Senior editor: Jon Ashworth **Email:** jashworth@thebusiness.co.uk

Our recent feature on Lloyd's of London triggered an unprecedented response from readers, most of whom agreed with our view that the insurance market is leaking market share and has lost its way. One who begged to differ was **Tim Congdon**, the leading economist. Here he argues that the market is in fact enjoying a golden age.

Lloyd's lives to die another day

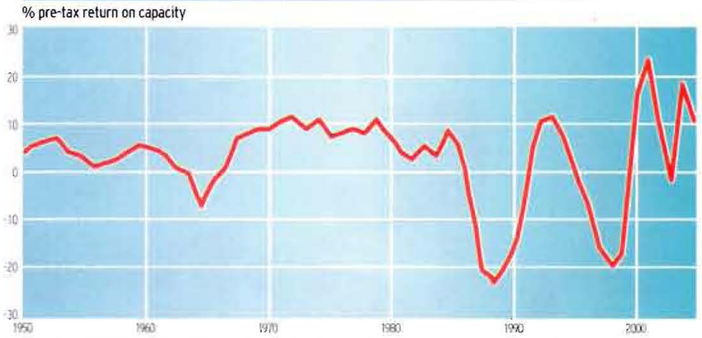
KNOCKING copy makes good journalism, particularly when it is directed against long-established and venerable institutions. Lloyd's of London – which has been insuring risks for over three centuries – is an ideal target and has been on the receiving end of such criticism for the last 20 years. "Lloyd's brain drain" in the 29 September issue of *The Business* was yet another example. The front cover of the magazine even referred to the "decline and fall" of Lloyd's, as if it were on its last legs.

But that is nonsense. Over the last five years Lloyd's has enjoyed the best period of profitability since detailed records began and possibly in its history. The article suggested that Lloyd's was about to disintegrate into little "pieces" that would be picked off by its Bermudan competitors. In fact, Lloyd's has actually outperformed the Bermudan companies in recent years.

Many of the Bermudan companies rely too heavily on US property insurance and reinsurance. When Hurricane Katrina hit New Orleans in 2005 they were, in effect, "mono-line insurers" and were inadequately diversified. They had heavy losses and were downgraded by the credit rating agencies.

By contrast, Lloyd's loss was trivial, a mere 2%-3% of its capacity. (Capacity is an expression for the total value of the insurance premiums an insurance organisation can safely underwrite in a year.)

Has Lloyd's underwriting been profitable in the long run? Source: Tim Congdon



Third-party capital provision at Lloyd's in three cycles

		Average annual return (%)		Standard deviation
		Capacity	Capital	of return on capacity
First cycle	1950 - 66	2.5	6.3	3.2
Second cycle	1967 - 92	2.8	7	9.5
Third cycle	1993 - 2007	3.2	8	12.3
Last five years	2003 - 07	11.4	28.5	9

Source: Tim Congdon

This year Lloyd's has been upgraded by the credit rating agencies, as they have come to respect the diversity of the risks it underwrites, its consistency in paying valid claims and the resilience of its business model. The business model is in fact unique. Despite many attempts in other countries, it has never been successfully copied.

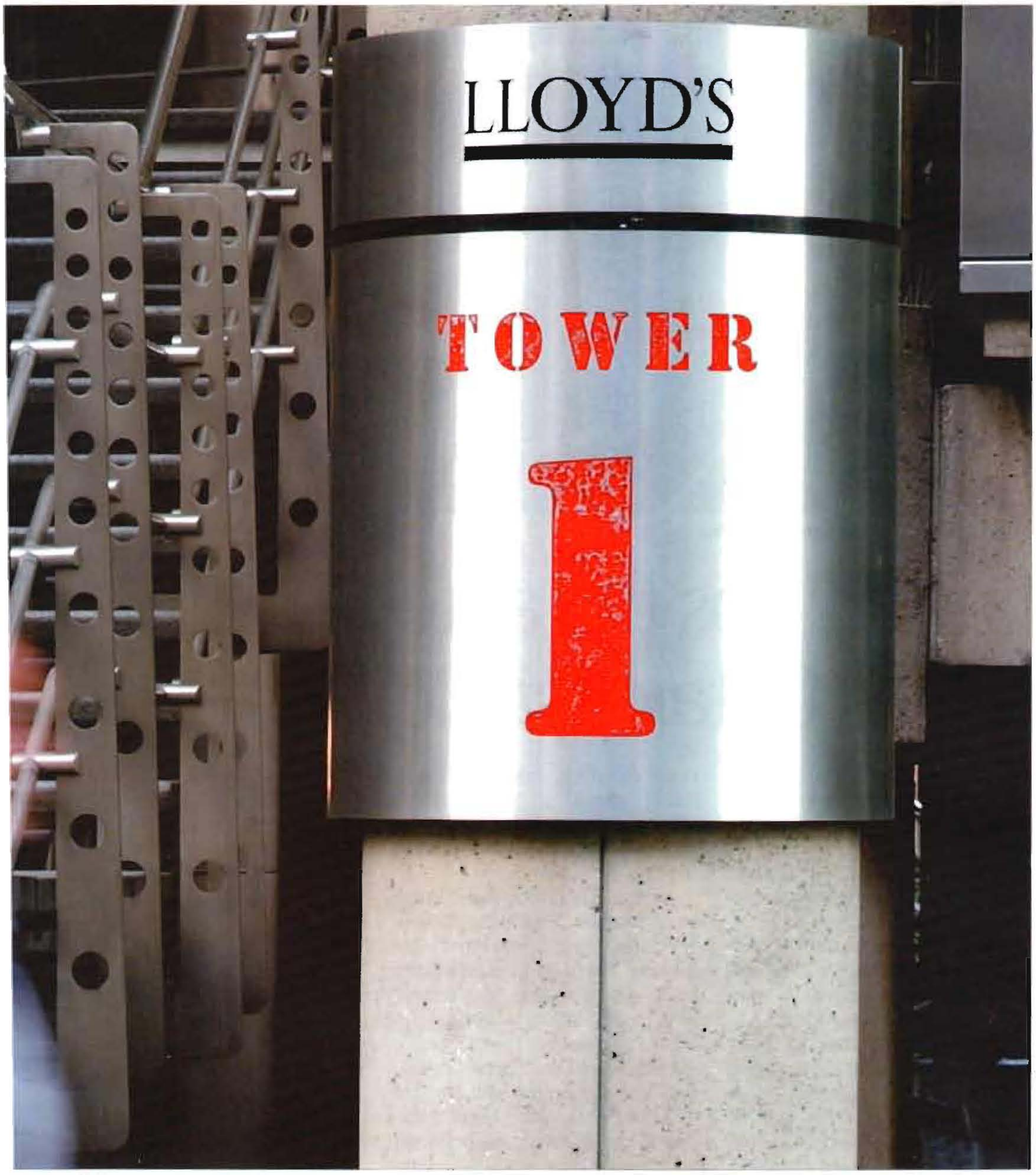
Insurance has three main parts – the marketing of policies for a premium to the customers (broking); the definition and administration of policies, and the paying of claims (underwriting); and the provision of capital in case claims exceeding premiums (capital provision). In some jurisdictions all three elements have always been integrated in single companies.

