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Q2 2014 Earnings Call

Company Participants

- Inga Kristine Beale
- John Parry
- Thomas Allen Bolt

MANAGEMENT DISCUSSION SECTION

Inga Kristine Beale

Hello everybody and welcome to the Lloyd's market 2014 interim results. Today – sorry – excuse me. Hello. I am Inga Beale, I am the CEO of Lloyd's and joining me today are John Parry, he is the Interim Finance Director and Tom Bolt, Director-Performance Management Team.

Today, we are holding a webcast only. So questions will need to be submitted online, and please feel free to submit your questions as we proceed through the presentation. These will then be taken at the end. Please also remember when you do submit your question, do state your name and the organization that you are with.

So I am nearly completing my eight months in the role and I am delighted to be announcing another excellent set of results for the Lloyd's market. For the first six months of 2014, the market has made a profit of £1.67 billion, which is an increase of 21% on the equivalent period in 2013. And I believe, this result is a real testament to the market's experts underwriting. Our combined ratio of 88.2% continued outperforms that of our primary competitor group.

However, pricing remains under pressure from the additional capital which has entered the industry and it's still entering the industry. So this has led to an intensely competitive environment. But some good news is that a low – despite a low interest rate environment, investment income for the market of £640 million is more than twice that in the first half of 2013. And finally the rating agencies. Fitch recently upgraded the market to a double AA- rating and excited our strong financial profile and market oversight, significant market position and after substantial investment in risk and exposure management practices as part of the Solvency II preparations as the main drivers for the upgrade. For the other two rating agencies S&P and A.M. Best, we remain on positive outlook with both of those.

Moving to the next slide, our results at a glance. As previously mentioned, these results show a further improvement on our 2013 half-year results and this is reflected in both our profit and our annualized return on capital of 16.5%. Our combined ratio although higher than the first half of 2013 outperforms as our primary competitors and then as illustrated on the next slide, which shows the comparison chart. You can see here for the past three years, we have consistently outperformed our primary competitive group at the half year

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in terms of combined ratio, with combined ratio of 88.2% versus 92.2% for our competitive group for the same period.

As you may remember from the annual results, we have changed our primary competitor group used to benchmark our performance to a group of companies that we think most accurately reflect Lloyd's business mix. Now these companies are derived from S&P, A.M. Best and Fitch's owns Lloyd's group (3:36)

So with that brief introduction, I will now hand over to John Perry, he will go through the financial results in some more detail.

John Parry {BIO 7237124 <GO>}

Thank you, Inga. Good morning, everyone. So I'm (3:50) John Parry and it's my pleasure to walk you through these excellent results in a bit more detail. So on slide six, you've got the gross written premium income £14.9 billion, that's down about 4% year-on-year and there are three moving parts of that. The largest single one is translating our overseas business back into converted sterling. As you realize with Lloyd's as a global market, a lot of our business has written overseas and the most dominant currency is the U.S. dollar, which was slightly weaker against sterling in the first six months of 2014 than it had in 2013 and the translation effect has reduced our premiums in sterling by about 5%.

Second moving part is the price change. There's no doubt that the competitive environment is getting increasingly challenging and that's seen an overall rate reduction of about 3% across our whole business mix. Offsetting that is a modest growth of approximately 4% bringing this back to the overall reduction of full year-on-year.

The third line of net incurred claims, so we realized it was a fairly benign period for major catastrophe activity, but the Lloyd's market is still incurring significant claims and supporting businesses and individuals, you can see that's a net claims incurred of £85 billion in the period.

On the next slide, you can see operating expenses are under some pressure. The market is investing significantly in its risk and exposure management practices, particularly it's preparations for Solvency II. We welcome all those developments, but they do clearly come at a small cost.

We've broken out from those underlying expenses, some movement on exchange. And just really that in a fairly stable combined ratio year-on-year that small movement from a small loss on exchange this year compared to small gain last year, just moves the underwriting results down attached (5:52) to £1.1 billion overall. Where the increased profit has come from is the additional investment return and I'll come back to that in a moment. And that produced our overall profit of £1.7 billion, one of the highest half year results that we've reported and the overall combined ratio of 88.2%.

