LLOYD'S

Market Bulletin

Ref: Y5410

Title	Revised guidance on Tier 2 capital limits; timing and open year solvency requirements
Purpose	To advise members and members agents on the updated requirements on the provision of capital to support members' Economic Capital Assessments
Type	Event
From	Ed Thomas, Head of Member Relations Contact: Client-Gateway@lloyds.com
Date	3 October 2023
Deadline	Effective immediately

Related links

Introduction

This bulletin revises the guidance previously issued and therefore supersedes Market Bulletin Y5177 (issued 12 April 2018). This bulletin addresses:

- The limits on members use of Tier 2 capital
- Coverage of open year solvency deficits
- Accelerated injection of capital by members

The current Tier 2 requirements were issued in response to the Solvency II tiering test, which introduced a restriction on the amount of Tier 2 assets (at member level: letters of credit, bank guarantees and life policies (collectively 'LOCs')) eligible for solvency coverage.

The requirements set out in Y5177 are deemed to be complex and open to interpretation. Consequently, we have taken steps to simplify them.

1. Application of the Tier 2 capital limits

The requirements detailed in Section 2 are applicable to members as follows:

- Members with an Economic Capital Assessment ('ECA') **greater than £5m only**. Where a member's ECA is £5m or less the Tier 2 capital limits do not apply.
- Tier 2 capital limits are applied to each member individually except where members are party to an inter-availability arrangement in which case the limits will be applied to the combined capital position of the donor and successor members.
- Tier 2 capital limits are applied separately to a member's non-life and life underwriting.

2. Tier 2 capital limits

Members may continue to utilise LOCs to support their ECA requirements. Increases in the proportion of LOCs within members' Funds at Lloyd's ('FAL') will be permissible in certain circumstances, subject to restrictions on the amount per the below.

The following requirements have not changed/ remain in force:

2.1. New members are allowed to fund up to 50% of their ECA with LOCs at the point they first provide capital. If they provide non-LOC FAL initially, any subsequent request to provide LOCs will be subject to the requirements detailed below.

2.2. Existing members whose ECA increases can fund 50% of the incremental ECA increase by LOCs within the relevant quarter.

Effective immediately, the following changes have been introduced:

2.3. Existing members can increase LOCs by up to 10% of their ECA per annum without seeking prior approval from Lloyd's, providing the new ratio does not exceed 50%.[1]

2.4. Existing members who wish to increase LOCs by greater than 10% of their ECA per annum can now apply for an increase. Prior consent must be sought in advance from Lloyd's[2] *and the 50% total limit rule will still apply.*

- *This changes the previous rule where no increase about the allotted 10% per annum would be allowed/ considered.*

2.5. Existing members whose ECA decreases are not required to reduce LOCs if Tier 2 capital remains at 50% or below when measured against the new ECA.

[1] Please note that clauses 2.2 and 2.3 operate independently. It is possible to increase LOC's by up to 10% of latest ECA in a given year (subject to the 50% limit). Separately, where ECA increases at any time, the increase can be funded up to 50% by LOC's. These two separate requests can occur in the same calendar year".

[2] Prior consent of the Deputy CFO and Head of Member Services required.

- *This replaces the prior rule that required a member to maintain a proportion of Tier 2 equal to or lower than the proportion pre.*

2.6. Existing members who are in breach of the 50% allowance are no longer required to rectify this issue within the quarter the breach occurs. Members will have an extended period – broadly aligning with Lloyd's bi-annual PRA Solvency II Ancillary Own Funds[3] applications in May and November each year – to address these breaches. <u>The deadline for resolving a breach will now be in May or November (depending on when the breach occurred).</u>

- *This is a significant change to the current rules, recognising that LOCs can be both timely and expensive to change. This change also seeks to address the issue that in Q4 members have historically been forced to make changes to their LOCs based on ECA figures later rendered redundant by changing Syndicate Business Forecasts.*

Worked examples:

- **A members ECA decreases from £100m to £60m, what is the impact?**
  They are not required to reduce Tier 2 capital if their LOCs are valued at £30m or less, £30m representing 50% of the new ECA in this example.

- **A new member has an ECA of £100m, what amount can be funded by LOC?**
  Up to £50m of the capital requirement can be funded by LOCs at the point of funding, thereafter, the member can increase the amount of the ECA funded by LOCs by a maximum of 10% per annum (note, Lloyd's may permit increases above 10% but prior consent is required).

