

## *Market Bulletin*

# LLOYD'S

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**LOCATION:** MRRU, G5  
**EXTENSION:** 5235  
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**REFERENCE:** Y3381  
**SUBJECT:** CP 04/7: SYNDICATE INTERNAL CAPITAL ASSESSMENTS  
**SUBJECT AREA(S):** Capital. RBC. Internal Capital Assessment (ICA)  
**ATTACHMENTS:**  
**ACTION POINTS:**  
**DEADLINE:** **15 December 2004 but earlier deadlines to be agreed with agents**

### **1 Introduction**

- 1.1 Agents will be aware that the FSA's proposed ICAS framework, which is set out in detail in their consultation paper CP04/7 for Lloyd's and in PS04/16 (the policy statement that followed the consultation paper CP190) for the company market, will require insurers and managing agents of Lloyd's syndicates to carry out an Individual Capital Assessment (ICA) on a regular basis.
- 1.2 Lloyd's is making good progress in resolving the practical details of how capital requirements will be set for members of Lloyd's, and some clear outlines can be stated with confidence now. The purpose of this bulletin is to give guidance to agents as they prepare their first ICA submissions, and to set out a timetable for the provision of material to Lloyd's. Lloyd's will review the ICAs and provide feedback to agents to help them with their ICAs in 2005.
- 1.3 The FSA have recently written to agents giving an up-date on their progress in implementing the ICAS regime for the Lloyd's market. Lloyd's requires ICAs during 2004 in order to prepare for the work in 2005 and to take account of them where appropriate.

- 1.4 Lloyd's is working with the FSA to ensure that member level capital requirements reflect both the syndicate ICAs and the capital value of the New Central Fund, as well as member-level diversification.
- 1.5 On 14 July we updated the market on the Capitalisation Project. The proposals for funding the New Central Fund which were contained in that update should be used for business planning purposes. In accordance with the normal timetable the Council will formally notify the market of the rates for central fund contributions and syndicate loans in September.

## **2 Timetable**

- 2.1 In order for a robust syndicate ICA process to be put in place during 2005, Lloyd's needs to receive syndicate ICAs for the 2005 year of account during the final quarter of 2004. Lloyd's will review these and provide feedback to the market to help ensure that the ICAs for 2006 are of high quality. Lloyd's will also update the FSA on its progress in reviewing ICAs towards the end of 2004 or early in 2005.
- 2.2 Lloyd's is aware that certain agents may be more advanced than others in the preparation of ICAs and has agreed with the FSA that a phasing of ICA submissions during 2004 is appropriate. Accordingly, Lloyd's will agree with each agent a timetable for the ICAs to be provided during the fourth quarter of 2004. Agents should note that the objective will be for all ICAs to have been received by Lloyd's and reviewed by the end of the year. The earliest ICAs should be provided by the start of October and the latest ones by December. MRRU and Risk Management will make contact with agents to agree timetables soon.
- 2.3 The FSA's CP 04/7 outlines two options for the timing of the application of ICAs (sections 2.57-2.62 of CP 04/7). Assuming 'option b' is selected then the ICAs submitted during 2004 will not unless exceptional differences are disclosed be used as an input in the determination of member capital for the 2005 Year of Account and the Risk Based Capital system, unadjusted for ICAs, will be used to determine member capital requirements at the November 2004 and the June 2005 Capital tests (see Market Bulletin Y3372). Lloyd's will issue separate guidance and timetable for 2005 ICA submissions (for the 2006 Year of Account) in the New Year.
- 2.4 The ICA submissions should be consistent with the latest versions of the agents' business plans for 2005. These may need to be updated following completion of the review of business plans by Franchise Performance (FPD), and after Coming into Line if capacity differs from that assumed in the ICA.

## **3 Expectations regarding ICAs**

- 3.1 ICAs should contain:
  - For each syndicate period as described in CP04/7, a statement of the capital that in the opinion of the agent is required
  - A brief explanation of the methods and assumptions underlying the assessment
  - Contact details for Lloyd's to use in obtaining further supporting information.