But at Lloyd's they were traditionally separated. Lloyd's brokers sold policies, Lloyd's syndicates took the premiums and managed the risks, and Names (wealthy individuals or families) provided the capital.

The article talked about a brain drain. *The Business* is correct that over the last 15 years, corporate capital, most of it in so-called integrated Lloyd's vehicles (ILV), has largely replaced the traditional structure. The article is also correct that these ILVs have recently divided their activities between Bermuda and London. But two important points must be made in qualification.

First, although Bermuda is a location where insurance companies are registered and policies are issued, much of the work involved in negotiating and drafting the policies – the work, in other words, which truly adds value to the process – takes place elsewhere. The highly paid brainwork is still concentrated in London.

Second, insurance is pointless unless it makes money. As Rolf Tolle, head of Lloyd's Franchise Performance Directorate, is fond of repeating, Lloyd's has three objectives: "Underwriting profit, underwriting profit and underwriting profit." If Lloyd's wanted to expand its market share, it could easily double or treble its capacity by cutting prices and letting in new capital, but the result would be massive losses. That would indeed lead to the decline and fall of the institution.



It is notorious that Lloyd's had big losses in the late 1980s and early 1990s, and again in the late 1990s. These loss-making phases were preceded and followed by profits. Earlier this year I conducted a study on Lloyd's long-run performance. It gives a very different message from that presented by *The Business*. (The study was financed by Hampdens, the Lloyd's members' agent, and is available from them.)

The purpose of third-party capital provision at Lloyd's is a double use of capital. The capital provider places assets with Lloyd's to be available for meeting losses if there are losses. The assets can be invested in, for example, a portfolio of equities. If premiums exceed claims and underwriting is profitable, the assets achieve both the usual returns on an equity portfolio and the returns due to underwriting profits.

The usual arrangement at Lloyd's has been that the capital providers' assets must be 40% of capacity if they are to be sufficient for the safe conduct of insurance business. My study showed that, since reliable data began in 1950, the average profit on capacity has been between 2%-3% a year. Because capital can be only 40% of capacity, this 2%-3% translates into a 5%-7.5% return on capital. The losses of two five-year periods, 1988 to 1992 and 1997 to 2001, were dreadful. That is not in dispute. Nevertheless, the profits – the virtually continuous profits from 1950 to the mid-1960s and again from the mid-1960s to 1987 – must be weighed in the balance. Losses and profits have gone together in at least three big cycles since 1950.

Moreover, the last five years have been stellar: 2003 and 2006 were bumper years, and – although uncertainties remain – 2007 looks likely to be very good. Lloyd's made a profit even in the hurricane-hit 2004. As a result, in the 2003-2007 period the average return on capacity will be over 11% and on capital almost 30%. Someone who in 2003 started underwriting by placing an equity portfolio in his or her funds at Lloyd's will have made an average return on capital of about 50% a year. Against these numbers, it makes no sense to talk of "decline and fall".

Like every other commercial activity in this country, the London insurance industry faces competition from low-tax and lightly-regulated competitors. Of course Lloyd's face challenges, and some of its business has been diverted to Bermuda, Dublin and elsewhere. We should all press even harder for tax and regulatory changes which would enhance the market's international competitiveness; Lloyd's is a unique institution that is unreplicated elsewhere, and remains a valuable source of profit and employment to Britain.

Tim Congdon is an economist and businessman, who has been a third-party capital provider at Lloyd's since 1991. He now serves as a non-executive director of the Association of Lloyd's Members