LLOYD'S

Management of Collateralised Reinsurance

Market Themes & Best Practice – August 2024

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Foreword

Collateralised reinsurance is used extensively across our market as an important component in many outwards reinsurance programmes. While only 13% of Lloyd's syndicates' current outwards reinsurance premium spend is supported by collateral, the majority of syndicates now use collateralised products to some degree.

Collateral mechanisms can range from letters of credit that support outsized or lower rated counterparty exposures, and which are not expected to be drawn upon under normal circumstances, to assets in trust used to pay regular reinsurance recoveries under transactions involving unrated cell companies and/or Insurance Linked Securities (ILS). Properly managed, collateral can mitigate counterparty credit risk under more traditional reinsurance transactions, reduce syndicate capital requirements, give reinsurance buyers access to a broader pool of risk-taking capital, and help manage liquidity risk.

But collateral arrangements are not risk free.

Some collateralised arrangements will feature legal and jurisdictional complications beyond those associated with traditional rated paper transactions. Unfamiliar documentation, combined with billings and collections processes that differ from conventional uncollateralised reinsurance, can introduce administrative and operational risks for the less experienced buyer. Non-payment remains a risk: collateral does not remove dispute risk; and while it's hopefully unlikely, the collateral provider or trustee themselves could become financially impaired. Lastly, by introducing additional parties into the transactions and facilitating risk transfer beyond the traditional reinsurance market, there is the potential for opacity and misinterpretation between stakeholders.

A syndicate's management of collateralised reinsurance is considered as part of the Outwards Reinsurance Principle under Lloyd's principles-based oversight framework. We expect all syndicates who use, or are planning to use, collateralised reinsurance to be on top of this risk.

In speaking with the market on approaches to collateral management we have found pockets of excellence which sit alongside areas for improvement. At Lloyd's, we want to support the market to strengthen reinsurance collateral management and minimise risk.

In addition to the appropriate management of collateral risk, the modelling must also be appropriate if syndicates are to recognise the benefit of such arrangements in their Solvency Capital Requirement calculations. Some high level considerations are included in this document, but for more detailed guidance on the treatment of collateralised reinsurance in the internal model we would refer syndicates to the current Lloyd's Capital Guidance (links included at the end of this document).

The intention of this report is to share those examples of best practice we are seeing through Lloyd's oversight process. We hope the guidance contained is useful for both syndicates seeking ways to improve their management of collateralised reinsurance risk, and syndicates looking to set up the processes and procedures needed to use collateral for the first time.

For further information or to discuss your plans, please contact your usual Lloyd's Outwards Reinsurance Manager.

James Cunnington, Head of Reinsurance, Lloyd's

1. Market Challenges

Lloyd's Outwards Reinsurance Team carried out a high-level review of collateral management and controls in 2024, engaging with a number of syndicates. From this, some strengths, weaknesses and common themes have been identified. This section discusses some of the potential challenges and risks within the market.

1.1 Collateralised reinsurance adds complexity

- Collateralised reinsurance forms part of the overall reinsurance programme but will require separate consideration within the reinsurance strategy, purchasing plans and processes.
- Collateralised exposures and trustee relationships will need to be expressly considered as part of the counterparty management process.
- Associated risk should be explicitly considered and potentially included within syndicate risk appetite.
- Additional reporting suites, management tools, time and expertise are needed to monitor and manage the collateral positions, releases and risks.
- If any associated capital benefit is included in the internal model, this must be clearly communicated, with collateral risk adequately represented.
- Formal collateral documentation, whether trust agreement or letter of credit, is in addition to the reinsurance documentation. This will require review, and will also need to be cross-referenced with the reinsurance contract to ensure no conflict or gaps in intention and terms.

1.2 Availability and experience of staff

- Levels of experience and understanding around collateralised reinsurance risk may be lower than for traditional reinsurance risk, which has been available for longer and is more widely used. This is especially true in syndicates where there are low volumes or purchasing frequency of collateralised contracts.
- Given collateral risk can be considered across multiple teams, this could affect more than just the Outwards Reinsurance function.
- Collateralised reinsurance typically requires specific identification of staff with the authority to transact on behalf of the syndicate, for example to draw down and/or manage the release of collateral. Where this involves only a small number of senior staff this can be subject to key personnel risk and delays if authorities not reviewed and maintained regularly.

