S1 2017 Earnings Call

Company Participants

- Inga Beale, Chief Executive Officer
- John Parry, Chief Financial Officer
- Jon Hancock, Performance Management Director
- Unidentified Speaker

Presentation

Unidentified Speaker

Good afternoon. Thank you for joining this webcast on Lloyd's 2017 Interim Financial Results. We are joined today by Inga Beale, Lloyd's Chief Executive Officer; John Parry, Chief Financial Officer; and Jon Hancock, Performance Management Director.

Inga Beale will begin the presentation by taking you through Lloyd's strategic and financial highlights. John Parry will then take you through the components of the results in more depth. And Inga will conclude by providing insight into Lloyd's plans and focus for the remainder of 2017. And Jon Hancock will be on hand during the Q&A session.

You are invited to ask questions at any point throughout the presentation using the submit a question icon available on the toolbar. We ask that you provide your name and organization, along with your question, and these will be answered by John, Inga, and Jon at the end of the presentation.

Please note, this presentation is being recorded and will be made available on our website for audio playback.

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

Inga Beale

Thank you and hello, everyone. Thank you for joining us today. First of all, I thought I would just kick off, before we get into the results, on a progress update on what we've decided to focus on for 2017.

We did announce this at the beginning of the year that these would be our five key strategic priorities. Without a doubt, market conditions has to be helped there. We all know what the competitive environment is for insurance at the moment, and this is really on a global basis. And we're also aware that there are -- not all our lines within the Lloyd's market are profitable. So, we've really had a focus within the performance management team of looking at maintaining underwriting discipline.

We want to balance that protection of the market with growth. So, the team have been really focused on discussing the syndicates, what profitable lines there are that can actually -- we can encourage to grow, but also take a look at those underperforming lines of business. And this is before we get into talk of some of the loss activity that we've just been experiencing.

Then moving on to Brexit, we've made significant progress on our project. It's all running to time. We are in the process of submitting our formal application to the Belgian regulator. The plan is that by the middle of next year, so the middle of 2018, we will have a locally-capitalized subsidiary in Brussels, and it'll be therefore up and running prior to any exit from the EU.

We want that to give reassurance and confidence to the syndicates, managing agents, customers, policyholders, cover holders, brokers who want to get them the confidence that there is a solution for an ongoing -- on an ongoing basis for the Lloyd's market to continue to provide the same type of coverage that it's been able to do up until now.

Moving on to Solvency II & Capital, you'll see when we go through the numbers the strong position, strong capital position that Lloyd's is in. But you'll also be aware that we're in the Solvency II regime and that a big piece of work this year has been around looking at our internal model. And as one would expect with models, they've always got to be continuously looked at, checked, tweaked, enhanced, so we have submitted a major model change application to the PRA and that's with them at the moment for their assessment. And we hope to have heard from them by the end of the year.

We also had a successful Tier 2 subordinated bond issuance at the beginning of this year, and as I said, we'll go through the capital numbers later when I hand over to John Parry.

On the London Market Target Operating Model, it feels to me as though we've got a lot of momentum around this. There are several key work streams under this initiative. We have the electronic placing piece, that's PPL, for those of you in the know, run by a PPL team as part of the TOM program, and we are about to be launching next month a release of that tool. This will be a significant enhancement of the previous system.

It will also include the ability to place facilities through that system, and we will also be migrating some of the old electronic placing platforms onto it. So, it will provide a much more seamless and modern system for underwriters and brokers to utilize, and therefore, we will be planning to roll out some of the other insurance lines on it when it starts up and live.

We've also been doing work behind the scenes, in terms of the automated premium and claims processing with the central services refresh. We got another module that will be rolled out later this year, but that's all coming through and on plan and, importantly, within budget.

There are other key initiatives such as looking at structured data capture. So once we've got some electronic submission -- it doesn't really matter what form the contacts being submitted in, it can be in some PDFs and Word format -- we've got now technology rolled out, and several market players have already adopted it, to then read all of that and put it into some structured data format that can be then fed into people's operating systems. So great step forward in that modernization of the market.

