LLOYD'S

MARKET BULLETIN

REF: Y4984

Title	Capital Tests – Release Test / Coming into Line (CiL) and Member Level Solvency
Purpose	To advise of changes following Solvency II implementation from 1 January 2016
Type	Event
From	John Parry, Director Finance +44 (0)20 7327 5129 – John.Parry@lloyds.com
Date	5 April 2016
Deadline	Immediate Effect
Related links	N/A

Summary

Solvency II became effective from 1 January 2016. This does not change the basis for setting members' economic capital assessments (ECA), since Lloyd's has already been using the Solvency II methodology for calculating available assets and capital requirements. It does change definitions of solvency, in particular the change to the calculation of the minimum margin of solvency. It also introduces a tiering test on quality of capital and this is explained below. Lloyd's has also taken the opportunity to simplify the capital test calculations, where possible.

Member Level Solvency December 2015

For the avoidance of doubt there will not be any change to the 31 December 2015 Solvency test calculations. These will be the final solvency calculations to be conducted under the existing GENPRU and INSPRU prudential sourcebooks.

Solvency II Tiering Test

In accordance with Solvency II requirements introduced from 1 January 2016, the Solvency Capital Requirement (SCR) must be covered by at least 50% Tier 1 capital. This test applies to Lloyd's on an overall basis, although it is built up from member level notional SCRs compared to member level capital .

Under Solvency II, certain forms of capital are now treated as off balance sheet capital or 'ancillary own funds' (AOF), and classified as Tier 2 capital. This includes letters of credit, bank guarantees and life policies held within members' FAL, as well as FAL provided by covenant and charge.

Lloyd's shall continue with its policy of permitting any member to provide FAL solely using a letter of credit. However, if coverage of the tiering test becomes marginal (this is only likely in the case of severe market loss and/or a significant general increase in the provision of LOCs) then Lloyd's will apply a policy of 'rationing' the availability of LOCs or "Ancillary Own Funds".

In this circumstance, the members providing the greatest proportion of their FAL requirement using LOCs would have a limit on the proportion of their ECA that they could provide, with the remainder having to be provided by Tier 1 capital e.g. cash, bonds. The percentage maximum shall be set by Lloyd's to ensure that the tiering test was covered with a satisfactory margin.

As an example, if a member has a Total Funding Requirement (TFR) of £50m and is currently covering this using a letter of credit, if Lloyd's concludes that the maximum AOF 'allowance' for any member is 80% of the TFR, then this member could continue to cover 80% of its TFR (£40m) with the letter of credit but would have to substitute £10m in Tier 1 capital for the balance. As a de minimis, smaller members - those with a TFR of no more than £5m – would be excluded from this test.

Margin of Solvency (Solvency II) – Member Solvency

From 1 January 2016 there will be a new methodology to determine the Minimum Capital Requirement (MCR) within the member solvency calculations, replacing the current premiums and claims calculation. The MCR represents the minimum level of capital required to be held by an insurer before the highest level of regulatory intervention is triggered.

In relation to this, Lloyd's is required to establish a 'member level reporting point' for each member, i.e. the member's solvency position after taking account of the syndicate solvency results determined on a Solvency II basis (in effect the Solvency II balance sheet position) and covering the new MCR. The results of this test must be reported to the Prudential Regulation Authority (PRA). This will commence from 31 March 2016 and continue on a quarterly basis thereafter. Attached at appendix 1 is an example member Solvency Test Statement prepared on a Solvency II basis.

The MCR for this purpose will be determined as a percentage of each member's notional Solvency Capital Requirement (SCR), based on each member's share of the syndicate SCRs. The percentage will be the same for all members, being the ratio of the Lloyd's MCR to the Lloyd's SCR. Under Solvency II, the percentage to be applied to the SCR cannot be less than 25% or greater than 45% of the SCR. The SCR used in the solvency calculations will be the "one year" SCR, not the "SCR to ultimate" which is used to determine a member's Economic Capital Assessment (ECA) used in the capital test calculations.

Impact on Capital Tests

As the MCR is a percentage of the SCR, it cannot ever be greater than the ECA (which requires the coverage of the SCR to ultimate uplifted by 35%), so any continuing role of the margin of solvency within the capital tests for members is redundant. As a result, for the capital test statements to be issued in April 2016 and thereafter the margin of solvency will not be included when determining a member's net capital requirement (NCR). The NCR will simply be the higher of the ECA or the minimum funds at Lloyd's requirement.

FAL Acceptability criteria

As regards the acceptability of assets for FAL, the implementation of Solvency II will change the emphasis from that of a prescriptive rulebook published by the PRA (i.e. GENPRU / INSPRU) to that of the new "Prudent Person Principle". Appendix 3 of the current M&URs will generally remain fit for purpose, and should continue to be used when considering acceptability of assets for FAL purposes, although we will be reviewing the gaps between the existing GENPRU / INSPRU rules and the "Prudent Person Principle". Changes to the M&URs may follow as a result.

Concentration of Asset Disallowances (COADs)

COADs will be applied to the 31 December 2015 Solvency calculations in accordance with the current INSPRU / GENPRU sourcebooks. Under Solvency II the rules are not prescriptive and COADs will no longer be applied to FAL, although where, in Lloyd's view, a member's FAL portfolio is concentrated or comprises assets with a higher risk profile, then Lloyd's may require the member to provide additional capital to mitigate the additional risk presented.

