LLOYD'S

MARKET BULLETIN

REF: Y4511

Title	U.S. Reinsurance – reduced collateral arrangements in New York
Purpose	Lloyd's has recently been approved under New York credit for reinsurance rules which permit financially strong reinsurers to post reduced collateral. This bulletin sets out how this will work in practice, outside of the multi-beneficiary trust funds which support Lloyd's reinsurance accredited status in all U.S. states
Type	Annual
From	Rosemary Beaver, Head of International Regulatory Affairs
Date	19 August 2011
Deadline	Ongoing responsibility
Related links	Link to New York Credit for Reinsurance Rule

Introduction

This bulletin is addressed to all Lloyd's market stakeholders dealing with the placement, underwriting, settlement and regulatory reporting of Lloyd's U.S. reinsurance business. It is further to Lloyd's market bulletin Y4508 issued on the 28 July 2011 in relation to Lloyd's approval under the New York credit for reinsurance rules to post reduced collateral in respect of future U.S. reinsurance contracts with New York domiciled cedants.

Lloyd's approval will give Lloyd's syndicates the option to reduce the collateral required from 100% to 20%[1] of gross liabilities on reinsurances of U.S. cedants domiciled in New York. This option applies to prospective business only (new/renewal) and is effective immediately, providing Lloyd's syndicates with the opportunity to post reduced collateral where commercially acceptable and practical for the parties to the reinsurance with respect to policies incepting on or after 1 January 2011[2].

This bulletin sets out the key considerations in respect of reduced collateral; contract negotiation and communications with the cedant; contract wording; slip requirements and processing and Lloyd's reporting requirements.

[1] This reduction is based on Lloyd's current financial strength ratings, which at the date of this bulletin, were an A rating from A.M. Best and A+ ratings from Fitch Ratings and Standard & Poor's. Please note that this may vary in the event of an upgrade or downgrade.

[2] Lloyd's approval is backdated to 1 January 2011

Background

Following debate on the issue for many years, New York and Florida have taken the lead in passing legislation to enable reform of reinsurance collateral rules in their states. Regulators in New Jersey and Indiana have also been proactive in amending their rules.

In determining whether U.S. cedants domiciled in their states should be allowed full credit for reinsurance under their reduced collateral rules, New York and Florida regulators consider certain factors relating to the reinsurer's financial strength and the adequacy of its domiciliary regulator. The rules then restrict the level to which collateral may be reduced based upon the financial strength ratings of the reinsurer received from an approved rating agency. Earlier in the year, Lloyd's submitted its application to the New York Insurance Department and, based on Lloyd's current financial strength ratings, the application has now been approved, giving Lloyd's syndicates the option to reduce the collateral required on reinsurances of New York cedants from 100% to 20% of gross liabilities[3].

It is important to note that reinsurance contracts subject to reduced collateral will be funded outside of Lloyd's Credit for Reinsurance Trust Fund (CRTF) and Lloyd's Credit for Reinsurance Joint Asset Trust Fund (CRJATF) trust arrangements and that the cedant will not therefore be a beneficiary of the CRTF and CRJATF with respect to the reduced collateral contract.

Lloyd's syndicates may however, continue to fund reinsurance contracts issued to New York cedants through the current CRTF arrangements, at 100% of gross liabilities, where this is commercially preferable to the parties to the reinsurance.

Key features of the reduced collateral rule

The following are the key features of Lloyd's reduced collateral approval. Appendices detail the considerations where Lloyd's underwriters are seeking to use the reduced collateral arrangements in New York, including contract language to enable underwriters and brokers to ensure that reduced collateral contracts address requirements under the New York rules.

1. **Key considerations:**

   1.1. The contracts subject to reduced collateral apply to a U.S. cedant domiciled in the state of New York. It is not possible to use reduced collateral rules for multi-state contracts which include cedants domiciled in states not subject to reduced collateral (or states where Lloyd's is not approved to post reduced collateral under their rules). In these circumstances, multi-state contracts remain subject to 100% funding under Lloyd's CRTF.

   1.2. This rule applies across all classes of reinsurance business (facultative and treaty, both proportional and non-proportional) in respect of New York domiciled cedants.

   1.3. The rule applies to prospective business only (new/renewal) and is effective immediately with respect to open market business incepting on or after 1 January 2011.

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[3] For details of ratings and levels of collateral allowed, please see link to New York Credit for Reinsurance Rule

1.4. The use of reduced collateral is available to Lloyd's syndicates on reinsurance contracts regardless of the size of Lloyd's line, and it is permissible to participate on placements with other <u>non-Lloyd's</u> reinsurers who fund at different levels and/or use alternative forms of collateral.

