

Lloyd's is facing a challenging year in 2010, with stagnant premiums, a new man in charge of syndicate performance, unfinished business on electronic reform and wider regulatory reform to deal with.



# The year ahead for Lloyd's

Despite wider economic woes, the last year was in many ways a good one for the London market, with a quiet hurricane season and the absence of large single-loss events that had characterised 2007 and 2008.

However, such is the cyclical nature of the industry that feast is often followed by famine, so as we head into another new year **Reactions** asks what the big challenges will be for the Lloyd's and the London Market in 2010.

Two words recurred again and again as **Reactions** canvassed market observers for their opinions – “underwriting discipline”. “I’d be worried if they hadn’t,” says William Stovin, President of Markel International.

He adds: “Top of anyone’s list has to be pricing and underwriting discipline. Pricing is adequate in most lines, but that will be under threat. Some lines will buck the trend because they have to. They have produced losses in the past. Each market needs to hold the line.”

While it is very hard to predict where rates are heading next year, the overriding sentiment is that rates will fall in most lines.

Recent figures released by broker Marsh forecast that insurance rates for both property and casualty risks could fall by up to 10% in 2010, with competition for good risks remaining strong and plentiful capacity in both lines.

Mark Coleman, reinsurance specialist in Europe at Standard & Poor’s (S&P), says: “Generally the message we are hearing is that renewals are flat and stable, but some of the specialty lines that Lloyd’s underwrites do need some price

momentum, as they have not been loss free.”

The uncertainty over what stage of the market cycle we are in is harder to clarify. There no longer appears to be one cycle. Instead, the past few years have seen a divergence of primary from reinsurance and property from casualty.

Robert Childs, chief underwriting officer and chairman of Hiscox USA, says: “There has to be recognition that we have reached the bottom. It is a bifurcated market because reinsurance property rates are holding up but direct rates are being squeezed from both ends.”

Despite the negativity surrounding the direction of rates, voices of optimism remain among the market’s commentators.

“Lloyd’s can repeat what it did in 2008,” says David Reeves, CEO of Barbican Insurance, which was formed in 2007 and owns Syndicate 1955. “We have seen a lot of capacity coming into the market so rates are under pressure. I think we will have to select risk very carefully and will only be able to grow very carefully and not write large volumes of undesirable business. But our opportunity will be there,” he says.

Reeves adds: “Lloyd’s is very busy at the moment with brokers coming in for face-to-face and subscription risks. I think that the promise of Lloyd’s has been retained, unlike some companies that have suffered in the credit crunch, like AIG [American International Group] and XL. Lloyd’s will continue to grow at the expense of the company market.”

Hiscox’s Childs agrees: “Lloyd’s must be considered an attractive place to do business,” he says.

John Muir, head of London market contracts at broker Willis, warns: "Lloyd's is eminently capable of withstanding a major catastrophe hit. Our clients are looking for the most competitive pricing from an insurer who is secure and has a good record for playing claims. What they don't want is unpredictability in pricing as it makes it impossible for them to budget."

One of the reasons Lloyd's has looked attractive over the past three years has been the bolstering of profits with reserve releases from the low losses experienced by the market between 2002 and 2004.

Chris Waterman, director at Fitch Ratings, says: "We still view cycle management as the biggest challenge for the non-life market. If you have not got the same level of reserve releases as in the past then what options are left to you? The insurance market generally has been fairly poor at cycle management."

Waterman adds: "Companies need to demonstrate their willingness to exit lines of business where there's a technical unprofitability in those lines. The test is whether they will step back and lose market share where necessary."

Reeves at Barbican says: "The reserve releases for the glory years of 2002, 2003 and 2004 will not be there, so if a big event happens there will not be that cushion to fall back on."

#### A new man in charge

Another reason that Lloyd's has looked more attractive in recent years has been an improvement in underwriting standards, which has helped the market return attractive earnings despite catastrophe losses and poor investment returns.

The Franchise Performance Directorate (FPD), which was created in 2003, is often cited as a crucial element in this improvement.

The departing head of the FPD, Rolf Tolle, has been influential in implementing underwriting standards, monitoring risk appetite and the approval of new syndicates.

As with any business, the replacement of important staff is a potentially risky period, so has Lloyd's handled Tolle's departure well? And what of his successor, ex-Berkshire Hathaway executive Tom Bolt?

"We have noticed the Franchise Performance Directorate's performance and we will continue to watch how underwriting discipline will be maintained. The proof will be in the pudding," says Waterman at Fitch. "Our view is that there won't be a radical change although doubtless Bolt will be making some small changes in time."



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Reeves adds: "There was a risk but Bolt is such a well-respected professional and he has already stated that he will be providing more of the same of what Tolle gave the market."

It is one of the oddities of the insurance and reinsurance industry that a successful year will bring with it a set of specific challenges for the future. The benign loss year means that capital has been replenished but now carriers must decide how best to deploy that capital.

"The sector has proved itself to be resilient to the credit crunch, though without the big event that would have caused recapitalisation," says Coleman at S&P. "It has been a spectacular year and capital has returned to the levels seen at the start of 2008, but businesses should not lose sight of the dynamics that caused that."

There are three options traditionally open to insurers and reinsurers looking to deploy excess capital: repatriate capital to investors, often through share buybacks; diversify into new lines of business, possibly through acquisition; or simply write more premiums in existing books of business.

