Market Bulletin

LLOYD'S

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FROM:	Rolf Tolle, Franchise Performance Director
LOCATION:	86/G5
EXTENSION:	5716
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REFERENCE:	Y3145
SUBJECT:	QUALIFYING QUOTA SHARE REINSURANCE ARRANGEMENTS FOR THE 2004 YEAR OF ACCOUNT
SUBJECT AREA(S):	
ATTACHMENTS:	Appendix 1: Qualifying Quota Share Reinsurance Contracts 2004 Appendix 2: Letter of Credit ("LOC") requirements
ACTION POINTS:	
DEADLINE:	

Having consulted with, and taken into account the views of the Lloyd's Market Association ("LMA"), we are now publishing the requirements for the arrangement of qualifying quota share reinsurance contracts ("QQS contracts") for the 2004 year of account. Please note these requirements, which are set out in Appendices 1 & 2, supersede all previous requirements.

The key points to note are:

- As indicated in our market bulletin Y3060 (dated 21 May 2003), the maximum level of QQS relief will be 10% for the 2004 year of account. An allowance of up to 10% is felt to provide the necessary flexibility to be able to respond to changing market conditions that create the opportunity to write business on exceptional terms following, for example, a major loss.

- QQS arrangements should only be entered into where it can be demonstrated the underwriting prospects are exceptional and it is not just a vehicle to maximise capacity in the normal course of business.

- QQS arrangements no longer need to be on all business written though the syndicate or of a class or category of business that represents at least 15% of the syndicate's allocated capacity.

- QQS arrangements should carry terms that reflect the underlying profitability of the business being ceded.

- QQS arrangements should contain commutation provisions that reflect the loss characteristics of the underlying exposures. In other words, the arrangements should not permit commutation until such time there is confidence that the reassumed liability cannot materially affect the syndicate.

- All QQS applications require the specific approval of the Franchise Performance Directorate before being entered into.

- The approval of a business plan, which stipulates the intent to utilise QQS, does not constitute specific approval of the QQS arrangement.

All applications should be sent to David Indge (x5716) or David Roe (x6518).

This bulletin has been sent to all underwriting agents, active underwriters, Lloyd's brokers, recognised accountants, market associations and the association of Lloyd's Members.

APPENDIX 1

QUALIFYING QUOTA SHARE REINSURANCE CONTRACTS 2004 REQUIREMENTS

1 Overview

1.1 To constitute a qualifying quota share reinsurance contract ("QQS contract"), the reinsurance contract and the reinsurer must satisfy the requirements set out in section 2 below.

1.2 All QQS contracts require Lloyd's approval.

2 The requirements

Requirements relating to the contract of reinsurance

2.1 In order for a reinsurance contract to constitute a QQS contract, it must satisfy the following requirements:

(a) the reinsurance must follow the fortunes of the syndicate in every regard and include a clause to that effect; and

(b) the reinsurance is governed in accordance with the laws of England and Wales and subject to the exclusive jurisdiction of the English courts.

Requirements relating to the reinsurer or the provision of a letter of credit ("LOC").

2.2 In order for a reinsurance arrangement to constitute a QQS contract, the reinsurer must either satisfy the relevant requirements set out in paragraph (a) to (b) below or provide an LOC which satisfies the requirements set out in appendix 2.

(a) The reinsurer must either be a Lloyd's syndicate or the reinsurer must:

(i) have a Standard & Poor's rating or an AM Best's rating equivalent to Lloyd's rating or better, or a Moody's rating of A2 or better, or a Fitch rating of A or better; and

(ii) have net tangible assets of at least £150 million (by reference to the reinsurer's latest audited balance sheet provided that this balance sheet is not more than 20 months old at the time that the QQS contract is effected); and

(iii) be incorporated in one of the following countries–

(i) a member state of the European Union;

(ii) Switzerland;
(iii) the United States of America/Canada;
(iv) Australia;
(v) Norway and Iceland;
(vi) Japan; or
(vii) South Africa

(b) Where the reinsurer is domiciled in Bermuda, the reinsurer must provide an LOC, unless the Bermudian reinsurer has a Standard & Poor's rating of AA, an A M Best's rating of A+, a Moody's rating of Aa2 or a Fitch rating of AA.

