Lloyd's Corporate Capital Working Party

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Lloyd's Corporate Capital

Lloyd's corporate capital is a relatively new concept in the London Market and an unfamiliar one to many people.

This paper gives an overview of the rationale for the introduction of corporate capital, a description of the different types of corporate capital and where the backing comes from, and an indication of the innovative uses of corporate capital by people not traditionally in the Lloyd's market.

In our workshop, we will expand on the innovative future uses corporate capital. We will also discuss how the corporate capital vehicles being setup today differ from the early vehicles. We will also present several "case studies" where we will follow particular corporate capital vehicles from initial setup to their current forms.

Section I - Why Corporate Capital?

Late in 1992 when capacity for the 1993 account has been finalised, it became apparent that the Lloyd's market was likely to suffer a further drop in capacity for 1994 due to the diminishing financial resources of those members of Lloyd's who had suffered the brunt of the market's losses. It was also clear that, as further losses would be declared on the 1991 and 1992 accounts the problem was likely to become worse. The Lloyd's Task Force report of 1992 had identified the need for more and different capital to back the Lloyd's market. It was widely recognised that the demand for new traditional unlimited liability participation at Lloyd's has been annihilated by the extent of the losses. The current participants might continue but they were old (average age 60) and unlikely to secure the long term future of the market.

The Task Force report had viewed the introduction of corporate capital at Lloyd's as a long-term goal achievably only after the Lloyd's Act of 1982 had been amended to allow this. However, a second legal opinion indicated that the Act would not, after all, need to be amended although the introduction of corporate capital would necessitate the (subsequently successful) renegotiation of all Lloyd's licenses.

The first tranche of listed corporate capital was raised in late 1993 for the 1994 account by around a dozen companies. Most were structured so that they would be able to attain investment trust status in due course and invested in a variety of syndicates across the market. They are commonly referred to as "spread vehicles". A variety of smaller private companies, including the first "dedicated" corporate vehicle, also raised capital at this stage.

Since then, the main emphasis of corporate activity at Lloyd's has been via "dedicated" vehicles. These companies' were set up by individual Lloyd's agencies specifically to invest in the underwriting of risk assumed by the syndicates managed by that agency. Thus, they provided underwriting capacity. This capital has been provided largely by insurance-related venture capital funds, most of which are US or Bermuda based. The trend has been for these companies also to purchase, progressively or instantaneously, the entire management company (managing agency) from the current shareholders. In the long term, if the balance of the underwriting capacity can also be purchased by these dedicated vehicles, they will become virtual Lloyd's insurance companies underwriting with limited liability. This route is perceived to be the one which will be the focus of future corporate activity.

There has also been corporate activity through an ostensibly similar but practically very different approach - the corporate syndicate. Capital is provided to back the underwriting of a new syndicate created specifically for the purpose. However, the corporate syndicate effectively writes business in consortium with another syndicate which is already in existence, the split of business being determined in advance and in proportion to the capacity provided.

Section I - Why Corporate Capital?

Predictably, corporate capital has grown in influence since inception. Growth is predictable because corporate capital is the only sizeable source of new capital (there are few new unlimited liability investors) and management has a natural preference for dedicated capital, which is only available in quantity from corporate investors.

Corporate capital has been touched as the saviour of the Lloyd's market. That is probably an over-simplification but it cannot be denied that apart from providing physical capital, corporate capital has given traditional capacity the confidence to continue to underwrite despite the financial distress it was suffering. The cost may have been that in over-capitalising the market, it has unwittingly saved some syndicates and agencies of limited merit. Dedicated capital in particular (as opposed to corporate capital in general) also has its flaws. Management must remain focused despite the knowledge that capital will not be withdrawn if performance is sub-standard.

Section 2 - How Does Corporate Capital Work

1. Basic Information on the Capital and Operating Structure of Lloyd's

Member

A Member commits to provide an amount of Underwriting Capacity which is normally allocated to a number of Syndicates.

Syndicate

The Syndicate for any year of Account is comprised of the capacity allocated to it by members. A Syndicate is an annual venture, where each member underwrites insurance contracts on his own behalf (several liability).

Managing Agent

The Members of a Syndicate appoint a Managing Agent to employ and manage the underwriter and his team. They in turn accept risks, pay claims, arrange reinsurance, close the account and strike a profit or loss on the year's trading the member's behalf.

Premiums Trust Funds (PTF)

Trust funds exist into which premiums received by a member are paid and which are available for the payment of reinsurance premiums, claims and syndicate and other expenses, and when the underwriting year has been closed, profits to members.

Close of Account & Reinsurance To Close (RITC)

A Syndicate normally closes the account for each year's underwriting 36 months after its commencement. The profit or loss for that year is either distributed to or collected from the members via PTF.

