Market Bulletin

LLOYD'S

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LOCATION:	86/G5
EXTENSION:	6743
DATE:	11 August 2003
REFERENCE:	Y3113
SUBJECT	**FRANCHISE PERFORMANCE GUIDELINES**
SUBJECT AREAS:	
ATTACHMENTS:	
ACTION POINTS:	Managing Agents to note
DEADLINE:	

1. Purpose

The purpose of this bulletin is to provide managing agents with an update on Franchise Performance Guidelines.

The review of the guidelines set out in the Chairman's Strategy Group, (CSG), consultation document, (as mentioned in bulletin Y3060 of 21 May 2003 regarding 2004 Annual Franchisee Business Plans), has been completed. We are now in a position to notify managing agents of the guidelines for 2004, along with details of the way in which they will be applied.

The proposals contained in this bulletin have been arrived at following a period of consultation with the market, the timetable for which has been balanced against the need to provide individual franchisees with sufficient notice to allow:

- Due consideration of the guidelines when preparing business plans for 2004, and
- Ample opportunity for constructive discussion between the franchisor and franchisees as to the appropriate implementation of the guidelines in the context of each individual franchisee's business plan.

As indicated in the bulletin of 21 May, reference Y3060, it is the intention that members of the Franchise Performance team will meet with relevant managing agency personnel to discuss and review progress of business plans as soon as practical in advance of Annual Franchise Business Plan (AFBP) submission, and indeed a number of these meetings have already taken place. Naturally, if any managing agency wishes to discuss franchise guideline implementation, or any other aspect of business planning, prior to the scheduling of a business plan review meeting, the Franchise Performance team is more than willing to do so.

2. Guidelines for 2004

After due consideration and market consultation it has been decided that the Franchise Performance Guidelines will not be changed for 2004. The current guidelines were established as a result of extensive consultation and analysis and, whilst it is acknowledged that in applying them one size does not necessarily fit all, it is still felt that they are sensible parameters within which franchisees should operate.

Given that guidelines were introduced for the first time in 2003, it is also felt appropriate to allow both franchisees and the franchisor the opportunity to ensure that existing guidelines, and their interpretation, are more clearly established before contemplating the introduction of changes.

A schedule of the existing Franchise Performance Guidelines is attached to this bulletin for ease of reference, (Appendix 1).

3. The Interpretation of Guidelines for 2004

The CSG consultation document stated two broad principles that are still fundamental to the way in which Franchise Performance Guidelines should be applied:

- Each franchisee is expected, under normal circumstances, to operate its business within the guidelines. If a franchisee wishes to operate outside the guidelines, it will need to discuss its position and agree in advance with the franchisor the way it wants to operate and why it is beneficial to operate outside the guidelines.

- It is not intended that the guidelines should be blindly applied by the franchisor to every syndicate, and on every line of business, if they can be shown to be inappropriate.

For 2003 there have been some significant and not always fully justified variances from certain guidelines, in particular those referring to Catastrophe Exposure, Gross Line Size, Reinsurance Leverage and Reinsurance.

In order to facilitate the process of ensuring that any future variances are justified, this bulletin is intended to provide franchisees with additional guidance as to how the franchisor, (consistent with the central goal of improving profitability and managing risk in the market), intends to interpret and apply these guidelines during the 2004 Business Plan review process.

3.1 Catastrophe Exposure

In reviewing a syndicate's management of gross and net exposure to minimum return period/specified Realistic Disaster Scenario (RDS) events, attention will be paid not only to overall syndicate capacity, but also to:

- The capacity allocated by the syndicate to the line of business,
- The level of risk based capital,
- The level of expected underlying profitability in the line of business absent major catastrophic events,
- The level of expected profitability in the other lines of business written by the syndicate, and the degree of inherent volatility in those other lines.
- The assumptions used in calculating RDS exposures.

This is consistent with the intent of the existing guidelines, and the CSG consultation document statement that "The capacity, (and hence capital), of any syndicate should not be threatened to a considerable extent by any one RDS event. Franchisees cannot be allowed in future to risk unreasonable exposures to their syndicate's own capital or the Central Fund in this way".

For the sake of clarity it is emphasised that it is not the intention simply to apply guideline percentages of syndicate capacity to the capacity allocated to the line of business, or to risk based capital.

