SOLVENCY II
SYNDICATE SCR FOR 2013 YEAR OF ACCOUNT

LLOYD'S

INSTRUCTIONS FOR SUBMISSION OF THE LLOYD'S CAPITAL RETURN AND METHODOLOGY DOCUMENT FOR 2013 CAPITAL SETTING

MAY 2012

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1 PURPOSE

1.1 To provide instructions and guidance in respect of the contents of the Lloyd's Capital Return (LCR), its completion, and the purpose of each form.

1.2 To provide instructions and guidance in respect of the contents and depth of supporting material to be provided in the methodology document in respect of the Solvency Capital Requirement (SCR) as at 1 January 2013.

1.3 To provide information in respect of the structure and timing of Lloyd's review.

2 SCOPE

Introduction

2.1 These instructions focus on submissions for the 2013 Syndicate SCRs for member capital setting and do not represent a full revision of the 2010 ICA Minimum Standards & Guidance to bring them into line with full Solvency II standards. This exercise will be conducted in Q4 2012 / Q1 2013 once the final Level 2 text is available and Level 3 guidance is produced.

2.2 The instructions and guidance set out in this document are based on Lloyd's interpretation of the current requirements in this transitional year. Agents should note, however, that all guidance issued is subject to on-going discussion and potential change as FSA requirements become clearer and may be affected by further guidance or instructions from the European Commission (EC) or European Insurance and Occupational Pensions Authority (EIOPA).

Submission requirements and deadlines

2.3 The Lloyd's Capital Return and supporting methodology document are required for all syndicates with an open underwriting year of account at 30 June 2012, including those in run-off or offering RITC only. This includes syndicates planning to close all years of account at December 2012, since this information is required for calculating the reinsuring member(s) capital requirement.

2.4 All forms within the Lloyd's Capital Return (LCR) must be completed in each submission due by 19 July and 20 September. The LCR, which captures the quantitative information required including the SCR, must be submitted via the Core Market Returns system.

2.5 A supporting SCR methodology document must be provided by 19 July with the initial LCR and submitted as an attachment to the LCR via form 990.

2.6 Where the submission has changed materially between July and September, agents should include an analysis of change with the September return. This should be consistent with the areas considered under agents' Model Change Policy. The more information and detail provided on the movements between submissions will enhance the effectiveness and efficiency of our review. The analysis of change should be submitted as an attachment to the LCR via form 990.

Regulatory requirements

2.7 The regulatory reporting requirements under Solvency I and the FSA Handbook continue to apply on the current basis up to and including December 2013. Consequently, solvency is calculated under the current regime, based inter alia on Lloyd's Valuation of Liabilities rules and members' Minimum Capital Resources Requirement. Solvency needs to be demonstrated on a continuous basis.

2.8 The FSA have granted permission for Lloyd's to utilise the syndicate internal models developed for Solvency II to meet its obligations under ICAS during 2013 provided that equivalent protection is provided to policyholders.

2.9 INSPRU requires firms to assess capital resources so that the value of assets exceeds liabilities to a 99.5% confidence level over a one year time frame. The time horizon is one year, which guidance clarifies as one year of new business and should not exclude material risks simply because they are unlikely to emerge within the next 12 months.

2.10 The starting point for assessing capital requirements is an assumed nil net assets balance sheet at time zero. Under ICAS, this is as valued under Solvency I, which is the audited financial statements prepared in accordance with UK GAAP including undiscounted technical provisions, subject to asset disallowances per FSA concentration limits etc. For Lloyd's, solvency also reflects loadings where Statements of Actuarial Opinions require higher reserves to cover their best estimate of future liabilities by year of account. Under Solvency II, the net nil assets are assessed on a Solvency II basis and the reconciliation between the two bases are discussed in 2.15. below.

One year SCR and "SCR to ultimate"

2.11 The critical difference between the two risk measures is that the Solvency II regulatory one year SCR captures the risk that emerges over the next 12 months (to December 2013) and the ultimate measure captures the adverse development until all liabilities have been paid. The one year SCR is the difference between the current balance sheet (projected as at December 2012) and what it would be in one year's time (i.e. December 2013) including claims paid during the year, given a 99.5th percentile adverse outcome.

2.12 This means, inter alia, that at December 2013 for the one year SCR calculation, you do not model downside risk that would happen in 2014 on policies that were written during 2013 but expire in 2014. For example on a risk written 1 October 2013, all the risks and rewards of that policy go to the 2013 year of account, but the one year SCR would consider the adverse outcomes for events and knowledge up to 31 December 2013 and not the potential adverse outcome for the period of exposure 1 January 2014 to 30 September 2014.

2.13 Consequently, the outcomes on this business for the 2014 period of the policy cover are included at their mean best estimate of the premiums and claims arising – it is contracted for, so needs to be in the balance sheet. The one year SCR at 1 January 2013 considers the adverse development in reserves over 2013 only, although our modelling shows that (particularly for long tail business) reserves can continue to move out significantly after 12 months – so within the ultimate calculation required by Lloyd's, but outside the regulatory SCR.

2.14 We consider that the ultimate SCR is the more appropriate risk measure on which to base member capital setting at Lloyd's. This captures the risk in respect of the planned underwriting for the prospective year of account in full covering ultimate adverse development and all exposures.

1:200 stress point is equivalent under ICAS and Lloyd's "ultimate SCR"

Solvency II balance sheet plus ultimate SCR provides equivalent policyholder protection to ICAS

2.15 For 2013, we require managing agents to prepare an SCR for each managed syndicate that meets the one year balance sheet to balance sheet Solvency II regulatory test at the 99.5th percentile.

2.16 We also require an "ultimate SCR" for member capital setting. This takes account of one year of new business in full attaching to the next underwriting year and the risks over the lifetime of the liabilities ("to ultimate"). The requirements include risks for all business attaching to the next underwriting year (through Inception Date Accounting). This is an equivalent recognition of risks and exposures and 1:200 confidence level as required under ICAS at Lloyd's.

2.17 The 1:200 estimated economic loss to ultimate and associated cash flows are not materially affected by the change in presentation of the December 2012 (Time 0 or T0) balance sheet from Solvency I to Solvency II.

2.18 The differences in assessment of technical provisions at T0 are all identifiable, including the material change through re-allocation of future premiums from debtors to (negative) technical provisions. We consider that the impact of each and every adjustment made to technical provisions when moving from Solvency I to Solvency II is offset by a contra adjustment between ICAs and SCRs on an ultimate basis as defined by Lloyd's in 2.16 above. This includes, for example, the run-off of the risk margin to zero in the ultimate calculation. More detail is provided in Appendix 1.

2.19 We consider that the aggregate of the Solvency I net nil assets at T0 plus 1:200 Capital Requirement under ICAS is materially the same as the aggregate of the Solvency II net nil assets at T0 plus 1:200 Capital Requirement per the SCR on an ultimate basis. Insurers are required to set out a reconciliation from published financial statements to their solvency position now (performed in the FSA Return) and will be required to do so under Solvency II.

2.20 For these reasons, we consider that preparation of SCRs to ultimate is an appropriate and prudential method of meeting ICAS requirements and provides an equivalent protection to policyholders as the ICAS regime.

Tiering

2.21 The SCR considers the movement in basic own funds. Lloyd's assumes that all assets held at syndicate level are tier 1 and consequently, there is no requirement for agents to take into account considerations around tiering or definitions of basic own funds, ancillary own funds etc. Agents should contact Lloyd's as soon as possible if there is any concern that syndicate assets do not qualify as basic own funds (tier 1). Lloyd's will address the issue of tiering within member capital outside of the syndicate SCR submission and review process.

Lloyd's Capital Return

2.22 Article 101 in the Level 1 Directive requires firms to ensure all quantifiable risks are taken into account and that they model their risks, including calibration to the 99.5th percentile (SCR). The LCR captures quantitative information that, alongside the qualitative model validation work, allows agents to demonstrate that they have systems enabling them to identify, measure, manage and report risk and calculate the SCR.

