

# MARKET BULLETIN

REF: Y5009

**Title** **Catastrophe Risk: Changes to Lloyd's AEP 1-in-30 metrics and Franchise Guidelines**

**Purpose** To inform managing agents of the new 'Whole World AEP 1-in-30' metric, and revisions to Lloyd's Franchise Guidelines

**Type** Scheduled

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**Related links** Market Bulletin Y4980

## PURPOSE

Further to [Market Bulletin Y4980](#) issued on 24 March 2016, the Franchise Board has now agreed changes to Lloyd's measurement and control of catastrophe risk starting in the 2017 Year of Account.

This Market Bulletin is to inform managing agents of the changes as follows:-

- 'Whole World AEP 1-in-30' metric introduced, with associated Franchise Guidelines
- Changes to Franchise Guidelines definitions and thresholds for existing 'AEP 1-in-30' and Realistic Disaster Scenarios

These changes will apply to the 2017 YOA business-plan forecasts, and will take effect from 1 January 2017 for in-force monitoring.

## 1 INTRODUCTION

### 1.1 NEW 'WHOLE WORLD' AEP 1-IN-30 METRIC

[Market Bulletin Y4980](#) announced a number of changes to Lloyd's business-planning and capital-setting processes for the 2017 Year of Account.

Page 3 of the Market Bulletin contained a section on "Lloyd's Catastrophe Risk Framework", explaining the reduction in cat risk forecasts required for 2017 and the introduction of a new 'Whole World AEP' measure.

This Market Bulletin confirms details of the 'Whole World AEP' measure, and associated Franchise Guidelines.

### 1.2 FRANCHISE GUIDELINE CHANGES

Changes to Reinsurance Contract Boundary accounting for 2016 caused problems in applying Lloyd's Franchise Guidelines for catastrophe risk, which use syndicates' Economic Capital Assessment [ECA] as the denominator.

The reduction in ECA for 2016, while offset by increases in syndicate's Technical Accounts, caused an increase in apparent breaches of Franchise Guidelines for the AEP 1-in-30 and RDS metrics.

To get round the problem during the transition to the new accounting rules in 2016, Lloyd's created a 'virtual ECA' for each syndicate by adding back the RCB adjustment. This 'virtual ECA' was used for calculating the 80% and 30% thresholds for AEP and RDS Franchise Guidelines. However, we do not want to continue doing this indefinitely. It is clearly more appropriate to re-define the Franchise Guidelines.

Separately, the Franchise Board recognises that ECA explicitly allows for the expected profits in the year via the return on capital loadings in the premium rates. When expected profits are high the ECA is lower and vice-versa (as with the soft market now). It makes sense to introduce a counter-cyclical element to the Franchise Guidelines for catastrophe risk, such that increased ECA due to falling rates does not necessarily allow increased volatility of catastrophe risk at medium-to-low return periods.

Therefore, the Franchise Board has agreed to a **re-definition of the Franchise Guidelines** for catastrophe risk starting in 2017.

## 2 'WHOLE WORLD' AEP 1-IN-30

**From 1<sup>st</sup> January 2017, there will be a new metric for measuring and controlling Lloyd's catastrophe risk, being Aggregate Exceedance Probability (AEP) loss-estimates at a return-period of 1-in-30 for the Whole World for natural catastrophe.**

The new 'Whole World AEP 1-in-30' metric will be compulsory for forecasting and in-force reporting, and will be subject to Lloyd's Franchise Guidelines as defined in section 2.1 below.

Managing agents will be required to submit, as part of 2017 Syndicate Business Forecasts, projected (i.e. forecasted to next calendar year) losses on a best estimate basis. The metric will form part of in-force reporting as part of the RDS and RDL returns.

Loss-estimates should be derived using methods that are entirely consistent with those used in the Internal Model.

### **3 CHANGES TO FRANCHISE GUIDELINES**

To accommodate changes to the capital calculation resulting from Reinsurance Contract Boundary adjustments, and to ensure that Franchise Guidelines for catastrophe risk include appropriate counter-cyclical measures in both soft and hard markets, the Franchise Board has agreed the following new definitions:-

#### **3.1 FRANCHISE GUIDELINES FOR 'WHOLE WORLD AEP 1-IN- 30' METRIC**

Projected and in-force loss-estimates shall not exceed:

- 110% of ECA-plus-Profit for Gross Losses; and
- 45% of ECA-plus-Profit for Final Net Losses.

#### **3.2 FRANCHISE GUIDELINES FOR ALL OTHER CAT RISK METRICS DEFINED IN TABLE 1**

Projected and in-force loss-estimates shall not exceed:

- 80% of ECA-plus-Profit for Gross Losses; and
- 30% of ECA-plus-Profit for Final Net Losses.

Please see the table on page 4 for the list of AEP 1-in-30 and RDS metrics to which Franchise Guidelines apply (column 4).

#### **3.3 DEFINITION OF 'PROFIT'**

'Profit' for this purpose shall be defined as 'Profit/Loss for the period' on an Ultimate basis in the Syndicate Business Forecast.

As at 1<sup>st</sup> July 2016, this is item 16 of Form 100s in the SBF.

### **4 FURTHER INFORMATION**

Should you have any questions or require any additional information, please contact Trevor Maynard, David Clouston or any member of Lloyd's Exposure Management team.

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	Scenario	Scenario ID	in SBF 2017	Subject to Franchise Guidelines	RDS/RDL in-force reporting 2017
1	AEP 1-in-30 Whole World ( <i>new for 2017</i> )	77	Yes	Yes	Compulsory
2	AEP 1-in-30 US Windstorm	65	Yes	Yes	Compulsory
3	AEP 1-in-30 North America Earthquake	66	Yes	Yes	Compulsory
4	AEP 1-in-30 European Windstorm	67	No	No	Compulsory
5	AEP 1-in-30 Japan Earthquake	68	No	No	Compulsory
6	AEP 1-in-30 Japan Typhoon	69	No	No	Compulsory
7	RDS Two events (North East Windstorm, followed by Carolinas windstorm)	41,42	No	No	Compulsory
8	RDS Florida Windstorm (two separate events - Miami-Dade and Pinellas)	2,3	No	No	Compulsory
9	RDS Gulf of Mexico Windstorm	12	No	No	Compulsory
10	RDS European Windstorm	8	No	No	Compulsory
11	RDS Japanese Typhoon	13	No	No	Compulsory
12	RDS California Earthquake (two separate events – LA and SF)	4,5	No	No	Compulsory
13	RDS New Madrid Earthquake	6	No	No	Compulsory
14	RDS Japanese Earthquake	9	No	No	Compulsory
15	RDS UK Flood	51	No	No	Compulsory
16	RDS Terrorism (two separate events)	43,44	Yes	Yes	Compulsory
17	RDS Alternative A & B	32,33	Yes	No	Compulsory
18	RDS Marine (two scenarios)	15,16	Yes	Yes	<i>de minimis</i>
19	RDS Loss of Major Complex	17	Yes	Yes	<i>de minimis</i>
20	RDS Aviation Collision	18	Yes	Yes	<i>de minimis</i>
21	RDS Satellite risks (four scenarios – <i>highest loss estimate only</i> )	70,71,72,73	No	No	<i>de minimis</i>
22	RDS Liability risks (two scenarios)	53,54	Yes	Yes	<i>de minimis</i>
23	RDS Cyber - Major Data Security Breach	76	Yes	Yes	<i>de minimis</i>
24	RDS Political risks	29,31,49,52,64	No	No	<i>de minimis</i>

Table 1