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Chapter 1. Introduction

Rapid structural change resulting from the collapse of an economic system is a less common phenomenon in insurance than in the history of other financial institutions, such as banks and stock markets, where flows of capital and credit act as highly visible indicators of market confidence and volatility.[1] Catastrophic losses, of course, have periodically delivered shocks to the insurance industry. The San Francisco earthquake and fire of 1906, for instance, led to an influx of European reinsurance companies into the US and the exit of weaker American and foreign direct insurance companies.[2] In this and other similar cases, however, such catastrophes largely resulted in the rearrangement of players on the field, rather than a fundamental change in industry structures or practices.[3]

One exception to this general pattern was the late twentieth-century crisis that afflicted one of the world's oldest and most famous insurance institutions, Lloyd's of London. Hitherto, explanations of the crisis have focused on the frauds, catastrophic losses and issues of inadequate governance that plagued Lloyd's from the late 1970s to the early 1990s. Such accounts, notwithstanding their excellence, were written, mostly contemporaneously, either by journalists seeking to tell an exciting story of City scandals, or by Lloyd's insiders, some of whom had witnessed their investments being wiped out, and who sought to blame those who governed Lloyd's during this period.[4]

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1 An economic system may be defined for present purposes as the process of organising and allocating resources and inputs to produce outputs such as products or services.

2 Direct insurance is where an insurer sells insurance protection to a customer. Reinsurance is the device by which a direct insurer (re-)insures with another insurer part of a risk that he/she has first insured, i.e. it is the insurance of insurers.

3 On the insurance market before and after the San Francisco fire, see Pearson and Lönnborg , 'Naturkatastrofer'; Röder, *Rechtsbildung*; Trebilcock, *Phoenix Assurance*. On the longevity of modern underwriting practices in reinsurance, see Jarzabkowski et. al., *Making a Market*.

4 Hodgson, *Lloyd's of* London; Mantle, *For Whom the Bell Tolls*; Gunn, *Nightmare on Lime Street*; Raphael, *Ultimate Risk*; Luessenhop, *Risky Business*; Proctor, *For Whom the*

This book represents the first scholarly study of the crisis written from an historical perspective. In contrast to previous accounts, it argues that the above factors - fraud, external catastrophes and poor governance - while important, were not sufficient. Together, these may not have resulted in the near death of Lloyd's had many of the actors involved not also suffered from multiple delusions of competence. Arrogance, elitism, greed, corruption, and stubborn resistance to reform in defence of vested interests comprised endogenous elements of the crisis, which compounded the series of exogenous shocks to insurance operations. Politically entrenched ideas about the virtues of self-regulation, and an exaggerated faith in the ability of insider experts to know what was best, also played a role. The result was a belated misdiagnosis of what ailed Lloyd's, and a series of institutional reforms that, while targeting the visible symptoms of the disease, failed to cure its underlying causes.

The issue of competence, which may be defined as 'a sufficiency of qualification' or 'a capacity to deal adequately with a subject', relates directly to the question of trust in experts and their expertise.[5] Political debates currently swirl around this issue with ever fiercer velocity. Recent controversies have particularly focused on the influence of medical experts, epidemiologists and environmental scientists in shaping the policies of governments towards the Covid-19 pandemic and climate change.[6] The nature, quality and accuracy of, and trust in, experts and their decisions, however, have also been widely discussed in a wide range of other areas, including surgery, healthcare, veterinary medicine, the wine and food

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Bell Tolls; Duguid, *On the Brink*. The impact on direct insurers of the liability reinsurance crisis, and of Lloyd's financial distress, have been examined respectively by Berger et. al., "Reinsurance", and Fields et. al., , "Lloyd's Financial Distress". Neither discuss the situation at Lloyd's at any length.

[5] This rudimentary definition is from the *Oxford English Dictionary*, but it is broad enough to encompass the functional, cognitive and behavioural abilities that comprise a holistic and multi-dimensional definition of competence. Cf. Deist and Winterton, 'What is Competence'.

