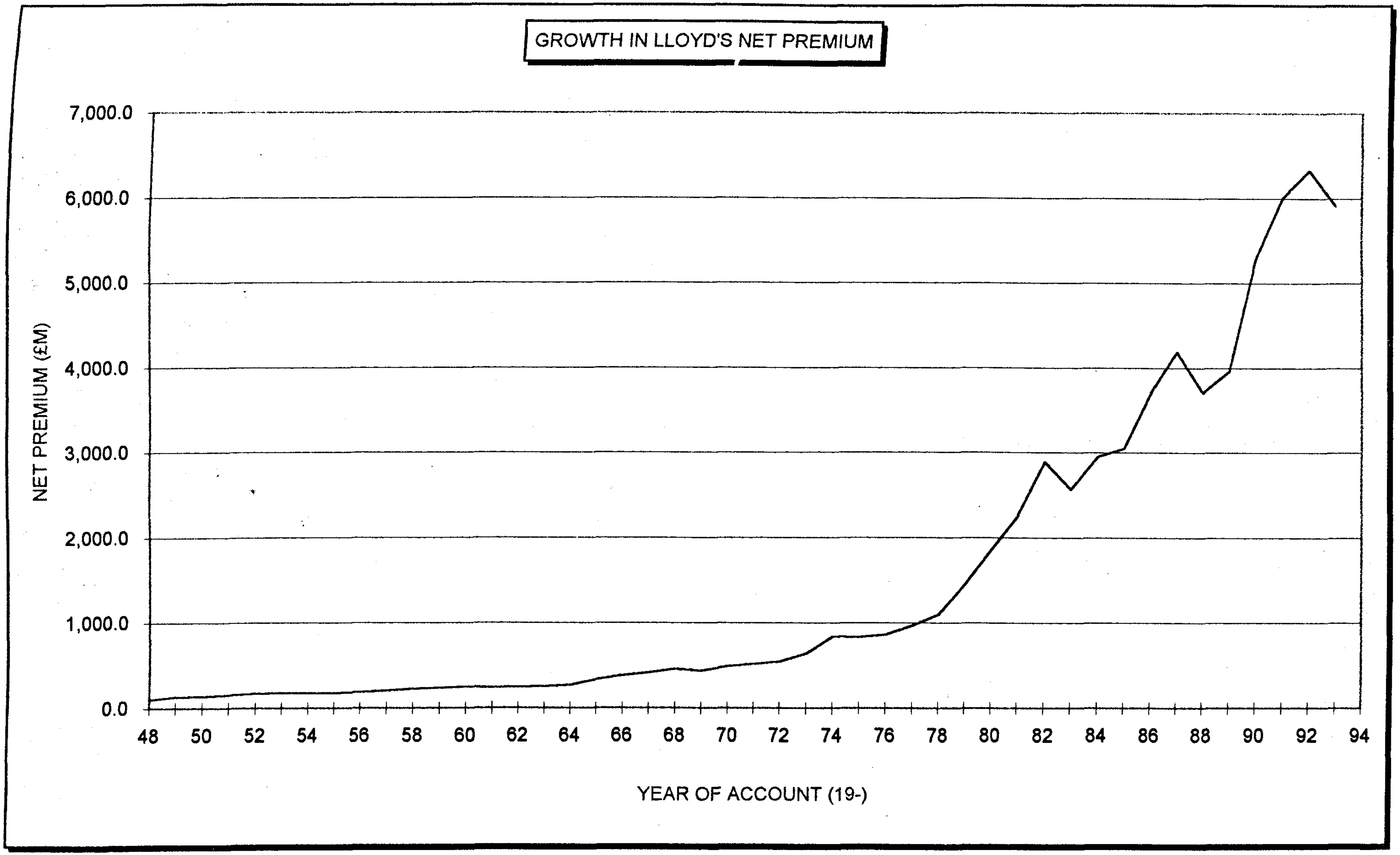



Figure 1.6: Net premium income to Lloyd's. (Source: Statistics Relating to Lloyd's, 1996)

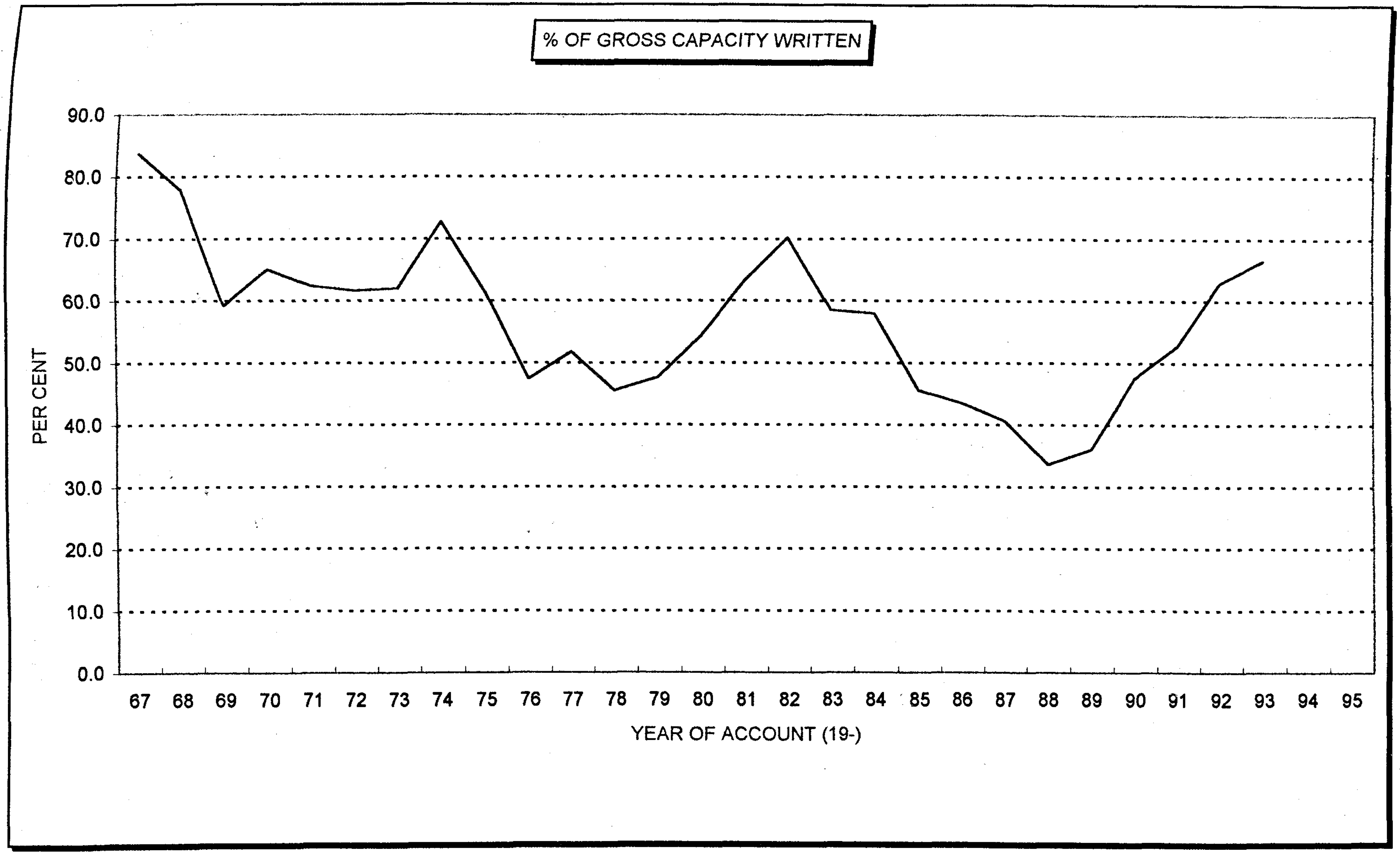



Figure 1.7: Ratio of net premium income to gross capacity. (Source: Statistics, Relating to Lloyd's, 1996; this author's analysis)

increase in premium income. Probable reasons for this were a lack of new business coming into Lloyd's and competitive pressures forcing a lowering of price. This author suggests that the reason for the decrease in premium income for the 1993 year of account, which was closed at 31st December 1995, was a result of the losses declared by Lloyd's over the preceding five years of account. These losses raised questions over the solvency of the Society and caused an exit of business out of Lloyd's.

### 1.9 Business written in Lloyd's

Figure 1.8 below displays business written at Lloyd's divided into the categories defined by the Department of Trade.

| *Yr of A/C* | *Accident & Health* | *Motor vehicle damage & liability* | *Aircraft dam/liab* | *Ships dam/liab* | *Goods in transit* |
|---|---|---|---|---|---|
| 1984 | 194.7 | 356.1 | 355.6 | 1,265.2 | 361.2 |
| 1985 | 172.3 | 420.2 | 405.9 | 1,253.4 | 340.7 |
| 1986 | 184.9 | 483.0 | 565.5 | 1,537.2 | 362.8 |
| 1987 | 213.7 | 561.1 | 695.3 | 1,794.2 | 395.0 |
| 1988 | 222.7 | 627.9 | 588.1 | 1,799.4 | 371.5 |
| 1989 | 268.7 | 688.1 | 672.6 | 2,205.4 | 391.6 |
| 1990 | 429.2 | 748.7 | 957.9 | 3,128.4 | 457.7 |
| 1991 | 629.4 | 1,047.6 | 1,023.5 | 2,678.8 | 367.5 |
| 1992 | 630.5 | 1,326.7 | 861.3 | 1,948.7 | 322.3 |
| 1993 | 512.2 | 1,362.7 | 836.6 | 1,878.1 | 309.0 |

| *Yr of A/C* | *Property damage* | *General liability* | *Pecuniary loss* | *Life* | *TOTAL* |
|---|---|---|---|---|---|
| 1984 | 1,000.8 | 653.5 | 1.0 | 5.3 | 4,193.4 |
| 1985 | 1,081.3 | 699.8 | 0.9 | 5.5 | 4,380.0 |
| 1986 | 1,274.0 | 821.7 | 0.9 | 5.3 | 5,235.3 |
| 1987 | 1,494.1 | 903.0 | 91.0 | 7.2 | 6,154.6 |
| 1988 | 1,349.2 | 835.7 | 97.8 | 7.3 | 5,899.6 |
| 1989 | 1,805.6 | 935.0 | 96.4 | 10.9 | 7,074.3 |
| 1990 | 2,252.5 | 1,208.2 | 126.2 | 17.1 | 9,325.9 |
| 1991 | 2,219.4 | 1,491.1 | 194.8 | 23.3 | 9,675.4 |
| 1992 | 2,342.0 | 1,461.1 | 198.3 | 39.3 | 9,130.2 |
| 1993 | 2,021.5 | 1,363.2 | 173.5 | 34.5 | 8,491.3 |

Figure 1.8: Gross premium income (net of reinsurance to close but gross of ceded reinsurance and net of brokerage and commissions. Excludes inter-syndicate transactions) in £million. Source: Statutory Statement of Business

To estimate the size of each of Lloyd's five traditional markets (Marine, Non-marine, Life, Motor and Aviation) the above premiums have been allocated thus:

**Marine = ships damage and liability; and goods in transit.**
**Non-marine = Accident and health; Property damage; Pecuniary loss; and General liability.**
**Aviation = Aircraft damage and liability.**
**Motor = Motor vehicle damage and liability.**
**Life = Life business.**

The percentage split across the five markets has remained relatively constant throughout the period 1984 to 1990. The largest market is Non-marine with about one half of all business written at Lloyd's. Figure 1.9 suggests that approximately 50% of Lloyd's premium income is non-marine, 25% marine, 10% aviation, 15% motor and negligible life business.

| Year of A/C | Marine | Non-marine | Aviation | Motor | Life |
|---|---|---|---|---|---|
| 1984 | 1,626.4 | 1,850.0 | 355.6 | 356.1 | 5.3 |
| 1985 | 1,594.1 | 1,954.3 | 405.9 | 420.2 | 5.5 |
| 1986 | 1,900.0 | 2,281.5 | 565.5 | 483.0 | 5.3 |
| 1987 | 2,189.2 | 2,701.8 | 695.3 | 561.1 | 7.2 |
| 1988 | 2,170.9 | 2,505.4 | 588.1 | 627.9 | 7.3 |
| 1989 | 2,597.0 | 3,105.7 | 672.6 | 688.1 | 10.9 |
| 1990 | 3,586.1 | 4,016.1 | 957.9 | 748.7 | 17.1 |
| 1991 | 3,046.3 | 4,534.7 | 1,023.5 | 1,047.6 | 23.3 |
| 1992 | 2,271.0 | 4,631.9 | 861.3 | 1,326.7 | 39.3 |
| 1993 | 2,187.1 | 4,070.4 | 836.6 | 1,362.7 | 34.5 |

Percentage allocation -

| Year of A/C | Marine | Non-marine | Aviation | Motor | Life |
|---|---|---|---|---|---|
| 1984 | 38.78% | 44.12% | 8.48% | 8.49% | 0.13% |
| 1985 | 36.40 | 44.61 | 9.27 | 9.59 | 0.13 |
| 1986 | 36.29 | 43.58 | 10.80 | 9.23 | 0.10 |
| 1987 | 35.57 | 43.90 | 11.30 | 9.11 | 0.12 |
| 1988 | 36.80 | 42.47 | 9.97 | 10.64 | 0.12 |
| 1989 | 36.71 | 43.90 | 9.51 | 9.73 | 0.15 |
| 1990 | 38.48 | 43.06 | 10.27 | 8.03 | 0.18 |
| 1991 | 31.49 | 46.87 | 10.58 | 10.83 | 0.24 |
| 1992 | 24.87 | 50.73 | 9.43 | 14.53 | 0.43 |
| 1993 | 25.76 | 47.94 | 9.85 | 16.05 | 0.41 |

Figure 1.9: Classification of business written at Lloyd's into the five traditional markets. (Gross premium income in £ million)

Figure 1.10 shows net premium income and an allocation to the five markets.

| *Yr of A/C* | *Accident & Health* | *Motor vehicle dam & liab* | *Aircraft dam/liability* | *Ships dam/liability* | *Goods in transit* |
|---|---|---|---|---|---|
| 1980 | 89.0 | 237.1 | 120.0 | 525.9 | 231.3 |
| 1981 | 108.3 | 265.2 | 173.5 | 683.4 | 253.9 |
| 1982 | 169.8 | 273.6 | 242.0 | 910.8 | 294.0 |
| 1983 | 188.4 | 283.4 | 188.7 | 768.5 | 254.3 |
| 1984 | 162.2 | 323.8 | 229.9 | 903.6 | 303.6 |
| 1985 | 143.6 | 382.6 | 252.7 | 832.1 | 287.2 |
| 1986 | 152.8 | 435.5 | 368.8 | 1,014.4 | 302.2 |
| 1987 | 173.2 | 516.0 | 428.3 | 1,135.5 | 331.4 |
| 1988 | 179.0 | 582.8 | 320.9 | 955.4 | 308.1 |
| 1989 | 214.0 | 643.5 | 281.0 | 1,013.3 | 312.4 |
| 1990 | 331.8 | 695.7 | 324.0 | 1,377.7 | 325.7 |
| 1991 | 485.9 | 959.5 | 432.2 | 1,165.7 | 269.9 |
| 1992 | 483.0 | 1,165.8 | 449.1 | 1,145.6 | 252.2 |
| 1993 | 362.9 | 1,141.8 | 462.8 | 1,176.0 | 249.9 |

| *Yr of A/C* | *Property damage* | *General liability* | *Pecuniary loss* | *Life* | *TOTAL* |
|---|---|---|---|---|---|
| 1980 | 434.1 | 223.1 | 0.3 | 1.5 | 1,862.3 |
| 1981 | 510.6 | 260.8 | 0.4 | 1.9 | 2,258.0 |
| 1982 | 653.5 | 346.1 | 0.5 | 2.2 | 2,892.5 |
| 1983 | 570.4 | 312.4 | 0.7 | 1.9 | 2,569.7 |
| 1984 | 666.3 | 364.8 | 0.9 | 4.0 | 2,959.1 |
| 1985 | 737.9 | 415.1 | 0.8 | 4.0 | 3,056.0 |
| 1986 | 910.4 | 523.5 | 0.8 | 3.6 | 3,712.0 |
| 1987 | 932.7 | 607.8 | 65.4 | 4.6 | 4,194.9 |
| 1988 | 875.3 | 414.7 | 72.7 | 4.8 | 3,713.7 |
| 1989 | 902.4 | 522.1 | 68.9 | 7.9 | 3,965.5 |
| 1990 | 1,245.0 | 877.4 | 90.7 | 12.6 | 5,280.6 |
| 1991 | 1,397.0 | 1,135.4 | 151.2 | 17.2 | 6,014.0 |
| 1992 | 1,510.1 | 1,131.4 | 162.8 | 31.2 | 6,331.2 |
| 1993 | 1,353.8 | 999.3 | 145.1 | 24.6 | 5,916.2 |

Table 1.10: Net ceded premium (net of ceded reinsurance, reinsurance to close and brokerage and commissions. Excludes inter-syndicate transactions). £million. Source: Statutory Statement of Business

As before, the business may be allocated to the five traditional markets (Figure 1.11 below).

| Yr of A/C | Marine | Non-marine | Aviation | Motor | Life |
|---|---|---|---|---|---|
| 1980 | 757.2 | 746.5 | 120.0 | 237.1 | 1.5 |
| 1981 | 937.3 | 880.1 | 173.5 | 265.2 | 1.9 |
| 1982 | 1,204.8 | 1,169.9 | 242.0 | 273.6 | 2.2 |
| 1983 | 1,022.8 | 1,071.9 | 188.7 | 283.4 | 2.9 |
| 1984 | 1,207.2 | 1,194.2 | 229.9 | 323.8 | 4.0 |
| 1985 | 1,119.3 | 1,297.4 | 252.7 | 382.6 | 4.0 |
| 1986 | 1,316.6 | 1,587.5 | 368.8 | 435.5 | 3.6 |
| 1987 | 1,466.9 | 1,779.1 | 428.3 | 516.0 | 4.6 |
| 1988 | 1,263.5 | 1,541.7 | 320.9 | 582.8 | 4.8 |
| 1989 | 1,325.7 | 1,707.4 | 281.0 | 643.5 | 7.9 |
| 1990 | 1,703.4 | 2,544.9 | 324.0 | 695.7 | 12.6 |
| 1991 | 1,435.6 | 3,169.5 | 432.2 | 959.5 | 17.2 |
| 1992 | 1,397.8 | 3,287.3 | 449.1 | 1,165.8 | 31.2 |
| 1993 | 1,425.9 | 2,861.1 | 462.8 | 1,141.8 | 24.6 |

Split by percentage:

| Yr of A/C | Marine | Non-marine | Aviation | Motor | Life |
|---|---|---|---|---|---|
| 1980 | 40.66% | 40.09% | 6.44% | 12.73% | 0.08% |
| 1981 | 41.51 | 38.98 | 7.68 | 11.75 | 0.08 |
| 1982 | 41.65 | 40.45 | 8.36 | 9.46 | 0.08 |
| 1983 | 39.80 | 41.71 | 7.35 | 11.03 | 0.11 |
| 1984 | 40.80 | 40.36 | 7.77 | 10.94 | 0.13 |
| 1985 | 36.63 | 42.45 | 8.27 | 12.52 | 0.13 |
| 1986 | 35.47 | 42.77 | 9.93 | 11.73 | 0.10 |
| 1987 | 34.97 | 42.41 | 10.21 | 12.30 | 0.11 |
| 1988 | 34.02 | 41.51 | 8.64 | 15.70 | 0.13 |
| 1989 | 33.43 | 43.05 | 7.09 | 16.23 | 0.20 |
| 1990 | 32.26 | 48.19 | 6.14 | 13.17 | 0.24 |
| 1991 | 23.87 | 52.70 | 7.19 | 15.95 | 0.29 |
| 1992 | 22.08 | 51.92 | 7.09 | 18.41 | 0.49 |
| 1993 | 24.10 | 48.36 | 7.82 | 19.30 | 0.42 |

Figure 1.11: Classification of net premium income into the five traditional Lloyd's markets.

Figure 1.11 shows that even on a net basis the non-marine market is the biggest of the five markets with about half of premium income - a percentage that has increased over time.

## 1.10 Reinsurance and direct business written at Lloyd's

Section 1.9 allocated Lloyd's premium income into nine classes. However there was no indication what the percentage split is between direct business and reinsurance. It is market practice to include facultative reinsurance (i.e. the reinsurance of an individual risk) with direct business. The term "reinsurance" thus only refers to treaty (proportional) reinsurance and excess of loss (non-proportional) reinsurance. Lloyd's only produces statistics on direct and reinsurance business based on a calendar year analysis. This information is contained in the Statutory Statement of Business. Figure 1.12 shows the calendar year split between direct and facultative and reinsurance.

From 1982 to 1995 there has been a gradual, but not marked, increase in the amount of reinsurance written compared to direct and facultative. Approximately one-third of business written at Lloyd's is reinsurance and two-thirds is direct and facultative. Overseas business dominates the Lloyd's market. In 1995 almost two-thirds of premium income was derived from outside the UK. However this percentage has been in steady decline since 1982 when the percentage of non-UK business was 71.3%, probably due to competition from foreign insurers and reinsurers. Over this period UK business has become a larger percentage of the overall calendar year premium income.

Figure 1.12 suggests that Lloyd's is an important market for non-UK reinsurance business with over seventy per cent of reinsurance premium income derived from territories outside the UK. The data in Figure 1.12 are extracted from the Statutory Statement of Business that Lloyd's submits annually to the Department of Trade and Industry.

| Calendar Year | Direct & facultative UK | Overseas | Total | Reinsurance (ex fac) UK | Overseas | Total | All Premiums |
|---|---|---|---|---|---|---|---|
| 1982 | 671.6 | 1,376.2 | 2,047.8 | 142.2 | 648.7 | 790.9 | 2,838.7 |
| 1983 | 727.7 | 1,506.0 | 2,233.7 | 164.6 | 848.7 | 1,013.3 | 3,247.0 |
| 1984 | 845.4 | 2,023.9 | 2,869.3 | 248.7 | 1,213.2 | 1,461.9 | 4,331.2 |
| 1985 | 909.6 | 2,048.7 | 2,958.4 | 273.2 | 1,150.9 | 1,424.1 | 4,382.5 |
| 1986 | 1,136.6 | 2,469.9 | 3,606.5 | 338.6 | 1,443.9 | 1,782.5 | 5,389.0 |
| 1987 | 1,251.4 | 2,081.9 | 3,333.3 | 334.2 | 1,202.5 | 1,536.7 | 4,869.9 |
| 1988 | 1,369.3 | 2,027.8 | 3,397.1 | 407.7 | 1,241.7 | 1,649.4 | 5,046.5 |
| 1989 | 1,471.1 | 2,122.0 | 3,593.1 | 559.4 | 1,431.9 | 1,991.2 | 5,584.3 |
| 1990 | 1,570.3 | 2,245.0 | 3,815.3 | 67.7 | 1,474.8 | 2,242.5 | 6,057.8 |
| 1991 | 1,801.5 | 2,812.5 | 4,614.0 | 871.1 | 1,687.0 | 2,558.1 | 7,172.1 |
| 1992 | 2,268.2 | 3,423.7 | 5,691.9 | 869.4 | 2,083.5 | 2,952.9 | 8,644.8 |
| 1993 | 2,548.0 | 3,500.8 | 6,048.8 | 656.9 | 1,899.9 | 2,556.8 | 8,605.6 |
| 1994 | 2,472.4 | 3,221.1 | 5,693.5 | 491.6 | 1,667.1 | 2,158.7 | 7,852.2 |
| 1995 | 2,180.8 | 3,233.4 | 5,414.3 | 345.2 | 1,591.6 | 1,936.8 | 7,351.0 |

The above is consolidated thus:

| Calendar Year | % UK | % Overseas | % Direct & fac | % Reinsurance (ex fac) |
|---|---|---|---|---|
| 1982 | 28.7 | 71.3 | 72.2 | 27.8 |
| 1983 | 27.5 | 72.5 | 68.8 | 31.2 |
| 1984 | 25.3 | 74.7 | 66.2 | 33.8 |
| 1985 | 27.0 | 73.0 | 67.5 | 32.5 |
| 1986 | 27.4 | 72.6 | 66.9 | 33.1 |
| 1987 | 32.6 | 67.4 | 68.4 | 31.6 |
| 1988 | 35.2 | 64.8 | 67.3 | 32.7 |
| 1989 | 36.3 | 63.7 | 64.3 | 35.7 |
| 1990 | 38.6 | 61.4 | 62.9 | 37.1 |
| 1991 | 37.3 | 62.7 | 64.3 | 35.7 |
| 1992 | 36.3 | 63.7 | 65.8 | 34.2 |
| 1993 | 37.2 | 62.8 | 70.3 | 29.7 |
| 1994 | 37.8 | 62.3 | 72.5 | 27.5 |
| 1995 | 34.4 | 65.6 | 73.7 | 26.4 |

Figure 1.12: Calendar year gross premiums split into direct and reinsurance (premiums are gross of ceded reinsurance and net of brokerage and commissions. They exclude premiums in respect of inter-syndicate reinsurance). £ million.
Source: Statutory Statement of Business Form 3.

In attempting to estimate the amount of reinsurance business underwritten at Lloyd's it is necessary to extract the facultative reinsurance figures from the block direct and facultative figures in Figure 1.12. An estimate of the relative proportions of both these business types is given in "Statistics Relating to Lloyd's" where it is stated that the split is 80% direct insurance and 20% facultative reinsurance. The data in Figure 1.12 allow estimates of the amount of reinsurance business underwritten at Lloyd's assuming that the proportion has remained constant at 80/20 respectively. Figure 1.13 shows the breakdown between direct and reinsurance business. Using this allocation, direct and reinsurance business are underwritten in a ratio of approximately 3:2 respectively.

| *Calendar Year* | *% Direct* | *% Reinsurance (inc facultative)* |
|---|---|---|
| 1982 | 57.7 | 42.3 |
| 1983 | 55.0 | 45.0 |
| 1984 | 53.0 | 47.0 |
| 1985 | 54.0 | 46.0 |
| 1986 | 53.5 | 46.5 |
| 1987 | 54.8 | 45.2 |
| 1988 | 53.9 | 46.1 |
| 1989 | 51.5 | 48.5 |
| 1990 | 50.4 | 49.6 |
| 1991 | 51.5 | 48.5 |
| 1992 | 52.7 | 47.3 |
| 1993 | 56.2 | 43.8 |
| 1994 | 58.0 | 42.0 |
| 1995 | 58.9 | 41.1 |

Figure 1.13: Breakdown of calendar year gross premium split into direct and reinsurance (premiums are gross of ceded reinsurance and net of brokerage and commissions. They exclude premiums in respect of inter-syndicate reinsurance). Source: Statutory Statement of Business Form 3.

A survey of slips processed through the LPSO was undertaken by the Lloyd's Planning Department during 1987 to 1989 the results of which are given in Figure 1.14 below. The data in Figure 1.14 do not match the data in figure 1.12 as not all premiums to Lloyd's are handled by the LPSO; premiums due to motor syndicates are often credited direct to the syndicate from the broker. However, we may use the data in Figure 1.14 to derive some estimate for the breakdown of business underwritten at Lloyd's. Figure

1.14 suggests that the mix of business in Lloyd's is 50% direct insurance, 15% facultative reinsurance, 23% non-proportional treaty reinsurance and 12% proportional treaty reinsurance. Approximately, therefore, twice as much non-proportional business (i.e. excess of loss) business is underwritten as is proportional business.

| | **1987** | **1988** | **1989** |
|---|---|---|---|
| *Direct* | 2,409 (50%) | 2,234 (50%) | 2,376 (49%) |
| *Facultative* | 739 (15%) | 660 (15%) | 664 (14%) |
| *Non-proportional* | 1,113 (23%) | 1,027 (23%) | 1,192 (25%) |
| *Proportional* | 559 (12%) | 538 (12%) | 596 (12%) |
| **TOTAL** | **4,820** | **4,459** | **4,828** |

Note: The premiums are gross of ceded reinsurance, but after deduction of brokerage; intersyndicate reinsurance is excluded in the total, estimates of which are:

| | | | |
|---|---|---|---|
| *Intersyndicate reinsurances* | 712 | 872 | 1,199 |

Figure 1.14: Lloyd's premiums processed through LPSO (Source: Lloyd's Planning Department) Figures in £m

## 1.11 Lloyd's share of the UK Insurance and Reinsurance Market

Carter and Falush (1995) estimate that for the 1993 revenue year, 48% of business in the London market (in terms of total gross premium underwritten) is underwritten at Lloyd's with the company market underwriting the balance. However, this figure may not be accurate as Carter and Falush (1995) used gross data and there are reinsurances between Lloyd's underwriters and the company market (and vice versa). Thus some business will be double-counted. Using data that are net of ceded reinsurance will overcome the double-counting problem but the figures will be distorted because of reinsurance payments to overseas companies. On a net basis "Statistics Relating to Lloyd's" states that Lloyd's proportion of the London market is sixty per cent.

Whilst Lloyd's proportion of the London market has been estimated both by Lloyd's and Carter and Falush (1995), no estimate has been made of Lloyd's proportion of the UK insurance market i.e. UK domestic business and overseas business underwritten in the UK. It has therefore been necessary to calculate these figures using data published in the ABI Statistical Bulletin of UK Market Statistics 1984-1992. Unfortunately, this author was unable to find these ABI statistics for post 1992. The ABI (Association of British Insurers) publishes General Business Net Written Premiums which give premiums on a calendar year basis net of ceded reinsurance but gross of brokerage. It is essential to compare the net premiums, before deduction of brokerage, of UK Companies with the net premiums of Lloyd's. In this way there is no double counting due to a Lloyd's syndicate reinsuring a UK Company or vice versa. Taking the premiums gross of brokerage gives a better understanding of the amount of insurance that is actually purchased from UK Companies and Lloyd's. The ABI figures comprise data from Insurance Companies (both ABI members and non-members), Lloyd's, mutual clubs and associations. The "UK Insurance Market" is defined as business written in the UK by all insurers operating in the UK on an establishment basis. The figures include home-foreign business written in the UK and reinsurance accepted in the UK (whether written by a UK registered company or by the UK branch of an overseas registered company), but excludes any business written by UK insurers to their subsidiaries and branches overseas.

Figure 1.15 below reproduces the General Business gross written premium income data in the ABI statistics and figure 1.16 below reproduces the General Business net written premium income data in the ABI statistics. The figures in brackets represent the proportion that the net figure bears to the gross figure (i.e. Figure 1.16 divided by Figure 1.15).

| *Revenue Year* | *Direct and Fac* | *Reinsurance* | *Total* |
|---|---|---|---|
| 1985 | 13,780 | 4,312 | 18,092 |
| 1986 | 16,594 | 4,773 | 21,367 |
| 1987 | 18,406 | 4,474 | 22,880 |
| 1988 | 20,512 | 4,642 | 25,154 |
| 1989 | 22,339 | 5,320 | 27,659 |
| 1990 | 24,503 | 6,227 | 30,730 |
| 1991 | 27,490 | 7,221 | 34,711 |
| 1992 | 32,579 | 8,176 | 40,755 |

Figure 1.15: General Business gross written premium income in £m. Figures are gross of brokerage and gross of ceded reinsurance.
Source: ABI Statistical Bulletin.

| *Revenue Year* | *Direct and Fac* | *Reinsurance* | *Total* |
|---|---|---|---|
| 1985 | 10,839 (0.7866) | 2,964 (0.6874) | 13,803 |
| 1986 | 13,212 (0.7962) | 3,400 (0.7123) | 16,612 |
| 1987 | 15,190 (0.8253) | 3,422 (0.7649) | 18,612 |
| 1988 | 16,979 (0.8278) | 3,368 (0.7255) | 20,347 |
| 1989 | 18,684 (0.8364) | 3,716 (0.6985) | 22,400 |
| 1990 | 20,133 (0.8217) | 4,198 (0.6742) | 24,331 |
| 1991 | 22,329 (0.8123) | 4,914 (0.6805) | 27,243 |
| 1992 | 25,832 (0.9729) | 5,636 (0.6893) | 31,468 |

Figure 1.16: General Business net written premium income in £m. Figures are gross of brokerage and net of ceded reinsurance. (Figures in brackets are Table 1.16 divided by Table 1.15)
Source: ABI Statistical Bulletin.

To estimate Lloyd's proportion of the UK insurance market it is necessary to produce Lloyd's statistics in the same format as the ABI statistics in Figure 1.16. In Lloyd's Statutory Statement of Business published annually there are revenue figures which give premiums net of brokerage and gross of ceded reinsurance. The Global accounts give an average brokerage figure for each revenue year. Using this figure it is possible to create Lloyd's premium figures gross of brokerage and gross of ceded reinsurance. In the global accounts are figures for each revenue year giving premiums net of ceded reinsurance and gross of brokerage i.e. in the format of the ABI figures in Figure 1.16. However, the proportion between reinsurance and direct is not given. This split may be "best guessed" by assuming that the reinsurance ceded from the Lloyd's market is in the same proportion as for the whole UK insurance market. Therefore, by applying the proportions in brackets in Figure 1.16 to Lloyd's gross premiums, it is possible to create Lloyd's net premium income figures (i.e. net of reinsurance ceded and gross of brokerage). When using this technique it was found that there was a margin of error between the calculated net premium income figures and the actual net premium income figures published in the global figures. In some instances the calculated figure was lower than the actual figure, but in other cases the calculated figure was more. The maximum margin of error was 8.2% though in many cases the error was much lower. Pro-rata adjustments were made to the calculated figures to absorb these differences.

Figure 1.17 gives the gross premium income figures for Lloyd's net of brokerage as published in the Statutory Statement of Business.

| | *U.K.* | | *Overseas* | | |
|---|---|---|---|---|---|
| *Year* | *Direct/fac* | *Reinsurance* | *Direct/fac* | *Reinsurance* | *Total* |
| 1985 | 909,638 | 273,219 | 2,048,712 | 1,150,898 | 4,382,467 |
| 1986 | 1,136,594 | 338,643 | 2,469,927 | 1,443,992 | 5,389,156 |
| 1987 | 1,251,386 | 334,178 | 2,081,884 | 1,202,495 | 4,869,943 |
| 1988 | 1,369,300 | 407,722 | 2,027,810 | 1,241,659 | 5,046,491 |
| 1989 | 1,471,094 | 559,362 | 2,122,015 | 1,431,862 | 5,584,333 |
| 1990 | 1,570,270 | 767,687 | 2,245,046 | 1,474,873 | 6,057,876 |
| 1991 | 1,801,482 | 871,125 | 2,812,514 | 1,687,032 | 7,172,153 |
| 1992 | 2,268,245 | 869,405 | 3,423,672 | 2,083,466 | 8,644,788 |

Figure 1.17: Lloyd's revenue figures. Gross of ceded reinsurance, net of brokerage. Excluding intersyndicate transactions. (£000)
Source: Statutory Statement of Business

Figure 1.18 shows the same data as Figure 1.17 but gross of brokerage. The percentage brokerage used is also shown.

| | U.K. | | Overseas | | |
|---|---|---|---|---|---|
| Year | Direct/fac | Reinsurance | Direct/fac | Reinsurance | Total |
| 1985 | 1,116,120 | 335,238 | 2,513,757 | 1,412,145 | 5,377,260 |
| 1986 | 1,391,180 | 414,496 | 3,023,166 | 1,767,432 | 6,596,274 |
| 1987 | 1,529,812 | 408,531 | 2,545,090 | 1,470,043 | 5,953,476 |
| 1988 | 1,676,010 | 499,048 | 2,482,020 | 1,519,778 | 6,176,856 |
| 1989 | 1,802,811 | 685,493 | 2,600,509 | 1,754,733 | 6,843,546 |
| 1990 | 1,926,712 | 941,947 | 2,754,658 | 1,809,660 | 7,432,977 |
| 1991 | 2,204,996 | 1,066,248 | 3,442,490 | 2,064,911 | 8,778,645 |
| 1992 | 2,776,310 | 1,064,143 | 4,190,541 | 2,550,142 | 10,581,136 |

| Year | Brokerage (%) |
|---|---|
| 1985 | 18.5 |
| 1986 | 18.3 |
| 1987 | 18.2 |
| 1988 | 18.3 |
| 1989 | 18.4 |
| 1990 | 18.5 |
| 1991 | 18.3 |
| 1992 | 18.3 |

Figure 1.18: Lloyd's revenue figures. Gross of ceded reinsurance, gross of brokerage. Excluding intersyndicate transactions.(£000) Source: Statutory Statement of Business, brokerage per cent from Global figures.

Figure 1.19 gives Lloyd's calendar year premium income net of ceded reinsurance but gross of brokerage. Thus Lloyd's figures are presented in Figure 1.19 in the same format as the ABI figures of Figure 1.16. Figure 1.19 also gives Lloyd's proportion of the UK insurance market.

| Year | Direct & Fac | % of UK Market | Reinsurance | % of UK Market | Total | % of UK Market |
|---|---|---|---|---|---|---|
| 1985 | 3,086 | 28.5 | 1,299 | 43.8 | 4,385 | 31.8 |
| 1986 | 3,830 | 29.0 | 1,693 | 49.8 | 5,523 | 33.2 |
| 1987 | 3,518 | 23.2 | 1,503 | 43.9 | 5,021 | 27.0 |
| 1988 | 3,582 | 21.1 | 1,524 | 45.2 | 5,106 | 25.1 |
| 1989 | 3,705 | 19.8 | 1,716 | 46.2 | 5,421 | 24.2 |
| 1990 | 3,701 | 18.4 | 1,784 | 42.5 | 5,485 | 22.5 |
| 1991 | 4,524 | 20.3 | 2,102 | 42.8 | 6,626 | 24.3 |
| 1992 | 5,752 | 22.3 | 2,595 | 46.0 | 8,347 | 26.5 |

Figure 1.19: Lloyd's revenue figures net of ceded reinsurance and gross of brokerage. Excluding inter-syndicate transactions. (£m) Source: Statutory Statement of Business and Global accounts(amended)

The figures in Figure 1.19 suggest that Lloyd's underwrites approximately one-quarter of the UK Insurance Market. This percentage has decreased from just over 31% in 1985. Lloyd's income has increased by 90% over the period 1985 to 1992, but Lloyd's market share has fallen from 31% in 1985 to 26% in 1992. Market share has fallen probably because of the expansion of direct writers of business such as Direct Line which is owned by The Royal Bank of Scotland. Lloyd's market share of the UK reinsurance market has remained at over 40% whereas Lloyd's proportion of the UK direct and facultative market has decreased from 28% to 22% . Figure 1.19 highlights the importance of Lloyd's as a reinsurance market.

## 1.12 Lloyd's proportion of the world non-life insurance and reinsurance market

The 1969 Cromer Report (paragraph 10) states that premium income from non-life business underwritten in Lloyd's in 1966 represented just under 2.5% of the world total. Cromer states that Lloyd's transacts about 16% of the world aviation insurance and a larger percentage of the world's marine insurance business. Franklin (1980) comments that in 1965, Lloyd's share of the world insurance market in 1965 was about 2.0% and in 1975 Lloyd's world market share had dropped to about 1.4% . "Statistics Relating to Lloyd's" gives Lloyd's world market share as 1.8% for the 1994 revenue year, the latest year for which statistics are available. This percentage has remained relatively constant since 1985. "Statistics Relating to Lloyd's" further states that for the 1994 revenue year Lloyd's had a 13.5% market share of the world's marine business, 1.8% of the world non-marine insurance, 25.7% of the world aviation market and 0.7% of the world motor market. Since 1985, these percentage market shares have remained constant other than aviation which has risen steadily from a 19.9% market share in 1985.

**1.13 The geographical split of Lloyd's business**

In many countries, insurance can only be provided by locally-based, licensed insurers. However, Lloyd's underwriters have been authorised to provide insurance under local insurance legislation in a number of countries including Australia, Canada, New Zealand, South Africa and several countries in Europe including France, Germany, Italy, Ireland and Switzerland. In many of the countries where Lloyd's underwriters are authorised, they are required to fulfill a number of local requirements, which may include the appointment of a general representative, the maintenance of local deposits and the filing of statistical reports. "Additional Securities Limited" is a wholly owned subsidiary of Lloyd's which provides funds for such deposits.

In other countries, Lloyd's underwriters are able to accept business without having to be licensed insurers. For example in the USA, although licensed to write direct insurance only in Illinois, Kentucky and the US Virgin Islands, Lloyd's underwriters are eligible to accept excess or surplus lines business. This is business which has been offered to the local insurers but declined - either because the local insurers are unwilling or unable to underwrite that business. There are Lloyd's brokers such as Bell and Clements Limited and Harman Kemp Limited that specialise in excess and surplus lines business. Lloyd's is able to trade on an equal footing with other insurers in the USA only in the states of Illinois and Kentucky. The insurance authorities in these two states require that a deposit must be held there and the "Illinois and Kentucky Dollar Agreement 1942" was an undertaking that underwriters would themselves provide the deposit instead of "Additional Securities Limited" on their behalf. Lloyd's underwriters are also able to underwrite reinsurance business throughout the world even in cases where they are unable to underwrite on a direct basis.

Figure 1.20 gives the breakdown of business by territory. Some premiums cannot be reliably allocated and these are shown in the column marked "Total unallocated premium". These unallocated premiums are understated since some double-counting of "allocated premiums" arises caused by the allocation of some premiums to more than one country (to comply with regulations in each). Given these caveats any detailed analysis of the data is perhaps unwise, however it is possible to draw conclusions from the figures. In respect of direct business the U.K. is the most important region with some 40% of premiums coming from the U.K.; this is not surprising as Lloyd's is based in London. However, in respect of reinsurance business the USA is the most dominant territory with approximately 40% of all premiums coming from the USA. For direct business the next biggest territory is the USA and for reinsurance the second largest source of premium income is the U.K. . About 60% of all direct business comes from

| Calendar Year | | U.K. | | U.S.A. | | Canada | | Rest of Europe | | Asia Pacific | | Africa & Middle East | | Other Countries | | Total allocated premium | | Total unallocated premium | | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1983 | Direct & Fac | 728 | 32.57% | 568 | 25.41% | 120 | 5.37% | 120 | 5.37% | 68 | 3.04% | 52 | 2.33% | - | 0.00% | 1,656 | 74.09% | 579 | 25.91% | 2,235 |
| | Reinsurance | 165 | 16.29% | 593 | 58.54% | 38 | 3.75% | 47 | 4.64% | 42 | 4.15% | 3 | 0.30% | - | 0.00% | 888 | 87.66% | 125 | 12.34% | 1,013 |
| 1984 | Direct & Fac | 845 | 29.44% | 671 | 23.38% | 140 | 4.88% | 149 | 5.19% | 84 | 2.93% | 51 | 1.78% | - | 0.00% | 1,940 | 67.60% | 930 | 32.40% | 2,870 |
| | Reinsurance | 249 | 17.03% | 748 | 51.16% | 50 | 3.42% | 58 | 3.97% | 51 | 3.49% | 3 | 0.21% | - | 0.00% | 1,159 | 79.27% | 303 | 20.73% | 1,462 |
| 1985 | Direct & Fac | 910 | 30.76% | 925 | 31.27% | 148 | 5.00% | 174 | 5.88% | 79 | 2.67% | 48 | 1.62% | - | 0.00% | 2,284 | 77.21% | 674 | 22.79% | 2,958 |
| | Reinsurance | 273 | 19.17% | 909 | 63.83% | 47 | 3.30% | 67 | 4.71% | 49 | 3.44% | 3 | 0.21% | - | 0.00% | 1,348 | 94.66% | 76 | 5.34% | 1,424 |
| 1986 | Direct & Fac | 1,137 | 31.52% | 1,153 | 31.97% | 153 | 4.24% | 222 | 6.15% | 58 | 1.61% | 48 | 1.33% | - | 0.00% | 2,771 | 76.82% | 836 | 23.18% | 3,607 |
| | Reinsurance | 339 | 19.01% | 1,101 | 61.75% | 46 | 2.58% | 82 | 4.60% | 35 | 1.96% | 3 | 0.17% | - | 0.00% | 1,606 | 90.07% | 177 | 9.93% | 1,783 |
| 1987 | Direct & Fac | 1,251 | 37.53% | 1,059 | 31.77% | 145 | 4.35% | 225 | 6.75% | 53 | 1.59% | 58 | 1.74% | - | 0.00% | 2,791 | 83.74% | 542 | 16.26% | 3,333 |
| | Reinsurance | 334 | 21.74% | 944 | 61.46% | 45 | 2.93% | 87 | 5.66% | 32 | 2.08% | 3 | 0.20% | - | 0.00% | 1,445 | 94.08% | 91 | 5.92% | 1,536 |
| 1988 | Direct & Fac | 1,369 | 40.29% | 889 | 26.16% | 141 | 4.15% | 209 | 6.15% | 58 | 1.71% | 60 | 1.77% | 40 | 1.18% | 2,766 | 81.40% | 632 | 18.60% | 3,398 |
| | Reinsurance | 408 | 24.76% | 830 | 50.36% | 73 | 4.43% | 79 | 4.79% | 36 | 2.18% | 3 | 0.18% | 32 | 1.94% | 1,461 | 88.65% | 187 | 11.35% | 1,648 |
| 1989 | Direct & Fac | 1,471 | 40.94% | 922 | 25.66% | 149 | 4.15% | 232 | 6.46% | 70 | 1.95% | 67 | 1.86% | 60 | 1.67% | 2,971 | 82.69% | 622 | 17.31% | 3,593 |
| | Reinsurance | 559 | 28.08% | 932 | 46.81% | 85 | 4.27% | 82 | 4.12% | 43 | 2.16% | 4 | 0.20% | 49 | 2.46% | 1,754 | 88.10% | 237 | 11.90% | 1,991 |
| SLIP | Direct & Fac | 1,270 | 37.84% | 1,095 | 32.63% | 118 | 3.52% | 426 | 12.69% | 94 | 2.80% | 100 | 2.98% | 253 | 7.54% | 3,356 | 100.00% | - | 0.00% | 3,356 |
| SURVEY | Reinsurance | 938 | 34.72% | 830 | 30.72% | 68 | 2.52% | 505 | 18.69% | 128 | 4.74% | 5 | 0.19% | 228 | 8.44% | 2,702 | 100.00% | - | 0.00% | 2,702 |
| 1990 | Direct & Fac | 1,570 | 41.16% | 1,024 | 26.85% | 148 | 3.88% | 292 | 7.66% | 104 | 2.73% | 79 | 2.07% | 94 | 2.46% | 3,311 | 86.81% | 503 | 13.19% | 3,814 |
| | Reinsurance | 768 | 34.24% | 1,019 | 45.43% | 90 | 4.01% | 121 | 5.39% | 48 | 2.14% | 7 | 0.31% | 67 | 2.99% | 2,120 | 94.52% | 123 | 5.48% | 2,243 |
| 1991 | Direct & Fac | 1,802 | 39.05% | 1,103 | 23.90% | 169 | 3.66% | 509 | 11.03% | 142 | 3.08% | 101 | 2.19% | 186 | 4.03% | 4,012 | 86.93% | 603 | 13.07% | 4,615 |
| | Reinsurance | 871 | 34.05% | 1,146 | 44.80% | 92 | 3.60% | 243 | 9.50% | 127 | 4.96% | 6 | 0.23% | 139 | 5.43% | 2,624 | 102.58% | - 66 | -2.58% | 2,558 |
| 1992 | Direct & Fac | 2,268 | 39.85% | 1,148 | 20.17% | 189 | 3.32% | 585 | 10.28% | 138 | 2.42% | 107 | 1.88% | 231 | 4.06% | 4,666 | 81.97% | 1,026 | 18.03% | 5,692 |
| | Reinsurance | 869 | 29.43% | 1,208 | 40.91% | 85 | 2.88% | 353 | 11.95% | 166 | 5.62% | 16 | 0.54% | 144 | 4.88% | 2,841 | 96.21% | 112 | 3.79% | 2,953 |
| 1993 | Direct & Fac | 2,548 | 42.12% | 1,474 | 24.37% | 158 | 2.61% | 654 | 10.81% | 154 | 2.55% | 118 | 1.95% | 400 | 6.61% | 5,506 | 91.02% | 543 | 8.98% | 6,049 |
| | Reinsurance | 657 | 25.69% | 1,247 | 48.77% | 87 | 3.40% | 305 | 11.93% | 207 | 8.10% | 9 | 0.35% | 145 | 5.67% | 2,657 | 103.91% | - 100 | -3.91% | 2,557 |
| 1994 | Direct & Fac | 2,472 | 43.41% | 1,222 | 21.46% | 132 | 2.32% | 659 | 11.57% | 187 | 3.28% | 112 | 1.97% | 721 | 12.66% | 5,505 | 96.68% | 189 | 3.32% | 5,694 |
| | Reinsurance | 492 | 22.79% | 1,103 | 51.09% | 48 | 2.22% | 242 | 11.21% | 186 | 8.62% | 13 | 0.60% | 128 | 5.93% | 2,212 | 102.45% | - 53 | -2.45% | 2,159 |
| 1995 | Direct & Fac | 2,181 | 40.28% | 1,316 | 24.31% | 142 | 2.62% | 664 | 12.26% | 200 | 3.69% | 110 | 2.03% | 649 | 11.99% | 5,262 | 97.19% | 152 | 2.81% | 5,414 |
| | Reinsurance | 345 | 17.81% | 912 | 47.08% | 44 | 2.27% | 191 | 9.86% | 165 | 8.52% | 10 | 0.52% | 219 | 11.31% | 1,886 | 97.37% | 51 | 2.63% | 1,937 |

**Figure 1.20: Geographical provenance of Lloyd's gross premium income (gross of ceded reinsurance and net of brokerage), £ million.**

Source: Statistics Relating to Lloyd's (1996).

