Market Bulletin

LLOYD'S

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FROM:	Rolf Tolle, Franchise Performance Director
LOCATION:	86/G5
EXTENSION:	5716/6518
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REFERENCE:	Y3403
SUBJECT:	QUALIFYING QUOTA SHARE REINSURANCE ARRANGEMENTS FOR THE 2005 AND SUBSEQUENT YEARS OF ACCOUNT
SUBJECT AREA(S):	
ATTACHMENTS:	Yes
ACTION POINTS:	**MANAGING AGENTS TO NOTE**
DEADLINE:	**With immediate effect**

Attached to this bulletin are revised requirements for the placement of qualifying quota share ("QQS") reinsurances for the 2005 and subsequent years of account. The attached requirements shall continue in force until further notice.

The key points to note are:

- The maximum level of QQS relief will continue to be 10% of syndicate allocated capacity.
- QQS arrangements need not be restricted to whole account covers or classes of business that account for more than 15% of a syndicate's allocated capacity. However, QQS arrangements may only be entered into where a managing agent can demonstrate exceptionally favourable underwriting prospects to the Franchise Performance Directorate ("FPD").
- No QQS reinsurance contract may be made or amended without the specific prior written approval of the FPD. The approval of a business plan which refers to the use of QQS

reinsurance does not constitute approval of any specific QQS arrangement for this purpose.

- The current requirements relating to the approval, security, cancellation and commutation of QQS contracts have been clarified and refined.

All applications for FPD approval of QQS contracts 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.

Rolf Tolle
Franchise Performance Director

APPENDIX 1

REQUIREMENTS FOR QUALIFYING QUOTA SHARE REINSURANCE CONTRACTS

1 Overview

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

1.2 In order to effect a QQS contract a managing agent must comply with the requirements set out in sections 3 and 4 below.

1.3 In order to amend a QQS contract a managing agent must comply with the requirements set out in paragraphs 4.4 and 4.5 below.

2 The requirements

Requirements relating to the terms of reinsurance

2.1 To constitute a QQS contract a reinsurance contract must satisfy the following requirements:

(a) it must follow the fortunes of the syndicate in every respect and include provisions to this effect;

(b) it must make provision (where necessary) for a letter of credit to be provided in accordance with paragraphs 2.2 to 2.4 of these requirements.

(c) it must make provision for the contract to be operated in accordance with the requirements of appendix 2 as necessary.

(d) it must contain provisions to the effect that the ceding syndicate shall not be liable to compensate the reinsurer in the event that the managing agent of the ceding syndicate is required by Lloyd's or any external regulator to cease or restrict the underwriting of risks that would otherwise by covered by the contract;

(e) it must contain provisions to the effect the contract may be cancelled by the ceding syndicate and may only be commuted by the mutual agreement of the ceding syndicate and the reinsurer; and,

(f) it must contain provisions to the effect that the contract shall be governed and construed in accordance with English law and that it shall be subject to the exclusive jurisdiction of the English courts.

Security requirements

2.2 To constitute a QQS contract, each reinsurer must either satisfy the following requirements or provide a letter of credit ("LOC") which satisfies the requirements set out in appendix 2:

(a) the reinsurer must be a Lloyd's syndicate; or

(b) the reinsurer must be a company that is duly authorised to reinsure Lloyd's underwriters which -

(i) is incorporated in one of the following countries–

(1) a member state of the European Union;
(2) Switzerland;
(3) the United States of America;
(4) Canada;
(5) Australia;
(6) Norway;
(7) Iceland;
(8) Japan; or
(9) South Africa; and,

(ii) has net tangible assets of at least £150 million as disclosed in 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) has a Standard & Poor's financial strength ("FS") rating or an AM Best's rating equivalent to Lloyd's FS rating or better, or a Moody's FS rating of A2 or better, or a Fitch FS rating of A or better; or,

(c) the reinsurer must be a company that is duly authorised to reinsure Lloyd's underwriters which -

(i) is incorporated in Bermuda;

(ii) has net tangible assets of at least £150 million as disclosed in 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) has a Standard & Poor's FS rating of AA, an A M Best's FS rating of A+, a Moody's FS rating of Aa2 or a Fitch FS rating of AA.

