# Market Bulletin

LLOYD'S

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| FROM: | Director, Finance and Risk Management | EXTN: | 6711 |
| DATE: | 15 July 2005 | REF: | Y3594 |
| SUBJECT: | **2006 ICA Guidance and Instructions for Managing Agents of Run-Off Syndicates** | | |
| SUBJECT AREA(S): | 2006 ICA submissions | | |
| ATTACHMENTS: | | | |

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| ACTION POINTS: | |
| DEADLINE(S): | **30 September 2005** |

This bulletin and the attached Addendum apply to managing agents of run-off syndicates other than those managing agents of certain run-off syndicates which were required by Lloyd's to complete their ICA submissions in accordance with Market Bulletin Y3526 of 23 March 2005.

The attached Addendum sets out additional guidance and instructions for the completion of 2006 ICA submissions by managing agents of run-off syndicates and should be read in conjunction with the Guidance and Instructions on completion of 2006 ICA submissions by managing agents of active syndicates issued with Market Bulletin Y3526 on 23 March ("the Guidance").

**Key issues**

There are three key areas of difference between ICA submissions for active syndicates and most run-off syndicates, which are fully explained in the addendum. In summary, these differences are:

- Time horizon of calculation: managing agents of run-off syndicates must calculate capital adequacy over the period necessary to allow the agent to run-off the business to ultimate rather than over a twelve month period;
- Confidence level: Agents should normally calculate capital required to ensure that, at a confidence level of 97.5%, all liabilities of the syndicate could be met as they fall due;
- Discounting and asset returns: both can now be included in the ICA calculation.

It is not expected that these differences will create a material amount of extra work as against the 2005 soft-test, based on feedback from agents.

**Process**

Agents must have a comprehensive and robust process for production of the 2006 ICA submission and the submission should clearly describe and evidence the process. In particular, agents' attention is drawn to Bulletin Y3526, page 9, on Overall Calculation and

Approach, which sets out the need for an explicit link between the ICA calculation and the risk framework. Managing agents should in all cases follow the template for ICA submissions given in Section G of the Guidance.

**Deadline**

Managing agents must submit ICA submissions for syndicates subject to the requirements of this bulletin to Lloyd's by 12.00pm on 30 September 2005. Unlike the 2005 soft-test submission, this is part of a capital-setting exercise for 2006 and extensions to the deadline will not be granted. Please contact OYM promptly if you consider there is any risk of failure to achieve this deadline.

**Assistance**

Please do not hesitate to contact any of the key contacts identified in this bulletin should you need assistance or clarification. Queries on the ICA guidance and instructions generally can be addressed to Eric Allman (020-7327-6772) or Julia Davis (020-7327-6595) in Open Years Management.

Luke Savage
Director, Finance and Risk Management

## Additional ICA Guidance and Instructions for Managing Agents of Run-off Syndicates - Addendum to Market Bulletin Y3526

### Introduction

Market Bulletin Y3526 of 23 March 2005 sets out guidance and instructions ("the Guidance") to enable managing agents of active syndicates to produce ICA submissions. This addendum ("the Addendum") is intended to assist agents of most run-off syndicates to apply the Guidance when they are producing their ICA submissions for 2006. The Guidance is generally applicable to run-off syndicates, and managing agents are expected to follow it, except where the Addendum provides otherwise or the Guidance is inappropriate under the circumstances or the subject matter immaterial. Where a managing agent considers this to be the case, the agent should explain this clearly, with detailed reasons, in the ICA submission. Managing agents should note that the ICA submission template provided in Section G of the Guidance should be followed as far as possible in all cases.

Where the Guidance refers to documents which are not normally available to agents of run-off syndicates, agents should use the most relevant alternative, and explain clearly in the ICA submission what they have done. For example, managing agents of active syndicates base much of their insurance risk work in the ICA submission on the syndicate business plan. Managing agents of run-off syndicates do not prepare syndicate business plans and they may need to consider whether it is necessary or appropriate to use actuarial reports and internal reporting on reserves to address insurance risk in their ICA submissions.