Notes:

1. Some premiums cannot be reliably allocated to any country, and these are shown separately. Unallocated premiums are understated in the table since some double-counting of "allocated premiums" arises caused by the allocation of some premiums to more than one country (to comply with the regulations in each).
2. In 1990 a slip survey was carried out by the LPSO (sample size = 1% of population) which enabled all premiums to be allocated to countries.

the USA and the U.K. and approximately 70% of reinsurance premiums emanate from these two countries. Europe (excluding the U.K.) has played an increasingly important role since 1983 but in 1992 only accounts for just over 10% of all direct and reinsurance premiums. With the collapse of many Eastern Bloc Communist regimes, there is the potential for Lloyd's to seek business in these countries. Indeed a company, Malsons Ltd, has been set up by a number of Lloyd's underwriters to look at the feasibility of writing Eastern European business.

In conclusion, UK domiciled business accounted for 34% of business at Lloyd's during the 1995 calendar year. The next largest territory is the USA which accounts for 30% of business written. Continental Europe accounts for 12% of premium income. No other individual territory constitutes more than 5% of Lloyd's premium income. Almost two-thirds of Lloyd's premium income comes from the UK and USA, thus it is not surprising the Lloyd's Business Plan (1993) states on page 5: "Our business development objectives are:... to build Lloyd's position in new markets, particularly Continental Europe and the Asia/Pacific region."

### 1.14 Summary of statistics

This chapter has analysed data that Lloyd's publishes in order to evaluate the type of insurance business that Lloyd's is underwriting. The business is approximately split 60% direct and 40% reinsurance. Lloyd's underwrites approximately one quarter of all business underwritten in the UK and is an important market for reinsurance business where the Society has about 40% of the UK market. Lloyd's is heavily reliant upon

USA and U.K. business with nearly two-thirds of its business emanating from these two territories.

### 1.15 A note on the constituents of the London Market

The core activity of the "London Insurance and reinsurance market" is the underwriting of internationally traded insurance and reinsurance business. This business is almost exclusively non-life (i.e. general) insurance and reinsurance, with an emphasis on high-exposure risks. Despite the growth of other international centres in the world, London is the world's leading international insurance and reinsurance market.

The London Market forms an important part of the world reinsurance market, and is a major source of UK invisible earnings, being the principal medium through which overseas insurance business is brought into the U.K. The London market is largely a "subscription market", in which most business is handled by brokers. Often insurances and reinsurances are placed with two or more insurers (or reinsurers) who subscribe to a "slip" which is prepared by the broker. The leading underwriter quotes the premium required for the risk and then signs the slip stating what percentage of the risk he wishes to accept. The broker will then go to other underwriters in London who, if they wish to underwrite the risk, will note on the slip the percentage of the risk they wish to accept. This process continues until the broker has sufficient underwriters on the slip for the risk to be fully, i.e. one hundred per cent, placed. The whole of the London Market is, in essence, a "club" where reputations are made and jealously guarded. The broker will present his client's case in the best possible light but he must give an honest picture to the underwriter. There is a whole background of opinion, based on tradition and experience, modified by current results, on which the underwriter arrives at a decision. Among international markets London is unique in that it is geographically highly concentrated. It comprises many insurers and intermediaries located in the City of London and its vicinity. Often an individual broker will know the personal strengths of many underwriters in the market. Brokers will use their knowledge of underwriters in order to get the best terms for their clients. The London market is supported by many firms supplying ancillary services, such as accounting, legal services and information technology.

In addition to Lloyd's, there are a considerable number of companies active in the London Market which fall into the following categories:

(a) A small number of large professional reinsurance companies, both of United Kingdom and of European origin, writing through UK branch organisations (e.g. Mercantile and General, Skandia Re, Munich Re.)

(b) The "Home Foreign" or reinsurance departments of UK composite companies. "Home Foreign" business consists of business written in London, where the risk originates from overseas; thus it is virtually synonymous with the London Market. e.g. Eagle Star, General Accident, Commercial Union.

(c) UK subsidiaries (or branches) of overseas insurance or reinsurance companies. To an increasing extent the branches are being converted into subsidiaries and there now remain very few active branches. The parent companies are extremely widespread geographically but there are considerable concentrations in the USA, Japan, Scandinavia and the EEC. Most (but not all) such companies are designated (Parent's Name) Insurance Co (UK) Ltd. e.g. Kemper Re (UK), St Paul Re (UK).

(d) Captive companies owned by UK or overseas industrial or commercial companies. Examples of this type include Athel Reinsurance Co (Tate & Lyle) and GTE Insurance Co (GTE Corporation, US).

(e) Small professional reinsurance companies set up by (or acquired by) large broking firms for the specific purpose of transacting London Market business. Such companies include River Thames (Sedgwicks) and Sphere Drake (Alexander Howdens) and Sovereign Marine and General (Willis Faber). Following the move to separate broking and underwriting concerns under the 1982 Lloyd's Act, such subsidiaries have, to a large extent been sold off or been subject to management buy-outs.

(f) There are two pools operating in the London market, International Oil Insurers and the British Insurance (Atomic Energy) Committee. Both operate on a net line basis i.e. insurers participating in the pool retain for their own accounts the business they underwrite.

In addition, a certain amount of marine business is written by Protection and Indemnity Clubs (P & I Clubs), which are essentially mutual insurance companies for groups of shipowners. These organisations specialise in marine liability insurance, including the provision of indemnity against damage to harbours and the cost of removing wrecks.

Besides the P&I Clubs, the combined membership of the Institute of London Underwriters (ILU) and the London Insurance and Reinsurance Market Association (LIRMA) provides a good indication as to the number of companies operating in the

London market. As at the beginning of 1996 there were 162 members companies actively underwriting business. The ILU is the trade association for companies underwriting marine, aviation and transport business in the London company market. LIRMA is the major organisation which represents international insurance and reinsurance companies writing primarily non-marine insurance and reinsurance business in London.

# Chapter Two: Studies on Lloyd's

## 2.1 Introduction

This chapter examines the literature that has been published that has had an influence on the operations of the Lloyd's market and also includes an evaluation of the Acts of Parliament from 1871 to 1986 pertaining to Lloyd's. A detailed analysis of the 1992 Task Force Report is provided as this is the first report to discuss the competitive strengths of Lloyd's. The Task Force Report culminated in the publication of Lloyd's first Business Plan in 1993 and an analysis of this is given.

## 2.2 Overview of Lloyd's regulatory status.

The Insurance Companies Act 1982 governs the business of insurance in the United Kingdom. Under its provisions it is unlawful to operate an insurance company unless the regulations of the Act are followed. Having stated that "no person shall carry on any insurance business in the United Kingdom" unless authorised by the Department of Trade and Industry, the Act makes three exemptions: trade union strike funds, registered friendly societies and Lloyd's. Lloyd's is thus immune from direct legislation which gives it a measure of self-regulation. Underwriters at Lloyd's are not, however, entirely exempt from the Act. The policyholder must still be protected and the Act lays down three requirements on Lloyd's underwriters: all premiums must be held under a trust deed from which claims may be settled; the underwriter's accounts must be audited each year and a certificate produced that the underwriter is solvent; and the Council of Lloyd's must file an annual return summarising the extent and character of the insurance business transacted by the members of Lloyd's. The first two provisions relate to each member individually so that there must be a separate trust fund and solvency certificate for each member of Lloyd's.

## 2.3 The Lloyd's Act 1871.

During the second half of the nineteenth century the main activities of the Committee of Lloyd's were the provision of premises for the transaction of marine insurance and arranging for the collection of shipping intelligence. In 1870 the Committee of Lloyd's attempted to exclude a member from Lloyd's (Forwood v Goschen). However, this was not possible because once a man was elected a member and had paid his entrance fee, he was beyond the Committee's control. In response to this situation Lloyd's secured a private Act of Parliament - the Lloyd's Act 1871.

The Lloyd's Act 1871 incorporated the membership of Lloyd's into the Society and Corporation of Lloyd's. This made Lloyd's a legal entity, creating a single body which could enter into contracts binding upon the Society, could hold property and assets on behalf of the Society and could issue its own seal. The Act gave Lloyd's a written constitution and entrusted the Committee of Lloyd's with the management and supervision of the affairs of the Society. The Act established an elected committee of twelve and gave the Society the power to make bylaws - this could only be exercised by the membership at a General Meeting, however. Although the Lloyd's Act 1871 referred only to the "carrying on of marine insurance business by members", Lloyd's was now underwriting non-marine business. A later Lloyd's Act (1911) amended the 1871 Act to "the carrying on by members of the Society of the business of insurance of every description....". According to sections 21, 22 and 23 of the 1871 Act a member would have his membership terminated on the conviction of an infamous crime, on conviction or adjudication of fraud, on bankruptcy and on non-payment of subscription. There were only two disciplinary offences for which the Act provided a penalty:

(i) Violation of the fundamental rules of the Society (Lloyd's Act 1871, section 20); and

(ii) discreditable conduct (Lloyd's Act 1871, section 20)

Both offences made a member liable to expulsion. There first had to be determination of guilt by the award of two arbitrators, and then a vote with a four-fifths majority of those present at a general meeting, provided that at least one hundred members voted.

The constitution that the 1871 Act established remained in force until 1982 when a new Lloyd's Act received Royal Assent. Four Lloyd's Acts were passed between 1871 and 1982 (in 1888, 1911, 1925 and 1951). However, many of their provisions are now repealed and the constitution of the modern Lloyd's is found in the 1982 Act.

**2.4 The Cromer Report.**

In 1965 a severe American hurricane led to historic changes in Lloyd's. Hurricane Betsy produced losses on a scale that Lloyd's had never seen before. Names lost on average £6,000 in 1965 and over £3,000 in 1966. In the twenty years following 1946 Lloyd's membership had grown steadily from 2,000 to over 6,000. Then, as a result of Hurricane Betsy, the membership of Lloyd's began to fall and only recovered in 1971. As a result, in 1968 Lloyd's commissioned a working party chaired by Lord Cromer to recommend what Lloyd's should do to encourage an efficient and profitable market.

The Report states in paragraph 28: "One of the reasons why (the) enquiry was initiated was that there were complaints about difficulties in placing risks at Lloyd's because of lack of capacity. This raises the question how to attract more capital into Lloyd's....". The Committee of Lloyd's gave the working party the following terms of reference:

> (1) To agree a target growth rate for insurance capacity at Lloyd's over the next ten years, having regard to the estimated annual world growth rate in insurance requirements;
> (2) To estimate the likely growth of underwriting membership under present arrangements and to examine any methods of encouraging a steady flow of new members;
> (3) To examine the existing capital structure of underwriting membership and consider whether there is potential for increasing premium limits bearing in mind that security is paramount;
> (4) To examine alternative methods of providing capital backing for underwriting (other than individual wealth of members) coupled with the legal and security implications of any such proposals.

The Cromer Report was the first major study commissioned on Lloyd's. The Report examined the role of Lloyd's in the insurance market, the organisation of its syndicates and markets, the role of brokers, and the taxation of Names. A large section of the Report deals with the sources of capital at Lloyd's and the capital structure (Lloyd's deposits, Special Deposits, Personal reserves, the central fund etc.). One chapter looks at Names' premium income limits and the relationship between a Name's Lloyd's Deposit and his overall premium income limit.

Cromer concluded that Lloyd's must stay in the business of insuring large risks and that it must therefore increase its capacity. As a result of the Report, the means test for UK Names who were not engaged in commerce nor in work at Lloyd's was reduced from £75,000 to £50,000 and that for overseas Names reduced from £100,000 to £75,000. It took some time for the number of members to increase but in the ten years that followed the Report, membership grew threefold from 6,000 in 1970 to over

18,000 in 1980. The lowering of wealth requirements was an extraordinary proposal as it inevitably allowed more people to join the Society who were less wealthy than previous Names. This proposal weakened the security behind the Lloyd's policy.

Lord Cromer's committee showed considerable foresight when it said:

> ....it (is not) surprising that the recent run of losses should lead to a more critical attitude by some Names towards agents. We think it would be a mistake to assume that this more critical attitude is a passing phase. Many names are waiting to see what comes out of the present review of the organisation of Lloyd's. Many Names have also made substantial losses which only a long series of profitable years will wipe out. In present conditions Names are likely to look for something akin to the relationship which would exist if they were shareholders in a company and expect at least the same degree of accountability and consideration as is generally extended to the shareholder. (Cromer Report, para 195)

Cromer pursued this theme and called for Lloyd's to require agents to publish audited syndicate accounts to their Names, to give a report on prospects for the two open years, and not to increase a Name's share in a syndicate or transfer him to another syndicate without his approval. Annual meetings of Names on syndicates were also proposed.

The Cromer working party recognised many of the difficulties associated with the regulation, under pre-1982 powers, of a Society likely to grow substantially in size. The problem faced by the Cromer working group was the need to provide more comprehensive regulation to govern relationships between Names and their agents which would be of a more commercial kind rather than the then present system of personal relationships of trust. The Cromer Report addressed a number of important regulatory issues such as the admission of agents, a model form of agency agreement, agents' charges, the provision of information to Names, and the ownership and control of underwriting agencies. The report also proposed that the Committee of Lloyd's should have more power to regulate the Society and a strengthened staff headed by a Chief Executive to assist them.

The Report made a number of recommendations which led to changes and simplifications in the calculation of members' premium limits as well as their required show of means. Cromer suggested simplification of rules governing the permitted extent of reinsurance and made recommendations regarding the authorisation of underwriting agents. One interesting recommendation that the Report makes is the admission of limited liability capital. The Cromer Report states in paragraph 81:

> It seems doubtful whether Lloyd's can expect in the next few years to get the number of names that it needs to maintain its position in the insurance market. While, therefore, we can understand the widespread preference for retaining the present methods of financing syndicates, we consider that Lloyd's should introduce, under proper safeguards, a limited amount of company participation.

The Report goes on to say that the total of all company participation in a syndicate should not exceed ten per cent of the syndicate's capacity. The Report discusses the concept of unlimited liability versus limited liability. Interestingly the Report states that insurance brokers "did not attach great importance to unlimited liability as a selling point for Lloyd's policies" (Paragraph 57). The Report discusses the concept of risk-based capital although the authors reject the notion that "there should be differentiation in premium limits according to the degree of 'exposure'" on the basis that relating the solvency margin to exposure had not been tested. However, the Report does not discount the possibility of this happening at a future date.

Very little notice seems to have been taken of these recommendations for over a decade; indeed the Cromer Report was not made available to Names until October 1986, almost seventeen years after it was presented to the Committee of Lloyd's.

Whilst the Cromer Report was commissioned to investigate how Lloyd's should increase its capacity, there is no discussion about any strategy to increase the Society's premium income, such as new insurance products or new territories to target. It could be inferred, therefore, that the Committee of Lloyd's expected the capacity to be consumed by natural growth in premium income.

**2.5 Self-regulation at Lloyd's.**

Regulation may be best divided into three types: structural regulation, prudential regulation and investor protection (Pawley *et al*, 1991 p 235). Structural regulation refers to the type of activities that different categories of financial institution are permitted to carry out, and prudential regulation refers to supervision in terms of, *inter alia*, liquidity, capital adequacy and solvency of financial institutions. The term 'supervision' is used here to mean the monitoring of financial institutions for investor protection, prudential regulation, and structural regulation purposes combined. Investor protection legislation overlaps with both prudential and structural regulation in that the investor is in theory protected from financial institutions becoming insolvent through excessive risk-taking and protected from conflicts of interest by separation of types of business (Pawley *et al*, 1991 pp 235-6). These three types of regulation may be carried out through a formal legislative code or through self-imposed rules (self-regulation) or a combination of both. A further form of regulation is the operation of monetary policy such as the raising of interest rates which will reduce the demand for credit.

The main difficulty with a regulatory regime is to strike a balance between competition and regulation and care must be taken to ensure that regulation does not impede the efficiency of the financial service. A major concern is the extent to which regulation stifles innovation within financial services. The more rules that exist, then the more likely a new product development will be prohibited by the rules. Excessive regulation may be an effective barrier to entry thus discouraging new participants to enter the market. However, companies that are excluded may take their business elsewhere thus losing potential business to overseas competitors.

Self-regulation is a peculiarly British method of supervising financial markets and Lloyd's is a good example of a self-regulated institution. Hay Davison (1987) suggests that for self-regulation to work effectively there are a number of preconditions. Firstly there must be a closed circle of members to whom the rules are to be applied, and it must be advantageous for the member to be part of that body and financially disadvantageous to operate outside the closed circle. Secondly, the self-regulation must be supported by statutory backing so that a member with a grievance cannot defeat the system by recourse to the courts. Thirdly, the members of the self-regulated society must be willing to accept that the proper rules are more helpful to the conduct of business than a complete free-for-all. Fourthly, the process of self-regulation will not work unless there are adequate procedures for consultation both from within the society and outside the society. It is important that as Parliament vests legislative powers in a private body, it follows that any proposed subordinate legislation should be open to public scrutiny in the same way as Bills of Parliament. Lloyd's is unique in that its investors, the Names, have unlimited liability, a feature not found in other financial services. Regulation must protect the interests of the policyholder and the Name. In a competitive market there will be successful companies and others that are not successful. Because the capital base of Lloyd's consists largely of individuals, the vast majority of whom have little insurance knowledge, the regulatory regime must ensure that there are no "losers" in the market, because with unlimited liability the level of loss could far exceed the wealth of the Name. With the introduction of corporate capital - limited liability capital - the level of loss that an investor can sustain is the face value of his shareholding. It could be argued that the level of investor protection afforded under a limited liability capital structure need not be so great as that required for an unlimited capital structure.

Self-regulation has various attractions for Parliament. Firstly it is less expensive, as market practitioners draft the rules rather than civil servants. Secondly, practitioners are better able to define the questions that need to be addressed and to prepare rules to prevent malpractices because they are more familiar with the market than are external legislators. Self-regulation is more efficient than statutory regulation as the rules can be easily adapted to a change in the market; the rules can be made more easily than having to wait for a suitable gap in the Parliamentary timetable. Furthermore, rules that are made by practitioners in the market are more likely to be observed by the members of the market than rules that are formulated by outside legislators.

However, the major disadvantage of self-regulation is that it gives freedom to vested interests. Unless the market practitioners show restraint, there will always be the danger of rules being inadequately enforced against friends of the rule makers or being exercised harshly against competitors. The key to effective self-regulation must, therefore, be adequate arrangements for control and to obstruct vested interests.

### 2.6 The Fisher Report and Self-Regulation

Many of the ideas raised in the Cromer Report were re-examined by a working party appointed in 1979 under the chairmanship of a former High Court judge, Sir Henry Fisher. The working party was set up at a time when there were two disputes which attracted adverse publicity. The first of these cases was the so-called "Sasse affair" where losses were sustained by Names arising out of property insurances written on their behalf in North America under binding authorities. (Hay Davison, 1987) The second dispute was the "Savitona" case which involved a disputed claim of about $700,000 for Fiat cars involved in a ship fire. The working party was set up because the Committee of Lloyd's was "(conscious) of the lack of powers to deal adequately with abuses and difficulties" (section 1.27). The Working Party's terms of reference were:

> To enquire into self-regulation at Lloyd's and for the purpose of such enquiry review:-
> (i) the constitution of Lloyd's (as provided for in Lloyd's Acts and Bye-laws);
> (ii) the powers of the Committee and the exercise thereof and;
> (iii) such other matters which, in the opinion of the Working Party, are relevant to the enquiry.
> and, arising from the review, to make recommendations.

Thus it was from the start an inquiry into self-regulation at Lloyd's rather than how best Lloyd's should be regulated. In the first chapter of the Report (section 1.12) the authors make quite clear their confidence in self-regulation:

> There are those that question the whole concept of self-regulation and would prefer to see a system of control by government (or by statutory bodies set up by government) along the lines followed in some other countries. We have no doubt that Lloyd's will be best served by a properly conducted system of self-regulation. Indeed we do not see how it could function in anything like its present form under any other system of regulation. Since the continued success of Lloyd's as an international market for insurance is important in the national interest, it is of national importance that Lloyd's should have an efficient system of self-regulation.

The Report thus begins with the assumption that self-regulation is the better way for Lloyd's to be regulated rather than by statutory regulation, and then lists recommendations for how such a system should work. The Report did not consider statutory regulation as a process nor suggest reasons for why self-regulation is to be preferred. The purposes of self-regulation were summarised by the Working Party thus:

> "The maintenance of the security of the Lloyd's policy; the maintenance of the highest standards of conduct and integrity by all users of the market; the preservation of Lloyd's as a market where conditions of free competition can obtain; and the maintenance of standards of fair treatment for those members of the Lloyd's community who can reasonably look to the Committee for protection."
> (Letter from H.A.P. Fisher to P.J.F. Green, Chairman of Lloyd's reprinted in the Fisher Working Party Report).

The Fisher Working Party came to the conclusion that the constitution of Lloyd's was no longer appropriate and that the Committee's powers were inadequate for self-regulation. The Working Party recommended that the Committee of Lloyd's should promote a new private Act of Parliament so that the constitution of Lloyd's could be brought up to date and its powers of self-regulation enlarged. The principal recommendations of the Working Party were:

(1) The creation of a governing Council composed of sixteen working members (who would also constitute the Committee), six external members and three outsiders who would be approved by the Governor of the Bank of England. The rule-making and disciplinary powers vested in the General Meetings of Members should be transferred to the Council. The power to make Regulations for the conduct of insurance business in Lloyd's should be delegated to the Committee.

(2) The Council should be given extensive powers to regulate the admission and registration of Members, Agents and Brokers. The Council should be given the power to veto the appointment of an Active Underwriter and also to inquire into the affairs of any Syndicate, Broker or Agent. The working party recommended that shareholding links between brokers and managing agents should cease within five years. This reform, divestment by brokers of their interests in managing agencies was the most dramatic reform introduced. The Fisher Report, in paragraph 12.03 said ".... the eight largest "Broker-Controlled" Agencies are controlled by the eight largest Lloyd's brokers who between them account for 58.8 per cent of the premium income of Lloyd's." Subsequent to the Fisher Report, the Higgins Inquiry into the Underwriting Agency System at Lloyd's in September 1982 found that 308 out of 431 syndicates (71 per cent of syndicates) would have to change ownership as a result of the Act.

(3) The Council should undertake overall responsibility towards Names and should exercise a supervisory role over Underwriting Agents. Specific recommendations included the mandatory re-registration of agents, greater disclosure of information about agents and syndicate performance to prospective and existing Names, and the introduction of a standard Agency agreement between agents and Names.

(4) There should be bye-laws detailing the precise requirements for membership.

(5) The disciplinary functions of the Council should be delegated to a disciplinary committee, with a range of powers to punish offenders, and an appeal tribunal. The Council should have the power to require that any dispute entirely within the Lloyd's community should be decided by arbitration. The Report stressed that the Council would strive to maintain the tradition of not interfering in market and underwriting matters, but recommended that the Council be given powers to ensure the maintenance of adequate means and deposits by all Members.

The Working Party Report set out a draft Bill to amend the Lloyd's Acts 1871-1951 and this formed the basis for the Lloyd's Act 1982.

**2.7 The Lloyd's Bill**

Following receipt of the Fisher Report, several groups were formed to work on the detailed recommendations of the report and to set about preparing for the passage of a private Bill to enact the new constitution. In order for the Committee to be able to proceed with the presentation of a Bill to Parliament, the issue needed to be voted on at a meeting of members. A meeting was duly held on the 4th November 1980 when a large majority of members voted in favour of the resolution supporting legislation on the lines stated in the Fisher Report. A Bill was introduced in late 1980 and received its second reading in the House of Commons in March 1981. The Lloyd's Act received Royal Assent in July 1982.

## 2.8 The Scandals of 1982

In late 1982 various scandals in Lloyd's began to emerge. A serious incident was the fraud uncovered at Alexander Howden. When Alexander and Alexander, the US broker, purchased Howden Underwriting Agency for $300 million, their auditors discovered a multi-million pound fraud. Four of Howden's directors (Grob, Commery, Page and Carpenter) had been secretly arranging reinsurances with offshore companies owned by Grob, Commery, Page and Carpenter. None of these transactions had been mentioned to the underwriting members of Howden. Alexander and Alexander alleged that $55 million was missing out of their $300 million purchase. (Mantle, 1992, p. 99)

Another damaging incident was the so-called "PCW affair". On 2nd November 1982 Lloyd's announced that Mr Peter Dixon, chairman of PCW Underwriting Agencies Limited (a subsidiary of Minet Holdings plc) and WMD Underwriting Agencies, had voluntarily suspended himself from all duties with the agencies. During the Alexander and Alexander investigations it was revealed that low risk, high profit reinsurance premiums from syndicates run by Peter Cameron-Webb (a past chairman of PCW who retired from this office in 1982) and Peter Dixon had been diverted to companies owned by the two men in the Isle of Man, Guernsey and Gibraltar. (Raphael, 1994, page 81)

The sums of money were huge. Over £40 million had been withheld from PCW syndicate members over a number of years. In addition, the PCW non-marine underwriters had written some unprofitable business and the losses were thought to exceed the monies diverted to the offshore companies. In 1985 it was announced that those members who had been involved with the "Howden" affair and the PCW matter had been expelled from the Society.

Against this background of adverse publicity for the Society and allegations of misconduct and concern expressed in Parliament about the adequacy of the new constitution, the Governor of the Bank of England made an important intervention at the end of 1982. He persuaded Lloyd's to create the post of Chief Executive (a post suggested by the Cromer report thirteen years beforehand). Ian Hay Davison was appointed to the new office with the additional title of Deputy Chairman and the status of a nominated member of the Council (Hay Davison, 1987 p. 6). This involved increasing the number of nominated member to four, making the total number of Council members twenty-eight. Mr Hay Davison's main role was to oversee the establishment of the new self-regulatory regime at Lloyd's as detailed in the Lloyd's Act 1982.

Another significant development was the establishment of the Association of Lloyd's Members (ALM). The objects of this association are to improve the understanding of Lloyd's among members and prospective members, to promote and represent the interests of its members both within and outside Lloyd's, to publish comparisons of syndicate results and to publish a quarterly newsletter which is distributed to members.

### 2.9 Developments since 1982.

The events of 1982 had a significant impact on the regulation of Lloyd's and the public perception of the adequacy of self-regulation. It appeared that just after Government had passed a Bill giving the terms of reference for self-regulation, the various scandals showed up the inadequacy of that self-regulation.

The findings of the investigations into the incidents detailed above revealed a number of facts about the inadequacy of the regulatory arrangements that had existed pre-1982. It also showed the standards of conduct that had existed in the market. Both of these facts had not been available to the Fisher Working Party. Two specific areas of abuse were identified. The first was the use of "baby" syndicates. An underwriter would sometimes have two syndicates - his main, large syndicate and a much smaller, "baby", syndicate which just consisted of himself and a few others, generally directors of the agency and perhaps a few close friends. When business was presented to the Box the underwriter had the opportunity to channel the best business shown to him to the baby syndicate rather than to the main syndicate.

The other abuse was the placing of reinsurance premiums on behalf of syndicates with companies (often offshore) in which the agency or a director of the agency had a financial interest. Some of these companies were not reinsurance companies at all, but simply a means to divert premiums that were due to Names. Others offered genuine reinsurance at terms that were favourable to the company and thereby allowing those involved to make profits at the expense of the Names.

### 2.10 The Neill Report.

The events of 1982 revealed regulatory inadequacies which had facilitated a few dishonest working members to profit at the expense of their Names. In 1986 the

Secretary of State for Trade and Industry set up a Committee of Inquiry to consider whether the regulatory arrangements established under the Lloyd's Act 1982 provided protection for members of Lloyd's comparable to that proposed for investors under the Financial Services Act 1986. Unlike the Cromer and Fisher working parties, the Neill Committee of Inquiry was composed entirely of outsiders. The Committee was led by Sir Patrick Neill QC, Warden of Hertford College, Oxford.

The Neill enquiry concluded that the regulatory arrangements in place at Lloyd's did not provide protection for Names comparable to that proposed for investors under the Financial Services Act 1986 (para 1.5 Neill Report). A central feature of this Act is the creation of Self Regulatory Organisations (SROs) comprising a number of independent members and an external overseer (The Securities and Investments Board) to set standards where required and to monitor performance by the SROs. The Inquiry did not feel that Lloyd's fitted into the framework of the Financial Services Act 1986 because any supervisory body at Lloyd's would not just be concerned merely with investor protection; it would have to deal with policyholder protection as well (para 1.8 Neill Report). The interests of these two groups are sometimes in conflict. The Inquiry noted that the Lloyd's Act 1982 had made a provision for nearly one-third of the Council members to be external members and to be directly elected by the investors (the Names). In addition there were four nominated members appointed with approval of the Governor of the Bank of England. One of these nominated members is the overseer for the rest of the City of London, the Chairman of the Securities and Investment Board.

The Neill Inquiry concluded that more independent oversight of the regulation at Lloyd's was required (para 1.9 Neill Report). The solution proposed was to reduce the number of working members on the Council so that they cease to have the majority, keeping the same number of external members, and doubling the number of nominated members. The changes thus proposed were:

**COMPOSITION OF THE COUNCIL OF LLOYD'S**

| **At the time of the Neill Inquiry** | **As proposed by the Neill Inquiry** |
|---|---|
| 16 working members | 12 working members |
| 8 external members | 8 external members |
| 4 nominated members | 8 nominated members |
| (including the Chief Executive) | (including the Chief Executive) |
| 28 | 28 |

The Inquiry felt that such a change would "provide independent oversight no less effective than the board members of any external supervisory authority could be expected to provide" (Neill Report para 1.10). The Inquiry made recommendations concerning the process of recruiting Names. The main recommendation was the need for Members' Agents to "produce written statements setting out their policy in relation to the advice given to individual Names about the consequences of membership, and setting out the terms of business, the syndicates to which they have access and their approach to allocating Names to syndicates." (Neill Report para 4.34 and Recommendation no 6 page 86). A series of recommendations were made for the contents of syndicates' annual reports, and the underwriter's report in particular. The Inquiry recommended that Lloyd's adopt inception date accounting as soon as it was feasible so to do (Neill Report para 5.9). Inception date accounting has been adopted for the 1996 year of account and subsequent years of account, no doubt somewhat later than the Neill Inquiry had intended.

One of the most important recommendations of the Neill Report related to the agency agreement between agents and their members. The agency agreement is the document signed by a Name and his members' agent. This is the agreement by which the Name delegates full control of his underwriting business to his members' agent and undertakes to pay all his liabilities associated with each of his syndicates. At the time the Neill Report was written the agency agreement was made between a member and his members' agent. Where a members' agent was a combined agent and to the extent that the member participated on the syndicates managed by that agent (i.e. he was a direct Name), no other agreement was necessary. However, where the members' agent was not also the managing agent, or where the combined agent placed a member on a syndicate administered by another managing agent, the member became an indirect Name and the members' agent was obliged to enter into a sub-agency agreement with the managing agent(s) concerned. The sub-agency agreement delegated to the managing agent(s) the power to underwrite on behalf of the Name. This meant that the members' agent was still contractually responsible to the name for the underwriting although having little control over the actions of the managing agent.

The Neill committee made various recommendations to alter the agency agreements to be more favourable to Names. Its major recommendation held that a direct contractual relationship be established between a member and the managing agent so as to enable members in future to sue their managing agents as well as their members' agent in contract (para 6.27 Neill Report). The Neill Committee also recommended that "the agency agreement should distinguish clearly between the functions of the two types of agent and contain a clear statement as to their respective duties" (paras 6.27 and 6.28 and recommendation no 22 Neill Report).

The other major recommendations of the Neill Inquiry were the setting up of a Lloyd's Ombudsman to investigate complaints by Names against the Corporation, the setting up of a Names' Interests Committee, encouraging the appointment of non-executive directors to managing and members' agencies and the mandatory institution of examinations for all those who wish to become active underwriters. The Neill Inquiry was in essence trying to create a regulatory regime comparable with that of other Financial Services which are subject to the Financial Services Act 1986. Some recommendations, such as the agency agreements, are refinements of the Fisher Report.

**2.11 Comment on Reports and Acts 1871 to 1986.**

The various reports written and Acts passed by Parliament during the period 1871 to 1986 relate principally to the regulatory regime at Lloyd's. Indeed reports such as Neill were commissioned in response to regulatory failure. The reports do not discuss the future of Lloyd's or discuss strategy or planning. None of the reports discusses the business at Lloyd's or provides an outline of any strategy for growth of the Society. The Cromer Report was commissioned in response to a lack of capital at Lloyd's. However, rather than suggesting how new capital might be attracted, the report suggested lowering the means requirements for Names.

## 2.12 "Lloyd's: a route forward" Report of the Task Force

### 2.12.1 Background

The Task Force report presents a plan for a comprehensive restructuring of Lloyd's. The report was written in 1991-2 at a time when Lloyd's was experiencing a serious decline in its membership from over 32,000 in 1988 to 22,000 in 1992. Moreover, the capital base was decreasing (£11.4 billion in 1991 to £10 billion in 1992) and Lloyd's was facing its first loss-making year, 1989, and with prospects of further more serious loss-making years to follow.

In November 1990, the Chairman of Lloyd's, David Coleridge, invited David Rowland, the Chairman of Sedgwick plc, to form a Task Force to consider the long-term development of the capital base supporting underwriting at Lloyd's. David Rowland invited twelve other people to join the Task Force, eight of whom were working within Lloyd's and three of whom were "outsiders". The terms of reference given to the Task Force by the Council of Lloyd's were:

> The group's objective is to look beyond the immediate future and identify the framework within which the Society should, ideally, be trading 5-7 years hence.
> The group will have regard particularly for the long-term competitive position of the Society.
> The group will examine and assess the advantages and disadvantages of the present basis on which capital is provided to support underwriting at Lloyd's and consider:
> (a) the tension between the one year syndicate and the need to reserve, plan and invest for the future of an ongoing business; its effect on Lloyd's competitive position.
> (b) the attractions and drawbacks of individual membership and unlimited liability to Names and policyholders and the extent to which the Central Fund and other vehicles lead to the mutualisation of liability.
> (c) the organisation of the capital supporting the underwriting to facilitate an effective response to the fluctuations in the insurance cycle.
> The group should, taking into account the legal, accounting and taxation consequences, recommend a framework for the future and the methods by which it might be achieved. (Task Force Report page 5)

The terms of reference are similar to those presented to the Cromer Working Party in 1968 but the Task Force examines the Society in more detail. The Task Force report is divided into four sections. Section One gives an overview of Lloyd's - its position in the world market and its competitive strengths. Section Two, entitled "Strengthening Lloyd's Capital Base", considers the need for Lloyd's to grow and suggests various reforms to syndicate structure. Section Three concentrates on improving Lloyd's competitiveness and the strengthening of distribution channels. The fourth section of the report proposes a new structure of governance for the Society.

### 2.12.2 Major Recommendations of the Task Force report.

The Task Force suggested solutions for both the short and long term. The report categorised their recommendations under Stage 1 (short term) and Stage 2 (5-7 years).

**Stage 1 reforms:**

(1) **Compulsory high level stop loss**. This is to provide more comprehensive protection for Names whilst retaining the traditional sole trader status. This scheme covers a Name's loss if over a 4-year period, the accumulated loss exceeds 80% of the Name's overall premium limit.

(2) **Strengthening Names' rights.** This is an attempt to give Names similar rights to those enjoyed by shareholders, for example the right to ongoing participation in a syndicate, and also the right to request the Council to replace the managing agent.

(3) **Additional reserving**. The Task Force identified the need to establish equalisation reserves at the level of the individual Name, and the need for a risk premium in the reinsurance to close to compensate the receiving Names for the risk of deterioration on closed prior years of account.

(4) **Increasing the liquidity of the capital base.** Whilst the partly paid nature of Lloyd's capital base is attractive to Names in that it allows them to achieve a second return on their assets, this structure, at times of loss, inevitably comes under stress. The Task Force recommended that criteria be developed for ensuring the accessibility/liquidity of Names' assets for the purpose of both the means test and for the deposit and reserves held at Lloyd's.

(5) **The introduction of Members' Agents Pooling Arrangements (MAPA).** The Task Force suggested that such arrangements will provide a low-cost method for Names to achieve a high level of portfolio diversification.

(6) **Managing old and open years.** The Task Force rejected an idea to mutualise specific losses such as asbestos and pollution, but suggested the best solution was to trade through the losses. The Task Force suggested that CentreWrite, a Lloyd's-owned run-off company, should produce policies which release individual Names from syndicates.

**Stage II reforms:**

1. **The introduction of limited liability capital in the form of Corporate Members.** The Task Force suggested that such Corporate Members would be structured as authorised insurance companies and would participate alongside Names on syndicates.

2. **The introduction of a system of value for syndicate participations.** The Task Force suggested that with a system of value, Names would secure access to syndicates through a market mechanism with supply and demand controlled by price. The Task Force, however, does not address the issue of who owns the reputation of a syndicate.

One of the conclusions of the Task Force (paragraph 4.2) is that to survive in the insurance marketplace, Lloyd's must commit itself to a strategy of real growth in income over a five to seven-year time-frame. In paragraph 4.7 the report states that a contraction in the Lloyd's market would adversely affect the ability of Lloyd's to lead and set terms on business. However, the capacity utilisation of the Society has been falling since the mid 1960s (Figure 1.7). In 1967 over 80 per cent of capacity was utilised; by 1992 this had fallen to just over 60 per cent. This graph suggests that over-capacity, not insufficient capacity, has been a feature of Lloyd's. Indeed, Lloyd's has sufficient capacity to accommodate growth without needing to increase capacity further. Over-capacity was probably a factor in the development of the loss-incurring London Market excess of loss (LMX) spiral.

Chapter 12 of the Report discussed the need for a reduction in costs over the whole market. One of Lloyd's historic competitive advantages was the ability to offer lower premiums than its company rivals due to lower costs. However, this cost advantage has been gradually eroded as Figure 2.1 below shows:

| | **1985** | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Lloyd's** | 29.7 | 28.8 | 30.9 | 33.5 | 35.2 | 38.3 | 36.0 | 32.4 | 31.6 | 32.0 | 31.8 |
| **Top 5 UK Cos** | 30.2 | 29.3 | 29.0 | 29.5 | 30.7 | 31.3 | 31.6 | 31.2 | 30.3 | 30.4 | 31.8 |
| **U.S. Primary** | 28.0 | 27.4 | 26.8 | 27.6 | 27.7 | 25.9 | 25.9 | 26.3 | 26.2 | 25.7 | 25.4 |
| **U.S. reinsurance** | 27.4 | 26.1 | 26.9 | 31.1 | 31.9 | 32.6 | 31.5 | 30.9 | 29.6 | 29.7 | 31.0 |
| **Swiss Re** | 34.3 | 34.1 | 32.4 | 32.5 | 32.0 | 30.2 | 30.2 | 30.5 | 31.3 | 29.1 | 30.3 |
| **Munich Re** | 32.1 | 31.9 | 30.6 | 30.1 | 30.4 | 31.0 | 31.0 | 31.8 | 31.7 | 28.6 | 28.9 |

Figure 2.1: Percentage expense ratios of Lloyd's and various companies.
(Source: Statistics Relating to Lloyd's, 1996).

Figure 2.1 shows that the expense ratio of Lloyd's increased from 1985 to 1991 whereas the expenses of the Society's competitors over that period decreased. Since 1992, expenses are broadly in line with Lloyd's competitors due to the implementation of the recommendations of the Task Force Report which recommended that expense ratios should be reduced to 5.5% of capacity compared to 7.2% of capacity for the 1990 year of account (Task Force report para 12.18). These targets were to be met by a reduction in agents' fees.

The Task Force Report includes a section on strengthening distribution channels; in this chapter the report recognises the need for Lloyd's to penetrate new markets, such as Europe, where it has traditionally been under-represented (para 13.1). The Report states "Achieving these challenging objectives will require meeting clients' needs by delivering a competitive product - competitive both in price and service." The Report did not consider the need for changes in the products that Lloyd's offered but considered how best to deliver the products through cost-effective distribution channels. The Report reaffirmed "Lloyd's brokers' exclusive right of access on mainstream London market business" (para 51), and suggested that the market's need for profitable growth could be achieved through strengthening the market's relationships with its existing brokers, i.e. syndicates should be underwriting more business from their existing brokers. The report recommended:

> ....selective and controlled liberalisation of business placed outside the Room. The imposition of an intervening Lloyd's broker should be relaxed in two areas: under strictly defined regulatory control, service companies should be free to accept business directly from non-Lloyd's brokers on U.K. regional business; Second, where syndicates have established a physical presence in European markets, they should be free to accept business from 'accredited' major European broking groups.

Interestingly the Report suggested that Lloyd's syndicates will need the flexibility to develop a range of distribution approaches in response to the changing needs of customers and that the divestment provisions of the 1982 Act should be reversed.

However, the Report did not discuss whether the introduction of sophisticated information technology such as Electronic Placing Support (EPS) would replace the role of the broker, but it did conclude that in the future brokers would need to rely on risk-structuring skills and fee-based advisory services; a low value-added role as simply conduits of commission-generating premiums would not be sustainable (Task Force Report para 13.20).

**2.13 The Losses at Lloyd's.**

The losses at Lloyd's have arisen from two principal sources. Firstly, asbestos and pollution claims arising in the USA and, secondly, a series of large natural catastrophes affecting Europe and the USA in the late 1980s and early 1990s. The asbestos and pollution claims largely arise from liability policies issued to American assureds during the period from the end of the Second World War to the late 1970s. The insurance industry has been badly affected by the liberal interpretation applied by American Courts to contract wordings (Davies Arnold Cooper, 1992). By late 1991 Lloyd's had paid £1billion on 60,000 individual asbestos claims under policies dating as far back as the 1940s (Chatset Guide to Syndicate Run-Off 1994). The Comprehensive Response Compensation Liability Act in the USA forces American industries to clean up polluted sites and the cost of cleaning up all American polluted industrial sites has been estimated at between $65 and $750 billion and companies are looking to their general liability insurers for reimbursement.

The natural catastrophes that affected the industry over the period 1987 to 1992 were unprecedented in their cost. Indeed, the aggregate catastrophe loss ratio for underwriting years 1990-1992 was 170 per cent (Guy Carpenter, 1994). These losses badly affected the Lloyd's market because of the existence of the London Market Excess of Loss (LMX) spiral. The LMX spiral was created as a result of one Lloyd's syndicate reinsuring the portfolio of another Lloyd's syndicate. The reinsuring syndicate likewise reinsured its portfolio with another Lloyd's syndicate. Thus a spiral effect was created. The LMX spiral was not just wholly a Lloyd's phenomenon but involved London market reinsurers as well such as Sphere Drake, English and American Insurance Company and Kemper Reinsurance Company (UK) Limited. The effect of the LMX spiral was to concentrate Lloyd's losses on to a few syndicates. For instance 66.8% of the Lloyd's loss for the 1989 year of account of £2.06 billion was attributable to thirteen syndicates which underwrote LMX business, one of which (Syndicate 290) produced a loss of £251 million, equivalent to over ten per cent of the total Lloyd's loss (Chatset Guide to Syndicate Run-Off, 1994). The losses arising at Lloyd's bankrupted many Names and forced Names into action groups to take legal action against underwriting agencies. There has been, and continues to be, much media coverage of these losses. The scale of the insolvency of Names is seen in the earmarkings of the Lloyd's central fund. As part of Lloyd's solvency procedures, whenever there is a shortfall in comparing a Name's Lloyd's assets with his or her liabilities at the preceding year end, sufficient central and other assets are identified to enable the Name to pass the Solvency Test and to meet the requirements of the Department of Trade and Industry. As at 31st December 1995 solvency shortfalls amounted to £1,001.2 million. This shortfall was covered by the available assets of the Central Fund and by assets of the Corporation of Lloyd's. Figure 2.2 shows the development of the solvency shortfalls.

| Year | Net assets before earmarkings | Earmarkings | Central Fund balance as at 31st December |
|---|---|---|---|
| 1987 | 254.4 | 24.0 | 230.4 |
| 1988 | 303.6 | 12.9 | 290.7 |
| 1989 | 384.5 | 21.8 | 362.7 |
| 1990 | 376.2 | 30.3 | 345.9 |
| 1991 | 438.0 | 67.9 | 370.1 |
| 1992 | 1,113.0 | 354.9 | 758.1 |
| 1993 | 904.0 | 661.6 | 242.4 |
| 1994 | 737.5 | 1,057.9* | (320.4) |
| 1995 | 540.9 | 1,001.2* | (460.3) |

All figures are in £ million.

**Figure 2.2: The Lloyd's Central Fund.**
Source: Lloyd's annual accounts

* The shortfalls were covered by the available assets of the Central Fund, the net assets of the Society and a credit for part of a double count in respect of losses which are covered by errors and omissions reserves.

The deteriorating position of the central fund reflects the financial problems that Names have experienced. As at 31st December 1994, the earmarkings of the Central Fund exceeded the funds available, so the net assets of the Society, principally the value of the Lloyd's building, were used in order for Lloyd's to pass the solvency test imposed annually by the Department of Trade and Industry.

## 2.14 The Lloyd's Business Plan

The deteriorating financial position of the Names and the resultant formation of Names Action Groups prompted the Council of Lloyd's to publish "**Planning for profit: a business plan for Lloyd's of London**" in April 1993. This business plan sought to give Names, and the insurance industry, a plan for the future of Lloyd's. The two most important features of the Business Plan were, firstly, a strategy to manage the claims arising from years prior to and including 1985 and, secondly, the introduction of limited liability capital. Chapter 3 of the Business Plan stated:

> "The continued losses arising on Lloyd's policies written many years ago are a grave threat to the Society's future. These losses place a great burden on the current membership and make it extremely difficult to attract new capital."

The proposition introduced by the Business Plan was to create a vehicle with sufficient capital in order to manage all the 1985 and prior liabilities of all the syndicates in Lloyd's. The capital for this operation would come from each syndicate reinsuring its 1985 and prior liabilities into the central vehicle, which has been named Equitas. Subsequent to the Business Plan, "**Lloyd's: reconstruction and renewal**" was published in May 1995. This document proposed an expansion of the Equitas project by reinsuring all Names' 1992 and prior liabilities into Equitas.