1.5. However, a single funding level must apply to the whole of the Lloyd's placement (leader and followers) including multiple layers placed on the same contractual document and therefore the use of reduced collateral will need to be agreed and understood by all Lloyd's leaders and followers subscribing to any of the layers of the reinsurance contract.

1.6. The contracts subject to reduced collateral must be funded by Lloyd's syndicates on a cedant and contract-specific basis where security will be provided to the cedant in the form of letters of credit or Regulation 114 trusts, outside of the CRTF/CRJATF, to permit credit for reinsurance to be taken.

1.7. Managing agents and brokers should be very clear in their communications with cedants that this collateral will be provided entirely separately from the Lloyd's CRTFs and CRJATF.

1.8. Since reduced collateral contracts will not be funded in the CRTFs, Lloyd's syndicates will not be considered authorized reinsurers with respect to reduced collateral contracts. Lloyd's underwriters should take this into consideration when negotiating the terms of their reinsurance contracts.

2. Contract Wording requirements (See Appendix A):

2.1. Lloyd's has created sample language specifically for contracts subject to reduced collateral. Underwriters should include this or similar language in the reduced collateral contract to avoid any confusion and ensure that the funding arrangement is clear to all parties.

2.2. Lloyd's U.S. reinsurance contracts utilising the reduced collateral rules in New York must also contain mandatory contract disclosures.

3. Slip requirements and processing (See Appendix B):

3.1. Lloyd's reinsurance contracts subject to reduced collateral will receive the U.S. Classification "U.S. Reinsurance" on the Market Reform Contract (MRC).

3.2. Reduced collateral contracts will be Foreign Insurance Legislation (FIL) coded by Xchanging using the same FIL codes applied to all other U.S. reinsurance business.

4. Lloyd's reporting requirements (See Appendix C):

4.1. Lloyd's managing agents will be required to report business subject to reduced collateral and in the event of a claim, where collateral has been posted, the amount of collateral posted within the Lloyd's CRTF U.S. reporting returns.

4.2. Form 2 of the Lloyd's CRTF U.S. reporting return allows Lloyd's syndicates to include a credit against reserves to ensure that the trust funds required are net of the reserves funded by the collateral provided directly to cedants.

4.3. Lloyd's syndicates are required to complete a memo note in the U.S. reporting pack in respect of the reduced collateral cedant contracts detailing the name of the cedant, the cedant's state of domicile, the value of collateral provided to the cedant at the 20% funding rate and the reserves funded by the collateral.

5. Facilities to arrange letters of credit with Citibank (See Appendix D):

5.1. Lloyd's has an existing facility available to managing agents with Citibank where collateral in the form of letters of credit issued to the cedant can be arranged by Lloyd's Settlement and Trust Fund Office (STFO) for the lead and following subscribing syndicates on risk, using LDTF assets.

Next steps

Lloyd's objective remains the wholesale removal at federal level of discriminatory collateral requirements for non-U.S. reinsurers. This could be accomplished through the pre-emption of state collateral requirements through specific powers conferred on the new Federal Insurance Office (FIO) by the Dodd-Frank Act.

Lloyd's approval in New York followed consultation with the Lloyd's market which confirmed that state level reduced collateral could provide commercial advantages but only where this did not require significant changes to current Lloyd's market processes supporting Lloyd's CRTF arrangements.

Lloyd's will continue to track developments in other states and has since made an application to Florida Insurance Department seeking approval enabling Lloyd's syndicates the option to post reduced collateral on reinsurances of Florida based cedants. Lloyd's will advise the outcome of this application and, working with the market, review where similar applications can be made in other states where this might be commercially advantageous.

Further information

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Appendix A

Contract wording requirements -

Lloyd's U.S. reinsurance contracts utilising the reduced collateral rule in New York must contain mandatory contract disclosures (see below). These include contract provisions covering service of suit, law and jurisdiction and a suitable insolvency clause (as is already the case with Lloyd's U.S. reinsurance contracts funded at 100% in the CRTF). Lloyd's underwriters may continue to use a service of suit clause (in the form of NMA 2974 (Service of Suit Clause (USA)), or equivalent, which also covers jurisdiction, i.e. a separate jurisdiction clause is not required.

