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LOCATION: Risk Management 86/G5
EXTENSION: 5743
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REFERENCE: Y3389
SUBJECT: Third party funding of corporate members
SUBJECT AREA(S): To advise direct corporate participant members, managing and members' agents on changes to the criteria for approval of Third Party funding arrangements of corporate members.
ATTACHMENTS: Yes
ACTION POINTS: **Direct corporate participants and underwriting agents to note the enclosed timetables for 2005 and subsequent yoa arrangements**
DEADLINE: **As detailed in the timetables**

Lloyd's has recently reviewed third party ("TP") arrangements in consultation with the LMA Regulatory Committee. This bulletin sets out:

- the conclusions of the review and the agreed changes to the approval criteria (see appendix 1): *and*
- timetables showing how the recommendations will be introduced – one for 2005 and one for 2006 and subsequent years (see appendix 2).

TP funding arrangements exist where all or part of a corporate member's Funds at Lloyd's (FAL) is provided by an entity that is not connected with that member's controllers or group companies. This is not to be confused with third party capacity sourced from individual members or from members' owned corporate vehicles, usually provided through the services of members' agents.

If you are in any doubt about whether a member's funding requires approval as a TP funding arrangement, or if you require any further information on these changes or have any questions or difficulties with the 2005 timetable, please contact Nigel Williamson, Admissions on 0207 327 6415 or by e-mail on nigel.williamson@lloyds.com.

This bulletin has been sent to all underwriting agents and direct corporate participant members (DCPs).

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THIRD PARTY FUNDING OF CORPORATE MEMBERS

Background

During 2004 Lloyd's Admissions department (Admissions) has carried out a detailed review of Lloyd's TP funding arrangements and their implications for the franchisor, franchisees and TP capital providers. The review included discussions with managing agents and capital providers and focused on the following areas:

1. confirming of how much capacity is currently supported by TP FAL arrangements and the mechanisms and structures that are used;
2. understanding why TP funding is used;
3. identifying the main risks to the Society from such arrangements;
4. deciding whether changes are required to the application process.

Extent and Nature of TP FAL Arrangements at Lloyd's for the 2004 year of account

The capacity figures for TP FAL at market level:

- Approved TP FAL capacity totals £1,112m, or 7.4% of Market capacity.
- £584m of this figure is provided by three capital providers. No other Third Party provides more than £50m capacity.

The capacity figures for TP FAL at member level and the structures employed:

- In total, 41 members have TP FAL arrangements.
- 25 of these members (with total capacity of £917m) have more than 20% of their FAL provided by Third Parties.
- The TP structures of these 25 members are broken down as follows:
 - 17 are 100% supported by TP FAL;
 - 5 have mixed capital where the direct and TP FAL is intended to respond on an excess basis or within a 'tiered' structure in the event of a drawdown (subject always to Lloyd's absolute discretion to drawdown on the member's FAL in any order);
 - 3 have mixed capital where the direct and TP FAL would respond to a drawdown in proportion to the level of their investment in the member (again, subject to the above Lloyd's discretion).

TP FAL at syndicate level:

- 7 managing agents have a dependency of more than 30% of capacity on TP FAL for their managed syndicates, with two having a reliance greater than 50%.

Reasons for Use of TP FAL

The primary reasons for franchisees and capital providers entering into TP funding arrangements can be summarised as follows:

Franchisees	Capital providers
<ul style="list-style-type: none"> ▪ to source flexible, non-shareholder short term capacity in a hard market and to use TP FAL capacity while it suits them ▪ to obtain capital that enables transition to an ILV 'own funds' structure ▪ to control a straightforward ILV structure to give total control of capacity ▪ to survive. ▪ to cover short term capital needs 	<ul style="list-style-type: none"> ▪ to participate in an investment mechanism that has a defined level of risk capital but with lower level of due diligence than is required for shareholder or own member participation. ▪ to control their investment (<i>through setting terms</i>). ▪ to obtain control over withdrawal of support. ▪ to maximise returns on short term investment. ▪ to avoid participation on previous open years (<i>through provision of TP FAL to a new dedicated member</i>) ▪ to avoid mutualisation of results in multiple participations (<i>through provision of TP FAL to unconnected members</i>)

Main Risks Associated with TP FAL arrangements

The franchisor has the following objectives in this area. To:

- encourage transparent and straightforward capacity structures;
- have a comprehensive understanding of the arrangements;
- minimise the potential for dispute;
- ensure that a potential source of capital for franchisees is not unduly constrained;
- manage undue or inequitable exposures to the Central Fund; and
- ensure that syndicates are not kept alive artificially through TP funding.

