Q4 2018 Earnings Call

Company Participants

- John D. Neal, Chief Executive Officer & Director
- John Parry, Chief Financial Officer & Executive Director
- Jon Hancock, Performance Management Director & Executive Director

Other Participants

- Andreas van Embden, Analyst
- Andrew Ritchie, Analyst
- Ben Cohen, Analyst
- Marcus Patrick Rivaldi, Managing Director

MANAGEMENT DISCUSSION SECTION

John D. Neal {BIO 15681439 <GO>}

All right. Good morning, everyone. Before I get started, please note that the presentation is being recorded and will be made available on lloyds.com for audio playback. In a moment, I'm going to take you through the headline financials and look back at some of the market's achievements this year. Our CFO, John Parry, will then go into the numbers in a little more detail; followed by Jon Hancock, our Performance Management Director, who will update you on the business planning and performance review plans, a few too many Johns (00:00:36) this morning and I apologize for that.

I'll come back at the end of the talk about our medium- to long-term strategy going forward. But before I get into this, as you're no doubt aware, there's been recent media coverage about inappropriate behavior in the Lloyd's market. I will be speaking to the market about this later today and I'll be happy to take any questions on this at the end.

So, on to the market's aggregated financial performance in 2018, so the headline figures recorded a £1 billion loss and a combined operating ratio of 104.5%. Yes, there were mitigating factors. The challenging investment environment meant the investment return fell from 2.7% 12 months ago to just 0.7%, and major losses were above long-term average for a second year in a row.

Even so, the 2018 results are not of the standard that we would expect of a market, both with the heritage and the quality of Lloyd's. That said, there are encouraging signs the market is starting to turn the corner. Losses have halved since 2017, and the combined operating ratio improved by almost 10 percentage points. The pricing environment saw a strengthening by 3.2% on renewal business, and the attritional loss ratio fell by 1.3% from the previous year.

Importantly, Lloyd's financial credentials and the quality of our balance sheet continued to go from strength-to-strength. Total assets grew by 9% to £118 billion, with net resources up 2% to £28.2 billion. And indeed, central assets, the final link in the Lloyd's chain of security also increased by 8% to £3.2 billion. And let's not forget, too, the valuable role the market played in helping our policyholders recover from the devastating natural catastrophes that took place last year, including hurricanes Florence and Michael, Typhoon Jebi in Japan, as well as the California wildfires. In total, the market paid out almost £20 billion in major claims in 2018.

So, the market made good progress in other areas, too, much of it already underway before I started at Lloyd's. The first priority in 2018 was to return Lloyd's to first-class performance and this was the corporation and the market's very strong focus last year. In particular, the performance review were carried out by Jon Hancock and his team. He will speak in more detail about this shortly. But suffice to say, while it was a tough process at times, the performance review will deliver a good result for Lloyd's.

Now, it's down to the market to turn these plans into reality and to drive further improvements in underwriting performance in 2019. The market also made good progress in 2018 on modernization. By the end of the year, almost 40% of in-scope contracts were placed electronically. That's a very good result. The market and the corporation continued to develop Lloyd's distribution channels through their ongoing work to create a simple, efficient streamlined process for delegated authority partners to work with the market. We should have all of that ready to go live by the end of this year.

Thankfully, given the continuing uncertainty and increasing challenges around the UK's exit from the European Union, we opened Lloyd's Brussels last year. And this is not just about making ourselves Brexit-proof although that was obviously important, but it's about having a physical Lloyd's presence in the heart of Europe, which will give us a good opportunity and time to develop and grow our European business.

So, overall, we made good progress in 2018. But this is work we had to do just to catch up to where we needed and wanted to be. We aren't there yet, which is why this year my team and I are focusing on what we need to do to set Lloyd's up for success in the medium- to long-term. So, more on that for a moment. For now, let me hand over to John Parry, who will go over the 2018 results in a little more detail.

John Parry {BIO 18896198 <GO>}

Thank you, John. Good morning, everyone. So, let's look at the income statement for the Lloyd's market for 2018. Important to remember, remember this is the aggregate of all of the syndicates trading on the Lloyd's platform together with a capital put up by the members as funds at Lloyd's and the return of central assets to back every policy that's issued by Lloyd's. This is the closest way that we can compare the aggregate performance of the Lloyd's market against competitors.

For the top line, you've got gross premium written that has increased by 6% to £25.5 billion, and we've got a slide to just walk you through the movement from the 2017 income.

For net earned premiums, the Lloyd's market purchases substantial amounts of (00:06:04) reinsurance protection and after allowing for that, our earnings patterns was an increase of 3% in net earned premiums. Net incurred claims reduced by 10% year-on-year, largely through the reduction in major claims when compared to 2017, but those are some signs of underlying improvement in underwriting performance.

