Q2 2016 Earnings Call

Company Participants

- Inga Kristine Beale, Chief Executive Officer & Executive Director
- John Parry, Director of Finance
- Theresa Froehlich, Interim Director-Performance Management

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen and welcome to the Lloyd's 2016 Interim Financial Results Presentation. Joining us today is Inga Beale, Lloyd's Chief Executive Officer; John Parry, Director of Finance; and Theresa Froehlich, Interim Director of Performance Management.

Inga Beale will start the presentation by outlining the financial and strategic highlights for the first half of the year. John Parry will then talk you through the financial results for the period ending on June 30, 2016. We will conclude with Inga Beale commenting on Lloyd's plans for the future. At the end of the presentation, you're invited to ask questions.

I would now like to invite Inga Beale to start the presentation.

Inga Kristine Beale

Thank you, and hello and welcome everybody. Today, we're announcing the interim to the Lloyd's market. And as shown on this slide, you can see that the market made a profit of nearly £1.5 billion, which indeed is up on the previous year, the same period in the previous year. However, we should be aware that there was a strong impact, positive impact, from the strengthening of the U.S. dollar relative to sterling. So indeed, this is a reflection of what happened, particularly following the outcome of the EU referendum on the exchange rate. So we shouldn't fool ourselves that this is necessarily going to be the way forward.

However, let's look into the numbers in a bit more detail. We've got a combined ratio of 98%. Now, that is a jump on prior year, and driven a few things that John Parry will go into later. It's driven partly by large claims activity, but also on the expense line.

The investment return, that showed an up-tick on last year, going up to 1.8%, last year's only 0.6%. Lloyd's capital position remains strong. You can see that increased 6% from the end of last year, up to getting close to £27 billion of net resources. And, of course, (00:02:33) figure, the return on capital, have increased on last year and it's showing a strong 11.7%.

Now, looking at more broad things, moving away perhaps from the numbers a little bit, I'll just focus on a few of the strategic highlights. Lloyd's reach across the world continues to strengthen and our brand continues to be best-in-class in the entire global insurance sector. Last year, we opened our Dubai platform and that has had its first anniversary this year and it's still growing with more interest from syndicates.

We also saw earlier this year the opening of our new office in Bogotà, Colombia. It's a representative office. But it's supporting our Latin American strategic push, which is focused a lot on Mexico and Colombia. We've got reinsurance license application, an onshore reinsurance license application going through in Malaysia. And, of course, there has been a lot of news about India and the Indian market opening up and Lloyd's is ready to go live next year, and we should be up and running for the big renewal season that comes along in India which is April 1.

Now, we can't go through any presentation without talking about Brexit. And indeed this has led to us diverting and reallocating some of our resources to work on this. We're waiting obviously to see what the outcome is or what the government will choose to negotiate, what their sort of destination is in terms of an outcome once the EU exits, and I believe they're still sort of gathering information on that, and we're contributing to that work. But we're not going to hang around. We've got contingency plans. One of them is to look at a subsidiary option in another – or in a country that will remain in the EU post-Brexit. And we're also looking at branching, so that would mean having a branch and licensing in each of the individual countries.

Both of those work streams, the work is ongoing. We've committed to have some more analysis or analysis – predominantly analysis completion by the end of the year and we'll be going out to the market to inform them of that work, and asking really for direction from some of our businesses in the market, the syndicates, the managing agents to also help guide us as to which way we should take – which way forward we should go.

We've also made great progress in the market modernization. The London market target operating model work, that was really launched last year and we put together a very senior level of market practitioners to join the steering board for this. In April, we had the back-office system for processing premiums automatically going live. That was a successful module, focused on a specific segment of reinsurance, but that was up and running in April. We've got another module of that going live in November for the claims. We also launched the electronic placing platform in July. July 11, it went live for terrorism risks. And we're working through that and monitoring the adoption of that, with the plans to go live with more substantial lines of business in the future.