2.3 A single rating agency must be nominated for each QQS reinsurer for the purposes of paragraph 2.4 of these requirements.

2.4 If during the term of a QQS contract a reinsurer suffers a rating downgrade so as to take its FS rating below that specified in paragraph 2.2(b)(iii) or 2.2(c)(iii), as the case may be, then it must provide a LOC which satisfies the requirements set out in appendix 2 for the duration of the contract from that point in time and the QQS contract shall operate on a funds withheld basis until such time as such a LOC is provided.

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

Notification requirements

3.1 Each managing agent that proposes to arrange a QQS reinsurance of one of its syndicates must notify the following persons of its proposals in writing and seek their approval of those proposals:

(a) the member's agent of each member of the syndicate;

(b) each direct corporate member of the syndicate; and

(c) Lloyd's Head of Underwriting & Business Plan Review.

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 direct corporate member of the syndicate for the year of account concerned of its intention to effect such a reinsurance. This notice must provide details of the following matters and seek the approval of syndicate membership for the proposed QQS contract:

(a) the name of the proposed reinsurer (identifying each Lloyd's syndicate, if any, and stating the current FS rating of any corporate reinsurer);

(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 proposed reinsurance is to be effective;

(f) the basis on which the contract is to be operated (i.e. "funds withheld" or "funds disbursed") where a LOC is to be provided as security for the contract.

(g) the proposed cancellation and commutation provisions for the QQS contract;

(h) the proposed profit commission percentage; and,

(i) the proposed overriding commission percentage.

Notification to Lloyd's

3.3 Each managing agent must send to Lloyd's Head of Underwriting & Business Plan Review a copy of any notice issued pursuant to paragraph 3.2 above at the same time that such notice is issued.

Approval by Lloyd's

3.4 No QQS contract may be made or amended without the prior written approval of Lloyd's Franchise Performance Directorate ("FPD"). The periodic revaluation of a LOC in accordance with the requirements of paragraph 3.1 of Appendix 2 shall not be regarded as an amendment to a QQS contract for this purpose.

3.5 All applications for FPD approval of proposed QQS contracts should be made in writing to Lloyd's Head of Underwriting & Business Plan Review.

3.6 The following information should be submitted in support of each application for the approval of a proposed QQS contract:

(a) Details of the rationale for the proposed contract.

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

(c) Details of any LOC that is to be provided as security for the proposed QQS contract, including the costs thereof and their proposed allocation between the parties.

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

(e) 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.

(f) A syndicate business plan showing the impact of the additional business to be underwritten with the benefit of the proposed QQS contract.

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

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

(i) 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).

(j) Confirmation of whether the syndicate's existing reinsurance programme applies to the QQS contract and that the QQS reinsurer is bearing its share of the costs of that programme.

(k) Details of the impact of the additional business on the managing agent of the ceding syndicate from an operational risk perspective (e.g. IT systems and staffing levels).

(l) Confirmation that the QQS has the support of at least 75% of the allocated capacity of the syndicate which voted on the arrangement of the contract.

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

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

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

  (iii) 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; and,

  (iv) it is in the interests of the members of the ceding syndicate to enter into the proposed QQS contract.

n) Confirmation from the directors of the managing agent of the ceding syndicate that if FPD approves the proposed QQS contract the agent will comply with section 4 of these requirements.

4 Ongoing requirements

Registration of all QQS contracts

4.1 Each QQS contract must be registered by FPD prior to its inception by the managing agent of the ceding syndicate concerned.

4.2 A managing agent may register a QQS contract by submitting the following documentation to Lloyd's Head of Underwriting & Business Plan Review:

a) a fully completed PIM 6 form;

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

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

Monitoring and notification requirements

4.3 Each managing agent of a syndicate that has a QQS contract should keep the contract under regular review and shall notify Lloyd's Head of Underwriting & Business Plan Review immediately it becomes aware of any circumstance which might affect the willingness or ability of the reinsurer to fulfil its obligations under the QQS reinsurance contract. A downgrade of a reinsurer's FS rating shall be treated as a notifiable event for this purpose.