Operating expenses increased by 2% to just under £10 billion. That's the combined sum of acquisition costs and syndicate administration expenses. Putting that all together, net earned premium, net incurred claims and operating expenses, you do get a reduction in the underwriting loss of two-thirds just £1.1 billion. But on the other side, net investment return fell by over 70% reducing from £1.8 billion £504 million in 2018 that is largely through the volatile market experienced in the fourth quarter, particularly December. And even though the Lloyd's market has a conservative asset disposition. The relatively small proportion of risk assets held by the market did suffer mark-to-market losses in the last quarter.

No real movement on foreign exchange and we have an increase in other operating expenses, the cost of the corporation. We've managed to keep our budget flat for run cost, but there has been an increase in our changed portfolio not least the investment and setup of the Lloyd's Brussels subsidiary and preparation for the Part VII transfer for our legacy EEA business to move into Brussels later on.

Moving to this slide, you see this is a walk from the 2017 figures to 2018. On the underwriting side, the first three bars you've seen an improvement in all three areas. So, the accident year excluding major claims improving by £388 million that reduction in major claims from the extreme catastrophe experience of 2017, which saw Harvey, Irma, Maria and the California wildfires. And then we've seen a small increase in the releases from prior years that is the claims estimate set up in the balance sheet of December 2017 running off within expectations. Then you have the reduction in the investment income giving us that overall loss for 2018 of just £1 billion.

So, I say we (00:08:35) come back to gross written premiums. So, in 2017, we reported £33.6 billion. The majority of business written in Lloyd's market is in overseas currencies, particularly U.S. dollars. And actually on average during the year, sterling was actually slightly stronger against the basket of currencies in the year. So when you report back that premium into sterling, it comes out lower and that's a reduction of 4% year-on-year.

Then we saw a reversal of the previous softening market and declining pricing with an increase on renewal business of just over 3% across the whole book. It was more focused towards catastrophe exposed lines that actually incurred losses during 2017, but we are seeing signs of improvement across the whole book.

Four new syndicates joined the Lloyd's platform in 2018, showing the continued attractiveness of Lloyd's and its license network and the opportunities that it gives rise to capital providers. That increased premium by 2%. Then, for existing syndicates, we have a combined growth of 5%. Now, 3% of this is from business written under delegated authorities in early years being reported through. That has typically been some of the more profitable lines of business written by Lloyd's, and that's contributed 3 extra points in 2018.

The balance of 2% is largely from new products and innovations so, our continued market-leading position in cyber, but also initiatives in a sharing economy, warranty and indemnity. And, again, more focus towards the more profitable lines of business, giving us that total income of £35.5 billion.

This slide breaks out our combined ratio into three component parts: the underlying current accident year excluding major claims, major claims and then the performance on reserves brought forward. So, the large pillar is the current accident year and you can see a sign of improvement there, where the attritional loss ratio has reduced from 58.9% to 57.6%.

Acquisition costs have edged up, and that's largely through our changing business mix, again, through the delegated authority business written, but then a reduction in administrative expenses. And we're seeing signs of the number of finance transformation and other cost-saving initiatives being put in place by our managing agents running the syndicates recognizing the cost pressures that the market is under. We continue to invest in market modernization through the target operating model to also realize benefits for our market.

On major claims, we saw that reduction from 2017. As John said, the principal events were Hurricanes Florence and Michael in the United States, Typhoon Jebi in Japan and the California wildfires. It is an above-average year, but not to the same extreme length as 2017, and that contributed 11.6% and a total of £2.9 billion of major claims, net of reinsurance to Lloyd's.

On prior years, we've seen releases of £976 million across the market, reducing the combined ratio to (00:11:54) 3.9%. That is the 14th year in a row that Lloyd's has seen a release from its balance sheet brought forward. We're very comfortable with the reserving processes and reserve assessments of the market, which coupled with our strong central reserve oversight gives us confidence in the balance sheet and the provisions being brought forward given a combined ratio of 104.5%, so nearly 10 points down on the performance in 2017.

We compare the aggregate Lloyd's market performance against a group of comparator companies, okay, (00:12:31) so we have 13 and we look to select their part of the results that most compared to Lloyd's market in terms of the mix of insurance and reinsurance and geographical spread. And you can see that the differential between Lloyd's and its competitor market narrowed in 2018 to 3.7%, down from an underperformance of 6.6% in 2017.

On investment return across all of the assets held at Lloyd's, the total return of £504 million represented a small, but positive return of 0.7%. It is down on previous years, reflecting that volatility in the fourth quarter as a general risk of attitude was taken by investors. We have seen interest rate rises in our principal market of the U.S. And so, our running yield on our fixed income portfolio which represented over two thirds of the assets held across Lloyd's that now offers a higher opportunity going forward.

There's been no significant change in the investment disposition of the Lloyd's market, which is why its conservative with 13% invested in equity and other risk assets and a very strong split by credit rating of the corporate bonds held by Lloyd's.

Cash and cash equivalents, which are largely letters of credit, have reduced year-on-year, reflecting some of the transitional measures put in place by Lloyd's to reduce the amount of letters of credit that were ineligible for solvency under the tiering test under Solvency II.