3.2 Gross Line Size

Similarly, in reviewing a syndicate's gross line sizes on individual risks for any class of business, attention will be paid not only to overall syndicate capacity, but also to:

- The capacity allocated by the syndicate to the line of business,
- The level of risk based capital,
- The risk characteristics of the line of business, and the level of expected profitability in that line,
- The level of expected profitability in the other lines of business written by the syndicate, and the degree of inherent volatility in those other lines,
- The quality and nature of the reinsurance supporting the gross line size, and
- Line size utilisation.

This is consistent with the intent of the existing guidelines, and the CSG consultation document statement that "Individual risks should not be allowed to threaten large portion's of a syndicate's capital".

Again, for the sake of clarity it is emphasised that it is not the intention simply to apply guideline percentages of syndicate capacity to the capacity allocated to the line of business, or to risk based capital.

3.3 **Reinsurance Leverage**

Since the guideline refers to a minimum net retention on each risk as a percentage of the gross line, obviously the considerations detailed above in relation to gross line size, will impact the net retained line.

The key consideration as regards reinsurance leverage, (as highlighted in the CSG consultation document), is the avoidance of aggressive arbitrage, i.e. reliance on reinsurance cover to compete at uneconomically low premiums. This is also consistent with the Profitability by Product Line guideline, which state that “There should be a reasonable expectation of making a gross underwriting profit on each line of business every year.”

Where there is a significant difference between the gross and net line size, the matching of reinsurance coverage to the underlying exposures, will also be an important factor in considering any variance from the guidelines. However, account will be taken of the availability of matching reinsurance.

3.4 **Reinsurance**

In addition to ensuring that franchisees place their reinsurance with reputable, secure reinsurers, the franchisor will be keen to ensure:

- That any reinsurance arrangements shared with non-Lloyd’s entities provide the appropriate level of protection and are not disadvantageous to the syndicate(s) concerned, (e.g. in terms of coverage availability, equitable sharing of premiums and reinstatement premiums etc.).
- That any finite risk reinsurance arrangements are fully transparent and provide the appropriate level of protection, and
- That undue concentrations of reinsurance with individual reinsurers are avoided or minimised.

3.5 **Multi-year policies**

Account will be taken of the availability of matching reinsurance.

4. Queries

As stated above, it is the intention that members of the Franchise Performance team will discuss the Franchise Performance Guidelines and their interpretation with relevant managing agency personnel as an integral part of the business plan review process in advance of the Annual Franchisee Business Plan submission.

However, if you have any comments or queries on the above, please contact David Roe on 0207 327 6518 or David Indge on 0207 327 5716

Rolf Tolle
Franchise Performance Director

Appendix 1

Existing Franchise Performance Guidelines

Profitability by product line - There should be a reasonable expectation of making a gross underwriting profit on each line of business every year.

Catastrophe exposure

(a) Catastrophe exposure should be analysed using tools or methods that are approved by the franchisor.

(b) Each franchisee should manage to a minimum return period agreed by the franchisor.

(c) The maximum gross and net exposures to a single Lloyd's specified Realistic Disaster Scenario (RDS) event for a syndicate are up to 75% and 20% of syndicate capacity respectively.

Reinsurer selection

Each franchisee should have an approved reinsurer selection process.

Gross line size

The maximum gross line that a syndicate should have on an individual risk is 10% of capacity.

Reinsurance leverage

(a) Each syndicate should retain a net minimum amount of exposure on each risk (e.g. 10% of gross line).

(b) No syndicate should pursue an aggressive arbitrage strategy (e.g. building business using inadequate pricing on the back of reinsurance).

Multi-year policies

(a) Non-cancellable policies covering a period of greater than 18 months should be recorded as multi-year policies.

(b) Multi-year policies should either have matching reinsurance cover or be limited to the agreed maximum net exposure to the class of business as set out in the syndicate's business plan.

Overall market dominance by a franchisee

No franchisee should control more than 15% of the overall market capacity without the prior agreement of the franchisor.

Dealings with brokers

All broker commissions and charges should be included in the profit and loss account submitted to the franchisor.

Service standards

Each franchisee should adhere to the service standards covering policy production and premium and claims payment as defined by LMP.

All policies should contain wording that allows cancellation to be forwarded directly to the policyholder should premiums be overdue (where legally possible).