[6] For example: Battiston et.al., 'Reliance on Scientists'; O'Shea and Ueda, 'Experts' Advice'; Bylund and Packard, 'Separation of Power'; Webb, 'Enough of Experts?'.

industry, nuclear power, disaster recovery, education, art criticism, financial forecasting, construction, workplace safety, the energy industry, forestry, agriculture, transportation, public procurement, crime, forensic science, and expert testimony before courts of law.[7]

This large body of literature on professional and scientific expertise has been closely allied to the pioneering research conducted in behavioural economics and cognitive psychology over recent decades. This research has uncovered some of the fundamental behavioural responses that underpin notions of competence, and that influence decision making, especially under conditions of uncertainty and imperfect information. These findings, which can only be summarised here, can help us better understand why the crisis at Lloyd's took the disastrous course that it did.

It is now generally accepted that decision making in fast-moving environments is associated with, and facilitated by, intuition and a reliance on the heuristic or rule of thumb.[8] As experimental psychologists have shown, however, intuitive decision making also generates systematic biases and errors in predictions. In particular, people tend to judge a risk based on the ease with which instances of it come to mind. They also often ignore the effects of random variation in small samples, and wrongly apply the law of large numbers to them.[9] The success of intuitive decision making depends greatly on the predictability of the environment in which decisions are made.[10] Intuition, however, can lead decision-makers, when confronted with a difficult problem, to simplify the decision, rather than apply a more sophisticated decision rule based on fuller information.[11]

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7 Examples include: Clarke and Knights, 'Practice makes Perfect?'; Currie and Macleod, 'Diagnosing Expertise'; Lidén and Dror, 'Expert Reliability'; Garrett and Mitchell, 'Proficiency of Experts'.

8 Kahneman, *Thinking Fast and Slow*.

9 *Ibid*., 7, 112-113; Yuan, 'Lure of Illusory Luck'.

10 Kahneman, *Thinking Fast and Slow*, 201, 240.

11 *Ibid*., 237, 243; Hey et.al., 'Theories of Decision Making'.

Intuitive thinking has been shown to be closely related to perceptions of expertise. Visual cues, for example, such as facial expressions, body language and clothing, can quickly dominate people's judgments of competence and performance. Research has found that such judgments are highly correlated with the perceived attractiveness, dominance, maturity, masculinity and status of an individual, as well as with racial and gender stereotypes.[12] When it comes to judging one's own competence, individuals are prone to egocentric biases, such as overconfidence and the illusion of control.[13] In stable environments, 'where an individual expects to continue a large proportion of his current activities and relationships for a long time in the future', overconfidence can be costly when it leads to complacency and low levels of innovation.[14] Some scholars have called this the 'curse of expertise': namely the way that an individual's professional or market experience, and his/her self-perception of competence, can produce 'cognitive dissonance', in other words a reduced willingness and ability to pay heed to the perspectives of others and a failure to take into account information, for example about a risk event, that lies outside the bounds of his/her own knowledge.[15] In short, experts systematically demonstrate an inability to know the limits of their expertise, and people in general systematically fail to recognise their own incompetence. Overconfidence can lead individuals to suffer from an optimistic bias in their predictions and to persist in operating according to established beliefs. Associated with this are several other observed phenomena: 'tunnelling', namely the instinct to make inferences too quickly and to focus on a small number of known sources of uncertainty; convergent behaviour within a group and 'herding',

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[12] Tolsá-Caballero and Tsay, 'Blinded by our Sight'.

[13] Fellner et al, 'Illusion of Expertise'.

[14] Dessi and Zhao, 'Overconfidence'; Malmendier and Tate, 'CEO Overconfidence'. Not all scholars agree that overconfidence is costly. Berg and Lein, 'Investor Overconfidence', argue that overconfidence among uninformed securities traders about experts' predictive ability and the quality of their information can lead to increased trading, improved liquidity and lower transaction costs.

