

FROM: Head of Market Reporting EXTN: 5129
DATE: December 2004 REF: Y3474
SUBJECT: **CAPITAL TESTS REVIEW**
SUBJECT AREA(S): Coming-into-line and Release Test
ATTACHMENTS: Yes

ACTION POINTS: Members' agents and Direct Corporate Members to note
DEADLINE(S): Release Test and Coming Into Line from June 2005

The purpose of this bulletin is to advise that the Franchise Board has recommended that solvency surpluses transferred to members personal reserve funds be eligible for release of funds as well as meeting capital requirements.

This bulletin also sets out the refinements to 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 following consultation with the Lloyd's Market.

General

There is no change to the proposal that there will be a two way capital test applied to active capital test providers which will apply to both the Release Test and the Coming-into-Line exercise. A separate one way test will be applied to non-active capital providers which will apply a higher threshold for prudential reasons.

The headline proposals were issued in the market bulletin Capital Tests Review (ref:Y3372) dated 10 August 2004. Appendix 1 sets out the revised capital tests to be applied from 2005 onwards.

Open Year Surpluses

The Franchise Board has permitted managing agents to transfer syndicate PTF solvency surpluses (CSTs) from the 2002 and 2003 years of account into member level personal reserve funds (PRFs) for the purpose of meeting cash calls. To the extent that these CSTs have not been applied towards meeting cash calls they have been available towards meeting member's capital requirements. However, under the terms of the managing agent's agreement they are not available for release to members.

In order to address this the Franchise Board has recommended that the managing agent's agreement be varied to permit the release to members of surpluses on open years. It is expected that the Council will approve a form of variation for execution by managing agents and members / members' agents. The earliest that papers can be presented to Council is February 2005.

Changes to the managing agent's agreement will also facilitate the release of that part of the syndicate profit determined on an annual accounting basis which is attributable to an open year of account, following the move to annual accounting for financial years commencing on or after 1 January 2005. Amendments for that purpose can be made by byelaw (made no later than April 2005) with effect from 2006.

The Inland Revenue has confirmed that the release of CSTs will not accelerate taxation of profits.

Refinements

Active members

Active members will be subject to the ceased member capital test rules, where they reduce their capacity by more than 50%. Following consultation with capital providers, the previous threshold of 20% has been increased. The 50% level provides flexibility for capital providers to prudently re-arrange their portfolio during a downward turn in the underwriting cycle.

Where a ceased member has made funds inter-available to an active member the ceased member will be treated as active for release test purposes.

Ceased corporate capital test providers will be treated as active where they are part of an ongoing corporate group at Lloyd's and there is a cross deficit clause in place.

Ceased members

The Enhanced Capital Requirement (ECR) will be included in the capital test for ceased members. A 10% buffer will be applied to the RBC requirement or the margin of solvency within the Total Funding Requirement. If the ECR is driving the capital requirement then the 10% buffer will not be applied.

Frequency of the capital test exercise

The capital test for active members will be calculated twice a year in May / June and November. The capital test in May / June will require capital shortfalls to be made good earlier than at present. For ceased members there will be one capital test calculated in May / June.

The formal requirements to bring the new capital test rules into force will be issued in the New Year.

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

CAPITAL TEST 2005

		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	Full off set across ALL years of account & run-offs SEE NOTE 3	Full off set across ALL years of account & run-offs 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 SEE NOTE 3
3	Closed Year Losses	Included	Included
4	RBC (Member Individual Capital Assessment)	Included (see note 4)	Included (RBC for run-off's subject to multiplier of 3)
		OR	OR
5	Margin of Solvency	Included	Include (2.0 multiplier applied)
			OR
6	Enhanced Capital Requirement	Not Included	Included
7	FAL (net of Concentration of Asset restrictions) plus closed / open year profits	Included.	Included
8	Total Funding Requirement (TFR)	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	10% of RBC or margin of solvency (not applied if ECR > RBC or Margin of Solvency)
10	Surplus / shortfall (only surpluses released to members)	Sum of 7 minus 8	Sum of 7 minus 8 minus 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.		
	Note 3. Any surplus generated is not carried forward in solvency against closed year losses / member's margin within the solvency calculations		
	Note 4. RBC (member ICA) to be determined in conjunction with syndicate ICAs		