Then looking internally, we committed last year that we would be looking at the corporation operating model, and we want to ensure it's efficiently set-up, our processes are streamlined. We have gone through a big organizational redesign that is going to be effective from 1 October.

We will be letting some of the employees go. The consultation period has now been completed and people have been informed of their new roles going forward. And the implementation will start to take effect in the fourth quarter and then continue throughout 2018. So, again, good progress on that initiative.

Moving on to the next slide, slide four, this captures on one page the key financial highlights for the year. Now, of course, everyone is aware that it's a real year of two very different halves. First half-year very benign loss activity.

Second half of the year a series of events that have been occurring. Lots of wind storm activity throughout the Caribbean and the US, but we also shouldn't forget that we've got Mexican earthquakes going on or have taken place. We've got flooding in Asia. We've had some typhoons in Asia. So, there's actually been quite a lot going on in the second half, so it's going to be a very different situation for the next six months.

But focus just for a moment on the first half-year, you'll see a strong profit there, a solid profit, GBP1.2 billion. Down a bit on 2016, but once you've stripped out the FX impact, you'll see that's accounting for a lot of the impact and that actually it would be equivalent to the same period last year stripping out the FX impact.

So, I won't go into any more detail on any of those numbers because I'll be handing over to John Parry, who will take us through all these financials. Thank you. Over to you, John.

John Parry {BIO 18896198 <GO>}

Thank you, Inga. Good afternoon, everyone. So, looking at the movement first between the six months to June '16 result of GBP1.5 billion to the GBP1.2 billion reported for the half year to June '17, the first thing to point out is the exchange gain that came through in the 2016 results following the EU referendum result.

Lloyd's holds assets in the currency in which it writes business and we have a small surplus of US dollar assets over liabilities with the fall in sterling towards the end of June 2016. Overall, that gave us a significant exchange gain. That's not prevalent in the results in 2017. That's the biggest single movement year on year. On the underwriting result, there's an improvement in the combined ratio and the total underwriting profit of GBP160 million.

On investment return, another solid and reasonable performance, returning 1.5% on the total assets held within the Lloyd's market (inaudible) just the GBP52 million year on year. And that gives us the overall profit of GBP1.2 billion, again a significant proportion derived from investment return and a moderate underwriting profit.

So, looking at the slightly fuller income statement, you've got the last two full-year results and the half year '16 and '17. On gross written premiums, the Lloyd's market reported growth in premiums to just under GBP19 billion for the first half of 2017. Approximately two-thirds of that increase is from foreign exchange, as we translate the business written in overseas currency, particularly US dollars, back into sterling. The next slide will show you that breakdown.

You see the increase in claims. That's largely also following the foreign exchange translation and also operating expenses. But, overall, a small improvement in the underwriting result as at June, but obviously it's still a sign of the intense price and trading competition given an underwriting result of GBP366 million on that GBP19 billion of premium.

Net investment income remaining over GBP1 billion. The other line of other expenses, that is the net costs of the corporation, small increase year on year as we continue to invest in strategic initiatives, particularly the modernization of the London market under the Target Operating Model, but it also reflects that we have paid interest on an extra debt issue in that when we issued the debt in January 2017, that enabled us to refinance and redeem at the 10-year data in June the Tier 1 debt. So, you have actually got debt costs for both issues in the first half, which you wouldn't see in the second half.

So, premium growth. Looking at the various steps, first thing on pricing. So this is the -- on a risk-adjusted basis, on renewal business, a movement in pricing across the whole account of a fall of 2%. That is actually less than anticipated by the market when setting their business plan expectations that we reviewed looking into 2017. So the rate of price reduction has been falling or slowing.

Then you have the biggest single movement, which is from foreign exchange. Remember, we are translating business at the average rate during the period, and in 2016, up until the referendum, sterling was slightly stronger at an average rate of $1.43 to the pound, whereas in 2017 that's an average rate of $1.26. So, approximately two-thirds of the increase in converting sterling from foreign exchange.

