

**REINSURANCE TO CLOSE AT LLOYD'S
AND RELATED ISSUES
(GISG CONVENTION, 10/90)**

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GIRO 1990

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(5473S)

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SECTION 1 - BACKGROUND NOTES (MGW)

1. 0 Preamble

These notes have been prepared in response to the increasing interest in Lloyd's expressed at the 1989 GIRO Conference.

For the purposes of the discussion at 1990 GIRO, Section 3 is not essential. It was felt that some notes on data would be of practical interest, but they are not essential to understanding the structure of Lloyd's. The authors are aware that many readers will have little knowledge of Lloyd's, whilst others will be very familiar with Lloyd's. In order that everyone can gain something from the session, these notes attempt to give a brief outline of Lloyd's structure, concentrating on those aspects of the structure which will be of most interest to Actuaries. It is hoped that this outline, together with the discussion points in Section 2, will be sufficient to stimulate a debate.

We have tried to concentrate on facts and to avoid expressing too many opinions. If the facts are wrong, this is our own responsibility, and any views which we may have expressed are our own, and not those of our employers. We would welcome correction on any aspects, especially from any Syndicate Auditors present at the conference.

1. 1 Names, Syndicates and Years of Account.

1. 1. 1 Names.

If you have a Lloyd's insurance policy, it is placed at Lloyd's, not with Lloyd's. The cover is provided by individual "Names", who each participate in accordance with their share of the syndicate(s) with whom the policy has been placed. In the old days, the names of all the Names (!) on the risk used to be stamped on the back of the policy document; this is no longer practical, so policies now only show which syndicates are involved and the proportion of the risk which each syndicate is taking.

Names are on a risk "each for his own part and not one for another". If an individual Name fails to meet a loss, recourse is had to Lloyd's Central Fund, not to the other Names on the syndicate. The Central Fund is maintained by a subscription levied on the entire body of Names.

1. 1. 2 Syndicates.

A syndicate is not a separate legal person like a company. It is merely a convenient way of grouping Names together to accept insurance risks. Each syndicate has its own underwriter who accepts risks and settles claims on its behalf.

1. 1. 3 Years of Account.

The Names constituting a syndicate change each year. Whilst there is a tendency for Names to stay on a syndicate for a number of years, some will join, some will leave and others will change their planned participation. So knowing that Syndicate 999 has written a risk is not sufficiently precise - one needs to know which year of account has written the risk to define which group of Names is involved and what their shares of the risk are.

Years of Account are not closed until the end of the third year, at which point the liabilities are usually reinsured with the subsequent set of Names on the same syndicate, i. e. with the next year of account.

The following simplified timetable may make the process clearer.

Syndicate 999 - Timetable for 1991 Year of Account.

- | | | |
|-------|------------------|--|
| 1) | During 1990 | Decide which Names will be on the syndicate for 1991, and what shares they will have. |
| 2) | During 1991 | Write risks, receive premiums, pay claims. |
| 3) | As at 31. 12. 91 | Look at accumulated fund, make solvency calculations. |
| 4) | During 1992 | Stop writing risks (the 1992 Names will now be writing risks), but still receive premiums and pay claims. |
| 5)(a) | As at 31. 12. 92 | Look at accumulated fund, make solvency calculations. |
| 5)(b) | As at 31. 12. 92 | Write the final risk, a reinsurance of the entire remaining liabilities of the 1990 Year of Account. Look at the premium received, make solvency calculations. |
| 6) | During 1993 | Continue to receive premiums and pay claims. |
| 7) | As at 31. 12. 93 | Pay a reinsurance premium to close the account (RITC premium), normally to the 1992 Names. Balance of fund is profit if positive, loss if negative. |

Thus during the syndicate's third year of operation, it is effectively carrying the liabilities of all prior years' run-off, to the extent that these have been reinsured through to the syndicate.

1. 1. 4 Names' Assets.

Names own a share of the assets held within each syndicate they are on, just as they have a share of the liabilities. They also have other funds at Lloyd's (known basically as deposits and personal reserves) and they also have to show a certain level of net means available to meet losses if necessary. These means are calculated after meeting any solvency deficiencies within their syndicates. The detailed capital requirements are not covered in these notes.

1. 2 How to Find out about Lloyd's Rules.

