MARKET BULLETIN

REF: Y4396

Title	Financial Guarantee Insurance, Contract Frustration, Trade Credit and related classes
Purpose	To update Lloyd's requirements in respect of Contract Frustration and Trade Credit insurance and to consolidate Lloyd's requirements in respect of the underwriting of Financial Guarantee insurance (which includes Contract Frustration, Trade Credit and related classes).
Type	Event
From	Tom Bolt, Performance Management Director
Date	7 May 2010
Deadline	Immediate
Related links	

Market Bulletin Y3991 of 30 March 2007 set out the provisions and requirements relating to the underwriting of Contract Frustration and Trade Credit business at Lloyd's. Recent events have shown a need for some revision to these provisions and requirements. This bulletin contains those revisions.

This bulletin also takes the opportunity to consolidate Lloyd's requirements in respect of the underwriting of Financial Guarantee insurance and its exempted classes, which includes Contract Frustration and Trade Credit. It is clear that Lloyd's requirements in this area are causing some confusion as they are spread across several bulletins, a number of which are now out of date. We have therefore brought the various requirements into a single bulletin. Except in relation to Contract Frustration and Trade Credit, the intention at this stage is merely to consolidate and simplify the earlier bulletins without making any material changes to the existing position.

Finally, this bulletin includes a statement of best practice for the handling of claims in respect of Political Risk and Credit risks (see below).

This bulletin applies with immediate effect and replaces the previous bulletins dealing with Financial Guarantee insurance and its exempted classes. In particular it replaces Market Bulletins Y3226 and Y3991. Where permissions or dispensations have previously been given, they remain in place subject to being reviewed in the ordinary course of the business plan approval process.

Financial Guarantee Insurance

In view of the risk that Financial Guarantee insurance creates for the market, and subject to the usual requirements for business plan approval, no managing agent may enter into a contract of Financial Guarantee insurance (as defined below) on behalf of a syndicate under its management unless either:

- The contract falls within one of the "exempted classes" as set out in Appendix 1 and the associated definitions set out in Appendix 2 and the principles contained in Appendix 3 are complied with; or

- The contract has been specifically approved by Underwriting Performance.

Managing agents seeking approval to write Financial Guarantee insurance which does not fall within one of the "exempted classes" should discuss their proposals with their account executive in the Underwriting Performance team as part of the business planning process.

Where a managing agent is considering a risk but is uncertain as to whether it falls within the definition of Financial Guarantee insurance or one of the exempted classes, it should discuss it with its account executive in the Underwriting Performance team.

Premium Income Limits

The Performance Management Directorate will consider all business plans that propose to include Financial Guarantee insurance (including the exempted classes) individually. By way of general guidance it is unlikely that business plans will be approved where the income arising from the "exempted classes" amounts to more than 2% of syndicate allocated capacity other than trade credit business where the relevant percentage figure is 5%, i.e. 7% in total.

Definition of Financial Guarantee Insurance

Financial Guarantee insurance is defined as contracts of insurance (which includes any indemnity, guarantee, bond, contract of surety or other similar instrument, and references to "insurance" includes reinsurance) where the insurer agrees to indemnify the insured against loss or pay or otherwise benefit the insured in the event of:

(i) the financial failure, default, insolvency, bankruptcy, liquidation or winding up of any person whether or not a party to the contract of insurance; or

(ii) the financial failure of any venture; or

(iii) the lack of or insufficient receipts, sales or profits of any venture; or

(iv) the lack of or inadequate response or support by sponsors or financial supporters; or

(v) a change in levels of interest rates; or

(vi) a change of rates of exchange of currency; or

(vii) a change in the value or price of land, buildings, securities or commodities; or

(viii) a change in levels of financial or commodity indices; or

(ix) any liability or obligation under an accommodation bill or similar instrument.

Political Risk & Credit Claims Statement of Best Practice

Following discussions between managing agents, the LMA and Lloyd's, a Statement of Best Practice has been developed for the handling of political risk and credit claims, in conjunction with the applicable Lloyd's Claims Scheme. Lloyd's supports this Statement of Best Practice, which is consistent with Lloyd's Claims Management Principles and Minimum Standards and is appended at Appendix 4.

In any reviews of managing agents' claims handling by Lloyd's, including when assessing whether managing agents meet Lloyd's Claims Management Principles and Minimum Standards, Lloyd's will have regard to this Statement of Best Practice.