Service of Suit (125.4(h)(6)(iv)(b))

> *(b) requires any unauthorized assuming insurer to designate a person in this State or the state of domicile of the ceding insurer as its true and lawful agent upon whom may be served any lawful process in a dispute, action, suit, or proceeding instituted by, or on behalf of, the ceding insurer*

Jurisdiction (125.4(h)(6)(iv)(d)(1))

> *(d) includes the following provisions:*
>
> *(1) "Any dispute, suit, action or proceeding under the contract, or any dispute, suit, action or proceeding arising out of, directly, indirectly, or incidentally, or related to the contract or of the transactions and actions arising from performance of the contract are to be subject to the jurisdiction, and resolved in the courts, of the United States or any state thereof, and that the assuming insurer submits to the personal jurisdiction of such court, complies with the requirements necessary to give that court jurisdiction, abides by the final decision of that court or of an appellate court in the event of an appeal, and consents to any effort to enforce the final decision of the court in the home jurisdiction of the alien assuming insurer, including the granting of full faith and credit or comity in the home jurisdiction of the assuming insurer or any other jurisdiction where the assuming insurer is subject to jurisdiction. This provision does not override an agreement between the ceding insurer and the unauthorized alien assuming insurer to arbitrate, in accordance with the laws of the U.S. or any state thereof;" and*

Governing Law (125.4(h)(6)(iv)(d)(2))

> *(2) "Any dispute, suit, action or proceeding under the contract, or any dispute, suit, action or proceeding arising out of, directly, indirectly, or incidentally, or related to the contract or of the transactions and actions arising from performance of the contract are to be governed by and construed in accordance with [choose one option] the laws of the State of New York or the laws of the state in which the ceding insurer is domiciled or the laws of any state chosen by ceding insurer. This provision does not override an agreement between the ceding insurer and the unauthorized alien assuming insurer to arbitrate, in accordance with the laws of the U.S. or any state thereof."*

The New York regulation governing reduced collateral requires a new additional mandatory contract provision related to insolvency of the ceding insurer. Lloyd's underwriters therefore must ensure that this provision is included in reduced collateral contracts with New York domiciled cedants. The following clause (or substantially similar language) must be included in reduced collateral contracts with cedants who are domiciled in New York.

> *In the event that, pursuant to Article 74 of the New York Insurance Law or the equivalent law of another state, an order of rehabilitation, liquidation or conservation is entered against the Company, the Company or the Company's agent shall immediately provide notice to the Reinsurer. Within 30 days of the entry of such an order against the Company, the Reinsurer shall fund the entire amount for which the Company has taken credit on its financial statements for reinsurance recoverable from the Reinsurer.*

Under the reduced collateral rules in New York there are certain events (such as a rating downgrade or a determination by the insurance regulator that the reinsurer is resisting enforcement of a final judgement) which, if they occur, will nullify the reduced collateral arrangement. In this case the funding obligation of the reinsurer will revert to 100%. It is recommended that Lloyd's underwriters seek to include language in the reduced collateral contract to ensure that if they are required to fund at 100% they have flexibility regarding the method by which such funding is provided (see example language below).

> *In the event that the Reinsurer is required to fund the entire amount for which the Company has taken credit on its financial statements for reinsurance recoverable from the Reinsurer, for any reason either provided in this Policy or pursuant to the requirement of an insurance regulatory authority, the Reinsurer shall have the option of determining the method of funding, including but not limited to the Reinsurer's Credit for Reinsurance Trust Fund, provided it is acceptable to the insurance regulatory authorities having jurisdiction over the Company.*

Reinsurance contracts funded through reduced collateral should be clear that funding is being provided outside of Lloyd's existing CRTF and CRJATF trust arrangements and that the cedant is not a beneficiary of the CRTF and CRJATF with respect to the reduced collateral contract. Sample language to address both of these concerns is provided below and could be included within the Interest and Liabilities section of the contract. Lloyd's underwriters should include this or similar language in the reduced collateral reinsurance contract to avoid any confusion and ensure that the funding arrangement is clear to all parties.

> *This Policy is being funded outside the Lloyd's syndicates' Credit for Reinsurance Trust Funds (CRTFs) and Credit for Reinsurance Joint Asset Trust Fund (CRJATF). The Company is not a beneficiary of the subscribing syndicates' CRTFs or the CRJATF with respect to this Policy.*

<u>Appendix B</u>

Slip requirements and processing -

The Open Market, Binding Authority and Lineslip Market Reform Contracts (MRC) include the heading "U.S. Classification" in their Fiscal and Regulatory sections. Lloyd's reinsurance contracts subject to reduced collateral will receive the U.S. Classification "U.S. Reinsurance".

The NAIC company code of the ceding insurer must also be captured. This should be verified to ensure that the NAIC company code and the state of domicile associated with that code are consistent with the reinsured's address captured under the "Risk Details" section of the contract. If the contract reinsures more than one ceding U.S. insurer, the NAIC code of each U.S. cedant must still be shown. Where this includes cedants who are domiciled in New York and cedants who are domiciled in other states (multistate placements), reduced collateral arrangements will not apply (see "1. Key considerations" above).

As is the case with any reinsurance contract, consideration also needs to be given to how layered placements are addressed under the Fiscal and Regulatory section of the contract. Each layer needs to have attention paid to its own regulatory and tax exposures, recognising where the layer(s) of the programme involve Underwriters at Lloyd's. This principle extends to any reduced collateral arrangements which apply to cedants covered by the relevant layers of the programme.