In terms of underlying growth, you've got a 1% attributable to new syndicates, those that joined the Lloyd's platform in 2015 to 2017, and the 6% increase from more mature or existing syndicates. That growth is weighted towards the better performing syndicates. It is also on those lines which have relatively more margin, particularly US binder business operating through delegated authority, both on property lines and professional casualty lines, and also includes new products as we develop our cyber offering to continue to offer the products that clients require insurance for. That gives us a total premium volume GBP18.9 billion.

Looking at the combined ratio, the first tower is the accident year performance, excluding major claims and performance on back years. That's a total of 96.6% with a loss ratio, excluding major claims, of 57.4%. Acquisition costs at 26.3% and admin expenses at 12.9%.

That's slightly down on the same period last year and we are aware that there are significant cost control initiatives in place for all managing agents as it is for the corporation. But we've also seen some impact from foreign exchange there, in that a significant part of our cost base is in sterling, and that's being compared about an increased premium base where a lot of that exposure is written in US dollars. And that must account for some of that reduction in the admin expenses.

But a total of 96.6% does show that there is no reason to relent on the underwriting discipline approach, and the market oversight from Lloyd's are looking at all aspects of the combined ratio.

The second bar is major claims. You see that contributed just 1.9% to the combined ratio in the first half of 2017. There were very limited major loss activity in the period up to June. In fact, no claim larger than GBP70 million which is from Cyclone Debbie in Australasia. Same period last year of major claims did include the fires in Alberta, Canada, so there was a reduction year on year in major claims.

Then you look at the performance on prior years and the reserve setup for future claims. We have seen very significant surfaces generated by the Lloyd's market in recent years. That has been based on actual experience coming in much better than projections. What we have seen in the first half of 2017 is that that experience hasn't been as good and we are down to a more -- much more modest level of release of 1.6%.

We have long flagged this and we do not anticipate that those higher levels of release that we saw in 2016 and the previous four or five years would be sustainable. We are confident in the Lloyd's markets reserving practices and the adequacy of reserves, but around -- to get to that level of release that we saw in previous years, you do need actual experience to be significantly better than expected. And that wasn't the case in first half of 2017, so a much more modest release: total combined ratio 96.9%.

The next slide, as with a few others, we try to put in some longer-term chart of performance and that we really see just the impact of major claims year on year and of prior-year reserve releases. And certainly on prior-year reserve releases, you can see the very strong performance 2012 to 2016. Remember, 2017's results are being compared against a very good performance in the past.

For major claims, you can see that Lloyd's does have an exposure to major claims. Back in 2012 it added 10 points to the combined ratio; 2016, 9 points. It is the one 1.9% that is remarkably low and I'm sure all this -- of course, that is based on the performance to June.

Looking at our results by line of business, these are pretty high-level groupings. For example, reinsurance covers a whole series of property and casualty lines of business, GBP3.9 billion of premium, and in the second bar, which is the accident year, benefiting from the lack of cat activity in the first half.

They are ordered by size of premium, but towards the right-hand side you will see motor and it does also affect casualty for excess of loss motor, where we are still being impacted by the announcement of the change in the Ogden rate for UK liability claims, which is added to reserve strengthening on the back years. Clearly, we are aware that there's been a recent announcement that that Ogden rate is subject to change, and as and when legislation is put through, we may see an improvement in the second half of 2017.

Generally though, across all of the book that Lloyd's writes, we see pressure on pricing and on overall market conditions in coverage, and that is why we remain absolutely focused on underwriting discipline.

This again is a slide showing a longer-term performance of the accident year ratio, showing that for the first half of '17 it did fall back below 100%. We are aware, though, that the biggest reason for that reduction is that small band in the middle with four major claims of adding just 1.9 points to the combined ratio for the first half of 2017.

Then looking at how our combined ratio compares against competitors. We have adjusted the competitive group for 2017 and adjusted all prior years to make sure that it does continue to best -- actually match up against the type of business that Lloyd's writes. So, in aggregate, a reinsurance and insurance marketplace.

We do actually look at it in the round and have also check this with the rating agents as these are the competitors that they would consider Lloyd's is a peer of. As you can see in the first half of 2017, Lloyd's combined ratio of 96.9% exceeds that of the average of competitors by 1.6%.