The Business Plan set out a programme of change to restore Lloyd's to profit. The Council of Lloyd's saw that there were two problems facing the Society: the "old years" problems and the outstanding legal disputes (Business Plan page 3). The aim of the Business Plan was to build a new Lloyd's with more independent regulation, higher professional standards, lower costs, with a strong and growing capital base and with a broader mix of business from new geographic markets. The main recommendations of the Business were as follows:

(1) **Plan for managing the old years problems.** This plan involves the a restructuring process to reinsure Names in respect of their individual liabilities for all Lloyd's policies written up to and including 1985 into a separately-capitalised reinsurance company.

The purpose of this restructuring was to create a "ring-fence" isolating the problems of the past.

(2) **A more independent regulatory regime.** The Business Plan recommended that the regulatory function should operate independently of the commercial operation of the market, as would external regulation (Business Plan, page 30). This would be achieved by a new tripartite structure of governance as suggested by a report published in June 1992 from working party chaired by Sir Jeremy Morse entitled "**A New Structure of Governance for Lloyd's**". The structure would consist of a Market Board and a Regulatory Board both of which are answerable to the Council which is the legislative organ of the Society. The role of the Regulatory Board would be to put in place an appropriate regulatory structure for the market's business; the Market Board would be the driving force in the development of Lloyd's and to be responsible for business strategy. The Market Board should also act as the parent body for all the central services such as premium handling, central accounting, policy issuing and claims handling.

(3) **Reducing costs.** The Business Plan recommended reducing syndicate expenses in order to reach a target profitability for the market of a pre-tax return of 10 per cent on capacity over the underwriting cycle (Business Plan, page 12). This would, in part, be achieved by a mandatory cut in managing agents' fees to Names. The Business Plan also recommended that electronic processing be introduced which would improve policy preparation of new business. The Business Plan suggested that this change would improve the service to customers and brokers and also reduce costs.

(4) **Overall strategy for capital management and the introduction of corporate capital.** The Business Plan recommended that the capacity of the Society should be

managed by the Council who would set an upper limit on capacity for each year (Business Plan, page 52). In this way the Council would be able to prevent the build-up of excess capacity which fuelled the LMX spiral. The most dramatic recommendation was that which admitted incorporated capital to Lloyd's for the 1994 year of account (Business Plan, page 56). The authors of the Business Plan set out their rationale for the admission of incorporated capital thus:

> "....Lloyd's needs to retain critical mass in order to remain an important and influential market, able to lead business and set terms, and it is clear that the alternative to growth is serious contraction. Secondly, the certainty of growth in demand for commercial insurance, particularly in the areas where Lloyd's has special skills, requires a positive response from Lloyd's; in the absence of growth, alternative outlets for the business will develop over time. We believe that some of the necessary growth will come from individual Names but it is unrealistic to expects that adequate fresh capital could come from that source alone." (Business Plan, para 14.2, page 56)

Thus the reasoning behind the admission of incorporated capital was the need for Lloyd's to grow and the supposition that such growth could not be met by the existing Names. This raises the interesting question as to what the capacity Lloyd's should be. The authors of the Business Plan and those of the Task Force Report believed that Lloyd's should grow. However there are underwriters in Lloyd's whom this author has interviewed who believe that such growth will lead to intra-market competition and that capacity could fall into the hands of underwriters who are not competent; one underwriter interviewed stated that the capacity of Lloyd's should be of the order of £6 billion. The Task Force also recommended that Lloyd's should grow in terms of capacity (Task Force Report, para 4.2, page 54) and further rejected the notion that Lloyd's should be a "niche of excellence" in which profitability is the sole concern, and absolute size is irrelevant (Task Force Report, para 4.5, page 56). This author found there were active underwriters in Lloyd's who believed that the future of Lloyd's lay as a centre of excellence and innovation where the size of the Society was not as important as its profitability.

Whilst the Business Plan recommended that Lloyd's should grow in terms of capacity, there was little discussion about how premium income should grow. Chapter 15 of the Business Plan discusses "Business development initiatives" and proposes that Lloyd's should build a position in new markets such as the Far East and Continental Europe. Whilst the strategy to expand into new areas is sound given that the Business Plan had recommended growth in the capital base, there is little discussion about the method of implementing such a strategy. Indeed, since the role of the Corporation and Council of Lloyd's is primarily in the regulation of the market, it could be argued that it is the role of syndicates to develop their strategy rather than the authors of the Business Plan.

### 2.15 Lloyd's Reconstruction and Renewal.

This report, which was written by the Council of Lloyd's, was published in May 1995 and represents an extension of the recommendation in the Business Plan to reinsure the "old years" into a central vehicle. There are four proposals to the Reconstruction and Renewal Plan:

(1) **Acceleration and expansion of Equitas strategy.** In order to resolve the problems of the past, the report recommended that Names be offered the prospect of "finality" i.e. a final reckoning of all their 1992 and prior liabilities and a chance to resign from the Society.

(2) **A £2.8 billion settlement offer.** To assist Names to resign from Lloyd's, the report recommended a £2.8 billion settlement offer which will provide Names with a

comprehensive settlement of all litigation and Names' liabilities up to and including the 1992 year of account.

(3) **"Triple profit release" in Spring 1996.** The report recommended an early release of 1993, 1994 and 1995 profits, to be released simultaneously in Spring 1996. These profits would be released to Names in order for them to meet the costs of "finality".

(4) **Strengthening central finances.** The report recommended that the central finances of the Society should be strengthened by around £850-900 million. It also stated that these funds would be raised as follows: £450 million from Members in the form of a special contribution which could be offset against future Central Fund contributions, £200 million from agents and £200-250 million from the future market.

The Reconstruction and Renewal project was a solution to the litigation which faced Lloyd's from the various action groups that had formed following the losses in the 1988 to 1992 period. The rationale behind Reconstruction and Renewal was to offer each Name a final settlement package which would allow them to resign from Lloyd's. In so doing, the 1992 and prior years would be reinsured into a central vehicle, Equitas, and the ongoing market would be free from any deterioration from these old years.

The Reconstruction and Renewal proposal was written at a time when the Society was experiencing severe financial strain - "....... We have concluded that, unless decisive action is taken, the resources of the Central Fund may be exhausted before the end of 1996." (Reconstruction and Renewal, para 13, page 9). The strain on the Central Fund is a consequence of Names being unable, or unwilling, to finance their underwriting debts. Lloyd's thus faced the prospect that, unless action was taken, the Society could fail its solvency test imposed annually be the Department of Trade and Industry and be unable to pay policyholders' claims.

The Reconstruction and Renewal plan, which was accepted by the members of Lloyd's in late 1996, is a fine example of syndicates and agents cooperating together for the benefit of the whole market. The new Lloyd's which has evolved from this project has a "firebreak" from the old years as well as a new capital structure - a mixture of traditional Names and new incorporated capital.

### 2.16 Conclusion.

The reports commissioned by Lloyd's up to and including the Cromer report, dwelt specifically on regulatory issues. Cromer ventured furthest as the report's brief was to make recommendations as to what should be done to encourage and maintain an efficient and profitable Lloyd's underwriters' market of competing syndicates. The implementation of Cromer's recommendation to relax the means requirements created an increase in the capacity of Lloyd's. However such capacity was under-utilised and as a consequence the LMX spiral was created. The omission from the Cromer report was an examination of methods to encourage more business flow into Lloyd's. Cromer focused on one aspect of the Lloyd's market, namely capital provision, and did not consider the implications of his recommendations, i.e. how the premium income into Lloyd's should grow with the expansion in the capital base.

The Fisher and Neill Reports examined the regulatory aspects of Lloyd's. Fisher examined self-regulation in Lloyd's from the assumption that this was the best method to regulate the operations of the Society. Neill examined whether the regulatory arrangements established under the 1982 Lloyd's Act provided protection for the interests of members of Lloyd's comparable to that for investors under the 1986 Financial Services Act. Both reports made recommendations as to changes in the regulatory system. Neither report examined the business development of Lloyd's.

A key element in the Lloyd's Reconstruction and Renewal plan was to reinsure all Names' 1992 and prior years into a central run-off company called Equitas. In September 1996 Equitas received its authorisation from the Department of Trade and Industry. Equitas is regulated by the Department of Trade and Industry rather than by Lloyd's. The introduction of incorporated capital into Lloyd's has resulted in some capital providers being regulated by two UK authorities - Lloyd's and the Department of Trade and Industry. For instance, the US insurance group CNA has a London branch office, CNA International, which is regulated by the Department of Trade and Industry, and has also provided £25 million of capacity for the syndicates managed by three managing agents (Claremont Underwriting Agency, Tower Managing Agents, and Cox Insurance Holdings) which are regulated by Lloyd's. It therefore seems a reasonable proposition that Lloyd's should be regulated by one body. As the 1992 and prior years are being regulated by the Department of Trade and Industry, this author suggests that the Department of Trade and Industry assume full responsibility for the regulation of Lloyd's.

The Task Force Report was written in the knowledge that Lloyd's was to declare some unprofitable years in the late 1980s and early 1990s. The brief of the Task Force was similar to that of Cromer although the Task Force examined the future of the capital base in more detail as the capital providers, the Names, were experiencing financial problems as a result of the loss-making years. Both the Cromer and Task Force reports saw the need for Lloyd's to grow in terms of premium income and capacity. The Task Force recommended the introduction of limited liability capital and, indeed, this recommendation was reinforced by the Lloyd's Business Plan. The Task Force report, as indeed Cromer, was written from the perspective that Lloyd's needs to commit itself to a strategy of real growth in income. However, there was no discussion as to whether such growth was necessary.

**Proposition One** **Lloyd's should abandon self-regulation and be regulated by the Department of Trade and Industry.**

This proposition was favoured by eighty per cent of senior executives interviewed by this author. One underwriter interviewed suggested that corporate capital providers would only wish to be regulated by one authority if, as well as having a Lloyd's syndicate, they owned a UK registered insurance company. This underwriter remarked that London would not be an attractive place to transact business if there were a dual regulatory system. Another underwriter commented that as the DTI were already regulating the 1992 and prior years, it was not too large a leap for the DTI to regulate the 1993 and post years. Given the scale of losses that Lloyd's has suffered and the inability of self-regulation to prevent the LMX spiral, several underwriters and brokers interviewed suggested that regulation by the DTI would give a positive signal to investors and to consumers that Lloyd's had changed.

## Chapter three: The architecture of Lloyd's and the capital base

### 3.1 Introduction

This chapter examines the nature of the structure or architecture of Lloyd's with special emphasis on the capital base of the Society. An analysis is made of the change in the structure of Lloyd's as a result of the introduction of incorporated capital.

### 3.2 Architecture

Architecture is defined by Kay (1995) as "a network of relational contracts within, or around, the firm". Architecture may be internal, the firm's own structure, and external, its external relationships and networks.

#### 3.2.1 Internal architecture of Lloyd's

The purpose of architecture is to create an environment in which employees of a company can perform to the best of their abilities. Successful architecture should lead to an environment to which talented people will seek to join. The Lloyd's market is not a homogeneous unit, and not all syndicates and agencies have common interests. The single feature is, however, that they all trade in the Lloyd's marketplace.

A syndicate consists of the active underwriter, a deputy to the active underwriter and possibly class underwriters each of whom will underwrite a particular class of business. The active underwriter has ultimate responsibility for the operation of the syndicate. Syndicates are small operating units and even those syndicates that have several class underwriters will often have meetings of the underwriters to discuss the progress of their respective accounts. This is different from a company structure where there are individual underwriting departments and perhaps little liaison between each department. The dynamic of a Lloyd's syndicate is that of a small business - a small number of people working together towards a common goal. Such a structure encourages the individuals involved to be innovative and to respond quickly to brokers' enquiries. An outstanding example of a Lloyd's underwriter is Cuthbert Heath, who in 1887 underwrote the first burglary insurance in response to an enquiry from a broker (Gibb, 1957). Such innovation is still a characteristic of Lloyd's today.

The internal architecture of the Society of Lloyd's is its structure of governance. This was discussed by the Task Force and Morse Reports (1992). The structure of Lloyd's in 1991 at the time of the Task Force is shown in Figure 3.1

At the time of the Task Force, the head of the governance structure was the Council of Lloyd's whose role was the advancement and protection of the interests of Members of the Society in connection with business carried on by them as Members of the Society. The Council of Lloyd's consisted of twelve working members (the Committee of Lloyd's), eight external members and eight nominated members and the roles of the Council covered both regulatory and business issues. Sitting beneath the Council of Lloyd's was the Corporation of Lloyd's which consisted of three major divisions:

(i) **Market Services Group:** This carried the responsibility for the central claims office, the Lloyd's Policy Signing Office and the marketing of Lloyd's.

(ii) **Systems and Communications:** This department was responsible for the development of information technology at Lloyd's and also had responsibility for the infrastructure of the Lloyd's building.

(iii) **Regulatory Services:** This department had the responsibility of regulation of the marketplace - underwriters, brokers and agents.

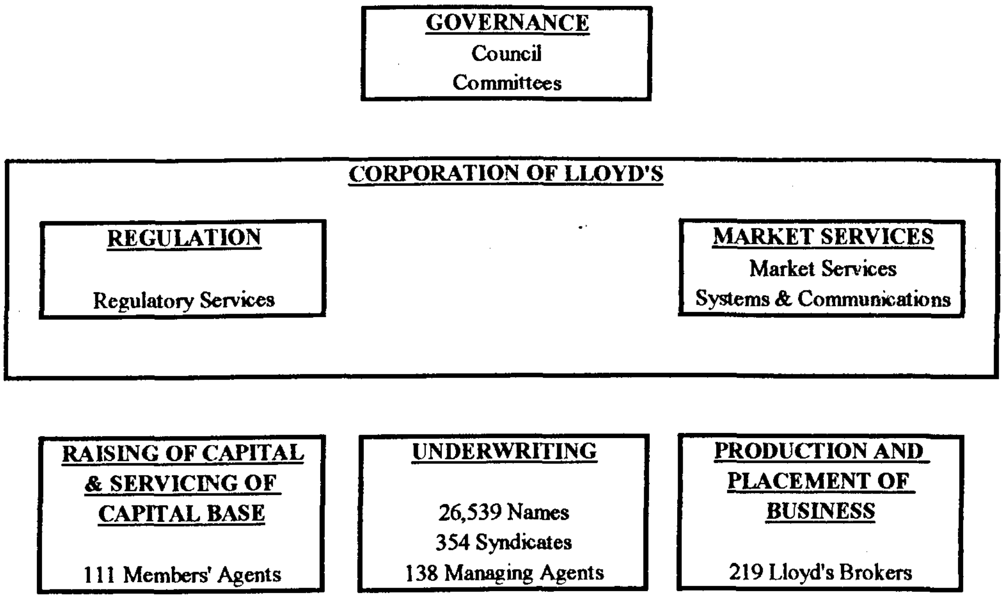



**Figure 3.1: The structure of Lloyd's pre Task Force Report (1991)**
**Source: Task Force Report 1992**

The dual functionality of the Council of Lloyd's was criticised by the Task Force Report as it concluded there was not sufficient independence between the policy-making role of the Council and the execution of regulatory policy. The Report suggested splitting the Council into a Market Board, responsible for all business issues, and a Regulatory Board. The governance of the Society was further discussed by a working party chaired by Sir Jeremy Morse, a nominated member of the Council and Chairman of Lloyds Bank. The Morse working party reported in June 1992 and concluded that the current structure of governance did not accord the right status to either business development or regulation with a perceived tendency for business leadership to be "squeezed out" (Para 2.5 Morse Report, 1992). However, the Morse Report did not suggest what the nature of such leadership should be. The business of Lloyd's is underwriting and thus the business leadership should be held by underwriters and brokers rather than by the Council of Lloyd's which holds no underwriting or broking role. However, the Task Force Report and the Morse Report were written at a time when Lloyd's was experiencing a period of loss-making years and, as a result had been criticised by Names for regulatory failure. Whilst the Walker Report on the LMX spiral did not attribute the development of such business to the constitutional arrangements under which Lloyd's was regulated, the Report did suggest there was a need for a more pro-active stance in the monitoring of compliance of standards set for managing and members' agents (Paragraph 1.12(a) Walker Report, June 1992).

The Morse Report recommended a new tripartite structure of governance. Two limbs of the structure would be concerned with the business and regulatory functions, the Market Board and Regulatory Board respectively. This reflected the recommendations of the Task Force Report. The Morse Report recommended that the Council of Lloyd's should remain as the legislative organ as envisaged by the Lloyd's Act 1982. Figure 3.2 shows the structure recommended by the Morse Working Party. The Morse Report envisaged that the Regulatory Board would be an informed monitor and facilitator, putting in place an appropriate regulatory structure for the market's business; and that the Market Board would concentrate itself on the development of Lloyd's, with its own responsibility for compliance and for making sure that the Regulatory Board is well informed of developments in the insurance market generally

**COUNCIL OF LLOYD'S** (14) (g)

| | | |
|---|---|---|
| 6<br>WORKING (a) | 4<br>NOMINATED | 4<br>EXTERNAL |
| CEO AND HEAD OF REGULATION<br>IN ATTENDANCE | | |

**MARKET BOARD** (15 or 16) (c) (g)

| |
|---|
| 6 WORKING (COMMITTEE) (a)(g) |
| 2 WORKING (UNDERWRITING ASSOCIATIONS) (b)<br>1 WORKING (LUAA) (b)<br>1 WORKING (LIBC) (b)<br>2 or 3 NON-EXECUTIVE (d)<br>CEO (e)<br>2 OTHER EXECUTIVES (i) |

**REGULATORY BOARD** (14) (h)

| |
|---|
| 4 NOMINATED<br>4 EXTERNAL<br>4 WORKING (f)<br>HEAD OF REGULATION (e)<br>SOLICITOR TO CORPORATION (e) |

**NOTES**

(a) To include the Chairman of Lloyd's and two elected deputies.

(b) To be nominated by associations in accordance with their own procedures.

(c) Preferably not more than three broker representatives in all on Market Board.

(d) Appointed by Council; could be external Names.

(e) Ex-officio appointments.

(f) Appointed by Council but not members of Council or Market Board.

(g) To be Chaired by the Chairman of Lloyd's.

(h) To be chaired by nominated member of Council who should have courtesy title of Deputy Chairman

(i) To be appointed by the Chairman of the Market Board, after discussion with the CEO, from amongst senior Corporation personnel.

**Figure 3.2: Recommended structure of the Council of Lloyd's and the Market and Regulatory Boards as proposed by the Morse Report.**

Source: A new Structure of Governance for Lloyd's. Report of the Working Party Chaired by Sir Jeremy Morse. June 1992 and in Lloyd's in particular. The Morse recommendations thus envisaged a more independent regulatory overview of Lloyd's than hitherto had been in place. However, with four market practitioners on the Board there would be some input into the regulatory process from persons with a knowledge of Lloyd's. The Morse Report recommendations go further towards an independent regulatory body than suggested by the Neill Enquiry but do not suggest a totally independent body as is the case with Self Regulatory Organisations formed under the Financial Services Act 1986.

The Morse Report stated that the Market Board "should be the driving force in the development of the Society" (para 6.1). The Task Force Report stated that the Market Board should "lead the market and promote its interests in all matters affecting the business of Lloyd's" and furthermore "be responsible for those aspects of business strategy that need to be decided centrally, and the changes necessary to maintain Lloyd's competitive position" (para 14.11). These terms are far more specific than the powers of the Council as detailed in the Lloyd's Act, 1992, namely:

> "The Council shall have the management and superintendence of the affairs of the Society and the power to regulate and direct the business of insurance at Lloyd's...." (para 6, Lloyd's Act, 1982).

The nature of the business strategy to be decided by the Market Board is not specified in either the Task Force Report or the Morse Report. The Lloyd's market is fragmented and the business strategy adopted by a U.K. household or motor syndicate may be totally impractical for a syndicate that underwrites worldwide excess of loss reinsurance. This author suggests that the role of the Market Board should not be to decide upon a strategy for Lloyd's but to ensure that Lloyd's is an environment where syndicates can adopt differing strategies depending upon their business requirements.

In essence the Market Board should ensure that Lloyd's is a freely competitive environment. The nature of the Market Board could therefore impede the competitive position of Lloyd's if it is too interventionist. The Market Board should allow syndicates to decide upon their own business strategies.

Proposition one recommended that Lloyd's be regulated by the Department of Trade and Industry. If this were effected then there would be implications for the Regulatory Board whose primary function of regulation would be administered by the DTI. Therefore this author suggests:

<u>**Proposition two:**</u> **The current Market Board and Regulatory Board should be replaced by a single Business Development Board.**

Such a proposition was widely welcomed by underwriters and brokers, indeed fifteen of the twenty senior executives who were interviewed agreed with this author's suggestion. There was concern voiced by seven underwriters that, given the recent loss history of the Society, there may be the tendency for the Regulatory Board to interfere with the business of the syndicates to the extent of dictating what classes of business could each syndicate underwrite. This could stifle innovation as underwriters may be prevented from underwriting certain classes of business that do not appear in their Business Plans which are submitted to the Lloyd's regulatory department. This author suggests that a Business Development Board should consist of underwriters, brokers, corporate capital providers and Names' representatives and should focus on new business initiatives and helping syndicates and brokers to achieve their business objectives. An example of the operation of the proposed new Board is the development of Lloyd's Japan Inc. This company was set up jointly by Lloyd's underwriters and the Corporation's Marketing Directorate. The proposition is that this company will be a locally incorporated Japanese subsidiary of the Society owned directly 100 per cent by the Corporation of Lloyd's for a ten year franchise period. Underwriters will participate by virtue of a co-investment agreement which provides rights over profit sharing, governance in a similar way to that of shareholding. Underwriters will only be able to underwrite Japanese direct business by being nominated by a participating managing agent in Lloyd's Japan Inc. The company will underwrite business via various consortium arrangements and each participating managing agent in the company will have access to these consortia.

### 3.2.2 External architecture of Lloyd's.

External architecture is the ability of an organisation to foster relationships between other organisations for mutual benefit. Clearly in Lloyd's the relationship between the syndicates and the brokers is important; indeed, business can *only* be transacted through Lloyd's brokers (Lloyd's Act, 1982 Section 8(3)). The relationship between brokers and Lloyd's underwriters was seen by the Task Force Report to be a source of competitive advantage (Para 3.31, Task Force Report, 1992). This is echoed by Melgard (1978) who states that the success of the Lloyd's and London market "lies in the interrelationship between and close ties between broker and underwriter".

The provisions of Sections 10 and 11 of the Lloyd's Act, 1982 do not allow a Lloyd's broker to own a managing agent and vice versa. Paragraph 12.12 of the Fisher Report referred to three ways in which abuses might arise from a broker's interest in a managing agent:

(i) action contrary to the interests of Names - by the broker applying pressure on an active underwriter of a controlled syndicate to underwrite business contrary to his better judgment; or to write business at premium rates below those he would offer to other brokers, or to give commissions higher than those he would give to other brokers; or to settle claims on terms he would not otherwise agree;

(ii) action contrary to the interests of policyholders - by the broker giving business to a controlled syndicate although better terms were available from other syndicates; and

(iii) action contrary to the interests of the Lloyd's market as a whole - by the broker undermining the principle of competition and, especially if he makes use of his knowledge of other brokers' business in so doing, by undermining the basis of trust on which the market operates.

As it is unlikely that a broker would wish to see his own insurance entity fail, it seems logical that broker ownership of managing agents would encourage better priced business to be shown to the managed syndicate. This would not, of course, be in the interests of policyholders, as suggested by the Higgins Report. However, a freely competitive environment would ensure that the customer achieves a fair price for his risk.

In London in 1995 there were 141 Lloyd's syndicates, 65 companies in the Institute of London Underwriters and 87 members of LIRMA (London Insurance and Reinsurance Market Association). The geographical proximity of the underwriters creates a huge coinsurance market that operates very efficiently. For a risk whose size or unusual features requires several insurers to agree on rates and policy terms, the London market can obtain such coverage in a matter of days. It could take several weeks to transact a similar insurance in the USA with underwriters in several cities and often in different time zones (Frinquelli *et al*, 1994).

Underwriters in London will often know each other's skills and if one underwriter is unable to rate a particular risk, then he is likely to know of an underwriter in London who will be able to progress the broker's enquiry. Talented underwriters build up knowledge that enables them to "lead" the rating and assessment of the risk. Other underwriters with less experience, or perhaps with less risk-bearing capacity, can "follow" the leading underwriter by taking a smaller share of the risk. The result of the architecture of the London market is a risk-transfer system that takes advantage of the best underwriters in the market and spreads that risk among underwriters and companies according to their capacity and appetite for particular types of risk.

One disadvantage of this structure is the geographical distance between underwriters and the risks they are assessing. Whereas international reinsurers will have a series of branch offices and therefore easy access to local knowledge, London underwriters have to rely on professional surveyors to visit and report on risks. Such local knowledge is more crucial in insurance than in reinsurance. During 1994 Lloyd's premium income from the United States Excess and Surplus Lines market was $1,550 million, representing 17% of the market (A.M. Best Company, 1995). Lloyd's has accessed this segment of the US insurance market by granting binding authorities to Managing

General Agents. Essentially Lloyd's underwriters are relying on the knowledge of local underwriters to produce profitable business. Whilst the conditions of the binding authority will restrict the Managing General Agent in terms of the type and scale of risk accepted, it is an arrangement built on trust between the Lloyd's underwriters and the Managing General Agent. Such binding authorities overcome the lack of a branch network, although there is the danger of a "rogue" agent abusing the underwriting authority given to him.

### 3.3 The concept of capital

There are various meanings that can be attributed to the word *capital* depending on the context and the purpose of its use. Dickinson and Roberts (1984) suggest three such uses. Firstly, there is real capital which encompasses the physical assets of the firm. Secondly, capital may be used as a concept in financial theory to describe the value of the firm to the holders of its security. The value of this type of capital is determined within the capital market and its value is determined by profit forecasts, cash flow estimates and political and economic forces. The term "market capital" may be better used to describe this meaning of capital. Lastly, there is the capital which is surplus to an assessment of the current liabilities of the firm; this form of capital may be termed financial capital; Dickinson and Roberts (1984) call such capital "corporate capital" but as this has a particular meaning in Lloyd's, the term "financial capital" is used here. Financial capital may be measured as the difference between total assets and liabilities at any one time. These funds will be used by the management of the firm in pursuing their corporate objectives. Financial capital is equivalent to the policyholders' surplus of an U.S. insurance company. The concept of financial capital is, however, static in that it does not reflect any particular growth paths that the company may wish to follow in the future (Benjamin, 1980). A calculation of financial capital relies on the assessment of assets and a valuation of liabilities. Assets should be valued as closely as possible to their market value and technical reserves should be assessed on a realistic set of assumptions. For an insurance or reinsurance company, the level of assets will be identifiable such as premium funds, investments and property. The total assets will be valued at a certain figure. This contrasts with the position of a Lloyd's syndicate where the assets of the syndicate are the premium trust funds and the members' funds at Lloyd's. The members' funds constitute the members' deposits held at Lloyd's together with special reserves and personal reserves also held at Lloyd's. The member has other assets which are not held by Lloyd's in trust for the member but are declared to Lloyd's via the means test, a valuation of the wealth of the member. A Name's means test is a valuation of the member's wealth which supports his chosen level of Overall Premium Limit (i.e. the amount of premium a Name can underwrite in any one year of account). Thus a Name may well have wealth in excess of that declared in the means test.

An insurance or reinsurance company will have a certain level of assets over and above its liabilities, i.e. it will have a certain financial capital that may be calculated. By contrast, a Lloyd's syndicate will be able to assess its liabilities but will not be able to calculate its financial capital as the assets of the syndicate are not readily quantifiable. These assets comprise the members' total resources and the assets held by each member in excess of their declared means.

The financial capital of an insurance or reinsurance company may be used by the management either to accept more premium income (i.e. more liabilities) or to expand the company such as by purchasing a competitor. Such a transaction may increase the share value of the company. By contrast the financial capital of a Lloyd's syndicate may only be utilised for accepting premium income. Any activity beyond this, such as the purchase of a competitor syndicate would have to be a financial transaction undertaken by the managing agent of the syndicate which are, almost exclusively, limited liability companies. The managing agent's only sources of revenue are profit commissions payable by Names on the managed syndicate and fees charged by the managing agent to the syndicate Names.

There is a growing body of literature about a fourth type of capital - reputational capital i.e. the assessment of the value of a company's brands - its brand equity. A good reputation enhances profitability because it attracts customers to the company's products, investors to its securities, and employees to its jobs. In turn, esteem inflates the price at which a public company's securities trade. The economic value of a corporate reputation can therefore be gauged by the excess market value of its securities (Fombrun, 1996 page 81). There are various methods for assessing the value of a company's brands although none has universal appeal. A method for estimating a brand's value is to make an assessment of the royalty on sales a third party would have to pay to obtain the right to use the name. An alternative approach is to make the assumption that stock market prices incorporate all known information about a brand and fully reflect a company's future prospects. Given this assumption, the value of a brand is its market value over and above the liquidation value of the net assets involved in producing and selling the brand. Given that a company's assets are valued at book value, the excess market value therefore incorporates not only the value of the company's reputation but also the market's best guess about the current market value of those historic assets (Fombrun, 1996 page 91). The market value of a public company reflects its value as an operating enterprise. The excess market value therefore corresponds to the overall regard that the company is held by investors, i.e. a gauge of its reputational capital. The reputational capital of Lloyd's syndicates is discussed in Chapter 6.

### 3.4 The chain of security at Lloyd's

One of the central issues discussed by the Task Force report was the future nature of Lloyd's capital base, indeed Section II of the report is devoted to strengthening the capital base. The main focus of the Task Force's work was to assess the advantages and disadvantages of the basis on which capital is provided to support underwriting at Lloyd's (Task Force Report page 53).

A peculiar feature of insurance is that capital is not needed since premiums are collected first and claims are paid later. The business should enjoy positive cash flow unless claims exceed premiums in which case capital will be called upon. In insurance, capital serves principally to provide reserves for the protection of the policyholders in the event of loss.

In the case of Lloyd's, underwriters will not call for Names to contribute until there is a loss on any particular year of account and capital is needed to fund the loss; then underwriters may call for as much capital as is required. Names at Lloyd's have unlimited liability as a result of their status in English law a sole traders, but only in respect of their own share of a syndicate's loss - a Name's liability is several and not joint. The security of a Lloyd's policy is dependent upon the ability of a Name to meet his or her obligation under insurance policies underwritten by the syndicate.

In accordance with the Insurance Companies Act 1982 all premiums must be paid into a premiums trust fund, on behalf of all policy holders (Section 83 (2)). This fund must only be used for the payment of claims and be held in short-term investments. Lloyd's has three premium trust funds - the U.S. dollar trust fund, the Canadian dollar trust fund and the sterling trust fund. Three years after the inception of a year of account, the active underwriter calculates a closing reserve. Most of the balance in the premiums trust fund will be used to buy a reinsurance policy, known as the reinsurance to close (RITC). The reinsurance to close indemnifies the fund against future claims. The other party with which the reinsurance to close policy is taken out is usually the same syndicate but for the next year of account. If after the calculation of the reinsurance to close there is a surplus in the premiums trust fund, this is distributed to the Names as profit.

If the premiums trust fund proves inadequate to meet the claims on a year of account then the capital in a Name's deposit and personal reserves are called upon. Each Name at Lloyd's is required to place a deposit with the Corporation of Lloyd's pro-rata to his premium income. This percentage ranges from 20% to 50% depending on the level of means shown and the category of the Name (i.e. whether a working Name, one who is employed within Lloyd's, or an external, non-working Name).

A Name's members' agent will normally require the Name to have Personal Reserves, accumulated out of past profits. In addition there are Special Reserves which allow a Name to set aside a small tax-exempt part of his underwriting profits. These reserves and deposits are there to meet losses. If the Lloyd's deposit is used to fund losses then a Name will be required to reduce his Overall Premium Limit (OPL) or cease underwriting until the deposit is made good. If the Name's deposit and reserves prove insufficient to meet his liabilities then Lloyd's will require the loss to be funded from the Name's means.

The Name's underwriting obligations are unlimited. If a Name's means are not enough to meet claims then Lloyd's must turn to the fourth and last line of defence: the Central Fund. The Lloyd's Central Fund was established by a trust deed in 1927 out of a small levy paid by every Name in proportion to his premium income (Hay Davison, 1987). It exists for the purpose of protecting policyholders, so that claims can be met when Names lack means. Essentially the Central Fund mutualises the losses of an individual member onto the whole membership. The Central Fund also provides security for two bonds. One of the bonds is in favour of Lioncover Insurance Company Limited. This insurance company was set up by Lloyd's in connection with the PCW settlement (a compromise settlement between the Corporation of Lloyd's and Names on the PCW syndicates who had been defrauded). The second bond is in respect of CentreWrite Limited which was set up to provide reinsurance for run-off years of account. The bonds may be called upon in the event that each company's liabilities exceeds its assets. As at the 31st December 1993, £30 million of the Central Fund was earmarked in respect of Lioncover's accounts (Global Accounts).

There are thus four parts to the security behind a Lloyd's policy: the premiums trust funds, deposits and reserves, certified means and the Central Fund. These provide the financial resources to back up a Lloyd's policy. Figure 3.3 shows the financial resources of Lloyd's at the 31st December each year from 1982 to 1995. The US and Canadian Trust Funds have been converted to sterling at the rates of exchange ruling at the 31st December for each year.

These four "lines of defence" are subject to two checks: premium income monitoring and the annual solvency check. Gross premium income (i.e. net of brokerage and commission and return premiums but gross of outwards reinsurance costs) is monitored by the Lloyd's Regulatory Department for each of the three open years of account. Premium income is monitored to ensure that the Syndicate's assets i.e. the assets of the Names should cover the risks they undertake. If a Syndicate's premium income exceeds its stamp capacity then, under the provisions of the Syndicate Premium Income Bylaw (Number 6 of 1984), the regulatory authorities of the Corporation of Lloyd's will stop the syndicate from underwriting any further business. Premium income is used by Lloyd's as a measure of risk. However no differential is made between the classes of premium income as the same asset requirements are required by Lloyd's irrespective of the type of premium income (and therefore risk) which a Name is assuming. This

| Year | Premiums trust funds | | | | | | Members' funds at Lloyd's | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Sterling | American | Canadian | U/writers advences in Illinois | Joint asset trust fund | Total technical reserves | (A) Deposit | (B) Personal reserves | (C) Special reserves | Total A+B+C | Other assets | Total members' means |
| 1982 | 1,505 | 2,593 | 151 | - | - | 4,249 | 773 | 119 | 180 | 1,072 | 1,750 | 2,822 |
| 1983 | 1,839 | 3,034 | 178 | - | - | 5,051 | 983 | 170 | 205 | 1,358 | 1,931 | 3,289 |
| 1984 | 2,272 | 4,179 | 273 | - | - | 6,724 | 1,212 | 212 | 231 | 1,655 | 2,268 | 3,923 |
| 1985 | 2,700 | 3,921 | 217 | - | - | 6,838 | 1,582 | 242 | 254 | 2,078 | 2,591 | 4,669 |
| 1986 | 3,224 | 4,707 | 268 | - | - | 8,199 | 2,092 | 273 | 240 | 2,605 | 3,300 | 5,905 |
| 1987 | 3,322 | 4,503 | 271 | - | - | 8,096 | 2,621 | 330 | 215 | 3,166 | 3,256 | 6,422 |
| 1988 | 3,128 | 5,174 | 353 | - | - | 8,655 | 2,831 | 465 | 226 | 3,522 | 3,492 | 7,014 |
| 1989 | 4,531 | 5,206 | 422 | 229 | - | 10,388 | 3,333 | 626 | 298 | 4,257 | 3,700 | 7,957 |
| 1990 | 4,632 | 4,154 | 355 | 177 | - | 9,318 | 3,504 | 621 | 293 | 4,418 | 3,036 | 7,454 |
| 1991 | 6,229 | 4,995 | 343 | 198 | - | 11,765 | 3,744 | 600 | 308 | 4,652 | 2,643 | 7,295 |
| 1992 | 9,418 | 5,774 | 396 | 246 | - | 15,834 | 3,718 | 601 | 178 | 4,497 | 1,880 | 6,377 |
| 1993 | 11,746 | 6,482 | 419 | 244 | 141 | 19,032 | 3,760 | 841 | 117 | 4,718 | 1,749 | 6,467 |
| 1994 | 12,307 | 6,987 | 401 | 229 | 135 | 20,059 | 4,227 | 778 | 73 | 5,078 | 1,487 | 6,565 |
| 1995 | 10,732 | 8,124 | 454 | 237 | 139 | 19,686 | 4,696 | 748 | 55 | 5,499 | 1,259 | 6,758 |

**FIGURE 3.3: SECURITY OF A LLOYD'S POLICY**
All figures in £m as at 31st December

(Source: Statistics Relating to Lloyd's, 1996 edn.)

weakness was recognised by the Lloyd's Business plan which recommended the introduction of risk weighted capital (Section 12.1 page 51).

A second check is the annual solvency test, formerly called the Lloyd's audit. This originated in 1908 when, in response to a scandal in which an underwriter bankrupted several Names, a proposal was issued by underwriters, led by Cuthbert Heath, to the Committee of Lloyd's suggesting that underwriters should produce a certificate signed by an approved accountant that a syndicate's Names were in the possession of assets sufficient to cover their liabilities (Gibb, 1957). Each year Lloyd's issues minimum reserves for each class of business in its first, second, third and subsequent years of development. Underwriters are required to calculate their reserves for both the open and closed years of account with reference to these minima. However, Names must provide more reserves if the pattern of claims warrants it. The calculation of the reserve must be agreed and signed by an approved auditor to certify that a Name has sufficient assets in his premiums trust fund, deposits or personal reserves to cover his liabilities. Any deficiency must be made good before the certificate is signed. Names who cannot provide certificates of solvency are declared to be in default and Central Fund assets are earmarked to cover the deficiency.

Underwriting is the most significant characteristic that defines the Lloyd's market. Underwriting at times leads to intramarket support and at other times to intramarket competition, but its main objective is to make underwriting profit by collecting more in premiums than is paid out in claims. Many of the more arcane and distinctive structural characteristics of Lloyd's were built around the pre-eminence of the art of underwriting and the role of the underwriter. Lloyd's capital structures, the administrative support organisations, accounting conventions and distribution systems, all support and evolved out of the pre-eminence of underwriting.

Lloyd's is a marketplace, not an insurance company, within which approximately 150 entities (syndicates) underwrite all classes of insurance and reinsurance business. This structure has developed over a period of some 300 years and is a model that has been remarkably successful, notwithstanding the 1988 to 1992 loss period. Despite the longevity of the market, this model has not been successfully copied elsewhere in the world.

At the very core of Lloyd's has been the concept of a capital base constructed entirely from individual sole traders, known as Names. Names were the exclusive source of capital at Lloyd's until 1994, when institutional capital (Corporate Capital) was permitted to invest in Lloyd's. Under English law, this sole trader status confers on the individual unlimited liability for any losses incurred, but also provides for considerable tax advantages, leading to high returns in times of profitability. Becoming a Name is open to anyone who has the required means. However, a potential Name has to be sponsored by existing Names. Names are "underwriters" by virtue of their sole trader status.

A unique feature of the Lloyd's capital structure is the annual venture. Before the commencement of each underwriting and calendar year, the constitution of the syndicate - a list of capital providers who wish to support the syndicate - is established for that year although the final result of the year will not be declared until three years after the start of the underwriting year. For example the underwriting year 1996, which relates to all policies underwritten during the twelve months beginning 1st January 1996, will not be "closed" until 31st December 1998. Once the year is "closed" then all the profit is distributed to the Names, or any underwriting loss on the year of account is collected from the Names. With agreement of the managing agency, Names select how much premium income or "capacity" they wish to receive from each syndicate, and the aggregate total pledged by all the capital providers gives the total premium income, the capacity, for the syndicate for the forthcoming year of account.

At the end of each calendar year, there is, in effect, a liquidation of the capital base and a recapitalisation of all the syndicates. New capital may wish to join for the following year of account thereby increasing the capacity of the syndicate. Alternatively, capital may wish to withdraw in which case the capacity of the syndicate will fall. At the end of the three year period, an underwriting year of account is "closed". The underwriter makes an assessment of the liabilities of the account to run-off to extinction and this is charged to the Names on that particular year of account. This reserve is known as the "Reinsurance to Close" (RITC). The RITC is transferred to the oldest open year of account and the transferring year will then be closed. Any surplus profits are distributed to Names and likewise any loss on the year of account is collected from Names. There is thus no retained surplus within any Lloyd's syndicate, as total profit and loss to capital is declared annually and either distributed to or called from its capital providers, the Names. "Surplus" is in the deposits and assets of the capital providers.

The main disadvantage of an annual venture is that managing agents are unable to plan ahead as the capital base could, in theory, decide to leave the Lloyd's market. This poses a problem when policyholders are seeking multi-year contracts. In reality, a profitable well-run syndicate will not have a problem in maintaining its capital base from year to year; an unprofitable syndicate, however, will lose its Names. A disadvantage in the annual venture is in investment strategy and asset/liability matching which require multiple-year planning - a difficulty for syndicates to achieve. The advantage of the annual venture is that syndicates have to justify themselves to the capital base each year - poorly performing syndicates will not be able to retain their capital base. The annual venture means that the capital base is very fluid and can thus respond to opportunities in the market. The annual venture allows syndicates to expand their capacity when rates in the market are high, and thus profits are able to be made, and conversely to contract their capacity when rates are depressed . Consequently, the annual venture allows syndicates to be counter-cyclical to the insurance market outside Lloyd's. The introduction of "permanent" capital could lessen the pressure to maintain quality results.

The capital base, representing the sum of the assets of the underwriting Names, is dedicated to the Lloyd's market, although it may move between syndicates within the Lloyd's market. Lloyd's syndicates only compete with capital with each other; they do not compete with the capital markets at large. This situation could change with the introduction of corporate capital.

There is a certain kudos in being a member of Lloyd's, like that associated with being a member of an exclusive club. This apart, however, there are sound financial reasons for wishing to be a member:

**(1) Partly paid capital base:** A major attraction of membership at Lloyd's is that individuals may participate in the market on a partly-paid basis. Rather than buying shares in an insurance company, individuals must show wealth of at least £250,000; however only 30% of these funds need to be held at Lloyd's (i.e. to constitute the member's deposit). Each prospective candidate for membership has to undergo a Means Test. Assets, which currently qualify for Means Test Purposes are divided into two main groups:

**(A) Assets which must constitute not less than 60% of Means Test**

(i) Stock Exchange Quoted Securities.
(ii) Cash at Bank or Building Society.
(iii) Surrender Value of Life Policies.
(iv) Absolute reversionary interest in Trusts at market value, calculated on an actuarial basis.
(v) Bank Guarantees, Insurance Company Guarantees, Letters of Credit.
(vi) Gold at 70% of its market value, subject to certain conditions.

**(B) Assets which must not exceed 40% of the Means Test**

(i) Homes other than the Candidate's principal residence, are permitted at market value, less any outstanding mortgage or loan.
(ii) All commercial property at its market value, less any outstanding mortgage or loan.
(iii) Farmland at its market value (excluding the value of the house, if the house is the principal residence), less any outstanding mortgage or loan.
(iv) Leasehold property, subject to certain conditions.

**(2) Highly leveraged returns.** In addition to allowing capital to be partly paid, Names also benefit from having their assets "work twice". For example if some of the Name's assets are in land or in commercial property, these could be earning an income whilst backing a Name's underwriting at Lloyd's. Similarly, assets that are deposited at Lloyd's such as securities or cash will earn a return in addition to supporting a Name's underwriting.

**(3) Gearing or leverage.** Names are required to deposit 30% of their overall premium limit as funds at Lloyd's. This means that if a Name achieves 10% return on capacity, this equates to a 33.3% return on the funds at Lloyd's in addition to the investment return earned on the deposit.

**(4) Tax advantages.** As Names have sole trader status, they may pool gains or losses from underwriting against other income to reduce tax liability. However, whilst sole trader status accords the Name favourable taxation status, the Name also has unlimited liability for any losses on underwriting.

### 3.5 The Introduction of corporate capital at Lloyd's.

The total losses declared by Lloyd's for the years of account 1988 to 1992 were £8.7 billion. Lloyd's declared a profit of £1 billion for the 1993 year of account and similar profits are expected for the 1994 and 1995 years of account (*pers comm* a Members' Agent). This loss-making period has been compared with the years 1964, 1965 and 1966 which all produced losses as a result of Hurricane Betsy which hit the Eastern Seaboard of the USA in 1965. However, by the 1969 year of account Lloyd's had recouped these losses. Lloyd's does not possess statistics relating to its capacity at the time of Betsy, but if an estimate of £450 million is made then the 1964 loss equated to 0.22% of capacity, the 1964 loss 7.7% of capacity and the 1966 loss 3.6% of capacity. Such losses are containable and indeed the capacity of Lloyd's grew steadily after this period. By contrast the 1988 year of account loss equated to a 4.63% loss on capacity, the 1989 result a 18.83% loss on capacity, the 1990 result a 26.33% loss on capacity and the 1991 result a 17.99% loss on capacity. These losses forced some Names into bankruptcy and led to the formation of Names' action groups in order to pursue legal remedies for their pecuniary losses against managing and members' agents e.g. the Gooda Walker action group, the Devonshire Names' action group.

The losses were the impetus for the formation of the Task Force and its subsequent report and the follow-up documents, the Business Plan and the Reconstruction and Renewal Plan. The losses gave Lloyd's a great deal of adverse publicity as some Names became bankrupt and others, faced with the prospect of mounting losses, committed suicide. There were 31,945 Names as at the 1st January 1993 of which 19,537 were active (Statistics Relating to Lloyd's). The remaining 12,408 Names had open years (i.e. run-off years of account) and could not leave Lloyd's until such times as the open years were closed. As at the 1st January 1988 Lloyd's had 32,433 active Names (Statistics Relating to Lloyd's). Thus in five years the number of active Names had almost reduced by one-third. With the decline in the number of Names came a drop in capacity from a maximum of £11,382 million in 1991 to £8,878 million in 1993, a drop of 22 per cent. As the Task Force report proposed that Lloyd's should grow, it was necessary to find a new source of capital. The Task Force report stated (page 64 para 5.18) that it would be optimistic to assume that the current Names could provide all the required growth, especially given that one quarter of Names were over 62 years old. A central part of the Business Plan was the proposal to introduce incorporated, limited liability, capital in additional to the existing unlimited liability capital base.

### 3.6 Lloyd's New Capital Structure.

As a result of the reduction in Lloyd's capacity from £11.382 billion for the 1991 year of account to £8.878 billion for the 1993 year of account, the Task Force Report concluded that:

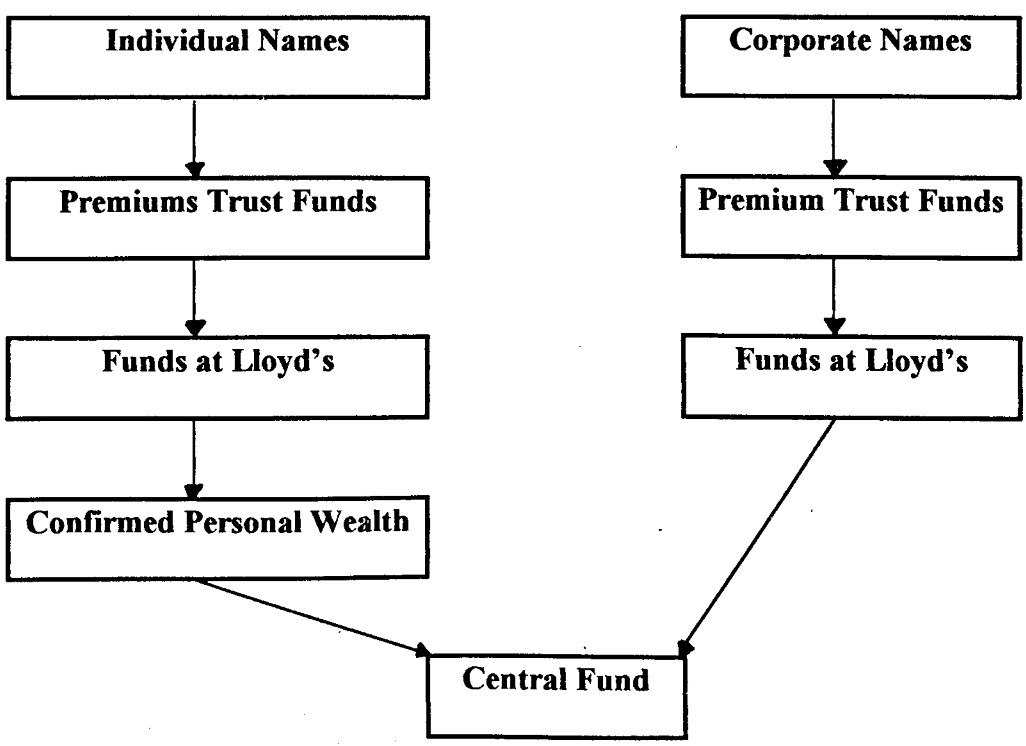
> ".... the Society should commit itself now to a strategy of real growth in income over the next 5-7 years. This will necessitate stable real growth in capacity......" (Section 4.1 page 54).

