

THE ANNUAL VENTURE: A REVIEW

OCTOBER 2006

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CONTENTS

Chairman's introduction	4
1 Executive Summary	5
1.1 Background and analysis	5
1.2 The advantages of diversity of capital	6
1.3 Transition to ILV status	6
1.4 The future of unaligned capital	6
1.5 Annual business timetable	8
1.6 Conclusion	8
1.7 Contact details	8
2 Issues associated with the annual venture	9
2.1 Issues map	9
2.2 Conclusions	14
2.3 Current trends	15
2.4 Future models of participation	15
3 A flexible agency agreement	16
3.1 Background	16
3.2 The issues	16
3.3 Improving the commerciality of the agreement	17
4 Special Purpose Syndicate	18
4.1 Structure	18
4.2 Terms of quota share contract	18
4.3 Lloyd's charges	19
4.4 Capital requirements	19
4.5 Approval arrangements	19
4.6 Mid-year starts	20
4.7 Reporting arrangements	20
4.8 Reinsurance to close and commutation	20
4.9 Multi-year obligations and transfers in participations	21
4.10 Tax considerations	22
Glossary	23
Appendix 1 – Summary of special purpose syndicate model	24

THE ANNUAL VENTURE: A REVIEW

In January, we published our three-year Strategic Plan to ensure Lloyd's continues to compete effectively in the global insurance industry. During 2006 Lloyd's has undertaken a thorough review of the strengths and weaknesses of the annual venture and its compatibility with our current strategy.

Our findings are set out in this report and have been compiled following extensive discussions with market participants and the input of the LMA, the ALM and the HPG. The report has also benefited from the time given by a small group of senior members of the market representing different perspectives on the issues. Members of the group were:

Andrew Annandale, Managing Director Argenta Private Capital Ltd

Nigel Hanbury, Chief Executive Hampden Agencies Ltd

Bronek Masojada, Chief Executive Hiscox plc

Preben Prebensen, Chief Executive Wellington Underwriting plc

The group has been instrumental in shaping the proposals in this report and they are fully supportive of the conclusions that have been reached.

In the past the issues associated with the annual venture have often been contentious and divisive. I believe that this report should be welcomed by all sides of the debate as a real step forward.

A handwritten signature in black ink, appearing to read 'Peter Levene', with a large, stylized flourish above the name.

Peter Levene
October 2006

1 EXECUTIVE SUMMARY

1.1 Background and analysis

To ensure delivery of the Optimal Platform, the Strategic Plan identified the need for a review of the current operating structure and timetable (the 'annual venture'). The Plan recognised that the current mobility of capital, talent and business means we need to ensure that businesses can operate on the platform with as few "Lloyd's specific" constraints as possible.

The term 'annual venture' is used to describe the manner in which, traditionally, a group of members come together, form a syndicate and underwrite insurance business for a particular year of account. Amongst other things, this annual process drives the need for three year accounting and reinsurance to close.

The issue of the annual venture is a multi-faceted one, with links to most aspects of the operation of the Lloyd's platform. Consequently, the first phase of our review concentrated on identifying the issues before determining how these might be addressed. These issues were identified and analysed following discussions with a significant number of stakeholders with different perspectives. In addition we received detailed submissions from the LMA and the ALM. The issues raised cover a broad range of topics some of which are directly connected to the "annual venture" while others are more loosely associated with it.

The issues were mapped into three broad groupings and analysed to consider their impact on the ability to deliver capital advantages, effective performance framework and platform efficiency. We also compared the impact of these issues on two particular stakeholder groups: those managing agents which manage only aligned capital (ILVs) and those which manage both aligned and unaligned capital (mixed syndicates). This analysis is set out in chapter 2 of this document.

The findings of our review confirm that the constraints associated with the annual venture are felt most acutely by managing agents which manage mixed syndicates. The source of these constraints is the standard form managing agents' agreement which sets out the terms on which members participate. These terms, and the rights they confer on unaligned members, are viewed by many managing agents as inhibiting their ability to manage business most effectively. The need to accommodate these rights also drives a complex, rigid and truncated annual timetable.

For an ILV, the majority of the constraints have no relevance or significant impact. In particular, the issues associated with the standard form agency agreement do not pose a difficulty. However, such businesses are constrained by the rigid annual timetable which is designed to deal with the unique features of unaligned capital.

The effect of members' rights and the strict timetable can make it very difficult for managing agents of mixed syndicates to raise and employ new capital quickly and efficiently to meet their business plan objectives and take advantage of new opportunities. As for ILVs, the annual venture is not regarded as a barrier to attracting new capital to support an ILV business which, subject to business plan approval, they are able to do at any time in the year. It is recognised that other issues outside of the annual venture structure can act as a disincentive for the entry of new capital and business into the market. These issues are being addressed separately in Lloyd's plans for the development of the platform.

Views differ in the market on the extent to which the issues associated with the agency agreement inhibit the performance of managing agents, their syndicates or the Lloyd's market as a whole. It is however the case that the participation of unaligned capital has decreased markedly over the years. Unaligned capital represents 19% of Lloyd's capacity in 2006 which compares to a figure of 64% eight years ago. Most of this unaligned capital is private capital supplied by individuals. There has also been an increasing trend amongst managing agents to buy-out the unaligned members on their syndicates and become ILVs. Over the last six years, the number of syndicates that are accessible to private capital has fallen by more than half, to 29 syndicates.

1.2 The advantages of diversity of capital

There is consensus around the fact that diversity of capital generally and the presence of unaligned capital in particular represents a source of advantage for Lloyd's. This diversity of capital is also regarded as a positive by the rating agencies. It is seen as supporting mutuality and offering the Lloyd's market access to a flexible alternative source of capital not easily available to the wider insurance industry. The annual venture supports this diversity, not just facilitating the participation of private capital but providing a unique means for all types of capital to enter the market and support insurance business. Lloyd's has demonstrated its commitment to diverse capital by facilitating the introduction of limited liability partnerships at Lloyd's for 2007.