Lloyd's Rules are largely contained in Byelaws made under the Lloyd's Act of 1982. These Byelaws are publicly available, and if practitioners want to get the full picture on any aspect they should consult these and discuss any queries with the relevant Corporation department. Practitioners should certainly not rely on these notes, which are intended to give an outline only.

1. 3 What RITC is

1. 3. 1 Defined in a byelaw (number 6 of 1985) to be an agreement where one group of Names reinsures the entire portfolio of a syndicate made up of another group of Names. It does not have to be a contract between the successive Names on one syndicate, nor do the managing agents involved have to be the same. Byelaw No. 17 of 1989, the run-off byelaw, in which actuaries have a role, only comes into play if a syndicate fails to close at the normal time.

1. 3. 2 RITC is a reinsurance, not a transfer of liability. The original contracts of insurance written at Lloyd's are between the Names who wrote each policy and the policyholders. If, say, the Names on a 1990 year of account failed to meet their obligations, the policyholders who had bought policies from earlier names would have recourse to the 1989 Names, and then the 1988 Names, etc., etc., - IN THEORY.

1. 3. 3 There are really no rules about how much premium should be paid for RITC - save one. It should be "equitable" between the Names involved. It could be argued that this is obvious as the underwriter(s) and managing agent(s) involved are acting on behalf of both parties. However, the requirement has been set down specifically in a byelaw, the Syndicate Accounting Byelaw, number 11 of 1987.

The byelaw has some explanatory notes which have no statutory force, and these include some guidance as to good practice when determining RITC. The guidance is of a "things to look

out for" nature and does not claim to be comprehensive in any way. It is a myth that discounting, whether implicit or explicit, is forbidden, as it is also a myth that there should be no profit element in RITC premiums to pay for any risk involved. The managing agent's task when acting on behalf of two sets of Names could perhaps best be described as being to achieve a willing buyer, willing seller price taking into account all the factors involved.

1.4 What the RITC is not

RITC is not in any way determined by the solvency instructions or by tax considerations. However, being aware of the way in which the contract will come into the tax calculations for both parties and the solvency release or strain involved should theoretically have some effect on the "willing buyer, willing seller" determination, just as a Life Office might look for a higher return on capital if a new product involves particularly high new business strain.

1.5 What the Tax Rules are relating to deductibility of RITC

1.5.1 The following extract is from the 1988 Income and Corporation Taxes Act.

" (a) in computing for the purposes of income tax the profits or gains of the continuing member's business as a member of the reinsured syndicate, the amount of the premium shall be deductible as an expense of his only to the extent that it is shown not to exceed a fair and reasonable assessment of the value of the liabilities in respect of which it is payable; and

(b) in computing for those purposes the profits or gains of his business as a member of the reinsurer syndicate, those profits or gains shall be reduced by an amount equal to any part of a premium which, by virtue of paragraph (a) above, is not deductible as an expense of his as a member of the reinsured syndicate;

and the assessment referred to above shall be taken to be fair and reasonable only if it is arrived at with a view to producing the result that a profit does not accrue to the member to whom the premium is payable but that he does not suffer a loss."

1.5.2 In practice, it is not quite correct to say that the Revenue "impose" a disallowance. A disallowance, if there is one, is the result of negotiations between the managing agent and City 35, the special office of the revenue set up for Lloyd's. One day the question of whether, and to what extent, an RITC is allowable may come up before the Special or General Commissioners, so in negotiation one should be considering what the Commissioners would decide if both sides dug their heels in. The main area of potential disagreement would appear to be where reserving is particularly difficult anyway, viz asbestos, pollution, etc.

1.5.3 If a Name leaves a syndicate, his element of the RITC is always fully allowable. If a disallowance is accepted it is only a deferral of tax relief - each Name is not permitted to deduct part of his RITC on the closing year, but, equally, he does not have to recognise for tax that same disallowed element when received in the following year.

1.6 What the Solvency Rules are

1.6.1 These are set out in the Solvency Instructions which are formally passed by the Council of Lloyd's each year after discussions with the DTI. They specifically state that they are not to be taken to apply for any purpose other than solvency. The liability section says don't discount, but there is no guidance on what reinsurance recoveries are allowable as a deduction from outstanding (and IBNR) claims.