Turning to the balance sheet, Lloyd's aggregate assets' gross liabilities increased again to £118 billion. After allowing for liabilities, net resources increased to over £28 billion. And as in 2017, we have seen the Lloyd's market capitalize successfully following losses to leave Lloyd's in a very strong financial position.

Member assets increased by 2%, and central assets increased again by 80% year-on-year. Yet, again, there have been no hits to the Central Funds or losses have been met by members who are trading forward. The increase in capital at member level and central has meant that our coverage of our central Solvency Capital Requirement increased from 215% to 250%. That's well ahead of our risk appetite of 200%.

We have a second measure of risk, which is the market-wide Solvency Capital Requirement. This is to remember the Solvency II won 200 tests, where we've seen an improvement from 144% to 149%. That is largely down to the reduction in our level of letters of credit, so that all assets now held by the market are eligible for Solvency.

We would expect in the first part of this year for that ratio to improve again as members inject capital for the losses they incurred in the fourth quarter. We've done a very successful again accelerated capital-raising exercise to restore all members up towards their capital requirement capital requirement to support the plans for 2019.

And that shows I think this is a final slide from me, shows the success of the Lloyd's market and the way that we distribute profits when assets are surplus to liabilities and capital requirements and also restore the balance sheet following losses. So, even though we've had loss of £2 billion in 2017 and £1 billion in 2018, the financial resources for Lloyd's market continue to grow to over £28 billion.

And with that, I'll hand over to Jon Hancock, Performance Management Director, to talk through managing market performance.

Jon Hancock {BIO 18712327 <GO>}

Okay. Thank you, John, and good morning, everybody. So, as you've heard from John Neal, and even taking into account those mitigating factors, the Lloyd's result is not where it should be. And so, our first priority and my first priority for 2018 was to get Lloyd's back on track to a sustainable profitable position and that meant taking some fast and decisive actions to address some problem areas across the market. So, I'm going to talk through the things that we and the market have been doing. And then, talk briefly about what we've seen at January renewals and then where our performance management focus is aiming at to in 2019.

So, what do we do alongside last year's regular business planning cycle, we introduced performance reviews and that was to look specifically perennially on profitable syndicates and classes of business. Those worst performing syndicates were eroding about 87% of the market's profit and the worst performing class is about half of the market's profit and therefore placing really undue strain on those better performers.

And whilst every one of those syndicates needed to demonstrate a route to sustainable, profitable performance, it didn't mean everything had to be fixed immediately, or that everyone and everything should have the same plan or the same time scales.

Different businesses and different portfolios are at different stages of evolution, and often have different challenges and different opportunities, but it did mean that every single one of those plans had to be strong and had to be credible and had to be deliverable.

So, what did we do? Well, first up, we looked top-down across the market to identify, was there any class of business that was having a disproportional impact on the market profitability and that's what we've been referring to as the portfolio review classes. But then, I think more importantly, we asked each syndicate to look bottom-up at their own portfolios, segment them into Deciles and identify the very worst performers and then to agree with us an action plan to either improve them or remove them and that's what we've been terming Decile 10. So, it's an approach very, very much targeted at the worst performers and the worst-performing portfolios in the market.

So, I'm just going to share a little bit of the outcome of that on this slide. Now, the place to aim for on the graph is the bottom right, and I'll talk a little bit about that in a moment. But the rest of the graph shows what happened with those worst-performing portfolio review and Decile 10 classes. And the vertical axis shows the change in profitability in the 2019 plans, and the horizontal axis shows the change in planned gross written premiums.

And you can see that those worst performers are all in the bottom left-hand corner of this graph. So, that shows that profitability is improving in them and the size of the portfolios for this year's plan is reducing and that's a good thing, because it means the very worst business is being improved or removed by the market. And in addition, the rest of the market, which is shown here in the larger purple bubble, is also improving profitability slightly and critically is projected to grow by around 4% in this year's plans.

We should also remember that this is a plan, where no class of business as a whole was closed across Lloyd's. So the market continues to offer capacity in every class of business that it did before. But some of that capacity may be a little bit more expensive and may be a little bit more discerning.

You'll also remember it's a stronger plan, because each syndicate is addressing its poorest performing businesses, but also looking to maximize its best performing business. And also, whilst we wouldn't expect to see growth at an overall market level this year, plenty of syndicates are in fine shape and are looking to grow this year. And we actually have a fairly equal split of syndicates growing, syndicates shrinking and syndicates staying flat in their plans this year.

And we should also remember that the plans approved for the market this year include more than £7 billion of new business, new and innovative business to replace the natural attrition and some of the poorer performing classes. So, ultimately, a strong plan for Lloyd's, strong outcome from the planning review really helps us get back to where the Lloyd's result should be.

Now, just briefly on the January renewal season, and there's been lots of commentary around there. So, I would say it's encouraging to see some good signs of momentum across the market and across the industry, although with much more needed. And the key headline for Lloyd's is that rate was positive at January and also in line with or better than planned at most of the syndicates as well.