The Report concluded that the retraction in Lloyd's capital base could not be allowed to continue and that further shrinkage would increase concerns surrounding the continued security of a Lloyd's policy, impair its ability to set terms and lead business, increase the relative burden of the old year claims arising from asbestos and pollution, limit the Society's resolve to achieve cost control and, finally, adversely affect the dynamism of the market (Section 4.7 page 56).

This author suggests that the concerns voiced in the Task Force Report are not all material. A decrease in the capital base of Lloyd's does not give a positive message to the worldwide insurance and reinsurance market especially in the USA where growth and expansion is a part of business philosophy. However, this viewpoint depends on viewing Lloyd's as a single entity. Purchasers of Lloyd's policies have, recently, become more interested in the composition, in terms of individual syndicates, of the security supporting their policy especially as the rating agency Standard and Poor has devised a rating system for Lloyd's syndicates. The ability of Lloyd's to set terms and lead business is not dependent on its size but rather the skill of its underwriters and the added value it gives to the risk transfer process as opposed to its competitors. The Task Force states that Lloyd's has to be able to grow if it is to trade through the overhang of old years' claims arising from asbestos and pollution. The Reinsurance to Close mechanism offers Names the ability to exit a syndicate but it does result in the oldest open year of account assuming all the liability from all the closed years hence Names pay for losses on years of account on which they had no participation. This is of no concern to Names if the Reinsurance to Close is an adequate assessment of the liabilities, but under-reserving results in current Names incurring losses on years of account in which they had no original participation. The Task Force assumed that the way to deal with this problem was for Lloyd's to grow and in effect to 'dilute' the problems of the old years. The Lloyd's Business Plan and the subsequent Reconstruction and Renewal Plan suggested that the old years (1992 and prior) should be closed into a single run-off company, Equitas. This has the benefit of closing any syndicates that have open years prior to and/or including 1992 into a central fund - essentially Equitas mutualises the liabilities of Lloyd's. Thus the Business Plan has effected the solution to this problem independent of the need for Lloyd's capacity to grow. Section 4.7 of the Task Force Report suggests that a decline in capacity would "adversely affect the dynamism of the market, and its attractiveness to entrepreneurs." If Lloyd's is viewed as a market where insurance expertise thrives and profits are made, then the size of the Society should not matter in order to attract the best underwriting talent. Indeed, it could be argued that if Lloyd's decreased in size the available capacity would fall to the most competent underwriters. Interestingly, the Task Force Report dismissed the suggestion that Lloyd's should become a "...small niche of excellence in which profitability is the sole concern, and absolute size is irrelevant" (Section 4.5, page 56). This author found that of those underwriters who were interviewed five believed that the capacity of Lloyd's should fall to a level of about £6 billion. This would prevent some intra-Lloyd's competition and result in the capacity being in the hands of competent underwriters. In this way Lloyd's **would** become a niche of excellence.

The Business Plan set a target figure for capital of £10-12 billion by 1997 (Section 12.3 page 52). The authors of the Business Plan were aware of the effect that the implementation of the proposals of the Cromer Report had had on capital, and the need to ensure that capital was not increased so as to lead to the over-capacity problems of the mid to late 1980s. The Lloyd's Business Plan recommended the introduction of limited liability capital as had been discussed some twenty years earlier by the Cromer Report. From the 1994 year of account onwards there was to be a new capital structure at Lloyd's consisting of the existing unlimited liability Names and limited liability incorporated Names as shown in Figure 3.4 below.

**Figure 3.4: Lloyd's capital structure from 1994 onwards.**



From the 1994 year of account onwards, Names fall into five categories:

(a) High liquidity Names. These are Names with liquid assets of at least £500,000. Names in this class will be allowed to participate in the market on a 20% ratio of funds at Lloyd's to overall premium limit, subject to a minimum deposit of £200,000 and requirements that they show means of at least 50% of premium limit and reconfirm annually.

(b) Names with means of at least £250,000 but less than £500,000. These Names are required to lodge 30% of their premium limit at Lloyd's.

(c) External Names with means between £100,000 and £250,000 or vocational Names (i.e. Names working at Lloyd's) have to deposit 40% of their overall premium limit at Lloyd's subject to a minimum of £25,000. Overall premium limits range from £50,000 to £600,000.

(d) Members with means less than £100,000 or vocational Names with nominal means are required to deposit 50% of their overall premium limit at Lloyd's. The overall premium limit for these Names must not exceed £190,000 and for vocational Names the overall premium limit must not exceed £100,000.

(e) For working members only there is a special category of membership which obviates the need to show any level of personal wealth. However, such Names must put 50% of the premium limit into funds at Lloyd's. This category of Name cannot underwrite more than £100,000 in premium income in any one year of account.

To assist members with limit premium levels in achieving some diversity of risk across syndicates, the Business Plan provides for the establishment of Members' Agents Pooling Agreements (MAPAs). Baillie-Hamiliton (1988) has demonstrated that the probability of a severe loss declines as the number of Syndicates in a Name's portfolio increases. A MAPA involves a members' agent combining all syndicate participations in a single pool. Names have a share in the pool rather than in an individually constructed (bespoke) portfolio. For the 1995 year of account approximately 40% of Lloyd's capacity is from MAPA names (*pers comm* a Members' Agent). Each MAPA must contain at least thirty syndicates and within that MAPA no one syndicate can constitute more than 7.5% of the MAPA's capacity. As Lloyd's is a subscription market if a Name underwrites through a MAPA he could well be on the same risk several times. In the event of a claim on that risk a Name could be in a worse loss position through a MAPA than through a bespoke portfolio. It is essential therefore that the MAPA offers a Name a portfolio of types of syndicate (marine, non-marine, motor, aviation and life) so that the Name achieves a diversification of risk. As a MAPA contains a number of syndicates, the profitability MAPA will tend to "mirror" the results of the overall market. It will only be possible to achieve higher than average returns if the Name's portfolio is bespoke. However such a bespoke collection of syndicates could achieve results worse than the market average.

In order to meet the Council's target of £10-12 billion of capacity, the formation of limited liability corporate capital was considered necessary. The reasoning behind this strategy was because of past losses the number of names was decreasing and those that remained were ageing. However the resilience of the names to remain trading in Lloyd's has been remarkable (Figure 3.5). Indeed for the 1994 year of account Names' capacity increased over the previous year and with over £1.5 billion from corporate investors, Lloyd's capacity increased by 24% to £10.9 billion. Whilst the number of members has more than halved since 1990, the average underwriting capacity of the names has increased by over 40% from £373,000 in 1990 to £525,000 in 1996. Corporate capital is providing an increasing proportion of the capacity at Lloyd's - from 15% in 1994 to 31% in 1996. Thus the enthusiasm of professional investors for Lloyd's is keen but the traditional capital base is proving more resilient than some commentators have forecast. The traditional base is likely to fall away once Equitas is operational and Names are presented with the finality quotes. However, given that many Names are still trading after the loss making period would suggest that they may continue for some time. However, this author proposes:

**Proposition three** **Over a ten year period all natural Names will incorporate and the capital base of Lloyd's will consist of entirely incorporated, limited liability capital.**

All the senior executives interviewed agrees with this proposition, although one underwriter suggested that Lloyd's would have a two tier capital structure with corporate capital and high limit 'natural' Names i.e. Names of considerable personal wealth who underwrite at least £1,000,000 each. Given that unlimited liability has caused so much financial loss to Names, the option to participate on a limited basis in Lloyd's would seem attractive. The corollary to the expected decline in the number of natural Names is that there will be fewer Members' Agents in the future. Indeed one Members' Agent, Ashley Palmer and Hathaway Ltd has closed and transferred its Names to Stewart Members' Agency which in turn has amalgamated with Kiln Cotesworth Members' Agency.

| Year of account | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| Names (£m) | 10,743 | 11,063 | 9,833 | 8,784 | 9,303 | 7,838 | 6,950 |
| Corporate capacity (£m) | | | | | 1,595 | 2,360 | 3,044 |
| Total Capacity (£m) | 10,743 | 11,063 | 9,833 | 8,784 | 10,898 | 10,198 | 9,994 |
| Change % | +1.1 | +3.0 | -11.1 | -10.7 | +24.1 | -6.4 | -2.0 |
| No. of Names | 28,770 | 26,539 | 22,259 | 19,537 | 18,117 | 14,800 | 12,800 |
| Av. capacity of Name (£000) | 373 | 417 | 442 | 450 | 513 | 530 | 525 |

**Figure 3.5: Lloyd's allocated capacity 1990-96.**
**Source: Lloyd's quarterly business report**

The initial requirements, developed in 1993 for corporate members, restricted corporate members to supporting syndicates on a passive basis in the same way as individual members.

The principal requirements enforcing this were:

- the control requirement: a prohibition on the control of a managing agent by a corporate member, insurance carrier or Lloyd's broking group;

- the diversification requirement: no more than 20% of a corporate member's overall premium limit (OPL) could be allocated by a corporate member to a single syndicate;

and - the concentration requirement: no more than 25% of a syndicate's capacity could be provided by any one corporate member group and no more than 50% of a syndicate's capacity could be provided by corporate members in total.

These requirements forced corporate members to participate through a spread of syndicates. For the 1994 year of account some £900 million of capital was raised by 25 corporate member groups to support £1,594 million of capacity. These spread vehicles were investment trusts that raised capital by issuing shares on the London Stock Exchange. A major attraction of investing in the Lloyd's market was the creation of Equitas which, at that time, was to provide a "ring fence" to shield providers of capital trading in years of account 1994 and following from claims on policies from prior to 1992. The maximum OPL for corporate members in Lloyd's was limited to twice the corporate member's funds at Lloyd's.

In 1994, some dispensations to the diversification requirements were granted by Lloyd's in response to commercial demands of corporate members who sought to focus their participation on a narrower range of syndicates managed by a single managing agent. This facilitated the evolution of dedicated vehicles and, in a few cases, the segregation of the corporate member's participation into its own syndicate set up in parallel to the existing syndicate, for instance Syndicate 322, J.D.P. Barnes and others has a parallel corporate syndicate, Number 2322 for which the capital backing is wholly from Frankona Reinsurance Company.

For 1995, Lloyd's maintained the rule that the corporate member was not permitted to gain control of the managing agent, and shareholdings in the managing agent held by companies related to the corporate member were restricted to less than 25%. The total corporate participation in Lloyd's for the 1995 year of account was £2,364 million, 23% of the total capacity of Lloyd's.

In the summer of 1995, the Council of Lloyd's revoked the majority of the concentration and diversification requirements for 1996. Also, the control requirements were relaxed allowing common ownership of corporate members and managing agents. Thus corporate capital providers could have direct control of the management structure of a managing agent rather than just being a capital provider.

A leading example of an integrated vehicle, incorporating both capital provision and managing agency in a single structure is the marriage between Brockbank Underwriting Agencies and Mid Ocean Re, a leading reinsurer based in Bermuda. £50 million in new capital has been raised to support two new corporate parallel syndicates writing alongside existing Brockbank syndicates. In addition, Mid Ocean Re will hold a controlling 51% share in the new expanded Brockbank group, the remaining 49% will be held by Brockbank. (Howard, 1996).

USF&G Corp of Baltimore, USA has established a syndicate in Lloyd's for the 1996 year of account. Through a new wholly-owned subsidiary, known as F&G UK Underwriters Ltd, the American insurer is the sole corporate member of Lloyd's syndicate 1211. At the same time, USF&G has formed a new managing agency, to manage the operations of the corporate syndicate (National Underwriter, 1996b).

These moves by insurers into the Lloyd's market have been matched by one Lloyd's dedicated corporate member to acquire a DTI insurer operating outside the Lloyd's market. Hiscox Dedicated Capital is to pay £30.1 million for the Economic Insurance Company, funded by an issue of ordinary shares. This will allow the Hiscox syndicates a cost-effective method to underwrite provincial personal lines business (Collison, 1996). A corporate member of Lloyd's has to deposit 50% of its OPL as funds at

Lloyd's (Corporate Participation at Lloyd's, May 1996). This will give the corporate member a minimum 50% solvency margin before reinsurance, assuming that the capacity is fully utilised. By contrast a DTI registered insurer only has to have a solvency margin of 40% net of reinsurance. Hence the Hiscox Group will underwrite personal lines through Economic Insurance Company and international reinsurance business through its Lloyd's syndicates.

An important feature of Lloyd's for new corporate capital, and indeed all investors in Lloyd's, is the separation of old liabilities into a run-off company, Equitas Reinsurance Limited. The formation of this run-off company effectively mutualises all 1992 and prior liabilities. Equitas "ring fences" corporate capital and Names from any deterioration on policies written prior to 1993. By pooling all the old year liabilities Lloyd's can strive for a level of provision that is consistent across all syndicates. This author suggests that, if at some future point, Equitas was under financial strain then other world-wide reinsurers and insurers would be under a similar strain and thus an industry-wide solution to such a problem would have to be found. By pooling all its old liabilities, Lloyd's will be able to effect block commutations with any one reinsurer for the whole market and will have much more influence in agreeing the quantum of any claim rather than this being negotiated piecemeal by each syndicate. The separation of the old liabilities from the continuing market will give Lloyd's a competitive advantage over its competitors. Investors and policyholders will not be concerned with any deterioration on old years which might affect the financial position of a syndicate. The US company Cigna Corporation has copied the Equitas model by proposing a "good bank / bad bank" scenario. Cigna sought permission from the regulatory authorities in Pennsylvania during early 1996 to restructure itself into two main subsidiaries - one inactive to run off costly claims, the other active to manage Cigna's healthier continuing operations. The Pennsylvania Insurance Department has given its approval for this restructuring (Snyder, 1996).

**3.7 Recent structural changes in Lloyd's.**

The following is a list, in no particular order, of some of the structural changes that have occurred in Lloyd's since the introduction of corporate capital in 1994:

(i) Terra Nova Holdings Ltd of Bermuda has acquired the ongoing business of Octavian Syndicate Management Ltd which manages five syndicates. The transaction involves creating a new managing agency for 1996 and beyond. It also allows for the provision of additional corporate capacity to each of the five syndicates. The five syndicates are: Non-marine syndicate 702, Aviation syndicate 959, Marine syndicate 1009, Marine syndicate 329 and Abbey motor syndicate 554. (National Underwriter, 1996a)

(ii) The most recent shift in capital structures comes from the largest limited liability spread vehicle, LIMIT plc, which is proposing to purchase majority shareholdings in two substantial managing agencies. LIMIT will acquire a majority stake in Bankside Syndicates Ltd., which manages eight syndicates with a combined capacity of £403 million. The investment trust will also take a controlling interest in Janson Green Ltd., which manages three syndicates with a total capacity of £345 million. (Moore and Morton, 1996).

(iii) In order to form a Lloyd's integrated vehicle, the Murray Lawrence Group have agreed to merge their business with Masthead Insurance Underwriting plc.

(iv) Aon Corporation are in the process of acquiring 49% of the shareholding of Jago Managing Agency.

(v). St Paul Companies Inc have acquired a 100% economic interest in the Gravett and Tilling Group and Cassidy Davis Group.

(vi) Murray Lawrence and Partners are to merge all their syndicates to merge into one umbrella syndicate number 2001 for the 1997 year of account.

(vii) The board of Methuen Underwriting Limited have agreed in principle to amalgamate some, or all, of their syndicates into one umbrella for the 1998 year of account. Bermuda based excess liability insurer ACE Ltd has acquired a 51% stake in Methuen Group Ltd with an option to purchase the remaining 49%. Methuen Group is the holding company for Methuen (Lloyd's Underwriting Agents) Ltd. As part of the agreement, ACE has agreed to provide an additional £50 million to help support underwriting by Methuen syndicates in 1997 and subsequent years.

(viii) Spreckley Villiers Burnhope and Co Ltd have signed a letter of intent with Aon Corporation to acquire a shareholding in the company.

(ix) Mid Ocean Ltd has purchased a £50 million stake in the Brockbank Group. Under the terms of the arrangement, Mid Ocean will provide £50 million of capital for two new dedicated corporate vehicles, which will operate in parallel with the Brockbank Group's three existing syndicates. One dedicated vehicle will write personal lines, while the second dedicated vehicle will concentrate on all other classes written by the Brockbank syndicates.

(x) Instead of buying an interest in an agency, CNA Corporate Capital Ltd, a subsidiary of CNA International, is providing £25 million of capacity for three managing agencies: Claremont Underwriting Agency; Tower Managing Agents, part of the Archer Group plc; and Cox Energy and Marine, part of Cox Insurance Holdings plc. Under the arrangement four dedicated corporate capital syndicates are to be set up to run in parallel with the existing syndicates of these agencies.

**3.8 Corporate capital and its influence on the structure of Lloyd's.**

The report published by Lloyd's in May 1994 entitled "Value at Lloyd's" linked the value of syndicate participations with the replacement of the current "annual venture" with a system of permanent capital. One theme of the report was that syndicate members could assign their future participations in a syndicate to a corporate member in exchange for shares, other securities or cash (Value at Lloyd's page 35 para 10). The corporate member would either support a spread of syndicates or would be a one member "corporate" syndicate. The report argues that a one member "corporate" syndicate would no longer be required to perform a reinsurance to close and would be able to undertake annual accounting (Value at Lloyd's page 35 para 10). Furthermore such a scheme would, the report states, resolve some of the competitive disadvantages of the annual venture system; in particular, a "corporate" syndicate would retain its earnings at syndicate level and offer the possibility of merging the business of the managing agent with the business of the syndicate (Value at Lloyd's page 35 para 10.1). The report goes on to say that the disadvantages associated with an annual venture, namely the costs of raising and servicing the Lloyd's capital base, which the report estimates to be £100 million (Value at Lloyd's page 38), and the difficulty of managing a business where the underwriter does not know his capital for the next year, would be solved. However, the structures of a corporate syndicate - essentially an insurance company - and a Name are different. A Name's underwriting is supported by the Lloyd's deposit and this deposit is "locked" until the year of account is closed. If a Name were offered shares in a corporate syndicate then he could either resign and wait until his deposit is released in order to buy the shares, or alternatively, commit more funds to Lloyd's. The report argues that a corporate syndicate would not have to calculate a RITC as all the liabilities would remain within the same syndicate. Whilst the calculation of the reinsurance to close is a major aspect of an underwriter's job, it is difficult to see how this is any different from the calculation of a year-end balance sheet for a limited liability insurer.

The introduction of corporate capital has altered the nature of the capital base of Lloyd's. It is no longer the case that Lloyd's needs individuals to provide capital but institutional investors may now enter the market. There are both spread vehicles and dedicated corporate vehicles. A spread corporate provider needs to have access to many syndicates but with the advent of dedicated capital the choice of syndicates available to a spread vehicle may, in time, become restricted.

The introduction of corporate capital opens up the Lloyd's market for new investment opportunities and allows the skills of Lloyd's underwriters to be utilised by new capital providers. For instance building societies request that the mortgagee insures the mortgaged property. The building society will arrange this insurance through its panel of insurers. The building society receives a commission from the insurer but the insurer retains the underwriting profit. A building society could invest capital into an existing Lloyd's syndicate or could form its own dedicated syndicate. The building society would then insure its mortgages' properties with the syndicate. The building society would the retain both the commission and the underwriting profit. There are syndicates in Lloyd's that are purely insurers of UK household business such as Syndicate 1191 (Boardman, Cunningham and Poland), thus the expertise exists in Lloyd's for such a proposal to occur.

Corporate members of Lloyd's provide £3.04 billion of capacity for the 1996 year of account, almost 30% of the total capacity. It seems, at first, perplexing that a market that has declared some £7.9 billion (pre-tax) of losses between 1988 and 1992 should be attracting investment. The Lloyd's guide "Corporate Participation in Lloyd's" states that some of the attractions of participating in the Lloyd's market are:

> "- access to underwriters who set the rates and terms on two-thirds of the business written in the London market;
> - ability to write direct insurance business in over 60 foreign states and territories;
> - an unrivaled brand name, despite recent losses, based on a reputation for always paying valid claims;
> - a market which has returned to profit (profits of over £2.5 billion are projected on the 1993, 1994 and 1995 years of account)."

These are no doubt powerful reasons to be investing in the Lloyd's market, however this author does not believe any of these reasons as being the primary influence in attracting investment into Lloyd's. London is, primarily, the world's centre for international reinsurance business. Before the introduction of corporate capital into Lloyd's, an insurer or reinsurer that wished to underwrite London market business had to set up an office in London. This required DTI registration and approval. A corporate syndicate need only have a minimum funds at Lloyd's of £500,000 (or £1.5 million if a US corporate member). The funds at Lloyd's must be 50% of the corporate member's overall premium limit. Lloyd's allows funds at Lloyd's to be provided in a number of forms such as cash, gilts letters of credit and bank guarantees.

Thus for a modest investment of just £500,000 a capital provider will have access to London market business. The capital provider will also be able to use the Lloyd's Policy Signing Office for processing premiums and the Lloyd's Claims Office for agreeing claims on behalf of the syndicate, the basic infrastructure of the Lloyd's market. The corporate syndicate will also be situated in the underwriting room in Lloyd's so that brokers will be able to have very easy access to the syndicate. This is in contrast to a new company that will have to market itself to the broking community. Setting up a corporate Lloyd's syndicate, or investing in an existing syndicate, is a cost effective way to access London market business.

One of the greatest advantages of Lloyd's is the worldwide licenses to trade. For three hundred years Lloyd's has been at the heart of the marine insurance industry. Informal business arrangements were gradually turned into centralised formal licences, so that individual syndicates did not have to negotiate independently with local regulators. This has the advantage of deriving considerable economies of scale. By having a common formula for security across all Names and corporate capital providers, Lloyd's is able to be licensed as a single entity. Furthermore the security of all policies issued by Lloyd's is backed up by the mechanism of the central fund to which all Names and corporate capital providers subscribe. The full list of the territories in which Lloyd's has either full or conditional licenses to trade is shown below in Figure 3.6.

| | | | |
|---|---|---|---|
| Aldeney | France | Jamaica | Senegal |
| Anguilla | Gabon | Jersey | Singapore |
| Antigua | Gambia | Kentucky, USA | Solomon Islands |
| Australia | Germany | Luxembourg | South Africa (Republic) |
| Austria | Gibraltar | Malawi | Spain |
| Bahamas | Greece | Malta | Sweden |
| Barbados | Grenada | Mauritius | Switzerland |
| Belgium | Guernsey | Monaco | Togo |
| Belize | Hong Kong | Namibia | Trinidad |
| Bermuda | Illinois, USA | Netherlands | Turks & Caicos |
| Cameroon | Iceland | New Zealand | United Kingdom |
| Canada | Republic of Ireland | Papua New Guinea | United States * |
| Cayman Islands | Isle of Man | Portugal | Vanuatu |
| Cyprus | Israel | St. Kitts | Virgin Islands (UK) |
| Denmark | Italy | St. Lucia | Virgin Islands (US) |
| Dominica | Ivory Coast | St. Vincent | Zimbabwe |
| Finland | | | |

**Notes:**
* Lloyd's is licensed only to underwrite Excess and Surplus Lines insurance business in the USA other than in Kentucky, Illinois and the US Virgin Islands where the Society is an admitted insurer.

Note that underwriters are not necessarily precluded from accepting insurance from countries not mentioned in this list, because in some cases no restrictive legislation may be in existence.

Source: Corporate Participation at Lloyd's, Lloyd's of London, May 1996.

**Figure 3.6: Lloyd's Licenses.**

### 3.9 Lloyd's Brokers

One of the features of the Lloyd's market is the special position of the Lloyd's broker as the sole intermediary with right of access to the market. This privileged position was originally codified by the Lloyd's Act of 1871. Under the Lloyd's Brokers Byelaw (No. 5 of 1988), Lloyd's has the power to "grant permission to broke insurance business at Lloyd's by virtue of the registration of the body corporate or partnership as a Lloyd's broker and for the review, renewal and withdrawal of such registration."

Subject to certain conditions, the byelaw prohibits the broking of insurance business at Lloyd's by any person not registered under the byelaw.

The Council of Lloyd's must be satisfied that applicants are "fit and proper" and, to this end, all directors and compliance officers are subject to character and suitability tests. The purpose of these tests is to identify any involvement in illegal or fraudulent activities and to assess their levels of relevant experience in their chosen fields. Other requirements imposed by the byelaw include:

- Capitalisation of not less than £250,000.
- An office (not necessarily the head office) located within close proximity of the Lloyd's building.
- Having completed a probationary period as an "umbrella" broker, effectively being sponsored by an existing Lloyd's broker for a period that should not exceed three years before making their own full application for approval.
- Maintain professional indemnity insurance protecting third parties against errors or omissions by the broker.
- Maintain professionally audited accounting records.
- Maintain "insurance broker accounts" (IBAs) with approved banks, through which all insurance business transactions must pass. The banks are unable to place any lien or charge on the accounts, and the accounts must bear the name of the broker together with the "IBA" designation.
- Make annual reports to Lloyd's, including details of any umbrella arrangements, latest audited accounts and details of current professional indemnity insurance.

The Lloyd's broker's role is considerably wider than that of the insurance agent or even an ordinary "High Street" broker. It includes the preparation of policy and signing documents (except for UK motor) as well as all marketing and considerable involvement in the handling of claims. The Lloyd's broker provides the Lloyd's underwriter with a large marketing effort, whose cost is directly proportional to the amount of premium written. If the underwriter does not write the risk, he has no marketing expense. The role of the insurance broker is essentially simple: the matching of carriers (insurance and reinsurance companies), seeking to earn a return on risk capital, with others, who wish to protect their capital by transferring or sharing their non-trading risks, thus protecting their balance sheet. Mahoney (1993) defines this matching exercise as seeking a risk-return corridor within which the two principals are willing to trade. Leaving aside the brokers' negotiating skills, the two key components are risk capital and a distribution system. Mahoney (1993) states that it is these two components that will be significant drivers of change from the brokers' perspective.

The Lloyd's broker plays a major role in market innovation by developing new types of insurance and special schemes. As a result, the broker has a large technical involvement in insurance, especially in developing new wordings, new methods of rating and new systems of arranging cover.

For many brokers, the Lloyd's market is one of many markets, as many risks are placed globally. The larger brokers have built up a substantial network of offices, regionally in the UK and in many countries overseas. Thus whilst Lloyd's syndicates are dependent on Lloyd's brokers for premium income, Lloyd's brokers are not necessarily dependent on syndicates in that Lloyd's brokers are free to place business outside the Lloyd's market. The "ownership" of the insurance business written in Lloyd's is thus with the brokers and not the syndicates, as the brokers can easily remove business from Lloyd's and place it in another market.

Whilst under the provision of the Lloyd's Act 1982 brokers are not permitted to have an interest in managing agencies, the Aon Corporation, the largest broker in the world, has recently invested in various managing agencies (e.g. Jago and Spreckley Villiers and Burnhope). Furthermore with the introduction of incorporated capital into Lloyd's, this has given managing agents access to new sources of capital and the equity markets. This author suggests that a future development could be the purchase of a broking house by a Managing Agent in order to access a constant flow of business to the managed syndicates. The broker would effectively become the marketing arm of the Managing Agent, although this would require a change to the Lloyd's Act, 1982 as under Sections 10 and 11 of the Act Lloyd's brokers and Lloyd's managing Agents are not permitted to own each other.

Due to the nature of the subscription market, marketing initiatives have not been easily implemented within Lloyd's. Individual syndicates and managing agencies are reluctant to market products lest that gives a competitor an advantage. However there have been some initiatives that have been implemented by syndicates that have met with success:

INITIATIVES UNDER THE LLOYD'S UMBRELLA

**-Binding authorities:** Binding authorities give approved coverholders the ability to accept business on behalf of underwriting members of one or more syndicates, within strictly controlled guidelines. The creation of binding authorities is governed by Lloyd's. Coverholders bind risks directly from insureds or from brokers or intermediaries. The binding authority schemes benefit Lloyd's in that syndicates get access to business that would not otherwise reach Lloyd's such as excess and surplus lines insurance from the USA. Coverholders are remunerated more on the profitability of the binding authority rather than the volume of business produced.

**-Access to Provincial Brokers:** Ever since they were first established, Lloyd's motor syndicates have operated almost entirely without the involvement of Lloyd's brokers. These syndicates have marketed their products through networks of hundreds of small, local insurance agents and brokers. The only role of the Lloyd's broker is to guarantee the premium of the small provincial brokers so that the syndicates avoid the credit exposure of the smaller agents. Recently, the principal of accessing business through provincial outlets has been applied to other types of insurance. Syndicates in the market now offer employers' liability, household and accident and health insurance through such networks.

INITIATIVES NOT UNDER THE LLOYD'S BROKERAGE UMBRELLA

**-Service Companies:** A further recent and potentially far-reaching development amongst motor syndicates has been the establishment of service companies, which effectively take the place of the broker altogether. The syndicate markets and advertises itself directly to the public or motor trade and carries out all policy issuing, premium collection and claims settlement in-house.

**-Wider Service Company Applications:** Keen to reduce the dependence on brokers and their cost, and access to difficult-to-reach business usually controlled by local insurance companies, non-motor syndicates have began to experiment with the concept of the service company. Such a concept appeals to syndicates that deal in relatively low-premium, high-volume business. For example, non-marine Syndicate 990 founded "Denham Direct Underwriters Limited". The Syndicate realised that the costs involved in underwriting small premium errors and omission business was becoming increasingly prohibitive within the Lloyd's system. The Syndicate felt that the intermediaries were not earning enough brokerage to warrant coming to Lloyd's as opposed to placing business with the major UK insurance companies. Denham Direct Underwriters Limited seeks business from various provincial UK intermediaries and brokers. The Syndicate administers and processes most of the work with the broker earning similar commission placing the business with Denham Direct as he would get from a UK composite insurer. The success of this service company is largely on its ability to get quotes to the insured within twenty-four hours of receiving the proposal from the intermediary.

The Managing Agent Roberts and Hiscox Limited has started Hiscox Insurance Agencies as a non-profit making service company to underwrite outside the Lloyd's building for the Syndicates managed by Roberts and Hiscox. Hiscox insurance Agencies is concentrating on high-value household business.

Hiscox (1989) foresees business being written at Lloyd's on a two-tier system. The most complicated catastrophe, innovative or creative insurance will be written at Lloyd's with the more simple insurance business being written in Managing Agents' offices outside Lloyd's, exactly as is done by insurance companies country-wide or even worldwide making extensive use of computer networks.

The large London brokerages are now international in a form that is distinct from that of 15 to 20 years ago. They are now part of worldwide broking organisations, some of them led by large brokers in the United States (for instance Bowring is owned by Marsh McLellan; Nicolson Leslie and Bain Hogg are owned by Aon). The implications are that they can more easily place insurance anywhere in the world. They are no longer dedicated to placing business in the London market. One implication of the globalisation of London brokers may be more flexibility on commission structures. Brokers in Lloyd's are remunerated by a percentage of the premium, however larger brokers should be able to take advantage of modern information technology and achieve economies of scale that have enabled them to convert many accounts to a fee basis in the United States.

Whilst there are broking houses in the London market that are part of global brokerages, there are some small independent broking houses that are purely focused on the London market and often particular niche areas. For instance, Bell and Clements Limited broke United States Excess and Surplus Lines insurance to Lloyd's syndicates and London companies. This author believes that such small independent brokers may well be the target for purchase by corporate capital providers who wish to secure business for their managed syndicates.

The number of Lloyd's brokers has been declining in recent years because of mergers, although the contraction has not been as sharp as with syndicates. The peak year for Lloyd's brokers was in 1983 when there were 272 firms. By April 1995 this number had dropped to 207 accredited Lloyd's brokers. However, the market is relatively easy to enter and new firms continue to be authorised; forty new firms were registered as Lloyd's brokers between 1990 and 1994. The insurance broking scene is fairly concentrated as is shown is Figure 3.7 below with the ten brokers placing over half of all the business in Lloyd's during 1993. The largest broking group controlled 10.6% of

Lloyd's total premiums in 1993, compared with 9.9% in 1992. The aviation market is dominated by a few large broking groups, where in 1993 the top company placed 17.1% of all Lloyd's premiums in this class. The top five broking groups' combined share of Lloyd's aviation premiums has ranged since 1976 from 46.0% to 63.7%.

| Class of Business | Percentage of total premiums | |
|---|---|---|
| | Largest broker | Ten leading brokers |
| Marine | 11.6 | 64.4 |
| Aviation | 17.1 | 76.2 |
| Non-MAT | 9.2 | 49.6 |
| All business | 10.6 | 51.8 |

Figure 3.7: Shares of Lloyd's total premiums placed by the largest broker groups, 1993. Source: *Statistics Relating to Lloyd's.*

As Lloyd's syndicates do not have branch offices like their competitors such as Munich Re and Swiss Re, this author suggests that the broking system in Lloyd's will continue, although more use will be made of service company arrangements to access low-premium high-volume business in a cost-effective manner. An important question is to what extent the relationship between the brokers and the syndicates might change with the introduction of sophisticated information technology systems.

Chiplin (1986) defines information technology as "the integrated use of computing, microelectronics and telecommunications technologies". It offers those engaged in the production and distribution of insurance services cost-effective facilities for:

(i) the rapid storage, processing and retrieval of policy records, accounting and other data;

(ii) the automation of not only routine functions such as settlement of balances, but also of tasks involving decision-making previously undertaken by trained underwriting staff;

(iii) the rapid transfer of data between intermediaries, their customers, processing bureaux, loss adjusters and others;

(iv) speedy access by insurers to external databases, such as credit-checking agencies, anti-fraud registers, and Lloyd's Register of Shipping.

The main function of information technology is to improve efficiency by enabling tasks to be performed more quickly and at lower cost. It also may be used as a tool for management control and for new mechanisms of distributing products.

Much has been written by various authors concerning the developments in information technology in the London insurance and reinsurance market (Burton, 1996; Carter and Falush, 1995; and Chelmsford, 1992 provide useful summaries). It is not the purpose of this author's work to describe the current developments in information technology but rather to evaluate the effects of such technology on the broker-underwriter relationship.

Information technology has already been an agent of change in financial services. For instance in the personal insurance sector, with direct dealing operations such as Direct Line and also in personal banking, with the introduction of automated till machines and telephone banking. The Stock Exchange after "Big Bang" changed rapidly from a face-to-face market to electronic dealing between trading rooms, which do not necessarily have to be in the same city or indeed on the same continent. Thus global 24-hour electronic trading has become a feature of the stockmarkets.

Computer networks are developing within the London and international insurance markets. Whilst business conducted across these networks is principally claims settlement, there is some electronic placement of risks. The development of Electronic Placing Support (EPS) within the London market will allow brokers to place business with London market companies and Lloyd's syndicates across a computer network - information on the risk is sent to underwriters who register their acceptance or declinature of the risk electronically. Whilst the EPS initiative is taking some time to be accepted by companies and syndicates, many underwriters interviewed acknowledged that electronic placing of risks will be a major feature of the London market in the future.

The implication of electronic placing means that the actual location of the risk-bearing capital and where business is conducted becomes less relevant. Computer networks not only lower the cost of transacting business, they also provide an electronically level playing field as all underwriters and brokers theoretically have equal access to all the markets. This will ensure that there is a competitive environment, but will increasingly challenge the broker to demonstrate how he is adding value to his clients.

It seems reasonable to assume that clients will ask their brokers what services they get for their fees and commissions. If the broker only provides access to the subscription market and undertakes various administrative functions (such as issuing cover notes, policy wordings and premium accounting), then the broker may be supplanted by technology as computer networks can provide all these functions.

The success of the Bank of Scotland's insurance subsidiary, Direct Line, shows that such personal lines business can be underwritten successfully by the use of technology without the need of an intermediary. Given the competitive pressures from the direct writers, this author believes that the added value associated with placing such commodity business will become small as to render this activity an extremely low-margin business. Such business may still be placed in the brokered market but will have to be performed in a more innovative manner than it is today.

This development is similar to that which occurred in the institutional equity secondary trading business following the end of fixed commissions. Commissions for this activity have been drastically cut and if investment banks had remained heavily dependent on their secondary equity market trading activities, their profit margins would have collapsed. Consequently, this industry was compelled to develop higher margin businesses. e.g. mutual funds, new forms of complex securities and entering the emerging securities markets.

This author suggests that the large international brokerage firms will be compelled to expand their business into higher-margin activities. A noteworthy example of such diversification has been the move by major insurance intermediaries to act as sponsors for some of the Bermuda based reinsurance companies (e.g. Marsh McLennan and Mid Ocean Re; AON and IPC Re; AON and LaSalle Re). Similarly, AON have invested in various managing agencies at Lloyd's e.g. Jago Managing Agency Ltd and Spreckley Villiers Burnhope and Co Ltd.

The added value that brokers have brought to the London market has been a cost-effective global distribution system to underwriters, without their having to sustain the fixed costs of operating offices world-wide. However, with computer networks and the possibility of a global network (WIN - the Worldwide Insurance Network), brokers must add more value to the risk transfer equation than merely accessing markets, a function that is that achieved by the computer network. In order to "add value" brokers will need to seek to operate with increasing sophistication in the compilation, analysis and distribution of risk-related data. Rosenthal (1994) states that those insurance intermediaries with the most sophisticated capabilities for accessing, analysing, and distributing such information will possess a potent competitive weapon for the capture and retention of high-margin risk-management business. The expansion of direct writers of property catastrophe business in Bermuda, such as Partner Re, shows that the managers of these companies believe they have better analytical capabilities that the reinsurance intermediary.

Insurance is only a subset of a broad range of risk management techniques for controlling loss exposures. There are capital market devices including debenture financing, surplus notes, Act of God bonds, standby lines of credit, and derivatives tied to catastrophe futures that are all alternatives to traditional reinsurance. Piccione (1996) suggests that for reinsurance brokers to succeed in the future, they will need to become experts in the use of these risk management techniques, in addition to finite and traditional catastrophe protection, in order to prescribe the optimum asset protection package to their clients. This author suggests that insurance brokers will increasingly resemble consulting practices, employing a diverse range of skills outside the traditional insurance sector.

### 3.10 Conclusion - the future role of the broker

Lloyd's brokers are unique amongst brokers as only they are able to place business in Lloyd's. Section 8 (3) of the Lloyd's Act, 1982 states:

> "An underwriting member of shall in the course of his underwriting business at Lloyd's accept or place business only from or through a Lloyd's broker or such other person as the Council may from time to time by byelaw permit."

The Act does not rule out the possibility of syndicates accessing business through intermediaries other than Lloyd's brokers, such as service companies, although the wording of the Act does not permit syndicates to trade direct. In addition, given that syndicates do not have a branch office network similar to that of the Munich Re or the Swiss Re, the role of the broker as the provider of business to syndicates would seem to be assured. However, with the introduction of corporate capital and the acquisition of managing agencies by overseas insurers (e.g. Ace and Methuen Underwriting Agencies Limited; USF&G and Ashley Palmer Limited), syndicates are effectively becoming the London branch offices, or London subsidiaries, of worldwide insurers. As reinsurance business is often placed globally because of the large limits required by the reinsured, the new owners of syndicates may well find it more cost effective to underwrite certain business direct through, for instance, their Bermudan subsidiary rather than writing it through a broker in the London market. However, there is reinsurance business which is entirely placed in London to which companies outside London do not have access.

The Lloyd's Act, 1982 heavily protects the role of the Lloyd's broker. However, the use of service companies to write commodity-type business cost-effectively is likely to grow, especially as much of this business may be underwritten entirely by one syndicate owing to the small sums insured. Complex or large risks which require worldwide capacity are likely to need the broker for placement. More formally, this author proposes:

**Proposition four** **The role of brokers will be focused into complex placements with simple business being handled outside the Lloyd's system.**

There was agreement amongst all the underwriters and capital providers interviewed with this proposition, although the brokers interviewed were less enthusiastic about this proposition. However, all acknowledged that the development of computer networks would mean that simple business could be underwritten without the intervention of the broker.

The growth of computer networks in London to place business is in its infancy and this author found that there was opposition from underwriters and brokers about the introduction of Electronic Placing System (EPS). The EPS system, which went live in March 1992, enables brokers to place risks with insurers in both the Lloyd's and the company markets and was developed by LIMNET (The London Insurance Market Network). LIMNET was formed in 1987 by the ILU, LIRMA, Lloyd's and Lloyd's

Insurance Brokers Committee to promote and facilitate the exploitation of IT on a market-wide basis. EPS enables a broker to send the slip and information about a risk electronically to the underwriter. The underwriter is then able to download this information into his own system without the need to re-key the information.

EPS does not replace the broker as it is he who sends the information to the underwriter. The EPS system does not link underwriters to each other; it is effectively a broker-controlled system. For the vast majority of insurance and reinsurance placements in the London market, EPS does not supplant the traditional system of brokers placing business with underwriters through a process of face-to-face negotiation, nor is it likely in the foreseeable future. It is however likely that simple business will be placed entirely through the EPS system. For large accounts which have voluminous quantities of information and require explanation, the face-to-face process is likely to continue.

In 1992, LIMNET, the Brussels based Reinsurance and Insurance Network (RINET), the American based Brokers and Reinsurance Market Association (BRMA) and the Reinsurance Association of America (RAA), whose members collectively handle much of the reinsurance business placed internationally, agreed to establish a joint venture, with RINET as the contractor. The aim is to develop common electronic data interchange standards for use by reinsurers and brokers worldwide. The ultimate objective is to facilitate international electronic communications networking for insurers, reinsurers and intermediaries globally. It is therefore feasible that there will be a truly international market for the placing of facultative and treaty reinsurance with participants located in London and other parts of the world. Such a system could, in theory, replace the necessity for brokers. However, the development of the network is receiving input from brokers, so it is unlikely that a system will be developed that supplants the need for brokers.

### 3.11 Should Lloyd's be established in other countries?

Three of the competitors of Lloyd's, Munich Re, Swiss Re and General Re have offices in many countries of the world. All these three companies have either opened offices in new countries or have purchased locally-domiciled companies. Munich Re, for instance, operates on a world-wide basis maintaining branch offices and subsidiary insurance companies. Facilities are provided for all forms of treaty and facultative reinsurance from Munich and in forty-eight cities world-wide by more than sixty offices abroad. Munich Re operates in more than 150 countries on five continents (Best's Insurance Reports - International, 1995). In 1991 Munich Re established a liaison office in Moscow, becoming the first foreign reinsurer to obtain authorisation to conduct business in all the former Soviet republics.

Lloyd's is not established overseas, in the same way as Munich Re, because Lloyd's is a brokered market whereas Munich Re will underwrite through brokers or direct. The traditional Lloyd's syndicate will wait for business to be brought by brokers whereas Munich Re will actively search for business as is evidenced by the company's strategy of acquiring insurance and reinsurance companies and opening new branch offices. Apart from relying on brokers, syndicates overcome their lack of overseas establishment by granting binding authorities to agents to underwrite local business on their behalf. Before the introduction of corporate capital, managing agents did not have the necessary capital raising structures to set up and finance an overseas office.

Overseas establishment is important in order to access local insurance business which is normally underwritten by local companies. This author suggests that Lloyd's syndicates could achieve overseas establishment in one of three ways. Firstly, a managing agent could open up a branch office; secondly, a consortium of syndicates could open up a branch office, and; thirdly, the Corporation of Lloyd's could open up a contact office. A recent initiative has been the opening of Lloyd's Japan Inc which is a joint venture between various Managing Agencies and the Corporation of Lloyd's to access Japanese insurance business. Lloyd's Japan Inc involves various Managing Agents pooling their expertise, resources and sharing expenses. Such joint ventures could be followed by similar initiatives in other parts of the world such as China, Vietnam and the Soviet Union.

An alternative to opening up an overseas office is a joint venture between a broker and a syndicate to develop business from a certain territory. Such a structure is a logical extension of the current subscription system, although a joint venture of this sort would probably only involve one syndicate. With the introduction of corporate capital, syndicates now have access to the capital investment that would be required for such a venture. This author suggests that as overseas establishment is an alien culture for syndicates as they have always operated from the Lloyd's building in Lime Street, such broker-underwriter ventures may become commonplace in the future.

This author interviewed a senior US regulator who stated that one of the problems facing Lloyd's was that there was little understanding in the US about how Lloyd's operated; he felt that the Society was far too remote. The regulator recommended that Lloyd's should open a US contact office, essentially a marketing office. This contact office would not have an underwriting function but would act as a liaison between the USA and London. The office would answer questions from the US regarding Lloyd's and could be staffed by members of the Corporation of Lloyd's. Such an office, it was suggested, would give Lloyd's much needed positive publicity after the loss making years of 1988 to 1992.

# Chapter four: Two Structural Models: The Porter Model and the Market-Hierarchy-Network Model

## 4.1 Introduction

Chapter three explored Kay's concept of architecture and Lloyd's was examined within this framework This chapter examines Lloyd's within two other structural frameworks. The first is a model of an industry developed by Michael Porter. This model is developed from industrial economics and stresses the competitive nature of the firms within an industry. By contrast, the second model - the Market-Hierarchy-Network Model - accommodates the concept of cooperation and collaboration between firms. Lloyd's is examined within both these frameworks.

### 4.1.1 The Porter Model

A financial model of an insurance company was developed by Harrison (1972) "to assist the Corporate Planning Department of the Insurance Company of North America (INA) to improve its long-range planning capabilities". This study dealt with the cash flows through INA and aimed to evaluate future strategies through forecasting INA's income statements and balance sheets for future years. Harrison (1972) designed a computerised financial model of the insurance and investment operations of INA. This model was designed to calculate the evolution of INA's financial position over a five to ten year period, given a set of assumptions about the way in which premium volume, loss and expense ratios and investment income will change over that period. The purpose of the Harrison model is to convert forecasts of premium volume, operating ratios, stock market behaviour and federal tax regulations into forecasts of the balance sheets and profit statements of the company. The model can be used to predict the financial effect on the company of ceasing to underwrite one particular line of insurance. This model is of use to a single insurance company but does not describe the insurance industry and cannot evaluate the effect of competitor behaviour.

A mathematical model of an insurance company has been developed by Bohman (1979). This model looks at the cash flows within the company and produces various mathematical formulae to describe them. The model describes an insurance company rather than the industry and is purely based on accounting principals.

Neither of the models describes the insurance industry as a whole. A better framework for the analysis of an industry is provided by Porter (1980). Porter's model is of an industry consisting of several competing companies. Porter suggests five competitive forces within the industry - the threat of entry, the threat of substitution, bargaining power of suppliers, bargaining power of buyers and rivalry amongst existing competitors. All five competitive forces jointly determine the intensity of industry competition and profitability. Figure 4.1 shows the Porter model. The collective strength of these five forces determines the profit potential in the industry, where profit potential is measured in terms of return on investment.