We think the single biggest differential between us and the competition is the expense base. So with approximately 40% of net premiums being taken up by acquisition and admin expenses that cost differential is proving a very difficult hurdle to get over on risk selection, despite our better loss performance. That is again why, on the strategic priorities, the Target Operating Model and operational efficiency remains a priority.

So turning from underwriting to investment return. In the first half of 2017, we reported an investment return of GBP1 billion, or 1.5%, across all assets held at Lloyd's. They are held in syndicates trust funds as premiums received ready to pay future claims, the capital put up by members in funds at Lloyd's, and in the central fund. Overall, it is a conservative asset disposition with just 13% held in equity and risk assets.

You will see there has been a modest increase from 12% to 13%, but I see most of that is from the strong performance on risk assets in the last year. So, that's an increase in reported values.

The central fund's return of 2.6% reflects the longer-term horizon that the central fund is able to take, given its exposure is after syndicate assets and funds at Lloyd's.

So on capital, it remains a very strong balance sheet, highly liquid with over GBP65 billion cash and investments and over GBP100 billion in total assets. Net resources remain stable at GBP28 billion. A small increase in central assets up to GBP2.9 billion, and that's with that refinancing of our subordinated debt in the first half of 2017.

That's enabled us to report our solvency coverage ratios in excess of our risk appetite. So, on the central fund, we have a risk appetite to cover our SCR twice over, so 200%, and we stand at 211%, and on a market-wide basis, a target risk capital at 125% and, again, a stable ratio of 147%. Just to emphasize, there have been no central fund hits in 2017.

I'll close with the another longer term look at Lloyd's performance, where the return on capital in the first half of 2017 on an annualized basis was 8.9% with a 10-year average over 10%. That shows the attractiveness of the Lloyd's market to participants and is also one of the reasons we think why capital is in excess in the insurance industry. And obviously, that's leading to some of the pricing and competitive pressures to the market, but at very attractive return on capital to date.

So, with that, I'll hand back to Inga to summarize.

Inga Beale

Thank you. Thank you, John. So, in summary, we believe it's a solid set of results, but obviously, we do face a difficult second half of the year. It's not going to be the same. We've got a series of events. We've got another three months to go. Anything can happen, right up until the last day of the year. So, very second -- very different second half of the year to the first.

The focus on underwriting discipline will continue. We have the loss activity, but the underlying work that we're doing about addressing unprofitable lines of business that will continue. We are not going to change our focus on that, that must continue throughout all of this.

But, clearly, a lot of our focus and a lot of our time and attention right now is supporting all of our policyholders who have been affected by these tragedies. We've already paid out claims already, Florida and Texas, and we are committed to fulfilling our promise and what Lloyd's has always delivered over the years in being very, very prompt, particularly when disaster strikes.

We will also continue to look at developing new products. So, cyber often gets the headlines, and certainly for Lloyd's this has been one of our fastest growing product lines. We estimate we got at least a 25% global market share, with syndicates planning to write about $1 billion -- sorry, GBP1 billion -- no, sorry, $1 billion of premium this year.

And the London Market Target Operating Model will still continue. We've got great buy-in from the market. Several of the work streams are led by CEOs in the market. We've got great momentum going and increasing adoption, so that work will also continue.

So with that, I will cease the formal part of the presentation and open it up to some questions. Thank you.

Questions And Answers

A - Unidentified Speaker

Thank you, Inga. Thank you, John. Rebecca Clemens [ph] from Lloyd's Communications Team, is now going to read out the questions that have been submitted online.

Good afternoon. The first question -- we have four actually -- from Rotger Franz, Director of Credit Research Insurance at Societe Generale.

The first is, can you please give some indication of what to expect from Hurricane Maria? Are losses for Lloyd's likely to be similar to Harvey and Irma? And related, do you see a risk that the three hurricanes and other events year-to-date could bring the MWSCR ratio close to the 125% appetite level? Please, explain how the MWSCR ratio will be restored, in this case, and how quickly this will be executed.

The third question is, do you have any indications or do you expect any syndicate to tap the central fund following the recent events? If yes, please give details. And in the interim report, you mentioned the reserve strengthening in property and motor business. Can you give some more details and quantify the deficiencies [ph]?