And on this side, the green line represents planned rate and the blue line above it shows the actual rate historically achieved by the Lloyd's market and you can see the actual rate tends to be higher. Again, this is evidence of the action that Lloyd's market has been taking as well as an acknowledgement that there's more work to do.

There are more encouraging signs as well. Positive rate has been achieved for six consecutive quarters at Lloyd's. And as John Parry alluded to earlier, that's part of the reason that the attritional loss ratio has improved last year by 1.3 percentage points. And those attritional loss ratio should continue to improve as that extra rate earns through the portfolio over this year and the next couple of years.

It's also worth pointing out that the majority of the classes across Lloyd's are showing positive rate. Positive rate across about 80% of the Lloyd's premium 49 out of 61 classes of business. Pricing is and should be specific to the individual policy and the individual risks. So, we shouldn't be surprised that we also see rates fall in the best performing areas and to ensure that adequate and fair price is maintained.

And just one final comment on this slide is that premium volumes achieved last year and this year-to-date are broadly in line with the syndicate plans for this year. So, I'd say that's a good sign of underwriting discipline, but also a really good sign of a pipeline of good quality business to be written at Lloyd's as well.

And finally, just a quick look at the oversight activity for this year. And our focus in 2018 was very much about Lloyd's setting up for success and 2019 is very much about maintaining that progress. So that does mean that everyone must deliver plans for sustainable performance and also aim to deliver profitable growth.

As I mentioned a little earlier, this year, we'll focus much more on a continuous improvement approach instead of one big annual exercise. In practice, that means regular portfolio management and ongoing management by the syndicates, which is just a natural part of good underwriting discipline. It also means we move from a pure Decile 10 approach to a more balanced Decile approach. So, we will keep monitoring and acting on those worst performing 10 Decile classes, but we'll be moving to show more interest and actively encouraging growth on those best performing Decile 1 and Decile 2 classes.

Another key part of our amended approach is that we're moving more from a minimum standards approach to really identifying best practice across the market in certain key areas. So, for this year, we've started on catastrophe underwriting and we'll move to best practice pricing later in the year.

We've also started reviews of acquisition and administration costs across the market. High costs are harming Lloyd's competitiveness and combined ratios, so we have to do more to improve them. We've delivered a thematic review on acquisition costs already this year, which the market are working through. And a second review on administration costs is about to start.

So, as I said at outset, Lloyd's results haven't been where we want them to be, but I do think the work that the market has undertaken last year alongside the corporation has delivered really good strong plans for 2019. And by delivering those plans, I'm confident we're on the right track to achieve in that sustainable, profitable performance that we're all talking about.

And that's our springboard to success and that's the place from where the market can leap into profitable growth in the future, which is essential for Lloyd's to deliver those medium- to long-term strategies, which John is now going to talk to you about. So, I'll hand over to John.

John D. Neal {BIO 15681439 <GO>}

So, thank you, Jon. I said earlier 2018 was about catching up from where we needed to be. So, the work that my team and I have been doing over the past six months has been thinking on what we need to do next. What changes do we need to make to the corporation and to the market to ensure that Lloyd's can thrive today, tomorrow and in the insurance marketplace in the future as we imagine it.

So, to answer that question, we've been listening to literally hundreds of market stakeholders, not just here in London, but around the world. So, that's everyone from policyholders to global carriers, who operate outside of our marketplace and carriers and brokers, large and small, who operate within our marketplace. So throughout that process, we've gained some incredibly valuable insights on what Lloyd's does well and of course what we could improve.

So, this listing too included some key markers around Lloyd's unique and valuable quality. So, for example, our global license network reverberates with almost everyone we talked to. The concentration of broking and underwriting expertise, our reputation for writing specialist business and the fact that we pay billions of claims every year, which is over £200 billion claims paid this century so far.

So, these are what powers the Lloyd's brand, the best known insurance brand in the world, and without a doubt, one of our greatest assets. So, the short- to medium-term has really been about making sure the corporation is set up to deliver the market's business aspirations in an agile, efficient and in an effective way. So, this year, as you've heard from Jon Hancock, we're continuing to work with the market to ensure its underwriting and the way in which it assesses risk and prices risk is world-class and how we can strip out unnecessary costs.

We are and will continue to modernize the market both, by delivering on our original promises for the target operating model and by beginning to think about what should be next to the benefit of the market as a whole. And we're putting in place a very different geographical focus. That means concentrating on those developed markets that have the greatest potential for future immediate growth such as the U.S. and topical (00:28:44) Europe.

And also, therefore, thinking about those emerging markets and emerging economies that offer the best return for our investment. And we're looking at how we can make better use of alternative capital. Then, there's the medium- to the long-term. So, we need to build a Lloyd's that reflects the fundamental changes the market and the world is experiencing. We need to have the business model, the technology, the talent, the products, the distribution channels and the capital structures in place to seize the opportunities our sector is competing for in this new world.

So, to start this process, we've redefined our purpose of sharing risk to create a braver world. We've also refined Lloyd's value proposition, that is the benefits to each of our constituent stakeholders, our carriers, our brokers, and really importantly our customers. So, this shows where we are unique and where we can compete on things other than price. And we're also developing our strategy to build the future at Lloyd's.