## 4.2 The Porter model and the direct insurance market.

### 4.2.1 The need for insurance

The single most compelling reason why commercial enterprises purchase insurance products is to provide financial stability. In theory, insureds willingly suffer a known predetermined loss (premium payments) to prevent against the potentially severe

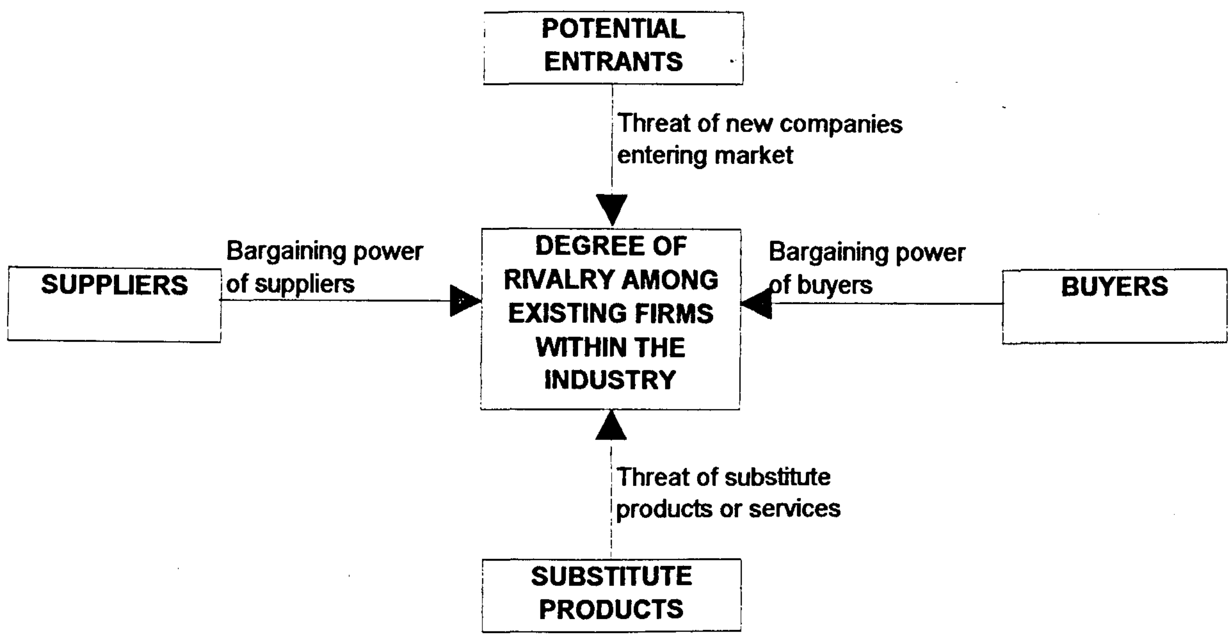



**Figure 4.1: The Porter Model (Source: "Competitive Strategy": Porter, 1980)**

financial impact of the occurrence or aggregation of random losses. Most risk managers recognise that insurance is simply a financing mechanism to spread their cost of risk over time. Corporate entities use insurance as a tool to stabilise cash flow and quarterly earnings (Beer, 1991). This author has applied the Porter model to the direct insurance market in figure 4.2. In the USA, the writers of direct insurance vary from small one-state mutual companies such as Germania in Texas to nationwide carriers such as Allstate Insurance Company and State Farm Insurance Company. The potential entrants are insurance companies who perceive that the market is profitable and wish to enter. Such companies may be foreign or domestic carriers who wish to write commercial business.

### 4.2.2 Regulation and consumer pressure

To apply the Porter model to insurance it is necessary to adapt the framework to add in the role of regulation. The regulatory regime is very pervasive in the insurance industry especially in the USA where consumer protection is a political issue. The regulatory authorities will require each new entrant to be licensed and may further require certain minimum capital requirements. Under the provisions of the Glass Stegal Act, banks are prevented from entering the insurance industry in the USA. Furthermore, USA admitted carriers in each State are requested to file their rates with the State Insurance Commissioner. After Hurricane Andrew hit Florida in 1992, regulators restricted insurers' ability to implement large rate increases, to not renew policies, to cancel policies, to cease writing certain lines, or to withdraw from the state entirely (Snyder, 1993). Florida's insurance commissioner was concerned about the availability of insurance and imposed a 90-day moratorium on non-renewals, and the state legislature

**Figure 4.2: Applying the Porter model to the direct insurance market.**

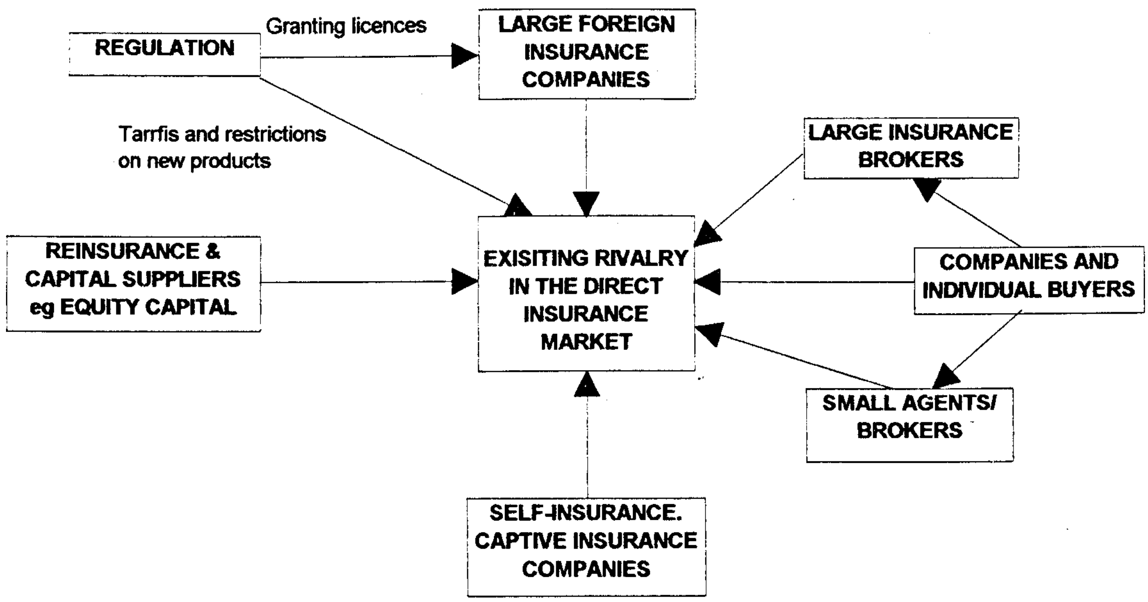
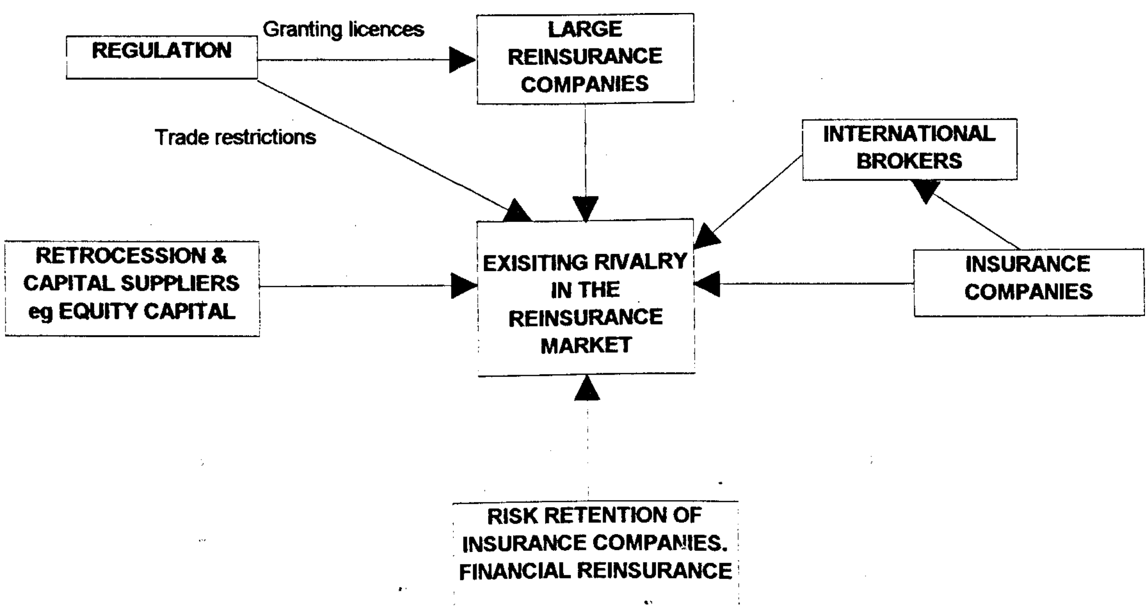



**Figure 4.3: Applying the Porter model to the reinsurance market.**



extended the prohibition by another 90 days (Satterfield, 1993; Hagstrom, 1993). As the moratorium was about to expire, Florida's legislature approved a Bill that limited individual insurers to canceling no more than ten per cent of their homeowners policies in any one county in one year and no more than five per cent of their property owners policies state-wide for each of the following three years (1993 -1995) (Silva, 1993).

### 4.2.3 Substitutes for insurance

The main substitute for insurance is for the company to self-insure. This can take the form of higher retentions, possibly in response to a programme of risk management or self-insurance via a captive company. Large corporations often have their own insurance subsidiaries, e.g. Tate and Lyle plc own Athel Insurance Company and The Virgin Group own The Scarlet Lady Insurance Company. One of the reasons for the formation of captive insurance companies has been the reluctance of direct insurers to provide large buyers of insurance with the insurance arrangements they require (Carter, 1981). During the period from 1985 to 1987 there was a scarcity of insurance capacity. A rise in pricing followed and, as a result, there was a greater retention of risk by some commercial insureds (Beer, 1991). It was this environment that spurred the growth of captives, risk retention groups, trusts, pools and other formalised risk-financing programmes.

### 4.2.4 The role of suppliers of capital

The suppliers in Porter's model equate to those entities that provide capital, namely reinsurers and investors. Reinsurance functions as a source of capital because when an insurer purchases excess of loss reinsurance, he is borrowing the capital of a reinsurer to absorb fluctuations in his own results due to unexpected and unpredictable variations in the frequency and severity of large losses (Hutter, 1991). If the ceding company increased its capital, it could retain more of its own business. Alternatively, the insurer could write lower policy limits fully supported by his own capital and purchase no reinsurance. Historically, quota-share reinsurance has been the most common method by which reinsurers have provided capital to insurers. If, for example, an insurer has a 50% quota share contract the company is using the reinsurer's capital to write larger lines on risks - in this case double the line that the company could if the reinsurer were not present. The reinsurer will pay a ceding commission to the cedant which helps to fund the ceding company's acquisition costs. This permits companies to finance growth without consuming statutory capital.

Porter's model emphasises that the intensity of competition in the industry is a function of the bargaining power of the suppliers capital. Porter (1980) states:

> "Suppliers can exert bargaining power over participants in an industry by threatening to raise prices or reduce the quality of purchased goods and services. Powerful suppliers can thereby squeeze profitability out of an industry unable to recover cost increases in its own prices."

An ample supply of reinsurance is likely to intensify the competition within the insurance industry. Insurers may be able to undercut the pricing of their competitors if their reinsurance arrangements are such that a large proportion of the liability is passed on to reinsurers. In this scenario an insurer can underwrite to increase its market share. Alternatively, low-cost reinsurance may mean that the insurer can achieve higher profits than the market average.

Conversely, an increase in the price of reinsurance may cause an insurer to re-think his reinsurance purchasing strategy especially if the insurer is unwilling to pass the additional costs to the consumer. Such a scenario may cause the insurer to increase his net retention, or reduce his participation in a particular segment of the insurance market. Expensive reinsurance generally has the effect of producing a disciplined insurance marketplace. A study by the American broker, Guy Carpenter (1994), estimates that the average cost of a US insurer's catastrophe excess of loss protection has increased 220% since 1982. This rise in cost has caused the retention levels of primary insurers to rise sharply to more than 4% of policyholder surplus in 1994, from 2% in 1989. Another way at looking at this is from the perspective of the level of industry loss that it is required to create a claim on the reinsurance programme. Guy Carpenter (1994) estimate this to be $3 billion loss for a typical reinsurance programme in 1994 compared to an industry loss of only $500,000 in 1982.

The catastrophes affecting the USA during 1992 such as Hurricane Andrew ($15 billion loss) and Hurricane Iniki ($1.6 billion loss) pushed the combined ratios for the 54 reinsurers reporting data to the Reinsurance Association of America (RAA) from 106.5 to 117.4. (A combined ratio is a formula used by insurance companies to relate income to claims, administration and dividend expenses. The formula is Combined Ratio = Loss Ratio + Expense Ratio + Dividend Ratio). This rise in reinsurers' combined ratios affected primary insurers. Having absorbed huge losses, reinsurers reduced their exposures in these overly concentrated areas - areas where reinsurance was in most demand. This further tightened the property insurance market. For instance, earthquake insurance capacity in California dropped by twenty per cent.

Problems in obtaining catastrophe reinsurance were a major factor in limiting new earthquake writings (Schachner and Harty, 1993).

According to a report commissioned by the California Department of Insurance (1991/2), earthquake insurance could not be sold by primary insurers in California without the participation of the reinsurance market, especially for commercial earthquake insurance. Due to the unpredictable nature of the hazard, great reliance is placed on per risk and catastrophe reinsurance, for instance the PML (Probable Maximum Loss) ceded by primary insurers writing in San Francisco was 69.4% for 1990; for carriers writing in the Los Angeles area the PML ceded was 74% for 1990.

The effect of the supply of capital to the insurance industry may take the form of increasing the size of an existing company, such as the recent increase by £7 million in the paid up capital of Copenhagen Re UK (Ladbury, 1996).

Alternatively, new capital will enter the market as new entrants. In this scenario there is little difference between suppliers of capital and new entrants. The intensity of the competition in the insurance industry is a largely a result of new entrants to the market. Direct Line Insurance, owned by Royal Bank of Scotland, managed to undercut the pricing of UK motor insurance by using quick and simple computer systems linked to powerful underwriting systems for analysing and managing risk. This model allowed the company to bypass the traditional broker channel and to take a 12% market share (Newing, 1996). Direct Line's approach was based on information technology, and using the telephone as the sole distribution channel allowed the company to centralise and base all its operations on IT systems.

### 4.2.5 The buyers of insurance

The buyers in the Porter model equate to individual persons or companies who require insurance. Such protection can be bought direct i.e. between the company or individual and the insurer, or through a broker. The broker may be a small "High Street" operation or a large multi-national concern such as the US "alphabet" houses (e.g. Alexander and Alexander, Marsh McLennan). The individual consumer is unlikely to be able to discern the difference between one insurer's product and another. The role of reputation, advertising and branding is important in influencing consumer choice.

Buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other - all at the expense of industry profitability (Porter, 1980). The bargaining power of an individual consumer is minimal in the personal lines market, however groups of individual can be an effective force. For instance, the UK charity Age Concern offers household insurance to people aged over fifty years. This portfolio of business has an annual premium income of £50 million and was, until 1996, administered by Bain Hogg Insurance Brokers and underwritten by various Lloyd's syndicates. This business was transferred to Commercial Union in January 1996. Commercial Union paid a fee to Age Concern and are returning all profits on the business other than a small margin. It seems logical that the broker will in time be no longer required as Commercial Union are capable of administering the business in-house (*pers comm* a Lloyd's UK underwriter).

In the commercial insurance market the buyers are more sophisticated than in the personal insurance market. Buyers of commercial insurance sometimes employ risk managers to structure a suitable insurance programme. Large purchasers of insurance are likely to be able to negotiate their insurance costs especially if the market has an excess of capacity, i.e. capital.

### 4.3 The Porter Model and the Reinsurance Market.

This author has applied the Porter model to the reinsurance market in Figure 4.3. There are many similarities between the insurance model in Figure 4.2 and the reinsurance model in figure 4.3. Regulation is also a feature of the reinsurance market but reinsurance is subject to less regulation than direct insurance (Carter and Dickinson, 1992). Carter and Dickinson suggest three reasons for this. Firstly, governments that wish to exercise control over the national insurance market recognise that this can be achieved without prejudicing their ability to gain access to the capital and technical expertise of reinsurers. Secondly, as reinsurance transactions are between one insurer and another, the regulatory authorities feel that insurers are better informed consumers than the general public so there is less need to be protective to the insurer. Thirdly, a more extensive use of reinsurance is considered, particularly in developing countries, to afford the balance of payments savings over trade in direct insurances.

#### 4.3.1 The reinsurance market and the threat of entry.

Entering the insurance or reinsurance market in the U.K. is a matter of satisfying the requirements of the Department of Trade and Industry as regards capital and the suitability of the officers of the proposed company. Similarly, for an individual to become a member of Lloyd's requires a certain level of liquid assets. Leaving the market is however more difficult as capital will be tied up to cover future liabilities. It is only after those liabilities have expired can the capital be released. A member of Lloyd's can only leave when all his open years of account have closed. If a member has open years then he will be called upon to pay any cash calls that may be asked for by the syndicate in order to pay claims. New entrants to the reinsurance industry bring new capacity, the desire to gain market share and often substantial resources. The premiums written during 1993 in the reinsurance industry were approximately $65 billion (Shapiro, 1994). The largest twenty companies write $46 billion, some 70% of the total worldwide reinsurance premiums. A list of the largest twenty reinsurers is shown below in figure 4.4.

| **Rank** | **Reinsurer** | **Net reinsurance premiums written 1993 (US$)** |
|---|---|---|
| 1 | Munich Reinsurance Co | $9,212,873 |
| 2 | Swiss Re Group | 7,577,726 |
| 3 | Employers Re Group | 3,336,857 |
| 4 | Assicurazioni Generali | 2,876,063 |
| 5 | Hannover Re/Eisen & Stahl Re | 2,804,520 |
| 6 | Cologne Re | 2,655,848 |
| 7 | General Re Corp | 2,524,000 |
| 8 | Frankona Group | 1,825,087 |
| 9 | Gerling Global Re Group | 1,756,479 |
| 10 | SCOR S.A. | 1,742,315 |
| 11 | Mercantile & General Re | 1,647,844 |
| 12 | American Re-Insurance Co | 1,371,000 |
| 13 | AXA Re | 999,162 |
| 14 | Tokio Marine & Fire Ins Co | 985,818 |
| 15 | Toa Fire & Marine Reinsurance Co | 985,818 |
| 16 | Prudential Reinsurance Co | 892,310 |
| 17 | Winterthur Swiss Insurance Co | 879,423 |
| 18 | Yasuda Fire & Marine Insurance Co | 688,113 |
| 19 | Aachen Re Group | 645,578 |
| 20 | Transatlantic Holdings | 631,693 |
| | **TOTAL** | **$ 46,040,234** |

FIGURE 4.4: THE TWENTY LARGEST REINSURERS IN THE WORLD
Source: Shapiro (1994)

Lloyd's is missing from the above table because it is a market and not a company. Lloyd's net reinsurance premium during income during calendar year 1993 was $6.1 billion. Therefore Lloyd's is the third largest reinsurer in the world after Munich Re and Swiss Re. These three reinsurers underwrite over one-third of the world's reinsurance premiums. Thus the reinsurance market is dominated by a small number of large reinsurers. This contrasts with the insurance market which is localised. The reinsurance market is global and this has undoubtedly been enhanced by the reinsurance broker whose role is to locate capacity for his client's reinsurance programme. For instance, a reinsurance programme of a Lloyd's syndicate may have as security other Lloyd's syndicates, London companies, European companies, US companies and Australian companies.

The growth in the reinsurance market is currently in Bermuda where capacity during 1994 was estimated to be $4.5 billion (Covaleski, 1994). The growth of this capacity was fueled by the decline in capacity of the London Market for property catastrophe excess of loss business due to adverse loss experience and the consequent high rates being achieved by the remaining writers of property catastrophe business. A study by the American reinsurance broker Guy Carpenter estimated that the level of available capacity for property catastrophe business in the London market dropped from $125 million per reinsurance programme in 1990 to $60 million per reinsurance programme in 1994. In contrast Bermudan capacity per programme for such business rose from nil in 1990 to $95 million in 1994. Covaleski (1994) suggests the reasons for setting up a reinsurance company in Bermuda are: the regulatory and political climates are stable which is a major attraction to reinsurers; its good business infrastructure; accessibility to the Americas and Europe; the lack of taxation of retained earnings; the costs of doing business in Bermuda are from 10% to 35% cheaper than conducting the same operations in the USA. Whilst there was a shortage of capacity for catastrophe business in 1993 (Macleod, 1994) which allowed London companies and Lloyd's to raise rates, with the extra Bermudan capacity entering the reinsurance market, rates became static during 1994 (Ladbury, 1994).

Access to the Bermudan capacity is through brokers although some companies are offering capacity direct to buyers. Partner Reinsurance Company for instance offered about 70% of its capacity through brokers and 30% direct (Souter, 1993). The investment in new Bermudan reinsurance companies has come from both banks and established insurance companies. Marsh McLennan, the US broker, and J.P. Morgan raised funds of $359 million to capitalise Mid Ocean Re. Partner Re had investment from Swiss Re and Centre Cat Ltd has a capital of $300 million funded by Centre Re Group which is controlled by Zurich Reinsurance Company.

#### 4.3.2 The purchasers of reinsurance.

In the London market all business is transacted through brokers and access to Lloyd's is solely through Lloyd's brokers. The purchasers of reinsurance are insurance companies and, as the buyers are in the same industry as the reinsurers, it is reasonable to assume they are sophisticated purchasers. The Porter model needs to be modified to take account of the role of brokers as there is not always a direct link between the insurer and reinsurer. An insurer's need for reinsurance will largely depend on how risk-averse the insurer is. Reinsurance is essentially a means to protect an insurer's balance sheet from a single major loss or an abnormal number of smaller (attritional) losses. Reinsurance is either proportional or non-proportional and can be effected to cover a particular risk or an entire account. The reinsurance market is global and the insurer can access the worldwide reinsurance capacity either by going direct to the reinsurer or by using a reinsurance broker. The bargaining power of the insurer, i.e. the ability of the insurer to obtain a competitive quote, depends on the availability of capacity wishing to reinsure the risk. It has already been seen that the influx of capacity into Bermuda has had the effect of stabilising rates and the author foresees that prices will decrease if there are two or three years of no major natural peril losses.

The bargaining power of the buyers of reinsurance will be a factor in determining the intensity of the competition within the reinsurance market. The bargaining power of buyers will depend on the availability of alternative products to reinsurance and the availability of capacity. The greater the available capacity, the more the insurer can bargain on price and/or broadened coverage. The bargaining power of the buyer is likely be enhanced if a broker is used, as the broker will have detailed knowledge of the marketplace.

### 4.3.3 The suppliers of capital.

In the reinsurance market the suppliers are the providers of capital, e.g. equity capital (shareholders), and also reinsurance cover provided by the retrocession market. In the context of Lloyd's, the suppliers of capital are the Names i.e. individuals which provide the capital for a syndicate in order for it to underwrite insurance. The retrocession market provides a mechanism for reinsurers to increase their capacity analogous to the way an insurer uses a reinsurer's capacity (Browne, 1991).

The bargaining power of capital providers will influence the competitive pressures within the industry such as the availability of reinsurance (or retrocessional) protection. However, the major factor influencing competition in the reinsurance market is new entrants to the market which provide capacity to underwrite risks.

During the period 1984 to 1989 there was a plentiful supply of affordable retrocessional reinsurance which encouraged reinsurers to underwrite property catastrophe excess of loss business in the USA where rates (i.e. pricing) were high. The retrocessional coverages underwritten in London formed the London Market Excess of Loss (LMX) network with London underwriters reinsuring each other's liabilities. With this coverage in place the capacity of the reinsurance market for US property catastrophe programmes approached $300 million per company in 1986. In addition, primary companies augmented their excess of loss catastrophe programmes by purchasing pro-rata treaties, most of which did not contain a limitation on the maximum payable by the treaty in the event of a major single loss such as a hurricane or earthquake (Powers and Hearn, 1993).

Over a four year period, beginning in 1988, a series of major catastrophes (the Piper Alpha oil rig explosion, Hurricane Hugo, European windstorms, Typhoon Mireille in Japan, the Oakland, California fires and Hurricanes Andrew and Iniki) battered the worldwide property catastrophe market. As a consequence of these losses, primary companies claimed on their reinsurance protections and, in turn, reinsurers claimed from their retrocessional protections. The continuing calls for large cash payments, due to the recurrent catastrophe losses, and the incestuous nature of the London retrocessional network triggered the "LMX spiral effect". This cascading of loss from one reinsurer to another produced the disastrous results in the Lloyd's and London market in the late 1980s and early 1990s. The LMX market began to collapse and the ability of reinsurers to arbitrage the catastrophe product (i.e. reinsure the liabilities at a cheaper price than they were originally written at) began to erode and reinsurers faced the prospect of larger net retentions. Large losses and the prospect of unreinsured aggregate exposures led them to withdraw from the property catastrophe market. As a consequence, by January 1993 the maximum available limit per company for worldwide property catastrophe excess of loss was $175 million (Powers and Hearn, 1993). As property catastrophe capacity decreased, catastrophe reinsurance prices increased by about 50 to 60 per cent. Instead of purchasing retrocessional protection some insurers boosted their financial strength. For instance, after Hurricane Andrew, Allstate Insurance Company, a subsidiary of Sears, Roebuck and Co, raised $2.3 billion through an initial public offering.

#### 4.3.4 Substitutes for reinsurance.

An alternative to buying reinsurance is for insurers to retain more of the risk net and unreinsured, for instance by purchasing reinsurance at a higher attachment point. With the decline in traditional reinsurance capacity for property catastrophe risks in the early 1990s, non-traditional products were developed to enable insurers and reinsurers to achieve a "spread" of risk. One alternative is "financial reinsurance". This is a mechanism to finance the future payment of a ceding insurer's losses by circumventing statutory accounting principles. This artificially improves the underwriting results and generally creates statutory surplus for the ceding insurer (Laurenzano, 1991). In contrast to traditional reinsurance, financial reinsurance does not protect against loss or compensate for losses suffered by ceding insurers under their policies of insurance, i.e. there is no risk transfer. A common form of financial reinsurance involves the transfer of funds from a ceding company in the form of premium, with the return of these funds plus interest over time from the reinsurer in the form of losses, profit commission or return premiums. The premium charged to the ceding company represents the present value of the assuming reinsurer's exposure under the contract. In effect, such an arrangement is little more than an investment contract with a guaranteed return. In the USA, statutory accounting principles generally prohibit the discounting of loss reserves. A financial reinsurance contract provides companies with a method whereby they can present value or discount reserves whilst reporting that discount as reinsurance recoverable and, in turn, as underwriting income.

### 4.4 The position of Lloyd's in the Porter model.

Lloyd's operates as both an insurer and reinsurer. Indeed, a single syndicate may operate in both the insurance and reinsurance markets. For example non-marine syndicate 183 (D.F. Bradstock and others) has both a reinsurance underwriter and an insurance underwriter. That syndicate competes with international reinsurance companies on catastrophe excess of loss business and competes with UK insurers on household comprehensive business. There are syndicates that specialise in insurance e.g. non-marine syndicate 1191 (Boardman, Cunningham and Poland) which only underwrites UK household comprehensive business. Lloyd's syndicates also provide retrocession cover to other Lloyd's syndicates and to London and foreign companies.

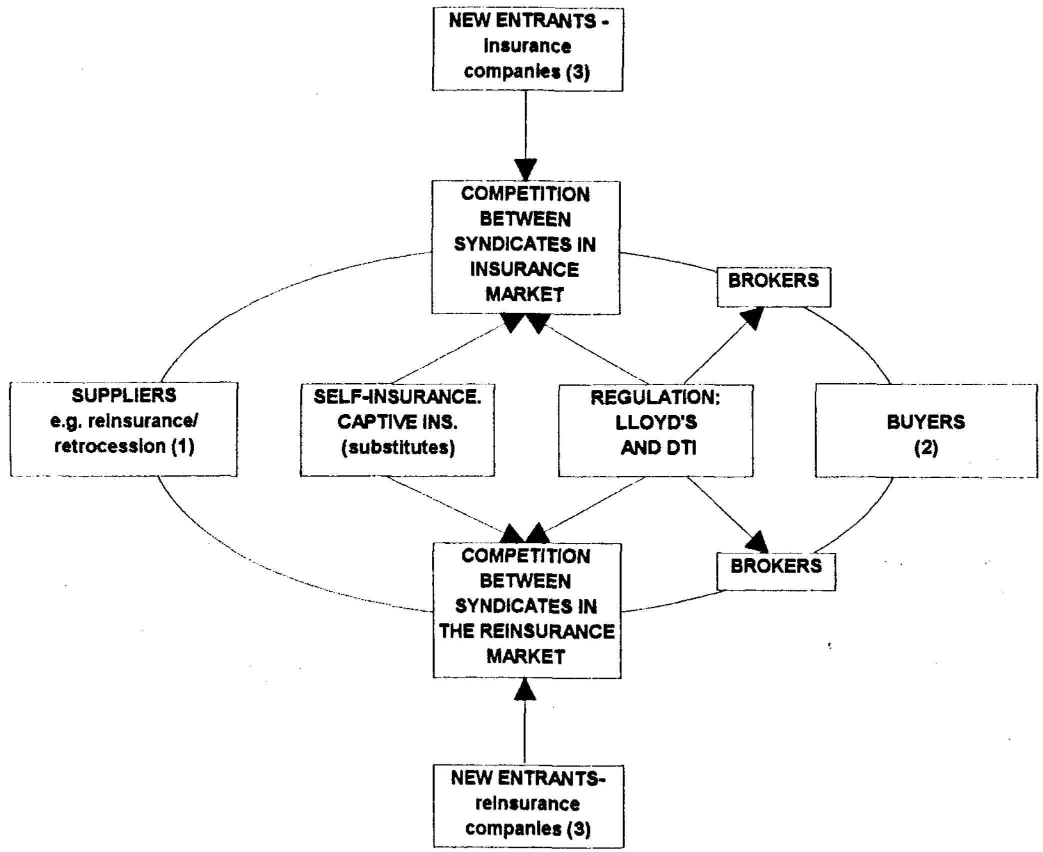
The "suppliers" of the Porter model are those entities that supply capital. The capital of the Lloyd's market comes from individuals called Names, from corporate vehicles and from the assets of Lloyd's central fund and the assets of the Corporation of Lloyd's. A syndicate may consist of individuals (Names) each with unlimited liability. There are also syndicates that consist solely of one capital provider, e.g. Syndicate 1211 which is a wholly-owned subsidiary of the American domiciled reinsurer F&G Re. Such syndicates have a capital base that has limited liability.

The funds in the Lloyd's Central Fund are there to pay claims in the event of Names being unable to pay their losses. The funds of the Central Fund are raised by a levy on each member's overall premium income limit (OPL). If the Central Fund becomes exhausted then the assets of the Corporation of Lloyd's will be used to pay claims. This is the chain of security which exists behind the Lloyd's policy. Some members of Lloyd's buy personal stop loss reinsurance which will cover all the member's losses for a particular year of account excess of a certain aggregate sum up to a certain limit of indemnity. Whilst a member's stop loss policy does not directly increase the capital he has available to commit to underwriting, it does allow the member to increase his overall premium limit because assets which the member may have to withhold in order to pay for future losses can be utilised for underwriting.

Porter provides a useful structure in which to analyse industries. This author has applied the framework to both the direct insurance market and the reinsurance market. Whilst the main features may be described using Porter, the model has to be extended to include the influence of regulation which is an important factor in insurance and reinsurance.

The Lloyd's market is both an insurance and reinsurance market. Lloyd's is a supplier of capital to the insurance market because there are syndicates that underwrite reinsurance business, i.e. are providers of reinsurance. The Society is also a competitor within the insurance market. Indeed, syndicates do not only compete with companies but compete for business with each other. Lloyd's syndicates are also purchasers of reinsurance. In the reinsurance market, Lloyd's is a competitor and is also a supplier of capital by being a provider of retrocessional reinsurance. In the reinsurance market there are Lloyd's syndicates that are buyers of reinsurance.

As Lloyd's syndicates are members of the insurance and reinsurance industry, the market cannot be said to be highly focused into one particular market. Lloyd's is, for instance, the world's third largest reinsurer and the second largest insurer of UK direct insurance business. This position is different from its competitors who are often focused into either reinsurance (Munich Re, Swiss Re) or insurance (Sun Alliance, Commercial Union). An attempt by this author to map the Porter model on to Lloyd's is given in Figure 4.5. Because Lloyd's syndicates operate in the insurance and reinsurance market, it is necessary to superimpose two Porter models upon each other. Suppliers to the insurance market may be syndicates who underwrite reinsurance




Notes: (1) Syndicates may be suppliers to the Lloyd's reinsurance market by providing retrocession protection and to the Lloyd's insurance market by providing reinsurance protection.

(2) Syndicates may be buyers of reinsurance from other Lloyd's syndicates.

(3) New Syndicates will be entrants to the Lloyd's insurance and reinsurance markets.

**Figure 4.5: Applying the Porter model to Lloyd's.**

business. There are other syndicates who reinsure syndicates that underwrite reinsurance business. The buyers from the reinsurance market may be Lloyd's syndicates who wish to reinsure their portfolio of risks. The Porter model concept thus may be applied to Lloyd's but the model is arguably being over-stretched.

### 4.5 The Market-Hierarchy-Network Model

The Porter Model views a firm as being in competition with all other firms in the same industry. Whilst this is a useful perspective, the model is not broad enough to encompass the concept of cooperation between firms in the industry. The author's research has revealed that cooperation is a feature of Lloyd's (see Chapter five), thus a new model which develops the concept of inter-firm cooperation would be useful when examining Lloyd's. Such a model is the Market-Hierarchy-Network Model.

In economic life there are a myriad of organisational forms that firms or a group of firms may take. Lorange and Roos (1992) suggest that all organisational forms lie on a continuum which measures the degree of vertical integration on a scale running from "free markets" to "internalised hierarchy", a framework shown in Figure 4.6. The left-hand side of the continuum represents a situation where all the activities are integrated within an organisation. Moving along towards the right-hand side, there are ever decreasing degrees of vertical integration to an extreme where all the transactions are conducted within an open market context.

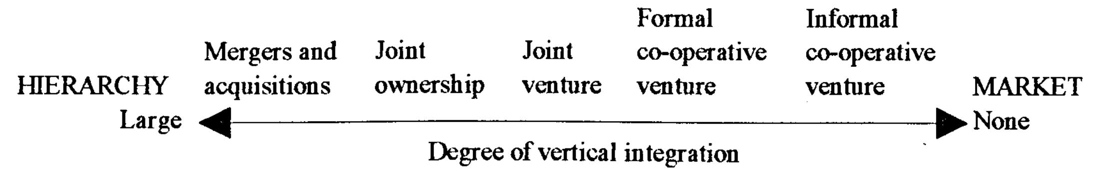



Figure 4.6: Organisational forms (Source: Lorange and Roos, 1992)

The term "market" may seem obvious enough, but there are many forms of market. The crucial feature of the market is that it is a coordination device involving the voluntary exchange of goods and services between two parties at a known price. Economists understand the term "market" not to mean any particular place but a region in which buyers and sellers are free to trade with each other so that the prices of the same goods tends towards equality. The characteristic feature of the neo-classical theory of the market, as expounded by Marshall (1936), is the concept of equilibrium - a position where supply and demand are the same and so there is perfect coordination between the desires and wishes of purchasers and suppliers. A perfectly competitive market is a structure in which there are so many buyers and suppliers that not one of them can individually affect the price. In contrast to the neo-classical theory the Austrian school of thought, such as Kirzner (1973) sees the market as a process of selection, turmoil and change where disequilibrium processes prevail. This is a dynamic theory of the market. Whilst the neo-classical theory emphasises the importance of the price of good in the market, Kirzner (1973) emphasises the effects of the competitive process that markets encourage.

At the other extreme of the continuum is the hierarchy and one of the most influential writers on this subject has been Williamson (1975,1985). Williamson's work develops that of Coase (1937) who argued that firms and markets were alternative means for organising similar kinds of transaction and that transactions will be governed by the institutional arrangement that is most efficient. Williamson has developed Coase's ideas into what has become known as the "transactions cost economics approach". Williamson argues that transactions that involve uncertainty about their outcome, that recur frequently and require substantial "transaction-specific investments" - of time, money or energy that cannot easily be transferred - are more likely to occur within a hierarchically organised firm. By contrast, exchanges that are straightforward, non-repetitive and do not require transaction-specific investment will take place across market boundaries. Transactions will be moved out of markets into hierarchies as transaction costs increase. Transaction costs arise from the following four factors: our inability to analyse everything in advance (man's bounded rationality); the fact that the future is uncertain; the presence of few suppliers and buyers of the product in question; and, the tendency of individuals to act in a self-interested manner and to do so with guile. The basic premise of Williamson's transaction-based theory is that firms will tend to absorb uncertainty by integrating its source inside their own boundaries and within their control rather than expose themselves to the marketplace.

Williamson's view of markets and hierarchies see firms as having definite boundaries. Outside the boundaries are competitors and within the boundaries, managers exercise authority. However, the boundaries of firms are changing and they are engaging in forms of collaboration that resemble neither arm's length market contracting nor vertical integration.

This blurring of boundaries is giving rise to a variety of inter-firm structures, that the literature describes generically as "networks" or "strategic alliances". Jarillo (1993) describes networks in terms of inter-company cooperation. He states:

> "Between the two basic ways to organize economic activities (market and firms), a vast intermediate area does exist, which has of late received the denomination of 'network'. This is a widely used term, and certainly lacks specificity....... (It is) a third kind of organization, between 'market' and 'firm', because economic activity therein is not coordinated (primarily) either by the price or by the hierarchical mechanisms." (Jarillo, 1990)

The transaction costs theory explains why some transactions are organised within the market mechanism while others occur within hierarchies; the reason is one of efficiency in that transactions are organised along that system which produces the lower cost. If the transaction cost for an activity is high, then the activity will be carried out within the firm, i.e. vertical integration. If the transaction cost is low, the activity will occur within the market. This reasoning does not explain, however, the emergence of the intermediate organisational form, the network. Jarillo (1988) contends that if a company finds a way to lower those transaction costs - by the intervention of an entrepreneur - then it would pay that company to sub-contract. As a result, the company would be less integrated than its competitors, and more efficient as it has lowered its transaction costs compared to its competitors'. The essence of a network is that a company finds a way to lower transaction costs which, until then, were forcing competitors to integrate. By so doing, it gains efficiency over its competitors, and sets up an organisational form that consists of independent units that are cooperating with each other. The question is, of course, why are the transaction costs lowered?

Jarillo (1990) agues that the 'glue' that holds the network together is neither the pure price signal, nor command from above, but rather it is *trust*, which Thorelli (1986) defines as:

> ".......an assumption or reliance on the part of A that if either A or B encounters a problem in the fulfillment of his implicit or explicit transactional obligations, B may be counted on to do what A would do if B's resources were at A's disposal."

Whilst Jarillo explains networks in terms of transaction costs, he pays scant attention as to how alliances actually work in order to bind the firms into a network of relationships.

Between the two extremes of organisational form, markets and hierarchies, there lie various organisational structures. Any merger or acquisition represents a lower degree of vertical integration than that found in the subsidiary organisation. Joint ownership arrangements exhibit even lower degrees of vertical integration and various types of formal and informal cooperative ventures lower still.

Many definitional problems are associated with networks, but they describe, in broad terms, *inter-* rather than *intra-*organisational forms (Egan, 1995). Networks provide an intermediate organisational mode to markets and hierarchies. They offset the uncertainties involved with market-based transactions and they avoid the complexities of integration.

Lorenzoni and Baden-Fuller (1995) point out that strategic alliances and inter-firm networks have been gaining in popularity with many firms for their lower overhead costs, increased responsiveness and flexibility, and greater efficiency of operations. Network forms of organisation have attracted much study; for instance, Miles and Snow (1986) have talked of "Network Forms", Handy (1989) has described "Shamrock Organisations"; Johnston and Lawrence (1988) have discussed "Value Added Partnerships" and Jarillo (1993) describes networks as "Borderless Organisations". Deriving a satisfactory definition of a network is difficult given that they occur in various forms. It is tempting to define a network as being a form that is neither a market, where there are arm's length relationships and price is the co-ordinating mechanism, nor a hierarchy, where there are vertical relationships and administrative "fiat" is the co-ordinating mechanism. However, defining something by what it is not, is hardly an intellectual approach to a problem.

The term "network" has become the vogue in attempting to describe organisations. However, there is little agreement in what organisational form constitutes a network. Baker (1992) argues that *all* organisations are networks - patterns of roles and relationships. For example, a network that is characterised by a rigid hierarchy of tasks and roles, vertical relationships and administrative apparatus separated from production is commonly called a bureaucracy. In contrast, a network characterised by flexibility, decentralised planning and control, lateral ties is closer to Baker's definition of the network type of organisational form. Some scholars such as Lorange and Roos (1992) argue that economic changes can be shown on a continuum with Market at one end and Hierarchy at the other. Other authors (e.g. Powell, 1991) see that networks are distinct forms of organisation, i.e. a network is a distinct form of strategic alliance. The problem of defining a network is arguably, semantic. At what point, for instance, does a joint venture between two hierarchical firms develop from being a strategic alliance into a network? This author suggests that whilst a market and a hierarchy may be defined in economic terms and are thus identifiable, networks are described in terms of their qualities; thus the definition of what a network is will differ from author to author. For instance, Jarillo (1988) defines networks as "long-term, purposeful arrangements among distinct but related for-profit organizations that allow those firms in them to gain or sustain competitive advantage vis-à-vis their competitors outside the network". Kaneko and Imai (1987) see networks as a particular form of multi-faceted, inter-organisational relationships through which new information is generated. Johanson and Mattsson (1991) regard networks as a method of dividing labour such that firms are highly dependent upon each other. The co-ordination of activities is not achieved through a hierarchy or a market, but through the interaction and mutual obligation of the firms in the network. These three definitions see networks as being a pattern of relationships between firms, but as Powell (1991) points out networks may also occur between individuals, independent production teams or very small business units. A network is often thought as a flat organisational form in contrast to the vertically organised hierarchy forms. The key feature of networks is that they are based on trust and cooperation. In contrast to either market or hierarchy, networks co-ordinate through less formal, more egalitarian and cooperative means (Thompson, 1991). A broad approach to the definition of a network is offered by Baker (1992) who states that the chief structural characteristic of a network organisation is the high degree of integration across formal boundaries.

Figure 4.7 represents Powell's attempt to summarise the key differences between markets, hierarchies and networks. In the market transaction there is no need for trust to exist between the actors and agreements are reinforced by legal sanction. Each party knows the benefit of the exchange. In the network form there is cooperation between the actors and extensive communication of information between the parties. In the hierarchy, communication occurs in the form of the employment contract. There is a clear chain of authority between the actors.

| | Forms | | |
|---|---|---|---|
| **Key features** | **Market** | **Hierarchy** | **Network** |
| Normative basis | Contract - property rights | Routines | Relational |
| Means of communication | Prices | Routines | Relational |
| Methods of conflict resolution | Haggling - resort to courts for enforcement | Administrative fiat - supervision | Norm of reciprocity - reputational concerns |
| Degree of flexibility | High | Low | Medium |
| Amount of commitment among the parties | Low | Medium to high | Medium to high |
| Tone or climate | Precision and/or suspicion | Formal, bureaucratic | Open-ended, mutual benefits |
| Actor preferences or choices | Independent | Dependent | Interdependent |
| Mixing of forms | Repeat transactions Contracts as hierarchical documents | Informal organisation. Market-like features: profit centres, transfer pricing | Multiple partners. Formal rules. |

**Figure 4.7: Stylized comparison of forms of economic organisation.**
(Source: Powell, 1991)

The network form of organisation was neglected by business writers for many years as they did not find it a useful concept. This neglect was probably due to the pre-eminence of the "competitive advantage" school of business thought, which is best represented by the work of Michael Porter. Porter states that the profits a company can achieve in an industry are determined, first by the profit potential of the industry, and second, by the position of the firm within the industry. The profit potential of an industry is determined by the interaction of five forces: how easy it is for a firm to enter, the intensity of rivalry between the existing competitors, the bargaining power of both suppliers and customers, and finally, the availability of substitute products. Thus in order to prosper, a company has to compete not only with its current competitors, but with potential competitors, as well as with its suppliers and its customers. This is an "atomistic" view of the economic activity, in which each company is alone against the world. This view is challenged by a network perspective, as network theory emphasises the pattern of relationships between among the firms in the industry, an issue that receives little attention in the Porter framework.

### 4.6 Towards a classification of the structure of Lloyd's

The above has given a very brief overview of the three types of organisational form - markets, networks and hierarchies. An interesting question is which of these models of coordination is applicable to Lloyd's? This question may be answered on two levels - firstly, on the level of the business transaction i.e. positioning the business process, and secondly, at the level of the governance of Lloyd's. It has been stated earlier in this chapter that there are syndicates in Lloyd's that underwrite insurance and others that underwrite reinsurance. Those syndicates that underwrite personal lines insurance such as motor and household form a market where the customer is able to choose between the coverage offered by one syndicate compared to another. Furthermore, these syndicates operate in the UK personal lines market and compete directly with other insurance companies for business. Sums insured are small and each personal lines syndicate underwrites 100 per cent of the risk. There is no cooperation between syndicates as they are in competition for the same business. We may therefore say that with respect to personal lines business, Lloyd's is a market.

The subscription system of risk placement is generally used for large risks where the capacity required exceeds that which may be supplied by one insurer, consequently it is generally used for reinsurance placements rather than insurance business. This author further suggests that the subscription system is also used for new insurance products where the legal implications of coverage have not yet been tested. In this situation, any one syndicate may wish to participate in only a small percentage of the liability. There are no agreements between firms in the subscription system - it is a method of trading rather than a formalised agreement. Such a system of risk placement may be likened to an informal cooperative venture where there is cooperation but in a loose and uncodified form. Thus the subscription market lies on the far right-hand side of the structural continuum given in Figure 4.6. In the subscription system, a risk may be underwritten by say twenty syndicates all participating with various percentage lines. Any one syndicate may not know the other syndicates participating in the risk, although they will be told by the broker which syndicate is the lead. At renewal of the risk, any syndicate is free to decline to write the risk and often new syndicates will participate and sometimes syndicates will increase or decrease their percentage lines on the risk. Thus the subscription market for any one risk may change from year to year.

A consortium arrangement involves the prior agreement between syndicates on the types of business to be underwritten by the consortium and the proportion of business ceded to each of the consortium members. It is a joint venture and the cooperation is formalised between the syndicates. Consortium arrangements are to the left of the subscription system of risk placement when superimposed on the structural continuum of Figure 4.6.

Consortium arrangements and the subscription system of risk placement are examples of strategic alliances, which some scholars would terms as networks; they fall between the two extremes of market and hierarchy - nearing towards a market - on the structural continuum of Figure 4.6. The subscription system exists primarily as a mechanism for placing risks that require a capacity greater than that provided by any one insurer. There is no formalised cooperation agreement between the syndicates; however, it is business practice that the following syndicates on the slip will agree with the judgments of the leading underwriter, especially in terms of claims handling and any changes in the coverage.

In a consortium arrangement, the composition of the consortium, in terms of the participating syndicates, is determined before any risk is underwritten. There is a consortium slip to which all participating underwriters subscribe and this details how the consortium will operate in terms of risk selection, claims handling and the payment of fees to the lead syndicate of the consortium. In both consortia and the subscription system, the transaction costs for any one syndicate are reduced because a syndicate can underwrite a risk which it otherwise would have to underwrite in total and then arrange facultative reinsurance protection.