So, just moving on to that combined ratio in a bit more detail, just starting with major claims. And on this slide, you can see the historical pattern of major claims to Lloyd's over the last 15 years, clearly showing that the events of 2014 are low in absolute terms and in relative terms. Single largest loss to Lloyd's market was the tragic loss of Malaysian Airlines MH370 earlier in the year, which we estimated a net cost to the Lloyd's market after reinsurance of £75 million.

Remember these results are at the 30 of June. So, the second Malaysian Airline disaster will be reported for the second half. The note of caution here is that yeah catastrophes can occur at anytime. And this slide shows that the second half of the year has historically provided some major claims to Lloyd's particularly given the U.S. windstorm exposures.

So, the major claims form part of the combined ratio overall on slide eight, the third bar, so adding just 1.4% to the combined ratio this time around. Moving back to the left hand side, you can see the underlying accident year ratio very stable at 93.8%, very much in line with last year. Then you've got the small difference through currency movements. I want to now talk about obviously (7:42) reserve movement.

So this is the revised estimate for future claims arising on business written prior to 2014 where we've continued to see very good experience compared to projections in claims development and that's led to release of approximately £760 million.

We believe that the Lloyd's market is robustly reserved and that's together with our oversight of the reserving methodology and the controls in place at syndicate level, give us comfort that even after this release there is a robust level of reserves within the market.

I'm now going to move to talk about investment income where we have seen an increase in the return for the period, so slide 10. So there's an improvement on the 2013 figures. So return in the period of 1.3%. This is split across the three parts of assets at Lloyd's. Both of the financial investments are held at syndicate level, that's claims reserves, then you've got the capital push up by the providers to participate at Lloyd's, and then you the central assets, predominantly the central fund that supports whole policies written at Lloyd's.

1.3% is an improvement in last year and that's come through a higher return on our fixed interest securities, particularly in the U.S. It's been a bit of flattening of the yield curve and a slight tightening of credit spreads, which we didn't see last year. So 2013 got proportion of our assets in cash and short duration fixed interest were barely returning very much in 2013.

So, house return to the levels 2010 to 2012, perhaps remember in historical terms, this is still a pretty low return given the interest rate environment that we have.

In terms of asset mix, slide 11 shows the overall investments across the whole of Lloyd's, and you can see that over 90% of the investments are held in either cash, government securities or high grade corporate bond investments, with less than 10% held in equities and alternative assets split of (9:52) hedge funds.

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On the right-hand side, we've split out the corporate bond holdings, which remain very much an investment grade portfolio with over 90% held in investment grades of BBB and above. There's been no sign of a trend to seek additional returns by going down the risk curve. It's more that there's been a small migration of the rating agency assessment of the various sectors that the Lloyd's market invests in, and nearly there are fewer AAA investments around now than they were pre the financial crisis. Those are the overall investments.

So, on the next slide, we just look at the assets of the Central Fund. Given the size of the Central Fund and £2.5 billion of assets under management, we're able to take advantage of that capital strength by diversifying our asset mix to take advantage of a slightly increased risk budget and we've been transitioning to this level of investments through the year.

You can see on the right-hand side, there's been a small additional portfolio of small – senior secured loans, where given the size of the investment fund and the other liquid assets, we're able to take advantage of the liquidity premium that those assets give us. It is a modest holding with just £75 million and a £2.5 billion fund.

On slide 14, just putting the context of our overall balance sheet, you can see that cash and investments are over £50 billion and total net resources there of over £20 billion. Now, Lloyds operates a 100% distribution method that once profits are earned but distributed back to capital providers, and we've been able to release £1.5 billion back to capital providers in the first six months.

Part of our overall net resources are the central assets, including the Central Fund and you can see there are small upticks. So central assets up to £2.5 billion and that reflects the ongoing contributions levied on the overall premiums of the market into the Central Fund and the negligible drawdowns on the Central Fund. There are no new insolvent members giving exposure to us.

And that gives rise on the next slide, which – where the line shows our solvency surplus which has increased further and that stands over £3.2 billion; demonstrating the financial security of the Lloyd's market. The columns are the breakdown of the net resources again between the syndicate assets, the capital put up by providers and our central assets.