1.3 Transition to ILV status

Nevertheless, it is clear that the current trend towards ILV businesses is likely to continue. Therefore, if the unique diversity of capital at Lloyd's is to be maintained, ways need to be found for unaligned capital to access syndicates in a way which is attractive to managing agents and, to the extent possible, maintains the features that makes participation at Lloyd's attractive to such capital.

Given the differing interests of the various stakeholders, it is not feasible or desirable at present to seek to impose a single solution on the market. There are some managing agents which do not have any significant issues with the way in which members support their syndicates and are content to continue on the current terms. For those managing agents that wish to pursue a strategy of becoming an ILV, a mechanism already exists to buy-out unaligned capital.

The issues around transition to ILV status are complex and emotive and the current rules are a source of frustration on both sides. At present, it is difficult to conceive of an alternative mechanism which would be more effective than the existing mechanism and which would meet with the approval of relevant stakeholders. It is not therefore proposed to make any changes to the minority buy-out rules or mandate managing agents to adopt a particular operating model.

1.4 The future of unaligned capital

Looking to the future evolution of the market, if unaligned capital is to maintain or grow its share of the market's capacity, the basis of that participation must change to become more attractive to a wider group of managing agents. To succeed, the terms of participation need to be flexible and subject to the normal forces of commercial negotiation and innovation. The current rigid standard form agreement does not represent a sustainable model for the future participation of unaligned capital. To that end it is for market forces to determine the precise basis on which

such capital can be made more attractive to managing agents rather than “solutions” being imposed on the market. Lloyd’s has examined two models for future participation and looked at what it can do to ensure that more flexible and attractive arrangements can be developed. These models are therefore a framework within which parties can discuss possible options.

A more flexible agency agreement

The terms of the standard form agency agreement are regarded by many as imposing constraints on the business performance and operation of mixed syndicates. To ensure the proper functioning of the market there are certain elements of the agreement which must remain uniform. However, it is clear that the parties should be able to negotiate and agree the commercial terms on which a syndicate is supported. Where a managing agent wishes to raise third party capital to support a syndicate and agrees commercial terms with capital providers which differ from the standard form, Lloyd’s will accommodate such variations. The issues surrounding the standard form agency agreement and possible areas for negotiation are set out in Chapter 3.

Special Purpose Reinsurance Syndicates

In this model, unaligned capital would be provided to a managing agent through reinsurance capacity as opposed to direct participation on the syndicate. Members’ agents (or others) could establish a reinsurance syndicate made up of unaligned capital which could provide reinsurance to another Lloyd’s “host” syndicate (whether ILV or otherwise). The terms of the reinsurance would be subject to commercial negotiation with the terms, such as price, rights and exit, established at the outset. Some parallels can be drawn with the recent trend in Bermuda towards “side-car” structures. Such structures would obviously be subject to Lloyd’s approval and in particular agreement of the associated business plans.

It is anticipated that such a model could be established at relatively low cost and structured to keep any additional operational costs to a minimum. For its part, Lloyd’s has examined the steps it could take to facilitate such a structure. This would include a streamlined approach to the admission of a reinsurance syndicate, ensuring that there is no “double-charging” through the application of central fund contributions and annual subscriptions, and a simplified approach to the setting of capital and business plan approval. The intention is also to give the option for such syndicates to commence mid-year.

The benefit to unaligned capital is that such a model has the potential to facilitate the access of unaligned capital to a much wider group of managing agents. This has the potential to allow greater syndicate choice and diversity of exposure. This offers real benefits when considered against the continuing trend for managing agents to become ILVs. Such a structure should allow unaligned members to continue to participate as members carrying on a trade for tax purposes and participate in “mid-year pre-emptions”. It also has the potential to offer unaligned capital a cleaner exit by means of a commutation clause.

The benefit to other syndicates at Lloyd’s is that they have the potential to access a unique low cost source of capital which has demonstrated itself to be flexible and agile. Importantly, however, the terms would be freely negotiable and such capital would be accessed without generating the issues associated with the current form of agency agreement and the current annual business timetable.

If this concept is going to work, the parties must be free to structure and negotiate the arrangements. Chapter 4 sets out a framework and Lloyd's position on various issues which may have an impact on the success of such a model.

1.5 Annual business timetable

The annual business timetable is seen by all stakeholders as a constraint. Whilst insurance businesses generally operate within an annual cycle, the Lloyd's annual business timetable does impose a further layer of complexity. It is primarily driven from the need to accommodate the features and rights of unaligned capital and has little relevance for ILVs.

ILVs have the flexibility to raise capital at any time in the year and consequently Lloyd's could do more to recognise explicitly that an ILV is a continuous business and free them from much of the timetable constraints. Work is underway on this issue with the aim of delivering improvements for ILVs during 2007. Once these improvements are in place an ILV will be able to operate at Lloyd's without being negatively impacted by the fact that other syndicates are supported by members on an annual venture basis.

For mixed syndicates, improvements in the timetable will be more difficult to achieve as the timetable is a symptom of the existing rights associated with unaligned capital. However, once we have established what improvements can be delivered for ILVs we will explore possible improvements to the timetable for mixed syndicates.

1.6 Conclusion

The participation of unaligned capital at Lloyd's is widely regarded as a positive and a source of potential advantage for the Lloyd's platform over other insurance domiciles. It is, however, also clear that whilst the capacity provided by unaligned capital has stabilised in recent years the general trend is downwards. This, coupled with the continuing trend for managing agents to become ILVs, has the potential to make it increasingly difficult for unaligned capital to continue to play a meaningful role in the Lloyd's market.