2.23 The LCR provides two figures for the 99.5th percentile: the Solvency II statutory one year balance sheet to balance sheet SCR and also the risk to ultimate "SCR".

2.24 The LCR provides data that forms a direct input into and is used to calibrate the Lloyd's Internal Model (LIM). The critical data points used are the mean and the 99.5th percentile. The other distribution points can help validate the parameterisation / calibration produced for the LIM at syndicate level.

2.25 The supporting analysis within each form provides additional evidence that the model is producing reasonable and adequate capital assessments for each risk category. The prescriptive basis for completion, as set out in detail in Section 5, will also enable meaningful benchmarking. These supplement the notes provided with the LCR on Core Market Returns.

SCR methodology documentation

2.26 Where the methodology has been set out in previous Solvency II submissions to Lloyd's and remains relevant agents do not need to repeat information. A clear reference to the appropriate sections within other documentation will suffice.

2.27 Where this information is currently contained within several individual documents, Lloyd's will not require agents to produce a new/combined document for this purpose but will require agents to provide all relevant documentation together with a clear mapping showing where the required information can be found.

2.28 For 2013 capital setting, the documentation is required to demonstrate that the SCR produced by the internal model meets the minimum standards under ICAS, not the revised additional tests and standards under Solvency II. For example, managing agents are not being assessed against the full Use Test requirements in 2012. The document is required to set out the methodology and derivation of capital requirements so Lloyd's review team can assess adequacy. Together with the LCR, the document should provide sufficient evidence that the SCR meets ICAS requirements, which are similar to the test set by Article 101, extended at Lloyd's to also cover the ultimate SCR.

2.29 As a guideline, managing agents should prepare the methodology document in accordance with requirements under article 125 to document the design and operational details of the internal model. The document should be prepared with the objective of demonstrating equivalent compliance with articles 121 to 124 and provide a detailed outline of the theory, assumptions and mathematical and empirical bases underlying the internal model. Agents should consider the principles of article 231 TSIM20 in the latest Level 2 text so that "the document [is] sufficient to ensure than any independent knowledgeable party would be able to understand the design and operational details of the internal model and form a sound judgement as to its compliance with articles 101, 112, 120 to 124 and 126". Managing agents should treat the Lloyd's review team member(s) as the knowledgeable party.

2.30 Accordingly, agents should include all information that they would reasonably believe would influence the judgement of a third party regarding the appropriateness of the methodology and the adequacy of the SCR produced. As a guideline, if agents consider an analysis or commentary might be useful then we would encourage its inclusion.

Stress testing, sensitivity tests and reverse stress tests: link to validation

2.31 We recognise that managing agents have planned their validation work to meet the 5 October 2012 submission deadline and that there is a strong link to validation for these tests. We do, however, consider that the earlier provision of this information will assist the effectiveness and efficiency of Lloyd's review. The requirement is for agents to have concluded their work by 5 October and include the detail of tests conducted and the results in the updated SCR methodology documentation or with a clear reference to the relevant sections of the Validation Report.

Capital setting

2.32 Members' capital will be set using the new SCR models utilising the "to ultimate" calculations with effect from CIL in November 2012 for the 2013 YOA. The eligible assets available to meet capital requirements will be the value of funds at Lloyd's plus / minus the net balance on a Solvency II basis all as at 30 June 2012. The only change from current practice is the substitution of the Solvency II syndicate balance sheet for the Solvency I balance sheets taken from the June QMA. The solvency II balance sheet is being submitted in September 2012 supported by a limited review opinion provided by the syndicate auditors.

2.33 The results for the six months to December 2012 on a Solvency II basis will be taken into account in the June 2013 mid-year CIL exercise. Again, this mirrors the existing recognition of syndicate results on a half yearly basis in arrears.

2.34 The basis for capital setting for the forthcoming CIL exercises is set out in Appendix 2.

2.35 The existing framework requiring members to remain adequately capitalised continuously remains unchanged. Consequently, managing agents remain responsible for monitoring their SCR and advising Lloyd's of material changes. Agents are also responsible for advising Lloyd's where syndicate loss experience may reasonably be expected to have eroded member capital materially. As a guideline, we would expect agents to advise Lloyd's promptly where the SCR increases by more than 10% or syndicate loss exceeds 15% of the latest agreed ultimate SCR (or ICA). The consideration of capital erosion through syndicate loss should look through to a year of account level to ensure that profits on one year do not offset losses on another, where syndicate membership changes year on year are relevant.

2.36 Lloyd's will require an economic uplift to be applied to determine a level of member capital that supports the risk appetite of the Society including its target Financial Strength Ratings and to support its licence network. The aggregate uplift will be similar in magnitude to the capital required through the current 35% uplift applied to syndicate ICAs. The formula and amount will be assessed by Franchise Board later in Q2 and published shortly thereafter.

2.37 Lloyd's expects that the aggregate level of member capital resources will be materially unchanged from the current position. Clearly, there will be "winners and losers" in the change from an ICAS based uplift to the Solvency II regime and Lloyd's may also put in place transitional measures to ensure volatility at member level is managed appropriately. These would also be presented to Franchise Board in Q2.

3 BASIS OF REPORTING

Going concern

3.1 The SCRs should be prepared on a going concern basis. Where the capital requirement would be higher should the syndicate cease at December 2012, this should be noted on form 990.

Balance sheet at December 2012 (Time 0)

3.2 The balance sheet projection at December 2012 (Time 0 (T0)) should be prepared on the basis of net nil basic own funds on a Solvency II basis. The LCR reports the projected net technical provisions at T0 and the model should assume that equivalent assets are held.

3.3 When preparing the technical provisions projections, the expected claims development and payment pattern should be assumed from the date on which the projection is based. We appreciate that this will be subject to change and would expect agents to update their projections in the September LCR for material deviations in actual v expected. As a minimum, that should reflect actual technical provisions at June 2012. Note that the June 2012 balance sheet is subject to a limited review opinion by the syndicate auditors.

3.4 When preparing the balance sheet and assessing the assets subject to market risk, any member deficits in respect of uncalled losses should be assumed to be received in full as at 1 January 2013, with no disallowance. Agents should assume that the Society passes the required ICAS capital adequacy test.

3.5 We recognise that the actual level of assets held in the syndicate will differ from the required level to equalise a Solvency II balance sheet, for the known multiple differences between held reserves under GAAP and Solvency II. Agents should assume that all surpluses are immediately available for distribution to members and fall outside of the SCR modelling. This also applies to funds in Syndicates (see 3.6. below). The investments held should be pro-rated to calibrate to the level of the Solvency II technical provisions – agents should not model on the basis that the riskiest assets are distributed first.

Funds at Lloyd's / Funds in Syndicates (FAL / FIS)

3.6 The investment income arising on surplus assets at syndicate level and on capital, whether provided as FAL or FIS, is outside the scope of the syndicate level SCR. Equally, the market risk associated with these assets is outside the scope and is considered within the central assets required to meet the Society capital requirement. This risk is effectively mutualised, although Lloyd's has prudential powers to require a capital charge to apply at member level where we consider it inequitable for all members (through central assets) to bear an increased level of risk brought by a member's portfolio.

3.7 The syndicate one year SCR (but see 3.8. below) and ultimate SCR should, therefore, consider solely the assets needed in the balance sheet at T0 to cover Solvency II technical provisions and the subsequent cash inflows on new business. This applies both to expected investment returns and the market risk associated with the portfolio.

3.8 For the one year SCR, technical provisions should be set on a Solvency II basis and be subject to discounting at the risk free rate and after inclusion of the risk margin.

Consistency with the SBF

3.9 The LCR submissions should be consistent with the SBF return provided the week before each deadline in July and September. Where the July SBF submission is a draft and effectively provided prior to finalisation of 2013 planning (for example ahead of group timetables), the LCR should still be based on the actual SBF submission.

3.10 The SBF includes Realistic Disaster Scenario information, which should be the maximum exposure during 2013, including unexpired risks for the 2012 and earlier YOA. The natural catastrophe scenarios are key feeds for the syndicate SCR benchmark and this is the assumed basis for their inclusion in our modelling.