And with that, I'll hand to Inga to wrap up.

Inga Kristine Beale

Thank you, John. So moving to the last slide and to recap, this is an excellent result in what are really challenging market conditions at the moment. However, I wonder no illusion that this may show us what will come in the future. We're in the risk business and that means that things could happen at any time and that's why we're here for. But if we do look ahead, the Lloyd's market has reacted well to the current pricing environment. Underwriting discipline has been demonstrated with the overall premium growth being

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restrained. And I believe with such discipline it will remain vital during the upcoming competitive environment.

Now, the market continue to be affected by a low interest rate environment, which is producing low investment returns on the asset side of the balance sheet, but it's also meaning that additional capital is attracted to the market because of the higher comparable returns seen in the entire insurance sector.

Now, with the upcoming or impending Solvency II date glooming, 1 of January, 2016, Solvency II does remain a priority for Lloyd's and we're continuing to invest considerable time and resources and that's both the market and the corporation. But we're making good progress in implementing our longer term strategy, our Vision 2025, and the recent announcement came out just a couple of weeks ago that the Chinese government has awarded Lloyd's China a license to establish a branch office in Beijing, is a significant step forward in making this vision a reality.

So that brings the presentation to an end. As I said at the beginning, I'm joined here by John Parry and Tom Bolt, and we're here to answer any of your questions.

Q&A

A - Inga Kristine Beale

So we have had one question in so far. And could I remind everyone to please state the name of their organization and where they are calling from please when they submit questions. So the first question is can I ask a question on capital management? What are your thoughts with regards to the quantum of hybrid debt issued by the Society in the context of overall solvency? And has the decision been taken in relation to call the euro denominator hybrid debt coming to call in November?

Okay. Thanks for that question. And obviously I'll hand over to John Parry to answer.

A - John Parry {BIO 7237124 <GO>}

Thank you very much. Thanks, Inga. So the Central Fund has a very good asset mix with overall capital planning, the mixture of equity, which for us, is the sort of contributions levied on the market to build up the fund and an additionally subordinated debt issues that we have. The call date of euro debt is in November and we are working towards that, but you can't expect me to comment before we give any formal notice to the noteholders.

A - Inga Kristine Beale

Okay. Thanks John. And may I remind you that you can submit your questions online and please state your name and the organization you represent. And if you do have any follow-up questions, please feel free to contact the Investor Relations team throughout the day. You'll be able to, if you don't know them already, you can find the details and have to contact them on lloyds.com.

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There has been, I believe, a comment perhaps rather than the question submitted complimenting the team. So I don't know who that's from, but somebody out there thinks we're doing a very good job, so thank you, IR team. Are there any other questions for the team here today?

No. Okay. As I said, feel free to submit questions directly to the IR team throughout the day if you wish. Thank you very much for joining us.

A - John Parry {BIO 7237124 <GO>}

Thank you.

A - Inga Kristine Beale

Bye-bye.

In fact, we do have one further question. And the question is what will be the ways in which you can assess potentially that discipline has been maintained in renewals?

Okay. Well, for those of you are very familiar with how the Lloyd's market works, we do have a robust oversight regime about what's going on and that area is indeed headed up by Tom Bolt, who is here today. And Tom would you like to answer this question?

A - Thomas Allen Bolt {BIO 20535299 <GO>}

Yes. We have exclusive report we get from each of the syndicates every month called the PMDR, leaving aside the jargon for a second. It does give us information on rate change relative to renewals and that's monitored by the team we have to make sure that people are adhering to their business plans. And so we have a way of tracking that month-by-month and if we see outliers, we have conversations with the individual syndicates to try and understand whether it's a major market movement or something specific to the month in what we received. So we have a fairly well organized central plan and process. We're taking care of that.

A - Inga Kristine Beale

Okay. Thanks, Tom. Any other questions from anyone? No. Okay. So take two on a close. Thank you all for joining us. Thank you. Bye, bye.

A - John Parry {BIO 7237124 <GO>}

Thanks a lot. Bye-bye.

A - Thomas Allen Bolt {BIO 20535299 <GO>}

Thank you.

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