To counter these trends, ways need to be found for unaligned capital to become more attractive to a wider group of managing agents. At this stage it is not for Lloyd's to impose a particular operating model on the market. However, there are structures which offer the potential for unaligned capital to be harnessed in a mutually attractive manner. Lloyd's would encourage the market to explore these and other possibilities.

1.7 Contact details

If you would like to discuss the issues raised in this document please contact:

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2 ISSUES ASSOCIATED WITH THE ANNUAL VENTURE

2.1 Issues map

The issues associated with the annual venture have been mapped against their potential impact on three aspects of the optimal platform: whether they result in 'Capital Advantages' for capital providers, promote or restrain the 'Performance Framework' within which managing agents operate, and how it affects the overall 'Platform Efficiency' of Lloyd's.

The issues were also analysed against different stakeholder groups, set out in the table below. For example issues associated with Capital Advantages have been assessed against different types of capital provider and Performance Framework issues have been assessed against different types of managing agent.

	Stakeholder Types		
Capital Advantages:	Trade capital 78%	Institutional capital 6%	Private capital 16%
Performance Framework:	ILVs and Corporate Syndicates (CS) 43%	Agents with 75% or more of capital provided by an aligned member 23%	Agents with at least 25% of capital provided by unaligned members 34%
Platform Efficiency:	Managing agents	Corporation	Capital providers

The percentage figures in the table are an estimate of the percentage stakeholder type (by capacity) currently represented in the market.

This chapter also illustrates, through the "life cycle" of a business, the different ways in which Lloyd's operating structure affects ILVs compared to managing agents managing mixed syndicates.

Capital Advantages				
Description of advantages and disadvantages	Capital provider impact			Comments
	Trade	Institutional	Private	
Ability to participate as a member - an insurer with the ability to change the insurance portfolio annually				Membership can take several forms which has appeals for the private retail investor who retains a high degree of control over his investment portfolio
Annual venture allows capital to enter through a new member which can invest in specific underwriting years and be ring-fenced from the past				Members are not exposed to underwriting liabilities already incurred except through any RITC. This is attractive for short-term capital but raises administrative and prudential issues for the Platform
Opportunities for investors to participate directly through third-party provision of FAL. Again this can relate to particular years of account				Certain reinsurers and a few private equity investors provide FAL to corporate members enabling them to participate directly in underwriting risk. Again, this is attractive for short-term capital but raises administrative and prudential issues for the Platform
The ability to use letters of credit as FAL provides a flexible alternative means of providing capital				Although not directly connected to the annual venture LOCs arose from the desire to allow private capital to use illiquid assets to support underwriting
There are certain tax advantages associated with the annual venture				Tax on underwriting profits is deferred for up to three years. Profits are taxed as trading income
Fungibility of FAL allows spread members to invest in several syndicates with a lower capital ratio				Key advantage for private capital who traditionally participate at Lloyd's with the minimum permitted capital ratio
RITC gives an additional option for exit for capital supporting underwriting year(s)				RITC mechanism allows members to effectively draw a line under their insurance obligations after 36 months on each syndicate year
The annual venture promotes full release of profits and minimum 'regulatory' capital levels at Lloyd's				Profits must be released to the members supporting a particular underwriting year and may not be retained by the managing agent to benefit future investors in the syndicate
RITC can only be effected after thirty-six months and may not be available at that time, delaying the release of an investor's capital				The minimum period required for, and any delays to, an RITC may reduce equity returns for investors. No other realistic options exist
Non-tradability of members' positions on open years reduces ability to exit early and realise profit/loss				Although members can trade capacity rights, the totality of their "investment" is illiquid
Lloyd's annual capital setting process provides a 'once a year' opportunity to invest				Lloyd's regime is structured around the investment decision being made once a year for the following year's annual venture
Lack of real investment alternatives for third-party capital				The market's ability to create alternative investment structures for investors has had limited success to date
Insurance assets (capital, premiums, reinsurance recoveries and the like) must be held in trust				Not directly linked to the annual venture, trust funds provide an assurance to policyholders/regulators and protect the Central Fund. They potentially reduce asset management flexibility

Key: advantage , neutral , disadvantage

Performance Framework				
Issue Description	Managing agent impact			Comments
	ILV & CS	>75% aligned	<75% aligned	
Managing agents have a limited window of opportunity to raise capital				Members on mixed syndicates have rights of pre-emption. Process can take four months and any additional capital raising must be in place by November for the following year's underwriting
Late notification of 'drop capacity' provides potential capacity/capital gaps for managing agents with unaligned members and may lead to overpriced capital solutions or unfulfilled business plans				Unaligned members can reduce/withdraw support at very short notice, leaving managing agents little time to raise replacement capital
Managing agents with mixed syndicates may be unable to react to business opportunities during the year if this necessitates an increase in their syndicate capacity				A capacity increase would likely change the syndicate constitution i.e. a new 'annual venture' would be formed, leading to complex accounting and administrative issues
Members have the power to influence managing agent business decisions in respect of their syndicates				The agency relationship gives members certain rights over business decisions affecting mixed syndicates where a conflict exists. This may restrict development of new opportunities on the Lloyd's platform where an organisation has choice
Security of tenure on syndicates afforded to members is regarded by some managing agents as an obstacle to achieving total control over their business				The only option open to managing agents to achieve greater control of syndicate business is to buy out the unaligned members. Although this has been successfully negotiated on many syndicates, some managing agents consider the price too high.
Annual venture acts as a disincentive to business development for the longer term. Fixed assets cannot be held at syndicate level				Non-permanent capital base can impact business stability. Members may cause a run on a syndicate. Drives short-term view of business, deterring investment in the future and product innovation
Ability to transact multi-year policies is impacted by annual venture				Multi-year policies can be entered into, but there are issues concerning apportionment of benefits and liabilities across several years of account, whilst acting in the best interest for each set of principals.
Lack of surplus capital to meet unforeseen events – slow cash call mechanism can lead to funding issues for syndicates				Annual venture promotes full release of profits. Only the minimum level of required capital is maintained such that businesses have no reserves of capital
Fear of losing third-party capital support on a syndicate promotes underwriting performance, resulting in better returns				Competition for capital also exists in ILV businesses and insurance companies. This is not a unique feature of the annual venture
Managing agents have the option to access a source of capital relatively cheaply compared to other insurers				For managing agents, in particular unlisted companies that have limited options, a ready source of cheap private capital to support their business is an advantage