"We would rather see repatriation of capital than a risky diversification play, but whatever happens it needs to be well-considered and done when companies have sufficient strength because companies need to retain sufficient capital to support their rating," comments Waterman at Fitch.

Coleman expects to see only selective mergers and acquisitions. These will depend on the business model of carriers, with share buybacks a more popular option for companies that do not want to take risks in the competitive environment.

However, not all challenges that the London market faces over the next 12 months will be controllable by the industry, such as reduced investment income. Investment returns look unlikely to be as high in 2009 as they have been in previous years. That outlook appears set to continue into 2010.

According to Childs at Hiscox, the challenge presented by stagnant investment returns is not to be underestimated. He says: "The biggest challenge in 2010 is that investment returns are going to be considerably less. If your investment return is going to be down 2% to 2.5% then you are losing that from your average return."

He continues: "Insurance companies measure their performance on combined ratio, which is a measure of underwriting and expense. If a company's target for combined ratio is 95% then you are going to have to raise rates or cut expenses to find that 2% to 2.5%. It is like looking at the rev counter to find out what speed you are going. It does not accurately reflect what you are doing."

- ◀ “The big expenses are people and the fact that London is a brokered community, and I don't see many brokers offering to reduce their fees and commissions.”

### Electronic initiatives

One method of cutting down London's expenses that has had some success in recent years is the search for efficiencies in business processes.

At the beginning of 2009 around 90% of new in-scope claims and premiums were capable of being transacted through the electronic claims file (ECF) and accounting and settlement applications, which were implemented in 2006 with the aim of enabling brokers to transmit documents to insurers and Xchanging instantly from their desktops. And 2009 saw the launch of the Lloyd's Exchange that will carry endorsements.

Stovin at Markel says Lloyd's and the London market need to keep pushing forward with reform initiatives.

“ECF is good, but there is still a massive amount to do,” he says. “The ECF just reduced the amount of paper and stopped people walking around with suitcases. But the claims process is too long and too expensive. We need to find better ways to pay simple claims.”

According to Muir at Willis, it is vital that Lloyd's and the wider London market finishes what it has started, and completes ECF and other projects.

“We want to see it being usable for all claims rather than just the 75% that are now in-scope,” he says.

Muir adds: “We are interested in seeing many other brokers supporting this market initiative and coming on board with Willis, Marsh and Aon. Can the Lloyd's Market Association and International Underwriting Association bring the carriers on board? It requires everyone to do it.”

Muir says doing this is essential if the London market is to compete. “It is a critical first stepping stone for the opportunity to do electronic trading,” he says. “Many of our clients see contract changes as a simple thing and they would be dismayed to find we still send people into the market to queue up and get them done.”

Waterman at Fitch says: “There's a perception that things are moving and there's now some momentum but it remains a big challenge and efficiencies will not come overnight. You never finish implementing it because it continues to evolve and develop over time.”

Jeff Ward of processing specialists TriSystems, says: “From a technology perspective the challenge next year will be doing endorsements electronically over the Lloyd's Exchange. Lloyd's CEO Richard Ward has thrown down the gauntlet to the market and Aon, Marsh and Willis have responded by saying that they will do it.”

He adds: “The challenge is how you make it level and democratic across the market. How do the small brokers do it? It is about hearts and minds. If they were ever to mandate it, they would have to make sure people had the technology available to them because you have to avoid the problems of a two-speed market.”

Stovin at Markel warns: “We cannot end up with a two-tier market. The strength of London is its collective strength. The company market cannot allow itself to be left behind.”

### Tough regulatory outlook

As the calendar turns from 2009 to 2010, the Solvency II deadline moves ever closer and questions remain over which parts of the European industry will be ready for the new regime's implementation in 2012.

Stovin describes Solvency II as the “elephant in the room”,

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which the London Market ignores at its peril.

He says: “All companies should be looking at risk in the way Solvency II encourages – it is the right way to run a business and it should not be too onerous. Farming this out to a consultant is not the way forward. Where people may struggle is with documenting the process and this will be especially true for the smaller players.”

Waterman adds: “The larger players have been doing good work and Lloyd's has been encouraging, but it remains to be seen how well the insurance market as a whole will implement Solvency II.

“The end goal of achieving a risk-based level playing field is a laudable one.”

Outside of preparing for Solvency II, London market players will also be aware of proposals to ramp up the powers of the Financial Services Authority in the UK and other regulators further afield.

Sean McGovern, director and general counsel at Lloyd's, says: “The area we will be watching in 2010, not just from a Lloyd's perspective but for the insurance market as a whole, is that the regulatory environment will be very challenging for 2010.”

McGovern continues: “It is a political thing, with financial services not being valued and insurers being lumped together with banks. There is pressure on regulators to atone for past failures and it is unlikely that they will be criticised for ramping up the regulatory burden on insurers. There is a basic lack of understanding about the insurance business model.”

He points to a recent report from the European Central Bank that had some “phenomenally poorly-informed statements about the risks facing the insurance industry” or the fact that the new European Systemic Risk Board has 60 members but only one representative of the insurance industry.

McGovern says: “The main problem is that the insurance industry is having trouble getting the message across. There's a general sweeping up of financial services but the insurance industry has a different model to the banks, it is not as highly leveraged in the same way as the banks are and you can't have a run on an insurer like you can on a bank.

“The industry has to get its act together and start speaking with a single voice.” ●

By Tim Evershed, a freelance journalist