The reduced collateral rule applies across the entire reinsurance contract, including multiple layers of the same contract. Therefore the use of reduced collateral will need to be agreed and understood by all Lloyd's leaders and followers subscribing to any of the layers of the reinsurance contract and varying levels of collateral on a single contract by different Lloyd's leaders is not permissible.

Reinsurance contracts classified as "U.S. Reinsurance" and subject to reduced collateral will be processed by Xchanging in the same way as "U.S. Reinsurance" contracts subject to 100% funding under Lloyd's multi-beneficiary trust fund arrangements. Reduced collateral contracts will be FIL coded by Xchanging using the same FIL codes applied to all other U.S. reinsurance business. This will ensure that this business is coded in accordance with Lloyd's existing regulatory and tax definitions, with all receipts and payments interfacing with the Lloyd's Dollar Trust Fund (LDTF). Similarly, Underwriting Signing Messaging (USMs), Syndicate Claim Messaging (SCMs), Broker Signing Messaging and payments will be unchanged, i.e. where a letter of credit has been issued for reinsurance collateral purposes a syndicate(s) will receive a USM's like any other letter of credit.

Appendix C

Lloyd's reporting requirements -

Lloyd's managing agents complete quarterly returns for U.S. regulatory reporting purposes[4]. The returns are partially pre-populated (premium, claims and investment data) by Lloyd's prior to their collection and completion by managing agents. The returns cover U.S. regulated business and allow Lloyd's syndicates to demonstrate that their U.S. situs trust funds[5] are adequately funded. This includes business classified as "U.S. Reinsurance". The returns will therefore also include "U.S. reinsurance" contracts subject to reduced collateral. The pre-populated data included within Schedule F pt 1 of the U.S. returns will show assumed reinsurance premium and claims as at the quarter end reporting date including business subject to reduced collateral and, where collateral has been posted, the amount of collateral posted.

This does not differ from the process currently utilised by managing agents reporting alternative collateral arrangements, i.e. where the cedant has been provided with collateral outside of Lloyd's CRTFs. Form 2 of the Lloyd's CRTF U.S. reporting return allows Lloyd's syndicates to include a credit against reserves to ensure that the trust funds required are net of the collateral provided directly to cedants. The only change to these requirements is that Lloyd's will require that syndicates complete a memo note in respect of the reduced collateral cedant contracts detailing the name of the cedant, the cedant's state of domicile and the value of collateral provided to the cedant at the 20% funding rate. Both the cedant and the Lloyd's syndicate(s) will be able to take full credit for the collateral provided.

Lloyd's has an existing facility available to managing agents with Citibank where collateral in the form of letters of credit issued to the cedant can be arranged using LDTF assets as collateral. Letters of credit provided in this way as collateral to the cedant will normally be arranged by the lead syndicate on the contract in question, and will subsequently be captured and included as part of the pre-populated Schedule F pt 1 included within the U.S. returns issued to Lloyd's managing agents.

Further details of the process for completing the Lloyd's U.S. reporting returns in respect of reduced collateral provided to cedants outside of Lloyd's CRTFs will be included in the market bulletin issued by Lloyd's in Oct 2011 in advance of the Q3 2011 U.S. regulatory filings.

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[4] See Lloyd's market bulletin Y4485, dated 13 April, 2011

[5] Lloyd's Credit for Reinsurance Trust Funds and Lloyd's Surplus Lines Trust Funds

Appendix D

Facilities to arrange letters of credit with Citibank

The reduced collateral funding arrangement in the form of a Letter of Credit (LOC) will be triggered upon notification of claim. Typically, a broker would notify Xchanging of a claim under a reduced collateral reinsurance contract. Xchanging would then send a notification via a Syndicate Claim Messaging (SCMs) to the lead (and following) syndicate(s) and also notify Lloyd's STFO to arrange an LOC under the LOC facility with Citibank.[6]. This facility is operated by Lloyd's (Settlement and Trust Fund Operations) and Citibank for the LDTF. For a syndicate to participate in this facility they must first have signed the relevant legal documentation between themselves and Citibank. The scheme is open to all managing agents, subject to sufficient collateral being available in a managed syndicate's LDTF accounts. The Scheme will cover the provision of one LOC to a beneficiary on behalf of one or a number of syndicates, where each syndicate is severally liable for their individual participation in each LOC.

It is also the case that reduced collateral provided to cedants outside of the CRTF does not have to take the form of an LOC. Under the terms of Lloyd's approval to post reduced collateral under the New York rules, cedant specific trust arrangements such as Regulation 114 trusts are also acceptable collateral.

For further information concerning the LOC facility operated by Lloyd's, please contact:

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[6] Full details of the scheme can be found in Lloyd's market bulletin Y3097, dated 16 July 2003