A Syndicate will normally re-form from year to year, and members for a particular year of account will generally reinsure the unexpired liabilities of the members of the immediately preceding year (RITC) in return for payment of a premium. Upon payment the preceding year of account is closed.

2. Principal Routes into Lloyd's

Share Purchase

The simplest route is to purchase shares in a corporate capital vehicle listed on the London Stock Exchange. A number are structured as investment trusts or investment companies. Another form of participation would be to purchase shares in one of the managing agents quoted or listed on AIM (Alternative Investment Market).

Third Party Provision of FAL (Funds at Lloyds)

Third parties may participate indirectly in the market by providing capital to support the underwriting of an existing vehicle. This can be done in a number of ways:

- by providing a 3rd Party deposit or Letter of Credit

- by lending to the corporate member

Conversion and Corporate Interavailability

Lloyd's has committed to develop mechanisms to enable individual members to convert to trading on a limited liability basis. All conversion schemes are likely to involve disposal of member's capacity rights to the successor vehicle.

Passive or Strategic

Direct participation can be grouped into 2 streams by reference to application process and the required Lloyd's regulatory consents. Both require the formation of a corporate member and can be classified as:

Passive - Where the corporate member participates on one or more syndicates but does not have control of the managing agent.

Strategic - Where the corporate member participates on one or more syndicates and either has control of the relevant managing agent or has a substantial participation on the relevant syndicates.

3. Principal Structures

In practice, 2 basic corporate member structures have emerged, Spread and Dedicated Vehicles.

Spread Vehicle (1996 Capacity - £2.1bn)

This usually takes the form of a corporate member, or a number of corporate members with a common holding company which participates on a broad range of syndicates, thereby spreading and diversifying the members exposure. This has to date often been a passive participation.

Dedicated Vehicle (1996 Capacity - £0.9 bn)

This usually takes the form of a single corporate member which participates on one or more syndicates of a single managing agent. The structure may involve a group of corporate members or take the form of a stand-alone corporate syndicate. This type may have either a passive or strategic participation.

4. Types of Syndicates

Corporate Members may participate on Syndicates which are:

Mixed Syndicates - Where the members of the syndicates are both corporate and individual members respectively. Usually the syndicate will have traded at Lloyd's for a number of years. Spread vehicles have, to date, participated on this basis.

Parallel Syndicates - Where the member participates as the only member in a specially set up syndicate operating in 'parallel' with the ongoing mixed syndicate. They are generally managed as though they were a single unit. It is possible for a single corporate member to write in parallel with several mixed syndicates.

Stand-alone Corporate Syndicates - Where a syndicate has a single corporate member and does not write in parallel with another syndicate.

5. Corporate Membership Requirements

The types of requirement (although the list is not exhaustive) are:

- They must be a company that has not previously traded with at least 2 directors, who are individuals.
- They must be exclusively dedicated to underwriting at Lloyd's
- All major shareholdings (15% interest) and controllers (30% interest) are required to give undertakings to Lloyd's.
- Control of a number of corporate members requires Lloyd's prior consent.
- Controllers, major shareholders, directors and managers have to pass Fit and Proper tests.
- They must appoint a sponsor, legal adviser and auditor, and should have appointed a Lloyd's adviser or members' agent. Each is required to give a declaration or opinion.

- Minimum FAL is £0.5m (or £1.5m if a US corporate member) and is to comprise of 'authorised investments' only.

- Minimum Solvency ratio is currently 50% of OPL (Overall Premium Limit)

- Subscriptions and Central Fund contributions are required to be paid annually.

- Additional requirements are imposed where a corporate member is a significant provider of capital on a mixed syndicate, and specific considerations apply to corporate members where the controller is an insurance carrier or Lloyd's broker.

6. Subscriptions, Fees and Contributions

A corporate member has to pay Managing agents' fees, Lloyd's Advisers' fees and commissions and the following fees and contributions to Lloyd's (plus VAT where applicable):

Application Fee - A fixed and non-refundable fee of £10,000 (plus VAT. currently 6.13%) payable on application.

Annual Subscription - Set at 0.5% of Gross allocated capacity for 1996 for all members.
Central Fund Contributions - Set at 1.5% of Gross allocated capacity for 1996 for corporate members.
Individual members pay a 0.6% contribution.

Both the annual subscription and the Central Fund contributions are paid twice yearly out of corporate members' PTF (Premium Trust Funds).

7. Funds at Lloyd's

All corporate members are required to provide sufficient security to support their OPL (i.e. the maximum amount of business which a member may underwrite for the forthcoming year of account.