[15] Zhang et al., 'Errors of Experts'; Fisher and Keil, 'Curse of Expertise'; Kang and Sim, 'Fragility of Experts';

namely the desire to avoid being an outlier in one's predictions, which has been widely observed of professional economists and financial forecasters; and 'confirmation bias', whereby experts try to interpret evidence with the aim of corroborating the rules that they had already made up.[16] The following account of Lloyd's applies some of these behavioural insights. We also return to them in the concluding discussion.

A wide range of sources have been consulted for this book: parliamentary papers and debates; contemporary newspapers; UK government records; Lloyd's Corporation internal records, including annual reports, the *Lloyd's Log* in-house magazine, and records of Council and Committee meetings and general meetings of members; and interviews recorded with Lloyd's officers, brokers and underwriters. As always with any historical investigation, the bias of evidence must be considered. Lloyd's records, even those not intended for outside consumption, were carefully presented, apparently with the effect of minimising the appearance of conflict within the governing bodies, namely the Committee of Lloyd's to 1982, and, from 1983, the Council of Lloyd's and its sub-committees. It is rare to read in these records any criticism, overt or implicit, of the Chairman of Council, and even the resignation of the Chief Executive Officer in November 1985 was passed over without comment, despite the acrimony that it caused. As a result, it is necessary always to read between the lines or to watch for telling phrases that may allude to dissent or contrary views. Lloyd's entered the 1980s regarding itself as essentially a private society, and nervous about revealing its inner workings to outsiders, while at the same time always keen to present itself as a jewel in the crown of UK financial services.

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16 Taleb, *Black Swan*, 58, 61, 149-51; Angner, 'Economists as Experts'; Ashiya and Doi, 'Herd Behavior'; Bewley and Fiebig, 'Interest Rate Forecasters'; Kang and Kim, 'Fragility of Experts'; Banerjee, 'Simple Model'; Deaves et. al., 'Dynamics of Overconfidence'; Dunning et. al, 'Why People Fail'; Bikhchandani et. al., 'Learning'; Acemoglu et.al., 'Bayesian Learning'.

It has also been necessary to consider the agendas of parties outside Lloyd's who took part in debates about reforming the institution - most obviously the political ideologies of individual MPs, and the personal vested interests of many of them as members of Lloyd's - as well as the desire of journalists to sensationalise stories or stretch evidence to fit their chosen narratives. To an extent, caution must also be applied to the evidence of disgruntled Lloyd's members campaigning for redress through law suits or the website truthaboutlloyds.com, or through the books and articles that they authored about the crisis.

Finally, watchfulness is also necessary with regard to the self-delusions of individual actors. One interesting example of this is Sir Peter Miller, chairman of Lloyd's in the mid-1980s, who in a 1989 interview declared himself to be 'anti-Establishment', which he defined as someone who dislikes being told what to do by persons in authority. Miller may have been 'bloody minded' - his own words - like many of the Lloyd's underwriters whom he admired, but with his deeply conservative political views and his social and educational background - he was schooled at Rugby and Oxford, his parents were barristers, his grandfather was a shipowner and banker, he could not be described as anti-Establishment in any sense.[17] Self-evaluations must be regarded with suspicion.

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17 BL C409/015, interview with Sir Peter Miller.

The following chapter provides a brief overview of the history of Lloyd's and the ways in which the market was organised between the eighteenth and mid-twentieth centuries. Chapter three provides an analysis of the social composition of Lloyd's and the political and economic outlook of its working members and leaders. Chapter four describes the scandals of the 1970s and early 1980s and the institutional and public response to these. Chapter five examines the first phase of reforms commencing with the new Lloyd's Act of 1982. Chapters six and seven provide, respectively, accounts of the major scandals that dogged Lloyd's through the 1980s, and the liability crisis and LMX spiral that nearly brought down Lloyd's by the mid-1990s. Chapter eight describes the subsequent reforms that enabled Lloyd's to survive, albeit in an entirely restructured form. The conclusion points to the implications of this history for the role of financial service regulation, and to the dangers for complex financial systems of entrenched beliefs in the competence of experts and the efficacy of self-governance. An epilogue provides a brief overview of developments during the last two decades and offers a retrospective view on the differences between Lloyd's now and as it was just 40 years ago.