While a limited number of risks were identified, the review concluded that, with two exceptions, these risks were not specific to TP funding arrangements.

The principal risk was considered to be that of dispute between a TP funds provider and the member/member's controller group. Of particular concern are those arrangements under which a TP is one of a number of investors in a single member and where the interrelationship between the various investors has not been fully addressed or understood. The impact of this risk is likely to be compounded if such misunderstanding arises following the drawdown of a member's FAL to pay underwriting losses. The review noted that the effect of such a dispute could result in damage to the interested parties' reputation and ultimately adversely impact the Lloyd's brand.

The second risk is over-concentration, at either syndicate or market level, of individual TP capital providers with the consequence that a single withdrawal of capital may impact significantly several franchisees.

The review concluded that Lloyd's has the opportunity to reduce the likelihood of these risks by amending the application process so that they are considered and understood at the time of application for TP funding approval and on an annual basis.

Conclusions

While the objectives of the franchisor, franchisees and capital providers are not necessarily wholly compatible, TP funding arrangements do provide franchisees with a useful source of short to medium term capacity. Lloyd's needs to provide guidance on third party funding structures and to communicate the parameters within which TP funding applications will be considered. This will be available in the first quarter of 2005 and will then be updated annually.

In addition, Lloyd's should help to manage the perceived principal risk of dispute by ensuring that, at the time of application, agents and capital providers have a clear and common understanding of the capital structure into which they are investing.

Changes to the Application Process

With the exception of a number of essentially cosmetic changes, the TP FAL application process and the information requested via the questionnaire and undertakings have remained unchanged since their introduction in 1994.

Recognising that TP FAL arrangements have increased in volume and complexity during the intervening period, we will be reviewing the content of these forms so that they provide more relevant information from applicants. In addition to background information about the TP funds provider, the additional information required is likely to include:

- copies of funding agreements *or a copy* of the reinsurance contract (as applicable);
- a clear explanation of complex arrangements (particularly where there are multiple FAL providers within a single member); and
- written confirmation from all parties that they fully understand the arrangement and the implications of putting up FAL for a member. *(While not part of the requirements for the 2005 Coming Into Line exercise, we strongly recommend that all managing agents review existing*

arrangements to make sure all parties are absolutely clear about the arrangements and their obligations).

The new forms will be available for applications made during 2005 and we expect them to be published by June 2005.

Recommendations

Lloyd's Executive Committee approved the following recommendations on 13 July 2004:

For avoidance of doubt, these recommendations only impact members that either have, or apply for approval for, TP funding arrangements.

These recommendations do not affect the corporate member application process, or the requirements to establish a new corporate member.

	Review recommendation	Rationale
1.	Where agents wish, existing arrangements should remain in place for the 2005 year of account (note also point 2).	To ensure that agents and capital providers can maintain existing capital planning for 2005.
2.	All arrangements will be subject to an annual review and approval for the 2006 yoa onwards.	To confirm that each TP FAL arrangement continues to meet its original purpose. To restrict the level of TP FAL at syndicate level, if considered prudent. To restrict market exposure to any single TP FAL provider, if considered prudent.
3.	Lloyd's will publish a 'Guide to Third Party Capital Provision Arrangements'. <i>Recognising that this will be updated annually, it is envisaged that the guide will be made available from the Lloyds.com website.</i>	The review highlighted a need for a guide about TP funding. The guide will seek to clarify the 'what' and 'why' questions about TP funding, identify key risks for the TP funds provider and Lloyd's and address common areas of uncertainty about Lloyd's for capital providers. It is intended that the guide will be reviewed and updated annually.
4.	The Admissions department will review and overhaul the application process for new TP FAL arrangements, including a revision of the application forms This process will necessarily include development of the TP FAL 'renewal' forms to be available by August 2005.	The application requirements have not materially changed since the introduction of TP arrangements in 1994. TP FAL arrangements have developed in volume and complexity presenting higher risks, ultimately to the Central Fund. The review highlighted that it is essential that all interested parties (Agents, capital providers and Lloyd's) have a full understanding of their interrelationships.
5.	Advise the market	Interested parties need to be made aware of the changes being made. This bulletin is the first stage of this process. Further information will be circulated to advise the availability of the new application and the TP FAL 'renewal' forms. Lloyd's will publish the Guide during the first half of 2005 (see point 3).

