Lloyd's to Restrict Members' Use of Letters of Credit as Funds at Lloyd's

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INTRODUCTION

The Lloyd's Market Bulletin Y5117 published on 12 April 2018 clarifies recent guidance from Lloyd's on:

- limits on members' use of Tier 2 capital, including letters of credit, to meet their regulatory capital requirements ("Funds at Lloyd's");
- coverage of open year solvency deficits; and
- situations in which an accelerated injection of capital may be required from members.

This client update sets out Lloyd's current position for each of these topics.

LIMITS ON USE OF TIER 2 CAPITAL

From 1 January 2016, when Solvency II[1] came into force, the Solvency Capital Requirement ("SCR") of each Solvency II firm must be covered by at least 50% Tier 1 capital, which includes ordinary share capital, non-cumulative preference shares and relevant subordinated liabilities. This requirement applies to the Lloyd's market as a whole, but not to each member in that market. Lloyd's members therefore had an advantage over insurance companies in that, provided the market as a whole had 50% Tier 1 capital covering the Lloyd's SCR, some members could cover their entire capital requirements, known as Funds at Lloyd's, with letters of credit ("LOCs"). Tier 2 capital includes qualifying LOCs, bank guarantees and life policies.

From 1 December 2020, each member's Tier 2 capital allowance as a proportion of its Funds at Lloyd's may not exceed 50% of its Economic Capital Assessment ("ECA"). This restriction will be phased in over the coming years, with a requirement that each

[1] Solvency II is the new regulatory regime covering all EEA insurance companies including Lloyd's.

member reduce its Tier 2 capital usage to no more than 90% from 1 December 2018, 70% from 1 December 2019 and, ultimately, 50% from 1 December 2020. No member's Tier 2 capital should exceed these limits at each of the respective dates.

Lloyd's previously released unpublished guidance forecasting this change and there has been speculation in the market that a bulletin of this nature would be issued. However, the announced 50% cap is more restrictive than was anticipated.

As a result, a large amount of capital in the Lloyd's market will be ineligible to cover its SCR, affecting the amount by which it exceeds its SCR (its SCR coverage ratio). According to Lloyd's, as at 31 December 2017, approximately £2bn of Tier 2 capital at Lloyd's was ineligible for solvency credit. Rating agencies consider the SCR coverage ratio in rating the Lloyd's market, which is currently rated A+ by Standard & Poor's, AA- by Fitch Ratings and A by A.M. Best. The SCR coverage ratio is a key advantage that syndicates may leverage off.

The bulletin states that:

- If a member's Tier 2 capital, including LOCs, is currently more than 50% of ECA, the member will not be allowed to increase its Tier 2 capital. The only exception is where there is an increase in ECA, in which case the member may cover up to 30% of any such increase with Tier 2 capital.

- If a member's Tier 2 capital is currently less than 50% of ECA, the member may use Tier 2 capital to cover up to 50% of any subsequent increase in ECA.

- Any new member to Lloyd's with an ECA of more than £5m may fund up to 50% of their ECA with Tier 2 capital.

- Tier 2 capital limits apply to a member's non-life and life underwriting separately. Where a member's ECA is £5m or less, these limits do not apply.

Managing agents, members' agents and members should consider their current use of Tier 2 capital to ensure that they comply with these new restrictions by 1 December 2018 and make plans to have alternative capital in place once the final 50% requirement comes into effect in 2020.

COVERAGE OF OPEN YEAR SOLVENCY DEFICITS

Solvency deficits represent the member's balance for each underwriting year, excluding funds in syndicate. All members are required to cover net open year solvency deficits with Tier 1 capital before the next coming into line deadline.

A member's non-life and life underwriting are assessed separately for these purposes.

Another development from the bulletin is that LOCs, bank guarantees and life policies under notice of cancellation are no longer eligible to cover net open year solvency deficits.

ACCELERATED INJECTION OF CAPITAL

Lloyd's reviews its members' financial situation quarterly. However, there is an expectation that managing agents inform Lloyd's when, in the interim, (i) the net solvency surplus or deficit decreases by more than 10% of the syndicate's ECA, (ii) the risk profile has changed so that the ultimate SCR ("uSCR") increases by at least 10%, or (iii) there is a shortfall of at least 10% against ECA.

Where the shortfall is against a member's ECA but not its uSCR, Lloyd's has discretion in deciding whether the member should be required to cover the shortfall before the next coming into line deadline. Generally, where the shortfall is greater than 10%, the member should expect to be required to inject capital to reduce the shortfall to less than 10%. Lloyd's has indicated that it will consider the materiality of any shortfall in making its decision as to whether an injection of capital is required from the member.

A shortfall of more than 10% against a member's uSCR must be reduced to no more than 10% of its ECA within 30 days of receiving notification from Lloyd's.

Where a member is required to inject further capital into the syndicate, they must also (i) notify Lloyd's if its capital position deteriorates again and (ii) provide written assurances that it has sufficient resources to cover the remaining shortfall by the next coming into line date.

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Please do not hesitate to contact us with any questions.

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