

FROM: Manager, Development, Regulatory Division
LOCATION: 58/NC1
EXTENSION: 5659
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REFERENCE: 092/99
SUBJECT: **FRONTING ARRANGEMENTS**

SUBJECT AREA(S): Introduction of certain regulatory measures with regard to the underwriting of fronting business.

ATTACHMENTS: Yes

ACTION POINTS: **Managing agents to note**

DEADLINE: **Immediate effect**

The Regulatory Board has recently become concerned by the increasing number of applications it has received which involve Lloyd's syndicates being utilised as a means by which to pass business to related insurance companies, rather than retaining any or a material proportion of the risk within the syndicate.

In such circumstances, the syndicate is often fronting on behalf of the insurance company in order that the insurance company can capitalise upon Lloyd's overseas licences. The Regulatory Board was of the view that such arrangements could prejudice Lloyd's licensing and tax arrangements in certain jurisdictions, as they could be seen as examples of Lloyd's syndicates facilitating regulatory arbitrage. Moreover, given that fronting arrangements result in a large proportion of the risk being reinsured, there is a risk that reinsurance failure could endanger the Central Fund.

The Board also recognised that access to Lloyd's licences was not the only reason for entering into fronting arrangements. Instances may arise where a Lloyd's syndicate is asked to front business as the client and/or its customers are not prepared to accept the security of the insurance company that has issued the original quotation. As a consequence, in return for an overrider, the Lloyd's syndicate will write the business and reinsure all or a substantial proportion of the business with the insurance company concerned. This further highlighted to the Board the possible ramifications that reinsurance failure could have for the Central Fund.

In response to the foregoing paragraphs, the Regulatory Board commissioned a full review of fronting in order to fully identify the regulatory risks involved. The major points arising from this review are summarised at Appendix 1. The Regulatory Board concluded that fronting per se did pose a threat to both the Central Fund and Lloyd's overseas licences. Moreover, in the case of fronting arrangements entered into with related insurance companies, the risk of

criticism from overseas regulators was more pronounced given that the business relationship with the reinsurer could be seen as a deliberate and contrived arrangement to circumvent overseas licensing and taxation requirements. Nevertheless, it was considered that these risks could be adequately managed by the introduction of regulatory safeguards, if it was felt that the commercial opportunities of this business warranted its facilitation in the Market.

On the latter point, the Market Board was consulted and discussions held with Lloyd's overseas representatives. They were of the general view that Lloyd's should be aware of the sensitivities of local insurance and tax regulators to fronting arrangements and that transgressions in this regard could give rise to regulatory sanctions being imposed, including temporary or permanent exclusion from the jurisdiction. The Market Board was anxious that all measures be taken to ensure that such situations do not arise, both from a business and reputational perspective. It was considered, however, that any action taken should not amount to a complete prohibition of fronting since it was believed that satisfactory controls could be introduced which would allow the Market to continue to enjoy the benefits from this business.

There were concerns, however, that the ability to introduce regulatory safeguards may be hindered by difficulties in defining what fronting means. It was apparent from discussions with market practitioners that there was familiarity with the term fronting, but there were differing views as to its application. Consequently, any attempt to define fronting could ultimately lead to certain nuances being overlooked, thus giving rise to the possibility of regulatory loopholes. It was considered that this could be overcome, however, by requiring the managing agent to define the term for its own business purposes and then ensuring through the monitoring process that the managing agent has adopted a responsible and reasonable approach.

In conclusion, therefore, the Regulatory Board with support from the Market Board has agreed that the measures explained in Appendix 2 should be introduced immediately.

Finally, agents should also give due consideration to the potential agency law implications of fronting business on behalf of related parties. Managing agents will be aware from the regulatory bulletin entitled "Agency obligations of Lloyd's Managing Agents" (ref 129/98) that, in circumstances where a managed syndicate has aligned and unaligned capacity, the managing agent is obliged under general agency law to effectively manage any conflicts that may arise if business is transacted with a related party. Such conflicts could arise when business is being fronted on behalf of a related party and the agent should seek advice as to whether the steps outlined in the further regulatory bulletin issued on this subject (ref 090/99) need to be followed.