3 Procedure to be followed before entering into a QQS Contract.

Notification requirements

3.1 In all cases managing agents must notify:

(a) members' agents and direct corporate members; and

(b) the Franchise Performance Directorate.

Notification to members' agents and direct corporate members

3.2 Before effecting a QQS contract the managing agent of the ceding syndicate must give notice in writing to every relevant members' agent, and to every member of the syndicate which is a corporate member, for the year of account concerned of its intention to effect such a reinsurance on behalf of the members of the syndicate. This notice must provide details of the following:

(a) the name of the proposed reinsurer (identifying each syndicate at Lloyd's, if any);

(b) the percentage quota share to be reinsured;

(c) the category or categories of business to be reinsured;

(d) the estimated premium to be ceded;

(e) the period for which the reinsurance arrangement is proposed to be effected (including particulars of any cancellation clauses);

(f) the profit commission percentage; and

(g) the overriding commission percentage.

Notification to Lloyd's

3.3 Managing agents should notify the Franchise Performance Directorate at the same time they notify members' agents and direct corporate members by sending a copy of the notice sent to the members' agents and/or direct corporate members.

Approval by Lloyd's

3.4 Lloyd's prior approval is required for all QQS contracts.

3.5 All applications should be submitted to Franchise Performance Directorate.

3.6 The following documentation should be submitted in support of the application:

1) Details of the rationale for the proposed QQS arrangement.

2) A copy of the final draft of the QQS slip and contract wording.

3) An explanation of how the additional premium will be acquired (e.g. new business and/or larger lines on existing business).

4) A projection of the profitability of the syndicate with and without the benefit of the proposed QQS contract, stating any assumptions made in respect of overriding commission, profit commission and syndicate costs and expenses.

5) A revised syndicate business plan showing the impact of the additional business to be underwritten.

6) An assessment of the impact of the additional business on the syndicate's gross and net RDS scenarios.

7) Details of changes to the syndicate's line sizes by principal class of business.

8) An assessment of the impact on the syndicate's reinsurance programme of the additional business to be underwritten pursuant to the proposed QQS contract (e.g. variations to net retention).

9) Confirmation of whether the reinsurance programme applies to the QQS contract and that the reinsurer is bearing its share of the cost of the reinsurance programme.

10) Details of the impact of the additional business on the agency and syndicate from an operational risk perspective (e.g. IT Systems, staffing levels etc).

11) Confirmation of the support of at least 75% or more of those members on the syndicate who voted on the proposed QQS contract.

12) Confirmation that the directors of the managing agent of the ceding syndicate are satisfied that:

    (a) the proposed QQS contract has been negotiated at arm's length;

    (b) the terms of the proposed QQS contract are fair and reasonable from a commercial point of view;

(c) the reinsurer is solvent and of good standing such that it will fulfil its obligations under the proposed QQS contract in a timely manner for the duration of the contract;

(d) it is in the interests of the members of the ceding syndicate to enter into the proposed QQS contract; and

(e) confirmation from directors of the managing agent of the ceding syndicate that they will continue to comply with the QQS requirements

4 Ongoing requirements

Registration of all QQS contracts

4.1 All QQS contracts are required to be registered with the Franchise Performance Directorate by the managing agent of the ceding syndicate(s) concerned.

4.2 A managing agent of a ceding syndicate may register its QQS contracts by submitting the following documentation:

a) a fully completed PIM 6 form;

b) a copy of the final signed contract for the QQS contract;

c) a copy of the LOC provided as initial security for the QQS contract if applicable; and

d) a copy of the notification letter to the capital providers on the syndicate, if not already provided.