3.11 Where there are changes between the July SBF submitted and the final September submission, the impact of these should be set out in the analysis of change document (see 2.6. above).

3.12 Where the SBF is subject to material changes from the submission in September, whether agent or Lloyd's driven, we require agents to reflect these in their SCR calculations. This should initially be evidenced by a resubmission of the LCR which, together with the revised SBF, will be used to update the Lloyd's benchmark. Agents may assume that the business plan changes have been communicated to the SCR review team where they are driven by Lloyd's feedback on the plan. Agents will only be required to submit supporting commentary by exception, where the review team are unable to conclude that the consequential impacts on the LCR are reasonable. Member level capital requirements will be updated as soon as practicable and the timing will reflect the materiality of the changes.

Foreign exchange

3.13 The LCR should be reported in converted sterling using the published 30 April 2012 rates of exchange for the July submission and the 30 June 2012 rates for the September return. The 30 April rates are set out in MB Y4590 issued on 3 May.

3.14 The managing agency may prepare its underlying model in currency and present figures in the methodology document in US dollars where that is the dominant currency of exposure. All figures presented in the LCR, however, must be reported in converted sterling, as above.

3.15 Syndicate models should include the risk associated with exchange rate movements post loss. Having said that, we recognise that a number of members deposit capital in US dollars to match exposures. We consider that this is sound risk management and do not want to impose a capital requirement for risk associated with US dollar exchange rate movements post loss when the required capital is matched. Accordingly, where the managing agent is aware that the member deposits significant US dollar assets and that the matching of currency exposure is a long term strategic disposition (as noted perhaps in the ORSA), we will take this into account. Agents should prepare their SCRs and LCR including this risk and then separately and clearly identify the impact that this has on the aggregate SCR within the methodology document. Lloyd's would then apply an adjustment at member level, where appropriate.

Mean balance sheet projections

3.16 When preparing the mean balance sheet to ultimate (or to one year), we expect that modelled insurance premiums and claims for contracted business (pre risk margin) will run-off at the projected figures included in the T0 balance sheet – i.e. no gain or loss arises. Consequently, there should be no concept of “reserve margins” as the Solvency II technical provisions are assumed to be set at pure best estimate and these should be treated as a surplus asset (see 3.5. above).

3.17 Underwriting profits emerging on new business should be consistent with the assumptions that build the submitted SBF. Note that the 2013 SBF will include both new business and the expected outcome on contracts bound prior to December 2012 that will be recognised within the T0 Solvency II balance sheet.

3.18 In respect of investment return, the projection to ultimate in the model may recognise compound income in respect of retained profits. We would expect the model to assume that the profit is deemed to be released as recognised annually (on a Solvency II basis) and require that this is no later in full than 36 months on RITC – this should avoid distortion in the results from inclusion of investment income up to the final claims payment date and would not reflect the reality of full distribution of profits at Lloyd’s. Otherwise, the presentation could overstate the volatility between the expected outcome and the adverse ultimate SCR. Note this only applies to mean balance sheet projections and should have no effect on the 99.5th percentile assessment of risk.

3.19 Regarding managing agent profit commission, we would recommend that all models exclude the impact of additional accrual of profit commissions in the mean expected balance sheets. This approach would ensure a consistent basis of preparation across all syndicates irrespective of whether profit commission is charged. Where agent models are built so that the accrual is embedded in the calculations, agents should comment on the amount of accrued PC (beyond the amount recognised in the T0 balance sheet) in the supporting methodology documentation.

Risk free yield curves

3.20 We have published a schedule of applicable risk free rates as at 30 April on lloyds.com. Agents may utilise these in projecting their technical provisions at December 2012 in the July LCR submission. We will also publish a schedule of applicable risk free rates as at 30 June on lloyds.com by 6 July, which agents may use in their September LCRs. Agents are free to use their own projected risk free rates to produce these figures.

3.21 When preparing the estimated balance sheets at December 2013 (T1) for the regulatory SCR, agents are required to use their own models and assessment of the prevailing risk free rates and the associated interest rate risk. The risk should be included within market risk in the LCR.

Ring Fenced Funds

3.22 We consider that overseas trust fund deposits do not fall within the definition of Ring Fenced Funds and agents are not required to model these separately. The liquidity risk that arises from material overseas regulatory requirements should be included in the model. Agents should include liquidity risk within market risk when completing form 309 in the LCR and include commentary within the SCR methodology document on their assessment of liquidity risk.

Contract boundaries

3.23 EIOPA have not issued a definition regarding the contract boundary treatment of premium income arising under binding authorities. Our view is that the authorisation of a binder does not lead to contractual arrangements with policyholders and, therefore, we recommend that one year SCRs capture solely the contracted underlying risks not the ultimate premium under the binder. This is not mandatory and agents should explain in their documentation, where they have taken a different approach.

3.24 Agents should be consistent in their treatment of contract boundaries when preparing their projected T0 balance sheet and the T1 balance sheets.

New syndicates

3.25 New syndicates are required to model hypothecated prior years when considering the SCR to ultimate. This applies to any syndicate with less than three complete years of account, including the prospective 2013 YOA. No hypothecated prior years should be included in the one year SCR calculation. Appendix 3 sets out an example of the approach to be adopted.

4 PRINCIPLES

Lloyd's review

4.1 Lloyd's review of each syndicate is designed to reach a confident conclusion on adequacy for capital setting – the test being applied is effectively a "one-way test" to maintain policyholder protection.

4.2 We also have an obligation to ensure capital requirements at member level are set equitably. Consequently, reliance will be placed on benchmarking including comparison of individual syndicate SCRs against market averages and peers within the market.

4.3 We have allocated responsibility for each risk category to the most relevant department to produce a multi-disciplinary team for each syndicate. The team will be led by the actuary within Market Reserving & Capital (MRC) supported by the Solvency II account manager. Each element of the SCR and the associated qualitative assessment has been assigned to a primary owner (for example Exposure Management have primary responsibility for assessing pre-diversified catastrophe risk) and on a "four eyes" principle an assigned challenge owner. Accordingly, agents should expect to deal with a number of different staff members, co-ordinated through MRC and the account manager. The account manager will provide the relevant contacts in due course.

4.4 The review will be a ground up assessment of each risk category, alongside the top down assessment, assisted by benchmarking and peer comparisons. We have made available sufficient resource to conduct a rigorous review that will be similar in depth to the ICA "2006 and 2007 seasons". This will inevitably require resource and management time from agents that exceeds the demands made during the ICA "lite" approach in the previous two years and we appreciate the commitment this entails. A thorough grounding now should facilitate a more rolling and less intensive review level as business as usual in 2013 and beyond.

4.5 The first stage in the review will subject the LCRs to initial checks and request resubmissions or clarification, where necessary.

4.6 Secondly, we will produce MI comparing submissions, including the use of peer groups, to test for outliers. We expect to share this information with agents and request that the underlying reasons for differences are justified or addressed.

4.7 The third and most intensive stage will be the review of each syndicate submission and methodology. We expect this to be a mixture of desk based review and on-site meetings and / or presentations from agents.

4.8 The usage of the new Solvency II models and the change in basis from ICAS means that we can place limited reliance on previous ICA review work undertaken and comparisons against ICAs for 2012 and earlier. We expect to raise challenges on risk areas even where significant discussion has taken place in previous ICA reviews to ensure that appropriate evidence is obtained on the current model and underlying assumptions.

4.9 We will take into account the evidence from the model walkthroughs conducted to date and the validation reports submitted in December 2011.

Uncertainty

4.10 Simulation error is common to all models. Where applicable, we would expect agents to select from the middle of the range when compiling their SCRs and advise us through the methodology document of the potential impact of selecting alternative runs / random seeds.

4.11 The uncertainty in establishing a 1:200 capital assessment is understood. We would expect agents to again select a mean SCR when finalising their figures. The methodology document should identify the key sensitivities affecting the SCR and provide explanations of why the modelling approach is appropriate for quantifying these extreme outcomes.