It has been stated earlier in this thesis, that this author has found that Lloyd's underwriters are entrepreneurial in their underwriting. The suggested reason for this was the existence of the subscription system which allows underwriters to experiment but not expose too much of their capital base to liability. Additionally, the subscription system allows risk information to pass freely from underwriter to underwriter. Jarillo (1988) argues that a network exists when the transaction costs are lowered and that this is the result of the action of the entrepreneur. Jarillo's reasoning would suggest that the subscription system exists as a result of the entrepreneurial nature of the Lloyd's underwriter. This author's contention earlier in this thesis, is that the subscription system encourages entrepreneurism, thus throwing into question Jarillo's argument. However, it may be that Jarillo's argument could be reversed in that the intrinsic ability for a firm to enter into a network arrangement with other firms encourages the entrepreneur to act and to seize the opportunity.

The subscription system performs two functions: firstly, a pooling a syndicate's capital in order to assume the risk, and secondly a pooling of underwriting expertise to review and assess the risk. There has been, and continues to be, a gradual growth in the size of syndicates, for instance ACE London Underwriting Limited announced in early April 1997 a merger of Syndicates 47 and 322 and of Syndicates 219 and 204.

Furthermore, with Managing Agents being owned by large corporate capital providers who can supply capital to syndicates, this author suggests that syndicates may continue to grow in size. With such mergers and acquisitions and organic growth in size, syndicates are able to underwrite bigger lines on risks because they have a larger capital base to support the liability. In the future, whether a risk is placed via the subscription system may thus depend not so much on the need for syndicates to pool their capital, but on the need for syndicates to pool their expertise.

Jarillo (1990) argues that a network is held together through trust and he illustrates this reasoning by describing the operations of the Italian textile manufacturer Benetton. Whilst there is trust within the subscription system in that all the syndicates are reliant on the judgment of the leading underwriter, this author suggests that trust is not the primary reason for the network. The subscription system exists because it is a mechanism whereby insurers can underwrite large risks. They could not underwrite such risks without either increasing their capital base or arranging reinsurance for the risk. This author suggests that the primary reason why the network exists is to compensate for the lack of capital of the constituents of the subscription system. Furthermore, the subscription system ensures that all underwriters pool their knowledge in risk assessment. The transaction costs of a syndicate participating in the subscription system are lower than those associated with raising extra capital or by employing extra underwriters. Trust is therefore not the primary reason that the network occurs.

We may view a consortium arrangement as being a pre-arranged subscription system. Unlike the subscription system, trust is more the essence of this alliance. A group of syndicates come together and pool their capital to form a consortium for underwriting certain types of business, e.g. the Marchant Space consortium and the Small Business Consortium. One of the members is the consortium leader and he will underwrite business for the consortium members in accordance with the rules of the consortium. The broker is the intermediary between the customer and the underwriter. The relationship is one of agent and principal and the law of agency applies. Some Managing Agencies are receiving investment from broking houses, e.g. Aon's investment in the Jago Managing Agency, thus we might expect to see some alliances between syndicates and brokers in the future. If we take a broad perspective on the role of the broker, then brokers may be regarded as the marketing arm of syndicates and, in this sense, there is an alliance between brokers and syndicates. Furthermore, in recent years brokers have worked closely with underwriters to develop products. These alliances are not formalised but are rather an agreement to work together for mutual benefit.

A syndicate may be viewed as a hierarchy, indeed the traditional view of a syndicate is a single underwriter in charge of a small number of staff. With the growth of syndicates, this structure has developed into one where there are line underwriters, essentially underwriting departments, e.g. property excess of loss, direct property, casualty, medical expenses. Each line underwriter will have to produce a business plan and negotiate capacity with the Board of Directors. Each underwriting department is viewed as a profit centre. This is the structure of syndicates that have a capacity in excess of £100 million, e.g. Brotherton, Charman, Harvey Bowring.

One of the features of Lloyd's is that syndicates outsource various functions, principally premium processing (to the Lloyd's Policy Signing Office), policy issuance (to the broker) and claims handling and negotiation (to the Lloyd's Claims Office). Syndicates "buy into" each of these services. Such a structure is a network form.

If the structure of Lloyd's is viewed from the viewpoint of its governance, then the Society resembles a hierarchy. The Council of Lloyd's may be likened to a board of directors which oversees various operating divisions (M-form organisation). However, the Council's role is primarily that of regulator and monitor and cannot direct the business underwritten by each syndicate nor direct each syndicate's strategy as can the centre in an M-form organisation. However, the Council of Lloyd's does have extensive powers over syndicates as the implementation of Equitas demonstrates.

The above discussion suggests that it is difficult to classify Lloyd's as being one particular organisational type. This author suggests that it is not useful to regard Lloyd's as an organisation but rather to view it as an industry, a microcosm of the insurance industry consisting of insurers and reinsurers. There are certain commonalties between the syndicates such as the unique capital base, close communication between the underwriters and shared central services. Lloyd's is, in essence, a collection of insurance entities that are gathered in a particular geographical space, the Lloyd's building. Comparison may be made between Lloyd's and the entire UK insurance industry. The DTI regulates the insurance industry in a way similar to how Lloyd's is regulated by the Council of Lloyd's. Contributions to the Central Fund are analogous to contributions that UK insurers make to the Policyholders' Protection Board, although this Board responds solely to claims from individuals whereas the Central Fund will pay all claims, both insurance and reinsurance. There are mergers and takeovers in the UK insurance industry similar to the mergers that have occurred between syndicates. The subscription system of risk placement occurs with companies as well as in Lloyd's.

There are thus various organisational forms that are present within Lloyd's and it is not possible to say that Lloyd's belongs to one particular structural type. We may view Lloyd's as being a sector of the insurance industry. However, because it is small and tightly controlled by the Council of Lloyd's and all the syndicates trade in the same building, it has a unique identity, that of being "Lloyd's". By contrast the UK insurance industry does not have a similar unique identity, due to the disparate nature of its participants. Figure 4.8 summarises the structures present within Lloyd's.

| **Structure** | **Generic type of organisational form** |
|---|---|
| Subscription system (syndicate-syndicate relationship) | Network: Informal cooperative venture |
| Consortium arrangement | Network: Joint venture |
| Individual syndicate | Hierarchy - internal structure.<br>Network structure - relationship with LPSO, LCO and broker |
| Governance structure of the Society of Lloyd's. | Hierarchy - resembles an M-form organisation |
| Broker-underwriter relationship | Network: Informal cooperative arrangement |
| Personal lines (insurance) syndicates | Market |

**Figure 4.8: Structures present within Lloyd's.**
**(Source: This author's analysis)**

## 4.7 Current structural changes in the insurance industry

It is interesting to speculate on the future structure of Lloyd's, but it is informative to first look at the changing structure of the insurance industry. Bebear (1990) comments that the future insurance industry will consist of niche insurers and large insurers. This scenario is reinforced by Schulte-Noelle (1994) and, in particular, Farny (1990) who states:

> "At the one extreme will be the (very) large insurers who operate in a fairly general way on a Europe-wide or worldwide basis.
>
> "At the other extreme will be the small or medium-sized insurers that operate nationally, perhaps even only locally, and will continue to do so. Specialisation in a limited area of operation is often followed by specialisation in specific business segments, for example in individual classes of insurance or -and this is becoming increasingly important- in individual groups of customers."

In the U.K personal lines industry, there is a drive for insurers to contain costs in order to compete effectively against the direct writers such as Direct Line. One way to ensure that expenses are handled efficiently is to seek economies of scale through merger with another company, such as that between Royal Insurance and Sun Alliance. In the reinsurance industry, there is consolidation between reinsurers, e.g. the merger of General Re and Cologne Re, the acquisition of Société Anonyme Française de Réassurances (SAFR) by Partner Re of Bermuda.

This consolidation within the insurance and reinsurance industries is being mirrored within Lloyd's with a gradual decrease in the number of syndicates but a growth in the average size of syndicate. Furthermore, the availability of new external corporate capital gives the potential for syndicates to grow in size. This author suggests that Lloyd's could develop into an insurance bourse with about 100 syndicates each with a capacity of about £100 million. This author further suggests that this will lead to a less flexible and less innovative Lloyd's than has previously been the case. There will also be a gradual decrease in the number of risks placed within the subscription market as the increase in the size of syndicates will result in more syndicates underwriting business fully rather than coinsuring with other syndicates. This is not the traditional picture of Lloyd's. Lloyd's has always been an institution where individual underwriters have been able to start up their own syndicates. This has ensured the regeneration of the Lloyd's 'market' and has encouraged the entrepreneur to flourish. Given this culture, it is interesting to speculate whether the large syndicates will spawn smaller break-away syndicates headed by underwriters who wish to have their own syndicate. We may therefore yet see a growth of new small syndicates. This, however, will only occur if the Central Fund is kept as the foundation of the security of Lloyd's. This is a subject discussed below.

Some scholars, such as Barnatt (1997) state that the future organisational form will be the network structure. Whilst this author concurs that the network form will be of increasing importance, the experience of the insurance industry with the current merger of companies suggests that this industry will be dominated by large hierarchical firms. The structure of the insurance industry would provide fertile ground for some further academic study.

# Chapter five: The Nature of Cooperation within Lloyd's

## 5.1 Introduction

This chapter discusses the role of cooperation within Lloyd's. From this analysis a descriptive model of Lloyd's is proposed. The chapter concludes with a description of the Illinois Insurance Exchange and a comparison between this Exchange and Lloyd's.

## 5.2 The subscription system

A dictionary definition of cooperation is "working together to the same end". This definition captures the essence of cooperation in that it identifies that cooperation requires two independent parties working together. The most pronounced example of cooperation in Lloyd's and in the London market is the subscription system of placing risks. This involves a broker placing each risk with several syndicates, each syndicate taking a percentage of the liability in return for the same percentage of premium. The broker will continue to place the risk with underwriters until the percentage placed on the slip is one hundred per cent. For some risks the broker is able to place over one hundred per cent of the risk, in which case the written line of each syndicate or company will be reduced proportionately until the total sums to 100 per cent. The subscription market operates due to the nature of the London market as a brokered market; there is no direct placement of business between the insured or reinsured and the syndicate or insurance company. This is not the case for other markets such as in Bermuda where direct placement of reinsurance business is common.

Carter and Diacon (1990) provide a very comprehensive summary of the operation of the subscription system which they describe as a system "essentially to canvas the opinion of underwriters on what should be the appropriate loss probability." Carter and Diacon (1990) see the subscription system as a method whereby the London market is able to handle the "more unusual and high risks insurances where, by definition, loss probabilities are not known or agreed by insurers." Thus the rate for the risk is achieved through consensus between underwriters. However, this view of the subscription market does not encompass its other function which is to achieve a consensus on policy wording and coverage.

Syndicates also cooperate in various administration functions such as LPSO and the Lloyd's Claims Office. Syndicates are required to use these shared services which are charged to the syndicate based on usage. By cooperating in this way, Syndicates can achieve economies of scale. Underwriting decisions are left to the underwriters of each syndicate, the Corporation of Lloyd's does not direct the underwriting.

The structure of Lloyd's may be likened to Chandler's M-Form organisation (Chandler, 1962). However, whereas in an M-form organisation the centre can direct the business decisions made by each business unit, this is not the case with Lloyd's. The centre (the Corporation and Council) assists the underwriter, but does not direct underwriting decisions. The profitable nature of Lloyd's comes from the broker-underwriter relationship not the centre-underwriter or centre-broker relationship. The Corporation of Lloyd's does not direct what type of business is written by each syndicate or direct the strategy of each syndicate - the centre can just monitor, regulate and assist in various functions such as accounting.

The subscription market relies on there being a large number of syndicates willing to cooperate. In recent years consortium arrangements have developed which offer brokers a predetermined subscription market. Essentially the subscription market is condensed into one "stamp". This arrangement allows brokers to place business with one underwriter who represents the whole consortium arrangement. A binding authority and lineslip are also methods to "condense" the subscription market.

The Porter model needs to be altered to take into account the cooperative nature of the Lloyd's market. This author suggests that Lloyd's is unique because of the nature of cooperation within the Society. Each risk is too large for any one syndicate to underwrite in totality, therefore cooperation enables each risk to be written across several syndicates. The advantage of such a method of underwriting business to the syndicate is that the underwriter can attain a better spread of business for a given premium income, i.e. a balanced book of business, both in terms of class diversification and in terms of geographical spread. As for the customer, he is not reliant on any one insurer or reinsurer, so gaining the advantage of risk spread. In addition the risk has been scrutinised by various underwriters, not just by one underwriter. This allows for a greater evaluation of the assessment of the risk for the customer and a sharing of information between underwriters. Indeed, this author suggests that the sharing of information between underwriters via the subscription system is an important aspect of the operation of Lloyd's.

Nalebuff and Brandenburger (1996) define added value as:

> "Added value measures what each player brings to the game. Take the size of the pie when you and everyone else are in the game; then see how big a pie the others can create without you" (Page 46.)

Given this definition, the added value of each syndicate is the maximum line it can underwrite for any particular line of business. This is true if the total capacity of the market equals the capacity of any one risk. But if the market capacity is greater than any one risk, the added value of each syndicate is zero, i.e. a "buyer's market". However, if the capacity of the market is less than the capacity of any one risk then the added value of each syndicate is greater than its maximum line, i.e. a "seller's market" and therefore the underwriters' prices will increase. There is asymmetry between shortages and surpluses in capacity - a small shortage will increase added value greatly but a small surplus will reduce added value to nil. Nalebuff and Brandenburger (1996) suggest that this asymmetry explains the recurring cycles in insurance. Whilst each syndicate may have zero added value in times of surplus capacity, the whole London market does have added value within the worldwide reinsurance market.

The subscription system of risk placement ensures that each syndicate is reliant on each other. If a risk has a capacity of say $100,000,000 and a syndicate has a maximum line of $10,000,000 on this risk, then the broker must find nine other syndicates with similar maximum lines for the risk to be fully placed. Given this degree of interdependency between syndicates, it is not unreasonable to assume that the strategy of one syndicate will affect the strategy of the others. For the subscription market to operate a large number of participants are required. However, the crucial feature is that no one company or syndicate is able, or willing, to underwrite each risk fully; each entity will take a fraction of the risk. With the introduction of corporate capital into Lloyd's and the purchase of managing agents by large reinsurers and investment trusts, there is the possibility of the growth of large syndicates which will have sufficient capacity to underwrite risks one hundred per cent. In this scenario, the subscription market will collapse for all but the largest reinsurance placements.

**5.3 Developing a structural model of Lloyd's.**

Porter provides a useful framework within which to analyse an industry, however whilst a Porter-type model may be developed for Lloyd's - see Chapter Four - such a model overstretches Porter's work. Furthermore, Porter's model does not take into account the role of cooperation which is a feature of Lloyd's. A more useful framework is that developed by Kay (1995). Whilst Kay's work is primarily directed at evaluating the core competencies of the firm, his concept of *architecture* may be used as a framework for analysing the structure of Lloyd's. However, like Porter, the work by Kay does not include an evaluation of cooperation or culture within a firm or industry both of which are elements strongly present in Lloyd's. This author's work on cooperation expands some of the ideas of Brandenburger and Nalebuff (1995) and Nalebuff and Brandenburger (1996) on coopetition.

All organisations consist of various activities, such as task, allocation, supervision and coordination. Such activities constitute the mechanics of the organisation and the fact that such activities can be arranged in various ways means that organisations can have a variety of structures.

Superficially, Lloyd's resembles a large diversified firm in which responsibility is pushed down to the business unit and to profit centre managers (Chandler, 1962). Goold and Campbell (1987) have investigated large diversified companies and have identified two extremes of company structure:

> "At one extreme we found companies such as BTR, GEC, Hanson Trust and Tarmac, who believe in:
> - limiting the activities of the centre to a few essentials, such as approving or rejecting proposals and appointing managers;
> - giving as much responsibility as possible to the managers in charge of the business units: the centre does not interfere in the thinking of these managers, other than to replace those who fail;
> - setting tough targets for profit and insisting that managers meet them: failure to meet budget in these companies can be tantamount to resigning.
>
> "At the other extreme, we found companies such as BOC, Lex and STC, who
> - believe that the centre should have a leadership role, giving direction to the business units, and helping to develop strategies that support the corporate objectives;
> - expect the centre to be involved in major decisions and to coordinate plans between different units within the group;
> - emphasize the value of strategic, long-term planning;
> - set targets mainly in terms of progress against competitors and seek motivation from a shared commitment to these goals."

Between these two polar opposites, Goold and Campbell found a variety of intermediate styles. In a diversified company the centre owns the subsidiaries and thus has ultimate control e.g. Hanson Trust, British Petroleum. However, in Lloyd's the centre does not own the syndicates in the sense of owning the capital base but may effect rules which exert control over the activities of the syndicates i.e. the role of the centre is primarily as a regulator. Under the Lloyd's Act 1982, the role of the Council is to manage the affairs of the Society and has the power to regulate and direct the business of insurance at Lloyd's. Furthermore, the Council has the power to "make such byelaws as from time to time seem requisite.... and for the furtherance of the objects of the Society..." (Section 6(2), Lloyd's Act 1982). The formation of Equitas was effected under this section of the Act, although the Council of Lloyd's asked the membership to vote to accept the formation of Equitas.

Goold and Campbell (1987) have proposed eight management styles based on their research into diversified corporations. These management styles are:

- Holding company;
- Centralised;
- Strategic Planning;
- Strategic Programming;
- Strategic Control;
- Strategic Venturing;
- Financial Control;
- Financial Programming.

Lloyd's may be likened to a Strategic Venturing Business which Goold and Campbell define thus:

> "...the centre delegates the development of strategies to business units, and makes few attempts to challenge their proposals. Controls are flexible, allowing time for the business units to build a position in the market. But the centre does more than in the Holding Company style. It monitors results being achieved, is willing to intervene if serious problems are emerging, and retains discretion over major resource allocation decisions. This style is similar to that used by venture capital companies."

However, unlike a diversified company, the "centre" of Lloyd's, the Council and Corporation, do not own the business units i.e. the syndicates. The development of each syndicate's strategy is a role performed by the syndicates and the managing agencies. Mintzberg (1991) describes the role of the headquarters in a diversified company as to exercise performance control and to develop corporate strategy. The Council and Corporation of Lloyd's cannot direct the strategy of each syndicate, but may assist each syndicate in achieving its objectives such as obtaining licences to trade in foreign countries. For instance, Lloyd's Japan Inc, a vehicle to underwrite insurance in Japan, was pioneered by various Lloyd's underwriters but received considerable input from the Corporation's International Department.

Whilst the Council and Corporation of Lloyd's are essentially charged with the regulatory aspects of the operations of the Lloyd's market, the centre will intervene in the operation of the market if this is deemed necessary "for the furtherance of the objects of the Society" (Lloyd's Act 1982). For instance the Council proposed the setting up of Lioncover Insurance Company in 1987. This company has reinsured the liabilities of Names on syndicates formerly managed by PCW Underwriting Agencies Limited, WMD Underwriting Agencies Limited and Richard Beckett Underwriting Agencies Limited and on Syndicates 2 and 49 (the PCW syndicates). Following a settlement in 1987 with the members of the PCW syndicates, the Society is liable to fund the amount by which Lioncover's liabilities exceed its assets. Similarly, the Equitas project was devised by the Council, implemented by the syndicates and approved by the membership.

Whilst there is a similarity between Goold and Campbell's Strategic Venturing Company and Lloyd's, there are some major differences. The capital base of Lloyd's is not owned by a central body, but by the individual business units. There is also competition between the business units which is unlikely to occur in a diversified company such as Hanson plc. The essential feature of Lloyd's is the tension between cooperation and competition. Cooperation requires an agreement between firms or, as is the case of the subscription market, it occurs as a function of the business process.

The culture of Lloyd's is an important aspect of its operations. Culture concentrates on the collective interest and the building of a unified organisation, through shared systems of beliefs, habits and traditions (Mintzberg and Quinn, 1991). Lloyd's has a rich history stretching over 300 years, its own coat of arms with the motto *"Fidentia"*, and in that time has evolved from being an organisation to being an institution. In Selznick's (1957) terms, the organisation has converted from an expendable "instrument" for the accomplishment of externally imposed goals into an "institution", a system with a life of its own. It "acquires a self, a distinctive identity".

The subscription system is the method by which Lloyd's has historically traded with its customers. Given that Lloyd's is a major international market, the question arises as to whether the success of Lloyd's is due to its being a subscription market. Is this cooperative arrangement at the heart of the success of Lloyd's?

Lloyd's is a market which is centered on the primacy of underwriting; furthermore it is a market which is centered on individuals - underwriters - rather than on corporations. It is a market where, historically, talented underwriters have been able to start up their own syndicates rather than working for a large company. This entrepreneurial culture encourages new syndicates to form and thus creates a market of small insurance entities. This author suggests that the only method by which such a group of small insurers can compete with competitors such as the Munich Re and Swiss Re is by cooperating with each other. The subscription market allows the transfer of information between syndicates and thus the customer's risk is reviewed by many underwriters, each of whom will have the opportunity to make comment as to the insurance coverage provided. From the perspective of the client, the security of one syndicate is the same as that of another as the solvency rules laid down by the Council of Lloyd's are applicable to all syndicates. The Council of Lloyd's furthermore does not prescribe rates nor requires rates to be filed, as is the case with US admitted insurers who have to file rates with the Insurance Commissioner of each State in which they are licensed. This allows syndicates great flexibility in pricing each risk.

Lloyd's therefore has a culture of entrepreneurial underwriters where decision making lines are very short - the active underwriter will make the final decision whether to underwrite a risk. There is little underwriting "by committee" as there is in some US insurance and reinsurance companies. This is coupled by an ability for underwriters to work together and share information on risk assessment. This is a competitive advantage unique to Lloyd's compared to other markets such as the Illinois Insurance Exchange. This author suggests that the subscription system of risk placing together with entrepreneurial underwriting are the prime reasons for the historic success of Lloyd's.

Cooperation can also occur within Lloyd's as a result of the rulings of the Council of Lloyd's. In this way the Lloyd's market cooperates en bloc because decisions are made by a third party, the Council of Lloyd's, the rulings of which are mandatory for all syndicates. The formation of Equitas - the pooling of all 1992 and prior liabilities into a central vehicle - is cooperation but this was only possible because the decision was made by the Council.

Each syndicate is bound by the decisions of the Council; thus no syndicate has complete freedom with which to conduct its business. The price of cooperation is to sacrifice some freedom. There is a culture in Lloyd's whereby syndicates, brokers, managing agents and members' agents will agree to act together "for the good of the Society"; the implementation of Lioncover and Equitas are examples of such cooperation. Such acts of cooperation are deemed to prevent damage to the Society's name i.e. protect the reputation of Lloyd's. For some syndicates that had traded profitably and had built up substantial reserves, the Equitas project removed their funds. However, for Names on loss-making syndicates such as those managed by Gooda Walker they were offered a settlement and the opportunity to resign from Lloyd's.

The cooperative nature of the market goes beyond the sharing of risks and sharing of administrative functions such as the Lloyd's Policy Signing Office and the Lloyd's Claims Office. The nature of Lloyd's is that it is simultaneously a competitive marketplace, i.e. syndicates compete for business with each other, and a cooperative marketplace. Lloyd's can therefore act as a single entity, as it had to with the implementation of the Equitas project, but also each syndicate is free to develop its own business and compete with every other syndicate for business.

One of the most intriguing questions, and one that was not addressed in the Lloyd's Task Force Report, is why is there no comparable Lloyd's-type entity elsewhere in the world. Lloyd's has been trading for more than three hundred years and it is one of the largest reinsurers in the world. Why has it not been imitated? Williams (1992) states:

> "Success brings on imitators who respond with superior features, lower prices, or some new way to draw customers away. Time, the denominator of economic value, eventually renders nearly all advantages obsolete".

If Williams is correct then there should be other Lloyd's-type entities in the reinsurance and insurance market. In reality there is, and only has been, one Lloyd's. Lloyd's was not founded by any particular individual but evolved from a group of merchants trading insurance in a Seventeenth Century Coffee House and, as Lloyd's developed, a structure to the trading of insurance also developed. Fundamental to this structure are the syndicates and the subscription system of risk sharing (the coinsurance market). This author suggests that this structure, or architecture, is difficult to imitate and this is the reason why Lloyd's has remained unique.

### 5.4 Towards a model of Lloyd's.

As already mentioned the structure of Lloyd's resembles Chandler's large diversified firm where responsibility is pushed down to the business unit and to profit centre managers. However, whilst Lloyd's possesses a centre - the Corporation of Lloyd's and the Council of Lloyd's - these cannot direct the business written. They can only formulate rules in which all syndicates should operate. The strategy of the syndicates is a concern for each syndicate and cannot be directed by the centre. The Council of Lloyd's does not instruct a syndicate to underwrite a certain type of business nor direct the personnel recruitment of each syndicate, or set profit targets for each syndicate. The Council can only prevent a certain type of business being written, for instance financial guarantee insurance, or monitor the writing of certain classes of business. The function of the Council of Lloyd's is primarily regulatory. The 1993 Lloyd's Business Plan which was commissioned by the Council of Lloyd's is thus not a business plan in the accepted sense. The "business plan" of Lloyd's is the sum of all the business plans of the syndicates.

As each syndicate is a separate business operating within the same market, although not all syndicates will operate within the same market segment, there will be competition between syndicates for the available business. However, the subscription system creates cooperation between syndicates and the Council of Lloyd's can direct that all syndicates should cooperate on certain matters - for instance, the implementation of Equitas and the future funding of Lioncover Insurance Company which is funded from contributions from the Central Fund. Yet the subscription system is not a formalised agreement, but rather the customary method of transacting business within Lloyd's and the London market. It is a cultural characteristic of the London market.

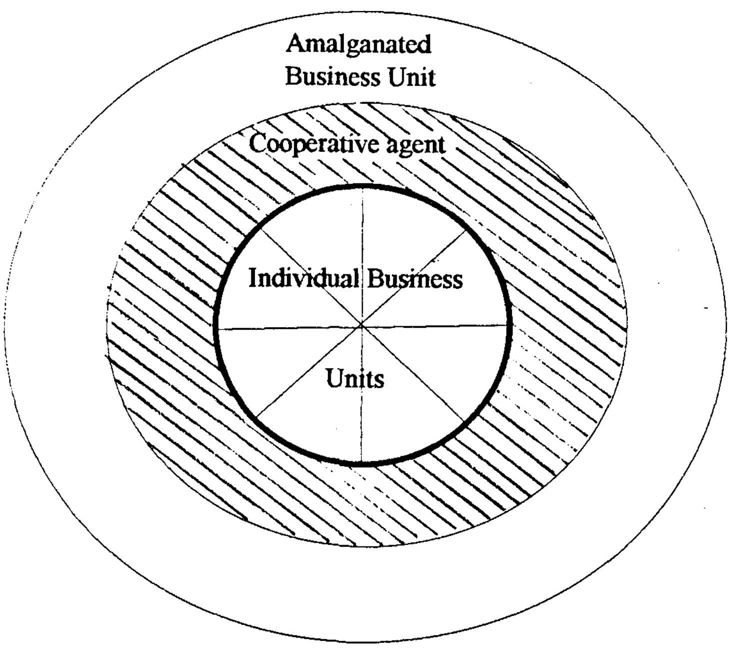
When Lloyd's cooperates, it is unified. When Lloyd's acts together, the Society in effect becomes a single insurance entity with £10 billion of capacity- the third largest reinsurer in the world. A £50 million syndicate, for instance, can thus gain the competitive advantage of a £10 billion insurer. By being united in the formation of Equitas, each syndicate is offering security that will not be affected by any deterioration on 1992 and prior years.

Cooperation, other than through the subscription system, occurs in Lloyd's because there is a third party which can create rules and enforce them. Cooperation is only possible if all syndicates agree to be bound by the rules laid down by the third party - the Council of Lloyd's. Lloyd's can thus act as a single insurer of £10 billion capacity or as a thriving market of 170 independent insurers all competing with each other and companies for business.

This author suggests that a diagrammatic model may be developed for Lloyd's. At the centre of the model are the syndicates, individual business units that compete with each other for business. Surrounding these syndicates is a "cooperative agent", a body that enables the syndicates to cooperate. Surrounding the cooperative agent is the "amalgamated business unit", synonymous with the entirety of Lloyd's i.e. the Society of Lloyd's. The amalgamated business unit and the individual business units co-exist simultaneously. The cooperative agent is the Council of Lloyd's. The model is shown in Figure 5.1. This model attempts purely to describe the structure of Lloyd's in terms of the syndicates operating within Lloyd's. It does not show, for instance, the capital structure of Lloyd's nor the competition between syndicates within Lloyd's and between syndicates and insurance and reinsurance companies.

**5.5 Institutions comparable to Lloyd's.**

It has already been stated that there is no similar entity to Lloyd's in the world. The closest is the Illinois Insurance Exchange in Chicago, USA. This exchange was created in 1980 as "an innovative response to the cyclical shortages in capacity for excess and surplus lines risks". (Marketing Literature *"Who we are - a market of opportunity"*, Illinois Insurance Exchange). The underlying concept behind the Exchange was to develop a Lloyd's of London-style market for insurance risks that are hard to place in the traditional insurance marketplace because of the lines of coverage, the exposures, or a uniqueness that requires creative or individual rating and underwriting.




*Individual Business Units* equate to the Syndicates.

*Cooperative agent* is the Council of Lloyd's.

*Amalgamated Business Unit* is the entire entity called Lloyd's.

**Figure 5.1: A Descriptive Model of Lloyd's (proposed by this author)**

There are currently twelve syndicates with a total of $441 million in assets and policyholders' surplus. Gross written premium income for 1995 was $150 million. Investment in the syndicates has come from private individuals and insurance companies. For instance all shares in Prime Syndicate Inc are owned by twenty-seven individuals; shares in Geneva Assurance Syndicate Inc are owned by Geneva Management Inc, an insurance holding company incorporated in the State of Illinois.

### 5.6 The Operations of the Illinois Insurance Exchange

The Exchange consists of three separate entities: the Central Processing Facility, the marketplace - the Exchange syndicates, and the Illinois Insurance Exchange Guaranty Fund Corporation and Immediate Access Security Association. The Exchange is designed to be a marketplace in which insurers and prospective insureds can be matched by brokers. The Central Processing Facility provides all the administrative functions, facilitates premium collection and disbursement, facilitates claim collection from syndicates and disbursement to brokers and performs all audit and regulatory oversight functions authorised by the Illinois Department of Insurance.

The Exchange is managed by a Board of Trustees who are charged with the control of the operations of the Exchange. The Board is composed of representatives of nine syndicates and four public members. Control is effected by through various committees, in conjunction with Exchange staff. There are three committees: Audit and Regulatory Oversight Committee, Operations Committee and Brokers Members Committee. The Audit and Regulatory Committee monitors the financial condition of each syndicate as well as adherence to Exchange rules and regulations. This

Committee is also responsible for reviewing new applications for syndicate membership on the Exchange. The committee also performs the necessary due diligence prior to making a recommendation for admission to the Board of Trustees.

The Operations Committee is responsible for overseeing the day-to-day operations of the Exchange such as the transfer of premiums and claims to and from brokers and syndicates.

The Brokers Members Committee reviews new applications for membership as well as monitoring the activities of existing Exchange brokers. The Committee also markets the Exchange to brokers and to potential customers.

The organisational structure of the Exchange provides a means for regulation of the syndicates and brokers. Corrective actions will be enacted by the Board if necessary. These actions may consist of restrictions on writings, injection of funds for additional surplus, restructuring of reinsurance and the issuance of cease and desist orders.

The Exchange has a Guaranty Fund similar to the Central Fund of Lloyd's. The Guaranty fund provides for claims to be paid to insureds in the event of the insolvency of an Exchange syndicate. There are two components of the Fund. The first is a surcharge of 1% of each syndicate's gross written premium income. This Premium Surcharge Fund is the first source to be drawn upon in the event of an insolvency. The second component is the requirement that each syndicate deposit $1 million of its assets into a Guaranty Fund Custodial Account, half of which is available to pay claims against any one insolvent syndicate if the Premium Surcharge Fund is insufficient. As a further safeguard, Exchange rules require that each syndicate maintain half of its capital and surplus in an Immediate Access Account, a custodial account controlled by the Exchange. This serves as a warning device to the Board of Trustees as a syndicate approaching an insolvent position would need access to these funds and permission to use them must be sought from the Audit and Regulatory Oversight Committee.

Unlike the Lloyd's Central Fund, the Exchange has per-claimant limits as well as a cap for an insolvency. The current claimant limit is $300,000 per insolvency and $15 million for any one insolvency (Rudolph, 1992). The maximum any syndicate can provide to fund another syndicate's insolvency is $500,000, and there is an aggregate of $1 million applicable to all insolvencies. In the event of a withdrawal of a syndicate from the Exchange, the custodial accounts and the Immediate Access Account must be maintained for three years following the year of withdrawal. All business brought to the marketplace must be presented by a broker member of the Exchange which will be either an independent broker or a syndicate's captive broker.

**5.7 Regulation of the Illinois Insurance Exchange**

The Illinois Department of Insurance retains the overall responsibility for the regulation of the Exchange. However, the authority to perform syndicate audits has been delegated to the Exchange, although the Department of Insurance receives and approves audit reports. The Exchange acts as a self-regulating body, but the Department has ultimate authority in the continued licensing of the Exchange as a marketplace. Currently, the syndicates have admitted status in Illinois only, but are eligible surplus lines insurers in forty-six states and approved reinsurers in twenty-two states.

### 5.8 Comparison of the Illinois Insurance Exchange and Lloyd's

The most striking difference between the Illinois Exchange and Lloyd's is the nature of the capital base. The Exchange consists of shareholders with limited liability which contrasts with the unlimited liability of Names in Lloyd's, although corporate capital at Lloyd's has limited liability. Another related difference is the level of capital required to be an investor in a syndicate on the Exchange. As little as $30,000 may be invested in an Exchange syndicate which then becomes the maximum that the investor can lose, instead of the significant larger minimum investment and the unlimited personal liability of a Lloyd's Name.

Structurally the Exchange and Lloyd's are very different in that the Exchange is not a subscription market. An Exchange syndicate does not coinsure with other syndicates on the Exchange - there is no culture of cooperation on risk sharing. Cooperation exists in the form of shared services rather than shared underwriting. A summary of comparisons between Lloyd's and the Illinois Insurance Exchange is given in Figure 5.2 below.

| Feature | Illinois Insurance Exchange | Lloyd's of London |
|---|---|---|
| Capital base | Limited liability | Mixture of limited liability and unlimited liability |
| Services | Shared between syndicates | Shared between syndicates |
| Subscription market | No | Yes |
| Who is the regulator? | Little self-regulation. Essentially regulated by Illinois Department of Insurance | Self-regulation |
| Central Fund | A Guaranty Fund exists but there is a per claimant cap and a cap per insolvency | A central fund exists - no cap per claimant or insolvency |
| Policy wordings | Each syndicate develops its own | Common policy wordings used by all syndicates |
| Business underwritten | USA business only | Worldwide business |
| Minimum investment | \$30,000 (£20,000) | £250,000 (\$375,000) |
| Number of syndicates in 1996 | 12 | 171 |
| Premium income | \$150m (in 1995) | £7,351m (in 1995) net of commission.<br>£8,927m (in 1995) gross of commission |

**Figure 5.2:** A comparison of the features of the Illinois Insurance Exchange and Lloyd's.

Source: Illinois Insurance Exchange, Statistics Relating to Lloyd's (1996) and this author's analysis.

## Chapter Six: Innovation, Entrepreneurism and Lloyd's.

### 6.1 Introduction

This chapter describes and evaluates the nature of entrepreneurism within Lloyd's and the reasons for its development. The chapter concludes with a discussion on the possible influence that the change in nature of the capital base may have on the entrepreneurial spirit of the Lloyd's market.

### 6.2 The Nature of Entrepreneurship

Entrepreneurship has attracted a plethora of studies from various scholars. These studies may be divided into three categories: *what* happens when entrepreneurs act; *why* they act; and *how* they act. In the first of these categories, scholars are interested in the results of the actions of the entrepreneur. This is a line of research taken by economists such as Schumpeter, Kirzner and Casson. The second category deals with the entrepreneur as an individual and that the individual, a person with ideas, goals, values and motivation, is the real object of the analysis. In the final category researchers analyse the characteristics of entrepreneurial management and how entrepreneurs achieve their aims.

A study of entrepreneurship must start with a definition of the term "entrepreneur". There are two approaches to such a definition: a functional approach and an indicative approach. In the functional approach an entrepreneur is defined by what he does, i.e. a definition based on the attributes of an entrepreneur. The indicative approach provides a description of the entrepreneur by which he may be recognised. The functional definition may be quite abstract, but the indicative definition is simpler as it defines an entrepreneur in terms of his legal status and his relationships with other parties. The majority of scholars have adopted the functional approach thus defining an entrepreneur as belonging to a particular group of people with certain characteristics. Casson (1982) defines an entrepreneur as "someone who specialises in taking judgmental decisions about the coordination of scare resources." In this definition the entrepreneur is seen as a person, not a team, nor a committee, nor an organisation. The definition emphasises that the individual is able to make decisions and captures the fact that the entrepreneur is an agent of change in that he coordinates scarce resources.

Stevenson and Gumpert (1985) describe entrepreneurship with such terms as innovative, flexible, dynamic, risk taking, creative and growth orientated. Drucker (1985) states that the entrepreneur in the United States is often defined as one who starts his own, new and small business. However, few scholars would agree that anybody who starts a new business is an entrepreneur. Consider the family that opens a small corner shop. They are indeed taking a risk but all they are doing is what has been done many times before. Few researchers on entrepreneurial activity would consider such an act worthy of study. However, McDonald's did not invent anything new in that its product was what American restaurants had produced for many years. But by applying management concepts and management techniques (asking, 'What is "value" to the customer?'), standardising the product, designing process and tools, and by basing training on the analysis of the work to be done and then setting the standards it required, McDonald's both drastically upgraded the yield from its resources, and created a new market and a new customer (Drucker, 1985). Scholars would agree that McDonald's is an example of entrepreneurship.

The growing literature on corporate entrepreneurship suggests that entrepreneurial activity may be found within mature organisations implying that Drucker's definition given above needs to be re-examined. There is thus a problem in defining entrepreneurship, although the problem is semantic. Any definition too narrow is likely to founder in that the nature of entrepreneurism is broad, but as Stevenson and Jarillo (1990) point out too broad a definition may make entrepreneurship equivalent to good management, thus effectively dissolving it as a specialised field of study. This author suggests that the following definition of entrepreneurship given by Stevenson, Roberts and Grousbeck (1989) is useful:

> "Entrepreneurship is a process by which individuals - either on their own or inside organisations - pursue opportunities without regard to the resources they currently control."

The essence of this definition is that it captures the nature of the entrepreneur as a being an individual who is willing to pursue an opportunity which we may define as being a desirable future situation. However, before an opportunity may be pursued, the individual must identify that the opportunity exists.

### 6.3 Theories of entrepreneurism.

In conventional economic theory, the term "entrepreneur" is generally absent. In mainstream or neo-classical economic theory, the entrepreneur is viewed as someone who coordinates different factors of production, but this role is viewed as non-important. The entrepreneur is synonymous with the capitalist employer, the ownermanager who has the wealth to enable production to take place, but otherwise does not have any special attributes. The notion that the entrepreneur has an important role in economic development has been developed by writers outside the mainstream of economic thinking.

For Kirzner, the entrepreneur is someone who is *alert* to profitable opportunities for exchange. The Kirznerian entrepreneur sees the entrepreneur as acting as a 'middleman' who facilitates the exchange. The entrepreneur is able to identify suppliers and customers and acts as the intermediary. The possibilities for profitable exchange occur because of imperfect knowledge; the entrepreneur has some additional knowledge which is not possessed by others and this enables the entrepreneur to take advantage of the opportunity. According to Kirzner, alertness to the disequilibrium in knowledge between the entrepreneur and others is the distinguishing feature of an entrepreneur. By contrast the Schumpeterian entrepreneur is an innovator who introduces new technological processes or products. The entrepreneur is the prime mover in economic development, and his function is to innovate, or to "carry out new combinations". Five different types of innovation are distinguished: the introduction of a new good (or an improvement in the quality of an existing good), the introduction of a new method of production, the opening of a new market, developing a new source of supply of raw materials or the creation of a new type of industrial organisation. The Schumpeterian entrepreneur develops new technology or products through innovation whereas for Kirzner the entrepreneur operates on opportunities that arise out of new technology. The concept of the entrepreneur as an innovator is important. Lloyd's underwriters have a reputation for innovation, for developing new products and thus according to Schumpeter are entrepreneurs.

Knight suggests that the entrepreneur is an individual who is prepared to undertake risk, and the reward - profit - is the return for bearing uncertainty and is an uninsurable risk. Knight identifies uncertainty with a situation where the probabilities of alternative outcomes cannot be determined either by *a priori* reasoning or by statistical inference. *A priori* reasoning is irrelevant to economic situations and statistical inference is impossible because the situation is a unique event. For instance, the probability of fire at a business premises may be determined from the large pool of data on fire losses and thus may be insured against, but the probability of that business failing is unknown and therefore such failure may not be insured against.

The entrepreneur as defined by Shackle is someone who is creative, imaginative and original. Whereas Kirzner's entrepreneur perceives opportunities, Shackle's entrepreneur imagines opportunities. The role of uncertainty and imperfect information is crucial for the view of the entrepreneur held by Shackle. Uncertainty gives rise for certain individuals to imagine opportunities for profit.

Casson's definition of an entrepreneur has been given above and in it he recognises that the entrepreneur has different skills from others and these skills enable him to make judgments and to coordinate scarce resources. Casson emphasises that entrepreneurs require command over resources and thus lack of capital would be a barrier to successful entrepreneurship. Deakins (1996) suggests that Casson's views are close to those of Knight. The entrepreneur operates within a set of technological conditions and by making difficult judgmental decisions entrepreneurs are able to enjoy profit from their ventures.

### 6.4 Attributes of the entrepreneur.

There is a diverse literature on the key personality characteristics that appear to be possessed by successful entrepreneurs. From this literature it is possible to argue that the supply of entrepreneurs is limited to a certain number of individuals who have a certain set of characteristics which marks them out as entrepreneurs. Whether an "entrepreneurial personality" exists is, however, the subject of debate. Deakins (1996) suggests that many of the characteristics that researchers associate with entrepreneurs are the same abilities and skills that could be applied to successful managers and it is therefore difficult to separate out specific characteristics of entrepreneurs.

Some early work on entrepreneurism was carried out by McClelland (1961) who gives the following key competencies of successful entrepreneurs:

- Proactivity: initiative and assertiveness
- Achievement orientation: ability to see and act on opportunities
- Commitment to others.

It seems reasonable that a key characteristic of an entrepreneur is the desire to achieve a goal, or a desire to excel. High achievers are those that accept responsibility for decisions and for achieving solutions to problems (Deakins, 1996). There is a difficulty in trying to search for the characteristic traits of entrepreneurs as such a study ignores the effects of environmental factors that may be more important than personality traits.

A further list of personality traits is given by Meredith *et al* (1982) who suggest that an entrepreneur has five core traits:

- Self-confidence
- Risk-taking activity
- Flexibility
- Need for achievement
- Strong desire to be independent

Given the above factors it may be inferred that profit or monetary reward are not the only motivating factors for the entrepreneur. A further feature of an entrepreneur is that he likes to be "his own boss" i.e. an entrepreneur has a high internal locus of control. The entrepreneur likes to be in control of his own environment and, in turn, his own destiny.

**6.5 The Entrepreneurial organisation.**

Section 6.4 above gave the main characteristics of an entrepreneur. Entrepreneurs need to build and achieve personally set goals or targets through the establishment of a firm.

Perhaps not surprisingly the features of such organisations, which we may call entrepreneurial organisations, are similar to those of the individual entrepreneur and, furthermore, the personal characteristics of the entrepreneur will have an influence on the type of firm that is created, and on the way that it is managed (Lafuente and Salas

1989). Cooper and Dunkelberg (1984) proved the existence of a relationship between types of work expectations and entrepreneurial tendencies. They distinguished between two primary types of labour expectations and, consequently, of entrepreneurs. The first is that of "craftsman" expectations, which are characterised by the individual's urge to decide what work he work he wishes to do, and by the desire to make that work free from someone else's authority i.e. he wishes to be independent. The second type is that of "managerial" expectations, defined by profit-seeking motivations and by the individual's wish to manage and exert power.

Schumpeter (1934) has pointed out the vital role of entrepreneurship in organisations. Stopford and Baden-Fuller (1994) state that entrepreneurship is based on innovations that require changes in the pattern of resource deployment and the creation of new capabilities to add new possibilities for positioning in markets. Building such capabilities may be undertaken at many different organisational levels, involve widely differing combinations of resources and have a wide range of outcomes. New business venturing is usually associated with individual entrepreneurship, but as Burgelman (1983) and Kanter (1983) indicate it may also be a feature of large corporations. The individual entrepreneur is able to take risks, innovate and make progress both in good times and in face of adversity (Baden-Fuller and Stopford, 1992). In the entrepreneurial organisation a single leader takes personal charge in a highly dynamic situation, as in a new firm or a small one operating in a growing market, or even sometimes in a large organisation facing crisis. The structure of the entrepreneurial organisation is often very simple. Mintzberg (1991a) describes it thus:

> ".......typically it has little or no staff, a loose division of labour, and a small managerial hierarchy. Little of its activity is formalized, and it makes minimal use of planning procedures or training routines."

In the entrepreneurial firm power tends to be focussed on the chief executive, who exercises a high personal profile and it is not uncommon for everyone in the organisation to report to the chief executive. Decision making is flexible, with a highly centralised power system, allowing for rapid response. Mintzberg (1991a) states that entrepreneurial organisations are often young and aggressive, continually searching for the risky markets that scare off the bigger bureaucracies. They are careful to avoid the complex markets, preferring to remain in niches that their leaders can understand. Their small size and focussed strategies allow their structures to be simple, so that their leaders can retain tight control and maneuver flexibly. Strategy making in these firms tends to be intuitive rather than analytical and is performed by men who have a "feel" for the business rather than by strategists. Strategies are not explicitly or formally elaborated but reside as the implicit and often vague vision of the leaders (Miller, 1983). In an entrepreneurial firm it is expected that there is a "leadership imperative" largely because the thrust of the firm is so closely tied to one person, the chief executive.

Traditionally, a Lloyd's syndicate has just consisted of a single underwriter, perhaps a deputy, various ancillary staff to handle the administration involved with underwriting, such as recording the risks in a book or computer, and a person who handles the syndicate's claims. Such an organisational arrangement is common amongst smaller syndicates, less than £75 million in capacity, for instance Syndicate 314, C.F. Palmer and others.

The majority of a syndicate's administrative functions are sub-contracted to various Departments of the Corporation of Lloyd's. Unlike policies for other insurance entities, a Lloyd's policy is not issued by the syndicates but by the Lloyd's Policy Signing Office (LPSO) on behalf of all Lloyd's underwriters who are party to the policy. In addition the LPSO collects premiums from brokers and distributes them to syndicates and collects administers the collection of claim payments from syndicates to brokers. The LPSO thus provides an accounting function for the syndicates. If an insured or reinsured makes a claim on his policy then the validity of this claim is assessed by the leading underwriter. If he is in agreement with settling with the claimant, the claim is then passed to the Lloyd's Claims Office (LCO) who will inform the following Lloyd's market on the slip of the claim. Thus, unless a syndicate leads business, the claims agreement function is outsourced to the LCO. Thus underwriters are able to concentrate on underwriting as the majority of the subsidiary functions are outsourced. However, the LCO and the LPSO are wholly owned by the Corporation of Lloyd's and are funded by fees charged to syndicates. The LCO and LPSO are dedicated to the Lloyd's market; they do not work for non-Lloyd's entities.

A syndicate may have several line underwriters each of whom underwrites a certain account such as property catastrophe business, medical expenses, personal accident etc. However there will still be a single underwriter, the active underwriter, who is in charge of the overall operation of the syndicate. Such an organisational arrangement is common with large syndicates (over £75 million capacity) such as Syndicate 861 (M.E. Brockbank and others).

There are thus two underwriting structures for syndicates - one for small syndicates, under about £75 million capacity and a more complex structure for larger syndicates. (See Figure 6.1).