Key: advantage , neutral , disadvantage

Platform Efficiency				
Issue Description	Stakeholder impact			Comments
	Managing agent	Corporation	Capital provider	
Lloyd's annual business planning process begins too early but is also concentrated at the wrong time of the year				Managing agents are asked to begin formulating plans in May. The main planning and review activity is sandwiched between the hurricane season and coming-into-line date
The capital-setting process and timetable is designed to meet the needs of 20% of Lloyd's capital base, requiring an annual review of all members' capital requirements				The approach is based on the need for every member to be individually assessed in relation to the level of risk posed to the Central Fund. This results in an opaque system and creates perceptions of unfair treatment
The existing relationship between business planning, capital-setting and capacity transfer creates a complex annual timetable				A 'one size fits all approach' leads to rushed activity to meet deadlines, suboptimal use of resources, demands for revised data and irritation for many stakeholders.
Lloyd's structure facilitates opportunistic capital and business start-ups				Capital providers have potential to invest on particular underwriting years of account. There is a potential ready source of private capital for new ventures
Delays in profit distribution for members				Lloyd's requires syndicate profits to be paid to the Corporation before being distributed to members
Managing agents must provide underwriting year accounting information as well as syndicate annual accounts on a UK GAAP basis				Managing agents with mixed syndicates must produce audited underwriting year accounts. All managing agents must provide underwriting year information to meet Lloyd's reporting obligations and preserve the declarations basis of taxation
There is a lack of transparency and simplicity				Businesses and capital providers must be aware of and understand Lloyd's specific practices to participate on this platform. These differences can act as a disincentive
Lack of 'off the shelf' options for managing agents to negotiate changes to members' rights				Platform has not been successful in finding solutions to facilitate resolution of perceived 'constraints'
Lloyd's complex capital structure, timetable etc. increases the amount of resource for, and cost of, the platform and adds to the direct costs of stakeholders				Capital providers participating as members, the trust fund structure and additional managing agent reporting are just some examples where extra cost/resources are incurred. The structure can give a negative impression of the platform to outside parties
Obligations of disclosure to unaligned members may conflict with a managing agent's duties under the Listing Rules				The agency agreement gives members broad rights of access to information. This is perceived to pose difficulties for listed managing agents operating mixed syndicates

Key: advantage , neutral , disadvantage

Comparison “life-cycle” of an ILV business versus a managing agent with a mixed syndicate

Issue	ILV syndicate business	Mixed syndicate business
Establishing new business at Lloyd's	Subject to Lloyd's approval and FSA consent business may be established at any time in the year.	In general, the syndicate would have to commence on 1 January. Also subject to Lloyd's approval and FSA consent.
Capital provision	Capital is provided via a single aligned member. Capital raising and provision is flexible and under the direct control of the Group (equity, debt etc). Structure supports temporary capital solutions.	Capital provided from multiple sources including the availability of 'cheap' capital in the form of unaligned members. Timetable constraints restrict capital raising window to once per year. Managing agent not in “control” of unaligned capital – uncertainty of capital commitment. Potential conflict between multiple capital sources increases execution risk. Different obligation owed (e.g. disclosure) etc makes capital raising more complex. Structure supports temporary capital solutions.
Exploiting new business opportunity/ improvement in market conditions	No restriction on business plans being altered as required to meet changes in market conditions or new business opportunities (subject to Lloyd's approval and capital requirements). Can react quickly to market events.	Unaligned members pre-emption rights mean consent (75% of capacity) required to increase syndicate capacity beyond 7.5% involving a lengthy process. Unaligned members have <u>right</u> but not obligation to underwrite increased capacity. If pre-emption capacity not sold at auction can be “dropped” late in year creating uncertainty of capital. Timetable constrains pre-emption to once per year process. Pre-emption rights and uncertainty make external capital raising more complex. Mid-year increases must be structured via parallel syndicates and QQSs which add complexity.
Reallocation of business portfolio across platforms	Business lines can be moved freely between the Lloyd's syndicate and any non-Lloyd's business of the ILV group.	Moving business away from the syndicate unlikely to be in the best interests of the unaligned members therefore could breach agency duties and be open to challenge. Without consent, the managing agent faces legal risk of challenge for account of profits. The agent can seek consent which historically has involved compensating unaligned members.
Accounting considerations	Must produce audited syndicate annual accounts on a UK GAAP basis and an audited syndicate Annual Return that includes information on an underwriting year basis (used for tax purposes).	Must produce audited syndicate annual accounts and Annual Return, and also audited syndicate underwriting year accounts
Profit distribution	Syndicate's annually accounted profit may be released to the aligned member's personal reserve fund (PRF) and may be available to be distributed to the member subject to Lloyd's Release Test calculation. Syndicate interim profits may be taken into account by the member as a capital credit for November coming-into-line and may lead to a release of surplus FAL.	Syndicate's annually accounted profit may be released to members' PRFs and may be available to be distributed to the members subject to Lloyd's Release Test calculation. Interim profits may be taken into account by members as a capital credit for November coming-into-line and may lead to a release of surplus FAL.
Approval of next year's syndicate plan	Initial syndicate plan and ICA submitted in June with final submission in September. Agreed plans and capital assessment by November ready for coming-into-line. Flexibility exists to change business plan and capital levels mid-year.	Initial syndicate plan and ICA submitted in June with final submission in September. Agreed plans and capital assessment by November ready for coming-into-line. Flexibility to amend business plan and capital levels constrained mid-year by pre-emption rights etc.
Exit from Lloyd's business	Investor can exit via share sale etc. (traditional insurance exit options difficult in Lloyd's context). Can also exit via RITC at 36 month point (or later) if available.	A managing agent must have regard to equity between members on different open years. Also, where a syndicate has ceased to trade the managing agent will generally seek members' views before agreeing an RITC. These considerations are likely to prolong the run-off of the business.

