Update to Lloyd's Supplemental Requirements on Outwards Reinsurance

3 August 2020

On 27 July, Lloyd's of London ("Lloyd's") published a Market Bulletin on its updated outwards reinsurance requirements that managing agents at Lloyd's will have to comply with.

At the start of 2020, Lloyd's published an updated set of guidelines called 'Performance Management - Supplemental Requirements and Guidance' (the "Supplemental Requirements") as a Market Bulletin. At the time, Lloyd's had indicated that the requirements for outwards reinsurance, including the relevant Franchise Guidelines, would be subject to a wider review. This review, which involved extensive discussions with managing agents and the Lloyd's Market Association, has now been concluded and the Supplemental Requirements have been updated to incorporate the new guidance. The requirements do not apply to reinsurance-to-close of any open year of account, which are subject to their own separate requirements in the Supplemental Requirements.

APPLICATION

The new requirements will apply to all outwards reinsurance arrangements for the 2021 year of account business planning and 2021 capital setting process. As a result, Lloyd's managing agents should, to the extent applicable, support their syndicate's business plan and capital submissions with narratives that address the notification requirements and information requests specified in the new requirements.

Lloyd's has indicated that the Capital and Planning Group will consider these submissions on a case-by-case basis and may provide syndicates with revised notification criteria, increased notification thresholds or additional reporting requirements or conditions either in the syndicate's business plan and capital agreement letter or as part of the syndicate's 2021 oversight plan.

THE NEW REQUIREMENTS

The revised outwards reinsurance requirements cover five key areas:

Reinsurance Leverage. The requirements require that a syndicate should avoid excessive financial and strategic reliance on outwards reinsurance and should not pursue business strategies reliant on aggressive arbitrage and/or unsustainable outwards reinsurance arrangements. In furtherance of this, Lloyd's requires prior approval from the Syndicate Performance team of an outwards reinsurance arrangement where the syndicate intends to retain a net minimum amount of exposure for any risk it underwrites that is less than 10% of the gross line written. In addition, certain reinsurance transactions that exceed specified thresholds require prior notification.

Reinsurer Selection. Prior notification to Lloyd's is required if:

- The syndicate intends to enter into a reinsurance arrangement with a single reinsurer or multiple reinsurance entities in the same group of companies (whether or not related to the syndicate) and under all reinsurance contracts with these reinsurers:
  - the total estimated gross reinsurance premiums (before the deduction of reinsurance commissions) in aggregate is expected to exceed 20% of any single syndicate underwriting year of account gross gross written premium; or
  - the total estimated UK GAAP balance sheet reinsurance recoverables (before the deduction of offset funds or collateral) in aggregate is expected to exceed 20% of the syndicate's total balance sheet assets; and/or
- The reinsurer's financial strength is below or falls below the following ratings: [1]
  - the reinsurer's financial strength rating is lower than "A-" or the reinsurer is not rated and the full potential liability of the reinsurer under the reinsurance contract is not supported in full with low risk forms of collateral/securitisation or funding; or
  - the reinsurer's financial strength rating is equal at least "A-", but it is known that the risk will be retroceded 100% on a one-for-one contractual basis with a reinsurer who would be caught under the financial strength rating criteria above.

[1] The criteria set out shall only apply where the total estimated gross reinsurance premiums (before the deduction of reinsurance commissions) in aggregate is planned or expected to exceed 2% of any single syndicate underwriting year of account gross gross written premium.

Non-Standard and Alternative Reinsurance Arrangements. Lloyd's will only permit arrangements that meet the legal definition of "reinsurance" and that provide genuine risk transfer to be treated as admissible outwards reinsurance for the purpose of calculating a syndicate's net inwards (re)insurance risk. As such, Lloyd's prior approval is required if a syndicate intends to treat a non-standard reinsurance or alternative risk transfer arrangement as a traditional reinsurance contract in the syndicate's insurance exposure/loss reporting, business plan or capital calculations.

