

FROM: Head, Market Reporting
LOCATION: 86/G5
EXTENSION: 5129
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REFERENCE: Y3372
SUBJECT: CAPITAL TESTS REVIEW
SUBJECT AREA(S): Coming-into-line and Release Test
ATTACHMENTS:
ACTION POINTS: Members' agents and Direct Corporate Members to note
DEADLINE: Release Test and Coming Into Line from June 2005

This bulletin sets out the proposals, agreed by the Franchise Board, to consolidate the Coming-into-line (CIL) exercise and the Release Test into one capital test for active members. The proposals are prudent and equitable, improve transparency and enable the release of profits for adequately capitalised members. There will be a separate Release Test calculation for non-active capital providers, which will apply a higher threshold for release of funds for prudential reasons.

The proposals ensure that the capital requirements are even-handed for active members whether required to inject new funds or release surplus capital. The proposals provide for a Total Funding Requirement, which is calculated differently for active members and non-active members.

Bi-annual CIL

A second CIL exercise will be undertaken in May / June based upon the latest available solvency and Risk Based Capital data requiring CIL shortfalls to be made good earlier in the capital setting cycle.

Total Funding Requirement (TFR)

Attached at Appendix 1 is the methodology to be adopted for calculating the TFR. The calculation of the TFR distinguishes between active and non-active capital providers. The TFR will be the aggregate of the net open year solvency results (naturally open and run-off), closed year losses and the higher of the RBC (subject the minimum of 40%) or the margin of solvency and for non-active members the Enhanced Capital Requirement.

Open years

With respect to open years, syndicates will, under annual accounting, be able to release profits to members. Any such profits will be eligible for release from Lloyd's. Where a syndicate retains profits, for liquidity or other reasons, any net surplus over all open years will be treated as nil within the new capital test. Retained profits will be included in the managing agent's assessment of the capital required to support the business of the syndicate under FSA CP 04/07.

Risk Based Capital

The FSA CP 04/7 proposes that managing agents calculate a syndicate level individual capital assessment (ICA). After review, Lloyd's will take account of the syndicate ICA in assessing the capital requirements of the society and individual members. This will produce a member level capital requirement (currently based on the RBC model). The RBC (member level ICA) will be included in the capital test.

The RBC requirement (member level ICA) in relation to run-off participations will be subject to a multiplier of 3 in the case of non-active members. It is considered prudent to continue to apply a multiplier for non-active members, because they are unlikely to provide additional funds and their exposures will naturally concentrate on fewer and fewer run-off syndicates as their syndicate participations close.

Where an active member's RBC requirement (member level ICA) within the TFR falls by more than 20%, then the more prudent release requirements for non-active members will be applied. This will restrict an acceleration in release of funds, where a member maintains an active underwriting status solely to ensure additional releases.

Margin of Solvency

The margin of solvency as shown on the most recent solvency statement will be subject to a multiplier of 2 in the case of non-active members.

Enhanced Capital Requirement (ECR)

ECR is an additional capital test introduced by the FSA and is a "benchmark" against RBC or capital adequacy. For non-active members if the ECR is greater than the RBC (member level ICA) then the ECR will replace the RBC. This is consistent with the FSA proposals for run-off companies, which are not required to capitalise at the ECR level, but may not make distributions until the ECR level is reached.

Buffer

A buffer will be applied to non-active members of 10% of the TFR when calculating releases for prudential reasons. The Franchise Board is considering de minimus limits that should apply to release of funds for active members.

Interavailability

Where a ceased member has entered into an interavailability arrangement with an active member, the ceased member will be treated as active for Release Test purposes provided the member for whom the funds have been made interavailable remains active. As is currently the case when determining a release of profits the IA FAL will be credited to both the ceasing and ongoing member. For prudence however, when determining a release of capital the IA FAL will continue to be disallowed for both the ceased and ongoing member.