A - Inga Beale

Okay. So, thank you for those questions. I'll let John Parry answer the ones about capital and reserve strengthening. But, first of all, I'll turn to Jon Hancock -- welcome, Jon -- just to talk about Maria. Thank you.

A - Jon Hancock {BIO 18712327 <GO>}

Okay. Thank you. Well, obviously we've announced some numbers earlier for Harvey and Irma. As regards Maria, like the rest of the industry actually, we're saying it's just too early to make a call on what those losses will be. There is very, very few estimates around the market from any of the modeling firms or any of the brokers or the carriers.

What we are doing, of course, is assessing it and talking to the market and understanding what exposures we have got, but until the situation becomes clearer over the next days and weeks, it's just simply too early to put a sensible number on potential losses.

A - John Parry {BIO 18896198 <GO>}

Thank you. So, your question I think was about the market-wide SCR. Clearly, yes, a net claims for Irma and Harvey of up to $4.5 billion will impact that. We have to remember that the Lloyd's market has profits that we have to the end of June, this GBP1.2 billion in the system, so one of the actions we have taken is to suspend release of profits to the market, pending assessment of the claims estimates for Irma and Harvey.

The Lloyd's market in terms of recapitalization has a well-established and good method for doing so. We have a full distribution model, so when capital and profits are held in excess of requirements we have a 100% release. And equally, when there are claims that reduce capital below that level, we are for recapitalization.

We've got a very strong central fund at over GBP3 billion. That does give the market time to recapitalize. In view of this, though, we will be looking to two members to come back into line before trading in 2018 based on the storm losses.

In terms of specifics [ph], you ask about the central fund. There is no impact on the central fund from these storms. Obviously, we are still in the very preliminary stages of loss assessment. It's still very early to be able to give out reliable estimates. We have given the information out based on what we are aware of at the moment.

For Lloyd's, the exposure is spread across a number of syndicates and we hold significant capital for US windstorm. It is our single-largest natural catastrophe peril and the single largest event for which we hold capital. So actually, this loss has been matched up well against the capital that we hold. At the moment there is no threats to the central fund or to that market-wide SCR.

Just changing slightly, you asked about property and motor. For property, when we drilled into it, you ended up at quite specific syndicate issues for small tens of millions, rather than being anything systemic across the market and, overall, it is a pretty small amount of deterioration in aggregate. But nothing systemic that we saw.

And for motor, it's quite a small premium base and, again, it's being exposed from that movement in Ogden, where some syndicates have booked that in the first half of 2017, having closed their books for '16 prior to the announcement of the rate change.

A - Unidentified Speaker

Thank you. The next question is from Marcus Rivaldi, Executive Director at Twelve Capital. There are three questions. Do you think the combination of events seen in second half are equivalent to a market-turning event? The second is, would you agree with the Hurricane Maria loss estimate range announced by AIR? The third is, do you expect the Mexico earthquakes be material events for Lloyd's?

A - Inga Beale

Okay. Thank you, Marcus. Let me just answer that market-turning event question before I hand over to Jon Hancock on Maria and Mexico. We did quite a considerable amount of work towards the end of last year across the market. Brokers were involved, Lloyd's syndicates were involved, company market participants were involved in looking at what a market-turning event could be and what the implications of that could be. This was released in a report earlier this year.

The culmination of that research said that actually very, very unlikely these days, with the amount of capital that is there, that one single event could be market turning. It said there have to be at least two, maybe a series of events, and they said that these should total $200 billion. So when we look at the modeled output from some of the events now, we -- they don't total $200 billion, so we are basing our views at the moment on that. So, that's our assumption. So, no concern at the moment that we've got this market-turning event situation.

So, over to you, Jon.

A - Jon Hancock {BIO 18712327 <GO>}

So, two specific questions there. One on the number, the ranges that were released by AIR two days ago. I think one thing we should remember is there are very few loss estimates in the public domain at the moment. The number that was published by AIR was obviously considerably higher than the number they were previously talking about, which was more in the $15 billion to $25 billion range. So, that number was a surprise to us and many.