2.2 Conclusions

Capital Advantages

Putting to one side the additional complications associated with the management of mixed syndicates, the capital structure is not viewed as an inherent constraint. The structure offers “novel” means for capital to enter and support insurance business, taxation of profits as trading income and a means for capital to exit an insurance investment via RITC. Where further improvements can be made to the capital structure, these are being addressed as part of the strategic plan implementation.

Performance framework

For managing agents with mixed syndicates the current terms on which third party capital participate are viewed as a real constraint on the ability of such managing agents to manage business most effectively. The operational inflexibilities relate to the need to seek the consent of members to increase the syndicate’s size (and associated pre-emption rights), the uncertainty of capital support and the difficulties associated with the development by a managing agent of insurance operations outside of Lloyd’s. The need to accommodate these rights also drives a difficult and complex timetable.

The existence of these rights and the associated complexities make it difficult for managing agents to raise external capital. The resultant structure is regarded as opaque and difficult to understand with managing agents finding it difficult to meet the often conflicting demands of different providers of capital and execute transactions particularly within the very tight timetable currently in place. To a greater or lesser extent these constraints are potentially affecting 25 managing agents managing 57% of the market’s capacity. Absent an alternative solution which deals with these issues and provides a means for unaligned capital to continue to participate, many managing agents will continue to pursue a strategy of buying out unaligned capital.

Platform efficiency

The current rigid annual business planning timetable is regarded as a constraint on all managing agents. It is highly complex, concentrated at the “wrong” time of the year (i.e. during the U.S hurricane season) and adds to the complexity of the Lloyd’s structure. It also raises resource and efficiency issues for the Corporation.

Summary

The issues most frequently associated with the current operating structure and timetable have, as their source the, terms on which unaligned capital participates (i.e. the terms of standard agency agreement).

Views differ in the market on the extent of these constraints. It is however clear that there is a strong perception that the current terms on which unaligned capital participates is limiting operational flexibility and making it difficult for some Lloyd’s businesses to respond to the competitive global insurance environment. For an ILV the remaining constraints are primarily associated with a “one size fits all” business timetable. For managing agents managing mixed syndicates the impact of these issues needs to be examined against the background of recent trends in the capital base.

2.3 Current trends

Over the last six years, unaligned capital has been a major supporter of several new syndicates, aiding the regeneration of the market. Nevertheless, the number of syndicates accessible to private capital has fallen over this period by more than half, from 78 to 29, and the percentage number of ILVs and corporate syndicates has risen from approximately 34% to 52%. Unaligned capital now represents 19% of total market capacity in 2006.

It is clear that the opportunities for unaligned capital to continue to participate at Lloyd's on the current traditional basis are reducing. This trend is compounded by the fact that once a syndicate becomes wholly aligned, its managing agent does not seek to access such capital again.

Against the backdrop of the continued trend for managing agents to move to ILV status the future of unaligned capital in the Lloyd's market has been considered. Although unaligned capital is viewed as a flexible and agile source of capital, without improvements to the way in which it participates unaligned capital is likely to continue to decline as a proportion of the market's overall capital base. The position of the LMA is that access to diverse capital is a source of potential advantage for managing agents provided it can be harnessed in a way which is commercially attractive. This diversity of the capital has the potential to offer Lloyd's a competitive advantage over other insurance domiciles and is regarded positively by the rating agencies.

2.4 Future models of participation

The next chapters in this report have therefore focused on how such capital could participate in the market in a way which is more attractive to managing agents (whether managing mixed syndicates or ILV syndicates) whilst continuing to accommodate the advantages enjoyed by unaligned capital.

Two possible models are outlined: direct participation on syndicates under more flexible agency contract terms, and an indirect participation through a special purpose syndicate. If such structures are to be successful they must be as flexible as possible. The parties must be free to reach the right commercial outcome rather than arrangements being mandated by the Corporation. As a consequence the structures offer a framework within which people can work.

Subject to ensuring compliance with the minority buy-out rules, managing agents should be able to add either of these alternative structures as an additional feature to any capacity offer proposals.

3 A FLEXIBLE AGENCY AGREEMENT

3.1 Background

Section 8(2) of the Lloyd's Act 1982 provides that "An underwriting member...shall underwrite contracts of insurance only through an underwriting agent." That necessitates the establishment of an agency relationship between each member of a syndicate and a managing agent.

The terms of the agency relationship are currently set out in a standard form agreement prescribed by Lloyd's. The agreement sets out the services to be provided by a managing agent, the powers of the managing agent and the duties which it owes to the members of the syndicate. The agreement may not be amended without the consent of the Council.

There are good reasons why parts of the agreement are standard. There is a need to ensure that:

- services are provided on a consistent basis with equality of treatment for members of the syndicate
- there is clarity around the basic obligations and duties of members and their agent who is conducting insurance business on their behalf.

Without this standard agreement there would be greater complexity and uncertainty around the performance of members' underwriting obligations.

The Agreement provides that each member delegates the sole management and control of its underwriting as a member of a syndicate to the managing agent and that the member will not in any way interfere with the exercise of such management or control. As a consequence the Agreement also includes certain obligations and duties on the part of the managing agent to safeguard the interests of the members.

The particular areas of tension with regard to the agency agreement are the application of the fiduciary duties and the fact that members have security of tenure.

