MARKET BULLETIN

REF: Y4755

Title	Financial Guarantee Insurance – Amendments to Requirements
Purpose	To update Lloyd's requirements for the underwriting of Contract Frustration and Trade Credit insurance and to make other changes to Lloyd's requirements for Financial Guarantee Insurance
Type	Event
From	Tom Bolt, Director, Performance Management
Date	23 December 2013
Deadline	Immediate
Related links	Performance Management: Supplemental Requirements and Guidance

Following consultation with the LMA, Lloyd's is amending its requirements for the writing of Contract Frustration and Trade Credit insurance to permit the writing of a wider range of risks. Lloyd's is also making a number of other limited changes to its requirements for Financial Guarantee Insurance. The changes to Lloyd's requirements are shown at Appendix 1.

Background

Lloyd's requirements for the underwriting of Financial Guarantee business are set out in Performance Management: Supplemental Requirements and Guidance.

In summary, in view of the prudential risks to the market that such business can present, managing agents may not write Financial Guarantee insurance (as defined in the Supplemental Requirements and Guidance) unless the contract falls within one of the exempted classes or the contract has been agreed by Lloyd's. Lloyd's also expects syndicates to limit the amount of premium income derived from Financial Guarantee business.

Contract Frustration and Trade Credit are both types of Financial Guarantee insurance. Lloyd's has long recognised, however, that where properly managed these classes are a profitable source of business for underwriters. Accordingly both of these classes are included as exempted classes within Lloyd's Financial Guarantee requirements. To date, however, Lloyd’s has only permitted the writing of risks in these classes where the risk is tied to a specified contract, such as a specified contract of sale, purchase, lease or delivery of assets, goods or services.

Changes to the Contract Frustration and Trade Credit exempted classes

Lloyd’s continues to keep the scope of the exempted classes under review. Having consulted with the LMA, Lloyd’s is satisfied that a wider range of Contract Frustration and Trade Credit risks can be written by syndicates. Specifically, Lloyd’s is amending its requirements to allow underwriters to write Contract Frustration and Trade Credit business in certain circumstances where the insured risk may not relate to a specified or secured contract but is in support of a trade flow or investment. The updated requirements are shown in Appendix 1. The changes from the existing requirements as set out in the Supplemental Requirements and Guidance are highlighted.

Lloyd’s believes that the changes to the requirements will bring Lloyd’s underwriters into line with the broader insurance market, allowing managing agents to better compete for risks and to write an improved, diversified portfolio.

While Lloyd’s is expanding the range of risks that can be written managing agents should note the following:

- While the requirements now allow for the underwriting of a broader range of risks, the categories of permitted risks remain strictly defined and underwriters should not write outside of the limits set. In the event of any doubt managing agents should discuss the matter with their account executive in the Underwriting Performance team of the Performance Management Directorate.

- Lloyd’s expects that underwriters will continue to exercise the same due diligence and risk assessment in the new risk categories as is expected for risks permitted by the current requirements. Underwriters need to be mindful of the relationship between credit quality and financing structure and, in circumstances where the latter is less structured or secured, the greater relative importance of the correct assessment of the credit quality. Lloyd’s will, therefore, expect underwriters to demonstrate clearly their risk appraisal process and their criteria for accepting or declining individual risks. The business written in these classes will also be closely monitored through the syndicate business plan process and, where appropriate, by conducting reviews.

Other Changes

Lloyd’s has additionally made the following changes to its requirements:

- The guidelines as to the premium income limits that managing agents may write have been amended. Syndicates may now write up to 5% of premium income in each of Contract Frustration and Trade Credit and a further 2% for any other permitted Financial Guarantee business (ie where that business is in one of the other exempted classes or the contracts are agreed by Lloyd’s). Note that the relevant percentages will now be measured on the basis of the syndicate agreed gross net written premium income rather than capacity.

- The definition of Acquisition Finance has been amended to permit risks where the borrower owns more than 50% of the shares or other ownership interest and for which the acquisition finance is appropriately secured.

- The requirements have been amended to include Seafarers Abandonment as an exempted class. This change is in response to the Maritime Labour Convention, 2006 (MLC) coming into force on 20 August 2013. MLC stipulates that seafarers have the right to be repatriated at no cost to themselves "in the event of the shipowner not being able to continue to fulfil their legal obligations as an employer of the seafarers by reason of insolvency". Managing agents are reminded that, as Seafarers Abandonment is give the risk code SA, as with the addition of any new risk code to a syndicate's business plan, the agreement of Lloyd's is required before the syndicate commences underwriting.