Further Information

Enquiries in relation to this bulletin or to any other aspect of Financial Guarantee business at Lloyd's, exempted or otherwise, should be directed to Judy Knights (judy.knights@lloyds.com or 020 7327 5595) or Bill Rendall (bill.rendall@lloyds.com or 020 7327 5188). Any request for dispensation in relation to the requirements of this bulletin should be made to the managing agent's usual Underwriting Performance account executive.

Tom Bolt
Performance Management Director

Appendix 1

Definitions of the Exempted Classes

Terms shown in italics are defined in Appendix 2 to this bulletin.

1 Contract Frustration (Risk Code "CF")

1.1 Contract Frustration insurance indemnifies an insured for loss under:

(i) a specified contract or contracts for the sale, purchase, lease or delivery of assets, goods or services; or

(ii) an agreement which relates directly to the financing of such specified contract(s); or

(iii) an agreement concerning financing which is secured against assets, goods or services and/or payment for assets, goods or services due under a specified contract or contracts, or where repayment is to be effected by the sale or receipts of such goods or services, or assets, royalties or other specified receivables; or

(iv) a *Bond* or *Bonds* provided in accordance with the terms of a specified contract, tender document or project;

1.2 due directly to one or more of the following perils:

(i) a *Political Force Majeure* event; or

(ii) an event resulting directly or indirectly from the actions, inactions and/or default, of a *Supra-National Authority*, or *Government Entity*, including the inability to make a currency conversion and/or exchange transfer. Such actions may also include default of a *Government Entity* which is guaranteeing the performance of either another *Government Entity* or of a *Commercial Organisation.*

1.3 Contracts that are permissible within section 1.1 may also include *Bonds* which are provided in connection with eligible contracts, concession agreements and *Project Finance*. However, coverage for such contracts may, where appropriate, be provided by policies which are classified as other classes of business subject to compliance with any requirements in relation to those classes.

1.4 For a contract to be eligible for inclusion under 1.1 (iii) above it must:

(i) directly finance a specified trade contract; or

(ii) be repaid from identified and assigned or assignable trade flows; or

(iii) be secured upon identified collateral or assets.

1.5 Under no circumstances should Contract Frustration policies cover:

(i) Contracts for which the purpose is the provision of working capital or general corporate lending unless such contracts fall within the provisions of 1.1 above; or

(ii) *Acquisition Finance*; or

(iii) *Sovereign Lending*; or

(iv) Currency fluctuations and/or devaluations.

1.6 Insureds acting in a lending capacity may also be indemnified under Contract Frustration insurance where they are the beneficiary of a policy protecting against *Lender's Interest* risks in accordance with the provision set out in the definition of *Lender's Interest* in Appendix 2, paragraph 7.

1.7 Contract Frustration insurance may cover currency inconvertibility and/or exchange transfer risks when there is no specified contract of sale, purchase, lease or delivery of goods, assets or services. However such cover shall not be designed or intended to be used for the purpose of currency speculation or trading. Except where the risk is Trade Credit, any section of a policy that covers currency inconvertibility and/or exchange transfer risks shall be considered as Contract Frustration insurance.

1.8 Where the currency of the insurance policy and the currency of the specified contract(s) are different, underwriters shall establish the mechanism by which the applicable rate of exchange to be used for the calculation of an insured loss will be determined.

2 <u>Trade Credit (Risk Code "CR")</u>

2.1 Trade Credit insurance indemnifies an insured for loss under:

i) a specified contract or contracts for the sale, purchase, lease or delivery of assets, goods or services; or

ii) an agreement which relates directly to the financing of such specified contract(s); or

iii) an agreement concerning financing which is secured against assets, goods or services and/or payment for assets, goods or services due under a specified contract or contracts, or where repayment is to be effected by the sale or receipts of such goods or services, or assets, royalties or other specified receivables; or

iv) a *Bond* or *Bonds* provided in accordance with the terms of a specified contract, tender document or project;

due directly to the actions, inactions and/or default by a *Commercial Organisation*.

2.2 Contracts that are permissible within section 2.1 may also include *Bonds* which are provided in connection with eligible contracts, concession agreements and *Project Finance*. However, coverage for such contracts may, where appropriate, be provided by policies which are classified as other classes of business subject to compliance with any requirements in relation to those classes.

2.3 For a contract to be eligible for inclusion under 2.1 (iii) above it must

(i) directly finance a specified trade contract; or

(ii) be repaid from identified and assigned or assignable trade flows; or

(iii) be secured upon identified collateral or assets.