Type of Assets

This security comprises a member's FAL which are held by Lloyd's as trustee.

Corporate members' FAL must be provided in the form of authorised investments comprising narrower and wider range assets, Letters of Credit (LOC) and Bank Guarantees.

- Narrower range assets include Cash and Gilt Securities

- Wider range assets include Equities listed on various stock exchanges

- Letters of Credit and Bank Guarantees must be lodged directly with Lloyd's and be in their standard form. The LOC must be evergreen, valid for 5 years and subject to a minimum of 4 years notice of cancellation. There are virtually no restrictions on the type of assets providing security for a LOC or bank guarantee.

The first 15% or £500,000 of Funds at Lloyd's, whichever is the lower, must be in a narrower range of assets. Funds may be held in all EU currencies, including ECUs , as well as Australian, Canadian, Hong Kong, Singapore and US dollars, Swiss Francs, Japanese Yen and Norwegian and Swedish Kronor.

How Much

the Minimum Ration of FAL to OPL is currently 50%. This compares to a ratio of between 20% and 30% for individual members who have shown means and have unlimited liability.

For 1995 a Risk Based Capital (RBC) system began to emerge and was applied to corporate members on an indicative basis. The RBC was developed further during 1995 and was used as basis for the 1996 year of account. Ratios of FAL to OPL for corporate members underwriting in 1996 ranged from 50% to 110%.

General

If at any time during the course of the year a corporate member's FAL has fallen by more than 15% from the amount used to calculate its OPL, the member is obliged to notify Lloyd's which may direct the deficiency to be made up.

Interest and dividends on the assets comprising a member's deposit may be distributed to the corporate member.

8. Tax Arrangements

Legislation covering corporate members at Lloyd's was introduced in the Finance Act 1994 and applied from 1st January 1994.

Corporate members will in most cases be liable for Corporation Tax (i.e. Schedule D Case 1). Underwriting profits/losses are treated as accruing evenly over the underwriting year in which they are declared.

Corporate members are not allowed to set up a Special Reserve Fund, unlike individual members, and they are not covered by the new Equalisation Reserves for corporate insurers.

There are special rules dealing with Stop-loss insurance, Reinsurance to close and Cessation.

Corporate members are required to register for VAT.

USA

Lloyd's has negotiated with the IRS (Inland Revenue Service), a US tax regime to apply to corporate members. This is referred to as the Closing Arrangement.

US tax liabilities of the corporate member will initially be funded by the syndicates and later reimbursed from the distribution of profits one year of account has closed.

Section 3 - Future Developments

A number of regulatory changes have been made to the use of Corporate capital at Lloyd's of London. There are now a number of new opportunities for companies in forming a corporate syndicate at Lloyd's as an alternative to establishing an insurance company through the DTI authorisation route.

The relaxation of rules now allows single entity corporate syndicates to be established and underwrite within Lloyd's.

In the Report of Lloyd's capital working party the following recommendations are made:

- Insurance carriers to be able to participate in the Lloyd's market;
- Lifting of restrictions on corporate participation;
- Parallel corporate syndicates to benefit from the advantages of a continuous syndicate; and;
- Introduction of a risk based capital system.

The opportunity to establish a dedicated corporate syndicate may appeal to a number of parties who have historically dealt with the issue in a different way.

Instead of setting up a captive insurance company offshore, a dedicated Lloyd's syndicate could be established in London to insure the risk management requirements of a company. This will appeal in particular to multi-national companies with world-wide operations, particularly with a UK base.

The first main benefit is the ability to issue an insurance policy that is accredited throughout the world. Closeness of location, savings in travelling time and cost and lack of communication are all useful additional points. Cynically, lack of golf courses, the opportunity for overseas travel and good weather may be some of the distinct disadvantages.

Direct Insurance Vehicle

Insurance companies writing business domiciled throughout the world can now underwrite from one corporate base in Lloyd's of London. This will save the company the complexity, complication and effort in establishing a UK insurance carrier and then developing a branch network or subsidiary companies throughout the world. The traditional route to obtain such extensive coverage is often prohibitive expensive for an individual company and a huge capital commitment along with the formation costs and expenses.

Reinsurance Vehicle

If a company wishes to set up a reinsurance operation in the London Market, it now has the option of incorporating a carrier in Lloyd's of London. This will provide the carrier with immediate access to the world's major wholesale insurance market with all its associated benefits. Some corporations invested in Lloyd's syndicates perhaps with this objective in mind.

Extended Warranty Carriers

In recent years there has been dramatic growth in the extended warranty insurance in domestic appliances in UK. This has traditionally been a profitable market that could now be incorporated as an in-house syndicate. The Lloyd's image may or may not add to the perceived customer perception of this product.