On the delegated authority front, this is really addressing the large coverholder base that Lloyd's have, which is the key element of our distribution. We've been looking at how we can simplify the process, simplifying the conduct side of how we're going out and auditing coverholders, making it easier for them to do business with Lloyd's. And of course we work very, very closely to the brokers on that to make sure that we're modern and we're not losing out the competition.

On that note, I'll now hand over to John who'll go through the financial results.

John Parry {BIO 18896198 <GO>}

Thank you very much, Inga and good morning everyone. So, I'm on page 5, the P&L account for the market. So, starting with the top line, gross written premium income has increased by 5% for the six months to June 2016 compared to the same period last year. That is largely a consequence of the strengthening of the U.S. dollar relative to sterling. Approximately two-thirds of Lloyd's business is denominated in U.S. dollars and translating that business back into sterling has led to an increase in these figures as reported of about 4.5%.

The other moving parts are an increase in volume of approximately 4%, coming both from new syndicates established in the last three years and also from established businesses, as they build on our market-leading reputation in cyber risk, and also exploiting our distribution network through managing general agencies, particularly in the U.S. on the property side. That has been at a whole account level, a price reduction of 3.5% on our renewal business. And those factors together give you that translated amount of plus 5%.

Net earned premiums also up 5%, that's after allowing for the outward reinsurance bought by the market. Net incurred claims have gone up 21%. There's the same foreign exchange impact, but we have also seen a rise in both attritional loss claims and also major losses. I will turn to that in a moment.

Operating expenses have increased by approximately 8%, representing now about 40% of net premium income. That increase is coming both from acquisition costs, so through distribution of actually accessing the business and also the costs of managing and controlling the complex specialty business that Lloyd's writes. Those factors have reduced the underwriting result by approximately 80% to a profit of just over £200 million in the period.

Investment income has risen considerably to just under £1.1 billion for the first 6 months of the year at a return of 1.8%. This has largely come from mark-to-market gains on fixed interest investments, following the full and the yield curve during the first half of the year. The result has been bolstered by the foreign exchange gains reported by the market, and that's from the fact that we are marginally long in U.S. dollars. We hold more U.S. dollar assets than the liabilities, and translating that back to sterling has led to gains of approximately £300 million.

Other expenses represent the costs of the corporation. And that increase reflects our investment in our strategic priorities, particularly market modernization and global market access. That gives us that profit of £1.5 billion and a return on capital for the first half on an annualized basis of 11.7%, up on the same period last year.

Moving to the combined ratio of 98%, we have broken out the combined ratio into three component parts. So, if we start with the bar to the left-hand side, which is the accident year performance during 2016 excluding major claims. And you can see the make-up of that 98% split between attritional loss experience of 57%, acquisition cost of 29%, and admin expenses of 11%.

The rise in the accident year loss ratio I think reflects the price change that has gone on during the period and that reduction on a whole account basis of approximately 3.5%. The rise in acquisition costs is largely a result of a slight change in the mix of business. We've seen a slight reduction in the reinsurance part of the book as a proportion of the total. So, I move towards more direct business, which carries a higher average acquisition cost ratio and also a slight move to increased exploitation development of our coverholder or delegated authority business, which also incurs significant distribution costs.

Admin expenses at 11.4%, represent the cost of managing a highly-regulated, highly complex business that the Lloyd's syndicates write. This area is not so sensitive to pricing. So, as prices change, the infrastructure remains in place, and in fact, as conditions deteriorate, it is more important than ever that the processes and controls and underwriting discipline is exercised by the syndicates. We have also seen syndicates expand their global footprint by adding to our Singapore and Shanghai hubs, and that initial investment to extend Lloyd's network will incur costs at the startup.

Major claims have increased to 5.7% or approximately £600 million in the period. That compares to an exceptionally low, just 2.7% in 2015. The largest single loss event was the wildfires in Fort McMurray in Canada, in Alberta, with an estimated loss after reinsurance of approximately £400 million.