### Definition of inactive run-off syndicate

Run-off syndicates fall into two categories, as follows. *Active run-offs* are those where the capital support includes a substantial element also supporting syndicates still underwriting in the Market. Such syndicates must complete their ICA submission in accordance with the Guidance and to the same deadline as active syndicates, to enable their members' ongoing capital requirements to be calculated, i.e. so that members can come into line. *Inactive run-offs* are those where most members are no longer underwriting anywhere in the Lloyd's Market. In general, where the active members are names or small corporates, even if the overall proportion of capital is material, the run-off syndicate will be regarded as inactive. The Addendum addresses only inactive run-off syndicates, as active run-off syndicates are required to comply with the Guidance and so have already made their 2006 ICA submissions.

### Standards

The 2006 ICA process is an essential element of Lloyd's compliance with the FSA's Individual Capital Adequacy Standards regime and also of Lloyd's management of the Franchise through capital setting. It is essential that managing agents complete their ICA submissions to a high standard in accordance with both the Guidance and this Addendum. However, Lloyd's does not intend to place unnecessary costs on run-off syndicates and managing agents are encouraged to consider carefully the need to undertake extensive exercises as part of the ICA process if more economic alternatives exist. OYM is willing to discuss such options with managing agents.

**Time Horizon of Calculation and Confidence levels**

Managing agents should calculate the capital required to ensure that, at the 97.5% confidence level, all liabilities could be paid as they fall due. Future liabilities should include claim payments, future expenses and future reinsurance costs on an ultimate basis. Where run-off syndicates are still exposed to multi-year policies, binding authorities or service agreements, the ICA must consider all such business written over the next 5 years, allowing for the market cycle. A sophisticated multi-year capital model will generally not be considered necessary for this aspect of a run-off syndicate's ICA.

If a managing agent believes that a run-off syndicate will be run-off to expiry, that is, all its liabilities extinguished, in less than five years even in adverse circumstances, a confidence level other than 97.5% may be appropriate and the agent should contact Open Years Management as soon as possible.

Allowance may be made for asset returns over the payment period, and these should be assessed allowing for asset and timing risks (to the extent that these are not included in the non-insurance headings of the ICA). Where such allowance has been made the ICA should state the assumed asset returns / discount rates over the payment period

In choosing an appropriate level of future asset returns (or discount rates) the agent should have regard to the prospective returns on the underlying assets used to match the liabilities. A fixed rate of return would not be unreasonable, but agents should also consider the appropriateness of varying this according to duration of the liabilities. A stochastic asset model may be appropriate for certain asset portfolios, but is not mandated. Due regard must also be given to any linkage with the market risk component of the ICA submission.

In order to assist Lloyd's in the production of its own 'Society ICA' agents should be prepared to give Lloyd's additional capital requirements at alternative percentile levels (other than 97.5%), although these are not explicitly required for inclusion in the ICA submission.

**Basis of run-off modelling**

In order to ensure that ICA calculations are based on reasonable and consistent assumptions, it is expected that agents' underlying models will provide for run-off of the syndicate's underwriting business to natural expiry, with risks running over the same period. Agents should not, for this purpose, assume that open years of account will be reinsured to close and managing agents should not include in the ICA submission any element of risk premium that they anticipate may be payable as a cost of reinsurance to close.

**Closure of open years**

Where a syndicate year of account is expected to close as at the date of the ICA, i.e. 31 December 2005, then a separate ICA will not be needed, although the risks run by the closing syndicate must be included in the ICA submission of the accepting syndicate. The grounds for believing that closure will occur must be compelling and the agent must submit an explanation in writing, in sufficient time to allow an ICA to be prepared, should Lloyd's disagree. An ICA will be required as a matter of high priority should closure fail to occur.

**Risk Framework**

The Guidance explicitly requires that agents' ICA submissions clearly demonstrate the link between their risk framework and ICA calculation. Very few agents of run-off syndicates provided this information in the 2005 ICA soft-test. This part of the Guidance applies equally to inactive run-off syndicates. Lloyd's expects that agents will, as a minimum, include a full copy of their risk register and explain how each risk in it impacts the ICA. Lloyd's is willing to discuss modifying this requirement where an agent can show that it is unreasonably onerous.