So what we're doing, we attempt to ascertain the drivers behind that number and we're still working through that. We are also waiting and talking with the other modeling firms to see what different views or similar views they come out with. And, in the meantime, obviously doing a lot of work internally across the Lloyd's market to understand exactly what our exposures are.

Obviously, we already tracked the exposures. We've got good data to understand what exposure we've got where, and waiting at the moment to translate that into some accurate loss estimates. So, we're taking it seriously. We're very watchful of it. We're also waiting to see some other industry loss estimates as well.

And on the second question on the Mexico earthquakes, yes, of course, Lloyd's does have some exposure there. And as Inga said on the other catastrophes around the world, our focus is absolutely on handling claims and getting people and businesses back up and running. That -- those two events will be significantly smaller to Lloyd's and to the market than the storms.

A - Unidentified Speaker

Okay. The next question is from Joanna Parson, Director at Stockdale. And the question has disappeared. So, we will move to Barrie Cornes, an insurance analyst at Panmure Gordon.

And he said, you've indicated -- something's not right. We will go back to Joanna. I'm not sure what's happening here. No, we're back with Barrie. You have indicated that you don't think the Q3 cat losses are market moving. How much surplus capital do you feel needs to be withdrawn before rates across the board will finally start to go up?

A - Inga Beale

Okay. Well, I'll just go back to the research that was done as a market-turning event. So, a series of losses giving rise to events totaling $200 billion. That would be the estimate. And that's why we're taking the view we are at the moment.

However, let's bear in mind, pricing for reinsurance is based fundamentally on three things. You're looking at the past experience, you're looking at the current exposures you're taking on, and you're looking at future exposures and future likely-to-claims. So, therefore, anything that's been affected by a claim in the normal throws of pricing and renewal, underwriting, and all of that, you're taking into account experience. So, we shouldn't come across as being naive about pricing. I mean these things has to be taken into consideration.

What I would say, though, is the global insurance market is really far-reaching now. And I was just out in China, it's got a thriving, growing insurance market there. Lloyd's now writes nearly GBP0.25 billion of premium in the Chinese market out of our Chinese company.

So, the world is very different with many, many regions of the world growing and with many regions having big, big domestic markets. And, therefore, I think the whole dynamics of the global insurance arena has changed a lot over the years. And as I said, we've got an abundance of capital out there at the moment. Hence, we based our comments on the research and that's feeling that you know the old way of thinking about cycles and insurance, I think are behind us to a certain extent.

A - Unidentified Speaker

Thank you. And the final question we have is back to Joanna Parson, Director at Stockdale, which is what is the overall Lloyd's catastrophic budget for a normal year?

A - Inga Beale

I think this might mean what do we have or what the syndicates hold in their reserves for what might come up, so the amount that you put out for catastrophe losses, and of course, each quarter this has -- an element of it has to be earned. So, I guess that's what you're talking about, because, of course, what we do have as we run all our RDSs, our realistic disaster scenarios, and we have peak exposures. We also have the syndicates modeling their exposures on an annual basis. Quite sophisticated modeling goes on, and we're not necessarily adding up all of those and then capitals held to that level.

But, I'll hand over to John also for a view. John Parry.

A - John Parry {BIO 18896198 <GO>}

Thank you. Thanks, Inga. Thanks, Jon. There is never is an average cat year, is there? If you look at -- I think on our modeling we would say that every other year, you would have at least $2.5 billion to $3 billion of net claims for catastrophe for our book. And on average, over the long period, it's been approximately 10% added to the combined ratio. I think last year it was 9%, which was the closest thing we've had to an average year.

So, $4.5 billion is not so extreme that we haven't seen it before. For example, in 2011. We incurred nearly $8 billion of catastrophe claims in today's money. If you go back further to 2005, Katrina, Rita, and Wilma, well over $7 billion. So the Lloyd's does -- Lloyd's does hold very significant capital for these events.

It looks certainly, even with three months ago, it may be an above-average year with $4.5 billion for Harvey and Irma, but certainly nowhere near the levels we do test for on the RDS regime, as Inga said.

A - Unidentified Speaker

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