2.4 Under no circumstances should Trade Credit policies cover:

(i) Contracts made by the insured with private individuals (other than sole traders operating in their business capacity); or

(ii) *Mortgage Finance Insurance*; or

(iii) Contracts for which the purpose is the provision of working capital or general corporate lending unless such contracts fall within the provisions of 2.1 above; or

(iv) *Acquisition Finance*; or

(v) Currency fluctuations and/or devaluations (but see the provisions of 1.7 above)

2.5 Where the currency of the insurance policy and the currency of the specified contract(s) are different, underwriters shall establish the mechanism by which the applicable rate of exchange to be used for the calculation of an insured loss will be determined.

2.6 Insureds acting in a lending capacity may also be indemnified under Trade Credit insurance where they are the beneficiary of a policy protecting against *Lender's Interest* risks in accordance with the provision set out in the definition of *Lender's Interest* in Appendix 2, paragraph 7.

<u>Application of risk codes</u>

Where financial default and insolvency is a covered cause of loss under policies described in section 1 and 2 above, underwriters must apply the appropriate CF and CR risk codes according to whether the obligor is considered to be public or private and give proper consideration to the appropriate apportionment of premium in respect of any policy which covers both Contract Frustration and Trade Credit perils.

3 <u>Mortgage Indemnity Insurance (Risk Code "FM")</u>

Mortgage Indemnity Insurance indemnifies a bank or other lender who has provided a loan to a borrower only where the loan is used to purchase a commercial or residential property (which shall mean a building and not, for example, a ship or aircraft) and where this property is mortgaged to the bank or lender as security for the loan. Mortgage Indemnity Insurance responds if a shortfall remains between the amount of the loan and the proceeds realised from disposal of the mortgaged property following repossession.

4 Surety Bond Reinsurance (Risk Code “SB”)

4.1 Surety Bond Reinsurance indemnifies a surety bond provider against the failure by the party (obligor) whose contractual obligation is the subject of the surety bond to execute a specified contractual obligation to the third party (obligee) identified on the surety bond.

4.2 Lloyd’s underwriters’ participation in such business is limited to the reinsurance of non-Lloyd’s entities which are licensed surety bond providers.

5 Salvage Guarantee Insurance

Collision, salvage and general average guarantees indemnify against the failure of a guarantor to perform its obligations under various forms of marine guarantees.

Appendix 2

Definitions of Italicised Terms used in Appendix 1

1. Political Force Majeure

Riots, strikes, civil commotions, malicious damage, sabotage, terrorism, war, invasion, acts of foreign enemies, hostile action by national or international armed forces (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power, or other similar events.

2. Supra-National Authority

A multi-national (also known as a "multilateral") institution (e.g. the United Nations, the International Monetary Fund or the European Union) which has a ruling body whose controlling interest is held by government ministers, or formally appointed representatives, of member states.

3. Government Entity

A "Government Entity" must conform to at least one of the following criteria:

(i) a Central Government or a Ministry, Department or Agency thereof (hereinafter referred to as "Government");
(ii) a Regional or Local Authority or a Department or Agency thereof (hereinafter referred to as "Local Authority");
(iii) a Nationalised Undertaking, including a Public Corporation or a State Trading Organisation or an entity in which the Government of the country(ies) concerned or Local Authority(ies) retain(s) a controlling interest or a majority shareholding; or
(iv) a central bank or other equivalent monetary authority.

In the event of a Government Entity obligor ceasing to conform to one of the above criteria during the currency of the policy period, then underwriters may maintain coverage on original terms and conditions at their sole discretion until the expiry of the original policy.

4. Sovereign Lending

Any loan or other transaction or activity for the provision of finance and any guarantee or indemnity in respect of such transaction or of any other financial obligation into which a *Government Entity* enters other than for an identified trade or *Project Finance* or which is secured upon a commodity, asset, royalty or other specified receivable.

5. Project Finance

The provision of any loan or an agreement concerning financing for a specific project.

6. Commercial Organisation

Limited companies, public limited companies, partnerships, and sole traders, which may include banks or financial institutions, but none of the foregoing may include a Government Entity.