Timetable for approval of new arrangements and review of existing approved arrangements – 2005 year of account

	Deadline	Action	Comments
Existing arrangements	15 October 2004	DCPs / Members' Agents (as applicable) with members' that are supported totally or in part by TP funds to advise Lloyd's whether existing arrangements (detailed by TP funds provider) are to remain in place for the 2005 yoa.	<p>This information is supplied by DCPs through completion of the form in section 3 of the MSU's annual Coming Into Line (CiL) letter.</p> <p>For other members, this will be by letter to Lloyd's Admissions department</p> <p>Advice to include:</p> <ul style="list-style-type: none"> • Amount of TP FAL and capacity provided for 2004 • Proposed amount of TP funds and capacity for 2005 (if applicable) • Explanation of source of additional TP funding (if greater than for 2004) • Details of material changes to the 2004 arrangement
	22 October 2004	Where TP funding arrangement is supported by reinsurance arrangement, DCP / Members' Agent to provide a draft copy of the draft 2005 contract	Contract must be limited to one year
	29 October 2004	All necessary submissions to have been provided. Admissions to confirm as such to DCP / Members' Agent	
	26 November 2004	Coming into line	Latest date for TP FAL provider to lodge any additional FAL with Lloyd's
	17 December 2004	Where applicable, Member to provide a copy of the agreed, signed reinsurance contract to Admissions department	
	Deadline	Action	Comments
New arrangements	22 October 2004	DCP / Members' Agent (as applicable) to provide completed questionnaire (CM210b) and Undertaking (CM210a) to Admissions	<p>This information is also summarised by completing the form in section 3 of the CiL letter.</p> <p>Where TP FAL arrangement is supported by reinsurance arrangement, application must include a draft copy of the proposed reinsurance contract.</p> <p>Admissions to confirm syndicate Business Plan proposals support need for TP FAL capacity</p>
	25 October – 5 November 2004	Admissions to meet representatives of the member, as necessary, to clarify aspects of the application	
	10 November 2004	Final date for Admissions to approve new arrangements	
	26 November 2004	Coming into line	Latest date for TP funds provider to lodge FAL with Lloyd's
	17 December 2004	Where applicable, Member to provide a copy of the agreed, signed reinsurance contract to Admissions department.	

**Proposed timetable for the 2006 and subsequent years of account
(This is only indicative – details and timings will be confirmed)**

	Deadline	Action	Comments
Existing arrangements	End June	DCPs / Members' Agents with members' that are supported totally or in part by TP funds to advise Admissions in writing whether existing arrangements (detailed by TP FAL provider) are to remain for the following yoa. It is envisaged that this advice will not take the form of a full 'new arrangement' application but will require submission of a short 'renewal' schedule, with additional documentation (e.g. syndicate capital structure).	Advice to include: <ul style="list-style-type: none"> • Amount of TP FAL and capacity provided for current year • Proposed amount of TP funds and capacity for following year (if applicable) • Explanation of source of additional TP funding (if greater than for current year) <i>The renewal schedule will be available from early June 2005. This will replace the information currently requested in appendix 3 of MSU's annual CiL letter.</i>
	Mid October	Where a TP funding arrangement is supported by reinsurance arrangement, DCP / Members' Agent to provide a draft copy of the contract for the following year	Contract must be limited to one year
	Early – mid October	Admissions to meet representatives of the member, as necessary, to clarify aspects of the renewal application	Admissions will confirm syndicate Business Plan proposals support need for ongoing TP funded capacity
	Mid October	All necessary submissions to have been provided. Admissions to confirm in writing continuance of arrangement to DCP / Members' Agent	
	November	Coming into line	Latest date for TP funds provider to lodge FAL with Lloyd's
	Mid December	Where applicable, Member to provide a copy of the agreed, signed reinsurance contract	
	Deadline	Action	Comments
New arrangements	Mid October	DCP / Members' Agent (as applicable) to provide completed application forms to Admissions	Where TP FAL arrangement is supported by reinsurance arrangement, application must include a copy of the draft reinsurance contract, along with any other relevant documents. Admissions to confirm syndicate Business Plan proposals support need for TP FAL capacity <i>Existing TP funding application forms (currently CM 210a and CM210b) are to be revised. Applications will only be accepted on the new forms which will be available during the first half of 2005.</i>
	Mid October – Early November	Admissions to meet representatives of the member, as necessary, to clarify aspects of the application	
	Early November	Final date for Admissions to approve new arrangements	
	November	Coming into line	Latest date for TP funds provider to lodge FAL with Lloyd's
	Mid December	Where applicable, Member to provide a copy of the agreed, signed reinsurance contract	