Amendment of QQS contracts

4.4 All applications for FPD approval of amendments to QQS contracts and supporting LOCs should be made in writing to Lloyd’s Head of Underwriting & Business Plan Review.

4.5 The following information should be submitted in support of each application for the approval of an amendment of the QQS contract:

(a) an explanation of the proposed amendment; and

(b) a copy of the final draft of the proposed endorsement to the QQS slip and amended contract wording.

5 Additional Guidance

QQS contract terms

5.1 It is important that each managing agent takes steps prior the inception of a QQS contract to minimise the risk and consequences of any dispute with the prospective QQS reinsurer.

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

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

(b) applicable law prohibits the payment of the claim (e.g. war legislation or sanctions);

(c) where the scope of the contract is not clearly defined;

(d) breach of warranties (given by the managing agent for itself or on behalf of the ceding syndicate); or

(e) the non-disclosure or misrepresentation of material facts. The reinsurer may seek to avoid the contract in such circumstances.

5.3 Managing agents should agree with prospective QQS reinsurers of their managed syndicates which levies, charges, costs and expenses reinsurers shall be liable to contribute to under the proposed QQS.

5.4 Managing agents should ensure that the terms of their proposed QQS contracts reflect the profitability of the business to be ceded under the contract.

US Funding Requirements

5.5 Managing agents 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.

RBC implications of use of QQS contracts for following years

5.6 Managing agents should note that although there are no capital implications for a ceding syndicate at the time of entering into a QQS arrangement, the additional QQS premiums will be taken into account in calculating the Risk Based Capital reserving risk on that syndicate year of account from the third year following the inception of the QQS contract. 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 2005 will impact their coming into line calculation for the 2007 year of account. Please contact the Market Risk and Reserving Unit if you require further clarification of this issue.

Commutation of QQS contracts

5.7 A QQS contract should only be commuted by the mutual agreement of the managing agent of the ceding syndicate and the QQS reinsurer. Managing agents should ensure the commutation of each QQS reinsurance is subject to (a) an external actuarial review beforehand and (b) the prior approval of the board of the managing agent.

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

5.9 The FPD will discuss with each managing agent that applies for approval of a QQS contract how it has addressed or proposes to address the issues referred to in paragraphs 5.1-5.8 above.

APPENDIX 2

LETTER OF CREDIT REQUIREMENTS FOR QUALIFYING QUOTA SHARE REINSURANCE CONTRACTS

1. Criteria for letters of credit

1.1 Where a letter of credit ("LOC") is required to support a qualifying quota share ("QQS") contract, the letter of credit 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.

1.2 Any whole account QQS contract that requires to be supported by a LOC must be arranged on (i) a funds withheld basis[1], or (ii) a funds disbursed basis[2]. Any QQS contract that is not a whole account QQS requires to be supported by a LOC that is calculated in accordance with the requirements paragraph 6.1 below.

2. Funds withheld basis of accounting

2.1 Where a whole account QQS contract is arranged on a funds withheld basis the value of the LOC shall be the higher of (a) the syndicate's Risk Based Capital ("RBC") ratio applied to the total gross premiums that is expected to be ceded under the QQS contract, and (b) the minimum funds at Lloyd's requirement. The LOC shall be maintained at this value for the duration of the QQS contract.

2.2 Each managing agent of a ceding syndicate shall notify Lloyd's Head of Underwriting & Business Plan Review in the event that it appears likely that the ceding syndicate will sustain losses that will exhaust the funds withheld from the reinsurer under a QQS contract and exceed in monetary terms the value of the reinsurer's RBC related LOC.

3. Funds disbursed basis of accounting

3.1. Where a whole account QQS contract is arranged on a funds disbursed basis, then the value of the LOC shall be equivalent:

(a) at the inception of the contract, to the higher of the ceding syndicate's RBC ratio applied to the total gross premium that is expected to be ceded under the QQS contract and the minimum funds at Lloyd's requirement.

