

AILA Conference – 3rd November 2006

Keith Stern – Lloyd's Australia Speaker Notes

Key characteristics

- a) Lloyd's is not an insurance company, but rather an insurance market. The market currently comprises 65 individual syndicates, managed by 45 managing agents.
- b) 1688 – merchants meeting at Edward Lloyd's coffee shop to insure their ships & cargo
 - 1712 – steam engine insured at Lloyd's
 - 1887 – 1st non-marine risk and late 1880s – 1st US risk – both by Cuthbert Heath – prominent Lloyd's underwriter and innovator
 - 1911 – aviation risks written at Lloyd's.
 - 1960s – satellites underwritten at Lloyd's.
- c) Specialisation of Lloyd's underwriters in their fields allows them to be flexible and design specific policies for customers
- d) Cuthbert Heath after the 1906 San Francisco earthquake famously instructed his San Francisco agent to “pay all claims irrespective of policy terms”

Global reach and local depth

- a) Including most prominently China and India. Earlier this year the Chinese government gave Lloyd's permission to apply for a reinsurance licence
- b) In almost 30 countries Lloyd's has a local representative office, such as Australia, which is a condition of Lloyd's authorisation in Australia.

How does Lloyd's work?

The individual members with unlimited liability are the group of members referred to as Names. Nearly 90% of capital provided to Lloyd's is corporate in nature.

A diverse, high-quality capital base

Lloyd's capacity for 2006 has increased 8% to 14.8 billion pounds. This capacity is a measure of the maximum amount of premium (net of brokerage) that may be written in accordance with Lloyd's requirements.

To put the capacity of the Lloyd's market into context, 14.8 billion pounds is approximately \$35.5 billion. According to APRA, the gross written premium of the Australian general insurance industry for the year ended June 2005 was \$27.3 billion. So

the capacity of the Lloyd's market is substantially bigger than the entire Australian general insurance industry.

A diverse mix of business

Australia is now the 4th largest individual territory for Lloyd's, behind the US, UK and Canada, having in the past 2 years overtaken Bermuda, and in the 2 years before that overtaken European countries such as France, Italy, Germany and Ireland

Chain of security

1st link – Premiums Trust Funds and Overseas Deposits: all premiums received held in trust for the protection of policyholders. These are liquid assets available to meet claims and other underwriting liabilities of Lloyd's members.

2nd link – Member's Funds. This is an amalgam of links 2 & 3 in the Chain of Security brochure. All Lloyd's members are required to hold additional capital at Lloyd's as further security for their underwriting. Members' other assets are also available to meet claims.

3rd link – Lloyd's Central Assets: Lloyd's operates a Central Fund, which is available at the discretion of the Council of Lloyd's, to meet any portion of any member's liabilities that the member is unable to meet in full.

In addition for Australia there is in effect a 4th link, namely APRA regulated trust funds held in Australia. These are currently at around \$1 billion, and are for the express protection of Lloyd's Australian policy holders.

This is reflected in the high quality ratings

Moody's ratings agency does rate Lloyd's syndicates individually. However the strength of Lloyd's comes from its market structure, and therefore Lloyd's endorses the ratings given by these agencies to the Lloyd's market as a whole. Each and every syndicate qualifies for the Lloyd's market rating regardless of whatever their individual rating may be. S&P, Fitch and AM Best provide a single rating for the Lloyd's market as a whole.

Outstanding performance in a challenging year

Hurricanes Katrina, Rita and Wilma.

Lloyd's in Australia

- a) S93 Insurance Act makes specific provision for the authorisation of Lloyd's underwriters in Australia
- b) Lloyd's is the 6th largest general insurer in Australia, with premium income of \$896 million in 2005, a slight increase on the \$889 of premium income in 2004

- c) In Lloyd's language, open market business refers to the large Australian brokers acting on behalf of their clients placing business directly with their Lloyd's broker offices in London to be placed directly into the Lloyd's market. This type of business would be the larger commercial business. Aon and Marsh produce around 40% of the open market, with other large brokers such as Oamps, Willis and JLT also regular open market correspondents.
- d) Coverholders are what are known in the broader market as underwriting agents. These are separate entities approved by Lloyd's as coverholders, and who are backed by Lloyd's brokers and underwriters, and issue policies on behalf of Lloyd's underwriters under binding agreements with those underwriters.