So, the first step on this journey is to launch a prospectus for consultation, which we've said we'll do on the 1st of May. All the ideas expressed in this prospectus are based on the conversations we have been having with the market and with all the stakeholders.

So, the preview on this slide sets out the four main strategic aims of this work, which you can see on the slide in the top left. And based on the input so far, we've come up with six possible options for building the future of Lloyd's, which will benefit all of the market participants and all of our stakeholders, really importantly, our customers.

So, these things – this includes things like a risk exchange through which customers' risk can be placed in minutes from anywhere in the world and at a fraction of today's cost. And, for example, an automated claims process that speeds up settlement to improve customer experience and indeed increase trust in the market.

I wasn't intending to go into any more detail today. That will happen on the 1st of May, when we launch the full prospectus. But, in the meantime, we are encouraging anyone who wants to feed into this process to do so and to register online. So, we will use this feedback to create a blueprint for the new market along with the prototypes of whichever elements we decide to progress with. We expect this work to be finished by September, so we can start the full solution build in October this year. You will see change. You will see differences in 2019.

So, overall then, it's been a mixed year, but I am genuinely encouraged by the positive signs of recovery and I'm confident that the plans we put in place will create a prosperous and sustainable future at Lloyd's. So, thank you.

Now, I think we have some time left over for Q&A. That could be questions either from the room or for people on the webcast.

Q&A

Q - Andreas van Embden {BIO 1795530 <GO>}

Good morning. Andreas van Embden from Peel Hunt. I have two questions please. If I think about your attritional combined ratio, the 96.8%, obviously that still gives you a very low margin to absorb cat losses even though you're still confident about potential reserve leases down the line. Where would you think that attritional combined ratio would need to be in the next two to three years to make the market structurally profitable on a normalized basis, so including your cat loading? And my second question is, you mentioned alternative capital and making better use as a market of alternative capital. Could you maybe sort of highlight, what your thoughts are on that? Thank you.

A - John D. Neal {BIO 15681439 <GO>}

Yeah. So, I take the second question, then I might ask Jon Hancock to take the first. For the second, I mean we know today that many of the participants in the marketplace use alternate forms of capital to support their balance sheet. So, what we're really suggesting is that, those alternative forms of capital could be nurtured within our market than outside of it. So, that could be a range of different options.

It could be Lloyd's acting as a transformer for the ILS market. It could be Lloyd's excepting the trading of indices for insurance. It could be allowing pension funds or other forms of alternate third-party capital to more readily connect directly with risk on the marketplace.

So, it's being very open-minded to the alternate forms of capital that we now operate in the insurance or reinsurance space globally and encouraging those alternate forms of capital to be nurtured and operated on our platform directly.

Jon?

A - Jon Hancock {BIO 18712327 <GO>}

Yeah. So, I'll answer the question slightly differently in that we haven't mentioned it here, but you've all heard us talk before about the normalized combined ratio. I think one of the positives in the results is we talked last year about our normalized combined ratio. So, where we simply normalize for what we consider to be a normal cat year. We don't ignore claims in that, which is what does a normal historical and look forward cat year look like. And if you normalize that in our results, then the combined ratio is around about 102, whereas last year, we were talking to you about around – about 105, so I think that's a really positive part.

Then if you expand that, so that includes a cat load of around about 9%. So, we assume that every year and trends are changing, but we think that 9%, 9.5% is our normal expected cat load. So, we would therefore expect the market to be profitable, including a 9.5% cat load. Then what would the attritional look like, and the reason I'm answering different (00:34:51) I don't think it's that simple, partly because some syndicates are pure cat syndicates and some are pure attritional syndicates. But it's also we look at the total combined ratio and we have an expense load of about 39%, 40%, and a claims load of about 60%, and we've got to attack both of those things.

So, for sure, I think there's a bit of improvement in the attritionals in certain areas and a lot in some areas, but we need to attack so that that combined expense and claims ratio in a normal 9.5% cat year is still profitable. And then we write the picture in the charts (00:35:29).

Q - Andrew Ritchie {BIO 18731996 <GO>}

So, Andrew Ritchie from Autonomous. One of the high-profile CEOs of a large operator at Lloyd's expressed concern that it required Lloyd's to intervene on the Decile 10 initiative to get people to start fixing things. And they, I think, felt that they were two years ahead of that. Does that concern you? Does that have wider implications about the standard of operating some of the syndicates or why do you think it needed such intervention? Secondly, John, I guess you've assumed the average rate which is plus 3.2% in 2018. It is relatively higher in 2019. And, finally, what do you think is the market's Cyber RDS now relative to net cat?

A - John Parry {BIO 18896198 <GO>}

Shall I deal with the first one. I don't think it's for us to speculate on what the market should or shouldn't have done, right? I think we felt that it was part of our responsibility in supporting the financial health of the market, but we should be robust in the way in which we challenge the plans. And I think as John's just set out to you today, we see that as a continuing process. Some of the focus points might change, but if it helps, and if it supports the businesses who I think are doing some good work themselves for us to be a little bit more interventionist then that's what we'll do and that's how we'll be.