1.6.2 The solvency test technically applies at the Name level, comparing his aggregate liabilities and funds at Lloyd's. Names keep funds at Lloyd's in addition to the funds within the syndicates (which are held via premium trust funds) - these additional funds are in the form of deposits and personal reserves, as mentioned above in 1.1.4.

1.6.3 The rules for the valuation of assets for a Lloyd's Name are fairly similar to those for an insurance company, but they are more restrictive in some ways. There appears to be more emphasis on liquidity.

1.6.4 The rules for the valuation of liabilities are implemented at syndicate level and there is basically a two pronged approach. The instructions say reserve properly for the winding up of all years of account (implying that there should be enough funds if no new business comes in) but in any case that the amount put up should not be less than the greater of tests 1 and 2. Test 1 is the minimum percentage test, with different percentages of net premium for different years of account and audit codes, but with an (outstandings and IBNR) test for the oldest years. Test 2 is basically an outstandings plus IBNR test for all years of account involved.

1.6.5 Syndicate auditors report on the position of each syndicate and the results are centrally processed into per-Name solvency positions. Each Name's other assets at Lloyd's held outside the syndicates are then taken into account. Each Name's position is simply aggregated, solvency deficiencies in one syndicate being offset by solvency surpluses on other syndicates. Only when a Name has been cleared through the solvency test can any remittance of profits be made to the Name.

A "syndicate" for this purpose is each year of account of a syndicate. As the constitutions of syndicates change, it is obviously necessary to keep entirely separate the calculations for the two open years and the closed year.

This is what the solvency instructions mean when they say that the instructions shall be applied separately to each year of account. They do not mean that specific calculations should be made for those years of account which have long since closed and are included in the more recent years of account. The data used for the calculations is of course all kept in terms of the original underwriting years.

SECTION 2 - SOME DISCUSSION POINTS.

- 2.0 Return on Capital and Risk - are they useful ideas?
- 2.1 Why doesn't the tax follow the solvency as in, say, Germany?
- 2.2 Lloyd's has, because of the RITC, a total distribution of profit - doesn't this put Lloyd's at a disadvantage as against the insurance companies who can hold back funds?
- 2.3 Can't the Name be viewed as an insurance company?
- 2.4 Lloyd's doesn't discount its reinsurance to close. Doesn't this put it at a disadvantage when competing for long tail business?
- 2.5 What does equity between Names mean in setting RITC?
- 2.6 What is the risk margin?
- 2.7 What if the RITC is set higher than the solvency reserve?
[The solvency instructions say that solvency reserves cannot be less than RITC, so in this case the two numbers are made equal].
- 2.8 What if the solvency reserve is higher than the RITC?
- 2.9 This is all very inconvenient. Can't the rules be changed?

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SECTION 3 - NOTES ON DATA AND OTHER PRACTICAL ASPECTS (HR)

3.0 Gathering the Data.

The accounting procedure which gives rise to statistical data consists of the following stages:-

- (i) After LPSO (responsible for central settlement of premiums and claims) close books around 20 January, individual syndicates' computer systems (often using external bureau software and facilities) process basic accounting and statistical data.
- ii) Accruals of
 - a) premiums receivable net of reinsurance premiums payable and
 - b) reinsurance recoveries in the pipeline in respect of paid lossesare collated by the syndicate, with allowance possibly being made for bad debts.
- (iii) The various Lloyd's claims offices (LUNCO, LUCRO, etc) close as at the same date and liaise with LPSO to avoid discrepancies and provide outstanding claims information. Such information may not be available until mid-February. Data on claims not handled by these offices (e.g. asbestos) must also be collated.
- (iv) Each syndicate assesses reinsurance recoveries in respect of outstanding claims, making allowance for reinstatement premiums and burning cost adjustments payable. Allowance for collectability of reinsurance would be made at this stage.

The above process may not be completed until the beginning of March (except for motor and short term life syndicates where LPSO etc are not involved and data may be available in late January). The solvency deadline is variable and is usually towards the end of April, but has been getting earlier.

For reserving purposes, information will also be required on both the nature and mix of the business written, and on reinsurance programmes over the years. Often, such information would be of a qualitative nature for all but the most recent years of account. The reinsurance information should ideally be sufficient to allow in projections for any gaps in the programme, exhaustion of coverage, doubtful security, reinstatement premiums and burning cost adjustments. The underwriter and the claims staff should also be asked to identify for further investigation any special problems which would not be allowed for by normal statistical methods.