**Modelling and stress testing**

As with the 2005 ICA soft-test, it is recognised that agents may not consider it appropriate or cost-effective to implement sophisticated stochastic modelling for small inactive run-off syndicates. In such cases, managing agents will need to submit stress test-only ICAs. It is also recognised that standard RDS scenarios may not be appropriate for run-off syndicates, as the risk of occurrence of sufficiently large losses may be extremely small. Agents should therefore include such RDS scenarios, possibly of their own design, as are appropriate to the business and the required risk tolerance. Lloyd's recognises that it may be appropriate not to supply any RDS scenarios in some cases. A detailed explanation should be given in the ICA submission of the reasons for variance from the requirements of the Guidance.

**Other issues arising from previous ICA process**

In addition to those matters raised in the Guidance, there are some run-off specific issues that agents should consider when completing their 2006 ICA submissions.

***Reserving risk***

This is usually by far the largest component of the ICA of inactive run-off syndicates and the submission should address this risk to the standard required by the Guidance. In addition, agents should give a clear and detailed description of the level of prudence in their current reserves. The required confidence level is 97.5% and ICA submissions should reflect that; there is no value in additional prudence in the ICA, if it already meets the required standards.

***Outsourcing***

Outsourcing is an important feature of many run-offs. Managing agents tend to outsource key functions to authorised run-off service providers more extensively than is usual in the active market. ICA submissions for inactive run-off syndicates should reflect the managing agent's consideration of this risk in a number of ways. In particular, the ICA should address the risk of the service provider failing to deliver as agreed, risk of failure or withdrawal from the market by the service provider and credit risk, where the service provider holds funds. Managing agents should not consider that this list is exhaustive and should ensure that any other risks which they identify as arising out the outsourcing of key functions are also addressed.

***New Central Fund***

Certain corporate members are unable to meet cash calls made on them by managing agents of the syndicates on which they participate because they have exhausted their funds at Lloyd's. In such cases, the members may have the benefit of an undertaking from the New Central Fund to meet the members' underwriting liabilities up to a certain amount over a certain specified period of time. It is not considered that there is any perceptible credit, liquidity or other risk arising from this circumstance and there should not normally be any impact on the ICA submission.

***2005 ICA Soft-Test feedback***

Feedback on the 2005 ICA soft-test was provided to all agents in letters from Luke Savage in May and July 2005. 2006 ICA submissions should include a section explaining how agents have addressed the issues raised in that feedback.

***Negative ICA components***

Some ICA submissions included elements reducing the overall amount of the ICA. Lloyd's considers that such circumstances should be rare and when occurring, should be fully explained in the ICA submission, together with the net impact on the ICA. Where negative elements arise from incorrect reserving, the error should be corrected prior to calculation of the ICA.

**2006 ICA process for active syndicates**

From our review of a number of ICA submissions to date, it is clear that far more information has been provided than for the 2005 soft-test and that a much greater level of consistency of submissions has been achieved. In some cases however, it has been difficult for us to connect clearly the overall conclusion of the ICA work (in terms of the ICA value) to the detailed work contained in the submission. This has resulted in increased work for Lloyd's to identify the relevant material as well as potentially unnecessary questions being raised to managing agents.

It is possible that sufficient relevant information is usually included in the papers received, but in order to streamline the work being carried out, we request that managing agents provide us with a summary mapping of their ICA value. This mapping should show an audit trail of the constituent parts of the ICA number back to the justification and rationale for conclusions reached, and where they can be found in the submission. This mapping should take the form of a 1-2 page summary breaking down the elements of the ICA value and showing the relevant sections or page numbers where the detailed work can be found.

We consider that compliance with this request will significantly improve the response time and value to agents of Lloyd's review of ICA submissions.

**Contact details in Open Years Management**

Steve McCann , Head of Open Years Management

020-7327-5984
steve.mccann@lloyds.com

Eric Allman

020-7327-6772
eric.allman@lloyds.com

Julia Davis

020-7327-6595
julia.r.davis@lloyds.com