Prior-year reserves, we have seen the release of 5.7% reducing the combined ratio. That compares to 8% in the same period last year. This level of reserve surplus is justified by the actual loss development during the period being better than expectations.

We are comfortable with the processes and controls exercised by the market in respect to this inherent reserve risk. We're comfortable with our oversight of the market. And we're comfortable with this level of release being supported by actual development coming in and being favorable compared to expectations. And finally, we're comfortable that the current level of reserving in the market remains prudent and supports a strong balance sheet. That gives an overall combined ratio of 98%.

Just looking at the historical trend of major claims, and the first half of 2016 is up on the same period last year, but in line with long-term averages. This graph would also show you that historically the second half year has seen higher major loss events than the first half and a lot of that is seasonal due to the U.S. windstorm exposure and the catastrophe book written by the market.

Looking at the performance by lass of business, a high level class of business, these bars are ordered by size of premium and they show you the performance in 2015 compared to 2016 on an accident year basis, with the third bar being the 2016 overall result for each class, after including those releases on prior-year claims reserves. Quite clearly, this show the impact of the challenging underwriting environment that there is, and accident year ratios remained under significant pressure. This is leading Lloyd's to really challenge the market regarding their portfolio selections as we run into 2017.

We compare the Lloyd's market results with a group of competitors operating in U.S., European, and Bermudan markets. We've shown here the relative performance from 2011 to 2016. And you can see that for the first time since 2011, that rise in the Lloyd's attritional loss ratio and expense ratio has pushed us above the competitor's comparable performance for the first half of 2016. The biggest differential does seem to be on attritional loss and expense base compared to competitors. This is just a six-month period after having four years of outperformance.

Turning to investments, and you can see the extremely strong performance in the first half of 2016, a return of just under £1.1 billion or 1.8%, considerably higher than the previous years. This has arisen from gains on investment-grade bonds, which represent the majority of the conservative asset disposition of the market. The overall asset mix has remained relatively stable, with equity and risk assets of just 10% of the total.

Clearly, that movement in bond yields and the ongoing low interest rate environment particularly in the UK and Europe does mean that the prospects for future investment return are on bonds remains modest.

Finally on the figures, we show the overall balance sheet for the Lloyd's market, an extremely strong liquid balance sheet, with over £62 billion worth of cash and investments. There is a currency impact here that so much of the market's assets are held in U.S. dollar and other foreign currencies to match exposures and liabilities. Sensible risk management and we have seen that members deposit the majority of their assets in U.S. dollars to map the potential exposures.

So we have seen an increase in net resources to over £26 billion, £26.6 billion, up 6% year-on-year. Central assets have increased to £2.7 billion. Again, very pleased to report there have been no hit to the central fund in the first half of 2016 and remain extremely well capitalized going forward. Our ratings remained very strong at AA- with Fitch, A with A.M. Best, and A+ with S&P.

And with that, I'll pass back to Inga to look ahead.

Inga Kristine Beale

Thank you, John. And I think the result show that the Lloyd's market definitely continues to be in a very robust financial shape, but we can't deny that the challenging conditions are still with us. And, we therefore must make sure that we look towards the future and what we can do, particularly when we've got this Brexit issue around as well. So, we're doing more than we ever have done before in terms of promoting new products, looking at emerging risks, and this week having been very successful in the U.S. market in selling cyber insurance, we've now had a big focus on Europe.

We launched a survey earlier this week that showed how many businesses in Europe are not necessarily aware of the full exposures. That many of them are not buying insurance. They're not understanding perhaps that even insurance is out there. So, we've got a big push to really make sure that Lloyd's is fully on the map in terms of Europe. And I think that also aids us when it comes to Brexit topic, when we've got concerns about that, but we can confirm that Lloyd's is there and ready to support, particularly in specialist lines of business.

The market modernization undoubtedly is an important factor as well to make sure that the London market is truly competitive, taking out cost, making it easier to do business with. So, we would continue our full commitment to modernizing and working towards that new target operating model.