4.12 In view of this uncertainty and the duty of Lloyd's to set capital equitably, we would expect agents to understand that a different view may well have merit, where it, for example, may sit within the agent's own range of foreseeable SCRs.

Credibility

4.13 We will treat all agent submissions on a goodwill and good intent basis. While the review process does have a duty to assess adequacy and probe assumptions and model outputs, agents are entitled to expect the Lloyd's teams to adhere to a code of conduct similar to that adopted by auditors. We will aim to demonstrate professional scepticism during the review of the SCR by applying similar conditions to those laid down by Auditing Practices Board (APB) for auditors. These conditions are documented in the APB's paper titled, "Professional scepticism" dated March 2012 and the conditions are as follows:

4.13.1 Develop a good understanding of the syndicate and its business

4.13.2 Have a questioning mind and be willing to challenge management assertions

4.13.3 Seek to understand management motivation for possible misstatement of the SCR

4.13.4 Investigate the nature and cause of deviations or misstatement identified and avoid jumping into conclusions without appropriate evidence

4.13.5 Be alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to enquiries

4.13.6 Have the confidence to challenge management and the persistence to follow things through to conclusion

4.14 Over time, we will place greater reliance on SCRs and internal models for agents where credibility is enhanced; whether through explanations that provide reasoned and persuasive answers to questions raised; best estimate projections that match actual results subject to explained deviations; LCR pro-forma information that fits together reasonably; detail that is declared to be available to support agent assumptions is provided promptly on request and / or simply the first submission from agents is within the foreseeable range of likely outcomes.

4.15 Where less credibility is affirmed, we will, for prudential reasons, take a more sceptical approach and, while remaining equitable, will trend towards selecting more pessimistic assumptions and requiring agents to model these to produce alternative SCRs. We will distinguish between simple errors, typos, the odd inconsistency that arises in complicated and lengthy documentation and with instances of misstatement. A judgement will be made regarding the significance of errors and agents should note that we take the view that a series of even small individual errors could be evidence of a lack of review, potential lack of management engagement and ownership and ultimately of a less reliable internal model.

Transparency and "prudent" assumptions

4.16 The SCR is defined as the 1:200 value at risk. There is no requirement to build in implicit or explicit prudence within the modelling and agents should perform each part of their modelling at the required stress level. During previous ICA reviews, we have commonly experienced difficulty in assessing aggregate capital adequacy in instances where agents point to one area of prudence offsetting other areas where challenge has highlighted a perhaps weaker area. Consequently, the review approach will be to assess each component for adequacy and agents will receive limited, if any, credit for "offsetting" margins elsewhere in the model.

4.17 We recognise that there is a place for selecting prudent assumptions and parameters, where there are model limitations or a simplified approach has been taken. For these areas, however, we would expect that the element of deemed prudence is not material and not quantifiable (if it is quantifiable, this would appear to assume that the more accurate assessment of risk is available). Again limited credit, if any, will be given in the overall assessment of adequacy.

4.18 For stress tests, the most informative results will be derived from scenarios that the agent considers to be approximate to the 1:200 stress point. There is less value in reporting stress tests in the documentation that are either a) passed by the model where the scenario is assessed at a 1:10 or 1:100 probability or b) failed by the model but assessed as being significantly more extreme than the required 1:200 confidence level.

Model change and analysis of change

4.19 The SCR submissions for the 2013 year of account fall outside the business as usual approach to be adopted by Lloyd's for review and authorisation of model change under Solvency II. Agents are expected to have adopted their model change policy into Business as Usual and should include commentary on the consideration of model changes that occur from the first submission in July onwards. For all agents, we would expect that the supporting documentation is updated or a supplementary paper submitted to us with the September return for major model changes.

4.20 We expect that agents would have completed their annual re-parameterisation of the model and key assumptions ahead of the July 2012 submission, subject to validation. Accordingly, we expect that the movements between July and September are primarily for amendments to planned underwriting or investment exposures and material changes to projected market conditions and / or technical provisions.

4.21 Where the submission has changed materially between July and September, agents should include an analysis of change with the September return. This should be organised between model changes, the results of validation and supplementary work and adjustments to model inputs (e.g. planned premium income).

Consistency with the SBF

4.22 As set out in section 3.9 to 3.12 above, the LCR submissions should be consistent with the SBF return provided the week before each deadline in July and September.

4.23 We strongly recommend that SBFs represent the best estimate of planned underwriting activity and do not include prudence within the plan assumptions. We recognise that some agents have embedded business reasons (prudence or setting stretch objectives for example) for managing their underwriting plan to a level that they consider more appropriate than pure best estimate. We expect agents to reciprocate this understanding regarding the challenge this presents to Lloyd's in its oversight across business planning and capital setting and we expect agents to set out explicitly any differences between the SBF and the inputs to the capital model. Our review will consider this and agents should note that the mean projected outcome will be a specific area of challenge in the assessment of capital adequacy.

4.24 The SBF represents the requested level of underwriting exposure to be undertaken for 2013. Accordingly, agents should model as a minimum the planned exposure as set out in the SBF and not adjust this downwards for management judgement that these represent "aspirational" plans or "theoretical maximums" for example the RDSs. This is in addition to the substantive operational risk that planned exposures are exceeded, which should be addressed in the SCR.

ICA Guidance

4.25 The guidance to approach and methodology set out in the 2010 ICA Minimum Standards & Guidance remain relevant to the production and presentation of the SCR in the LCR and the supporting methodology document. The ICA Guidance evolved over a number of years and was subject to detailed scrutiny by market practitioners. It includes a number of helpful considerations for agents when submitting their methodology documents. The Guidance has not been repeated here, but we would strongly encourage agents to refresh their knowledge of its contents and include appropriate commentary to address issues raised in the Guidance, where it covers their material risks. **[Link to ICA Guidance]**

4.26 The ICA Guidance includes a "Minimum Standards Checklist" in Appendix 2. We are reviewing this and will provide a revised version on Lloyds.com by end of June to assist agents and our review. We expect agents to complete the revised checklist with their September submissions and attach it to LCR form 990.

5 LLOYD'S CAPITAL RETURN (LCR) - FORM BY FORM

Form 309 - LCR Summary

Headline contents

5.1 Section 1 reports the headline aggregate one year SCR and ultimate SCR as at 1 January 2013. Section 2 provides analysis of the SCRs by risk categories both pre and post diversification. For run-off syndicates a flag is required where premium risk is not zero with details for that to be reported on form 990.

Insurance risk

5.2 Premium risk should capture the risk in respect of all underwriting exposures from 1 January 2013 for all years of account. We appreciate that some models are prepared on an underwriting year basis, however, for consistency we require line 2 to reflect all future underwriting risk and that reserve risk on line 3 is the risk that reserves on earned business deteriorate. Premium risk should include catastrophe risk (see form 313) for all events occurring after 1 January 2013.

5.3 The total insurance risk on line 1 should represent the diversified aggregate of premium risk and reserve risk. For columns A and E (Pre-diversification) this should be captured prior to correlation / diversification with other risk categories.

5.4 All anticipated future underwriting profits should be included within the assessment of premium risk. There should not be a profit offset included within line 10 (diversification between risk categories).

5.5 The discounting benefit at the risk free rate should be included within insurance risk in the respective premium or reserve risk lines. The one year SCR should include premium risk based on the discounted technical provisions at T1 at the risk free rate.

5.6 For reserve risk, as the assets eligible for discounting represent solely the existing assets at T0 plus future premiums and excludes cash injections to meet capital shortfalls, we would expect this to be restricted to a maximum of the discounting credit within the T0 balance sheet.

5.7 The risk free discounting credit in the one year SCR should reflect that existing assets may be depleted more quickly in a 1:200 scenario and consequently the risk free return will reduce compared to best estimate projections.

5.8 Excess returns over risk free should not be included here as they should be reported within the market risk category (line 7).