- A comparison with the syndicate RBC and with the Enhanced Capital Requirement (ECR) for the relevant syndicate periods. The reasons for any divergence between the ICA and the ECR should be explained.

Appendix 1 contains a proforma submission.

- 3.2 Agents are expected to develop an internal process to determine a capital assessment for each syndicate period. The process should identify the key risks to which the syndicate is subject, and seek to quantify these risks. Lloyd's anticipates that the process will be centred around two approaches:
- Stress and scenario tests and/or
  - Economic capital models
- 3.3 Agents need not produce a detailed actuarial model of their business, although some form of probability modelling is likely to form a part of the submission. However, Lloyd's anticipates the degree of sophistication of the ICA to be commensurate with the complexity of the underlying business. The FSA's consistent standard for capital adequacy is a ½% probability of ruin. This standard is also sometimes expressed as there being a 99.5% confidence level in the capital, or a Value at Risk (VaR) of 0.5%.

The RBC system uses an actuarial model which is in many ways similar to the kind of model that could form part of an ICA. However while RBC can provide a benchmark, agents should make their own assessment of the ICA amount.

- 3.4 Agents should test their ICAs using stress testing methods as well as probability calculations. Appendix 2 contains guidance on stress tests that agents might wish to consider applying. PRU 2.3 Annexe A in PS04/16 contains advice on stress and scenario testing.
- 3.5 For this first ICA submission agents should make a concerted effort to arrive at an accurate ICA within the time available. Adjustments to Lloyd's calculations of member capital requirements are most unlikely before the capital setting process for the 2006 year of account (YOA) and even then downward adjustments will be made only in cases where a high quality and objective ICA has been produced.
- 3.6 The following technical questions and answers are given to guide agents in the application of the ICAS regime to the Lloyd's market:
1. *What is the effective date of the ICA calculation?* ICAs should be calculated as at the start of the planned underwriting year. For example, the ICA submitted in 2004, for the 2005 YOA will be calculated as at 1.1.05, and should be based on projected reserves and planned underwriting at this date.
  2. *Should the ICA calculated by the agent incorporate an allowance for the benefits of the Central Fund and Lloyd's mutuality?* No. ICAs should be calculated ignoring the Central Fund and using the FSA's 99.5% VaR standard. The Society will allow for the Central Fund in setting member capital. Once the ICA process is running, Lloyd's will provide guidance on the likely effect at member level of changes year on year in the ICA. For the 2006 year of account this will only be

possible if the 2005 ICA (the ICA that is to be provided during the fourth quarter of 2004) has been produced by the agent, reviewed by Lloyd's and reached the necessary standard.

3. *Over what time period should the ICA be calculated?* In order to ensure consistency between ICAs, Lloyd's application of the FSA's 99.5% standard is for the ICA to be calculated over a 1 year time horizon. However, agents should also demonstrate that they have robust plans to ensure that they can expect to maintain capital support to meet the standard over a three to five year horizon.
4. *Should an ICA be calculated for a syndicate in run-off?* An ICA must be calculated for each syndicate, active or inactive. For the purposes of the timetable outlined in section 2 above, ICAs are only expected for open syndicate years on which an active corporate member participates. For the moment, ICAs are not required for other open syndicate years (in particular those syndicates in run-off where all participating corporate members have ceased underwriting). Separate guidance and timetable will follow in due course for these run-off syndicates. Lloyd's will shortly advise agents of ceased spread syndicates whether they fall into this category.

#### **4 Feedback**

- 4.1 Lloyd's will review and provide feedback to each managing agent on the ICAs submitted by the agent. This feedback will include both specific comment and benchmarking against the rest of the market and will be aimed at helping agents to make sure that their 2005 ICAs are of high quality.
- 4.2 If the earliest of ICAs received provide useful insights, Lloyd's will offer guidance immediately to those who have yet to submit ICAs, although recognising that it may be impossible for agents to make use of the guidance in their submissions because of time constraints.
- 4.3 Lloyd's will provide the FSA with information on its review of ICAs, probably early in 2005.