A - Jon Hancock {BIO 18712327 <GO>}

Yeah. And there's a huge divergence. This is a market of 90-odd underwriting firms, and you'd expect to see different standards. And you see different standards in performance and different standards of who's ahead of the curve and who's behind the curve. And I think you see a distribution and some require more intervention than others. (00:37:25)

Q - Andrew Ritchie {BIO 18731996 <GO>}

I do.

A - Jon Hancock {BIO 18712327 <GO>}

...that's fair, fair to say. On the Cyber RDSes, I'll say a couple of things, one is we do a lot of work and we've done a lot of work on Cyber RDSes, and they are nowhere near the size of a natural catastrophe. I say that with the caveat, of course, that we still learn with cyber. We have the benefit of we may not have got the models, but we've got 350 years of modeling experience on natural catastrophes. We don't have that on Cyber.

And much as there's clearly some climate changes and different incidences going on cyber, probably, the risks are changing daily, aren't they and our learning is changing daily, but let's say we look at the knowns to the affirmative and the silent (00:38:11) cyber cover, they're nowhere near the size of a nat cat.

We're actually in the midst of doing some more work right now to reevaluate those RDSes to set some different RDSes. We've set some centrally. We ask each syndicate to do their top-five scenarios as well. We're in the course of updating those as well to make sure we understand the exposures and make sure that we're set forward.

Q - Andrew Ritchie {BIO 18731996 <GO>}

And then, the average rate?

A - Jon Hancock {BIO 18712327 <GO>}

Yeah. So, average rate is – so, average rate, I think, is a good indicator, but that's all it is. And, I think, in a – and, I mean, at a marketplace of 90 underwriting firms, I think averages are quite dangerous, because I don't think there is an average syndicate at Lloyd's. There are cohorts who look and feel the same sort of business. I think averages are very dangerous.

And if you look at that 3.2%, that could be every – anything from minus 10 in some places to plus hundreds in others depending on. So, I think, what we will get is, and you've seen it play out in the newspapers and you'll see it play out in some of the reports, if you look at those loss-affected areas, will continue to drive higher rate increases.

From Lloyd's perspective, those portfolio review classes and those real worst performers have attracted much harder rate than the better performers. So, I think we'll see a mix. We know what the targets are. Will it be higher or lower? I think it will be in the ballpark actually. And I think continual sticky rates that stays with us and is fair on customers and allows everybody to manage efficiencies is much better than trying to get back to the cycles (00:39:54) I think it's the momentum and the stickability is the most important part at the moment.

A - John D. Neal {BIO 15681439 <GO>}

The thing I'll add on cyber, which so it's third of the world's premium for cyber is underwritten in Lloyd's. I think the good news for that is, we've got a better dataset than most. We've actually handled over 25,000 cyber claims already. So, it's not only in terms of assessing and measuring the risk as we would see it, and we would use our capital models in the same way you would expect us to do to do that. We've actually got real data to see actually what happens in the event of loss and how loss translates compared to how we protected it.

So, as Jon said, we're evolving our thinking and our assessment of measuring exposure. But the quality of that data is helping us to get we think more precise, which the corollary of that is I think the product gets better and the product that we're selling to the customer gets better.

Q - Marcus Patrick Rivaldi {BIO 19170623 <GO>}

It's Marcus Rivaldi, Twelve Capital. A few questions, please. The first one, you talked about growth on existing business about 5% last year. I'm assuming that was a lower number reflecting the impact of your Decile 10 action. Could you give us a sense what the - should we say the level of premium being cut (00:41:07) from that action was? And perhaps is that something we'll see more in 2019 rather than 2018 that impact coming through?

Secondly, do you think we should be expecting a very steep decline in the loss ratio at the market to reflect the action that you've been undertaking, or is it going to be more gradual level of improvement?

Next, on acquisition cost. John, do you think there's a self-help story here, or is this something really more as a gift of the brokers to get that acquisition cost ratio down going forward?

And finally on PYD (00:41:44), whether any positive one-offs in that number perhaps for an Ogden (00:41:47) rebasing? Thank you.

A - John Parry {BIO 18896198 <GO>}

Should we take it in reverse orders, do you want to do PYD (00:41:53) first?

A - John D. Neal {BIO 15681439 <GO>}

No. In terms of Ogden (00:41:57) syndicates haven't moved much during 2018. The Ministry of Justice, it's coming but that's prudent rather than very prudent. In terms of Harvey, Irma and Maria, on that loss estimates remained stable exactly where they were a year ago. It's more general releases from a significant minority of syndicates who hold initially prudent claims estimates and then recognize them as more certainty emerges over time rather than being related to any one-off either major claim or release of a court judgment.