[1] i.e. where the syndicate retains the QQS premiums until the conclusion of the contract.
[2] i.e. where the syndicate pays over premiums to the QQS reinsurer on a periodic basis during the contract term

(b) at all times from the end of the first quarter in the first calendar year of the contract, to the SUM of:

   (i) the higher of the ceding syndicate's RBC ratio applied to the total gross premium that is expected to be ceded under the QQS contract and the minimum funds at Lloyd's requirement; PLUS

   (ii) the net amount disbursed by the ceding syndicate that is attributable to the reinsurer under the QQS contract, i.e., signed premiums less paid claims; PLUS

   (iii) any paid losses still to be recovered from the reinsurer ("unrecovered paid losses") and noted outstanding claims attributable to the reinsurer in excess of 100% of the cumulative net[3] premium paid to the reinsurer under the QQS contract.

(c) at all times from the end of the first calendar year, to the SUM of:

   (i) the higher of the ceding syndicate's RBC ratio applied to the total gross premium that is expected to be ceded under the QQS contract and the minimum funds at Lloyd's requirement; PLUS

   (ii) the net amount disbursed by the ceding syndicate that is attributable to the reinsurer under the QQS contract, i.e. signed premiums less paid claims); PLUS

   (iii) the balance of any unrecovered paid losses and noted outstanding claims and incurred but not reported ("IBNR") losses attributable to the reinsurer in excess of 100% of the cumulative net[4] premium paid to the reinsurer under the QQS contract,

SAVE that the value of the LOC shall never be less than the higher of the ceding syndicate's RBC ratio applied to the total gross premium that is expected to be ceded under the QQS contract and the minimum funds at Lloyd's requirement;

3.2 For the purposes of paragraph 3.1(c) (iii) above the ceding syndicate's IBNR losses shall be the IBNR losses shown for reinsured year of account of the ceding syndicate in its latest Syndicate Return.

Monitoring and revaluation of letters of credit

3.3. Where a QQS contract is arranged on a funds disbursed basis the managing agent of the ceding syndicate must calculate on a quarterly basis whether the LOC requires to be revalued in accordance with the requirements of paragraph 3.1 above.

3.4. Where a LOC requires to be revalued in accordance with the requirements of paragraphs 3.1. above, the reinsurer must lodge with the managing agent of the ceding syndicate a revised LOC within 90 days of the end of each quarter <u>BEFORE</u> that quarter's premiums are paid to the reinsurer.

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[3] i.e. net of paid claims.
[4] i.e. net of paid claims.

3.5. In the event that a reinsurer fails to lodge a revised LOC in accordance with requirements of paragraph 3.4 above, the ceding syndicate shall retain the premiums attributable to the reinsurer under the QQS contract and the contract shall be operated on a funds withheld basis from that point save that the existing value of the LOC shall be maintained until the commutation of the contract in so far as it is not reduced by draw downs in respect of unrecovered paid losses.

3.6 Each managing agent of a ceding syndicate shall notify Lloyd's Head of Underwriting and Business Plan Review immediately in the event that a reinsurer fails to lodge a revised LOC in accordance with requirements of paragraph 3.4 above, or it experiences any difficulty in respect of a LOC supporting a QQS contract under which its syndicate is reinsured.

4. Form of the letter of credit

4.1. Each LOC should be expressed to be for the benefit of the members of the syndicate year of account reinsured under the QQS contract.

4.2 It is recommended that all LOCs in respect of QQS contracts should follow the same form as LOCs provided by Lloyd's members in respect of their 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.

5. Duration of the letter of credit

5.1 The LOC should only be terminable by the agreement of the managing agent of the ceding syndicate upon the expiry of all liabilities reinsured under the QQS contract

6. Provision of letter of credit for non whole account reinsurances

6.1 Where the QQS is not a whole account QQS the Market Risk & Reserving Unit shall determine the appropriate RBC ratio for the purpose of the calculation to be made under paragraph 2.1 or paragraph 3.1 above.