#### **5 Credit for Central Fund and for member diversification**

- 5.1 The details of these adjustments remain to be finalised. Lloyd's is working with the FSA to ensure that both the diversification effect at member level and the capital support provided by the Central Fund are reflected fully in member level capital setting. For the 2005 YOA, the RBC system will be used to set member capital requirements and where the results of syndicate ICAs differ materially from the syndicate RBCs, the RBC parameters for that syndicate may be adjusted. Both now and in the future, overall capital adequacy will comprise FAL, central assets and syndicate assets. Lloyd's must ensure and demonstrate that FAL and the Central Fund together are adequate given the Balancing Amount.

**Appendix 1:**

Proforma ICA submission for Syndicate number, Syndicate period.

(For spread syndicates, each open YOA is likely to be a separate period). All figures as at 1 January 2005 converted to £ at 2005 PIM rates 2005 YOA to be included on plan basis with reserves stated based on plan ULRs.

**Headings:**

- 1) Capacity for each pure YOA included
- 2) Lloyd's basis gross and net premium written for each pure YOA included (2005 figures per plan)\*
- 3) Annually accounted gross and net of reinsurance earned premium, and UPR gross and net of reinsurance, for each pure YOA included (2005 all unearned)\*
- 4) Reserves Gross and Net of reinsurance on Lloyd's solvency basis (this will change to Annually Accounted basis after the end of 2004)\*
- 5) ECR at syndicate period level (i.e. excluding asset charge on non-syndicate assets)
- 6) RBC at syndicate period level ignoring Portfolio Diversification Credit (MRRU will provide PDCs for syndicate periods)
- 7) ICA at syndicate period level
- 8) Method adopted (descriptive – e.g. “Management judgement with stress tests” or “stochastic economic model with stress tests”)

- 9) Details of stochastic modelling if used:
- Description of data used in deriving assumptions, and summary data (further details may be requested)
  - Probability distributions assumed for main lines of business, including parameters where relevant – e.g. if reserves are assumed to contain margins the mean should be shown to be less than the reserves
  - Approach to combining portfolios – e.g. correlation, copula including type
  - Overall probability distribution for this syndicate period (either by naming the distribution and showing sufficient parameters or by showing empirical distribution)
  - Method of generating output – e.g. internal simulation model, named consultant's model
  - Contact name for further details
- 10) Details of stress tests applied:
- See appendix 2

\* For items 2, 3 and 4 we prefer annually accounted data but will accept three-year basis data if AA data are not available or are not robust yet.

## Appendix 2: Stress tests for ICA

In looking at their Individual Capital Assessment for a syndicate, managing agents may assess their financial position using a number of stress and scenario tests, including the results from their Realistic Disaster Scenarios. In producing the RDS loss estimates, the managing agent will have considered all sources of aggregating underwriting losses that can generate losses above the de-minimis level (10% of Capacity for Gross Losses and 3% of Capacity for Net Losses), as well as their exposures to a number of mandatory scenarios. The RDSs should therefore provide a meaningful assessment of large loss and catastrophe exposures.

As a guide, a syndicate's ICA should be sufficient to withstand any individual RDS loss, and should also be tested against the following:

- 1) A poor underlying (pre-catastrophe) underwriting result at least equal to the worst such result experienced by the syndicate, or greater result based on the historical volatility of the classes of business in the syndicate's portfolio.
- 2) A worsening in the reserving position on the relevant years of account, based on its two largest reserving risk exposures (say, on liability exposures dependent on developing claims, or on an adverse outcome from a dispute or legal case).
- 3) A degree of reinsurance "bad debt" should be assumed, increasing the final net loss figure by a proportion of the assumed reinsurance recoveries. The proportion chosen should take account of the duration of the business, the quality of the reinsurers and the background conditions that would accompany each assumed scenario (e.g. where there has been a major industry level loss).
- 4) Combinations of RDSs (the number depending on the diversity of the syndicates' portfolio) should also be tested. It is expected that a combination of extreme losses, underlying underwriting result and reserve deterioration will exceed the ICA.
- 5) As well as the above risks, the ICA should be assessed against the other risk categories (credit, market, operational and liquidity risk) detailed in Lloyd's Integrated Prudential Sourcebook.

If an agent uses different stress test then they should explain why they believe these are more appropriate.