How to become a Lloyd's Name

Buying into the world's leading specialist insurance market is a risky business – and you need a big initial investment. But the rewards can be highly lucrative. David Stevenson reports.

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Lloyd's insures against disaster in shipping and many other areas

Got a spare £600,000? You might want to consider investing in Lloyd's. Not the troubled high-street bank – heaven forbid. We're talking about Lloyd's of London. So how does it work and why would you be interested?

Officially a society, rather than a company, Lloyd's is the world's leading specialist insurance market, the 'go to' cover provider for the most complex and extreme risks around. More than 90% of Dow Jones Industrial Average companies and the same proportion of FTSE 100 firms buy cover at Lloyd's. The market also knows more than anyone else about what's happening in world shipping.

Set up in Edward Lloyd's coffee house in 1688 – predating the Bank of England by six years – the market now accounts for half of all international insurance premiums underwritten in London. The Lloyd's market is currently made up of 51 managing agents who run 87 insurance syndicates. These are funded by corporate groups such as investment firms and international insurers, and also by individual members, otherwise known as Names.

The basic principles are simple. Lloyd's brokers drum up business from clients, other brokers and intermediaries around the world. They bring this to the professional underwriters employed by the syndicates. These underwriters then decide what risks to take on and at what price (in other words, what premiums they'll charge). In return for this income, the Names stand toe to toe with the market's corporate capital backers in covering the liabilities agreed by their underwriters.

What does Lloyd's insure?

Becoming a Name can earn you good money. But make no mistake. As Neil Smith of managing agent Hampden Agencies emphasises, "this is definitely a 'risk' investment". What ratchets up the risk is Lloyd's particular specialisation – reinsurance – which accounts for a third of all business carried out in its market.

Reinsurance is used to protect against large claims. Insurers providing cover against a fire destroying a large oil refinery, for example, will want to cap their own potential exposure in the event of a full-scale disaster. So they'll reinsure part of the liabilities they've agreed to cover with other insurers, meaning they'll pass on some of the risk in return for a proportion of the premium. This helps insurers to balance out their underwriting results each year without too many peaks and troughs. They can also widen their international risk spread, vital when an insurer is heavily committed to a country that's vulnerable to natural disasters.

For Lloyd's, reinsurance can be very lucrative. But because of the types of cover provided, it can also be very risky. So it's not always been plain sailing for the market or its members. Historically, Names had unlimited liability to the risks they were underwriting. In the late 1980s/early 1990s, Lloyd's entered the most traumatic time in its history. Unexpectedly large legal awards in US courts on asbestos, pollution and health hazard policies (APH) served up huge losses to many Names, a large number of whom lost their shirts. Names' numbers dropped from over 30,000 to below 10,000.

Lloyd's went through the pain barrier to sort out the problem. In 1996, all pre-1993 liabilities were split out into Equitas, a 'run-off' fund that could only settle existing claims but not write any new business. Still-solvent existing members agreed to pony up £15bn to meet potential APH claims over the next 40 years. Then Warren Buffett's Berkshire Hathaway took over Equitas's liabilities in 2006. Despite widespread individual woes, Lloyd's proud boast is that it has never failed to pay a claim.

Should you become a Name?

Today, Lloyd's is a very different animal. "The Lloyd's market is now clean," says Smith, "there are no 'back year' liabilities." Control is much tighter due to a mix of self-regulation and external monitoring by the Financial Services Authority (FSA). Prior to writing any business, all syndicates must produce an underwriting plan for approval by the Lloyd's Franchise Directorate. Further, each syndicate will insure several different risk levels with a spread of claim likelihoods, and must put up capital based on the risk coding of the business written. Reserves against future claims are much higher these days – many syndicates often have reserves of between 300% and 400% of their liability book. But the real key is that limited liability has now been brought in to protect Names and ensure there's no repeat of the APH horrors.

So what are the pros and cons of becoming a Name now? Unless you can put up a minimum of £600,000 (£400,000 capital plus the £200,000 cost of buying into a syndicate), this isn't for you. And we're talking here about liquid assets, such as cash, shares, gilts, letters of credit or bank guarantees, all of which could be realised quickly if necessary. What's more, you have to keep your capital level topped up. If you were to drop, say, £150,000 in a bad year, you'd need to rustle up that amount on top of your original £400,000 investment. Then there's the cost of buying into a syndicate – your equity stake, if you like. At current prices, that's likely to cost you in the region of a further £200,000, although you could eventually make a profit on that.