The Australian Regulatory Environment

Prudential Regulation – the relationship with APRA

As discussed above, Lloyd's is an authorised insurer in Australia. The special provisions in the Insurance Act 1973 were updated in 1998 to incorporate the new trading arrangements which have required Lloyd's underwriters to maintain trust funds in Australia since July 2000, along with a local office. Currently, over the past two years or so, these funds have been fairly static at approximately \$1 billion although a rebalancing exercise takes place every quarter.

Stage 2 reforms have been introduced by APRA and took effect in October this year. Stage 1 reforms were introduced in July 2002 and were primarily involved with capital insolvency requirement affecting the domestic insurance market and similarly, the Stage 2 reforms are also restricted to the domestic insurance market and contain requirements which include non-executive representation on the board of directors, the rotation of auditors and the provision of documentation to substantiate the reinsurance arrangements arranged by the company.

Lloyd's existing trading arrangements will not be affected by the introduction of these new standards.

Terrorism – reporting to the ARPC

48 Lloyd's syndicates have chosen to enter into reinsurance arrangements with the Australian Reinsurance Pool Corporation (ARPC) in respect of the terrorism cover which they are compelled to offer by virtue of the Australian Terrorism Insurance Act 2003. Reinsuring with the ARPC is an annual exercise and syndicates are free to exit or enter into such arrangements on an annual basis.

Taxes and charges – including the future of Insurance Protection Tax (IIT)

A brief word about Australian taxes and charges applying to Lloyd's. You would be aware that as a financial product, insurance is highly taxed in Australia as far as the consumer is concerned and despite the best efforts of the Insurance Council of Australia, we still find ourselves in the position of selling products which attract stamp duty and fire

service levy and for coverholder business, GST as well. Lloyd's open market business is considered an off-shore supply, and therefore does not attract GST.

Insurance protection tax which is approximately 1% is an additional cost of underwriting as it is imposed on Lloyd's underwriters and although it was established to fund the run-off of HIH which has been running for some years now, there is no indication that this tax will be removed in the immediate future. It applies to NSW only.

For clarification, the primary tax which underwriters pay in Australia is withholding or non-residents tax of 3% of gross premium and fire service levy.

The impact of Direct Offshore Foreign Insurers (DOFIs)

I cannot stress enough that Lloyd's, by virtue of its authorization under the Insurance Act, is not a DOFI.

There has been a long-standing review conducted by the Federal Government into the ability of unauthorized foreign insurers to trade freely in Australia. The latest findings suggested that the Government should allow unauthorized insurers to trade in Australia where they originate from well-regulated countries such as the UK, the US and Europe but as far as certain other parts of the world such as the Pacific and certain countries in Asia, new regulatory requirements would be introduced. That said, so far, there has been no change to the current environment which allows any insurance vehicle to trade in Australia unencumbered. In the future it is possible that all DOFI's regardless of their country of origin may have to deposit assets or funds in Australia to support their underwriting.

In the meantime the impact for Lloyd's is that we compete with direct offshore foreign insurers but at the same time we can use our authorisation to our advantage because the trust fund reserves which are local to Australia provides brokers and their clients with an additional level of comfort.

The National Claims and Policies Database (NCPD)

This database was implemented by Treasury approximately twelve months ago and is policed by APRA who have engaged Fujitsu to collect data.

The data collection exercise is in respect of open market business, binder business and claims in general and relates only to professional indemnity and public liability. We are compelled by APRA to contribute to this data collection exercise but it remains to be seen how useful or effective it would be in terms of monitoring these classes of business. Lloyd's has its own set of standards to which it must report.

The new General Insurance Code of Practice – application to Lloyd's

Lloyd's is currently a member of the Insurance Council of Australia and the existing Code which is applied to personal lines business and was adopted by Lloyd's in 1995. A

new Code which is largely claims related has been introduced by the ICA and applies to both personal lines and all commercial lines business, except for statutory classes.

Lloyd's membership of the Insurance Council is dependent on our ability to adopt the new Code, and we have been engaged in extensive discussions with the ICA as to how the new Code and the Lloyd's market could fit together.