3.2 The issues

The agency relationship between members of a syndicate and a managing agent give the members certain rights with respect to the business of the syndicate and drives certain protections which are embedded in Lloyd's structure. The key rights are:

- i) the right to remain on a syndicate in perpetuity (subject to certain limited circumstances)
- ii) the right to resign from a syndicate at short notice
- iii) pre-emption rights over any proposed increase in syndicate capacity
- iv) the requirement for managing agents to obtain approval of at least 75% of syndicate members to an increase in syndicate capacity of more than 7.5%
- v) power to prevent a managing agent doing anything that conflicts with their interests
- vi) right to compensation where a managing agent has breached its fiduciary duties
- vii) restrictions on the ability of a managing agent to increase fees and profit commissions which requires Lloyd's consent.

Some managing agents have expressed the view that these rights constrain their operational freedom to pursue business initiatives. Some initiatives may not be pursued at all because obtaining the agreement of the members of a syndicate is a difficult process with no guarantee of success. This has encouraged managing agents to buy-out unaligned capital to achieve ILV status. The consequence is that the managing agent will need to seek alternative capital and the unaligned capital will no longer have access to that syndicate.

3.3 Improving the commerciality of the agreement

Many provisions of the standard agreement are necessary for the performance of the business of insurance at Lloyd's, and any variations to their terms are not contemplated here. However, it is possible to envisage variations to those parts of the agreement which are considered to be the main cause of the constraints felt by managing agents, namely those relating to the fiduciary duties and security of tenure.

Lloyd's is not currently planning to propose a new standard form agreement or to propose standard form variations to the agreement for use by the market. These are best developed by the market through the active negotiation of real anticipated transactions. However, the type of variations could include:

- modifications to or limits on a managing agent's fiduciary duties to the members of a syndicate. This would allow the managing agent to transfer business away from the affected syndicate and/or to acquire or develop new business for its own benefit or the benefit of other capital providers;
- clarifying that, if fiduciary duties are agreed, whether they apply to directors or employees of the managing agent when carrying out other roles in another capacity;
- varying the basis upon which a managing agent may terminate the agreement, or making the agreement a fixed period contract after which it automatically terminates;
- waiving the pre-emption rights provided by the Syndicate Pre-emption Byelaw in relation to the relevant syndicate.

Lloyd's is willing to consider approving these types of amendments to the standard form on the basis that all members of the relevant syndicate participate on essentially the same terms. Variations of these types could be proposed by managing agents in respect of their existing syndicates provided they can secure the agreement of the capital providers. This would have to happen in the context of a minority buy-out and could be offered as part of the consideration for such a buy-out.

Where a managing agent is seeking to raise unaligned capital to support a new syndicate, it may wish to negotiate these terms as part of the capital raising.

4 SPECIAL PURPOSE SYNDICATE

4.1 Structure

In this model unaligned capital would participate via a reinsurance arrangement as opposed to direct participation on the relevant “host” syndicate. Members’ agents (or others) could establish a syndicate made up of unaligned capital which could provide quota share reinsurance to another Lloyd’s business (the “host”) which could be an ILV or a mixed syndicate. The reinsurance contract would be subject to commercial negotiation with the terms, such as price, rights, obligations and exit, established at the outset. Some parallels can be drawn with the recent trend in Bermuda towards “side-car” structures.

These structures would obviously be subject to Lloyd’s approval and in particular agreement of the associated syndicate business plans. In essence, a similar approval process will apply as for a qualifying quota share (QQS) arrangement and new syndicate application albeit that Lloyd’s will streamline the procedure where feasible.

The simplest model would be a special purpose syndicate providing a whole account quota share reinsurance to a single host syndicate operating on a funds withheld basis. This would benefit from a streamlined approval process, simplify the capital setting process and minimise the reporting requirements. In turn it would keep operational costs to minimum.

There is no reason why a special purpose syndicate could not provide reinsurance of particular lines of business or indeed reinsurance more than one “host” syndicate. However, this would add complexity and cost. It would require both the preparation of a more comprehensive business plan and a more in-depth capital assessment.

As with any other syndicate, a special purpose syndicate would be operated by a managing agent. To ensure that the quota share contract is negotiated on arms-length commercial terms and that no conflicts of interest arise during the creation and operation of the reinsurance arrangement, it may be preferable for the special purpose syndicate and the host syndicate to be managed independently. However, where these conflicts can be adequately managed, or addressed within the terms of the quota share contract, it may be possible for the host syndicate and the special purpose syndicate to be managed by the same managing agent.

4.2 Terms of quota share contract

At this stage Lloyd’s does not anticipate mandating any terms of the contract (except those that may be required in a QQS arrangement) although Lloyd’s will wish to see and approve its terms as part of the business planning approval process. The parties will be free to negotiate the terms of the reinsurance. However, in the context of an arrangement of this nature Lloyd’s would generally expect that:

- the special purpose syndicate will share the benefits and costs of the host’s reinsurance programme
- the special purpose syndicate will follow the fortunes of the host syndicate in every respect
- the agreement will set out how and when the contract is to be commuted.

The period of the quota share reinsurance would be for the parties to determine. For example, it may be for a fixed term of two or three years, or an annual contract renewable at the option of one or both parties.

4.3 Lloyd's charges

Where a host syndicate intends to increase its capacity through a quota share reinsurance of the type contemplated it will incur an increase in central costs (by way of annual subscriptions and central fund contributions) levied on that increased capacity. Similarly the reinsurance syndicate would also incur Lloyd's charges on its capacity. This gives rise to potential double-charging. From Lloyd's perspective the arrangement should not result in any material increase in central costs or exposure for the New Central Fund. Accordingly, it is proposed that any double-charging effect should be avoided.

