LLOYD'S

Market Bulletin

Ref: Y5375

Title	Franchise Guidelines – Catastrophe & Tail Risk Exposure and Line Sizes
Purpose	To update Lloyd's Franchise Guidelines for Catastrophe & Tail Risk Exposure and for Gross & Net Line Sizes
Type	Event
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Date	21 June 2022
Deadline	Immediate
Related links	

Lloyd's has prescribed a number of Franchise Guidelines, which are set out in 'Performance Management: Supplemental Requirements and Guidance'. Managing agents are expected, under normal circumstances, to operate their businesses within the guidelines. A dispensation is required from Lloyd's where a managing agent proposes that a syndicate should operate outside the guidelines.

Following a review, the guidelines on Catastrophe Exposure and Line Sizes are being revised. The full text of the amended guidelines, showing the changes we have made is included at Appendix 1. The following outlines the main substantive changes:

1 The limitation on a syndicate's 'AEP 1-in-30 Whole World' modelled loss has been removed. Lloyd's now monitors aggregate natural catastrophe risk using other tools and this restriction is no longer required.

2 A new requirement has been introduced to restrict the amount of tail risk that a syndicate can be exposed to. This operates as follows (depending on whether a syndicate has an internal model and submits an LCR to Lloyd's):

- For syndicates with an internal model that submit an LCR, the 99.8th percentile (1-in-500) of the insurance claims shall not exceed 135% of the 99.5th percentile (1-in-200) of insurance claims. Both measures refer to the total modelled insurance claims net of reinsurance on an ultimate basis as reported to Lloyd's in the LCR submission (Form 311).
- For syndicates that do not have an internal model or submit an LCR, the 99.8th percentile of Final Net LCM WWAP losses shall not exceed 135% of the 99.5th percentile of Final Net LCM WWAP losses and the 99.8th percentile of Final Net LCM WWAP claims shall not exceed ECA plus profit.

3 A new net line size requirement has been introduced specifying that the maximum net line size that a syndicate may have on an individual risk cannot exceed 30% of ECA plus profit, where profit is defined as 'Profit/Loss for the period' on an Ultimate basis in the approved Year of Account SBF (Item 16 of SBF Form 100s).

4 The maximum gross line size that a syndicate may apply without requiring a dispensation has been increased to 25% of GWP, subject to a maximum line size of £200m. We are satisfied that gross line sizes can be considered as part of the usual business plan agreement process, and the need for dispensations should only apply in the most material cases.

The new guidelines for tail risk and net line size to ECA restriction are being introduced to ensure that syndicates do not expose the Central Fund to disproportionate risk in relation to individual syndicate losses. We have back-tested these guidelines using prior year data and, over the period tested, only a small number of syndicates would have exceeded the guidelines. We therefore do not anticipate that these guidelines will materially impact most syndicates in most years. We will be contacting syndicates that may be impacted to discuss with them how they will manage the tail risk and their net line sizes, to comply with the guidelines.

Further information

Managing agents should contact their Account Manager if a breach of these guidelines is considered a material risk for the next LCR/SBF submissions.

The changes to the Franchise Guidelines apply with immediate effect.

Appendix 1 – Revised Franchise Guidelines for Catastrophe & Tail Risk Exposure and Line Sizes

Lloyd's Franchise Guidelines are set out in the 'Performance Management: Supplemental Requirements and Guidance'. The updated Franchise Guidelines for catastrophe and tail risk and for gross and net line sizes are set out below, highlighting the changes from the current Franchise Guidelines. The changes apply with immediate effect. The 'Performance Management: Supplemental Requirements and Guidance' is periodically updated and the change will be incorporated at the next update.

