LLOYD'S

Market Bulletin

Ref: Y5177

Title	Provision of capital to support members' Economic Capital Assessments; timing and Solvency II tiering limits
Purpose	To advise members and managing agents of the consolidated framework for the provision of capital to support members' Economic Capital Assessments
Type	Event
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Deadline	Immediate

Related links

Introduction

This bulletin consolidates and revises the guidance previously issued and therefore supersedes Market Bulletins Y4984 and Y5113 and the supplementary guidance issued post the Q3 2017 loss events. This bulletin addresses:

- The limits on members' use of Tier 2 capital
- Coverage of open year solvency deficits
- Accelerated injection of capital by members

The Solvency II tiering test has introduced a restriction on the amount of Tier 2 capital (at member level: letters of credit, bank guarantees and life policies (collectively 'LOCs')) eligible for solvency coverage. Any Tier 2 capital in excess of 50% of the Lloyd's Market-Wide Solvency Capital Requirement (MWSCR) does not count towards market-wide solvency coverage; at 31 December 2017 there was approximately £2bn of Tier 2 capital which was ineligible for solvency. In addition, rating agencies consider the level of ineligible assets for solvency when determining their rating.

The above factors led to the introduction of restrictions on the level of Tier 2 capital lodged as members' FAL and the requirement for open year solvency deficits to be covered by Tier 1 capital, as set out in Market Bulletin Y5113 and supplementary guidance issued to the market post the Q3 2017 loss events (CFO note dated 16 October 2017).

The key changes to the requirements are:
(i) Members' Tier 2 capital should not exceed 50% of their Economic Capital Assessment ('ECA') from 1 December 2020;
(ii) Where a member's Tier 2 capital is greater than 50% of ECA no further increases in Tier 2 capital will be allowed, except to cover up to 30% of any increase in ECA; and
(iii) Where a member's Tier 2 capital is less than 50% of ECA up to 50% of any increases in ECA can be covered by Tier 2 capital.

The following requirements are unchanged and continue to apply:
(i) All members' net open year solvency deficits must be covered by Tier 1 capital; and
(ii) Where a member's ECA is £5m or less the Tier 2 capital limits do not apply.

The transition to members' Tier 2 capital being no more than 50% of ECA has been introduced to align members' capital provision with solvency requirements over time and in doing so reduce the level of ineligible Tier 2 capital across the market. These requirements are effective immediately and will continue to apply until replaced. We will revisit these requirements should the current approach fall short of delivering fully eligible capital for solvency at market level.

Details of how the above mentioned changes apply at member level are set out in the sections below.

1. Tier 2 capital limits

Members may continue to utilise LOCs to support their ECA requirements, however they are subject to restrictions on a phased basis to 1 December 2020 to minimise ineligible assets.

Those members whose proportion of Tier 2 capital currently exceeds 50% of ECA will be required to reduce this to no more than 90% of ECA from 1 December 2018, 70% of ECA from 1 December 2019 and 50% of ECA from 1 December 2020. No member's Tier 2 capital should exceed these limits at the respective dates.

Those members whose proportion of Tier 2 capital is less than 50% require advance approval from Lloyd's (steve.jules@lloyds.com) if they are seeking a one-off increase in LOCs and should not expect the increase to exceed 10% of ECA absent exceptional circumstances.

Increases in the amount of LOCs within members' FAL will be permissible in certain instances and subject to restrictions on the amount.

The following requirements are applicable with immediate effect:

1.1 <u>Tier 2 capital to ECA ratio less than 50%</u>

a) *Member's ECA increases*

- Where a member's ECA has increased, up to 50% of the increased capital requirement may be funded by LOCs.

e.g. if a member's ECA increases from £100m to £160m up to £30m of the incremental capital requirement can be funded by LOCs.

b) *Member's ECA decreases*

- Where a member's ECA has decreased the ratio of Tier 2 capital to ECA should **<u>not</u>** be greater than it was prior to the reduction in capital requirement;

e.g. if a member's ratio of Tier 2 capital to ECA is 25% before its capital requirement reduces, the ratio should not exceed 25% after the reduction in ECA.

1.2 <u>Tier 2 capital to ECA ratio 50% or more</u>

a) *Member's ECA increases*

- Where a member's ECA has increased:
  - up to 30% of the increased capital requirement may be funded by LOCs; and
  - the ratio of Tier 2 capital to ECA should not exceed: 90% at 1 December 2018, 70% at 1 December 2019 and 50% at 1 December 2020 and at each coming into line date thereafter.

e.g. if a member's ECA increases from £100m to £200m up to £30m of the incremental capital requirement can be funded by LOCs.

b) *Member's ECA decreases*

- Where a member's ECA has decreased the ratio of Tier 2 capital to ECA should **<u>not</u>**:
  - be greater than it was prior to the reduction in capital requirement; and
  - exceed: 90% at 1 December 2018, 70% at 1 December 2019 and 50% at 1 December 2020 and at each coming into line date thereafter.

e.g. if a member's ratio of Tier 2 capital to ECA is 65% before its capital requirement reduces, the ratio should not exceed 65% after the reduction in ECA. If a member's ratio of Tier 2 capital to ECA is 95% before its capital requirement reduces, the ratio should not exceed 90% at 1 December 2018 after the reduction in ECA.

