

Now Is A Good Time To Look At Lloyd's As An Alternative Asset Class

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For private capital at Lloyd's, the credit crunch brings opportunities. Syndicates are finding it harder to obtain the capital needed to increase their capacity and write the extra business which the Lloyd's Market is attracting, and are increasingly turning to private capital which can be flexible and responsive.

The outstanding results produced by specialist insurance market Lloyd's of London in recent years, in spite of major claims, can hardly fail to draw attention. In 2003, clients of members' agent, Hampden Agencies Limited, made a 21.2 per cent profit on their Lloyd's underwriting. Even in the hurricane-filled 2005 the profit was 5.4 per cent, and 2006 and 2007 are expected to produce 19.6 per cent and 11.2 per cent respectively.

The returns on the assets supporting underwriting are even higher due to a gearing effect (see below): 52.9 per cent for 2003; 13.5 per cent for 2005; and 49 per cent and 28 per cent for 2006 and 2007. In the search for alternative investments to diversify their portfolios, investors are increasingly attracted to Lloyd's of London.

How Does Lloyd's Work?

Lloyd's is a society of members and a marketplace. Brokers arrange insurance and reinsurance policies for clients, which are underwritten by syndicates. The syndicates are capitalised by members, both individual and corporate, who purchase the right to participate by acquiring syndicate capacity in an annual auction process. Members usually support a number of syndicates, spreading their risk by underwriting different classes of business, and receive profits or accept losses proportionally. Syndicates trade on an annual basis but operate a three year system of accounting. Under normal circumstances, a year of account is closed after 36 months, at which point a profit or loss is determined. In exceptional circumstances, syndicates can remain open longer and their final result is only determined with their ultimate closure.

Lloyd's today is very different from the Lloyd's of old. All new members now join with limited liability, trading through limited liability vehicles. Structural changes in recent years include the Franchise Board, established in 2003, which oversees all aspects of underwriting, and the reinsurance through Equitas of all pre-1993 liabilities, meaning that Lloyd's effectively has no legacy issues from these years.

Who Joins Lloyd's, And Why?

New members are high net worth individuals, usually investing five or ten per cent of their wealth. They choose Lloyd's for the following simple but powerful reasons:

Potential for significant profits over the insurance cycle

In recent years the profit on underwriting has been as much as 20 per cent and even years with major claims, such as 2005, have produced profits. Research can identify trends and syndicate performance, to help select appropriate syndicate portfolios for the current stage in the insurance cycle.

Gearing effect on funds supporting underwriting

Members deposit Funds at Lloyd's to support their underwriting. These are usually (based on

current requirements) 40 per cent of the maximum amount that may be underwritten, known as the Premium Income Limit. This means that returns on FAL are geared by 2.5 times. Acceptable FAL could include cash, letters of credit, shares, and bank guarantees. If a member underwrites a PIL of £1 million, they would usually require £400,000 in FAL. The member's profit or loss could then be expressed as either a return on PIL or a return on FAL, reflecting the gearing effect.

Double use of assets

Because the member retains the beneficial interest in the funds (held by Lloyd's in trust) they benefit from any investment return on these assets. For example, commercial property could be used to support a bank guarantee lodged with Lloyd's, while the owner continued to receive rental income.

Low correlation with other asset classes

The insurance cycle has low correlation with other financial cycles, and even in tough times business cannot do without insurance. The low correlation of Lloyd's with other asset classes has been particularly noticeable in the recent financial turmoil, not least because, on the underwriting side, it has low exposure to financial institutions and, on the investment side, syndicates' funds are mostly in cash investments such as gilts, or corporate bonds. In addition, troubles at AIG may increase business placed at Lloyd's, while recent hurricanes are likely to have a positive effect on insurance rates.

Financial Planning Opportunities

Underwriting with a LLV - either a Limited Liability Partnership or a limited company, known as a Nameco - offers a number of tax and pension benefits. Profits from a LLP are treated as UK earnings and can be paid into a pension scheme with full relief for income tax, subject to annual and lifetime limits. Losses can be relieved against taxable income and gains from other sources. Profits from a Nameco are usually paid as dividends, after deduction of corporation tax.

The value of an investor's interest in a LLP or shares in a Nameco qualifies for 100 per cent Business Property Relief, provided this has been owned for at least the two years preceding the transfer of value on death, or by gift inter vivos. Relief also applies to FAL supporting a LLP or owned by a Nameco, provided that they are appropriate to the level of underwriting.

For non-resident investors the following exceptions apply: profits from LLPs are not liable to NICs and dividends from Namecos are not liable to UK higher rate tax; gains on foreign registered shares in FAL, where the investor retains beneficial ownership, are not liable to UK capital gains tax; and the value of such shares is not liable to UK inheritance tax on death or on gifts made inter vivos.

Membership Opportunities

New participants underwrite at Lloyd's by establishing a LLV for this purpose, or purchasing an existing one. This can be a LLP with at least two members or a Nameco, with one or more shareholders. Both have liability limited to the value of their assets. The LLV becomes a member of Lloyd's and FAL are deposited to support underwriting. The LLV then purchases the rights to participate on syndicates at the annual Lloyd's capacity auctions. The cost of acquiring capacity varies according to the portfolio chosen but, on average, £1 million of capacity for 2008 was available at approximately £220,000.

Members allocate their underwriting capacity to syndicates, usually across a variety of business classes. Some members have a bespoke portfolio; others use a members' agents' pooling arrangement, managed by their agent. Syndicate profits and losses are distributed to members on an individual basis according to the proportion of the syndicates' capacity which the member has provided.

Now is the time for investors considering Lloyd's to start making enquiries. The deadline for new applications is the end of August but applications should be submitted by the end of July to ensure that paperwork is completed in time for the September capacity auctions. This means that it is too late to join for the 2009 year of account which will start underwriting on the first of January, but the perfect time to consider joining for 2010.