A - John Parry {BIO 18896198 <GO>}

I'll take the middle two questions and I'll hand over to Jon on the growth question. I think in terms of improvement, as you know, the lifecycle of an insurance policy runs for two years anyway, accepting the policies incept on the last day of the year. So a lot of the underwriting that features in the financial accounts in 2019 was committed in 2018 and some of it in 2017. So the simple reality is, does the improvement does take a bit of time. Not a lot actually. So, I think in two years, you could see meaningful change. In one year, you'll see some change. So, our expectation and our plans tell us that the market for that normalized cat allowance is back in profit in 2019. We would therefore expect to see further improvements in 2020.

I think the total acquisition cost, yeah, there's a bit of self-help. I think, yeah, the underlying businesses really need to understand the moving parts and the components of their P&L and address that for themselves, but there's a lot we can do as well. So, as John said in his sort of highlights for 2019, we are looking at all parts of the P&L and actually having a particular focus on the way in which remuneration is paid for (00:43:52) distribution, how is that structured, is your business model right for different types of distribution and what are your own administration costs.

So, I think there's a nudge we can do on that. Yeah. The talk that we're putting into the marketplace around the future is to say, well, how can we make it easier to do business with Lloyd's, and we've got to drive very ambitiously to significantly reduce the cost of doing business. So, if we're at 39 to 40 points, that's not too high, it's significantly too high.

So, part of the thinking around the way in which we see the market operating is to very, very substantially simplify the way in which we do business at Lloyd's and therefore take cost out with actually one objective is we've got to be able to sell our product to the end customer for less money. If not, then we'll find ourselves in a very challenging space. So, short term, we can act. We can nudge those underneath us to act. But, our longer term thinking is to significantly attack and reduce the cost of doing business.

A - Jon Hancock {BIO 18712327 <GO>}

Yeah. So, on the growth and to continue where John left off, on that prior year premium cost, that is generally, and I think John Parry said coming through good areas. It's largely delegated authority business, which we earn slower and notifies more slowly and it's largely in some of the more profitable short-tail classes.

Equally, that's premium that was written two or three years ago and hasn't had the benefit of some of the rate adjustment, so that weighted average starts to look different. And so, we look at the written premiums and the written loss ratios as well as the earned. So, some of that will start to improve in two years when that quality of earnings starts to come through.

Talking specifically on the numbers. So, the 5% across existing syndicates is that lower than normal last year. It's about in the ballpark actually last year. I mean, Lloyd's has been growing 5% to 6% per year over the last few years and the world has been growing at 1%, 2% and insurance rates. So, that's probably about an average number, but I think the makeup is different. That's why we make the point of that 5 percentage points of growth, 3 percentage points comes from years prior to 2018.

So, what you'll see and I'll share a number with you've asked is those two bubbles of the Decile and the performance review classes, that premium equates to about £3 billion of premium that is ultimately being removed from the marketplace. And that's a number that we've shared not widely, but we have shared that that number.

And of course, that's been restocked by about £7.5 billion of new business. And so, the trick here, of course, is to make sure that that new business that's coming in is of equal or better quality to your good performing business as well and those are the standards that all of the underwriters are setting themselves. So, some of that will continue to wash through this year. It hasn't all come out last year, which is why we've said we don't expect to see market growth this year, but we do expect to see that big purple bubble growing, because that's the good business and the other which we've really targeted significantly growing.

Q - Ben Cohen {BIO 1541726 <GO>}

Hi. Ben Cohen, of Investec. I wonder if you could just say something more in terms of claims inflation. Any areas specifically by the subclasses that concern you that maybe pricing isn't keeping up in line with claims increases that you're seeing. And specifically any issues around potential recession in Europe or indeed a slowdown in the U.S. economy and the impact that that could have. Thank you.

A - John D. Neal {BIO 15681439 <GO>}

So, let's start and you can add some color. So, on the macro question, we're not seeing any evidence of superimposed claims inflation. So, if you look through all of the lines of business, particularly the casualty lines, there's no evidence of superimposed claims inflation yet. We are looking for it, because we would be asking the same question you're asking, should this happen, could it happen. So, it's something we're looking for closely. We're not seeing it. I think the second part before John will goes bit more detail around the descriptor of the claims book is the great thing with the actuarial science and the reviews that are placed to reserves, no actually ever it seems the inflation doesn't exist. So they always assume that inflation exists and therefore, are always inflating reserves.

When you look at first-party claims actually, we're in a world of negative inflation, costs are coming down and that's part of the reason why you continue to see prior reserve releases at Lloyd's is that there is a continuing assumption that inflation exists in recent times. We simply haven't seen it and for that reason you're seeing some prior year reserve releases, but John might have some...

A - John Parry {BIO 18896198 <GO>}

Yeah. There's no doubt there's a high inherent risk, and that's one of the reasons – one of the controls that Lloyd's has is an independent statement of actuarial opinion on every syndicate's reserves. And in that report to Lloyd's, they have to comment on how they have allowed for claims inflation in the reserves. So, that's an area that we have been highlighting with the market just because the risk is there and highlighting do not bank the fact that, for the last five years, you're on development triangles that haven't seen significant claims inflation.