Lloyd's would propose to levy the host syndicate in respect of the combined capacity of the host and the reinsurance syndicate and exempt the special purpose reinsurance syndicate from any charges. The parties would then be free to negotiate any re-apportionment of these charges as part of the terms of the quota share arrangement.

4.4 Capital requirements

The capital requirement for the members supporting the host syndicate will be driven by the host's ICA. The host syndicate will take account of any credit to be given for the host's reinsurance programme, including any arrangements with a special purpose syndicate. The host will also need to take account of the credit risk and dispute risk associated with any such reinsurance arrangement.

Depending on the commutation and exit arrangements, the host syndicate will receive an additional reserving risk in the future, following the any commutation of the quota share contract. This will need to be taken into account in the host's capital assessment.

The capital requirement for members supporting a special purpose syndicate will likewise be driven by that syndicate's ICA. For the most simple reinsurance arrangements involving a whole account quota share contract, Lloyd's will exempt the special purpose syndicate from the requirement to provide a separate ICA and will take a proportion of the host syndicate ICA for the purposes of calculating capital.

However, where the reinsurance arrangement relates to certain class(es) of business only, a separate ICA for the special purpose syndicate will be required. Whilst this will add to the costs in establishing the syndicate, the necessary information to conduct such calculation will be available from the host.

4.5 Approval arrangements

The host managing agent will be required to submit a business plan showing the impact of the additional business to be underwritten with the benefit of the quota share contract. The business plan should also include such details as

- changes to the Host syndicate's line sizes by principal business classes
- the impact on the Host syndicate's reinsurance programme
- an assessment of the impact on gross and net RDS scenarios
- a copy of the proposed quota share contract

As in any other case, Lloyd's will need to be satisfied that the host's business plan is reasonable given the prevailing market conditions and does not unduly increase the exposure of the Central Fund. On this latter point, particular regard will be had to any additional risk posed by the reinsurance arrangement to be entered into with the special purpose syndicate.

All new syndicates are subject to Lloyd's prior consent. However, where a special purpose syndicate will only be seeking to undertake a single contract of reinsurance with a single host syndicate, Lloyd's will ensure that the application procedure is kept to a minimum. In particular, it is anticipated that exemption will be granted from the requirement to provide a separate business plan and ICA for whole account reinsurance arrangements.

4.6 Mid-year starts

Lloyd's acknowledges that to be commercially attractive it is necessary for a special purpose syndicate to be able to establish itself other than for a 1 January start date. This could potentially cause administrative issues for the Corporation in situations where it is dealing with many different members seeking to increase their underwriting mid-year. Practically it would not be sensible to allow these arrangements to be established at any point in the year, but there are key times when managing agents may wish to increase syndicate capacity through such a mechanism. As a first step, it may be possible to facilitate 'mid-year' arrangements to take effect for the 1 July renewal season. To provide certainty to both parties, this may require that the special purpose syndicate be approved, and capital lodged by the relevant members, by 15 June. Such a timeframe may dovetail with the mid-year coming-into-line exercise that is already in place.

Members, members' agents and the Corporation potentially must be prepared to act quickly in order to ensure that additional funds at Lloyd's are lodged within a permitted timeframe. Whilst Lloyd's is in favour of allowing as much flexibility as possible, there are practical implications to be addressed with regard to mid-year starts and further work will be carried out in order that an agreed process can be put in place.

4.7 Reporting arrangements

Where a special purpose syndicate is writing a single whole account reinsurance a full business plan and ICA will not be required. Other more complex structures will require a separate business plan and capital assessment.

Lloyd's will consider a reduced reporting regime for special purpose syndicates. For example, it may be possible to give a dispensation, or a reduction in reporting requirements, in the following areas

- quarterly monitoring & reporting
- realistic disaster scenarios
- annual syndicate accounts

4.8 Reinsurance to close and commutation

The result of a host syndicate year of account will be determined in the normal way, following RITC, usually after 36 months. It is expected that the calculation of an RITC by the host syndicate will act as the basis for determining any commutation of the reinsurance arrangement with the special purpose syndicate for that year of account.

For a reinsurance arrangement that is for more than one year, a number of options may be available. The managing agent of the special purpose syndicate may rely on the Host syndicate's RITC as the basis for determining the RITC of the special purpose syndicate for a particular underwriting year. An alternative approach may be for the parties to agree a commutation in respect of each year separately for which the reinsurance contract is in place.

For the final year of account of the reinsurance arrangement, following the end of the contract period (e.g. after 24 months), it is expected that the managing agent of the special purpose syndicate will wish to have the capability to challenge the host managing agent's assessment of the performance of the quota share contract and its calculation of the commutation price.

For members participating in a special purpose syndicate, a guaranteed exit at a pre-determined time would be an attractive benefit avoiding the potential for capital to be trapped in run-off years of account. The quota share contract may therefore set out the terms on which the commutation is to be settled. The commutation will end the reinsurance syndicate's obligations under the contract and allow the final year of the special purpose syndicate to be RITC'd back into the host syndicate at a nominal price.

4.9 Multi-year obligations and transfers in participations

It is anticipated that members participating on a special purpose syndicate would have the right and obligation to continue on that syndicate for the duration of the quota share contract entered into with the host. This means that for a multi-year contract, members will not have the opportunity to leave the syndicate at the end of an underwriting year. Also, it is not anticipated that members will be able to trade these participations in Lloyd's capacity auctions. However, should a member wish to leave at any time prior to the commutation of the quota share contract, the members' agent may act as a "market-maker" to find an alternative member take up such participation in the syndicate both in respect of the business already written but also any remaining term.

The fact that a special purpose syndicate is likely to enter into a multi-year arrangement has implications where one or more members participating in that syndicate have a shortfall in their FAL or become insolvent. In the former case it may be possible to require that the affected members reduce their underwriting on other traditional syndicates in order that they continue to have sufficient FAL to support any longer-term commitment to the special purpose syndicate. This also implies that a limit might need to be put on the amount of a member's underwriting portfolio that comprises participation in special purpose syndicates.

