FROM:	Head, Market Reporting & Solvency
LOCATION:	MRSD/58/NE3
EXTENSION:	5364
DATE:	15 September 2000
REFERENCE:	MRSD/kn/cil/rbccil/Y2373
SUBJECT:	INTERAVAILABLE FAL AND CAPITAL REQUIREMENT TESTS
SUBJECT AREA(S):	COMING – INTO – LINE
ATTACHMENTS:	ILLUSTRATION OF METHODOLOGY TO BE FOLLOWED
ACTION POINTS:	**Members' agents and direct corporates to note**
DEADLINE:	**Immediate**

The 2001 Membership & Underwriting Requirements (M&URs) issued on 14 September 2000 (ref: Y2367) no longer include the rules relating to the amount of net FAL that a member must set aside to cover his open year participations where he wishes to participate in an interavailability arrangement. These will be included in the conversion rules. The rules, currently set out at Appendices 3 and 10 to the 2000 M&URs issued on 5 July 1999 (ref: Y2086), remain unchanged.

The purpose of this bulletin is to clarify certain aspects of the calculations in respect of set-aside and interavailable FAL for converting members and corporate consolidations by reference to the solvency liabilities which need to be covered within the coming-into-line (CIL) exercise and their interaction with the four capital requirement tests set out in the market bulletin dated 11 May 1999 (ref: Y2045): Risk Assessed Framework – The Approach for Conversion Vehicles.

Unlimited-liability members converting to limited-liability for 2001

Members' agents will be aware that there has been some confusion over the application of the four capital requirement tests and their interaction with solvency liabilities within the CIL exercise where a member converts from unlimited-liability status to some form of successor vehicle. This bulletin seeks to clarify the operation of the conversion rules with regard to the treatment of solvency liabilities within the CIL calculations and the resulting application of the four capital requirement tests which are summarised below.

1. The Specified Fund and the Unappropriated Fund less the solvency liabilities must be greater than or equal to the RBC requirement for the pre-conversion years.

2. The Specified Fund must be “earmarked” to the extent that the RBC requirement of the pre-conversion years exceeds the Unappropriated Fund after adjusting for the solvency liabilities.

3. The Specified Fund less the earmarking must be sufficient to cover the RBC requirement of the successor vehicle.

4. The Specified Fund prior to any earmarking must be greater or equal to the minimum net FAL requirement.

<u>Methodology</u>

The CIL calculation for a converting member is complex. This is necessary to ensure that members are sufficiently capitalised to meet all known and future liabilities for both pre- and post-conversion years. On conversion there will be two members for whom account has to be taken collectively of the solvency liabilities (if they exist), the amount to be set-aside and the RBC requirements covering both the pre-conversion years (RBC*ulby*) and the successor vehicle (RBC*sv*). The attached spreadsheet illustrates the methodology for CIL which must be followed where a member enters into a conversion arrangement. The illustration also shows the application of the four capital requirement tests and demonstrates that a non-converting member is not disadvantaged, in terms of his capital requirement, against a converting member and vice versa.

The following points should be noted:

1. A member’s special reserve fund (SRF) and personal reserve fund (PRF) **can** be used to cover the set-aside amount for his pre-conversion years but **cannot** be made interavailable.

2. Any set aside not covered by a member’s SRF and PRF must be covered by part of the Lloyd’s deposit.

3. The balance of the Lloyd’s deposit not utilised for set-aside may then be made interavailable (the Specified Fund), subject to a capital requirement test by reference to the RBC requirement of the ceasing member.

4. The RBC of the ceasing member (RBC*ulby*) may be covered by unencumbered funds available to support the back years (the Unappropriated Fund). If these are insufficient, the Specified Fund must be earmarked to cover this shortfall. The balance of the Specified Fund will then be available to cover the RBC requirement of the successor vehicle (RBC*sv*).

5. OPW may be used to cover up to 10% of the RBC*ulby,* provided that the ceasing member has demonstrated net eligible means of at least £300,000.