But we're also aware that we must look at our internal processes. So, for the corporation itself, how can we make sure that we're modern, we've got modern consistent processes internally, so we're also having an internal review on that work. And that should be having an impact into next year.

So, overall, feels very positive, great return on capital, although we mustn't be complacent and we must be aware of the challenging conditions and particularly keep an eye on that combined ratio that's come up to 98%.

So, with that, we're now ready to take questions. And as a reminder, we also have Theresa Froehlich here with us, who is overseeing the underwriting performance of the market, and is here to answer questions as well as John and myself. So thank you. Over to you.

Q&A

Operator

Thank you to Inga and John for taking us through the results. We now turn to our first question, which is being submitted by Marcus Rivaldi of Twelve Capital. Marcus asks, can you please comment on your position under Solvency II? When should we expect to get detailed disclosure on your solvency position under the new regime?

A - Inga Kristine Beale

Okay, Marcus. Thanks for that. I'll get John Parry to give you an update on that.

A - John Parry {BIO 18896198 <GO>}

Yeah. Thank you, Marcus. So, Solvency 2 disclosure of the solvency capital requirement, the requirement is to disclose that in the first public return to regulators, which is in May 2017. We're currently considering that and we think a natural point for that will be to disclose that in our Annual Report that would come out in March 2017.

A - Inga Kristine Beale

Is there another question?

Operator

Our next question also comes from Marcus Rivaldi. He asks, how comfortable are you with the market's top line growth at the half year, given market conditions? Also, what is the outlook for the impact of large losses over the remainder of the year, such as the Hanjin bankruptcy and jubilee, et cetera?

And finally, how confident are you that new market entrants for 2017 are genuinely bringing new business to the market rather than looking to compete business away from existing syndicates?

A - Inga Kristine Beale

Okay. Thank you, Marcus. So, I will ask Theresa just to comment on that premium growth and how comfortable we are particularly when people have heard the pricing is falling. She can get a little bit of background into new entrants and things. And she can also comment on the question that Marcus elaborated on, I suppose, about these new market entrants, which is, are we confident or how confident are we that they're really bringing something new into the market.

Now, in terms of some of the other events that are going on in the world and you mentioned a couple of them, what impact will they have on the rest of the year, there were no signs yet, but it's going to have significant impact. But, obviously, we are always here, and we all know this. We're here when something may go wrong. And we shouldn't deny that at any moment, some event could happen around the world. But still fairly low loss activity, I would say, across this whole sector.

A - John Parry {BIO 18896198 <GO>}

Yeah. And if I could add to that, Inga, Marcus, the large risk events are built into business plans in anticipation that there will be severe events. But, in fact, our capital is set to a much more extreme level to cope with much more significant claims events. Alongside the detailed capital modeling from the ground up, there is a series of stress and scenario tests. For example, our realistic disaster scenario suite, to ensure that the market can withstand significant shock losses and trade forward with a very strong capital base.

A - Inga Kristine Beale

Okay. Theresa, do you want to (00:23:13)?

A - Theresa Froehlich {BIO 21367647 <GO>}

Okay. Yeah, to respond to, Marcus, your initial question which was about premium growth, in fact if we look at the numbers for half year and we look to them in original currency, given that large part of our business is dollar denominated, we have actually very little growth coming through the market this year. What we have been seeing as a trend, what's – given the change in market composition is we are seeing large amounts of business which is being transferred by some of our existing – from – to some of our existing syndicates from other parts of their groups. So, we are seeing that and that is having an influence on business coming in. So, whilst we're seeing people pulling back, and in some instances, quite meaningfully, pull back on some of the more difficult classes, particularly aviation, casualty and energy, we are also seeing new business coming in, and that is a trend that we would expect to see repeated for 2017.

We've seen the initial plans that people are putting in for next year and it very much reflects what we're seeing this year, which is basically that there are reductions in the difficult classes and there is new business which is being transferred in, which is compensating.