2. Catastrophe and tail risk exposure

a. Catastrophe exposure should be analysed using tools or methods that are approved by Lloyd's.
b. A Syndicate's ~~'AEP 1-in-30 Whole World' modelled loss,~~ projected and in-force loss estimates for Realistic Disaster Scenarios, shall not exceed 80%~~110%~~ of ECA plus Profit for Gross Losses and 30%~~45%~~ of ECA plus Profit for Final Net Losses.
~~c. For all other cat risk metrics, as prescribed by Lloyd's in its RDS Guidance and Instructions Document, 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.~~
c. The 99.8th percentile (1-in-500) of the insurance claims shall not exceed 135% of the 99.5th percentile (1-in-200) of insurance claims. Both measures refer to the total modelled insurance claims net of reinsurance on an ultimate basis as reported to Lloyd's in the LCR submission (Form 311). For syndicates which do not have an internal model and do not submit an LCR to Lloyd's this does not apply. Instead, the 99.8th percentile of Final Net LCM WWAP losses shall not exceed 135% of the 99.5th percentile of Final Net LCM WWAP losses and the 99.8th percentile of Final Net LCM WWAP claims shall not exceed ECA plus Profit. Final Net LCM WWAP metrics will be calculated by Lloyd's based on syndicates' latest approved LCM Forecast submissions.

'Profit' for these purposes~~this purpose~~ shall be defined as 'Profit/Loss for the period' on an Ultimate basis in the approved Year of Account SBF (Item 16 of SBF Form 100s).

- Guidance

In reviewing a syndicate's management of gross and net catastrophe exposures and tail risk, attention will be paid not only to overall syndicate capital, but also to:

- ~~The net written premium allocated by the syndicate to the line of business~~
- The level of expected underlying profitability in the line of business absent major catastrophic events
- The level of expected profitability in the other lines of business written by the syndicate, and the degree of inherent volatility in those other lines

- The quality, nature and effectiveness of the reinsurance protecting the gross exposures; in terms of the overall scale, types of product purchased, the legal and structural strength of the contracts involved, the financial strength and concentration levels of the reinsurance counterparties involved, and the quantity and quality of any supporting collateral arrangements
- The overall liquidity of the syndicate, and its ability to meet any expected regulatory funding requirements
- The assumptions used in modelling catastrophe exposures, and
- The managing agent's capability and competence

The purpose of this guideline is to ensure that the capital of any syndicate (and ultimately the Central Fund) should not be threatened to an unreasonable or unexpected extent by catastrophe losses or undue tail risk.

3 Gross and net line size

The maximum gross line that a syndicate should have on an individual risk is 25%~~8%~~ of GWP, subject to a maximum line size of £200m. The maximum net line size that a syndicate should have on an individual risk cannot exceed 30% of ECA plus profit, where profit is defined as per 2 above.

- Guidance

In reviewing a syndicate's gross line sizes on individual risks for any class of business, attention will be paid not only to overall syndicate GWP, but also to:

- The GWP allocated by the syndicate to the line of business
- The level of capital
- The risk characteristics of the line of business, and the level of expected profitability in that line
- The level of expected profitability in the other lines of business written by the syndicate, and the degree of inherent volatility in those other lines
- The quality, nature and effectiveness of the reinsurance protecting the gross line size (including the overall scale, types of product purchased, the legal and structural strength of the contracts involved, the financial strength and concentration levels of the reinsurance counterparties involved, and the quantity and quality of any supporting collateral arrangements)
- Line size utilisation, and
- The managing agent's capability and competence

When reviewing the net line size in relation to the level of capital, the following aspects will be taken into account:

- Line size utilisation and the number of risks exceeding the threshold
- The risk of accumulation between individual risks
- The maturity of the syndicate and future growth plans, and

- The member structure of the syndicate.

The intent of the guidelines is that~~This is consistent with the intent of the existing guidelines, and the CSG consultation document statement that "Iindividual~~individual risks should not be allowed to threaten the viability of the syndicate, putting members and the Central Fund at risk~~large portions of a syndicate's capital~~".

For the sake of clarity, it is emphasised that it is not the intention ~~simply~~ to apply guideline percentages ~~of syndicate GWP~~ to the premium or ECA and profit allocated to the individual line of business, but to the GPW or ECA and profit of the syndicate as a whole~~or to capital~~.