1.3 Divided operational management

- For syndicates that are part of a larger group where that group holds responsibility for the collateral strategy and overall collateral management, there is a potential for reduced visibility and lower understanding of the risk by the syndicate.
- On occasion, collateralised reinsurance is shared across entities. Shared reinsurance, including collateralised reinsurance, carries its own risks and must be subject to robust protocols and processes.
- The management and monitoring of various collateral features (such as monitoring of funds or validation of counterparties) could sit across different teams within the syndicate and communication is vital to ensure the risk is understood.

1.4 Evolving market experience

- Collateral is not risk-free and there have been a small number of issues affecting some of the market over the last few years. The market can learn from these experiences and work to strengthen processes and controls to mitigate future issues.

2. Collateral Features

There are different types of collateral arrangements. The characteristics can vary, with some arrangements giving the ability to drawn down funds immediately following a loss, and others offering collateral on a contingent basis, or only if the reinsurer fails to meet a contractual obligation. Risk considerations inevitably vary across these different types of arrangement.

This section outlines Lloyd's approach to some of the key features of collateral arrangements. The following considerations focus on the structure and operation of collateral arrangements. Specific considerations relating the composition of the collateral itself are summarised on the following page.

- As a general rule, contingent collateral (arrangements where the collateral is only posted following a loss or other triggering condition) is not considered to be 'held' collateral and benefit for financial strength cannot typically be taken in the capital model for this type of arrangement.

- Parental Guarantees are generally not considered a form of collateral. In some cases they can act to mitigate counterparty credit risk, but any benefit taken should be subject to careful consideration as some have the potential to be legally unenforceable.

- Benefit for collateral can only be taken up to the current financial value. Any gap between the value of the collateral held and the reinsurer's total contractual exposure should be considered as unprotected.

- Collateral requirements can change over the lifetime of the exposures. Where collateral release mechanisms exist (requiring release of any excess in line with prescribed calculations, and/or mandatory commutation processes) these should be allowed for in the internal modelling and for loss reserving. In general, it may not be possible to have collateral reinstated if there are loss deteriorations following a release, so any gap should be considered as unprotected.

- Where a single collateral arrangement is being used by a counterparty as a financial guarantee for multiple beneficiaries and/or multiple exposures, the contractual exposure will generally be considered as unprotected by the collateral.

- Benefit can only be taken for collateral arrangements that are payable on demand, or have acceptable terms of trade to minimise liquidity risk.

- There is an exchange rate risk where the collateral arrangements are in a different currency to the reinsurer's exposure which will need to be factored into any benefit taken.

- Collateral is not risk-free and internal models should take into account the potential for financial failure of the credit institution holding the funds.

The following table provides some guidance for treatment of some of the most common forms of the collateral itself. In all cases the choice of financial strength rating equivalence for modelling and management purposes should be evidenced-based and specific to the collateral in question. Syndicates should also consider the extent to which collateral arrangements would be impacted in stressed scenarios when determining approach.

Collateral Form	Risk Considerations	Recommended Credit Risk Approach
Cash in Trust	Cash is placed into a separate legally protected trust account. As such, the funds are reasonably well protected against financial failure of the credit institution managing the trust, however there is still a risk of contract dispute, regulatory action, and delayed payment / liquidity risk	Expected financial strength equivalence in 'A' to ‘AAA’ range.
Cash equivalents in Trust*	Can be to be considered ‘equivalent’ to cash if the assets can be immediately convertible to cash with little to no risk of devaluation in value	Expected financial strength equivalence in 'A' to ‘AAA’ range; lower if market/liquidity risk
Assets in Trust*	As above, but noting there is still a risk of contract dispute, regulatory action, delayed payment / liquidity risk, and devaluation / market risk on the individual assets which will vary significantly depending on the specific nature, investment ratings and diversity profiles of the underlying assets	Max financial strength equivalent to ‘A’
Government financial instruments in Trust	Considerations similar to Assets in Trust	Max financial strength equivalent to credit ratings of applicable government / sovereign
Letters of Credit (LOCs)	A form of ‘financial guarantee’ rather than granting access to explicit assets, and so present different forms of non-payment risk than others forms of collateral. They will be directly affected by any financial failure of the credit institution providing the LOC. Additional considerations include the strength and/or domicile of the credit institution, whether LOC period matches the period of the reinsurers exposure and is clean and irrevocable, notice of cancellation provisions, law of jurisdiction.	Not to exceed financial strength of: credit institution / collateral provider; applicable government / sovereign; ‘AA’ equivalent

**Excluding government financial instruments*

Solvency II regulations outline various requirements that must be met for collateral arrangements to be recognised in the Solvency Capital Requirement calculations, with the key points being that the reinsured should have access to the collateral assets in a timely manner in the event of default; that the collateral should be of sufficient credit quality and stable in value; and the value of the collateral should not be dependent on the credit quality of the counterparty.