Any queries arising on the content of this bulletin should be directed to Andrew Adie (extension 5659).

This bulletin has been sent to all agents, Lloyd's brokers and market associations and for information to all recognised accountants.

Andrew Adie
Manager, Development
Regulatory Division

WHAT ARE THE DANGERS OF FRONTING?

Appendix 1

There are two potential dangers involved with fronting:

- a) risk of capital loss at Lloyd's: and
- b) risk of jeopardising Lloyd's trading position (this includes reputational risk and the taxation position).

Risk of capital loss at Lloyd's

Capital loss may arise from three potential risks:

- i) *credit risk* - i.e. the reinsurer does not meet claims under the reinsurance contract(s) either because it has become insolvent, or because it refuses to pay;
- ii) *litigation risk* – if the reinsurer refuses to pay claims, the syndicate may have to incur the costs and effort of litigation to recover reinsurance, all the while funding claims without the benefit of reinsurance; and
- iii) *competency risk* – the syndicate may have accepted risks purely on the basis that the reinsurer will assess them and reinsure them 100%. This may lead to syndicates accepting the business under the direction of the reinsurer, without due consideration of the terms and conditions of the insurances and without proper understanding of the class of business. Should it prove impossible to recover under the reinsurances, the syndicate's position would be aggravated because it lacks the expertise to run-off effectively a portfolio of that particular class of business.

Risk of jeopardising Lloyd's trading position

Regulators within the country from which the business emanates may become concerned by the fact that a Lloyd's syndicate is fronting for another (unlicensed) insurer and this may jeopardise Lloyd's license in that jurisdiction. The issue of fronting is particularly sensitive in certain territories, for example the United States. Regulators may disapprove of fronting for two reasons:

- i) *regulatory arbitrage* - the use of fronting can be perceived as an attempt by the reinsurer to underwrite business from a territory without becoming licensed in that jurisdiction, thus remaining outside the regulator's control and not being subject to funding requirements etc. imposed by the regulator; and
- ii) *risk to the cedant's security* – if the insurer is ceding a large amount of business to one company it may become over reliant on the financial security of the reinsurer and its solvency may be jeopardised if the reinsurer does not meet claims.

As a result of these concerns regulators are likely to look at the frequency, materiality and intent of fronting arrangements.

Some tax authorities may also become concerned if a Lloyd's syndicate is fronting for a related insurer in a low tax jurisdiction, and perceive this as an arrangement to divert profits to a favourable tax location. This could jeopardise Lloyd's current tax arrangements.

Related fronting

Where a Lloyd's syndicate is proposing to enter into a fronting arrangement with an insurer that is a related party to the agency managing that syndicate, there may be greater grounds for regulatory concern than where the two parties are unrelated. Related arrangements might be perceived by overseas regulators as a systematic attempt to indulge in regulatory arbitrage, and therefore pose a greater threat to Lloyd's licences. It is also possible that pressure could be applied upon the syndicate by a related party to enter into insurance and reinsurance contracts that it would not normally consent to, and which could be to the detriment of non-aligned capital providers and to the Central Fund.

Captives

Captive syndicates have not been addressed separately in this bulletin although it is recognised that they may reinsure substantial percentages of their portfolios. The managing agent of a captive syndicate must be independent of the captive's group, and the provisions of the Related Parties Byelaw will catch reinsurance with a party related to the managing agent.

FRONTING: REGULATORY MEASURES**ALL ARRANGEMENTS****Monitoring**

- The Board of the managing agent must have an agreed policy on fronting arrangements, which must include but is not limited to:
 - a statement that each arrangement must have a sound business case and be to the benefit of all members of the syndicate; and
 - that due consideration must be paid to the contractual basis upon which losses are to be settled by the syndicate and recovered from the reinsurer.¹
- The managing agent's policy on fronting arrangements must be communicated and understood by all underwriting staff.
- When developing its policy on fronting, the managing agent must use its professional experience and judgement, given the sensitivities of overseas regulators to such arrangements, to evaluate whether the significance and/or nature of the arrangement(s) proposed could give rise to concern on the part of overseas insurance regulators and/or tax authorities. If the managing agent is in any doubt at all then contact **must** be made with the International Department of the Business Development Unit and/or the North America Unit (NAU)², dependent upon the territories from which the business is to be exported, for guidance. It may be necessary for the managing agent to commission a law firm in the jurisdiction concerned to obtain legal advice on the matter, the results of which **must** be shared with the International Department/NAU before clearance will be given for the arrangement to go ahead. In addition, discussions **must** be held with the Taxation Department to consider the potential effect on Lloyd's tax position at both a syndicate and member level.

