The Ultimate Risky Business: How Lloyd's of London Insures Its Own Future

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As CEO of the venerable insurer Lloyd's of London, Richard Ward oversees $33 billion in premiums each year, underwriting such valuables as actress Ugly Betty's smile, soccer star David Beckham's knees and singer Celine Dion's vocal cords.

It's all part of the tradition at the 321-year-old Lloyd's, which is described as a British insurance market rather than an insurance company, because it serves as a meeting place for a variety of agents to pool and spread risk. Over its long history, Lloyd's has written policies covering everything from the legs of 1940s movie star Betty Grable to the potential paternity liabilities of 1980s rock star David Lee Roth to the tongue of Gennaro Pelliccia, chief taster for the U.K.'s Costa Coffee coffee chain. Not to mention the first commercial air flight, the first commercial space flight, and all manner of bridges, oil rigs, fleets, real estate holdings in climactically dangerous regions and corporate investments in politically unstable countries.

As Ward noted during a recent Wharton Leadership Lecture, "It's a very large and varied range of activities we get involved in. Basically, what we do is insure things other people can't or won't."

But for all the unusual policies written by Lloyd's 50 component franchises, Ward said, the key to success is a simple lesson that ought to be followed by individual investors, multinational banks and anyone else in business: Understand your risks. Lloyd's employs an army of researchers to study such data as the ages of the jets in the Sultan of Oman's private fleet and the threats that might have disrupted the 2008 Olympic Games in Beijing.

If this collection of brains can't understand something, Ward figures, that's reason enough to stay away from it. "When we don't like a risk, we don't write it." It's a lesson Lloyd's learned the hard way in the years before Ward took the helm at the world's most famous insurer three years ago. "In the past at Lloyd's, we used to write a lot of financial institution risk," Ward noted. "We provided a lot of cover to two great names, Enron and WorldCom. As a result of that, we paid out some really large claims."

But also as a result of that, Lloyd's made "a conscious decision to scale back our exposure to financial institutions because we were uncomfortable with that type of risk," Ward said. "We didn't really understand it that well. And if you don't understand it that well, don't do it. We scaled it right back to the extent that now, with the subprime problem, the [Bernie] Madoff problem, the [R. Allen] Stanford problem, we find very little exposure to those institutions, to those organizations and to those subprime claims. So, [regarding] all the problems arising out of the financial crisis, we will be able to [conduct] business as usual."

The 'Names'

The venerable insurer had weathered two major storms over the decade before Ward took the helm, including one in the mid-1990s, as claims for years of asbestos exposure in U.S. buildings began to come due. "We found ourselves having to pay out claims totaling over $15 billion," Ward said. "In the 1990s, $15 billion was an enormous sum of money."

The losses did in fact wipe out many of the wealthy individual members -- known as the "Names" -- who, under Lloyd's unusual structure, pledge all of their personal wealth to underwrite the policies of its syndicates. Some of the Names, in turn, accused the insurer of perpetrating a massive fraud by recruiting new members without revealing the huge claims that were looming. The ongoing proceedings, Ward said, represent the longest court case in British history.

Lloyd's eventually revamped its organizational structure, ending the recruitment of new "unlimited liability" Names and spinning off pre-1993 business, at great expense, into a new vehicle called Equitas. To pay for this, Lloyd's unloaded assets, including its landmark London building. "We sold absolutely everything except the silver," Ward said. "It's a very important lesson for us: As a result of being able to take those toxic liabilities and the good liability and create that new vehicle, we were able to trade forward."

Then, in 2001, the terrorist attacks on the United States and the subsequent calamities in the travel and transportation industries threatened Lloyd's again. As the largest insurer of the World Trade Center, Lloyd's was stuck with $11 billion out of the $40 billion in total claims. "One day after the World Trade Center, we had the same people sitting there saying, 'We're about to go bankrupt. We can't pay this $11 billion,'" Ward said. "It's quite extraordinary that so soon after the problems of the 1990s, we were faced with a similar problem."

The immediate issue was liquidity: American regulators worried that Lloyd's didn't have enough cash to stay in the market. After hectic meetings in Washington, the crisis was averted. But, said Ward, "that was truly the defining moment for us where the management of Lloyd's at the time said, 'Hold on, we are going to have to do things very, very differently going forward if we want to survive as a business.'"

One example of the style that would have to end: Although Lloyd's was insuring the World Trade Center, no actual policy had been written beyond the term sheet -- a problem that was common across the industry. "When you end up as a business leader and you're told by your chief risk officer that you've got a policy, ask to see the policy," Ward advised his audience.

Lloyd's eventually put in a new management structure that Ward calls "the McDonald's of Lloyd's." Like the fast-food chain, it's a franchise structure. "Ronald McDonald is able to put in standards across the whole of the McDonald's franchise and get everyone to do the same thing," Ward said. What's good for Big Macs and fries is good for risk standards, too. "Anybody who wants to write business inside the Lloyd's market does it according to the standards we set."