3.1 Analysis of the Data.

The syndicate accounting rules require information to be sub-divided into the three major currencies and also into all the relevant Lloyd's audit codes; thus it is likely that triangulations of paid and incurred claims by currency will be

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available. Triangulations by audit code should also be available in theory, but some syndicates may not have collated the historical information going back more than a few years; triangulations by the underwriter's class of business codes may also be available.

Following reforms in syndicate accounting, and perhaps also the influence of the Revenue, the resulting data progressions are often on a more rigorous and consistent basis in recent years than was previously the case. Net of reinsurance triangles may show the effects of contracts such as rollovers and tonners which have been banned since the early 80's. Accruals now tend to receive a more "correct" treatment; for example, in the past many syndicates netted reinsurance recoveries due in respect of paid claims against outstanding claims so that paid loss progressions are now smoother than they were. The treatment of reinstatement premium protection policies can play havoc with net claims projections if the payment of reinstatements is classified with net premium statistics and the reinstatement premium policy recovery is classified with net claims statistics. Difficulties may arise in examining triangulations sub-divided by audit code net of reinsurance; market inconsistencies in audit coding can arise when reinsurance recoveries are coded differently to the claims which gave rise to them. It is of course necessary to ensure that the effects of exceptional items are taken out of triangulations, e.g. time and distance policies, unlimited run-off reinsurance policies, latent claims, etc. However, this can be extremely difficult to achieve, especially in relation to latent claims, since LPSO advices do not separately identify them, and also the year of account allocations in the syndicate records may not correspond with the actual LPSO payments.

Whatever the degree of data sub-division and projection method, it is necessary for solvency tests that net premiums, gross outstanding claims, reinsurance recoveries thereon, and net IBNR are sub-divided by the three major currencies and audit code.

As well as working closely with underwriting and claims staff, an actuary will tend to rely on the syndicate auditor in relation to accuracy of the data, and in turn may be called upon to explain to the auditor the extent of actuarial investigations and conclusions (assuming the actuary is acting before the RITC determination is made and not afterwards, as would frequently be the case if he were involved only for tax advice).

3.2 What results are required?

The actuary will frequently be asked to advise on reserves, perhaps for a sub-set of the business, rather than the RITC as such. The RITC is a management decision to which the actuary's advice will be one of the inputs.

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The actuary would usually present his results in terms of ultimate loss ratios, ultimate losses, or IBNR. For the purposes of disclosure in Syndicate Accounts, only one net IBNR number is strictly necessary. However, where possible, best practice is to show gross IBNR and also to show estimated reinsurance recoveries on the IBNR, the net IBNR being the difference between the two.

Given that there may be substantial uncertainties in the projection of syndicates' results for a variety of reasons (latent claims, recently established syndicate without a track record, change of business mix, change from occurrence to claims made coverage, quality of historical data, changes in reinsurance program, etc) then the actuary may give his results in the form of a range within which the results might reasonably be expected to lie. The acceptability of this to the underwriter would depend upon the actuary's term of reference; an auditor, on the other hand, may feel less comfortable with a range than with a point estimate. An extreme position arises when uncertainty is so large that the underwriter considers leaving the year of account open - it is a matter of debate whether the actuary should recommend doing so, or should merely draw attention to the uncertainty and let the underwriter draw his own conclusions.

Finally, although not strictly speaking RITC, the open years (years one and two) still need to be reviewed for the purposes of the Solvency Test. It should be noted that the open year accounts are not drawn up in a manner fully consistent with the closed year treatment; thus, for example, the concepts of prudence and accruals are not required to be applied to the open years of account unless to disregard them would be material or misleading. Hence, not only is there much more uncertainty due to immaturity of claims development and the likelihood of substantial further premium development, but the quality of data may often be very much lower for open years than for closed years, and very variable from year to year. As a consequence, in many cases the best that can be done is to give a rough indication of the expected out-turn and to investigate and comment on any special circumstances which could have a serious impact (e.g. Piper Alpha, natural catastrophes, major changes in business mix or reinsurance protections, major changes in premium levels).