Shared Reinsurance Arrangements. Shared reinsurance arrangements are any reinsurance contract where a syndicate shares any of the coverage of the reinsurance contract with either one or more other syndicates or with one or more non-Lloyd's (re)insurance entities (regardless of whether the other reinsured syndicate or (re)insurance entities are related parties to the syndicate). In connection with these sorts of arrangements, there are a series of additional requirements with which the managing agent should comply including, among other things: (i) securing a non-avoidance clause (wherever possible), (ii) allocation of premium in a "clearly defined and equitable manner" and (iii) an ongoing obligation to monitor and review the structural and economic effectiveness of shared reinsurance during the contract period.

Inter-Syndicate Reinsurance. Managing agents must not permit a syndicate managed by it to reinsure or be reinsured by another syndicate managed by it, or by a related managing agent, unless: (i) it is satisfied that the reinsurance is in the interest of all the members of its respective syndicates, (ii) the terms are fair and reasonable, (iii) the reinsurance is of a type that both the reinsuring and reinsured syndicates may be party to, and (iv) the reinsuring syndicate is not the leading[2] or sole reinsurer (or, if it is the leading or sole reinsurer, that the managing agent is able to demonstrate that all aspects of the reinsurance contract have been negotiated, agreed and operated on an "arm's length" basis).

In instances where only an internal independent assessment of risk transfer pricing has been relied upon, the managing agent must be able, on request, to provide evidence to demonstrate that the individual(s) involved are suitably independent from the transaction.

The managing agent is subject to an obligation to retain proper records of all inter-syndicate reinsurance arrangements, including a declaration for each transaction that the requirements under the Supplemental Requirements have been complied with, and which is signed by a member of the managing agent's board and the active underwriter for each syndicate.

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[2] A syndicate is considered to be the "leading reinsurer" if it has negotiated and/or set the terms and conditions of the reinsurance contract.

In connection with the five areas covered above, the Supplemental Requirements detail a list of information that should be provided with the approval request or notifications described above.

In the case of an unexpected change where there is a material increase to a previously notified position, the managing agent should notify Lloyd's.

In terms of timing, Lloyd's should communicate any specific action required by the managing agents within ten business days following the notification or approval request.

Depending on the Performance Management Directorate's (the "PMD") analysis of the potential for reinsurance risk, certain requirements may be imposed by Lloyd's, which are set out in the Supplemental Requirements. In connection with the highest level of risk, these include:

- Requiring specific forms of funding and collateral arrangements to support the reinsurance transaction;
- Requiring amendments to the contract terms;
- Additional reporting requirements;
- Requiring a reinsurance risk loading to be applied to the syndicate's capital; or
- Requiring the syndicate to terminate or commute specific reinsurance arrangements.

In connection with shared and inter-syndicate reinsurance arrangements, the managing agent must formally record that it has considered the full suite of requirements, which must be provided to the Lloyd's Outwards Reinsurance team at the same time as it submits its Syndicate Reinsurance Structure submissions to Lloyd's.

BENEFITS

Lloyd's believe that the new requirements will provide managing agents with a number of benefits, including:

- Consolidation of the requirements on outwards reinsurance into a single section;
- Reflecting current best practice for the utilisation and management of outwards reinsurance and providing a clearer and more robust set of rules;

- Bringing the requirements into line with Lloyd's current risk-based approach to oversight; and

- Better alignment between the outwards reinsurance requirements with Lloyd's Minimum Standards for Reinsurance Management and Control (MS7).

Lloyd's expects that the new requirements will allow for improved engagement between managing agents and the PMD by better reflecting Lloyd's expectations for outwards reinsurance and will support Lloyd's in adopting a consistent and effective approach to oversight.

Going forward, Lloyd's managing agents should take account of these new requirements, particularly in connection with their 2021 year of account business planning and capital setting process.

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Please do not hesitate to contact us with any questions.

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