4.3 Managing agents should register QQS contracts with the Franchise Performance Directorate prior to the inception of the QQS contract.

Monitoring and notification requirements

4.4 Managing agents whose syndicates have a QQS contract should keep the contract under regular review. The Franchise Performance Directorate should be notified immediately if the managing agent becomes aware of any circumstances which might affect the willingness or ability of the reinsurer to fulfil its obligations under the QQS reinsurance contract.

5 Additional Guidance

QQS contracts

5.1 It is important that managing agents ensure that they have taken steps to minimise the risk of dispute or avoidance on QQS contracts.

5.2 Managing agents should be aware that apart from the credit risk of the reinsurer, the QQS reinsurer may not respond to claims under the QQS contract in the following circumstances:

i) lack of authority (i.e. the reinsurer is not authorised under applicable law or its constitutions to enter into and perform such contracts);

ii) applicable law prohibits the payment of the claim (e.g. War legislation or Sanctions);

iii) the claim is outside the scope of the QQS coverage (although a clear "follow the fortunes" clause should address this);

iv) breach of warranties (e.g. warranties given by the managing agent/syndicate);

v) non-disclosure – (i.e. the managing agent/syndicate has misrepresented material facts); or

vi) dishonesty.

5.3 Managing agents should take all reasonable steps to mitigate the above mentioned risks with QQS reinsurers before the QQS contract is entered into. The Franchise Performance Directorate will also discuss how these risks have been addressed with all applicants.

Commutation of QQS contracts

5.4 The commutation of a QQS contract should not take place without the mutual agreement of the managing agency and the QQS reinsurer. Managing agents should ensure the commutation of the QQS reinsurance is subject to an external actuarial review and the commutation of the QQS contract is approved by the board of the managing agency.

5.5 Generally, Lloyd's would expect the commutation to take place at the earliest at 36 months as part of the syndicate RITC exercise. However, each managing agency will need to determine whether 36 months is too early to effect a commutation. This will depend on a variety of factors, including the levels of uncertainty affecting the year of account or the lines of business ceded to QQS reinsurers under the QQS contract.

RBC Implications for years following the use of QQS

5.4 Managing agents should note that although there are no capital implications on the syndicate at the time of entering into a QQS arrangement, the additional QQS premiums will be taken into account in calculating the RBC reserving risk on that syndicate year of account from the third year following the inception of the QQS contract. As a result, this will impact the capital requirements of ongoing members who participated on that year of account from the third year, so that a QQS entered into in 2004 will impact their coming into line calculation for the 2006 year of account. Please contact the Market Risk and Reserving Unit if you require further clarification on this aspect.

US Funding Requirements

5.5 Managing agents should be aware that the syndicate may be required to lodge US trust funds on a gross basis in respect of its US business and therefore must ensure that sufficient funds are available to meet US funding requirements after taking into account the QQS contract. Generally, the QQS contract should make provision for the QQS reinsurers to meet their share of US funding requirements.

APPENDIX 2

LETTER OF CREDIT ("LOC") REQUIREMENTS

1.1 Where a letter of credit is provided, it must be:

a) evergreen; and

b) provided by a credit institution authorised to accept deposits in the UK by the Bank of England with net tangible assets of at least £500 million and a long term debt rating by Fitch and Standard & Poor's of 'A', an A M Best's rating of A, or a Moody's rating of A2 or better.

Valuation of LOC's

1.2 Where an LOC is required, then the QQS contract must be arranged on either of the following bases:

a) If the QQS contract is arranged on a **"funds withheld"** basis[1], then the value of the LOC should be the syndicate's RBC requirement applied to the gross premiums to be ceded under the QQS contract (subject to the minimum Funds at Lloyd's requirement)[2].

b) If the QQS contract is arranged on a **"funds disbursed"** basis[3], then the letter of credit should always be equal to the SUM of:

