FINANCIAL TIMES

October 16, 2008 5:30 pm

Lloyd's and the parallels with the banking crisis

By Michael Wade

During the 1980s the capacity of the Lloyd's insurance market grew, together with ever increasing numbers of members of Lloyd's; yet the world insurance and reinsurance industry did not indicate the same measure of growth. The assumption being made was that Lloyd's was just that bit more entrepreneurial, just a bit more clever, than its rivals and that was why it could outpace industry growth patterns.

Subsequently we discovered that there was a fundamental flaw; in reality, there was not enough business to underwrite. Due to the surplus of capital, it became necessary to invent "new ways" of trading. Specialist syndicates developed that reinsured other syndicates. So long as there were no underlying losses, these new syndicates showed good profits. More capital became attracted to them. The market "grew" yet further.

But the reality was that the market was not actually growing; it was simply inventing ways of recycling the excess of capital. When underlying losses did develop they became funnelled into the new reinsurance syndicates – and we had what became known as the LMX spiral (London market excess of loss spiral).

There were many cries of "foul" and some were justified; but the basic flaw was that the council of Lloyd's – as regulator – did not see it as being its role to restrict capacity. This was for the free market to determine.

The consequence was that the underlying risks could be underpriced as they were being passed on to the new specialist reinsurance syndicates; they, in turn, could not measure the correct pricing as they appeared to be hugely profitable.

So, when the underlying losses did occur, there came a virtual systemic collapse of the Lloyd's market not just because the losses went around in an impossibly complicated spiral but also due to the fact that many members of Lloyd's were members of other reinsurance syndicates and the losses came back to them in another cycle of contracts.

Those who thought they had been prudent turned out to be caught in the spiral; and even if they were not, they would be caught in a systemic collapse as Lloyd's was a

mutual society with an ultimate shared chain of security and, then, with personal unlimited liability.

The bottom line was that it became so serious that no one could escape the losses or the failure.

There was only one solution; make sure that the society continued to pay all valid losses to policyholders and ensure that the market was able to continue to trade through the problem.

An essential ingredient of that strategy was to bundle all past years into a vehicle – which became known as Equitas – and discount the liabilities allowing for time. In this way, the vast capital deficit could be set aside and run for the long term whilst the current trading programme could continue with additional capital raised to support it.

And so it came to pass that the market traded out of its difficulties, new disciplines and transparency were introduced to ensure that capacity matched needs not supply, and the Equitas vehicle was later sold to one of the richest organisations in the world.

There are blindingly clear parallels between 2000-2008 in the financial markets and Lloyd's 1985-1995. And so there are lessons to be learned not just in the cause, but more importantly the solution we must now address.

The cause of our current financial solution has been an unnecessary oversupply of capital and lack of transparency. The oversupply has been generated by the "new ways" of creating instruments of debt – notably collateralised debt obligations. It was unnecessary because the capacity was not actually needed and was clearly growing at a pace well beyond the growth of the real economy – but these instruments were not transparent which is why no one could calculate where capital was being employed.

The principal failure has been the utter misuse of shareholders' capital with virtually fraudulent employment incentives to create false short-term returns that were not actually profits if correct accounting standards had been applied.

Governments, regulators and the accounting profession – not to mention the rating agencies – have failed society.

However, what matters at this particular moment is how to get out of this mess and move forward. Let us learn from the Lloyd's parallel.

Perhaps the issue of systemic collapse has been addressed; the debt spiral together with investment bankers and the hedge fund managers are being cut out of the

system. Ordinary shareholders – and people's pension funds – have lost out substantially. And they will be rightly angry once the systemic risk has passed, giving way to the "what next" series of issues.

So, to the point of this note and the lesson of the Lloyd's market; in the UK we will need to create our own national "Equitas" into which we can separate the long-term assets and liabilities that the taxpayer has now been forced to accept. First, we will need to discount liabilities and project assets in order to make the books balance, which should be managed independently, and as a co-ordinated enterprise with a view to ultimate sale. Second, by separating these longer-term issues, we can return to the shorter-term balance sheet of our country and not allow the key services of health, education and security to suffer.

The writer was a member of the council of Lloyd's and of the McKinsey & Co taskforce commissioned to address the issues facing Lloyd's in the 1990s. He is currently a treasurer of the Conservative party and was a member of the party's economic competitiveness policy group

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