We're talking about markets like the U.S., UK and Europe, which is sort of nearly 80-odd-percent of our book. So, you do need to allow for that, particularly now in the United States, where we've seen interest rate rises, so the risk with sort of GDP and the rest of it.

The other protection for Lloyd's is that our liabilities are longer than our asset portfolio. So, in terms of asset liability matching, we're slightly short of duration. So, actually, sort of a inflation – a modest inflation within so, actually, economically beneficial overall when you start putting the assets and the liabilities together.

A - John D. Neal {BIO 15681439 <GO>}

I have a question from William Hawkins (00:50:25), KBW. You have £37 billion of new and innovative premium entering the market, how comfortable are you with your ability to assess this business so that it does not become the next portfolio review Decile 10 cohort?

A - Jon Hancock {BIO 18712327 <GO>}

Okay. And that's one of the conversations we have with ourselves and with the marketplace. I mean, the first point I'd make, of course, is, we, at the corporation, do not underwrite this business, so the quality of underwriting, the underwriting discipline and the discipline to ensure that all of that hard work of attacking the worst-performing business isn't undone by writing some poor quality and new business. And so, we have to assume and trust the syndicates to take the writer action equally.

We have a lot of oversight and monitoring of that, we have very, very specific KPIs for each class of business at each syndicate and some callouts, where we can see if certain traditionally challenged portfolios look like they're growing too quickly. But the market is very, very well aware that they don't want to undo all of the hard work and I'd say I think we have seen increasing underwriting discipline around to say, let's not watch – and when we're talking about rates, we've been talking about on that renewal business that rates have been I think trending upwards, which is generally a good thing where there's underpricing, let's not make sure it's undone by poor quality new business.

So I'm confident the syndicates are doing that and I'm confident we've got the oversight to look out for it.

A - John D. Neal {BIO 15681439 <GO>}

And there's a question (00:52:07). Can you comment on the importance of Lloyd's rating and maintaining at its current level?

Yeah. So, there's no doubt the financial strength rating is important to the customers to give them confidence that all valid claims will be paid. We've taken steps to address I think the two critical areas from the rating agents, which was the sustainability of our underwriting performance through the performance management actions that have been taking place.

And secondly, on the quantity and quality of capital, so particularly that removal of having assets on our balance sheet that were ineligible for Solvency. So, letters of credit access under the Solvency II tiering. By removing that, and showing demonstrable improvement in underwriting and confidence in our plans, that's where we were looking. We talked to the rating agency about during this year as they come up to their annual committees.

A - John Parry {BIO 18896198 <GO>}

I think two things to add to that. I think John spoke about that quite eloquently. When we looked at the balance sheet, despite two very challenging years in 2017 and 2018, you can see no evidence of the balance sheet being rated to improve the P&L, number one. And number two, the quality of the balance sheet has actually improved over that period of time. So, I think whether it's the rating agency or the policyholders, they should have increased confidence in all that underpins the policy underwritten with Lloyd's.

Q - John D. Neal {BIO 15681439 <GO>}

Yeah. (00:53:33). About the flexibility of capital access in the market, I'm thinking I heard a comment this morning that you are thinking about moving away from the one coming into line date. Can you give some more thoughts on that? I would like you to (00:53:48) comment more on your prospectus later in the year. And I've got second question as well. We talked a lot about underwriting. On the investment side of the balance sheet, to what extent are you able to keep an eye on what the syndicates are doing in terms of how they're investing their assets, is there a temptation that bearing in mind the returns it might go further down the risk curve and do you have control over that?

Sure. I'll answer the first question.

Yes.

I'll ask John Parry to answer the second. I think on the first, all of these really pretty clear, everything's up for review and we mean everything. So, I think if we're prepared to imagine what the future could look like then we should be prepared to discuss every item and aspect of what we do today and that includes one day around coming into line of funds. So, we are absolutely looking at that.

A - John Parry {BIO 18896198 <GO>}

And I would say on top of that it is a pretty flexible model. And that when losses are incurred, we do talk to the market about recapitalizing outside of any fixed date, because it is a partial mutual and we are looking to protect the Central Fund when there is a capital erosion or a change in risk profile.

In terms of investments, so I think we saw earlier on the slide, about 13% of the market's investments were in equity and risk assets. They had increased slightly during the last few years. So, that's largely been a very strong equities performance that we saw in 2016 and 2017, rather than the change in strategy.

The Central Fund can take a longer-term horizon and that has about 40% of assets and risk assets across a mix of portfolios. I think the market could move a long way before investment risk becomes anywhere near the challenge of insurance risk. This is a marketplace where our capital is poor reserves catastrophe and poor attritional loss experience. Investment risk is modest compared to those three key (00:55:39).

A - John D. Neal {BIO 15681439 <GO>}

Thank you. Okay. I think that's the questions. So, thank you very much, everyone, both in the room and on the lines for joining us this morning.

A - John Parry {BIO 18896198 <GO>}

Thank you.