Impact on Capital Tests

As a result COAD deductions will not appear on the April 2016 capital test statements. However, counterparty exposure will continue to be reviewed in tandem with the capital setting process. Counterparty exposure will be monitored and where there is material exposure to a counterparty (in excess of 10% of FAL) then the position will be reviewed, with the possibility that Lloyd's may require additional capital and / or restrictions may be imposed on the release of capital.

Solvency II Balance Sheet (QMC) Results

The Solvency II Balance Sheet (SIIBS) results are included within the capital test statements and form an integral part of the capital setting process. For the interim half year results, this will now be presented as the cumulative SIIBS results as at Q2 when the September capital test statements are issued. This recognises that active members already have full benefit of the cumulative Q2 position for capital setting.

Non-Active Members

In previous years, the interim results have not been reflected within the capital test calculations for non-active members. To simplify the process further, non-active members will be treated the same as active members, and have their half year capital test positions refreshed with the Q2 cumulative SIIBS results.

Attached at appendix 2 is a template of how the capital test statement will appear post the above changes which includes a narrative of the source of each data point.

Any queries to the bulletin should be addressed to Kevin Nethersell ext. 6253 (kevin.nethersell@lloyds.com).

APPENDIX 1

EXAMPLE SOLVENCY II MEMBER STATEMENT

099999X AN Other Limited Status : Active

NON-LIFE UNDERWRITING RESULTS

Syndicate/Mapa	Year	Closed Year Results	Open Year Results / Run-Off Results	
8888	2013	10,000,000.00		
8888	2014		15,000,000.00	Note 1
8888	2015		-3,000,000.00	
Results Total		**10,000,000.00**	**12,000,000.00**	

Breakdown of above results total by year

	Year		Closed Year Results	Open Year Results / Run-Off Results
	2013	Account Total	10,000,000.00	
	2014	Account Total		15,000,000.00
	2015	Account Total		-3,000,000.00
Breakdown Overall Total			**10,000,000.00**	**12,000,000.00**

Net Underwriting Position		**22,000,000.00**	

NON-LIFE SOLVENCY ANALYSIS

Net Underwriting Position		**22,000,000.00**	
Lloyd's Deposit (N/L)	50,000,000.00		
Personal Reserve Fund (N/L)	5,000,000.00		Note 2
	55,000,000.00		
Net Solvency Position		**77,000,000.00**	
Minimum Capital Requirement (MCR)		**15,000,000.00**	Note 3
Member Level Reporting Point		**62,000,000.00**	Note 4

Explanatory Notes

Note 1 Syndicate Results determined on a Solvency II Balance Sheet Basis. Provided by the managing agent via the QSR / QMC

Note 2 Capital Held on behalf of the member

Note 3 New margin of solvency (known as the Minimum Capital Requirement (MCR)). Based upon the Solvency Capital Requirement (1 year). Derived from the internal Lloyd's Member Capital System.

Note 4 Member Level reporting Point after taking account of the syndicate results, capital held and the MCR. Position to be reported to the Prudential Regulatory Authority (PRA) on a quarterly basis

APPENDIX 2

EXAMPLE CAPITAL TEST STATEMENT (POST SOLVENCY II)

Member: 099999X A N Other Ltd

Economic Capital Assessment Requirement			60,000,000.00		**Note 1**
Minimum Funds at Lloyds *(FAL Ratio % - 40%)*			40,000,000.00		
A - Net Capital Requirement *(greatest of the above)*				**60,000,000.00**	**Note 2**
Open Year Deficiency		YOA			**Note 3**
		2015	*(3,000,000.00)*		
		2014	*15,000,000.00*		
			0.00		
Open Year Deficiency		Total	12,000,000.00		
Premium Trust Fund Debt			0.00		
B - Total Liability / (Asset)				**(12,000,000.00)**	
C - Total Funding Requirement (A+B)				**48,000,000.00**	
Funds at Lloyd's			55,000,000.00		**Note 4**
Funds in Syndicate			0.00		
Distribution Assets			10,000,000.00		
D - Total Assets				**65,000,000.00**	
E - Determining Surplus/Shortfall					
E - Total Surplus/(Shortfall) = (D-C)				**17,000,000.00**	**Note 5**
F - Release of Distribution Assets					
Distribution Assets			10,000,000.00		
Premium Trust Fund Debt			0.00		
Net Distribution Assets			10,000,000.00		
F - Maximum Distribution Assets available for Release				**10,000,000.00**	**Note 6**
G - Release of Funds at Lloyd's					
Potential Release of Funds at Lloyd's			7,000,000.00		
Less Interavailable Funds at Lloyd's	*(if applicable)*		0.00		
Surplus excluding Interavailable Funds			**7,000,000.00**		
Funds at Lloyd's	*(excluding IA)*	55,000,000.00			
Less Special Reserve Fund	*(if applicable)*	0.00			
Non SRF Funds at Lloyd's	*(excluding IA)*	55,000,000.00			
Less 30% Premium Limit	*(Active SRF Members only)*	0.00			
Less additional retention for minimum FAL		0.00			
G - Maximum Funds at Lloyd's available for release				**7,000,000.00**	**Note 7**

Note 1 ECA based upon the Solvency Capital Requirement (to ultimate)

Note 2 Net Capital Requirement. Higher of ECA or Minimum Funds at Lloyd's (Active Members Only). For non-active members (ECA) remains subject to 10% loading

Note 3 Cumulative year surpluses determined on a Solvency II Balance Sheet (SIIBS) basis. Derived from the QMC (SIIBS) submission provided by the managing agent. The results will be refreshed at the year end and the half year

Note 4 Capital held on behalf of the member

Note 5 Capital test position

Note(s) 6 & 7 Amount of distribution assets (profit) and FAL available for release