5.9 We expect agents to capture the impact of the market cycle on insurance business. With respect to applying expected loss ratios and 1:200 loss experience, we would not normally expect material differences to apply over the life of the 2013 YOA. Accordingly, agents may model the one year and ultimate premium risk for the 2013 YOA as a whole, with no requirement to apply judgement to model different outcomes dependent on the timing of individual risk attachments. Where agents consider this is a material area of difference between assumptions for the one year SCR compared to the ultimate SCR, please include a commentary on its impact in the methodology document. This is a separate point to loss emergence recognition, which is expected to be a material driver of difference between the two modelled 1:200 outcomes.

Risk margin

5.10 The risk margin is designed to represent a capital charge that would apply to another undertaking to take on the technical provisions (TPs). The balance sheet at Time 0 has a risk margin added to the TPs for this “cost of capital”. The one year SCR also has a risk margin in at 12 months’ time, based on the technical provisions in the (stressed at 99.5th percentile) balance sheet at that date, and so includes the movement in the risk margin over one year. The change in risk margin from T0 to T1 should be split between premium risk in respect of new business bound post 1 January 2013 on line 2 and reserve risk for the change in respect of incepted business (as at December 2012) on line 3.

5.11 The ultimate SCR does, however, include a gain from the risk margin running off to zero. This is because at the ultimate time horizon, all claims have been paid, no technical provisions exist and so no associated cost of capital. This means that as the calculation of the SCR is the difference between ultimate 1:200 losses (no risk margin) and the Time 0 B/S (risk margin in), a credit is effectively produced. This should be set off against reserve risk in line 3.

Binary events and other expenses

5.12 The balance sheet at T0 includes allowances for certain administrative and investment expenses and binary events that increase TPs. These may be more extreme than 1:200 so that the ultimate SCR effectively credits them back when considering the aggregate cash flows at the required stress point. Any such reduction should be set off against reserve risk in line 3.

5.13 The presentation of the T1 balance sheet on an expected outcome basis, and for stressed distribution points including the 1:200, should include the required allowance for binary events, as they are within the balance sheet at T1 on a Solvency II basis.

5.14 The balance sheet at T1 should also include the allowance for binary events on the unexpired proportion of exposure – the “unemerged risk” at December 2013.

5.15 Additional binary event risk at the 1:200 confidence level arising on new business should be included within premium risk on line 2.

Lapse risk

5.16 Lapse risk should be included within premium risk in respect of new business bound from 1 January 2013 on line 2 and within reserve risk on line 3 where it relates to incepted business. We would normally expect this risk to be immaterial, but where it is considered material, please include commentary within the SCR methodology document. This applies to both life and non-life business.

Credit risk

5.17 The aggregate credit risk on line 4 should represent the diversified aggregate of reinsurance credit risk and other credit risk. For columns A and E (Pre-diversification) this should be captured prior to correlation / diversification with other risk categories.

5.18 Reinsurance credit risk should be reported under this risk category in full on line 5. This should exclude dispute risk or reinsurance exhaustion, which should be modelled and reported within insurance risk on lines 1-3.

5.19 Reinsurance bad debt provisions within technical provisions at T0 are set out on form 312. Projected mean modelled insurance losses should assume this provision runs out at no profit or loss, as under Solvency II this is the underlying pure best estimate. For additional mean provisions modelled to emerge on new business, this can be included implicitly within the insurance risk assessment or included within the reinsurance credit risk category – the amounts and treatment should be set out in the document. The stress level of reinsurance credit risk on line 5 should take account of the amount already being held at best estimate and should, therefore, be the excess deviation from currently held provisions to the 1:200 confidence level.

5.20 Credit risk excludes the default risk applying to financial investments, which should be reported within market risk (see 5.21 below).

Market risk

5.21 Market risk should represent the net 1:200 deterioration from the opening balance sheet at T0. The expected return in excess of the risk free rate should be taken into account in the calculation.

5.22 Market risk should include the risk that there are changes to the risk free rate in the valuation of T1 technical provisions in the one year SCR.

5.23 Agents should state clearly the time horizon adopted for market risk when assessing the ultimate SCR and ensure this is consistently applied for expected returns and associated asset risk. All returns should exclude capital and surplus syndicate assets.

5.24 Foreign currency risk should be included here.

Liquidity risk

5.25 Liquidity risk should be included within market risk on line 7.

Operational risk

5.26 Operational risk should be analysed between “stand-alone” risks e.g. business interruption through loss of the building or technology and risks associated more closely with other risk categories e.g. mis-reporting of case reserves or rogue underwriter. Agents should make clear in their methodology document the delineation between operational risk and inclusion of the capital impacts in other risk categories to ensure no duplication or omission. In particular, agents should be explicit in the allowances made in assessing operational risk for historical data considered to capture implicitly such risks e.g. binding authorities exceeding limits or contracting business outside its terms of reference.

Group risk

5.27 Group risk should be included within operational risk on line 8.

Diversification

5.28 The total of individual risk categories post diversification (line 9 of columns C and G) should equal the diversified total on line 11 of columns A and E.

5.29 Agents should present the post diversification totals for each risk category in as informative manner as possible. We do not expect agents to enter the dominant risk (usually insurance risk) as a fixed amount extracted from the pre-diversified amount and adding the incremental capital for successive risk categories.

5.30 Agents may consider using an average of the outputs in simulations around the 1:200 VaR to produce a reasonable representation of the post diversification risk by category.

Form 310 – Key Capital Assumptions

Headline contents

5.31 The form reports the projected balance sheet in one year's time (i.e. at December 2013) as the mean in line 1, column A. This is the difference from the current balance sheet, which is set to net nil where assets equal liabilities. Agents should assume that all declared losses up to that point are called in full and made available at T0, with no solvency disallowance, and any surplus assets or profits (on a Solvency II basis) are distributed.

5.32 This fits with Lloyd's 100% distribution policy and that reported losses are funded in full.

5.33 The projected balance sheet to ultimate is reported in row 2 on a mean expected outcome basis and at the 1:200 confidence level.

5.34 Columns B to F also report the balance sheet at various distribution points on a one year basis.

5.35 The 99.5th percentile loss in Column G equals the SCR and ultimate SCR as shown on form 309 and are pre-populated from that form.

5.36 There is a check box to confirm that the methodology document includes a reconciliation between the one year and ultimate projections for the mean and 99.5th percentile.

Mean balance sheet projections

5.37 The mean balance sheet projections should be completed in accordance with the Basis of Reporting set out in 3.16 to 3.19 above.

5.38 The mean at one year is the expected result on a Solvency II basis in 2013, covering underwriting profit and investment income. To ultimate, the mean profit is expected to be higher for many agents, although we would expect the biggest difference to relate to investment income in excess of the risk free rate (as that is already booked as a discount in the technical provisions) and the running down to nil of the risk margin. We do not expect the form to report materially higher underwriting profits to ultimate than at one year, since the expected result (to expiry of the risk) on contracted business should be booked in the balance sheet at T1.

5.39 We would broadly expect the mean to be comparable to the expected profit in the 2013 SBF, certainly directionally on an ultimate basis. Agents should explain material differences in the methodology document after allowing for the inclusion of expected profits in the T0 Solvency II balance sheet for un-incepted obligations. Where recognition patterns affect emergence of profits at the expected outcome, supporting analysis should be provided.

Balance sheet distributions 50th percentile to 99th percentile

5.40 Reporting the various distribution points provides evidence that may be subject to validation, which should cover the full probability distribution. The internal model needs to produce modelled surpluses / deficits on an expected basis (mean) and other points as well as simply considering the 99.5th percentile downside. The LIM is calibrating to both the 1:200 and the mean and this enables us to compare our model curve with multiple data points rather than one or two, which improves the parameterisation.

5.41 As with insurance operations in general, the various outcomes of next year's trading is expected to be skewed – the downside is much worse than the upside compared to planned outcomes. Agents should provide commentary in the document in terms of the break-even return period and where historical experience is relevant and would sit compared to the projected model outputs.