- The requirements have been amended to clarify that Maritime Liens is an exempted class.

- Following discussions with the LMA, Part IV (Principles for Exempted Classes) has been amended so that the requirement to include the clauses listed in that section now only applies to Contract Frustration and Trade Credit policies. Managing agents should note, however, that business written in the other exempted classes remain subject to all other Lloyd's requirements, including in relation to the writing of NCBR risks, which is addressed elsewhere in Performance Management: Supplemental Requirements and Guidance.

- The drafting of the requirements in a limited number of instances has been amended to clarify the existing requirements.

Note that Lloyd's is currently reviewing the appropriate risk codes to be used for Salvage Guarantee and Maritime Liens. Updated requirements will be confirmed to the market in due course following consultation with the LMA.

Application of the new requirements

These changes to Lloyd's requirements apply with immediate effect. A revised version of the Supplemental Requirements and Guidance will be issued during 2014 and will be updated to include the revised Financial Guarantee requirements.

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 David Freer in the first instance (david.freer@lloyds.com or 020 7327 5516) or otherwise to David Indge (david.indge@lloyds.com or 020 7327 5716). 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.

Appendix 1

[*The following requirements amend and replace the requirements for Financial Guarantee insurance set out in 'Performance Management: Supplemental Requirements and Guidance' (November 2011)*]

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 in Part I) on behalf of a syndicate under its management unless either:

- The contract falls within one of the "exempted classes" as set out below in Part II and the associated definitions set out in Part III and the principles contained in Part IV 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. Unless agreed by Underwriting Performance (and except as stated in these requirements) any approval given will require the application of risk code "FG".

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 PMD 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~~agreed Syndicate Business Plan gross net written premium income, other than ~~trade credit~~Trade Credit and Contract Frustration business where the relevant ~~percentage~~ figure is 5%~~, i.e. 7% in total~~ for each.

Part I: 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:

1. the financial failure, default, insolvency, bankruptcy, liquidation or winding up of any person whether or not a party to the contract of insurance; or
2. the financial failure of any venture; or
3. the lack of or insufficient receipts, sales or profits of any venture; or
4. the lack of or inadequate response or support by sponsors or financial supporters; or
5. a change in levels of interest rates; or

6 a change of rates of exchange of currency; or
7 a change in the value or price of land, buildings, securities or commodities; or
8 a change in levels of financial or commodity indices; or
9 any liability or obligation under an accommodation bill or similar instrument.

Part II: Definitions of the Exempted Classes

Terms shown in italics are defined in Part III below.

A. Contract Frustration (Risk Code "CF")

1 Contract Frustration insurance indemnifies an insured for loss under:

a. a specified contract or contracts for the sale, purchase, lease or delivery of assets, goods or services; or
b. an agreement which relates directly to the financing of such specified contract(s); or
c. 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
d. an agreement concerning financing to a Government Entity:
i. whose core business is the buying and selling of commodities; or
ii. whose core purpose is to promote trade and/or investment as evidenced by its mandate, rating agency review or by analysis of the asset portfolio; or
iii. where the loan agreement stipulates the funds are to be used for trade purposes and the lender has the right to request evidence of the use of the funds.
e. an agreement concerning financing to a Government Entity whose specific purpose is to develop or operate infrastructure and the loan agreement stipulates the funds are to be used for this purpose; or
f. a co-insurance with/or reinsurance of a multilateral institution, an export credit agency or a regional trade or development organisation whose main purpose is to support trade flows or investment; or
g. ~~d.~~ a *Bond* or *Bonds* provided in accordance with the terms of a specified contract, tender document or project;

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

a. a *Political Force Majeure event*; or
b. 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*.

3 Contracts that are permissible within section A.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 classified under other risk codes, subject to complying with any requirements that apply to policies written in those risk codes ~~provided by policies which are classified as other classes of business subject to compliance with any requirements in relation to those classes~~.

4 For a contract to be eligible for inclusion under A.1(c), above it must:
a. directly finance a specified trade contract; or
b. be repaid from identified and assigned or assignable trade flows; or
c. be secured upon identified collateral or assets.