Transition Provisions

From 1 January 2005, Lloyd's will adopt annual accounting under UK GAAP for financial reporting as well as regulatory reporting and for capital setting purposes. Under annual accounting the solvency

balance at 6 and 12 months is unlikely to be a material surplus due to the restriction on the recognition of profits to earned premiums only.

Assuming that the 2004 year of account is profitable, members would be receiving the benefit of an increased solvency surplus, since the syndicate solvency results at 31 December 2004 will be prepared on the current basis of ultimate expected profits and claims. before Lloyd's had moved to a full annual accounting basis from 1 January 2005, To counter the effect of the material difference any 2004 solvency surplus will not be offset against prior year deficits within the revised Release Test and CIL calculations. This treatment will only apply during 2005.

Timing

There will be no changes to the release test or CIL requirements for this year, as the open year solvency position calculated for members at December 2003 does not take account of the move to annual accounting or the new Solvency 1 regime. In addition the capital requirement for members remains under review under the consultation paper FSA CP 04/7. Also arrangements need to be made to amend the central systems which determine releases of funds.

These proposals are subject to review and amendment, once the consultation period for FSA CP 04/07 has concluded and final proposals are issued.

The formal requirements to bring the revised Capital Test calculations into force will be drafted and issued before the end of November. We will also then advise the timings of the Capital Tests to apply to releases from funds at Lloyd's and the injection of new funds to come into line.

If you have any other queries relating to this bulletin, please address them to Kevin Nethersell on Lloyd's extension 6253 or Mike Steer extension 5709. This bulletin is being sent to all members' agents, managing agents, direct corporate members, licensed advisers, recognised accountants, and market associations for information.

John Parry

SOLVENCY / CIL / RELEASE TEST 2005

		Solvency Test	NEW CAPITAL TEST (APPLIED TO CIL & RELEASE TEST FOR ACTIVE MEMBERS) See note 2	Release Test (Non-Active members) See note 1
1	Naturally Open years	Off set across ALL years of account & run-off years (See NOTE 3)	Full off set across ALL years of account & run-offs (same as solvency) SEE NOTE 3	Full off set across ALL years of account & run-offs (same as solvency) SEE NOTE 3
2	Run-off Years	Offset across run-off years of account & against naturally open year positions (See NOTE 3).	Offset across run-off years of account & against naturally open year positions (same as solvency) SEE NOTE 3	Offset across run-off years of account & against naturally open year positions (same as solvency) SEE NOTE 3
3	Closed Year Losses	Included	Included	Included
4	RBC (Member Individual Capital Assessment)	Not included	Included (see note 4)	Included (RBC for run-off's subject to multiplier of 3)
5	Margin of Solvency	Included	OR Included	OR Include (2.0 multiplier applied)
6	Enhanced Capital Requirement	Not included	Not Included (Note 5)	OR Included (Note 5)
7	OPW (only applicable to individual members)	Not allowed	Not allowed	Not allowed
8	Total Funding Requirement (TFR)	Not applicable	Sum of 1 and 2 (if negative) and 3 plus higher of 4 or 5	Sum of 1 and 2 (if negative) and 3 plus higher of 4, 5 or 6
9	Buffer to be applied to TFR	N / A	de minimus limits to apply	10%
10	FAL (net of Concentration of Asset restrictions) plus closed year profits	Included	Included.	Included
11	Surplus / shortfall (only surpluses released to members)	N / A	Sum of 10 minus 8	Sum of 10 minus 8 plus 9
	Note 1. Revised Release Test calculations applied to non-active members only			
	Note 2. Revised CIL calculation to apply to Release Test provided member is active in the calendar year in which the Release Test calculations are made. NB. Updated solvency & RBC data to be included.			
	Note 3. Any surplus generated is not carried forward in solvency against closed year losses / member's margin within the solvency calculations (except life)			
	Note 4. RBC (member ICA) to be determined in conjunction with syndicate ICAs			
	Note 5. Impact still to be determined on the assumption not included in solvency calculations			