Although pending completion of the deed of adoption formal approval at the August ICA Board meeting was given, whereby the ICA has accepted our proposal to apply the new Code to all binder business written by Lloyd's coverholders (which is worth approximately \$290 million per year), while excluding from the operation of the Code open market business written directly in London, as well as coverholder claims handled out of London.

The Australian Commercial Environment

Lloyd's position in Australia

Lloyd's premium income in Australia (which for the past two years has grown to approximately \$900 million) is dominated by commercial property and general liability including professional indemnity, public liability and medical malpractice. Currently, Australia is the fourth largest territory to Lloyd's albeit a long way behind the US, the UK and Canada.

Lloyd's small book of personal lines business comprises mainly niche motor and home building facilities, group personal accident facilities, with some travel, pleasurecraft and moveables facilities.

Dominance of the "big 5" insurers

The big 5 insurers are QBE, IAG (including CGU), Suncorp (including GIO), Promina (Royal Sun), and Allianz, which write approximately 80% of GWP in Australia.

For the past two or three years, Lloyd's has held sixth spot with approximately 3% - 4% of market share, albeit that Lloyd's is clearly more dominant in specialist classes. Lloyd's is still a long way behind the big 5, and could realistically only move further up the list as a result of mergers among the big 5.

Current market conditions for commercial lines

It would appear that the soft market is finally finding a floor. Although commercial rates continue to fall, the well-publicised hardening global reinsurance market should provide a reprieve for rate pressure. Indeed the massive insured losses arising from the 2005 North American hurricane season has assisted in this process, as for example the Lloyd's market had expected a 7-8% reduction in capacity for 2006, which was eventually reversed with the 8% increase in capacity.

Current market conditions for personal lines

Lloyd's personal lines income is approximately \$25 million or 3% of our total book of business in Australia but for those of you writing these classes of business, it is worth noting that rates are likely to remain flat to slightly down.

Deutsche Bank has advised that personal lines premium rates will do well to hold level over 2006.

The importance of coverholders – mergers and acquisitions

Of the \$900 million premium income that Lloyd's underwriters wrote last year, approximately 20% of that relates to reinsurance. Of the remainder being the direct book of business, 40% of this is generated by coverholders. So with approximately \$290 million GWP, the 80 or so coverholders in Australia are an important source of business for Lloyd's.

There have been notable mergers and acquisitions within the last twelve months which are worth noting. Australia's largest independent broker, Oamps, and also the only accredited Lloyd's broker in Australia, now owns a number of Lloyd's coverholders, namely yourinsurancegroup, Booker and Universal. In turn the Oamp's Group has become the subject of a takeover from Wesfarmers/Lumley. This year the Dexta Corporation (now Stardex) acquired former Aon agencies SLE, Macquarie and Pacific and another top ten broker and coverholder, Freeman McMurrick based in Melbourne, has entered into publicized heads of agreement with Aon to sell its business to Aon.

Facilitation of new business – the role of Lloyd's Australia

Lloyd's Australia receives enquiries throughout the year from would be coverholders and brokers wishing to place open market business and also directly from potential clients and we are happy to refer these enquiries either to our local coverholders or directly to those interested parties in the Lloyd's market.

We are also able to provide a degree of due diligence on intermediaries who may have approached underwriters for facilities with Lloyd's.

Additionally, we also provide a free service to review any Lloyd's policy from a compliance perspective with respect to the Insurance Contracts Act and the Code of Practice where it applies.

Whilst business facilitation is a secondary role to our primary function which is to maintain Lloyd's trading platform, it is nevertheless an important one and we are happy to undertake and assist in any research and development needs that you may have.

The Lloyd's Australia office also assists Lloyd's policyholders who have complaints about their policies and/or claims. Lloyd's is a member of the Insurance Ombudsman Scheme so policyholders falling within the IOS Terms of Reference may have any unresolved disputes independently determined. Policyholders not eligible to make a referral to IOS are referred to Lloyd's Complaints Dept in London which will take the complaint up with the relevant Lloyd's underwriters involved.

Depending on the terms of the specific policy, the Lloyd's Australia office may also be the address at which Lloyd's underwriters may be served in Australia with legal papers.