5 Under no circumstances should Contract Frustration policies cover:
a. Contracts for which the purpose is the provision of working capital or general corporate lending unless such contracts fall within the provisions of A.1 above; or
b. *Acquisition Finance*; or
c. *Sovereign Lending*; or
d. Currency fluctuations and/or devaluations.

If currency inconvertibility/exchange transfer is the only Contract Frustration exposure under a Lender's Interest policy the terms of A.5 (a) & (b) do not apply.

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 Part III, paragraph 7.

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 coded~~considered~~ as Contract Frustration insurance.

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.

B. Trade Credit (Risk Code "CR")

1 Trade Credit insurance indemnifies an insured for loss under:
a. a specified contract or contracts for the sale, purchase, lease or delivery of assets, goods or services; or
b. an agreement which relates directly to the financing of such specified contract(s); or
c. 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
d. an agreement concerning financing to a Commercial Organisation:
i. whose core business is the buying and selling of commodities; or
ii. where the loan agreement stipulates the funds are to be used for trade purposes and the lender has the right to request evidence of the use of the funds; or
e. a co-insurance with/or reinsurance of a multilateral institution, an export credit agency or a regional trade or development organisation whose main purpose is to support trade flows or investment; or
f. ~~d.~~ 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 Contracts that are permissible within section B.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 classified under other risk codes, subject to complying with any requirements that apply to policies written in those risk codes ~~provided by policies which are classified as other classes of business subject to compliance with any requirements in relation to those classes~~.

3 For a contract to be eligible for inclusion under B.1(c) above it must:
a. directly finance a specified trade contract; or
b. be repaid from identified and assigned or assignable trade flows; or
c. be secured upon identified collateral or assets.

4 Under no circumstances should Trade Credit policies cover:
a. Contracts made by the insured with private individuals (other than sole traders operating in their business capacity); or
b. *Mortgage Finance* Insurance; or
c. Contracts for which the purpose is the provision of working capital or general corporate lending unless such contracts fall within the provisions of B.1 above; or
d. *Acquisition Finance*; or
e. Currency fluctuations and/or devaluations ~~(but see the provisions of A.7 above)~~.

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.

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 Part III, paragraph 7.~~

Application of risk codes

Where financial default and insolvency is a covered cause of loss under policies described in section A and B 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.

C. Mortgage Indemnity Insurance (Risk Code "FM")

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.

D. Surety Bond Reinsurance (Risk Code "SB")

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.

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

E. 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.

F. Seafarers Abandonment (Risk code "SA")

Seafarers Abandonment insurance indemnifies against the costs of repatriation of abandoned seafarers, following the insolvency of the shipowner.

G. Maritime Liens

Maritime Liens insurance indemnifies against financial losses incurred due to third party claims or costs arising directly from the insolvency or failure to pay of a charterer or prior owner of the vessel.

Part III: Definitions of Italicised Terms used in Part II

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:

a. a Central Government or a Ministry, Department or Agency thereof (hereinafter referred to as "Government");
b. a Regional or Local Authority or a Department or Agency thereof (hereinafter referred to as "Local Authority");
c. 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

d. 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:

a. an expropriatory act;
b. arbitration award default where the award is to remedy an insured expropriatory act or licence cancellation;
c. a *Political Force Majeure* event;
d. prevention of currency conversion and/or exchange transfer;
e. embargo/licence cancellation;
f. 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 A and B of Part II, 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.

The following do not fall within the Acquisition Finance exclusion: -

At the time of attachment of risk an acquisition regarding shares or other ownership interest in a company or business

1) in which the borrower owns more than 50% of the shares or other ownership interest prior to entering into the Acquisition Finance;
2) for which the Acquisition Finance is secured upon identified collateral, assets owned by the borrower and not forming any part of the assets of the company or business to be acquired.

Part IV: Principles for Exempted Classes

1 All policies which fall within the scope of the Contract Frustration and Trade Credit exempted classes as set out in Part II ~~should~~must 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. (Note that policies written in all exempted classes remain subject to all other applicable Lloyd's requirements. This includes Lloyd's requirements for the writing of Nuclear, Biological, Chemical and Radioactive Contamination.)

2 Assignment of Policy

All policies ~~should~~must 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~~must 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.

3 Insolvency of the Insured

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

4 Fraud

All policies ~~should~~must 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.

5 Nuclear, Biological, Chemical and Radioactive Contamination

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