- **A member has an ECA of £100m and current Tier 2 capital of £30m, can they increase the proportion of Tier 2 assets?**
  Yes – they can increase LOCs by £10m (i.e., 10%) per annum or less without seeking prior approval from Lloyd's. If they wish to increase their LOC by more that 10% in one year, prior consent must first be given by Lloyd's.

- **If a member's ECA increases from £100m to £200m in the year, can they increase the amount funded by Tier 2 assets?**
  Yes – Members can fund up to 50% of the incremental increase via Tier 2 assets in the year (in this example, up to £50m of the total £100m increase).

[3] Lloyd's is required to submit an Ancillary Own Funds application to the PRA twice per annum. Submissions are made in May and November each year.

- **A Member has breached their Tier 2 allocation, holding 52% in LOCs in their Q4 Quarterly Corridor Test (QCT). When does this need to be rectified by?**
  Where a Tier 2 breach is identified in a Members Q4 QCT, issued on Working Day 35 around 17 November annually, the breach would now only need to be rectified by the PRA deadline around 10 May in the following year. Similarly, a breach recognised in a Members Q2 Capital Test statement or QCT would now need to be rectified by the PRA deadline around 1 November.

Tier 2 breach identified	Deadline to be rectified
Q4 / Q1	PRA deadline around 10 May
Q2 / Q3	PRA deadline around 1 November

Members are reminded of the following general guidance:

- These requirements are effective immediately.
- Lloyd's retains the right of review and the rules are subject to change at any time to ensure compliance with Solvency II requirements at a market-wide level.
- Members should be mindful of the 50% limit. Lloyd's recommends Members maintain an adequate buffer to ensure they are not affected by volatility (such as foreign exchange fluctuations) that may impact them adversely. Please note there is no *de minimis* to the application of the rule and, as such, the 50% limit should be considered a hard cap.
- Where a member uses LOCs to support its ECA, they must be lodged with Lloyd's in accordance with the timetable for the provision of LOCs in May and November. Deadlines for lodging LOCs are published separately as part of the FAL business timetable.
- Lloyd's require all issuing banks to confirm the validity of each LOC issued on behalf of members on a six-monthly basis. If this confirmation is not provided by the issuing bank, Lloyd's reserves the right to discount the value of the LOC as part of a member's FAL until such time as the bank provides the necessary confirmation.

3. Application of the guidance on open year solvency deficits

The requirements detailed in Section 4 are applicable to members as follows:

- All members, regardless of their size, are required to ensure open year solvency deficits are covered by Tier 1 capital.
- Applied to each member individually except where members are party to an inter-availability arrangement in which case the combined solvency deficit of the donor and successor members needs to be covered by Tier 1 capital.
- Member's non-life and life underwriting are assessed separately.

4. Open year solvency deficits

Solvency deficits or surpluses represent a Members balance for each underwriting year on the solvency return, excluding Funds In Syndicate ('FIS'). All net open year solvency deficits – open years' solvency deficits net of solvency surpluses – reported on members' capital test and corridor test statements need to be fully covered by Tier 1 capital by the next coming into line (CIL) or corridor test deadline.

Coverage of net open year solvency deficits does not necessarily require an injection of Tier 1 capital. If a member has already lodged Tier 1 capital (FAL or FIS) which is equal to the value of its net open year solvency deficits no additional injection of Tier 1 capital is necessary. This is subject to the member also meeting the tiering limits as above.

Worked examples:

- **A Member's net open year solvency deficit is £100m and there is £150m of Tier 1 capital as FAL or FIS, is an injection necessary?**
  No – no further injection of Tier 1 capital is necessary as the entire solvency deficit is covered by the £150m Tier 1 assets already held.
- **A Member's net open year deficit is £100m and there is £75m of Tier 1 capital as FAL or FIS, is an injection necessary?**
  Yes - an additional injection of £25m of Tier 1 capital is needed to cover the unfunded shortfall of the deficit.

Members are also notified that LOCs under notice of cancellation are no longer eligible to cover net open year solvency deficits therefore the guidance set out in market bulletin Y3857 no longer applies.

5. Accelerated injection of capital

On the occurrence of an event, or series of events, that has a material impact on the level of a member's solvency, Lloyd's reserves the right to request from the member an additional injection of FAL or FIS.

Full guidance on this is included in Paragraph 2.5L. to 2.5O. in the Revised Membership and Underwriting Conditions and Requirements (M&UR's) issued under Market Bulletin Y5353.

If you require any more information regarding this bulletin, please contact the Client Gateway team client.gateway@lloyds.com