N.B. Under no circumstances should any managing agent or third party (e.g. law firm) make a direct approach to a regulator in any jurisdiction to discuss fronting arrangements; any contact with external regulators must be through the NAU or International Department.

- The Board must have in place satisfactory controls to ensure that they are kept fully aware of all fronting arrangements entered into and techniques to monitor the development of such arrangements on a regular basis.
- Security of all reinsurers must be objectively assessed by the managing agents' reinsurance security committee and regularly monitored.

The performance of all agents in response to the above measures will form part of the normal general review process.

¹ This is to seek to ensure that the possibility of disputes is minimised and the syndicate does not experience cash flow difficulties.

² The International Department and the NAU are currently updating the procedures manuals for particular overseas jurisdictions which, where possible, will address the local laws on fronting. These manuals are available in hard copy and it is anticipated that they will be available electronically in the 1st quarter 2000.

Disclosure

Syndicates must disclose to capital providers in business forecasts and to the Monitoring Department, Regulatory Division, in syndicate business plans:

- a statement of their policy with regard to fronting³;
- a statement of policy regarding fronting arrangements with related parties;
- underwriting agents are already required to disclose reinsurance contracts with related parties to the Authorisation Department on an annual basis; however, the format has not previously been specified. It will now be a requirement that agents disclose this information on a pro forma sheet, a copy of which is attached at Annex 1. Moreover, agents will now be required to make this declaration on a bi-annual basis.

ADDITIONAL SAFEGUARDS FOR RELATED FRONTING

There are already certain regulatory provisions which guard against potential abuse by related parties:

- *Agency Agreements Byelaw and General Law on Fiduciary Duties* – lay down the principles on which the business relationship between managing agents and any related parties should be administered, including managing any conflicts of interest;
- *The Related Parties Byelaw* – the byelaw prohibits a managing agent, without consent, permitting a syndicate managed by it placing, whether directly or indirectly, insurance business with:
 - (i) an insurance company or a related company of an insurance company which owns an interest in that managing agent; or
 - (ii) its controller or any related company of its controller.

General consent may be granted in respect of all such reinsurances of a syndicate, provided that, in addition to the provisions of agency law, no syndicate shall place more than:

- 10% of its total reinsurance spend with any one related insurance company; and
- 20% of its total reinsurance spend in aggregate with any two or more related companies.

The agent is required to report the details of all such contracts to the Authorisation Department, as mentioned above, and the reporting timetable has been accelerated to twice yearly.

³ This would then identify any agents that may be adopting an unacceptable approach and thus could be jeopardising licensing provisions.

Reinsurance that goes beyond these limits requires specific approval. In addition, the active underwriter of the syndicate is required to confirm that the reinsurance is:

- 1) in the interests of all the members of the syndicate;
- 2) on terms which are fair and reasonable;
- 3) that the category which would normally be procured for the benefit of the syndicate; and
- 4) in the case of a long term contract, the terms of that contract have been approved by Council.

In circumstances where an application is made under the Related Parties Byelaw and it is considered that the contract is a fronting mechanism, all such applications will also be reviewed by the Authorisation Committee in accordance with the following criteria:

- Regulators – the agent must satisfy the Authorisation Committee that it has taken adequate steps to determine that Lloyd’s trading position in those territories from which the business is to be exported would not be jeopardised as a result of the proposed arrangement. This would include consideration of taxation issues at both syndicate and member level.
- Controls – the agent must satisfy Lloyd’s that it will exercise sufficient controls over the business as set out under the Monitoring section above.
- Members’ interests – the agent must satisfy Lloyd’s that it will underwrite the business in the interests of all members of the syndicate. Dependent upon the materiality of the contract involved disclosure of the contract to unaligned capital providers may be required.