Volatility

5.42 The difference between the mean and the 99.5th SCR point is a measure of the volatility of the plan and the reserves. We expect agents to compare this to the volatility in the data provided for the Lloyd's Catastrophe Model and the total modelled insurance losses, reported on form 311. As form 310 captures all risks, we would expect the deviation from the mean here to exceed the deviation in insurance risk (modelled insurance losses) on 311. Where it does not, even allowing for discounting and future investment income that are booked here on form 310 but excluded from form 311, agents should address the explanation for this in the supporting document.

Form 311 – Non-life Statistics

Headline contents

5.43 Section 1 reports the total insurance gross and net claims and claims expenses falling within the model from 1 January 2013. The amounts should all be stated on an undiscounted basis.

5.44 On a one year basis, the total represents claims and claims expenses technical provisions projected to be brought forward from 31 December 2012 plus claims that will emerge on business contracted for in the next 12 months. In other words, total claims payments from 1 January 2013 on all business written and bound prior to 31 December 2013. For the ultimate basis, the total represents claims technical provisions at December 2012 plus claims arising on all new business bound to the 2013 year of account in full.

5.45 Columns B to F report the claims and claims expenses at various distribution points on a one year basis.

5.46 Section 2 analyses the expected net claims and claims expenses (mean) by underlying pure year of account. The brought forward claims provisions are pre-populated from form 312 in column H of this section. Column I records adjustments, if required, for differences between the forecast technical provisions and the equivalent capital model outputs. The column should be reserved for differences in respect of opening claims provisions only. Column J reports expected claims arising on business contracted in the next 12 months post 31 December 2012.

Basis of reporting

5.47 Premiums and premium expenses should be excluded.

5.48 Claims expenses represent allocated loss adjustment expenses (ALAE). Unallocated loss adjustment expenses (ULAE) should be excluded.

5.49 All figures should be on a Solvency II basis, except that they should be undiscounted and exclude the risk margin.

5.50 We do not expect material adjustments to be made in column I, as agents should prepare consistent claims and claims expense projections for inclusion on form 312 and as part of the internal model. Agents should include a commentary in the supporting SCR documentation, where these adjustments are significant.

5.51 The final year of account in the section 2 table is 2014, since at T1 (i.e. at 31 December 2013) risks will have been bound but not yet incepted for the 2014 year of account. These figures are pre-populated from form 312 in column J (new business).

5.52 The mean expected claims arising on business bound in the twelve months from 1 January 2013 to 31 December 2013 should be reported in Column J. A warning message alert is included in the software for claims reported against underlying years of account 1993 to 2010 inclusive. We consider that it is unlikely that the model will include additional business attaching to these mature years of account and agents should include a commentary in the supporting SCR documentation, where these amounts are significant.

5.53 The sum of mean expected net claims and claims expenses within the model in section 2 should equal the total reported in Section 1 column A line 1, which is a validation built into the software.

5.54 All entries should exclude reinsurance bad debt provisions, but include allowance for reinsurance dispute and exhaustion. Accordingly, the net insurance claims pre-populated from form 312 are taken from the entries prior to the projected bad debt provision (separately reported on form 312 in column N).

5.55 We would expect agents to compare the net claims for the 2013 pure YOA against the total net claims in the 2013 SBF and provide a commentary on their consistency.

5.56 The final row in Section 2 reports claims arising on un-incepted legal obligations (ULO) as at 31 December 2013 for the 2014 YOA. We are content for agents to prepare models assuming these equal the anticipated claims arising on un-incepted legal obligations at December 2012 for the 2013 YOA. Agents should enter adjustments in Column I where this is not the case (perhaps for new syndicates with planned increases year on year), and include appropriate commentary in the supporting documentation.

5.57 We do not expect agents to model changes to prospective market conditions applying to ULO for the purpose of adjusting entries for the 2014 YOA on this form.

Volatility

5.58 The difference between the mean and the 99.5th SCR point is a measure of the volatility of the plan and the reserves. We expect agents to compare this to the volatility in the data provided for the Lloyd’s Catastrophe Model and the total insurance risk and overall SCR on forms 309 and 310. As form 311 captures net claims only, we would expect the deviation from the mean here to be lower than the total risk modelled on form 310.

5.59 Where there is a significant relationship between adverse claims experience and movements in modelled premiums, agents should address the explanation for this in the supporting document. This should include analysis of reinstatement premium income that is driven by the adverse claims experience and other movements. Other movements should be described in some detail – for example, foreign exchange risk post loss which is reported within market risk on form 309 and should be excluded from this measure of stand-alone claims volatility.

Form 312 – Technical Provisions

Headline contents

5.60 The form breaks down the forecast technical provisions as at T0 (December 2012) between gross and net premiums and claims and shows them by pure year of account (1993 -2012, Section 1).

5.61 There are premium and claims entries for the 2013 YOA due to the inclusion of un-incepted legal obligations (section 2).

5.62 The entries for insurance losses are split between claims, expenses and the discount applying to them (at risk free rates). The separate entries for expenses (columns B and I) are in respect of ULAE and administrative expenses.

5.63 For premiums, the form shows the amounts gross of acquisition costs, acquisition costs and discounting effect. The net best estimate liabilities (claims less premiums) are then subject to a risk margin being applied, also shown by YOA, to derive total technical provisions.

Basis of reporting

5.64 All amounts should be on a Solvency II basis and represent the pure best estimate of all possible outcomes as at December 2012.

5.65 The projected provision for bad debts in respect of anticipated reinsurance recoveries within technical provisions should be reported separately in column N.

5.66 Acquisition costs relate to amounts that fall to be deducted from gross premium income for stamp monitoring purposes and for calculation of Central Fund contributions. They should, therefore, exclude internal costs re-allocated to acquisition costs for accounting purposes – these should be included in expenses.

5.67 The claims reserves form part of total future claims payments and should be included within modelled insurance losses, at the mean, on form 311. Form 311 covers modelled claims and excludes premiums.

5.68 We would expect the ULO for the 2013 year of account at T0 to be comparable with the ULO in one year's time (for the 2014 YOA) and this line entry has been deleted from the LCR submitted last year. Please see the instructions for form 311.

5.69 We would expect agents to compare the ULO for the 2013 YOA against total net premium income forecast in the SBF to determine whether the proportion reported as a ULO as at December 2012 is not unreasonable. Agents should also comment on the expected net profit (or loss) expected on the ULO and its consistency with the overall loss ratio and combined ratio expectations in the 2013 SBF.

5.70 Agents should prepare a reconciliation of the Solvency II projected technical provisions from the actuals at the date of preparation and the projected UK GAAP balance sheet and include this in the supporting documentation.

5.71 Where agents model the risk margin at whole account level, this may be pro-rated to year of account based on net insurance losses.

Form 313 – Financial Information

Headline contents

5.72 Section 1 reported the latest planned gross and net premium income for the proposed (2013) YOA and the current (2012) YOA.

5.73 Section 2 reports the average claims duration of expected net claims – in calendar years to one decimal place – and confirms the exchange rate applied to US dollars. This should be the April rate of exchanges for the July submission and June rates of exchange for the September return.

5.74 Section 3 reports the analysis of net insurance losses between catastrophe claims and all other business. This is required for the expected claims and the 1:200 adverse experience both for the one year SCR and for the ultimate SCR. The total modelled losses after diversification should equal the total on form 311 Section 1, lines 1 and 3.

5.75 The form includes a check box to prompt agents to consider whether there is any material difference in the treatment of all reinsurance applicable to catastrophe claims in the LCM data feed compared to the full internal model.

Basis of reporting

5.76 Section 1 is included as a confirmation to us that the internal model is consistent with the latest submitted SBF for the 2013 YOA and the latest approved SBF for the 2012 YOA. The SBFs also form key data feeds to the LIM and the syndicate SCR benchmark.

5.77 The average claims tail is the estimated duration of payment of net claims at the mean from 1 January 2013. Agents are expected to model that estimated net claims up to the value of the mean are expected to settle more rapidly in a 1:200 adverse scenario in view of the increased quantum of total claims. Where the duration diverges materially at the 1:200 point, agents should include appropriate commentary in the supporting documentation.