In the new world of Lloyd's, Ward noted, "if you're Company A and you're writing risks inside Lloyd's, we look at the risks that you're writing, and then we look at how your risks plus everyone else's risks add up together to what the aggregate exposure is [in order to make sure] that first, the capital you have is sufficient to support your business, and second, the capital the market has is sufficient to support the risks across the whole market."

In 2005, when losses from hurricanes Katrina, Rita and Wilma added up to $60 billion, Lloyd's share was $16 billion -- even higher than the $11 billion in claims it faced after 9/11. But whereas the 2001 attacks ultimately cost the Lloyd's market $5 billion in losses, the risks were now sufficiently diversified that the market's overall losses were just $160 million. Ward called the new discipline "life changing."

Modernizing an Exchange

With a Chemistry PhD -- his research involved some of the early work on liquid crystal display technology -- and a background in commodities trading, Ward was an unusual choice when he was tapped to lead Lloyd's in 2006. But research science, he said, was good training for business. "It's a discipline that encourages a rigorous intellectual approach. It's very demanding, you're continually having to fight for funds, you're involved in a lot of politics ... and you have to be a bit of a salesperson," especially when it comes to winning scholarly grants.

Early in his career, Ward held a range of positions at BP, including a stint as a derivatives trader in London -- a move he calls courageous on the part of the firm, which had taken a leap based on the hunch that a respected scientist with no trading background could add value to its operations. During his time there, swaps, options and the array of hedges that have become so well known in recent years were first emerging, giving Ward some early experience with the complicated ways that risk can be assessed and traded.

In 1999, Ward left BP to lead the International Petroleum Exchange, the London-based commodities exchange. Although the hedges being traded were modern, the exchange's operations at the time were anything but. It operated an old-fashioned trading pit -- a format, Ward said, that tended to benefit anyone who was six-foot, six inches or who had a high-pitched voice, but one whose "future was, I think, limited" in a wired era.

As CEO, Ward moved to institute electronic trading, which enabled rival exchanges to open themselves up to vast and distant new markets. But the idea was distinctly unnerving to the exchange's current traders -- many of them with burly physiques well-suited to work in the pit. "When you challenge someone's way of doing business and challenge the way they make money, it is extremely threatening," Ward said. He recalled being grabbed in a restroom by one especially tall trader claiming he was going "to knock my block off."

Eventually, however, Ward was able to find a group of traders at the exchange who recognized the upsides of the new idea. One piece of the sales pitch: Ward had noticed that many traders liked playing electronic poker during down times. He argued that, by trading virtually on screens rather than in person in the pit, they would be able to keep playing while they traded. "The key was to find those people, bring them together in a small group to convince them of the value of the change, and then use that cell as a virus to spread out in the trading community."

The pit closed in 2005, after a period in which Ward traveled with a "posse" of bodyguards recruited from Britain's Special Air Service. The reason he didn't give up on the idea was "I absolutely knew it was the right thing to do. I had the courage of my convictions to pursue a change agenda in the face of extraordinary hostility. And that's a very important business lesson."

Ward sees his role at Lloyd's as one that involves a similar need to adapt to new technology that challenges traditional ways of doing business. In an industry where salespeople and brokers have always played a major role, the Internet, with its democracy of information and ease of comparison-shopping, is a disruptive force. But Ward also said the fallout from the financial calamities of the past two years will change the outlook for all CEOs. The post-AIG, post-Lehman Brothers future, he predicted, will be a time of more regulation, more protectionism and greater government intervention, not to mention more taxes on businesses and falling public confidence in their leaders.

"It's extraordinary how quickly reputations can be damaged and how long it takes to rebuild them," Ward said. "At Lloyd's, it has taken us 10 years to rebuild our reputation that was lost overnight in the 1990s and lost overnight [again] in the World Trade Center. We used to be the watchword for disaster. If I were standing here five years ago -- well, I wouldn't be standing here. You wouldn't have invited me. You would have invited the CEO of Lloyd's Bank, instead."

Unrelated to the insurer, that particular bank, a high flyer not so long ago, was the recipient of a multibillion-dollar infusion from British taxpayers to keep it from collapsing this fall. Its toxic assets have been estimated at upwards of 250 billion pounds.

The lesson: "Expectations are changing in how we should behave as business leaders," Ward said. "No longer is it acceptable to just say you're doing it for the sake of profit. Stakeholders, employees, shareholders, customers are actually expecting a little bit more.... They're expecting business leaders to have integrity. They're certainly expecting me as a business leader to say, 'I'm doing this because I think it's right, not because everyone else is doing it.' There is a lot more personal responsibility."