LLOYD'S

Market Bulletin

Ref: Y5191

Title	Financial Guarantee, Contract Frustration, Credit Risk and related classes – updated requirements
Purpose	To provide updated, principles-based requirements for the writing of Financial Guarantee insurance, including Contract Frustration, Credit Risk (formerly Trade Credit) and related classes
Type	Event
From	Jon Hancock Performance Management Director
Date	13 June 2018
Deadline	Immediately
Related links	

Financial Guarantee risks have long been identified by Lloyd's as a class of business that can bring a high level of prudential risk to the Society if written without proper controls and therefore the underwriting of this class is closely monitored and restricted.

Whereas in the past Lloyd's has published detailed rules prescribing the type of risks that can be written, Lloyd's now proposes to operate a more risk-based approach and will consider proposals on their merits through the business planning process having regard to the characteristics of the business being proposed and managing agents demonstrating that they have the appropriate controls in place.

Further, managing agents will no longer be required to obtain approval for the underwriting of individual contracts unless the risk falls outside the syndicate's business plan or the managing agent has been required by Lloyd's to submit individual contracts for agreement.

It is important to emphasise that this change of approach is not intended to signal a relaxation in Lloyd's risk appetite for the writing of this class of business, which remains limited. However, by operating a risk-based approach Lloyd's can assess each proposal individually and managing agents are not limited in the type of risks they can write by unduly rigid rules.

Definition

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" include reinsurance) where the insurer agrees to indemnify the insured against loss or pay or otherwise benefit the insured in the event of any of the following:

1 the financial failure, default, insolvency, bankruptcy, liquidation or winding up of any person whether or not a party to the contract of insurance
2 the financial failure of any venture
3 the lack of or insufficient receipts, sales or profits of any venture
4 the lack of or inadequate response or support by sponsors or financial supporters
5 a change in levels of interest rates
6 a change of rates of exchange of currency
7 a change in the value or price of land, buildings, securities or commodities
8 a change in levels of financial or commodity indices
9 any liability or obligation under an accommodation bill or similar instrument.

In addition to risks which are coded as FG, included within Financial Guarantee are the following classes:

- Contract Frustration (Risk Code CF)
- Credit Risk (to be renamed from Trade Credit) (Risk Code CR)
- Mortgage Indemnity Insurance (Risk Code FM)
- Surety Bond Reinsurance (Risk Code SB)
- Salvage Guarantee Insurance (Risk Code FG)
- Seafarers Abandonment (Risk Code SA)
- Maritime Liens (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, the managing agent should discuss it with its account executive in the Syndicate Business Performance team.

Premium Income Limits

PMD will consider all business plans that propose to include Financial Guarantee insurance, in any of the above classes, individually. By way of general guidance it is unlikely that business plans will be approved where the income arising amounts to more than 2% of the agreed Syndicate Business Plan gross written premium income, other than Credit Risk and Contract Frustration business where the relevant figure is 6% for each (in addition to income arising from other Financial Guarantee classes).

Credit Risk and Contract Frustration

Within Financial Guarantee, the two largest classes written at Lloyd's are Credit Risk (which is being renamed from Trade Credit to more accurately reflect the scope of business included in the class) and Contract Frustration. These codes cover insurance that indemnify an insured, in relation to the provision of assets, goods, services and/or financing, either (1) for the non-performance of a valid contractual obligation or (2) in relation to the calling of a valid contractual bond.

In Contract Frustration, the obligor is a government entity or a commercial entity controlled and/or majority owned by a government entity(ies). In Credit Risk the obligor is a commercial entity with a majority private ownership.

It should be noted that Lloyd's is unlikely to agree business plans where any expected obligor is an individual, unless the proposed insured contracts relate to their trade, business or profession.

In agreeing to plans for Credit Risk and Contract Frustration business Lloyd's no longer expects the risks to be explicitly linked to a trade, contract or security. Instead, business plans will be considered individually.

Managing agents are reminded of Lloyd's requirements for the inclusion of NCBR exclusions in all policies (see 'Performance Management: Supplemental Requirements & Guidance'). In the case of Credit Risk and Contract Frustration, however, Lloyd's recognises that where the insured is a bank or other financial institution then the insured may seek to have any NCBR exclusion removed to allow the insured to take credit for the insurance for the purposes of setting regulatory capital. Lloyd's may therefore agree to the removal of NCBR exclusions in such policies as part of the business planning agreement process. Managing agents must nevertheless ensure that they comply with the requirements for reporting NCBR exposures. Syndicates must also have matching back-to-back reinsurance or the exposure must be within their net risk appetite.