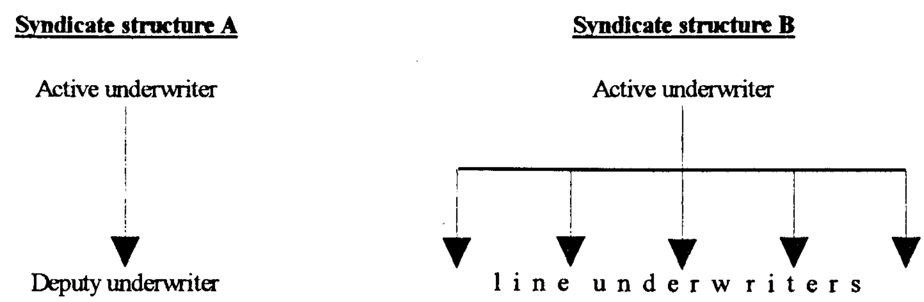



**Figure 6.1: The underwriting structure of two syndicates (Source: This author's analysis)**
A. Small syndicate
B. Large syndicate

Because underwriters outsource many of the administrative functions, this allows underwriters to concentrate on underwriting. The operation of the syndicate is very much in the hands of the active underwriter. This level of focussed control combined with their small size, allows syndicates to be entrepreneurial. In addition, the capital base, when composed entirely of individuals, did not have a say in the operation of the syndicate or in the business underwritten. Indeed, few syndicates, until the 1990s, held annual general meetings of their Names, as all communication with the syndicates occurred through a Name's Members' Agent. One retired underwriter remarked that he rarely spoke to Members' Agents and never spoke to his Names. This author suggests that this detachment between the capital base and the underwriter allowed syndicates to be innovative as they could suddenly change course from underwriting one line of business to another as opportunities arose.

A good illustration of the ability of syndicates to move into a new class of business was seen in the non-marine market during the last three months of 1989. In this year there were a spate of major disasters in the USA - Hurricane Hugo, the San Francisco earthquake and the explosion at the Phillips Petroleum Plant in Pasadena, Texas. Syndicates in Lloyd's often purchase their reinsurance protection for twelve months incepting on 1st January. It is the custom in the London reinsurance market to provide one reinstatement for each layer of a syndicate's outwards reinsurance programme. With the spate of losses in the USA, some syndicates believed that they would not have reinsurance protection for the last three months of 1989 as their current protections would be potentially exhausted by the US losses. Hence during October 1989 there were opportunities for syndicates to underwrite other syndicates' reinsurance protections at highly inflated prices. The Lloyd's market thus divided into sellers of reinsurance and buyers of reinsurance.

### 6.6 The entrepreneurial nature of Lloyd's syndicates.

The Schumpeterian entrepreneur is an innovator who brings about change through the introduction of new technological processes or products. Following Schumpeter's definition, an entrepreneur working in the sphere of insurance will be someone who introduces new products or who remodels an existing product. Thus Peter Wood who founded Direct Line is an entrepreneur because his company has taken motor and household insurance and sold these products direct to the insuring public, via the telephone, without the commission expenses of brokers. The competitive advantage of Direct Line is its low prices charged to customers compared to other insurance companies'.

Lloyd's has pioneered various new forms of insurance, indeed it is often said that *any* risk may be insured in Lloyd's. This is not strictly true but there are numerous examples of Lloyd's underwriters insuring unusual risks - wine tasters' palates, film stars' legs to name a few. The essence of the entrepreneurial underwriter is seen in Cuthbert Heath (1859-1939). Gibb (1957) argues that insurance companies in the early 1900s only issued policies that were of their own formulation. Heath, however, found out what he thought his clients required and then did his best to supply it. Heath found reasons for accepting new enquiries rather than reasons for declining new business. During the period from 1900 to the New York financial crisis in 1907, America enjoyed a great burst of prosperity. Coupled with this growth was the need for insurance. Heath is credited with underwriting the first burglary policy in 1889 (Gibb, 1957), the first "all risks" property policy, the first jewellers block policy and the first business interruption policy. Underwriters at Lloyd's were able to provide the policies that America required during its expansion. Gibb (1957) states:

> "...if Lloyd's underwriters could provide policies of the kinds that America wanted, America was ready to send her orders in profusion. It was just the place for the young non-marine market to sell its wares, and the new types of policies that had been thought out for British merchants began to be exported to the United States, while others which would have been unsaleable in Europe but were suited to America, were thought out for American consumption."

Perhaps the most notable event during Heath's underwriting career was the 1906 San Francisco earthquake. Several American insurance companies failed at this time but Heath sent a telex to his agents in California telling them to pay all policies in full irrespective of the terms of their insurances. This action has undoubtedly helped to secure the reputation of Lloyd's as an insurer that always pays its claims.

The development of aviation insurance during the early part of this century was spearheaded largely by Lloyd's underwriters. Indeed, London is and always has been the most influential market in international aviation insurance. Almost every single major risk will be led in London where the expertise in servicing these accounts and claims handling has been built up over many years. The importance of Lloyd's to the aviation market is shown in Figure 6.2 which shows the percentage of international aviation (airline) insurance lead in Lloyd's. Over half of the world's international aviation business, 54.5%, is lead in Lloyd's by four syndicates - Ariel, Sturge, Maylam and Butler. London companies lead 27.5% and the balance is lead by foreign companies. This illustrates the importance of Lloyd's as an aviation market. The purchase of both the Ariel syndicate, managed by Methuen Underwriting Agencies, and the Sturge syndicate, managed by Ockham Underwriting Agencies, by the Bermudan insurer ACE Ltd has resulted in this company effectively leading 30% of the world's international aviation business.

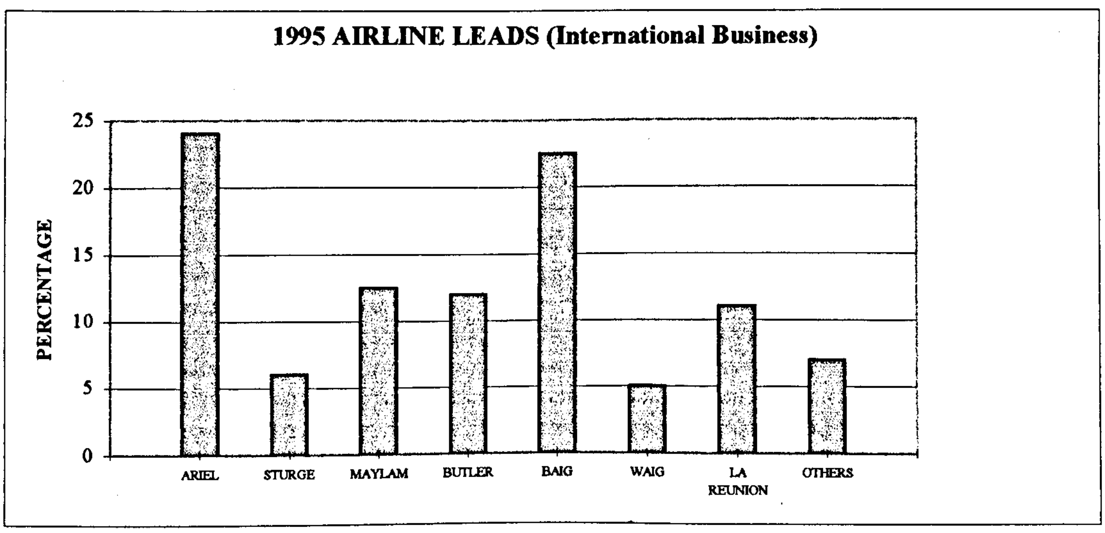



**Figure 6.2**: 1995 Airline leads. Source: Corporation of Lloyd's.
(Ariel, Sturge, Maylam and Butler are Lloyd's syndicates. BAIG is the British Aviation Insurance Group. WAIG is the Westminster Aviation Insurance Group. La Reunion is a French insurance company)

Underwriters at Lloyd's have historically been innovative; indeed one chief executive officer of a major US property and casualty company interviewed by this author stated that innovation is Lloyd's only competitive advantage. Macleod (1994) comments:

> "Lloyd's is the most critical market for difficult and high-limit risks. Without a strong London market, the costs and availability of those coverages would be problematic."

Hatcher (1989) remarks that the strength of Lloyd's lies in the insurance and reinsurance of catastrophic risks underwriters elsewhere in the world are not prepared to insure and that this has placed Lloyd's at the "cutting edge" of innovation. This theme is echoed by Wetherall (1993) who agues that much of Lloyd's reputation is built upon its ability to underwrite large and complex risks.

The innovation of Lloyd's underwriters is seen is a recently-launched commercial legal expenses insurance product (Gibb, 1994). The scheme is marketed by Litigation Protection Limited, London to companies who are in dispute and legal action has begun. For an agreed premium, individually assessed for each case, Lloyd's underwriters will pay all legal fees and expert witnesses' expenses of both parties to the action, plus court costs up to £500,000. Litigation Protection Limited seeks legal opinion to assess each case and only provides insurance to those companies who are deemed by Litigation Protection's lawyers to have a reasonable chance of winning their case. Protection is given up to a maximum payout of £500,000. The premium for this coverage is up to forty per cent of the indemnity.

Successful innovation is a corollary of talented underwriting, indeed Butt (1996) describes Lloyd's as a centre of underwriting skill and Agnew (1989) states that the success of Lloyd's is due largely to the ability of each and every underwriter to develop personal relationships with brokers, to trust some and reject others, to question and search for truthful answers, to have the time and expertise to make a valid judgment on each risk.

Lloyd's structure as a marketplace of independent competing units offers brokers an innovative and responsive environment in which to underwrite risks. The market consists of many small units with short-decision making lines which leads to a flexible and agile environment able to tackle the most difficult risks. Thus the architecture of the market encourages innovation and entrepreneurism. Hiscox (1989) states:

> "The success of the underwriting (of Lloyd's) has been in no small part to the fact that Lloyd's is split into many syndicates each of which is run autocratically by an individual underwriter. The ability to make decisions with the minimum interference and the fact that underwriting is still the dominant activity of most Managing Agents attracts the best underwriters to the market."

A fundamental question is why is the Lloyd's market associated with innovation? From interviews with brokers and underwriters, this author suggests there are four reasons. Firstly, syndicates are small and are generally lead by a single person, the active underwriter. Because much of the broking is conducted on a face-to-face basis between the underwriter and the broker, responses to enquires from potential clients can be responded to quickly. In the USA much of the broking is conducted over the telephone and via fax, consequently response times are much slower. The face-to-face method of broking encourages underwriters to be flexible to the needs of their insureds and reinsureds as any issues can be handled directly between the underwriter and the broker. Secondly, the structure of the syndicate is simple and non-bureaucratic allowing underwriters to focus on the underwriting function. Thirdly, the capital base of individuals is fragmented and therefore lacks any "voice" in the operations of the syndicate. This allows underwriters to underwrite freely without undue interference from the capital providers. The final reason is that the subscription market allows underwriters to experiment. The nature of the subscription market allows risk sharing, coinsurance, between underwriters. In a new form of insurance coverage, there will no be no legal precedents for the interpretation of the wording, the rating will not be based on historical data and the scope of the coverage may not be fully apparent. Thus for a new product there is an element of uncertainty. The subscription market allows underwriters to experiment with new products as each underwriter can take a small part of the risk so that each underwriter is not overly exposed.

If we view Lloyd's as a single institution, then the individual components of the institution have the dynamics of entrepreneurial organisations. The Corporation of Lloyd's administers premium processing (through the LPSO), claims handling (through the LCO), arranges licences to trade for the whole market in foreign territories and ensures that deposit requirements are complied with. The marketing of Lloyd's syndicates is a function of the Lloyd's brokers - syndicates rarely market themselves, although several have corporate brochures. In addition, there are standard Lloyd's wordings for all types of coverages which all syndicates are able to use. There is thus an infrastructure to which all syndicates have access. Furthermore the Corporation of Lloyd's is dedicated to the Lloyd's market and therefore has an interest in ensuring that syndicates continue to underwrite insurance. This infrastructure allows underwriters to concentrate on the role of underwriting without being burdened by too much administration. This infrastructure is similar to that found in large insurance companies such as Royal Sun Alliance or Munich Re. Thus syndicates have the dynamics of entrepreneurial organisations but also the infrastructural advantages of a large company.

### 6.7 Corporate Entrepreneurship and Lloyd's.

There is a growing body of literature on the concept of corporate entrepreneurship. Though a term which is ill-defined, the literature identifies two broad types of corporate entrepreneurship. One is the creation of businesses within an existing business, often called intrapreneurship (for example Burgelman, 1983). The second type is the transformation or renewal of existing organisations, i.e. the struggle of large firms to renew themselves (for example Kanter, 1983). Corporate entrepreneurs help their organisations to pursue new territories and to move into the realm of innovation. Guth and Ginsberg (1990) argue that the essential ingredient in corporate entrepreneurship is that decisions are made and actions are taken that result, in the words of Schumpeter, in new combinations of resources being carried out. This change in the pattern of resource deployment transforms the firm into something different from what it was before. This transformation from the old to the new reflects entrepreneurial behaviour. Kanter (1983) argues that entrepreneurs have for the most part existed outside of and apart from the corporation and that it is an open question whether large organisations can accommodate and take advantage of individuals with an entrepreneurial spirit. Moreover, Kanter (1983) stresses the need for individuals in large organisations to have the opportunity to experiment (to be innovative) in order that the organisation might develop and grow.

This author argues that Lloyd's can behave as a single united body because all the syndicates are governed to a certain extent by the Council of Lloyd's. Whilst individual syndicates are entrepreneurial, the question arises as to whether Lloyd's viewed as a single body, i.e. as the Society of Lloyd's, exhibits corporate entrepreneurism?

If the results of Lloyd's are viewed overall from 1988 onwards, then there is a dramatic deterioration from 1988 to 1992 with a recovery in 1993. Lloyd's was facing a crisis in that the Central Fund was rapidly becoming exhausted (see Figure 2.2) because it was paying the losses of Names who could not afford to pay their losses themselves. Lloyd's was facing an uncertain time and journalists in the popular press frequently wrote that Lloyd's would not survive. The response of the Council of Lloyd's to the growing insolvency of the Society was the publication of the Lloyd's Business Plan and the Reconstruction and Renewal document. Central to both these reports was the creation of a run-off reinsurance company, Equitas, where all Names' liabilities from 1992 and prior years could be placed. Equitas quoted a premium to all the Names to assume all 1992 and prior liabilities. This in turn released the Names from future cash calls and allowed them to wind up their underwriting affairs at Lloyd's. The Equitas strategy essentially mutualised all Lloyd's 1992 and prior liabilities into one central company. Fearing that Names would not support an ongoing Lloyd's, the Council recommended that incorporated capital be introduced into Lloyd's.

The Equitas project has helped to save Lloyd's from the verge of bankruptcy. Figure 2.2 shows that the earmarkings of the Central Fund as at 31st December 1995 exceeded the funds available. Thus Lloyd's was technically insolvent. Lloyd's only passed the annual solvency test imposed by the Department of Trade and Industry as at 31st December 1995 by using the net assets of the Society of Lloyd's, principally the Lloyd's building, to set against the liabilities of the Central Fund. The Equitas project pooled all Lloyd's 1992 and prior liabilities, thus well-reserved syndicates could help to fund loss-making syndicates. Also a common reserving philosophy including discounting of reserves could be applied to all the liabilities.

The Equitas project has created a fund of money from which 1992 and prior claims will be paid. At the time of writing, Equitas has not published its accounts and there is little reliable financial information within the public domain. One underwriter interviewed commented that the Equitas project will allow Lloyd's time to have several years to trade before Equitas starts to run out of money to pay claims. If this is the case, and it is no more than speculation, a cost of participation in the ongoing market, i.e. the "price" of the Lloyd's franchise, could thus be a levy to help keep Equitas solvent. The Lloyd's market has always prided itself on the fact that it has always paid valid claims; indeed, this is an important component in the reputation of Lloyd's. If Equitas finds itself unable to pay claims at some future date, then the reputation of Lloyd's could be affected. Thus the ongoing market could be asked to pay a levy to fund the 1992 and prior years.

The concept of the Equitas project was first discussed in the 1993 Lloyd's Business Plan which was commissioned by the Council of Lloyd's. The Equitas project is entrepreneurial as it has transformed Lloyd's from being an organisation that was foundering to one that has now solved its problems and is looking to the future with confidence. The Council of Lloyd's has effected change across the whole of the Lloyd's organisation - a feature of corporate entrepreneurism (Baden-Fuller and Stopford, 1992).

The ability of Lloyd's to change collectively is due to the structure of Lloyd's in that the Council of Lloyd's has a measure of jurisdiction over the whole market; this gives the ability for major changes to be effected across all syndicates and brokers.

During 1990 the Council of Lloyd's effected a series of changes which were intended to make it a stronger, more marketable and more competitive force in the insurance world. These changes were designed to benefit the policyholders that purchase cover from Lloyd's underwriters, the brokers who place the coverage and the members who provide Lloyd's with its capital (Shapiro, 1990). These changes were:

*(i) Allowing for the first time some business to be placed in the market without the use of a Lloyd's broker.* Beginning in October 1991 personal lines and commercial automobile business could be placed with a "Lloyd's entity" such as a service company operated by a Managing Agent.

*(ii) The elimination of market barriers on 1st January 1991.* This decision was aimed to make Lloyd's a more attractive marketplace for Lloyd's brokers (Lloyd's Press Release, 1989). Before 1st January 1991, Lloyd's syndicates were constrained by rules broadly requiring that each class of business be written only by those syndicates which operated within one of the four traditional sectors of the market: marine, non-marine, aviation and motor. The decision to remove market barriers was prompted by the

needs of some insureds to have a package or all-risks policy (Margolis, 1990). The removal of market barriers has led to the development of large composite syndicates such as S. Catlin and others.

*(iii) Developing a unified claims system in 1991 whereby all four markets will use the same procedure to process claims.* Before the implementation of the unified claims system, aviation syndicates, marine syndicates and non-marine syndicates all had their own claims bureaux. This change was to ensure that claims are paid quickly.

*(iv) The elimination of premium and claims card advices from the Lloyd's Policy Signing Office (LPSO).* Premium and claims advices from 1st January 1991 were to be purely electronic. This change was implemented to reduce syndicates' expenses.

*(v) Life syndicates were allowed to accept business from non-Lloyd's intermediaries.* Despite this change, however, a guarantee would still be required from a Lloyd's broker. Motor syndicates are permitted to form service companies to acquire business from the vast number of non-Lloyd's "High Street" brokers. This has been a successful business move as Lloyd's has the largest share of the UK private motor business, some 25% (Mulrenan, 1991). This decision is seen by Mulrenan (1991) as offering opportunities to sell term life business:

> "The life syndicates will probably never compete head-on with the likes of Prudential or Norwich Union, but concentrate on niche products where they can deploy the traditional flexibility and innovation of the Lloyd's underwriter."

*(vi) Introduction of consortium arrangements.* During 1990 the Council of Lloyd's permitted syndicates to set up consortium arrangements. A consortium enables a syndicate to write a line for a group of major insurance or reinsurance companies or syndicates in addition to the line for itself. The advantages of such an arrangement are twofold. First, the syndicate that underwrites for the consortium will earn commission and so some of the syndicate's expenses can be defrayed. Secondly, the Names on the syndicate bear no responsibility for the other partners in the consortium in the event that a consortium partner does not pay a claim.

Various consortia have been developed since 1992. These include the agricultural risks consortium set up by syndicate 55, an energy consortium set up by syndicate 65, the Marchant space consortium with syndicate 282 as consortium leader and the International Fire Consortium. The Marchant space consortium is one of the largest lead underwriters of satellite insurance in the world and has the capacity to offer cover of up to $60 million on any one launch, satellite or spacecraft (Gibson, 1994). The International Fire Consortium was initially set up to enable small and medium sized syndicates to see business that having been written by the large gross line syndicates such as C.E. Heath, Sturge and D'Ambrumenil, went out to the company market to be finished. The inception of the International Fire Consortium coincided with the demise of these three traditional leaders and in part the Consortium took over the role of leader. There are four accepting (leading) underwriters who are named individuals rather than "anyone" on a particular syndicate and they are linked with each other by a personal computer network so that the brokers cannot use one underwriter to quote against any other. All quotes, declinatures and firm orders are available to the following market on a weekly bordereau together with up-to-date aggregate exposures. The consortium holds monthly meetings open to all members to discuss progress. The Consortium writes direct and facultative property business. No North American and Canadian business is written but all other territories are considered. Written lines are considered on an estimated maximum loss (EML) basis. The object of the consortium is for the panel underwriters to be empowered to write a combined line on behalf of themselves and for all members of the consortium, on fire and/or all risks of physical loss or damage and/or consequential loss business brokered at Lloyd's. The Consortium hopes to be of service to brokers in the placing of risks and at the same time enable members of the consortium to see business that individually they would probably not be shown. The Consortium was conceived as complementary to and not in substitution for the normal underwriting of consortium members. If a risk is declined by the panel on behalf of the consortium, all members are free to underwrite the risk for their own accounts, if it be shown to them. Similarly, members are free to write second (i.e. additional) lines on a risk which carries a consortium line. The panel underwriters are given absolute discretion in deciding the risks to which they commit the consortium with the consortium panel being absolved of any liability.

It is perhaps questionable whether these changes can be classed as corporate entrepreneurism. They are not particularly innovative, indeed those changes that were made in order to cut costs could be described as "good management". Whilst these changes to Lloyd's were promulgated by the Council of Lloyd's to improve each syndicate's ability to compete with competitors, they cannot claim to have transformed Lloyd's in the same way as the implementation of Equitas. Nevertheless, such developments show that Lloyd's can change and that such change is possible over the whole organisation because the Council of Lloyd's are able to create new byelaws which affect all the syndicates and can open up new opportunities for syndicates.

## 6.8 Entrepreneurism and the introduction of incorporated capital.

A notable step taken by the Council of Lloyd's, was to permit the introduction of incorporated capital, i.e. limited liability capital, into the Lloyd's market. The capital base of the syndicates is gradually changing from being unlimited liability Names to limited liability capital (see Figure 6.3).

| | ALLOCATED CAPACITY (£m) | | | |
|---|---|---|---|---|
| | **1994** | **1995** | **1996** | **1997** |
| Spread Vehicles | 1,574.6 | 1,907.4 | 2,084.7 | 2,421.0 |
| Dedicated vehicles | 20.5 | 412.5 | 876.1 | 1,659.0 |
| Standalone syndicate | - | 40.0 | 82.8 | 420.0 |
| **TOTAL** | **1,595.1** | **2,359.9** | **3,043.6** | **4,500.0** |

Figure 6.3: Corporate capital at Lloyd's.
Source: Corporation of Lloyd's

The providers of capital are also purchasing Managing Agents, resulting in a merger between the ownership of the capital base and the ownership of the management structure of syndicates. As has been stated earlier, Lloyd's syndicates are entrepreneurial organisations. It is the role of the Managing Agent to manage the syndicate, ensure regulatory compliance and to provide essential "back office" functions such as accounting. The senior syndicate staff will be on the Board of Directors of the Managing Agency. Essentially we can view the Managing Agency and the syndicate as synonymous. This author suggests that syndicates are able to be entrepreneurial because the capital base does not have a say in the day-to-day underwriting affairs; in this way underwriters can be innovative and experimental. With the change in the capital structure and the merger between the capital providers and the owners of the management structure, the capital providers are likely to require a voice in the operations of the syndicates. Thus an important question may be posed, namely to what extent will the entrepreneurial nature of Lloyd's underwriters be altered due to the change in the nature of the capital base?

The new providers of capital are large corporations such as CNA, ACE and USF&G. There is a danger in the clash of cultures between the small entrepreneurial syndicate and the large more mature organisation. Large organisations tend to be more bureaucratic, if only because of their size and the number of personnel employed. However, there are large corporations that are innovative such as Intel and Microsoft in the computer industry. The big business - small business clash is described by Leith (1996) in the sale of her catering company to a large international group thus:

> "At the time of the sale we turned over £14 million, employed 350 people and made a very decent profit. But we never had a business plan, a budget, targets nor objectives. We had no sales department, marketing department, nor glossy brochures and we were totally decentralised. Head office consisted of me, my husband, and our joint secretary.
>
> "All of the managers could have told on any day what last week's profit was and event what the profit on the ice-cream sales had been the day before and month-end accounts were finalised for the group by the 9th of the next month. By the time our new owners had been in charge for a year, we had a sales department targeted entirely on volume not profit, with the result that we had: taken five new contracts all of which lost money, felled a forest to produce a corporate image of well-designed, expensive gloss, occupied a huge central office that ate every penny made, lost two of our best contracts, results were not finalised until the third week of the following month and we had an unhappy workforce."

Leith (1996) explains frankly the problems that can arise with the takeover of a small business by a larger group. The reason for the mismatch between the small catering company and the large international group lies in the difference in structure of each of them. Leith's small company was entrepreneurial, employing a small number of personnel and power in the organisation was focussed on the chief executive. Furthermore the distinction between management and staff was blurred. The large international corporation has a different structure more akin to Mintzberg's "machine organisation". This organisational structure is characterised by large-size operation units, formalised communication channels throughout the organisation and an elaborate administrative structure with a sharp distinction between managers and staff (Mintzberg, 1991b). In the operating core of the machine organisation, work processes are standardised with employees performing narrowly defined functions with little opportunity to move outside their job description. The machine configuration, which is typically found in mature organisations, and the entrepreneurial organisation are at opposite ends on the structural continuum, indeed the machine organisation can evolve from the entrepreneurial context as a result of the growth of the company. The synergy of each organisation structure is different and this is the reason for the problems that Leith experienced. Interestingly, however, Hamel and Prahalad (1994) point out that corporate regeneration may be achieved in the machine organisation through a strategy of acquisitions as well as intrapreneurship.

In this author's interviews with ten clients of Lloyd's, all chief executives of insurance companies, the innovative underwriting of Lloyd's was seen as its competitive advantage. One Chief Executive commented that if the innovative nature of Lloyd's changed, then the Lloyd's market would have difficulty in attracting clients. If Leith's experiences of a take-over by an international company are mirrored in the Lloyd's market, then Lloyd's competitive advantage could be threatened.

It seems a reasonable assumption that whether corporate capital providers will stifle the entrepreneurial spirit of syndicates will depend on the nature of the corporate capital provider - whether they are entrepreneurial or mature organisations. According to Hamel and Prahalad (1994) there is a common preconception that it is almost impossible for large companies to be truly innovative, the problem being with large organisations that they are bureaucratic and the lack of personal freedom of employees bottles up innovation. Nevertheless, it is difficult to imagine that the employees of a large company are any less imaginative that those of a small company, the difference is that in a small company the individual employee may be able to influence the direction of the company. Hamel and Prahalad (1994) suggest that large companies, by investing funds in education and training, help to train entrepreneurs who perfect their skills in large companies before starting their own business. Hamel and Prahalad (1994) stress that the "role of large companies in launching new companies is as vital as the role of venture capitalists." Given these authors' thesis, the involvement of large corporations in the Lloyd's market could generate better educated underwriters who may wish to start their own syndicates.

The original "spread vehicles" which placed corporate capital across a wide range of syndicates as a passive investment are complementary to the traditional individual Names' capacity in that the "spread vehicles" have little involvement with the day-to-day underwriting affairs of the syndicates. However, corporate Names that have acquired controlling interests in Managing Agencies, could push for more structured decision making at the expense of the freedom traditionally given to Lloyd's underwriters. This author suggests that corporate capital vehicles could stifle the entrepreneurial nature of the Lloyd's market if they make their Lloyd's syndicates synonymous with a subsidiary or a branch office, with the underwriter having to refer certain risks to the home office. The counter argument is that large corporations which search for a syndicate in which to invest are being, if not entrepreneurial, risk takers and it could be argued that they would be unlikely to dampen the entrepreneurial spirit of the syndicate.

A central question which develops out of the change in capital structure of Lloyd's is the future nature of Lloyd's. Will it become a bourse of insurance companies, similar to the London International Insurance and Reinsurance Association (LIRMA) or the Institute of London Underwriters (ILU), or will it remain primarily a market in which individual capital, i.e. Names, is strongly represented. This issue is of vital importance as the different types of capital supporting Lloyd's have different strengths and weaknesses. There is a danger in that with the transition from the individual unlimited liability Name to various forms of limited liability, Lloyd's will lose some unique characteristics that have given it a pre-eminent position in insurance and its ability to meet policyholder claims.

A significant feature of the individual capital structure of Lloyd's is that the solvency of Names is carried out by centrally by the Corporation of Lloyd's and in so doing uses the mechanism of the Central Fund which comes to the assistance of Names who are unable to pay their losses. The result of this is that all Lloyd's Names and syndicates trade with the same security based on the Central Fund. An important consequence of this procedure is that new syndicates can be established with the security of Lloyd's as a whole. The result is that new businesses can rapidly establish themselves as they will have immediate access to first class security and to the worldwide Lloyd's licences. This feature is one reason for the entrepreneurial character.

Such a structure has advantages for Names in that it allows them to choose between syndicates both old and new. They are not restricted to supporting old established syndicates as they can support new syndicates that from time to time start up.

For the new corporate capital providers, this structure is not necessarily beneficial. For the "spread vehicles" - investment trusts that use their assets to support a wide range of syndicates - they require new investment opportunities and so need Lloyd's constantly to regenerate itself through the establishment of new syndicates. For the dedicated corporate investors, whose underwriting is limited to a single syndicate or the syndicates of one Managing Agent, the existence of the Central Fund is not so advantageous. Whilst for a Name and a spread vehicle the Central Fund is a mechanism for ensuring the growth of new syndicates, for a dedicated corporate capital vehicle the Central Fund is a means for promoting competition.

Consider, for instance, the Bermudan reinsurer who has purchased a Managing Agent and underwrites through the agency's syndicates. The Central Fund mechanism requires an annual contribution of 1.50% of stamp capacity and the prospect of a further levy if a competitor fails and the Central Fund requires bolstering due to paying the losses of the insolvent capital provider.

It is this central conflict of interest that Lloyd's has to resolve. This author believes that if the Central Fund were abolished, Lloyd's could lose its entrepreneurial characteristics. At present the distribution of the different types of capital providers is being left to market forces. Whilst the resilience of the Names over the years 1988 to 1992 has been remarkable, there have been few new Names joining Lloyd's. There is a dilemma in that the capital keen to invest in Lloyd's, dedicated vehicles, has an interest in destroying its unique characteristics. The danger is that Lloyd's could transform into an insurance bourse with no common Central Fund. Lloyd's would thus be giving up its unique niche in the insurance industry to become similar in capital structure to its competitors. If Lloyd's does not have common security and therefore does away with common licences, the Lloyd's market would consist of a collection of medium-sized insurance companies none of which could would be large enough to compete with large insurance and reinsurance companies such as General Re and Munich Re.

This author suggests that there is a need for a coherent capital strategy which balances the needs of the Names and spread vehicles, on the one hand, and the dedicated vehicles on the other. This author suggests that there should be a balance between the three types of capital providers which would allow the advantages of each group to benefit the whole; perhaps the capital structure should be one-third of each of the three types. There is clearly an analogy with the London Stock Exchange 'big bang' which brought the London securities' markets up to international standards by the injection of the capital and skills of foreign houses. A similar process would benefit Lloyd's given that there has been criticism from Names for regulatory failure over the losses declared.

At the present time Lloyd's does not need any extra capacity and probably a reduction of the 1996 capacity of £10 billion would have been preferable to an increase to £10.3 billion for 1997. With rates in most sectors of the insurance industry falling, there is no need for an increase in capacity and a decline to about £9 billion would probably have been sensible. It follows that Lloyd's has no need to encourage new corporate capital and would probably be better to wait for the market conditions to improve. Such a lapse of time would allow Lloyd's to develop a capital strategy. Such a strategy would be developed by the Council of Lloyd's and could put a maximum limit to the capacity of Lloyd's for any one year.

# Chapter seven: The reputation of Lloyd's

## 7.1 Introduction - what is reputation?

Nelson (1970) contends that consumers can obtain information on price or quality of products either by search or through experience. Search involves the consumer evaluating each product available to him. His problem is to establish the utility of each product; for instance, he can search for a suit and try several on and thereby establish the relative utility of each option. For some goods the search procedure is inappropriate - goods for which it is less expensive for the customer to evaluate by purchase rather than by search. Nelson uses the following simple, but effective illustration:

> "To evaluate brands of canned tuna fish, the consumer would almost certainly purchase brands of tuna fish for consumption. He could, then, determine from several purchases which brand he preferred. We will call this information process "experience".
>
> For tuna fish there is no effective search alternative open. At the low price of experience, there is insufficient demand for specialized establishments selling tastes of various brands of tuna fish."

If we take Nelson's arguments one stage further, then how do consumers choose between products where goods cannot be inspected and are consumed only once, such as pension plans and funeral services? Search yields little information about the reliability of a consumer durable such as a washing machine or a car or indeed of the claims service of an insurance company. Experience does yield this information, but such experience is costly. In these instances consumers will make choices between products based on the reputation of the product and manufacturer.

Reputation is the "estimation of the consistency over time of an attribute of an entity" (Herbig *et al*, 1994). This estimation is based upon the ability of the entity to perform an activity repeatedly in a similar fashion. The reputation of a firm develops over time and requires a consistency of performance of the firm. A firm's reputation will lower if it does not perform its actions consistently. Kay (1995) states that reputation is the name for a reiterated high-quality strategy in a market for long-term experience goods. Kay (1995) goes on to say:

> "Producers of long-term experience goods characteristically draw attention to the long-established nature of their enterprise. There is no clearer statement that the firm is playing a repeated game than 'founded in 1853', and it is banks and insurance companies, rather than the producers of search and short-term experience goods, which make these claims."

A reputation embodies the history of other people's interactions with the products or company in question. A good reputation increases the credibility of the product, making the purchaser more confident that he will get what is promised. Marketers and advertisers know that an endorsement of a product by a well-known personality will help to boost sales. This is because the reputation of the personality is then linked with the product. Psychologically, consumers create a mental link between the personality, the product and the company that produces the product. Consumers are willing to pay higher prices for the good because it has been endorsed by the famous personality. Conversely, if the personality is linked with scandal then the company will rapidly disassociate the personality from the promoted product. For instance, PepsiCo in the USA withdrew its advertisements featuring a well-known pop artist after accusations of impropriety with a minor, even though no legal charges had been filed. By dropping the person from the advertising campaign, PepsiCo recognised the need to minimise the impact of a potential major scandal on the company's reputation. There are some syndicates in Lloyd's that underwrite insurance which will cover the cost of re-shooting the advertisement in the event of such a scandal.

The process of building a reputation is central to the marketing of many everyday products such as soap, clothing, cereals and cosmetics. Companies that make these products will promote them through advertising and marketing. Their aim is to differentiate the product from similar goods i.e. to convert the product into a brand. Companies spend considerable sums of money on research, development, advertising and promotion in order to develop brands and to maintain their uniqueness, appeal and value. After the loss-making years of 1988 to 1992, the Lloyd's Marketing Department produced various advertisements and literature to market the insurance products developed by syndicates and brokers. One such advertisement stated:

> "After more than 300 years, Lloyd's of London is still at the heart of the international insurance market. One of the UK's largest insurance organisations, Lloyd's attracts more than half the international insurance premiums that flow into London, which is the world's foremost insurance centre.
>
> "This is neither coincidence nor nostalgia. Lloyd's is efficient, innovative, responsive, competitive and secure. Leading independent brokers know that Lloyd's underwriters' willingness to consider the exceptional alongside the conventional makes a Lloyd's policy suitable for clients whose needs may be out of the ordinary as well as those that are totally straightforward. Very little is too large or too small, too complex, too simple or too new to be too much for Lloyd's. And once a risk is accepted, rest assured: throughout the world Lloyd's is known as a market where a valid claim is honoured, come what may."
>
> (Quoted from "Insuring Your Business" published by Lloyd's of London, 1991)

This advertisement stresses the innovative nature of Lloyd's underwriters and the security of the Lloyd's policy, both powerful marketing tools.

Fombrun (1996) states that in companies where reputation is valued, managers will build, sustain, and defend that reputation by the following practices that firstly shape a unique identity, and secondly project a coherent and consistent set of images to the public. Fombrun (1996) suggests that such practices include:

- ***designing advertising campaigns that promote the company as a whole, not just its products and brands.*** The Corporation of Lloyd's has a marketing department which has developed press advertisements with the slogan "Lloyd's covers the world". (See also advertisement given above)
- ***Carrying out ambitious projects that champion product quality and customer service with an eye on keeping customers happy.*** Lloyd's, in its marketing literature, stresses that the Society has always paid valid claims.
- ***Maintaining control systems that carefully screen employee activities for their possible reputational side effects.*** Lloyd's has recently required that all staff employed by underwriting agencies be individually registered. This is a scheme whereby all individuals who are connected with underwriting or claims handling are required to give details of their career and education. In this way the Underwriting Agents Department can monitor who is underwriting in Lloyd's and thus try to prevent those underwriters with a bad reputation from operating within Lloyd's.

Companies develop reputations by creating and projecting a set of skills that customers recognise as unique, which in the case of Lloyd's is innovative underwriting and the security of the policy. For some companies this is achieved through differentiating themselves through innovation - nurturing new ideas, producing new products and marketing them well. In other companies uniqueness is achieved through operational excellence i.e. providing good service to the customer. In knowledge-based institutions, such as universities, consultancy firms, law firms and insurance companies, reputation is important. Their "products" or the services they provide are largely intangible. Economists call the services of these institutions and companies "credence goods" (Darby and Karni, 1973) - goods that are purchased on faith, i.e. reputation.

Executives in the US insurance and reinsurance industry are very conscious of how their companies are rated by the various rating organisations, such as A.M. Best, Moody and Standard & Poor. A poor rating can have negative reputational effects as investors get concerned as to the financial stability of the company. If it is down-graded by a rating agency, then it will lose business. A rating is a reflection of an insurance company's financial strength and if its future is in doubt, this is reflected in its rating. It follows that insurance companies are very sensitive about their rating. A good rating can reinforce the reputation of a company. Standard & Poor have produced stability rankings on all syndicates currently trading in Lloyd's. The rating agency has identified various key financial performance characteristics that indicate the likelihood of a syndicate ceasing to trade three or more years in advance. Key performance areas include underwriting exposure, ceded reinsurance, investments, lines of business and reserves. Standard & Poor have assigned one of five grades of stability ranking based on how closely a syndicate's financial characteristics match those of syndicates that have voluntarily ceased trading. Rankings range from one crown (well below average performance) to five crowns (well above average financial characteristics). The crown ranking system is being used by some insureds and reinsureds as a method of differentiating between syndicates, even though each syndicate is composed of Names, both individual and corporate, who have to satisfy various financial tests and are all backed up by the Central Fund. It is interesting to note that Lloyd's treated as a single entity has not been rated, only the constituent syndicates. A well ranked syndicate is likely to use its ranking to enhance its reputation.

Critical to the concept of reputation is credibility which Herbig *et al* (1994) define as "the believability of an entity's intentions at a particular moment in time." Credibility is whether a company can be relied upon to do what it says. Herbig *et al* (1994) further state that credibility is time-sensitive in that the perceived credibility of a firm today can differ from the perceived credibility of the same firm on a previous or future date. An established firm that has been trading for several years in a consistent manner is likely to perform in a similar manner in the future, thus established entities, such as Lloyd's, can more easily persuade customers as to their credibility than younger firms.

The value of a firm's reputation is seen in its sales since as the reputation grows so do the sales (Shapiro, 1982). A firm with a good reputation owns a valuable asset - "goodwill" or reputational capital.

### 7.2 Reputation and Lloyd's.

The following discussion on the reputation of Lloyd's is based on this author's experiences as an underwriter and from interviews with underwriters and brokers. The reputation of Lloyd's is in two tiers - the reputation of Lloyd's as a whole (i.e. the perception of Lloyd's by the insuring public or reinsurance buyers) and the reputation of individual underwriters and hence their syndicates within Lloyd's. The reputation of the Society of Lloyd's has been gained over the past 300 years. It is a peculiarly English institution - there is no similar institution anywhere else although its closest imitator is the Illinois Insurance Exchange in Chicago. Within Lloyd's, each underwriter has his own reputation. Some underwriters are well known as non-marine catastrophe excess of loss specialists - for instance the active underwriter of syndicate 51 (A.N. Taylor and others). If a broker manages to get this syndicate to lead his slip then the broker will be able to get the risk fully placed. With a lesser-known leading underwriter, or one whose specialism is not catastrophe business, the broker may have problems in placing his business. The following market (i.e. underwriters who do not generally lead business) will not be confident to follow this underwriter.

In July 1995 Research International issued a report on Lloyd's image among personal insureds in the U.K. Whilst this author was not granted access to this report, some findings were released. The report found that Lloyd's strengths were seen as being an established name with history and tradition, and one of the largest insurers in the world. Financial strength, although considered by those interviewed to be Lloyd's fourth most important strength after a well known name, history and size, was only mentioned by 14% of those interviewed. Lloyd's main weakness was found to be the recent bad publicity which has affected confidence in Lloyd's among insureds. The report concluded that although personal insureds know and have views on Lloyd's, it is not associated with personal lines, however it is recognised by insureds as a provider of commercial insurance.

When a broker is placing his risk in Lloyd's he will try to get certain underwriters to underwrite the slip. The presence of particular underwriters on a slip says something positive for the quality of the broker's business. Thus the broker's task becomes much easier to broke his business to other underwriters. Sometimes an underwriter may not write a slip if he does not see certain underwriters on the slip.

For a broker a good reputation is most important. On an individual level, a broker must always be truthful. Business in Lloyd's is written on the basis of utmost good faith as the broker will know much more about the risk than the underwriter. In insurance, the broker and his client possess all knowledge of the risk, i.e. there is an asymmetry of information between broker and underwriter. Thus the broker must always answer the underwriter's questions truthfully and the client must also be truthful. If a broker gets a reputation for being untruthful then no underwriter will ever wish to deal with him. Similarly, if the broker's client is untruthful or tries to be underhand then underwriters will be suspicious of dealing with that client again. Such information is passed down the successive generations of underwriters, so it can be many years before a broking house or an individual broker recover their reputations. The broker-underwriter relationship and the underwriter-client relationship, are examples of the Prisoner's Dilemma. The Prisoner's Dilemma can only be resolved if the game is repeated and there is trust between the two parties (Kay, 1995). Indeed, trust, utmost good faith, is central to the activities of Lloyd's.

In the motor market at Lloyd's individual motor syndicates market themselves and develop their own brand names such as Admiral, Eclipse, MT Motor Policies. Such syndicates are not part of the subscription market and therefore can trade under their own brand names rather than the name of Lloyd's. It is interesting to note that as syndicates grow in size, they are more able to underwrite a risk one hundred per cent rather than being part of a subscription market and taking a share of the risk. Syndicates, who have traditionally been part of the subscription market, are now starting to produce their own brochures stressing their own capabilities. They are thus attempting to develop their own brand and market themselves rather than relying on the brokers and the Lloyd's marketing department. As Managing Agencies align themselves with corporate capital providers, many of whom are insurance and reinsurance companies, such branding may be an increasing feature of Lloyd's.

### 7.3 Who owns the reputation of Lloyd's?

The Council of Lloyd's has certain powers to protect the name of Lloyd's, for instance the power to expel members from the Society and to ban them from underwriting under the Misconduct, Penalties and Sanctions Byelaw (No. 5 of 1983). Thus, if in the view of the Council, the Society's name is being damaged the Council can take appropriate action. Under this Byelaw members and others defined within the byelaw are guilty of misconduct if they:

(i) contravene or fail to observe any provisions of Lloyd's Acts 1871 to 1982 or any byelaw;

(ii) contravene or fail to observe any verdict, order, award, penalty or sanction made or imposed, or any condition or requirement imposed, or any undertaking given, pursuant to Lloyd's Acts 1871 to 1982 or any byelaw;

(iii) contravene or fail to observe (subject to certain provisos) any regulation or direction made or given under Lloyd's Acts 1871 to 1982 or under any byelaw;

(iv) conduct themselves in a manner which is detrimental to the interests of Lloyd's policyholders, the Society, members of the Society, underwriting agents, Lloyd's brokers or others doing business at Lloyd's;

(v) conduct any insurance business in a discreditable manner or with a lack of good faith; or

(vi) conduct themselves in any manner whatsoever, which is dishonourable, disgraceful or improper.

The penalties which may be imposed upon those found guilty of misconduct are dependent upon the category of person concerned. In those cases where a member of the Society is concerned, he can be:

(i) excluded or suspended from membership of the Society; or (ii) required to cease underwriting at Lloyd's permanently or temporarily and either totally or in part.

Where the misconduct is by underwriting agents, they may have their permission to act as agents revoked or suspended totally or in part. Similarly, Lloyd's brokers may have their permission to broker business revoked or suspended totally or in part.

In those cases where an individual is involved, his right of admission to the Room and the other parts of the premises of Lloyd's may be suspended, permanently or temporarily. In the above cases, the following sanctions are also applicable:

(a) a suspension, permanently or temporarily, of the right to transact, or be concerned or interested in the transaction of, the business of insurance at Lloyd's or any class or classes of such business, either totally or in part;

(b) a fine;

(c) the posting of a notice of censure in the Room;

(d) a reprimand.

The Council of Lloyd's also has the power to direct that a Lloyd's person may be administratively suspended. The rules concerning administrative suspension are laid down in the Administrative Suspension Byelaw (No.7 of 1987). The power of administrative suspension is used to protect the interests of Lloyd's policyholders and the Lloyd's community. Administrative suspension is not a disciplinary penalty but is rather a mechanism to avoid damage which might otherwise arise had the power not been exercised.

An example of where administrative suspension is used is in the case of a Lloyd's member who fails the "annual solvency test". The member is suspended from underwriting until he provides sufficient funds to make good his solvency shortfall. In this way the security behind the Lloyd's policies is preserved.

A direction of administrative suspension can only be made in one of the following two circumstances: (i) in the case of a Member with a solvency shortfall; and (ii) in cases where the Investigations Committee administratively suspends a Lloyd's person as a result of matters emerging during the course of an inquiry.

The Byelaws discussed above give the Council of Lloyd's power to protect the name of Lloyd's and thus its reputation. However, by the time such disciplinary action is taken the damage to the reputation of Lloyd's has probably already occurred. Thus all the Council can do is to react to the situation. The fact that the Council of Lloyd's can act to prevent or control damage to the name of Lloyd's suggests that ownership of the reputation of Lloyd's is vested in the Council.

It has already been stated that the reputation of Lloyd's exists on two levels - the overall reputation of the institution (what might be called the public perception of Lloyd's) and the reputation of the individual syndicates within Lloyd's. A pertinent question is - Who owns the reputation of the syndicates?.

The reputation of a syndicate is generally centered around the active underwriter, even in those syndicates that possess class underwriters. This is because syndicates are small entities both in terms of their premium income (compared to international companies) and their staffing levels. The active underwriter receives praise if the syndicate is profitable and criticism if the syndicate makes a loss. Furthermore, the role of the active underwriter is further enforced by the fact that the syndicate is almost always named after him, e.g. the active underwriter of Syndicate 314 (C.F. Palmer and others) is Clifford Palmer; the active underwriter of Syndicate 991 (A.E. Grant and others) is Alan Grant.

The reputation of a syndicate is dependent on its central figure, the active underwriter, or more accurately, the underwriting decisions made by the active underwriter. If the active underwriter is removed, the added value to the syndicate given by the active underwriter is lost. This is the reason that, when the active underwriter is nearing retirement, Managing Agencies always stress that the active underwriter's successor is very competent (*pers. comm*: a Members' Agent).

The agency agreement between a Managing Agent and a Members' Agent grants a Members' Agent the right to place members on a syndicate up to an agreed capacity. The Name will pay a fee to the Managing Agent which is a percentage of the Name's capacity on the syndicate. The Name will also pay a similar fee to the Members' Agent. If the syndicate is profitable then the Name pays profit commission to both the Managing and Members' Agents.