The underwriting cycle

If you're not scared off by risking what, even these days, is a fairly chunky sum of money – and remember, you could theoretically lose every penny, although that's unlikely – becoming a Lloyd's Name could turn out to be a very worthwhile long-term investment. The market can be highly volatile, but there's a low correlation between Lloyd's returns and assets such as shares or property. That's because Lloyd's profits move in line not with the economy, but with underwriting cycles, which are driven by how much capital is in the market. When syndicates' profits rise, more capital flows in, premiums drop (a soft market) and underwriters make less money. So they cut back their business, rates tighten up (hard market) and profits rise again. Peak to trough, the cycle tends to last five to seven years.

There are several other benefits. Your capital remains yours. The £400,000 capital must be lodged with Lloyd's, which becomes trustee and has first charge over your assets. But you continue to receive all dividends and interest. So you get double use of your assets. Further, your capital is leveraged – as a Name you may underwrite up to 2.5 times your funds at Lloyd's. And because of Names' limited liability status, there may be other tax, pension and estate-planning advantages too, says Hampden Agencies, but clearly these depend on individual circumstances.

How much might you expect to make? As we have explained, there are no guarantees. Lloyd's operates a 36-month accounting system to allow for ongoing claims. This means that the results for any one year are only finalised 24 months after year-end, and enables the ultimate returns to be smoothed out. On top of the published returns, syndicates like to tuck a little away into reserves for a rainy day.

Bearing that in mind, below is a table of underwriting returns achieved by clients of Hampden Agencies since 2001, showing the actual returns on capital Names have made.

Year	Returns made by Name clients of Hampden as % funds at risk	Underwriting returns on £1m of capacity
2001	-31.10%	-£124,000
2002	34.30%	£137,000
2003	52.90%	£212,000
2004	26.20%	£105,000
2005	13.50%	£54,000
2006 (Est)	49.00%	£196,000
2007 (Est)	28.00%	£112,000

"Lloyd's leveraged returns could soon look very good"

In 2001 – the year of the terrorist attacks in New York and Washington – losses totalled £124,000. But after topping up their capital by that amount at year-end, Names were back in profit by end-2002 after premium rates surged. After that, returns have been consistently good, although remember that at Lloyd's, the adage that 'the immediate past is no guide to the future' is never more true. For now, 2008 looks likely to have been a flattish year, while prospects for 2009 look better. But anything could happen anywhere in the world tomorrow, and Lloyd's could have to pick up the tab.

How do you become a Name?

First, you need to find a managing agent for technical advice. The average sign-up time is six months, which enables Lloyd's to check your finances. Meanwhile, you set up a Limited Liability Vehicle (LLV), or buy into an existing one. Then you have to decide what level of risk and return you want to take on, after which you buy into a syndicate at a closed auction. The cost will vary, depending on the financial strength of the syndicate, its profitability, the quality of the underwriting team that it employs and, of course, how many other people want to get in, too. Your managing agent will advise you here, although just now you'd expect to pay about 20p per £1 of underwriting capacity, ie £200,000. Thus you become a Name. Then you need do nothing else, apart from pick up the profits – or, of course, pay up on your losses.

What happens if you want out? Once on board, Names tend to stay. But you can sell your LLV whenever you want, including your underwriting 'pipeline'. Again, the price will vary, depending on how many buyers there are for your stake. Just like any other investment, if you need to sell in a hurry, your chance of getting a good price could drop sharply. Also, in the early years, you might not recoup what you paid to get in. But if all goes well, after a few years your syndicate should have stashed away enough surpluses into its reserves – which would be factored into your exit price – to enable you to get out at a decent profit.

So should you take the plunge, if you can afford it? Always remember that Lloyd's is a risk investment. If you're feeling at all jittery about your future financial situation, don't do it. But with risk comes rewards. And compared with most other investment classes, Lloyd's 'leverage' could make these look very good over the next few years. If you're interested, the best place for more information is the Lloyd's website, www.lloyds.com.