1) For the first 12 months of the contract:

a) the syndicate's RBC ratio applied to that proportion of the gross premiums to be ceded under the QQS contract (subject to the minimum Funds at Lloyd's requirement); PLUS

b) the net amount disbursed (signed premiums less paid claims);

PLUS

c) any incurred losses (defined as paid losses plus noted outstanding claims) **in excess of 100%** net signed premium

2) At the end of the first 12 months of the QQS, the LOC must be revised to take into account the IBNR amount based on the syndicate's audited annual accounts. The LOC must therefore be equal to:

a) the higher of either the syndicate's RBC or the minimum Funds at Lloyd's requirement;

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[1] i.e. where the syndicate retains the QQS premiums until conclusion of the contract

[2] In the event that the syndicate sustains losses during the year, the managing agent should discuss the level of the LOC with the Admissions department.

[3] i.e. where the syndicate pays over premiums to the QQS reinsurer on, say, a quarterly basis

PLUS

b) the net amount disbursed (signed premiums less paid claims);

PLUS

c) ultimate loss estimates (incurred losses, as defined above, **plus IBNR,** as calculated by actuary for year end Solvency Test) **in excess of 100%** net signed premium; but

d) if the ultimate loss estimates (paid losses+ outstanding losses+ IBNR) are projecting **less than 100%** of net signed premium, then a LOC release can be made for the difference between the actual ultimate loss projection and the 100% net signed premium on an annual basis.

Form of the LOC

1.3 It is recommended that all LOCs in respect of QQS contracts follow the same form as those provided by members in respect of Funds at Lloyd's. The principal difference being that the beneficiary of the LOC will be the members of the syndicate instead of Lloyd's. Where the LOC does not follow this form, the managing agent should discuss this with the Admissions department.

Duration of the LOC

1.4 The LOC must be evergreen and should only be able to be terminated by the agreement of the managing agent upon the expiry of all liability. The LOC should be provided for the benefit of the members on the year participating in the QQS contract.

Provision of LOC for more than one year of account

1.5 Generally, the QQS reinsurer is expected to provide a separate LOC for each year of account. However, Lloyd's will allow the LOC to be provided for the benefit of more than one year of account, if the following arrangements are followed:

a) the QQS contract is operated on a funds withheld basis;

b) the value of the LOC is determined by the Lloyd's Market Risk and Reserving Unit on a similar basis to the calculation of the funds at Lloyd's requirements for a Lloyd's member;

c) the LOC is extended to cover an additional year of account;

d) in the event that either year sustains losses, the managing agent ensures that the LOC is always maintained at a level equivalent to the LOC valuation set by the Lloyd's Market Risk and Reserving Unit. Specifically, Lloyd's will expect the LOC to be adjusted:

i) to take into account the year end Solvency Test; and

ii) the submission of the 18-month syndicate forecast to Lloyd's and subsequent forecasts thereafter.

1.6 Managing agents wishing to set up the QQS contract using an LOC covering more than one year must obtain specific Lloyd's permission for the arrangement.

Monitoring of LOC's

1.7 The managing agency should review adequacy of the LOC on a quarterly basis to determine whether the value of the LOC needs to be adjusted.

1.8 The reinsurer must lodge with the syndicate a revised LOC within 90 days of the end of each quarter and BEFORE that quarter's premiums are passed to the reinsurer.

1.9 In the event of the reinsurer not lodging the revised LOC within the above period, the syndicate should retain the premiums and the QQS contract should revert to a 'funds withheld' basis.

1.10 The managing agent should notify the Franchise Performance Directorate immediately if the revised LOC is not lodged within the above period, or there are any other problems or difficulties being experienced with LOC's.

Reinsurance security falling below minimum requirements during the period of the QQS contract

1.11 Where the security of the reinsurer falls below the minimum required threshold during the period of the QQS contract, then the QQS contract must revert to a 'funds withheld' basis, until the reinsurer provides an LOC. The QQS contract should incorporate a clause to this effect.

1.12 The managing agent should notify the Franchise Performance Directorate immediately if this situation arises.