The Managing Agent has the right to withdraw the agency agreement between itself and the Members' Agent. Similarly the Members' Agent can exercise its right to not place Names on the syndicate if it so wishes.

There is a symbiotic relationship between the two types of agents. A Managing Agent employs the active underwriter and staff of the syndicate and manages the affairs of the syndicate; although in reality the day-to-day affairs of the syndicate are likely to be dictated by the active underwriter. A Managing Agency can only receive capacity to operate its syndicate from a Members' Agent and, as from 1994, from corporate capital providers. The access to the active underwriter is controlled by the Managing Agent as this entity can grant agency agreements to Members' Agents. However, a syndicate cannot underwrite without capacity and this is accessed only through a Members'

Agent. This implies that Managing Agencies own the expertise of the syndicate, i.e. its staff, but the capital is owned by Members' Agents. The syndicate can only exist if the two agents are present thus implying that the reputation of the syndicate is jointly owned by the two types of agents. However, if this reasoning is extended then the reputation of the syndicate must in part be owned by its Names as these individuals provide capital.

In February 1994 the Council of Lloyd's formed a working party to develop a system for enabling members to create and realise the value of belonging to a Lloyd's syndicate. The report of the working party, entitled "Value at Lloyd's", was published in May 1994. There were two main recommendations. Firstly, that existing members of a syndicate should be given the right to participate on a pro-rata basis in any proposed increase in that syndicate's capacity, i.e. the Member should be given pre-emption rights. Secondly, Names should be given the right to transfer a participation in a syndicate for future years of account to another Member, i.e. a system of assignment. These proposals were radical in that they in effect stated that the member owned the reputation of the syndicate rather than the Agents. Prior to the "Value at Lloyd's" document, Managing Agents could agree to have a certain capacity from a Members' Agent and the Managing Agent had the sole right in determining for future years of account whether that allocation should increase or decrease (assuming that the Members' Agent wished to continue supporting the syndicate). If a member wished to resign from the syndicate then the Members' Agent had to request the permission from the Managing Agent to re-allocate that capacity to another person.

The system of assignment was expanded in a document published by Lloyd's in 1995 entitled "Capacity Allocation by Auction". The document states:

> "The essence of the auction process is that members of Lloyd's who wish to surrender their right to underwrite on one or more syndicate(s) for the 1996 year of account can now do so via a series of four weekly public auctions to be held (in August). Under the auction process, members of syndicates in 1995 will be able to realise any value attaching to 1996 capacity on surrender. On the other side, members will be given access to all syndicates. There will be a single price (the "execution premium") for each syndicate in each auction which will be determined by supply and demand. The execution premium may vary between different auctions."

The auction process is not intended to resemble a full market but rather, its primary function is to provide members with access to syndicates and to enable members to achieve value for their existing participations. Trading is not permitted (Rule 7(4)(a)) thus members will not be able to subscribe or tender in one auction and then attempt to reverse the transaction in a subsequent auction.

The system of realising value places a quantifiable monetary figure on the value of the capacity of each syndicate which, in turn, gives a qualitative indication as to the reputation of each syndicate. It therefore provides a mechanism to compare syndicates with each other based on the auction value of the capacity. The fault of the system of realising value is that it views the reputation of the syndicate as being wholly owned by the Name as it is only the Name who profits from selling his future participation. As the reputation of the syndicate is jointly owned by Names and the Managing Agents it would be equitable that, since Names are allowed to realise the value of their future participation in the syndicate, then Managing Agents should be granted the ability to set their own level of fees. However, one of the resolutions of the 1993 Business Plan was the mandatory cut in Managing Agents' fees to 0.4% for the 1995 year of account (section 9.4).

The danger of the system of realising value is that Managing Agents lose control of which agents have capacity on syndicates. One Members' Agent could purchase the capacity of another Members' Agent, for instance. The syndicate may not wish to be too dependent upon one Members' Agent as the ownership of a large percentage of capacity could wish to exert its influence in how the syndicate is managed. However, Section 8.4 of the "Capacity allocation by auction" guidebook (1995) states that Managing Agents may prohibit subscription orders which would result in a member's or a MAPA's prospective participation in a syndicate for 1996 exceeding ten per cent of the syndicate's estimated capacity. This rule therefore does give Managing Agents a control over the sources of capital.

### 7.4 Conclusion

As services have no tangible shape or form, customer satisfaction is less readily defined. Indeed, in life assurance, it could be argued that there is no appreciable satisfaction at all! Insurance is a peculiar commodity because it is a promise to pay a sum of money on the occasioning of an event such as fire or death. An insured can only evaluate his level of satisfaction once a claim is made. In insurance, experience is of little value in evaluating the product as people do not often claim from their insurers. A pertinent question must be - What factors influence the purchase of insurance? Insurance is a long term experience good only if the consumer claims on his policy, i.e. "experiences" the product. Insurance is not a search good because the policy of one company is likely to be similar to that of another company and the consumer may not have sufficient specialist knowledge with which to compare policies. However, reinsurance may be regarded as a search good as the purchaser - the insurance company - will have specialist knowledge of the product he wishes to purchase. This author suggests that reputation is the only gauge a consumer has to satisfaction in the personal insurance market. Insurance companies advertise in order to enhance - or create - a reputation. For instance, the Commercial Union, we are told from the television advertisements will not make a "Drama out of a Crisis". In the personal insurance market pricing is important, as consumers are influenced by the premium charged. The success of The Royal Bank of Scotland's Direct Line is due both to its ease of access (via the telephone) and its inexpensive policies compared with other carriers. Pricing is therefore a source of competitive advantage. However, the personal insurance market-place is very competitive and if one company is charging less than its competition, its competitors will often follow suit in their pricing. Once pricing ceases to be a source of competitive advantage, companies will need to stress their service they offer the policyholder. For instance, the recent radio advertisements for Direct Line stress the efficient claims-handling of the company.

In the reinsurance market, the purchasers are sophisticated buyers and the factors influencing their decisions are likely to be different from those that influence the choices made by buyers in the personal insurance market. Buyers will have to balance price and policy terms with the quality of security required. Long-term relationships between reinsureds and their reinsurers are important, as reinsureds are likely to want to trade with a market that is stable.

From interviews with brokers and underwriters, this author found that all interviewees agreed that the reputation of Lloyd's is based on the ability of Lloyd's underwriters to be innovative and to be flexible to the needs of the client. Also Lloyd's reputation for security was seen as an important factor in the growth of the reputation of Lloyd's. This author suggests that the innovative nature of Lloyd's is due to its structure, or architecture, as a subscription market and also the entrepreneurial nature of Lloyd's underwriters. Thus the reputation of Lloyd's is a direct result of its structure.

One of the features of Lloyd's is that the Society has always honoured valid claims. This is a corollary of the nature of the capital base, namely unlimited liability investors. Whilst all insurance companies have unlimited liability for losses, a limited liability company has quantifiable assets supporting its liability. At Lloyd's the assets supporting the underwriting liabilities are unquantifiable. The question arises as to whether the unlimited liability of the capital base is a competitive advantage and therefore a possible explanation for the reputation of Lloyd's? In an address to a conference on the future of Lloyd's, Hagen (1988) stated that "Lloyd's offers the strongest policies in the world". However, the Cromer Report stated that "...(brokers) did not attach great significance to unlimited liability as a selling point for Lloyd's policies". Indeed with the losses experienced by Lloyd's in recent years the very concept of unlimited liability has been called into question. Illingworth (1994) remarked "....Lloyd's, the world-renowned insurance market, (has) come to symbolise monumental failure." The underwriters interviewed by this author all expressed the opinion that the security of the Lloyd's policy was of the utmost importance for maintaining the reputation of Lloyd's. One underwriter stated that if the Central Fund were abolished, this would signal the end of Lloyd's.

The reputation of Lloyd's which has been gained over the past 300 years is an important feature of the institution. Indeed, during the loss making years of 1988 to 1992, the capacity of the Society hardly decreased at all and new capital was attracted to Lloyd's, thus demonstrating the steadfastness of the reputation.

# Chapter eight: Conclusions and recommendations.

## 8.1 Conclusions and recommendations

This author's research has examined Lloyd's within the theoretical framework developed by Kay, namely architecture, innovation and reputation. This examination has revealed that the distinctive capability of Lloyd's is its innovative underwriting. In this author's opinion, such innovation has historically been derived from four distinctive aspects of the architecture of the Society -

(i) Lloyd's syndicates are small entrepreneurial organisations focussed on underwriting.

(ii) the subscription system of risk placement which has enhanced the ability of syndicates to be innovative in their underwriting. The subscription system is an example of the cooperative nature of Lloyd's and ensures that information on risk assessment is passed from underwriter to underwriter. This results in many underwriters being able to have an input into the coverage and rating of the risk.

(iii) a capital base of individual members ("Names") who had little, if any, involvement in the underwriting process. This gives underwriters freedom to underwrite and to experiment in new classes of business and to capitalise quickly on any opportunities.

(iv) the presence of the Central Fund which has ensured that all the syndicates offer the same level of security and, moreover, has allowed new small syndicates to form giving the entrepreneur the opportunity to set up his own syndicate. This has meant that Lloyd's has been able to foster new underwriting talent which has encouraged the constant regeneration of the 'market'.

For the 1994 year of account onwards, a new type of investor - corporate capital - was allowed to invest in Lloyd's. This author's research suggests that the introduction of this type of capital may have a profound influence on the four distinctive aspects of the architecture of Lloyd's thus resulting in Lloyd's losing its distinctive capability - innovative underwriting. Also the presence of two types of capital, unlimited and limited, challenges the current regulatory structure. Furthermore, the current capital architecture of Lloyd's is underpinned by the Central Fund. This author suggests that the interests of corporate capital may not be compatible with the existence of the Central Fund.

This author's research has revealed that there are two major issues facing Lloyd's as a result of the introduction of corporate capital: (1) the future regulatory structure, and (2) the influence of corporate capital on the distinctive aspects of the architecture of Lloyd's.

**8.2 Recommendations for regulatory reform**

One of the strengths of Lloyd's is that its structure of entrepreneurial underwriting units is bound together by a common set of standards. These standards are set internally through the process of self-regulation. This has certain advantages in that market practitioners, who have close knowledge of the workings of Lloyd's, are regulating the Society rather than bureaucrats who may have little knowledge of Lloyd's. With corporate capital entering Lloyd's, some investors are subject to two regulatory authorities: the Department of Trade and Industry for the regulation of their insurance company and the Council of Lloyd's for their corporate syndicate. There is thus logical sense in rationalising this situation. The question of examining whether Lloyd's should have statutory regulation rather than self-regulation has not been faced by the Society before. Lloyd's is, however, subject to DTI regulation at present in that the 1992 and prior years are administered by Equitas Ltd which is a DTI-regulated company. This author recommends that Lloyd's syndicates, agencies and brokers should be regulated directly by the DTI. This would give a positive marketing boost to the Society as self-regulation has come under scrutiny by various commentators, notably in the popular press, for having failed due to the large losses incurred by Names over the 1988 to 1992 years of account. This author suggests that the imposition of a new regulatory regime would help to instill confidence in Lloyd's customer base. Furthermore, Corporate Capital providers would only be responsible to one regulatory body rather than two.

By removing the regulatory role from the Council and moving Lloyd's into statutory regulation, the Society would be under the same regulatory framework as all UK insurers and reinsurers. This author suggests that statutory regulation is likely to be more widely accepted by overseas countries than self-regulation. Indeed, given that the 1993 Business Plan states that "...... we need to build our position in new markets such as Continental Europe and the Far East." (para 15.4), continued self-regulation may be a competitive disadvantage given that this regulatory regime has come under criticism as a result of the losses suffered by the capital base.

It has been stated earlier in this thesis that Lloyd's has traditionally been associated with innovation. This author suggests that one of the reasons for this is that the

Society is regulated by Lloyd's practitioners who are unlikely to wish to see the entrepreneurial spirit of the Society unduly hampered by excessive regulation. It is important that any external regulation must not influence the adaptability of Lloyd's and that regulation must be conducted within the liberal tradition that Lloyd's has enjoyed. Indeed the DTI does not prescribe rates nor requires rates to be filed - as is the case with the USA regulatory system.

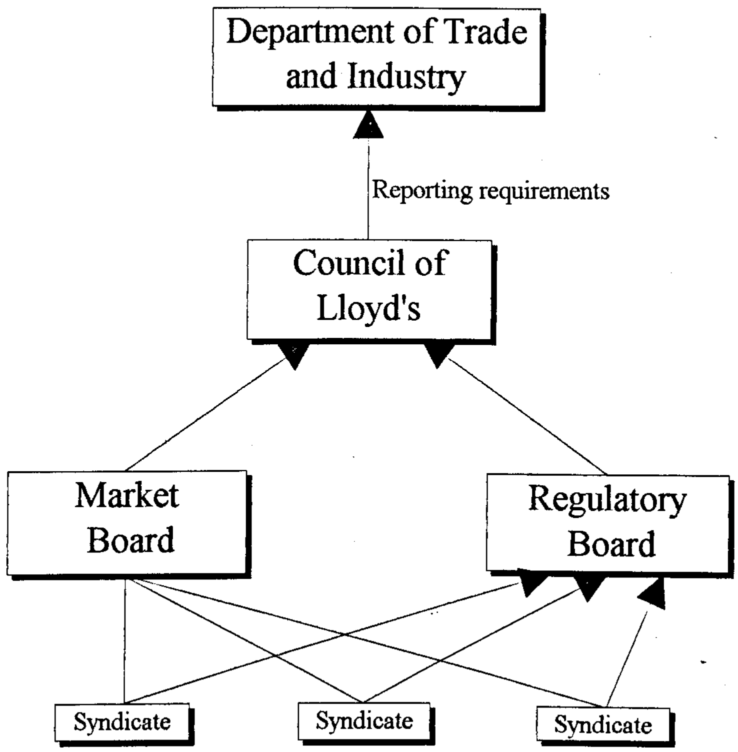
The corollary to external regulation is the need to find a new role for the Council of Lloyd's as their regulatory function would no longer exist. This author proposes that the Council of Lloyd's should focus on being the spokesman for the Society, have responsibility for ensuring the adequacy of the Central Fund and act to protect the reputation of Lloyd's. The Lloyd's Act 1982 confers a self-regulatory status on Lloyd's and states that the "Council shall have the management and superintendence of the affairs of the Society and the power to regulate and direct the business of insurance at Lloyd's....." (para 6.1). This author suggests that the regulatory function of the Council, which is currently administered by the Regulatory Board, be exercised by the DTI. As such, the Lloyd's Act 1982 would require an amendment.

With external regulation, there would be no need for a Regulatory Board; its role may be reduced to liaising between syndicates and the DTI. This author suggests that the present Market Board should become a Business Development Board whose function would be to market the Society and advise and help syndicates to broaden their business base.

The Lloyd's Regulatory Board and the Lloyd's Market Board were established in January 1993 and stemmed from the recommendations of the Morse Report. This Report proposed that the two boards should operate under the authority of the Council. The Morse Report suggested that the Market Board should comprise a range of Lloyd's and outside expertise and saw this Board providing "the necessary focus for business leadership" and being the "driving force in the development of the Society" (para 6.1). These terms of reference are difficult to define, especially in a market-type context such as Lloyd's. This author suggests that the Business Development Board should focus on helping syndicates to achieve their business objectives. This author suggests that this Board should be able to direct the resources of the Corporation of Lloyd's into projects that would benefit syndicates; an example is "Lloyd's Japan", a joint venture between the Corporation and managing agencies to underwrite Japanese insurance. Figure 8.1 (a) shows the current management and regulatory structure of Lloyd's and gives the proposed new structure.

Because the Business Development Board would be focussed on expanding the business base of Lloyd's, this author recommends that it should be largely comprised of Lloyd's practitioners who have a detailed understanding of the Society and the insurance business. Such practitioners would be underwriters, brokers, members of the Corporation and representatives from the market associations. This author also suggests that capital providers (Natural and Corporate Names) should also be represented on the Board. Given that this author recommends statutory regulation, the need for non-executive members on the Business Development Board to ensure a degree of independent oversight would not arise. Figure 8.1 (b) gives a detailed

Current management and regulatory structure




Proposed new management and regulatory structure

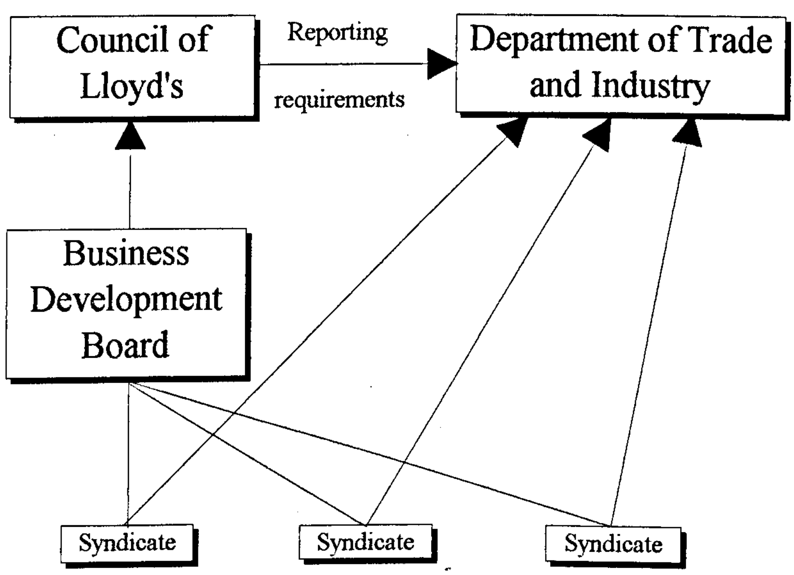



**Figure 8.1 (a): The current management and regulatory structure of Lloyd's (as given in the Morse Report) and the proposed new management and regulatory structure.**

## Current management structure of Lloyd's.

COUNCIL OF LLOYD'S (14)

| 6 WORKING MEMBERS | 4 NOMINATED MEMBERS | 4 EXTERNAL MEMBERS |
|---|---|---|
| CEO AND HEAD OF REGULATION IN ATTENDANCE | | |

MARKET BOARD (15 or 16)

| 6 working members (form the Committee) |
|---|
| 2 working members from the Underwriting Associations<br>1 working member from LUAA<br>1 working member from LIBC<br>2 or 3 non-executive members<br>Chief Executive Officer of Lloyd's<br>2 other executives from the Corporation of Lloyd's |

REGULATORY BOARD (14)

| |
|---|
| 4 Nominated members<br>4 external members<br>4 working members<br>Head of Regulation<br>Solicitor to the Corporation |

**Note:** LUAA is Lloyd's Underwriting Agents Association (the members' agents association).
LIBC is Lloyd's Insurance Brokers Committee.
A working member is a member of Lloyd's who works in Lloyd's as a broker or as an underwriter.
The Underwriting Associations are the various underwriters' associations - Lloyd's Underwriters' Association (for marine underwriters), Lloyd's Non-Marine Association (for non-marine underwriters), Lloyd's Aviation Underwriters Association (for aviation underwriters) and Lloyd's Underwriters Motor Association (for motor underwriters).

## Proposed management structure of Lloyd's.

COUNCIL OF LLOYD'S (14)

| 6 WORKING MEMBERS | 4 NOMINATED MEMBERS | 4 EXTERNAL MEMBERS * |
|---|---|---|
| CEO IN ATTENDANCE | | |

BUSINESS DEVELOPMENT BOARD (14)

| |
|---|
| 6 working members - 3 underwriters & 3 brokers<br>2 working members from the Underwriting Associations<br>1 working member from LUAA<br>1 external Name (unlimited liability Name)<br>1 representative from corporate capital providers<br>Chief Executive Officer of Lloyd's<br>2 other executives from the Corporation of Lloyd's |

**Note:** * The external members of the Council should be two representatives from corporate capital providers and two natural (unlimited liability) Names.

**Figure 8.1 (b): The composition of the Regulatory and Market Boards and the proposed composition of the Business Development Board.**

breakdown of the current composition of the Market Board and the proposed make-up the Business Development Board. This author suggests this new Board should consist of fourteen members, i.e. a similar size to the current Market Board. As the Board will consist of persons from all aspects of Lloyd's, this author suggests that this blend of expertise will generate a worthwhile and creative committee. However, the importance of underwriters and brokers in the development of business for Lloyd's is reflected in that they comprise some forty per cent of the Business Development Board.

The current composition of the Council of Lloyd's is six working members, four nominated members and six external members. The working members are senior executives of managing and members' agents and senior executives of broking houses. The external members of the Council are Names and the nominated members are persons who are not associated with Lloyd's and thus are able to provide a degree of independent oversight. This author suggests that the current composition of the Council is well balanced between the market practitioners (the working members) and the capital providers (the external members). However, there is currently no representation on the Council from Corporate Capital providers despite the fact that they provide some £4,500 million of capacity for the 1997 year of account. This author suggests that the external membership on the Council should comprise two natural Names and two corporate Names in order to redress this inbalance.

## 8.3 The influence of corporate capital on the architecture of Lloyd's

The second major issue is the influence that corporate capital will have on the architecture of Lloyd's. The Names system has given underwriters much flexibility in their underwriting in that they have been able to underwrite freely without the intervention of the capital base. This flexibility has encouraged entrepreneurism which in turn has been stimulated by the subscription system of risk placement. The capital structure of the Society is changing from multi-source (the Names) to single sources (corporate capital providers). This author's research concludes that such capital is likely to wish to have a voice in the underwriting affairs of the syndicates, which could hamper the freedom of underwriters. Also there is the danger of syndicates becoming little more than branch offices. Furthermore, there has been a growth in syndicate size over the past decade from an average capacity per syndicate of £22.4 million in 1986 to just over £60 million in 1996, as is shown in Figure 8.2. This is resulting in an increasing proportion of business being written one hundred per cent by a single syndicate rather than being shared amongst several syndicates through the subscription system. This author therefore foresees a two tier underwriting system developing; small risks will be written fully by one syndicate and much larger risks, such as the sums insured in reinsurance placements, will be placed within the subscription system. This author suggests that this process will be further accelerated as syndicates have access to large pools of dedicated capital. Lloyd's could thus become a bourse along a line similar to the Illinois Insurance Exchange.

Since the introduction of limited liability capital into Lloyd's in 1994, there are now three types of capital: (i) unlimited liability Names; (ii) spread Names (unit trusts), and;

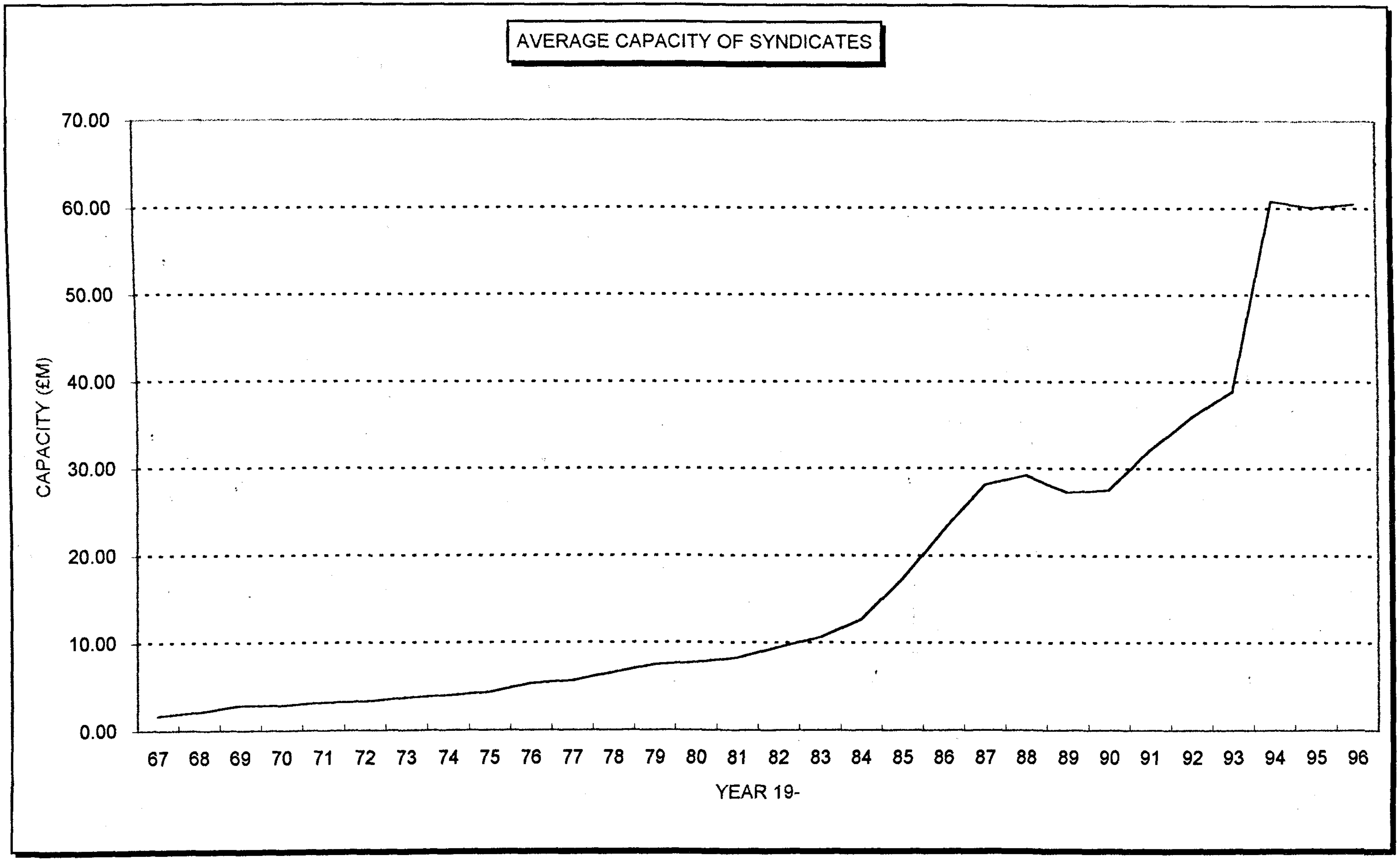



Figure 8.2: The average capacity of syndicates from 1967 to 1996. (Source: Membership Department, Corporation of Lloyd's; this author's analysis)

(iii) dedicated corporate Names. There has also been a gradual change in the ownership of the managing agents, as most have now been sold to, or invested in by, corporate capital vehicles. Figure 8.3 shows that the managing agencies that manage almost 80% of the capital base of Lloyd's have some investment by corporate capital.

One of the traditional features of Lloyd's has been that the managing structure of the syndicates (the managing agencies) has been independent of the ownership of the capital (owned by the members' agencies). With corporate capital being allowed to own the management structure and also able to invest in the syndicates they manage, it may well be expected that syndicates will over time become insurance companies with a single investor as the capital base, rather than a diverse capital base of investors, both traditional Names and limited liability capital. Given this scenario, this author suggests that the traditional unlimited liability Name does not have a long-term future within Lloyd's. Indeed, all those executives who were interviewed agreed that the traditional Name would not exist within ten years, although two stated there would still be a role for the high-value Name, i.e. the Name underwriting £1,000,000 or more.

The future of spread vehicles is also uncertain. Spread vehicles invest in a number of syndicates, but with the ownership of syndicate management being transferred to single corporate entities who in turn will wish to invest in their managed syndicates, the future of spread vehicles is left uncertain. Some such vehicles have invested in managing agencies e.g. LIMIT's investment in Bankside and Janson Green Managing Agencies, and Angerstein's investment in JE Mumford and PB Coffey Underwriting Agencies. This author suggests that such vehicles will gradually become dedicated

| Managing Agent | Managed Capacity (£'000) | Agency Backer(s) | Type: principal backer | % equity in managing agency | % managed capacity provided by aligned corporate | |
|---|---|---|---|---|---|---|
| Active Syndicate Management Limited | 27,419 | Berkshire Hathaway | US Insurance | 33% | *108.32%* | * |
| ACE London Aviation Limited | 204,080 | ACE | Bermudan Insurance | 100% | 0.62% | |
| ACE London Underwriting Ltd | 157,331 | ACE | Bermudan Insurance | 100% | 9.05% | |
| Methuen (Lloyd's Underwriting Agents) Ltd | 383,485 | ACE | Bermudan Insurance | 100% | 33.10% | |
| AE Grant (Underwriting Agencies) Ltd | 58,894 | Riverside Group | US Insurance | 0% | 13.16% | + |
| Apollo Underwriting Ltd | 71,386 | Various reinsurers | US Insurance/Non-US/Bermudan Insurance | 0% | 54.71% | + |
| Archer Managing Agents Limited | 380,437 | Chartwell Re | US Insurance | 100% | 19.53% | ++ |
| Ashley Palmer Limited | 181,734 | F&G | US Insurance | 80% | 12.57% | |
| Bankside Syndicates Ltd | 422,012 | LIMIT | UK Institutions | 65% | 22.51% | |
| Brockbank Personal Lines Ltd | 88,938 | Mid Ocean | Bermudan Insurance | 51% | 55.55% | |
| Brockbank Syndicate Management Ltd | 426,358 | Mid Ocean | Bermudan Insurance | 51% | 21.73% | |
| Cassidy Davis Syndicate Management Ltd | 72,759 | St Paul | US Insurance | 100% | 27.62% | |
| Catlin Underwriting Agencies Ltd | 196,666 | Catlin Westgen Ltd | Bermudan Insurance | 75% | 62.03% | |
| Charman Underwriting Agencies Ltd | 330,181 | Tarquin | US Insurance venture capital | 100% | 60.62% | |
| Kingsmead Underwriting Agency Ltd (formerly Claremount) | 179,479 | TIG/AON | US Insurance | 100% | 18.91% | |
| CNA Underwriting Agencies Limited | 25,000 | CNA | US Insurance | 100% | 100.00% | |
| Cox Group Managing Agencies | 271,215 | Cox plc | UK Institutions/US Insurance venture capital | 100% | 44.12% | |
| Christopherson Heath | 212,491 | Cox plc | UK Institutions/US Insurance venture capital | 100% | 6.59% | |
| Crowe Syndicate Management Limited | 220,410 | NLC | UK Institutions | 20% | 19.85% | |
| DP Mann Underwriting Agency Limited | 234,210 | Chase Manhattan/others | US Insurance venture capital | 40% | 11.74% | |
| Duncanson & Holt Syndicate Management Ltd | 108,225 | D&H Europe | US Insurance | 100% | 44.16% | |
| Trafalgar Underwriting Agencies | 54,424 | D&H Europe | US Insurance | 100% | 18.83% | |
| Gammell Kershaw | 86,107 | Goshawk Insurance Holdings plc (c.40% Synd. Capital Trust) | UK Institutions | 100% | 16.96% | |
| Gravett & Tilling (Syndicate Management) Ltd | 157,941 | St Paul | US Insurance | 100% | 11.66% | |
| Hiscox Syndicates Ltd | 370,469 | Hiscox plc (33% Trident) | UK Institutions (Bermudan Insurance) | 100% | 15.83% | |
| JE Mumford Underwriting Agencies Ltd | 76,248 | Angerstein | UK Institutions | 100% | 6.16% | |
| Jago Managing Agency Ltd | 121,020 | Unionamerica/AON | US Insurance | 57% | 3.99% | |
| Janson Green Limited | 325,548 | LIMIT | UK Institutions | 70% | 10.14% | |
| CLM Managing Agency Ltd | 44,887 | CLM | UK Institutions | 100% | 90.74% | |
| Liberty Syndicate Management Limited | 185,000 | Liberty | US Insurance | 100% | 100.00% | |
| Ockham Personal Insurance Agency Limited | 217,975 | Questor | US Insurance venture capital | 33% | 20.26% | |
| Octavian Syndicate Management Ltd | 388,101 | Terra Nova | Bermudan Insurance | 100% | 47.33% | |
| Owen & Wilby Underwriting Agency Ltd | 51,117 | NALU/D&H Europe | US Insurance | 0% | 87.00% | |
| PB Coffey (Underwriting Agency) | 37,658 | Angerstein | UK Institutions | 100% | 14.07% | |
| PXRE Managing Agency Ltd | 35,000 | PX Re | US Insurance | 100% | 100.00% | |
| QBE Underwriting Agency Ltd | 63,500 | QBE | Non-US Insurance | 100% | 93.04% | |
| RGB Underwriting Agencies Ltd | 128,833 | Capital Re Corporation | US Insurance | 100% | 30.85% | |
| Service Managing Agency Ltd | 32,959 | Phoenix | UK Institutions | 100% | 54.48% | |
| Spreckley Villers Burnhope & Co Ltd | 224,455 | AON/Strategic partners | US Insurance | 40% | 5.35% | |
| Chaucer Syndicates Ltd (formerly Stewart Syndicates Ltd) | 217,537 | BRIT/Electra | UK Institutions | 50% | 7.01% | |
| TIG Syndicate Management | 20,000 | TIG Re | US Insurance | 100% | 100.00% | |
| Venton Underwriting Agencies Ltd | 225,550 | Trident | Bermudan Insurance | 63% | 40.68% | |
| Wellington Underwriting Agencies Ltd | 603,083 | Wellington | UK Institutions | 100% | 10.90% | |
| Wren Syndicate Management Ltd | 293,967 | BRIT/FUIT | UK Institutions | 25% | 14.97% | |
| **Total 1997 Aligned Capacity** | **8,214,089** | | | | | |
| **Total 1997 capacity of Lloyd's** | **10,323,602** | | | | | |
| | | | | | | |
| **% of Lloyd's capacity aligned** | **79.57%** | | | | | |

Notes: * - via DTI approved company with parallel consortium arrangement in place
+ - Negotiations continuing regarding proposed stake in managing agency
++ - Includes capacity provided by ADIT and Oak Dedicated

**Figure 8.3: Analysis of Managing Agent Alignment** (Source: Lloyd's Corporate Membership Department)

vehicles, investing in single syndicates, or a small group of syndicates. Furthermore, such spread vehicles may start up their own stand-alone syndicates as has CLM Investment Trust. CLM has a £20 million capacity syndicate, number 1415, managed by CLM Managing Agency Ltd with CLM as the only member.

This author believes that the decision to allow corporate capital to invest in managing agencies was a mistake, as there is now no independence of the ownership of the management structure from the ownership of the capital base. Furthermore, it was this independent structure that encouraged new syndicates to form as members' agents, who controlled the capital within Lloyd's, could identify and back new talented underwriters. This independent management/capital structure encouraged the entrepreneur and, in this author's opinion, has helped to build the reputation of Lloyd's as a 'market' of innovation. The start-up of new syndicates is now more difficult as underwriters will have to raise their own capital from outside Lloyd's, although perhaps corporate capital investors may start up their own stand-alone syndicates by identifying an underwriter and setting him up on his own.

An important question is how will corporate capital affect the role of the entrepreneur in Lloyd's. As has been stated earlier, the traditional capital base, the individual unlimited liability Name, did not have a say in the day-to-day underwriting affairs of the syndicate. This gave underwriters much freedom and flexibility to underwrite. The managers of corporate capital, in this author's view, are likely to want to have more input into the underwriting, as they are responsible for the capital which is at risk. Indeed, £1,518.58 million of capacity at Lloyd's is provided by insurance companies, some 14.71% of the total capacity of Lloyd's for 1997 (see Figure 8.4). It is difficult to assess whether corporate capital will adversely affect the entrepreneurial nature of Lloyd's underwriters, but the fact that corporate capital is likely to require an input into the portfolio of business written suggests that Lloyd's could well become a less innovative 'market' in future.

## 8.4 The Central Fund

One of the most important questions that Lloyd's faces is the issue of the Central Fund. Ultimately all syndicates have the same security because of the mutualisation mechanism of the Central Fund. However, it is unlikely that dedicated corporate vehicles will wish to guarantee the claims paying ability of competitors. This author suggests that syndicates supported by a single capital base pose a potentially more serious threat to the Central Fund than syndicates comprising capital from many sources, be they solely unlimited liability Names or a combination of natural Names and corporate capital. With a dedicated vehicle, losses on consecutive years fall on the same capital provider. However, by contrast, with a conventional unlimited liability syndicate, the loss is spread across many capital providers and furthermore the constitution of the syndicate changes from year to year. This situation is recognised to some degree in that a corporate capital provider pays a levy of 1.50% of its capacity to the Central Fund, whereas an unlimited liability Name is charged 0.60% of capacity. This author suggests however, that the Central Fund would be more secure if the ratio of funds at Lloyd's to capacity for corporate vehicles were raised from its current figure of 50%. This author suggests a reasonable figure would be 75%.

| Insurance Company backer | Company investing at Lloyd's | Non-US/ Bermudan Insurance Industry (£m) | US Insurance Industry (£m) | Bermudan Insurance Industry (£m) | Total Capacity (£m) | |
|---|---|---|---|---|---|---|
| ACE | ACE Limited | | | 142.43 | 142.43 | |
| ACE | ACE Staff Corporate Member Ltd | | | 0.38 | 0.86 | * |
| St Paul | The St Paul Companies Inc (Camperdown ) | | 57.50 | | 57.50 | |
| Western General | Catlin Westgen Ltd | | | 91.50 | 121.99 | * |
| Citadel | Citadel Underwriting Ltd | | 4.86 | | 4.86 | |
| CNA | CNA Corporate Capital Ltd | | 47.97 | | 47.97 | |
| Mid Ocean | Mid Ocean | | | 142.06 | 142.06 | |
| Capital Re | CRC Capital Limited | | 39.75 | | 39.75 | |
| Duncanson & Holt | Duncanson & Holt Underwriters Ltd | | 98.85 | | 98.85 | |
| Centre Re | Euclidian plc | | | 7.91 | 98.90 | * |
| USF&G | F&G UK Ltd | | 22.84 | | 22.84 | |
| Frankona | Frankona Capital Ltd | | 12.03 | | 12.03 | |
| Global Capital R/I | Global Capital Underwriting Limited | | | 6.50 | 6.50 | |
| TIG/AON | Heraldglen Limited | | 33.93 | | 33.93 | |
| Trident Partnership | Hiscox Dedicated Corp Member Ltd | | | 18.77 | 58.66 | * |
| AON/Unionamerica | Jago Capital Ltd | | 4.83 | | 4.83 | |
| LaSalle | LaSalle Re Corporate Capital Limited | | | 16.33 | 16.33 | |
| Liberty | Liberty Corporate Capital Ltd | | 185.00 | | 185.00 | |
| Lumley Underwriting Management | Lumley Underwriting Ltd | 5.30 | | | 5.30 | |
| Medical Insurance Exchange of California | MIEC Investment Company Inc | | 4.65 | | 4.65 | |
| Allianz of America | N. American London Underwriters Ltd | | 49.20 | | 49.20 | |
| Navigators | Navigators Corporate Underwriters Ltd | | 34.00 | | 34.00 | |
| Nissan | Nissan Lloyd's Underwriting Ltd | 5.49 | | | 5.49 | |
| Chartwell Re | Oak Dedicated Limited | | 32.81 | | 32.81 | |
| PX Re | PX Re Limited | | 35.00 | | 35.00 | |
| QBE | QBE Corporate Ltd | 59.08 | | | 59.08 | |
| Reinsurance Group of America (General American Life) | RGA Capital Limited | | 2.79 | | 2.79 | |
| Frankona | RGB Capital Ltd | | 22.73 | | 22.73 | |
| Navigators/Shelter Mutual | Riverside Corporate Underwriters Ltd | | 26.76 | | 26.76 | |
| AON + partner | SVB Underwriting Ltd | | 4.81 | | 12.01 | * |
| Terra Nova | Terra Nova Capital Ltd | | | 183.70 | 183.70 | |
| TIG | TIG Corporate Name (No. 1) Limited | | 20.00 | | 20.00 | |
| Trident Partnership | Venton Underwriting Ltd | | | 91.75 | 91.75 | |
| Yasuda | Yasuda Lloyd's Corp Member Ltd | 2.02 | | | 2.02 | |
| Zenith Insurance Company | ZIC Lloyd's Underwriting Ltd | | 5.05 | | 5.05 | |
| | TOTALS | 71.89 | 745.36 | 701.33 | 1,687.63 | |
| | Capacity of Lloyd's | 10,323.60 | | | | |
| | Capacity supplied by the insurance industry | 1,518.58 | | | | |
| | % of capacity of Lloyd's | 14.71% | | | | |

Notes: * - Balance of capital supplied from non-insurance industry sources.

**Figure 8.4: 1997 Corporate Members with Insurance Industry Involvement**

**(Source: Lloyd's Corporate Membership Department)**

The presence of the Central Fund has ensured that small syndicates are able to thrive within Lloyd's as they have the backing of this large fund and, more importantly, Lloyd's has been able to obtain licences to trade in foreign countries for all syndicates. The Fund helps the Society to renew itself which in turn encourages the entrepreneur who wishes to start his own syndicate. Without the Central Fund, Lloyd's would become little more than a building housing various insurance companies, similar to the London Underwriting Centre. This author suggests that the abolition of the Central Fund would completely alter the nature of Lloyd's. Indeed, Lloyd's, as known today, would not exist.

Because all syndicates are underpinned by common security, i.e. the Central Fund, the capital structure of Lloyd's is analogous to that of a firm where there is a common 'pool' of capital supporting the business operations. The nature of this capital structure gives Lloyd's a single identity in that the security (i.e. solvency) of one syndicate is identical to that of another. This is an important aspect of the effectiveness of the subscription market. Furthermore, without common security and common levels of solvency, syndicates will not be able to compete with competitors, such as Munich Re and Swiss Re.

### 8.5 Conclusion: The future structure of Lloyd's

In conclusion this author offers his assessment of the future capital structure of Lloyd's within five to ten years. This will consist of syndicates of various sizes, both large and small, some generalist insurers and others specialists in niche areas. The syndicates will share the backing of the Central Fund to which they will all contribute. They will also share licenses, central services, a communications infrastructure and perhaps a blanket financial strength rating covering the whole of Lloyd's. Each syndicate will have its own source of capital and there will no be unlimited Names and no spread vehicles. Syndicates will underwrite each risk in full, although the subscription system of risk placement will still exist but only for the very large capacity risks such as a catastrophe excess of loss reinsurance placement. There will therefore be less cooperation between the syndicates and less information flowing between underwriters. This author predicts that Lloyd's will be a less flexible and less innovative 'market' as the capital base will largely dictate the portfolio of business underwritten.

Members' agents will no longer exist as there will be no unlimited liability Names. All the Names will have either left Lloyd's or be investing in syndicates via corporate vehicles. Syndicates will no longer be annual joint ventures, which write business for one calendar year and close their books after three years, because there will be permanent capital and not individual investors. Syndicates will be thus able to underwrite multi-year contracts, be able to purchase long-term reinsurance and be able to create free reserves to smooth results from year to year.

This author suggests that the importance of the broker as the sole conduit of business will gradually change with the introduction of Electronic Placing Support, although this system is still in its infancy. This author recommends that syndicates should be able to trade direct with customers, if this is the most cost-effective method of placing the business. Reinsurance business such as catastrophe excess of loss is a class of business that can easily be traded direct as many of the Bermudan reinsurers are doing. This view is at variance to that expressed in the Task Force Report which reinforced the role of the broker as the primary source of business (Para 13.28). A possible future role for the broker may be to become the marketing arm of a managing agency. This would require an amendment to the Lloyd's Act 1982 which in Sections 10 and 11 prohibits the investment of Lloyd's brokers in managing agencies and vice versa. However, the American broker Aon Inc has acquired a 49% shareholding in the Jago Managing Agency and has signed a letter of intent to acquire a shareholding in the managing agency Spreckley Villers Burnhope and Co Ltd. Through the formation of various holding companies, Aon Inc has circumvented the provisions of the Lloyd's Act 1982.

This author suggests that brokers will be focused into complex placements where their knowledge of the world-wide market is essential. Commodity-type business, such as personal lines and motor, will be transacted via a service company outside the Lloyd's system.

This author recommends that managing agencies should be able to establish branch offices overseas. Such overseas establishment could come through a joint venture between groups of managing agencies, or via a Corporation/managing agency joint venture such as Lloyd's Japan. With the introduction of corporate capital into many managing agencies, there is the funding available to finance such offices. Indeed, this author interviewed a prominent US regulator who stated that Lloyd's should open a contact office in New York. He stated that Lloyd's is seen to be too remote by being based in one central location. The competitors of Lloyd's, such as Munich Re and Swiss Re, are continually expanding their operations by opening new offices. For instance, Munich Re was the first western insurer to open an office in Moscow. In order for syndicates to compete effectively, they must be able to attract new business by methods other than waiting for business to arrive in London.

# Appendix

## Interviews

During the course of this research various interviews were undertaken both to test this author's hypotheses and to obtain input on issues from practitioners within Lloyd's. Initially, a questionnaire was sent out to twenty syndicates but this did not generate any meaningful response, indeed very few replies were received. It was then decided to hold interviews as this would be a more productive method to gain information and opinion.

Interviews were held with ten active underwriters from syndicates, five brokers, three corporate capital providers and two Members' Agents. Many more people were approached by this author but declined to be interviewed. The Lloyd's Planning Department and the Lloyd's Information Centre also provided valuable assistance, guidance and information.

The questions asked were as follows:

1. How do you believe the capital base of Lloyd's will develop over the next ten years?

2. Should Lloyd's have external regulation or remain as a self-regulated body?

3. What do you see as the future of the Council of Lloyd's?

4. What do you believe to be the reason for Lloyd's having a reputation for innovative underwriting?

5. How is the growth of syndicates affecting the subscription system of risk placement? What is the future of the subscription system?

6. Do you believe that there will be further consolidation in the number of syndicates operating within Lloyd's?

7. Given that corporate capital is becoming more important as the capital base of the Society, do you agree with the view that Lloyd's will become an insurance bourse like the Illinois Insurance Exchange?

8. Should Lloyd's be allowed to trade direct with certain classes of business?

9. Do you believe that the divestment rules should be modified so that managing agents can purchase broking groups?

10. What do believe the effect of corporate capital will have, if any, on the entrepreneurial nature of Lloyd's underwriters?

11. Should Lloyd's syndicates be allowed to establish themselves overseas, or be permitted to have foreign offices?

The opinions of those interviewed form a central feature of this thesis and the information gathered from the interviews is discussed within the main body of the text.

**The author's propositions**

In this thesis there are four major propositions which were developed by the author during the research (see pp 71, 77, 100 and 124). In order to test these propositions, they were presented to the interviewees for their comments. The propositions were put to the interviewees as the opinions of the author and they were invited to agree or disagree and give their reasons. The responses of the interviewees are shown below.

| **Proposition One** | **Lloyd's should abandon self-regulation and be regulated by the Department of Trade and Industry** | | |
|---|---|---|---|
| | Number in agreement | Number in disagreement | Number undecided |
| Underwriters | 8 | 2 | 0 |
| Brokers | 3 | 2 | 0 |
| Corporate capital providers | 3 | 0 | 0 |
| Members' Agents | 2 | 0 | 0 |

| Proposition Two | The current Market Board and Regulatory Board should be replaced by a single Business Development Board. | | |
|---|---|---|---|
| | Number in agreement | Number in disagreement | Number undecided |
| Underwriters | 7 | 2 | 1 |
| Brokers | 4 | 1 | 0 |
| Corporate capital providers | 3 | 0 | 0 |
| Members' Agents | 1 | 1 | 0 |

| Proposition Three | Over a ten year period all natural Names will incorporate and the capital base of Lloyd's will consist of entirely incorporated limited liability capital. | | |
|---|---|---|---|
| | Number in agreement | Number in disagreement | Number undecided |
| Underwriters | 10 | 0 | 0 |
| Brokers | 5 | 0 | 0 |
| Corporate capital providers | 3 | 0 | 0 |
| Members' Agents | 2 | 0 | 0 |

| Proposition Four | The role of brokers will be focused into complex placements with simple business being handled outside the Lloyd's system. | | |
|---|---|---|---|
| | Number in agreement | Number in disagreement | Number undecided |
| Underwriters | 7 | 2 | 1 |
| Brokers | 1 | 3 | 1 |
| Corporate capital providers | 3 | 0 | 0 |
| Members' Agents | 2 | 0 | 0 |

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