If there are any questions regarding the appropriate approach for the modelling of reinsurance collateral please contact the Lloyd’s Market Reserving and Capital Team or the Outwards Reinsurance Team.

3. Market Best Practice

This section explores in more detail some best practices exhibited by syndicates relating to management of collateral.

Lloyd's does not mandate that specific processes and controls be used by syndicates; this is not a 'checklist' but a collection of good practices employed by some syndicates to manage collateralised reinsurance risk and to support achievement of positive reinsurance outcomes.

Syndicates should consider their level of Expected Maturity and the extent to which they use collateralised reinsurance and tailor their approach, management and controls accordingly. This concept applies to all syndicates: even those with only an occasional purchase of collateralised reinsurance will need to have adequate management and controls.

It is important that syndicates refer back to the Outwards Reinsurance Principle and sub-principles under Lloyd's oversight framework when designing or evaluating how they manage collateralised reinsurance from both an operational and a risk perspective.

3.1 Reinsurance Strategy for Collateralised Reinsurance

Syndicates exhibiting best practice make informed, deliberate choices around the use of collateralised reinsurance. Some examples of good practice that support this are as follows:

- Clear strategy, regularly reviewed, around use of collateralised reinsurance – including which types of collateral and funds (if any) are deemed acceptable.
- Inclusion of collateralised reinsurance within risk management framework, and documented procedures outlining practical management.
- Transparent and clearly communicated risk appetites for collateralised reinsurance, including consideration of concentrations applying directly to the syndicate business strategy (especially where a syndicate is part of a wider group), enabling targeted control, management and decision making.
- Thorough consideration of collateralised reinsurance planned for the prospective year, reported in the Syndicate Business Forecast (Form 730) and clearly articulated in the narrative.
- Appropriate consideration given to management and controls (in line with the Outwards Reinsurance Principle under Lloyd's oversight framework) before any new collateral arrangements are entered into, even where the syndicate has assessed it unnecessary to have formal policies and processes in place due to low historic utilization of collateralised reinsurance.
- Express consideration given to collateral within counterparty approval process.
- Stress and scenario testing of delayed or non-payment of collateral, particularly where collateralised reinsurance forms a meaningful part of the outwards reinsurance strategy.

3.2 Roles, Responsibilities and Rules around Collateralised Reinsurance

Syndicates exhibiting best practice have a clear understanding of roles and responsibilities relating to collateralised reinsurance arrangements, supported by frameworks and policies at an appropriate level for the risk and materiality presented. Some examples of good practice that support this are as follows:

- Clear accountability and ownership for the management of the collateralised reinsurance, including documented roles, responsibilities, governance and decision-making authorities relating to reinsurance collateral.
  Examples could include specifying the individuals or committees with overall responsibility and accountability for collateral, system recording, filing and administration, monitoring of balances, internal and external reporting, escalation routes, authorities and hierarchy structures (for binding, withdrawal, release, commutation), contract review, bank and/or trust account checks, peer review, independent review of process.
- Clearly defined and sufficiently detailed collateral management processes (including monitoring, reporting, escalations routes, and collateral release process), that are effectively followed.
- Where management of collateral takes place at group level, the syndicate can demonstrate a clear understanding of the policies, processes and controls in place, and that it has adequate and regular oversight of values involved, and a view of the potential collateral risks.
- Where collateralised reinsurance is shared with another party, the syndicate has clear and effective rules for managing shared reinsurance and associated collateral.
  Please note that the additional risk associated with the shared collateral must be recognised in the capital model.
- Active application of control framework across all collateralised reinsurance, irrespective of the expected levels of risk or activity.