1.3 Application of the Tier 2 capital limits

The above requirements are applicable to members as follows:

- Members with ECAs greater than £5m are required to adhere to the Tier 2 capital limits. Where a member's ECA is £5m or less the Tier 2 capital limits do not apply.
- New members with an ECA greater than £5m will be allowed to fund up to 50% of their ECA by LOCs. If the new member's ECA is less than £5m the Tier 2 capital limits do not apply.
- Tier 2 capital limits are applied to each member individually except where members are party to an inter-availability arrangement in which case the limits will be applied to the combined capital position of the donor and successor members.
- Tier 2 capital limits are applied separately to a member's non-life and life underwriting.

2. Open year solvency deficits

Solvency deficits or surpluses represent the members balance for each underwriting year on the solvency return, excluding Funds In Syndicate ('FIS'). All net open year solvency deficits – open years' solvency deficits net of solvency surpluses – reported on members' capital test statements need to be fully covered by Tier 1 capital by the next coming into line deadline i.e. members will be required to cover net open year solvency deficits reported on the April capital test statements with Tier 1 capital by 30 June 2018.

Coverage of net open year solvency deficits does not necessarily require an injection of Tier 1 capital. If a member has already lodged Tier 1 capital (FAL or FIS) which is equal to the value of its net open year solvency deficits no additional injection of Tier 1 capital is necessary. This is subject to the member also meeting the tiering limits as above.

e.g. if a member's net open year solvency deficit is £100m and there is £150m of Tier 1 capital as FAL or FIS, no further injection of Tier 1 capital is necessary. If a member's net open year deficit is £100m and there is £75m of Tier 1 capital as FAL or FIS, an additional £25m of Tier 1 capital is needed.

LOCs under notice of cancellation are no longer eligible to cover net open year solvency deficits therefore the guidance set out in market bulletin Y3857 no longer applies.

2.1 Application of the guidance on open year solvency deficits

The above requirements are applicable to members as follows:

- All members, regardless of their size, are required to ensure open year solvency deficits are covered by Tier 1 capital.
- Applied to each member individually except where members are party to an inter-availability arrangement in which case the combined solvency deficit of the donor and successor members needs to be covered by Tier 1 capital.
- Member's non-life and life underwriting are assessed separately.

3. Accelerated injection of capital

Managing agents are responsible for monitoring capital adequacy in respect of the net asset position of the syndicate and its risk profile. Whilst Lloyd's reviews members' capital positions each quarter, we require managing agents to advise Lloyd's as soon as it is reasonable for the Board to consider that either:

(i) the net solvency surplus or deficit of the syndicate has deteriorated by more than 10% of the syndicate ECA since the previous quarter's filing; or
(ii) that the risk profile has changed so that the uSCR (and by extension the ECA) has increased by 10%; or
(iii) a combination of events leads to a shortfall (i.e. available capital is less than ECA) of 10% against ECA – a reserve deterioration for example will incur a loss of net assets and a consequent increase in reserve volumes which could well drive an increase in uSCR.

Where a member's capital position indicates a shortfall against their ECA but not their ultimate SCR (uSCR), Lloyd's exercises its discretion in determining whether a member should cover that shortfall before the next coming into line deadline. As a guide, where a member's shortfall is greater than 10% of their ECA they should expect, at a minimum, to accelerate the injection of capital to reduce the shortfall to no more than 10% of their ECA; materiality of the member's shortfall will be considered when assessing the need for an accelerated injection of capital. If a member's capital position indicates a shortfall against their uSCR this shortfall has to be covered, to reduce the shortfall to no more than 10% of their ECA, within 30 days of being notified by Lloyd's (para 6(3) M&URs).

Where members are required to accelerate the injection of capital they will also be required to: (i) notify Lloyd's immediately if their capital position deteriorates and (ii) provide assurances to Lloyd's, in writing, that sufficient resources are available and committed to cover the remaining shortfall by the next coming into line date.

The guidelines above related to the limits on Tier 2 capital and coverage of open year solvency deficits should be considered in determining how shortfalls should be funded.

4. Timetable for lodging LOCs

Where a member uses LOCs to support its ECA these must be lodged with Lloyd's in accordance with the accelerated timetable for the provision of LOCs in May and November for mid-year and full-year coming into line respectively. Deadlines for lodging LOCs are published separately as part of the coming into line business timetable.

If you require any more information regarding this bulletin then please contact Steve Jules steve.jules@lloyds.com or Kevin Nethersell kevin.nethersell@lloyds.com.