Lloyd's Capital Guidance

Cover Note – *Key changes from previous Guidance*
June 2020

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1 Introduction

1.1 Purpose and Scope

"Lloyd's Capital Guidance", or "the Guidance", provides guidance for the calculation of the Solvency Capital Requirements (SCR), the submission of the Lloyd's Capital Return (LCR) and any supporting documents required.

This Cover Note is intended as a guide for managing agents when using the Guidance, by highlighting changes to requirements and expectations, and providing timescales for implementation.

1.2 Background

Each year since 2012, Lloyd's has published an SCR guidance document. Two of these were detailed documents (2013 YOA, 2017 YOA), and most were shorter documents covering submission instructions, clarifications to guidance, and thematic review areas.

"Lloyd's Capital Guidance", published in June 2020, is considered a standalone document and managing agents should refer to that document for the full set of Lloyd's requirements. It consolidates all existing requirements and aims to be unambiguous on all areas of capital for the Lloyd's market.

1.3 Related Documents

In addition to the Lloyd's Capital Guidance, relevant additional documents are published on Lloyds.com:

- Submission instructions detailing any changes to requirements or review processes, published annually
- Focus Areas Return collecting information of particular relevance to the submission, published annually
- Model Change Guidance
- Validation Guidance
- Minimum Standards 13, 14 and 15 related to capital modelling and validation

1.4 Governance and Review

The Guidance has been subject to detailed review by numerous stakeholders. These include:

- LCR guidance working group
- The Committee of Actuaries in the Lloyd's Market (CALM)
- Lloyd's functions: Exposure Management, Outwards Reinsurance, Market Reserving & Capital

All efforts have been made to address feedback on the Guidance. We would like to thank all parties who have provided their feedback, in particular the participants of the LCR guidance working group for their detailed review and feedback.

2 Key Changes & Clarifications

Further details have been provided on some of the key changes and clarifications to guidance below, as it has been considered useful to highlight these and provide further context and explanation around the change.

2.1 Analysis of Change

From the 2021 SCR, there is a requirement for a separate Analysis of Change (AoC) document.

Prior to the 2021 SCR, managing agents submitted an AoC, and quality varied. Managing agents included the AoC in their methodology document, or in their validation report, and some only provided comments in LCR Form 600.

From the 2021 SCR, Lloyd's requires a separate document to accompany the SCR submission. In the new Guidance, Lloyd's has included an appendix with further detail on Lloyd's expectations for AoC submissions and examples. This is not a new requirement, but explicitly states Lloyd's expectations. Appendix A of the Guidance contains good practice examples, see section 4.8.2 of the Guidance for more detail.

On CALM's request, managing agents have received an email concerning the quality of their analysis of change and Lloyd's expects changes to be implemented (if required) by the 2021 LCR submission. The reason is that this is not a new requirement, but a clarification of an existing requirement. The AoC will greatly aid Lloyd's review and reduce the need for ad hoc questions during the SCR review.

2.2 Simulation Error & Model Stability

There is no change to the previous approach, but Lloyd's has provided more guidance and a recommendation to use spread VaR to calculate SCR. See section 6.5 of the Guidance for more detail.

2.3 Discounting and Market Risk

Lloyd's has clarified (but not changed) the Guidance stating that Insurance Risk must be reported on an undiscounted basis. See section 7.2 of the Guidance for more detail.

Lloyd's has also provided more clarity regarding the treatment of discounting in Market Risk. This includes:

- The consistency of discount rates used in the capital model and the technical provisions (see section 3.7.3 of the Guidance for more detail)
- The "capping" of the discount benefit for the ultimate SCR (see section 10.3.3.3 of the Guidance for more detail), which relates to managing agents not taking credit for investment income on Funds at Lloyd's (FAL) and emphasising that assets should be depleted when necessary (i.e. if required to make claim payments). Clarification has been added to both the ultimate and one-year basis.

Moreover, Lloyd's has added further detail on liquidity risk and split interest rate risk reporting into interest rate on assets and on technical provisions.

2.4 Correlations Between Classes

Lloyd's has clarified the requirement for a minimum level of correlation between classes (see sections 7.3.9, 9.3.5 and 13.4.1 of the Guidance for more detail). Lloyd's has queried managing agents in the past where no minimum correlation has been applied, but has now formalised this requirement.

2.5 Board Sign-off of the SCR

The requirement for Board sign-off of the SCR is now stated explicitly (see section 4.2 of the Guidance for more detail). This is not a new requirement, but it has been made explicit.

2.6 Time Horizon

Previously, managing agents could choose their modelled time horizon (as a proxy for Ultimate) for Market Risk, Operational Risk, and Other Credit Risk.

This Guidance document removes the flexibility for Operational Risk and Other Credit Risk: going forward, these must be modelled to ultimate – however, one-year operational and credit risk can be modelled as ultimate. The flexibility for choosing a Market Risk time horizon (as a proxy for Ultimate) remains, subject to a one-year minimum.

See section 3.5 of the Guidance for more detail.

2.7 Dispute Risk

Dispute risk must be allocated to RI Credit Risk (see section 11.4.9 of the Guidance for more detail). This was allocated to insurance risk in the past.

2.8 Operational Risk

Lloyd's has provided a clearer delineation of operational risk and other risk types (see section 12 of the Guidance for more detail).

2.9 Large v Attritional v Catastrophe Losses

Lloyd's has defined Large losses, Attritional losses, and Catastrophe losses (see section 8.3.6 of the Guidance for more detail). In particular, large and attritional claims should be defined from the ground up as large or attritional.

2.10 Dependencies & Volatility

Lloyd's has provided additional guidance on what should be included in dependencies and volatility. This is covered in Section 6.3.2 of the Guidance. Further details can be found in Section 13 (Diversification) and Section 7.3.8 (Claims Inflation). Additionally, Lloyd's has also been more specific on factors to be considered when parameterising the model. The requirements on how to deal with parameter uncertainty have been set out in section 6.3. The requirements on how trends like claims inflation should be considered have been set out in section 7.3.8. Furthermore, an additional section on how the uncertainty of premiums should be taken into account has been added in 8.3.5. None of these requirements are new per se – most are based on requirements which have been in place since the ICA guidance was published in 2010. However, Lloyd's have clarified expectations within these requirements and have made them more explicit than in previous versions of the guidance.

2.11 New syndicates: Making it Happen process

Lloyd's has set out the process we will follow in relation to new syndicates going forward, in particular requirements relating to new syndicates coming off the syndicate benchmark model (Section 15 – Appendix B).

3 Timelines for Implementation

Managing agents are required to calculate and report their capital from 2021 YOA in line with this guidance. There are some exceptions where the guidance has changed, and time may be required to implement the change. These exceptions are:

- Capping requirements for Market Risk: see section 2.3 of this document.
- Risk Type Time Horizons: see Section 2.6 of this document
- Dispute Risk: see Section 2.7 of this document
- Operational Risk delineation: see Section 2.8 of this document
- Large v Attritional v Catastrophe loss definitions: see Section 2.9 of this document
- Dependencies & Volatility: see Section 2.10 of this document

If managing agents are out of line with the guidance in any other area, they should state this in their documentation and lay out a plan on how to address this going forward. If being out of line with the guidance might result in an understatement of capital, then Lloyd’s might load the submitted SCR.