3.3 Collateralised Reinsurance Data, Reporting and Management

Syndicates exhibiting best management of collateralised reinsurance have good quality data and effective reporting of key information. The following approaches may help to achieve this, and will depend on the nature and materiality of a syndicate's collateral exposures:

- Accurate, complete, up-to-date and consistent records that are proportionate and can be easily identified.
  For example, a central syndicate system capturing all data relating to collateralised transactions.
- Appropriate management information and active use of collateral reports to understand current utilisations, effectiveness of cover, what this means for the business, and whether actions are needed as a result.
- Accurate reporting of collateral in the relevant Lloyd's market returns during the year, namely SRS, QMA, RDS and RDL.
- Active monitoring of exposures to Trust Accounts, Loss Funds and Letters of Credit.
  For example, a maintained and up-to-date list of all in force Letters of Credit which are validated at least annually. This monitoring extends to include any collateral being held by a Group entity on behalf of the syndicate.
- Effective process in place for regular monitoring of data quality and adherence with defined procedures and authorities, which can be evidenced through independent audit.
- Where capital benefit if being taken for collateralised reinsurance, the syndicate has made adequate consideration of the risks associated with collateralised reinsurance in the internal model, including clear articulation of the methodology employed.
  Please note that any potential gaps, such as where collateral is not ringfenced to the syndicate and transaction or is not held to the full limit of liability, should be considered as unprotected.

3.4 Collateral Counterparty Management

Syndicates exhibiting best practice take a proactive approach to management and monitoring of collateral counterparty risks. Some examples of good practice that support this are as follows:

- Independent verification of banks or similar institutions acting as a party to the collateral arrangement, prior to binding of contract and also at regular intervals while the collateral is still in force.
- Evidencing of internal and external authorities, signatories and key contacts relating to the collateral arrangement. Details maintained and reviewed regularly to avoid unnecessary delay in collateral release. *Consideration should be given to communication flow to minimise dependence on receipt of correspondence by small number of individuals.*
- Regular monitoring of bank statements and assets in trust details relating to collateral; the frequency of such checks corresponding with the materiality of the risk / exposures.

3.5 Collateralised Reinsurance Documentation

Syndicates exhibiting best practice have clear unambiguous terms in both the reinsurance contract and the collateral arrangement, with full alignment of intent between the two. Some examples of good practice that support this are as follows:

- Clear expectations around the acceptable format of the formal documentation (hard copy or electronic) and timely filing.
- In addition to the reinsurance contract, review of the collateral documentation (trust agreement and / or Letter of Credit) by suitable person(s) with cross referencing against the reinsurance wording to ensure no conflicts and full understanding of the risks.
  We would recommend that this include review by Legal teams if the collateral arrangement is deemed to be significant to the syndicate, and / or contracts are complex, and / or there is a potential that the usual reinsurance / wording functions do not have level of expertise to assess the collateral contract.

4. Key Messages

This document shares best practice considerations for collateral management relating to the Lloyd's Outwards Reinsurance Principle in the face of potential and realised challenges. Lloyd's expects syndicates to have collateral management and controls appropriate for the risk presented.

Of the various ideas discussed in this document, the key observations are as follows:

- It is essential to carry out independent verification of banks or similar institutions acting as a party to the collateral arrangement, prior to binding of contract and at regular intervals while the collateral is still in force.
- If management of collateral takes place at group level, the syndicate must still have a clear understanding of the policies, processes and controls in place, with adequate and regular oversight of values involved.
- Careful review and cross referencing of reinsurance and collateral contract documents is important to ensure there is no conflict in terms or gaps in intention, particularly relating to the release of collateral versus liability.
- Consideration must be given to management and controls in line with the Outwards Reinsurance Principle under Lloyd's principles-based oversight framework before any new collateral arrangements are entered into – even where the syndicate deems it unnecessary to have formal policies and processes in place due to low historic use of collateralised reinsurance.
- Where capital benefit is being taken for collateralised reinsurance, the internal model must adequately consider the risks associated with the arrangements. Any potential gaps, such as where collateral is not ringfenced to the syndicate and transaction or is not held to the full limit of liability, should be considered as unprotected. The Lloyd's Capital Return should include a clear articulation of the methodology employed.

5. Useful Links

Lloyds.com: Principles for Doing Business

Principles for doing business at Lloyd's

https://www.lloyds.com/conducting-business/market-oversight/principles-for-doing-business-at-lloyds

Includes

- The Principles Maturity Matrix
- A summary of Materiality Metrics which determine Expected Maturity for each Principle

Lloyds.com: Capital Guidance

Capital Guidance - Lloyd's (lloyds.com)

https://www.lloyds.com/resources-and-services/capital-and-reserving/capital-guidance