5.78 The catastrophe net claims included in Section 3 should cover the five peak perils included in the LCM plus all other claims deemed to be catastrophe in the internal model. Agents should include commentary on the different bases for inclusion of modelled losses in the one year and ultimate SCR estimates analysed between risk emergence and period of exposure captured in the respective calculations.

5.79 Agents should include a commentary on the treatment of whole account reinsurances in allocation of net insurance losses between catastrophe and other. Where this is different to the LCM data inputs, agents should also address this in their analysis.

5.80 The total all other insurance losses covers both non cat premium risk and reserve risk modelled losses pre diversification between these elements – the diversification on line 3 is the total diversification applied for insurance risk, not the diversification between cat and non-cat underwriting risk. The supporting commentary should set out how these estimates fall within the totals for premium risk, reserve risk and diversified insurance risk on form 309.

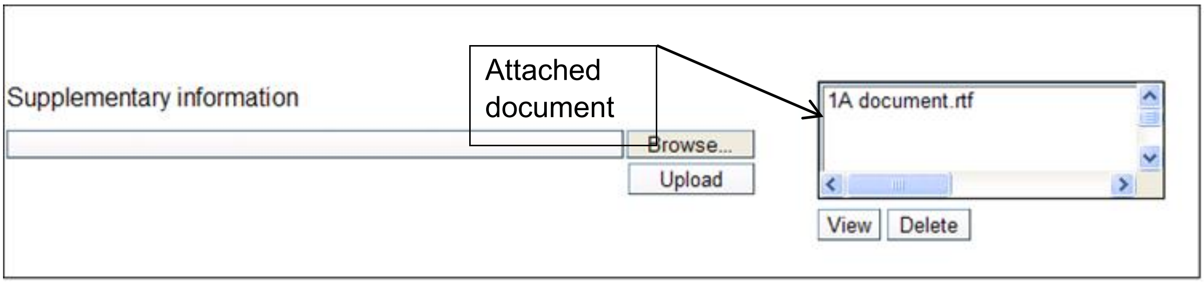
Form 990

Headline contents

5.81 This form reports additional comments and should include file attachments for supporting documentation.

5.82 Select the **[Browse...]** button to find the document on your local computer system then select **[Upload]**. There is no file size limit, but larger files may take longer to insert and save. Lloyd's preference for the format of the documents is: word, pdf or excel and the naming convention should contain the syndicate number and agent name.

5.83 Uploaded documents can be viewed or deleted using the buttons under the document panel:



5.84 To add general comments to a return, select **[Add New Item]** under the *Add any section comments* on form 990. Enter a Subject and enter the appropriate free format text.

6 QUANTITATIVE INFORMATION WITHIN SCR METHODOLOGY DOCUMENT

Link to validation

6.1 The Validation Report guidance issued by Lloyd's in 2011 [link to Validation Report guidance] is a useful source to consider when deciding on the level and detail of quantitative information to include in the SCR methodology document. Agents should also refer to the feedback provided on the model walkthrough evidence for consideration of the areas that we would consider appropriate to include.

6.2 We will issue further guidance on Validation Reports by 31 May 2012.

Mean expected outcome and deterioration to 1:200 stress points

6.3 The mean balance sheet on an ultimate basis is captured (in total) on form 310 in the LCR. When producing the SCR documentation, please set out a table showing the mean analysed between the risk categories and the deterioration to the 99.5th percentile for each. In particular, please analyse this between the expected outcome on underwriting and the expected investment return.

6.4 The document should then set out the stress applied to each category from the mean and the diversification then applied between the two elements of insurance risk and again between all risk categories.

Reconciliation between one year and ultimate SCRs

6.5 When analysing the difference between the one year SCR and the ultimate SCR, agents should set out:

6.5.1 The proportion of premium income, gross and net, that is exposed to adverse development in calendar year 2013 compared to all premium on risk to ultimate.

6.5.2 The expected profitability on contracted but unearned premium at December 2013 that is included in the balance sheet at T1. This should be analysed between the 2012 unexpired risks and 2013 year of account un-incepted legal obligations.

6.5.3 The risk emergence patterns adopted in the model showing proportions by major classes of business that emerges in year one compared to ultimate.

6.5.4 The risk margin included in the 1:200 balance sheet at T1 and the resulting movement from the risk margin at T0.

Reconciliation between UK GAAP technical provisions and Solvency II TPs

6.6 The adjustments to technical provisions include the re-assignment of future premiums receivable from debtors in the ICAS / GAAP regime to technical provisions. They are treated as negative liabilities within Solvency II TPs so the net liabilities in the balance sheet at T0 are lower when compared to GAAP. It should be possible to reconcile the aggregate of TPs and ultimate capital on the two bases, having adjusted for the premium debtor.

6.7 The document should set out a high level reconciliation between UK GAAP reserves and the Solvency II technical provisions, including the premium debtor re-assignment. This should be provided based on the as at date of preparation of the projections or against the

December 2011 figures for the July submission. For September, agents should present this reconciliation as at June 2012 and, if possible, against the figures presented on form 312. Lloyd's would expect the analysis to cover the difference between unearned premium reserves under GAAP and best estimate net claims under Solvency II, reserve margins within GAAP TPs, binary events and additions for investment and administrative expenses. The differences for discounting and the risk margin will be captured from the information on form 312.

Sensitivity tests and drivers of the 1:200 stress

6.8 Sensitivity tests reporting the impact of changes to key assumptions should be accompanied by numerical tables.

6.9 Agents should consider the incremental capital required for each change in key assumptions and provide commentary on the results. We would also expect agents to comment on the incremental impact of adding risk categories to the dominant risk. For example, include an analysis of the impact of adding new business (premium risk and associated credit and operational risk etc.) to the capital required solely to run-off the contracted for business at 1 January 2013.

6.10 The key drivers of the SCR should be set out in the document including reverse stress tests that analyse the threats that would cause a (near) insolvency of the business. Again, we require this to be supported by numerical examples that demonstrate the capital for each driver - e.g. material reserve deterioration in a key class - and the capital requirement when that occurs alongside a neutral position for other risk categories and when combining with other adverse developments.

6.11 As stated in 2.31.above, the earlier this information is available, the more effective and efficient the review process should be. We recognise, however, that agents may not be in a position to conclude this work by July. Accordingly, the requirements are that stress and sensitivity tests are included with the Validation Report in October at the latest.

Information for benchmarking

6.12 Lloyd's is developing a suite of benchmarking tests to enable comparison between syndicates to assist us discharge our duty to set capital equitably. Much of this will be drawn from the LCR, but there is additional data that should be included in the documentation to facilitate further analysis:

6.12.1 Total net and gross premium (net of brokerage & commission) on risk from 1 January 2013 to ultimate and the proportion of premium that is on risk in calendar year 2013 compared to ultimate.

6.12.2 Total reinsurance recoveries relied on within modelled losses prior to assessment of bad debt provisions, at the 1:200 stress points. These should be analysed by rating band with identification of the major individual counterparties (all those in excess of 10% and any non A rated reinsurers with more than 5% of total). Agents should consider the most appropriate method for presenting these results and include a comment on the approach taken.

6.12.3 Gross and net 1:200 ULR and derived reinsurer ULR at whole account level on business on risk from 1 January 2013 and for major classes (premium in excess of 10% of total).

6.12.4 For catastrophe modelled losses, the split between the LCM peak perils and all other catastrophe losses. This should include an approximate gross and net catastrophe ULR at the 1:200 (all cat not just the LCM perils). Agents should base the ULR on a whole account basis, although we would consider it useful to include and comment on the indicative ULR on catastrophe exposed business. Where significant catastrophe risk runs into 2014, an analysis of the diversification assumed for exposures in the two calendar years – i.e. some analysis that demonstrates the approach with numerical tables for the treatment that derives from having premium exposed in different periods for the same peril - is required.

Material reinsurance contracts

6.13 Where the SCR takes credit for material reinsurance arrangements, for example a whole account stop loss or quota share treaty, Lloyd’s requires that the document clearly sets out the SCR pre and post the reinsurance. This should show the premium and anticipated recoveries at the underwriting (or reserve) risk level, diversified insurance risk, the incremental reinsurance credit risk and at aggregate level after all diversification between risk categories. The SCR should naturally account for the reinsurance premium in 100% of simulations and the diversified appropriate recovery (net of any premium adjustment) at the stress point after including all modelled losses that fall outside the cover.