In relation to the new entrants and whether or not we're confident that they are bringing something new to the market, this is something that we've actually spent quite some time speaking to the franchise board about recently, to make sure that we can get comfortable on that and we have very much reiterated that that is what we're trying to do, is to make sure that they are, in some way, bringing something additive to the market and maintaining the position that we have for innovation, et cetera.

If we look at the new syndicates which started in 2016, both Credit Suisse and Everest Re have transferred business in from their company platforms, which is a great testament to the strength of our own brand there. And it's fair to say that we've got an extremely healthy pipeline of new entrants, which you were speaking to for coming into (00:25:10) or later in 2017. And again – and looking at them, we are making sure and the franchise board is very clear – so, very core part of the discussion on new entrants that there is something which there are bringing to the market, which is additive. I hope that answers your question. Thanks.

A - Inga Kristine Beale

Okay. More questions?

Operator

Thank you. Our next question comes from Steve Evans of Artemis. Steve asks, can you update us on your thinking as to alternative capital's future role in Lloyd's? How you believe Lloyd's can leverage ILS trends to add to its own profitability without capitalizing that of its members?

A - Inga Kristine Beale

Yeah. I'll just start on that. We were working, as I'm sure many of you are aware, on Lloyd's Index, and this really was aimed at how we can make sure that Lloyd's is at the center of reselection. We've got the underwriting expertise here in the market. We do the original risk selection and pricing, and then capital markets would be able to be part of that or play off – trade off the index and rather than go down to the original risk source.

We had to show that temporarily we hope and we've had to pause that activity because of Brexit. We've got a finite number of resources and we really have to reprioritize. We've probably got a team of about 50 working on Brexit at the moment on the various contingency plans and lobbying government. So, we did have to divert resources, but we have had confirmation that the government really is keen to get an ILS structure up and running in London next year. They are still to look at the tax environment and what tax structures they could put in place to make it attractive.

We've also being consulted in terms of how our members at Lloyd's could benefit from this, because while we – then there might be opportunities for alternative capital to pay, we also want to make sure that our traditional members of Lloyd's can also benefit from this.

We're working through that at the moment. We've got a team here in Lloyd's working with the London Market Group that's leading all of this work. So, it's work in progress, but we do see opportunity, and particularly, I think it's great – really positive news. If we think about Brexit and some of the fears that have been expressed about what will happen to London as a financial center, I think it's great that the government is still pushing forward on this.

A - John Parry {BIO 18896198 <GO>}

And if I just add, I mean, the Lloyd's markets (00:27:46) access to the – for the catastrophe bonds and insurance-linked securities market, as well as the traditional reinsurance. And we have also seen alternative capital providers join the Lloyd's market in its current format, so led I think initially by Nephila, and we've had two other participants join, I think Credit Suisse and Securis. So, the Lloyd's platform remains attractive to all forms of capital.

A - Inga Kristine Beale

Is there another question?

Operator

Thank you. Our next question is from Tim Doyle of RGA. He says thank you for taking my question. In the light of the warning yesterday from David Rule as the PRA about insurers cutting prices and relying on prior-year reserve releases to prop up for combined ratio, how is Lloyd's able to police this in the market and ensure that technical price discipline is maintained, particularly in classes such as energy and motor, where the accident year ratio continues to be poor?

A - Inga Kristine Beale

Yes. Indeed. I did read David Rule's statements and I think he touched on some very, very pertinent issues of concern, and in fact, we all received, the insurance sector here received a letter in July (00:29:02) from the Bank of England, from the PRA, expressing their concern that people mustn't be using reserves on prior years to boost their current results and we can see what's happening on the current underwriting just by looking at some of the Lloyd's results.

So, I think they're very wise words and I think it is important that people do focus on price. We obviously have our robust performance management team that are constantly looking at this that are reviewing. Also we review reserve adequacy across the market. But I'll ask Theresa just to comment on some of the action that we're taking within the corporation here to address the actual frontline underwriting.