7. Lender's Interest

Lender's Interest insurance shall be limited to a Policy which indemnifies against default or non-(re)payment by a *Commercial Organisation* on a loan, whether or not there is a specified trade contract, where the default or non-(re)payment is directly caused by one or more of the following perils:

(i) an expropriatory act;

(ii) arbitration award default where the award is to remedy an insured expropriatory act or licence cancellation;

(iii) a *Political Force Majeure* event;

(iv) prevention of currency conversion and/or exchange transfer;

(v) embargo/licence cancellation;

(vi) other Contract Frustration perils as may be agreed.

However, Lender's Interest policies must not cover non-performance by the borrower or non-payment of the loan except where the non-performance or non-payment directly arises from the perils specified above.

Underwriters should give proper consideration to the risk coding of business written. In particular, currency inconvertibility/exchange transfer exposures should be coded “CF”. However, this shall not preclude the use of the applicable risk codes for the other perils mentioned above.

8. Bonds

For the purposes of Contract Frustration and Trade Credit insurance as set out in Sections 1 and 2 of Appendix 1, bonds shall be defined as guarantees, including on demand bank guarantees and standby irrevocable letters of credit issued or counter-guaranteed by banks, guaranteeing the performance of specified obligations of an insured in favour of another party to whom the obligations are owed under the terms of the contract or tender to contract.

9. Acquisition Finance

A loan or other form of funding for the purchase of shares or other ownership interest in a company or business for which the anticipated principal method of repayment arises from the revenues and/or assets of the acquired entity.

Appendix 3

Principles for Exempted Classes

All policies which fall within the scope of the exempted classes as set out in Appendix 1 should include in the policy wording terms which meet the following requirements. Managing agents should only omit or vary terms to this effect if they have received approval to do so through the business planning process.

1 Assignment of Policy

All policies should contain a condition that only allows assignment of the policy with the prior written agreement of underwriters. Where assignment of a policy does take place, the obligations placed upon the original insured by the terms of the policy should be transferred so that they become obligations of the assignee.

It is acceptable to allow for the proceeds of a policy to be paid to a third party provided that the obligations on the insured under the terms of the policy remain with the insured.

2 Insolvency of the Insured

All policies should contain an exclusion in respect of any loss arising from the insolvency of the Insured or, in the case of *surety bonds*, the obligee.

3 Fraud

All policies should contain a clause to the effect that the policy will become void, and all claims thereunder will be forfeited, if the insured has made any material statement, report, application or claim, where the Insured knew that the statement, report, application or claim was false or fraudulent.

4 Nuclear, Biological, Chemical and Radioactive Contamination

All policies should contain an exclusion in respect of any loss arising from or contributed to by the use of nuclear, biological, chemical weapons and radioactive contamination.

Appendix 4

POLITICAL RISK & CREDIT CLAIMS STATEMENT OF BEST PRACTICE

Applicable to PR, CF and CR risk codes

The Lloyd's leader must ensure that other Lloyd's agreement parties are advised, including XCS in order that they may advise the following market

	SITUATION	ACTION (CF, CR RISK CODES)	ACTION (PR RISK CODE INCLUDING CEND & AIRCRAFT REPO)
1	**The insured notifies of a possible claim or circumstance that may give rise to a claim**	• Monitor • Advise other Lloyd's agreement parties including XCS • In the event of insolvency advice is to be immediate	• Monitor • Advise other Lloyd's agreement parties including XCS • In the event of CEND advice is to be immediate
2	**Waiting Period is triggered**	• Monitor • Advise other Lloyd's agreement parties including XCS • Where Waiting Period is less than 180 days, advice is to be immediate	• Monitor • Advise other Lloyd's agreement parties including XCS • Where Waiting Period is less than 180 days, advice is to be immediate
	Waiting Period is less than 180 days, or 180 days or more but 50% eroded	• Claim agreement parties (CAP) to determine coverage and communicate reserving and recovery strategy to followers • Include Loss Adjuster, Legal Team, Recovery Agent as applicable	• Claim agreement parties (CAP) to determine coverage and communicate reserving and recovery strategy to followers • Include Loss Adjuster, Legal Team, Recovery Agent as applicable
3	**Recovery prospects**	• Determine recovery strategy at the time of reserving if possible and communicate to CAP	• Determine recovery strategy when reserving & communicate to CAP
4	**Waiting Period expired and claim validated**	• Pay & initiate recovery procedure • Provide regular updates to the following market through XCS unless and until recoveries are exhausted	• Pay & initiate recovery procedure • Provide regular updates to the following market through XCS unless and until recoveries are exhausted