Members already in interavailability arrangements

For existing converted members, the Specified Fund (SF) and the Unappropriated Fund (UF) should remain as determined at the time of conversion. The set-aside calculation determines the level of the UF and cannot subsequently be changed.

Solvency liabilities for the successor vehicle must be deducted from the SF to determine the unencumbered SF going forward.

Solvency liabilities for the ceasing member should be covered by the UF. To the extent that the UF is insufficient, the shortfall must be deducted from the SF.

Example 1:

Specified fund (SF)	100
Unappropriated fund (UF)	20
Total funds	120
Solvency liability (SD_{UL}) ceasing member	15
Solvency liability (SD_L) successor vehicle	10

UF = 20 (solvency liabilility of ceasing member of 15 is therefore covered)

SF	100
SD_L	10
Unencumbered SF	90

The UF of 20 and the SF of 90 should then be used in the application of the four capital requirement tests above.

Example 2

If the UF was insufficient to cover the solvency liabilities on the pre-conversion years (e.g. the UF was 10) then the UF would be fully utilised and the SF will be reduced as follows:

UF = 10 (solvency liability of ceasing member of 15 is not fully covered, therefore shortfall of 5 must be deducted from the SF)

SF	100
SD_L	10
SD_{UL} (balance)	5
Unencumbered SF	85

The UF (i.e.10) and any balance remaining within the SF (i.e. 85) is then used in the application of the four capital requirement tests above.

Any queries regarding this market bulletin should be addressed to Steven Wells (ext 6034) or Kevin Nethersell (ext 6253). These contacts are however not available to answer enquiries relating to specific members. This bulletin has been sent to all underwriting agents, corporate members, recognised accountants and market associations.

Patricia Hakong

INTERAVAILABLE FAL AND CAPITAL REQUIREMENT TESTS: ILLUSTRATION						
			SRF*	**PRF***	Deposit	Total FAL
	FAL at CIL valuation date (30 June 2000)	A	50,000		900,000	950,000
	***Cannot be made interavailable**					
1	**NON - CONVERTING MEMBER**					
	Solvency liabilities at CIL					
	Open year shortfalls	B	150,000			
	Cash calls made since 31.12.99	C	17,000			
	Unpaid Cash Calls	D	0			
	Total open shortfall to be covered (B - C + D)	E	133,000			
	Shortfall in E covered by SRF	F	50,000			
	Balance of shortfall after SRF (to be covered by deposit E - F)	G	83,000			
	Deposit	H	900,000			
	Unencumbered Deposit (Fund H - G)	I	817,000			
	Assume 2000 OPL maintained	J	2,121,000			
	RBC Req't **(RBC*ultot*).**	K	1,127,000			
	Additional FAL Req'd to meet RBC Req't (**RBC*ultot)*** if member did not convert.	L	310,000			
2	**CONVERSION**					
2A	**CEASING MEMBER**					
	SETASIDE AMOUNT. (Calculated in accordance with formula (App. 3 Market Bulletin Y2086). Setaside covered by F + G	M	205,000			
	Balance of Deposit to cover Setaside	N	72,000			
	Specified Fund = (I) - (N)	O	745,000			
	RBC for ceasing name **(RBC*ulby*).**	P	396,000			
	Test 1. Specifed Fd *(O) + Balance of Deposit to cover Setaside* (N*) > or* = to RBC*ulby* (P)	Q	**PASS**			
	Test 2. (EM). Specified Fund earmarked to meet RBC*ulby = P - N.*	R	324,000			
2B	**SUCCESSOR VEHICLE**					
	OPL Required (Same as 2000 OPL J)	S	2,121,000			
	Unearmarked Specified Fund to cover **RBCsv** (U) = (O - R)	T	421,000			
	Capital **(RBC*sv*)** required	U	731,000			
	Test 3. Unearmarked Specified Fund (T) to cover RBV*sv* (U). NB. (if minus shortfall in Specified Fd)	V	-310,000			
	Additional FAL to meet **RBC*sv (U*).**	W	310,000			
	Minimum FAL requirement 40%	X	848,400			
	Test 4. Specified Fd (O) > Minimum FAL Req't (Y)	Y	-103,400			