Additional requirements for the writing of Financial Guarantee risk

When considering proposals for the writing of any type of Financial Guarantee risks Lloyd's will expect that the managing agent can demonstrate that the following points are addressed:

<u>Appropriate capability and resource</u>

The writing of Financial Guarantee classes requires a high level of technical expertise in the underlying risks. Where it is proposed that a syndicate will write any of the Financial Guarantee classes then Lloyd's will expect the managing agent to be able to demonstrate that it has suitable underwriting resources in place. In particular, Lloyd's will expect managing agents to have a suitably robust analytical resource to support the underwriting of any business. Managing agents should also have appropriate models in place, suitable to the types of risk being underwritten.

Assignment of policy

All Financial Guarantee policies (in whichever of the risk codes listed above) 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 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.

Insolvency of the Insured

All policies must contain an exclusion in respect of any loss arising from the insolvency of the insured. In a number of territories or classes it is recognized that market practice may mean that a full exclusion is not achievable (examples of such classes include Japanese contingency, aviation contingency business, and (re)insurance of Export Credit Agencies). In such cases Lloyd’s, on a request received from the managing agent (either as part of the business plan agreement process or for individual risks), may agree with the managing agent the use of clauses that do not provide a full exclusion. Lloyd’s will also agree the scope of business that can be written on this basis.

Delegated underwriting

Other than where delegation is to a service company coverholder, Lloyd’s is unlikely to agree plans for the writing of Financial Guarantee business in any of the classes listed where the risks are bound by way of delegated underwriting. This includes, in particular, binding authorities and line slips.

Accelerated payments

Where policies provide for the insured to be indemnified for the non-payment of a financial obligation by the obligor where the obligation in question involves the obligor making a payment at a future date or a number of payments over time (for example the re-payment of a loan in installments) then it will be usual for the insurance backing the obligation to pay out over time in accordance with the original payment schedule. Lloyd’s may agree in appropriate cases to the inclusion of provisions for the making of accelerated payments at the sole election of the insured. As a general rule, however, underwriters should, in each case, have the opportunity to agree or decline to make the accelerated payments.

Fraud

Subject to any local legal or regulatory requirements, all policies must contain a clause, or clauses, to the effect that the insurer shall have at least the remedies available under the Insurance Act 2015 in relation to fraudulent misrepresentation and fraudulent claims.

In s8/Schedule 1, the Act sets out that if a qualifying breach of the duty of fair presentation was deliberate or reckless, the insurer (a) may avoid the contract and refuse all claims, and

(b) need not return any of the premium paid.

In s12 the Act sets out that if the insured makes a fraudulent claim, the insurer (a) is not liable to pay the claim, (b) the insurer may recover from the insured any sums paid by the insurer to the insured in respect of the claim, and (c) in addition the insurer may by notice to the insured treat the contract as having been terminated with effect from the time of the fraudulent act.

Contracts of surety

Underwriters are reminded that Lloyd's does not permit the writing of contracts of surety. Additionally, licensing restrictions apply to this class in most jurisdictions.

Proposals that are unlikely to be agreed

In view of the nature of the risks involved, managing agents should note that Lloyd's is unlikely to agree plans that involve the writing of the following types of risks:

- Where the underlying risk is a tradeable instrument or a contract for difference
- Where the primary risk is price risk rather than credit risk, for example:
  - Currency fluctuation risk
  - Commodity price fluctuation risk
  - Financial market fluctuation risk
  - Property/land price fluctuation risk

Reporting

To allow Lloyd's to monitor syndicate exposures against plan, Lloyd's has put in place additional reporting obligations for Financial Guarantee business. This requires the submission of an additional Financial Guarantee return for all FG, CR, CF, FM, SA, and SB coded business as part of the business plan agreement process and six-monthly thereafter. The return requires managing agents to provide details of their exposure to certain obligors and for those writing or planning to write GWP in the aggregate for this business above a threshold, currently set at £10 million for the 2019 underwriting year of account to provide details of their exposures in these classes, including by country, by sector and by exposure over time, per obligor.

Further Information

If you have any questions regarding Lloyd's requirements for the writing of Financial Guarantee business please contact Eleanor Gibson, Class of Business Manager (Tel: 020 7327 5593; email: eleanor.ejgibson@lloyds.com).