6.14 This will provide insight into the reliance being placed on the cover and ensure that, after the economic uplift is applied, the credit against member capital is, in aggregate, no greater than the maximum recovery.

6.15 Where the treaty is very material, consideration will be given to Lloyd’s risk appetite for retention of risk and to the concentration risk arising. Accordingly, we would expect the capital charge to increase in step with the materiality of the contract and be significantly higher than perhaps the stand-alone Financial Strength Rating, albeit appropriately stressed, would indicate.

6.16 Where treaties are placed intra-group, Lloyd’s requires agents to treat them on a par with external reinsurers with comparable financial ratings or strength. Lloyd’s will give limited credit, if any, to arguments that the agent has insight to the sister company that leads to management having greater comfort in the counterparty risk than is publicly apparent.

Reinsurance risk

6.17 Reinsurance credit risk should be reported under this risk category in full. This should exclude dispute risk or reinsurance exhaustion, which should be modelled and reported within insurance risk.

6.18 Reinsurance bad debt provisions within technical provisions at T0 are set out on form 312. Projected mean modelled insurance losses should assume this provision runs out at no profit or loss, as under Solvency II this is the underlying pure best estimate. Where additional mean provisions are modelled to emerge on new business, this can be included implicitly within the insurance risk assessment or included within the reinsurance credit risk category – the amounts and treatment should be set out in the document. The stress level of credit risk should take account of the amount already being held at best estimate and should, therefore, be the excess deviation from currently held provisions to the 1:200 confidence level.

6.19 We have prepared example templates for some of the quantitative information requirements that would apply to all or many agents. These are in excel format on Lloyds.com. Agents may utilise these or prepare their own formats that provide the relevant detail.

APPENDICES

APPENDIX 1 - DEFINITION OF THE ULTIMATE SCR

1. The 1:200 discounted net cost to ultimate for all years of account combined, including the 2013 prospective year of account's underwriting LESS the sum of projected net liabilities on the solvency II balance sheet at T0 (December 2012) and premiums received for the 2013 and prior years of account underwriting that are not already included in the T0 balance sheet projected net liabilities.
2. 'Ultimate' is defined as the final realised position – not the most prudent time step path to ultimate. For liquidity risk, the costs associated with trust funding requirements or peak losses in the interim must be considered if material and included within market risk.
3. We require managing agents to capture Insurance and Reinsurance Credit risk to ultimate. Other risk categories may be modelled over a shorter time horizon (subject to a one year minimum). The modelling time horizon should be clearly set out in the methodology document.
4. This means agents may model market risk over a one year period. This involves consideration of the risk and return on assets held over one year. Agents may also consider a time horizon between one year and ultimate, however, agents should note that the time horizon for modelled market risk and the credit for excess returns above the risk-free rate should be consistent.
5. The risk margin at T0 should be assumed to run down to zero in the ultimate SCR calculation and effectively forms a profit offset. This should be booked under reserve risk in the LCR.
6. The ultimate SCR considers all risks attaching to the 2013 year of account and excludes exposures relating to underwriting years beyond the proposed YOA. This differs from the one year SCR where un-incepted legal obligations on the T1 balance sheet will relate to underwriting years beyond the proposed YOA.
7. The ultimate SCR will differ from the ICA due to the asset and liability valuations being based on a Solvency II basis. For example, an ICA includes credit for the recognition of profits on the UPR at T0 whereas this profit flows through into the starting balance sheet for the SCR. The SCR also excludes credit for expected profits on un-incepted legal obligations at T0 whereas the ICA includes credit for profits.
8. For new syndicates (in first three years of trading), the ultimate SCR should include a minimum of two prior years' hypothecated reserves based on the prospective underwriting year's business plan. This is different to the one year SCR, which should be based on actual exposures.
9. Net liabilities, rather than assets, should be adopted as the starting position and should exclude surplus assets which are used to meet member solvency requirements. Please note the market risk on member capital requirements are mutualised at Lloyd's, subject to equity between members.

APPENDIX 2 - TIMETABLE FOR BASIS OF MEMBER CAPITAL: ASSUMING SOLVENCY II STARTS 1 JANUARY 2014

CIL DATE	BASIS	SUPPORTING EVIDENCE
Nov 2011	June 2011 GAAP net assets Reserve margin at Dec 2010 1 Jan 2012 ICA	Auditor review opinion SAO Lloyd's review and benchmark
Jun 2012	Dec 2011 GAAP net assets Reserve margin at Dec 2010 1 Jan 2012 ICA (y/e FX)	Audit true and fair opinion / SAO SAO Lloyd's review and benchmark
Nov 2012	June 2012 GAAP net assets *June 2012 Solv II net assets and reconciliation from GAAP* 1 Jan 2013 Ultimate SCR	Auditor review opinion *Auditor review opinion / actuarial function sign-off* Lloyd's review and benchmark
Jun 2013	Dec 2012 GAAP net assets *Dec 2012 Solv II net assets and reconciliation from GAAP* 1 Jan 2013 Ultimate SCR	Audit true and fair opinion / SAO *Auditor review opinion / actuarial function sign-off* Lloyd's review and benchmark
Nov 2013 / Jun 2014	As Nov 2012 / June 2013 + 1 year	As Nov 2012 / June 2013
Nov 2014	June 2014 *Solv II net assets and reconciliation from GAAP* 1 Jan 2015 Ultimate SCR	*Auditor review opinion / actuarial function sign-off* Lloyd's review and benchmark
Jun 2015	Dec 2014 Solv II net assets 1 Jan 2015 Ultimate SCR	Audit "properly prepared" opinion and Actuarial Function sign-off / *SAO (TBA)* Lloyd's review and benchmark

APPENDIX 3 - ULTIMATE SCR FOR NEW SYNDICATES

1. A new syndicate is defined as a syndicate with less than three complete years of account.
2. Where a syndicate starts underwriting at Lloyd's part-way through 2012, the SBF premiums should be annualised and then hypothecated to back-years. (Where the period to year end is too short to reliably annualise, the second year plan should be taken as proxy for annualised first year)
3. For a new syndicate that commenced trading on 1 January 2012, agents should include two prior years of reserving risk. The level of such reserves should be hypothecated assuming the same classes of business and premium volumes as per the initial agreed SBF were written in the previous two years.
4. Where a syndicate enters its second year, the first year's annualised exposures should be modelled as the most mature year. The latest year exposures should be annualised and used for the proposed year and hypothecated to the second year.
5. Where a syndicate enters its third year, the first year's annualised exposures should be modelled as the most mature year. The syndicate can treat the two most recent years of account naturally.

6. An example of how this process should work:-

   - Syndicate A starts writing business at Lloyd's on 1 July 2012.

   - The SBF proposed premium is £40m for 2012.

   - The syndicate incepts most of its business on 1 January, therefore, the 2012 annualised premium is £100m.

   - The syndicate proposes to write £150m in 2013

   - The syndicate proposed to write £200m in 2014

   - The payment pattern for the syndicate is 20%, 30%, 30% and 20% for the first four underwriting development years respectively.

   - All business is written to an 80% ULR

The syndicate should model the following *expected* claims exposures in their SCR:

2012 SCR	2012 YOA: £80m (£100m premium)	2011 YOA: £64m (£100m premium)	2010 YOA: £40m (£100m premium)
2013 SCR	2013 YOA: £120m (£150m premium)	2012 YOA: £96m (£150m premium)	2011 YOA: £40m (£100m premium)
2014 SCR	2014 YOA: 160m (£200m premium)	2013 YOA: £96m (£150m premium)	2012 YOA: £40m (£100m premium)

7. As can be seen from the example, the hypothecated back-year methodology will still result in capital increases for new syndicates over time where the syndicate has an aggressive growth strategy.

8. **Hypothecated back-years are not required for the one year SCR calculation.**