A - Theresa Froehlich {BIO 21367647 <GO>}

Yes. Thanks very much, Tim for the question. Really, as we all know, the market has been under some pressure for some time. We have always carried out various schematic reviews of different classes of business and syndicates where we were concerned about pricing. And we do obviously constantly monitor people's technical pricing and rate change to see whether or not they look appropriate and in line with the market.

What we did announce in May was a portfolio review, where we're going to take a far more – far reaching and comprehensive approach to doing that. And in doing that, what we did was we identified the most challenged and (00:30:26) performing classes. So, those classes where we were seeing, for example, very high lost ratios or combined ratios, but at the same time, we're seeing significant growth once where we weren't comfortable with the price benchmarking, et cetera, and we have been doing as part of our review of 2017 plans. We've identified the bottom quartile in all of those classes and we have been working with them to ensure that they have a robust re-underwriting or review of those classes to make sure that either that business is stopped or changed. But in any event, they look to seek to reduce exposures or to increase pricing accordingly.

Now, we've just got that detail in with the September plans, but what we have seen in the high-level discussions that we had already with the syndicates in July was that that is already starting to have an impact on how syndicates are approaching those classes in terms of both loss ratio and premium volume. So, we are taking robust action on that.

A - John Parry {BIO 18896198 <GO>}

Thank you, Theresa. I'll just talk about reserves. So, yes, the PRA wrote to the UK insurance industry in July. We actually wrote to our market a year before that regarding recent casualty business. So, we are live to this risk. There are significant amount of claims reserves set up by the market. But in terms of some of the specific points raised by the PRA, we have already required all of the independent actuarial sign-offs that we get that required un-syndicate reserves to specifically talk about claims inflation and how they've addressed that, and also the reserving cycle. Very conscious of that link between current underwriting or prospective underwriting and the bridging analysis that you take from recent reserve setting. That is why the actuarial team works extremely closely with the performance management team led by Theresa on that casualty business and the focus for us is on that recent liability business written. So, we are live to the risk. And again, we'd still remain very comfortable with the processes and controls put in by the market.

The reserve releases that we have seen from the Lloyd's market over now, I think over 10 years has been a sustained trend, and those have been in years with very significant underwriting profits reported as well as the more margin results this year, and we have seen no evidence that reserve surfaces or reserve releases have been linked to the current underwriting result.

A - Inga Kristine Beale

Next question, please.

Operator

Thank you. A question has been submitted by Joanna Parsons of Stockdale Securities. Joanna asks, how comfortable are you on the level of reserve releases, even if they fell slightly year-on-year? Noted the warning by the regulator to insurers, how is TOM progressing? Are you confident that this will deliver the cost savings? And lastly, past attempts have not been successful. So, what progress has been made to-date?

A - Inga Kristine Beale

Okay. Thank you. So, because the questions are being submitted in text form, I think we have already addressed that reserve question, the first part of that, but let me move on to TOM and whether it's really going to make a difference. Certainly, we have actually started to deliver. For the first year ever, we have delivered modules that were part of the modernization program. We've delivered on processing at the backend, and we've delivered an electronic placing platform. These are massive steps forward in the modernization.

We're very aware we've got thousands of people working in the market here. We have tools to make sure that all of the individual businesses, via the broker or an underwriter, is also changing their processes and systems to feed into and take data from the new systems that are going in. But there is really almost full engagement with all of the operating firms in the market. So, I am very, very, very, very confident that this is going to move forward.

It took us significantly forward when the London Market Group, the LMG, got together, and we've got senior people, so we've got CEOs who've running businesses in the London market working together. They're on the steering board. They're involved in this. They're making investments in their own businesses, and that to me indicates that they all want this to happen. And we are very aware that we must move. So, it feels like a real sea change in the attitude towards embracing modernization.

Next question, please.

Operator

As there are no further questions, we will now conclude today's presentation. Thank you for listening.