Where one or more members become insolvent (or, in the case of an individual member, dies) those members will no longer be able to support their obligations under the reinsurance contract. In such circumstances:

- other members may be able to take the place of the insolvent members, for the following year of account of the special purpose syndicate, or
- the terms of the quota share contract must allow for the proportion of business accepted under the arrangement to be reduced in any year should the capacity of the special purpose syndicate fall for this reason.

4.10 Tax considerations

Lloyd's members' UK tax status as traders is a key feature of their participation, particularly for non-aligned members. Although we have not reconfirmed this with HM Revenue & Customs we believe that participation on a special purpose syndicate should be treated for UK tax purposes in the same way as participation on a traditional syndicate.

So far as overseas taxes are concerned, the agreement between the host syndicate and the special purpose syndicate would need to specify the arrangements and respective obligations and rights for dealing with any premium taxes, income taxes or other taxes.

GLOSSARY

Agency relationship	The relationship between the managing agent and the members on its syndicate is governed by agency law evidenced by a standard agency agreement
Aligned member	A corporate member of a syndicate that is directly or indirectly owned by the same firm that owns the managing agent of the syndicate
Capacity offer	An offer made by a managing agent or other person to acquire the capacity of members of a particular syndicate for consideration
Coming-into-line	A procedure currently undertaken in November each year which requires members to demonstrate that they have sufficient eligible assets to meet their current underwriting liabilities and to support future underwriting before they may underwrite for the next following year of account
Corporate syndicate (CS)	A syndicate comprising a single corporate member which is not aligned to the managing agent
Drop capacity	Where a member does not take up his capacity on a syndicate for the following year and has not transferred these rights to another member, the capacity is said to drop back to the managing agent. The capacity will remain unallocated and unused unless the managing agent allocates it to another member (e.g. its aligned corporate member)
Funds at Lloyd's (FAL)	Funds of an approved form that are lodged and held in trust at Lloyd's as security for a member's underwriting activities
ILV or integrated Lloyd's vehicle,	Is where all the capacity of a syndicate is provided by the managing agent's aligned member
Institutional capital	Professionally managed capital funds such as private equity and hedge funds
Minority buy-out	Occurs where a managing agent or a connected company has been given consent by Lloyd's to buy out the remaining members of a syndicate following the making of a capacity offer
Mixed syndicate	A syndicate which is made up of unaligned members, but which may include an aligned member
Nameco	A corporate member which is owned by an individual investor or a connected group of individuals
Open year	An underwriting year of account which has not been closed by reinsurance to close
Pre-emption	Where a managing agent increases the underwriting capacity of a syndicate, for example when it expects to write more business in future. The participations of the members of the syndicate are increased proportionately to the extent the managing agent's pre-emption offer is taken up
Private capital	Capital provided by private individuals and trading as Names, Namecos or Scottish limited partnerships
RITC or reinsurance to close	A reinsurance which closes a year of account by transferring the responsibility for discharging all the liabilities that attach to that year of account (and any year of account closed into that year) plus the right to any income due to the closing year of account into an open year of account of the same or a different syndicate in return for a premium
Run-off year	A year of account of a syndicate which was not closed at its normal date for closure by reinsurance to close and which remains open
Syndicate constitution	Comprises the members participating on a syndicate for a particular year of account and their respective share of the syndicate capacity
Third-party FAL provider	A person or company, not being affiliated with a member, that provides FAL to that member
Trade capital	Capital provided by an entity whose primary business is insurance
Unaligned Capital and unaligned members	Refers to members of a syndicate which are not affiliated to that syndicate's managing agent

APPENDIX 1 – SUMMARY OF SPECIAL PURPOSE SYNDICATE MODEL

Structure

- Whole account or line of business quota share reinsurance of a host syndicate
- A special purpose syndicate could reinsure one or more host syndicates
- A special purpose syndicate could be managed independently of the host syndicate or by the same managing agent
- Cost and efficiency benefits will arise if the special purpose syndicate reinsures a single host syndicate on a whole account basis

Contract terms

- Freely negotiable between the parties (subject to certain clauses to be prescribed by Lloyd's)
- Possible commutation mechanism that gives certainty of exit
- Could be single or multi-year arrangements
- Lloyd's to have copy of contract terms as part of the business plan review.

Capital

- Host syndicate ICA will drive capital requirements in usual way
- For straightforward arrangements involving a whole account quota share the special purpose syndicate may rely on the host syndicate's ICA to determine the capital requirement for the members participating on the special purpose syndicate
- For more complex arrangements the special purpose syndicate may require a separate capital assessment

Lloyd's charges

- No 'double charging' where this can be avoided
- The special purpose syndicate to be exempted from such items as New Central Fund contributions and annual subscriptions
- Ability for the host to pass on a proportion of Lloyd's charges under the terms of the reinsurance contract

Interface with the Corporation

- Lloyd's prior consent to the host syndicate's business plan incorporating the quota share reinsurance arrangement with a special purpose syndicate
- Lloyd's authorisation process for a special purpose syndicate to be proportionate to the nature of its business
- For whole account quota share reinsurance arrangements, Lloyd's will rely on host syndicate ICA and business plan when approving or reviewing the special purpose syndicate
- Reduced, or exemptions from, reporting requirements will be put in place for the special purpose syndicate, where feasible

Mid year starts

- Ability for a special purpose syndicate to be established mid-year (initially for 1 July renewal season)
- Members' agents will need to introduce new processes to allow for the acceptance of special purpose syndicate capacity and lodging of additional capital by their members, in a timely fashion
- Detailed arrangements and process changes to be agreed

Commitment to a special purpose syndicate

- Members' may not be in a position to trade or obtain a release from their obligations under the quota share contract prior to its termination