A step in the right direction

The trade finance insurance market is set to undergo one of the biggest shake-ups in its history after Lloyd's of London this year announced new financial guarantee regulations that will give managing agents greater freedom to write the business they want. *Alex Wright* reports.

Financial guarantee insurance is big business globally, with the Lloyd's market alone writing around £400mn in credit, contract frustration and financial guarantee business in recent years, according to industry sources.

The new requirements governing financial guarantee insurance, which were unveiled in June and come into force next year, cover contract frustration, credit risk – the two largest classes within the category written at Lloyd's – and related lines.

Under the new rules, Lloyd's will take a more risk-based approach to regulating the sector by considering each business plan proposal put forward by the managing agent of a syndicate on its merit, provided they can prove that they have the right controls in place.

Essentially, underwriting agents that manage a Lloyd's syndicate will no longer be bound by strict technical rules but instead be more flexibly regulated according to the particular risk they want to write.

They will also need to show that they have a clearly defined risk appetite to write the business and the relevant experience and resources to do so within their plan, for example having access to high-quality credit analysis that will provide the data to underpin their underwriting.

This will enable agents to underwrite only the risks they want without needing to gain Lloyd's approval for individual contracts unless they fall outside of the syndicate's business plan.

For credit risk and contract frustration, Lloyd's will also no longer require each risk to be explicitly linked to a trade, contract or security, but will rather assess every business plan individually.

In other areas there will also be greater scrutiny, with Lloyd's requiring a more detailed breakdown of the syndicate's risk aggregation to be submitted for salvage guarantee insurance (which covers the risk of non-payment for a marine salvage claim), credit risk, contract frustration, mortgage indemnity insurance, seafarer abandonment and surety bond reinsurance business, in order to measure the syndicate's exposures against its plan.

David Powell, head of non-marine underwriting at the London Market Association (LMA), who has been spearheading the new reforms, says that the key driver behind the changes was a dual effort between Lloyd's and the LMA to make it easier for managing agents to write financial guarantee insurance. They were also designed to finally bring the category in line with other classes, he says.

"It was a market initiative to try and get some changes made to the way the regulations worked in order to remove some of the restrictions that were causing some commercial difficulties for underwriters," he explains. "At the same time Lloyd's was looking to try and change the way the regulations worked to make them fit in with the way other lines of business are written."

Force of change

Previously, if a managing agent wanted to underwrite a financial guarantee risk they had to refer it to the performance management directorate (PMD) at Lloyd's, who would then review and approve it on a case-by-case basis. But Powell says that after making some minor changes to regulations in 2013, the LMA and Lloyd's then carried out a further review of the regulations two years ago, and drew upon those results for the latest set of changes.

"Over the last few years we have been trying to change the regime to more a risk-based approach," he says. "Essentially, now it's a much more seamless process whereby as long as the business that underwriters want to write falls within their approved business plan, they can write it."

However, Powell adds that the onus will still be on managing agents to show they have the necessary approved in-house expertise to write the business. Agents are also bound by the level of premium income they can earn in the financial guarantee classes that their syndicate writes, he says.

The new rules state that if the income derived from pure financial guarantee business exceeds the gross written premium (GWP) figure agreed in a managing agent's business plan by more than 2% then it is unlikely to be approved by the PMD, says Powell. That limit has been imposed to ensure managing agents don't become overexposed to the financial guarantee risks on their books.

The equivalent figure for both credit risk and contract frustration has also been increased by 1% to 6% as per the new regulations, giving agents greater scope for writing more business, Powell adds.

"For a larger managing agent, that's quite a decent chunk of extra headroom to write more business, but for a smaller managing agent with a US$100mn syndicate 1% is not a significant increase," he says. "I don't expect there will be a big increase in terms of volume of premium written, but it should improve the credit quality of the overall market."

Today, all business written by managing agents has to be a trade or contract-related deal, but the new regulations mean everything is potentially fair game. As a result, it could be argued that the quality and diversity of the Lloyd's portfolio will improve as syndicates are exposed to a much wider selection of business, putting them on par with their competitors outside of Lloyd's, explains Rupert Boyle, executive director of structured credit and political risk at Gallagher.

"From an underwriting perspective, it means that they are going to have a broader spread of business," he says. "They are now going to be dealing with not only trade departments but also non-trade departments within their existing clients' business as well as probably finding some new clients because the new rules free up managing agents to write high-credit quality business not attached to a specific trade or project."

Trade and non-trade market benefits

The new regulations also open up more distribution channels for the banks by allowing them to partner with Lloyd's syndicates on non-trade business, says Nick Ollerenshaw, also an executive director of structured credit and political risk at Gallagher. In doing so, banks will avoid having to do business with their competitors, he says.

"If a bank is better able to insure not just their trade-related business but also the non-trade, such as general purpose working capital lending, then they are likely to transact more business with the insurance market as the principal syndication partners," he says. "If they can avoid sharing their deals and customers with other banks and financial institutions they are likely to be keen to do so, thereby ensuring that the Lloyd's market remains a more attractive proposition."

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David Powell, London Market Association

James Morrell, class underwriter for credit risk at Brit Insurance, says the new rules represented a seismic shift in the way managing agents are regulated. By giving them more freedom to write the risk they want to, it is a win-win for both managing agent and their clients.

"The regulations are a big shift from a hard and fast set of rules towards much more less prescriptive guidelines," he says.

Essentially it puts a lot more trust in underwriters to do what they say they are going to do.

"For the trade finance insurance market it should mean that Lloyd's underwriters are able to cover a much broader swathe of risks. It should also mean that as Lloyd's underwriters become more sophisticated they are able to help their trade partners access even the hardest forms of coverage to obtain."

All of this, of course, has to be seen in the context of Lloyd's continuing to strive to remain relevant and compete against the commercial markets. It's unlikely to be the last change, but for now at least it's a step in the right direction. GTR

A risk-based approach

"Lloyd's now proposes to operate a more risk-based approach and will consider proposals on their merits through the business planning process having regard to the characteristics of the business being proposed and managing agents demonstrating that they have the appropriate controls in place," wrote Jon Hancock, performance management director at Lloyd's, in his market bulletin dated June 13, 2018. "Further, managing agents will no longer be required to obtain approval for the underwriting of individual contracts unless the risk falls outside the syndicate's business plan or the managing agent has been required by Lloyd's to submit individual contracts for agreement.

"It is important to emphasise that this change of approach is not intended to signal a relaxation in Lloyd's risk appetite for the writing of this class of business, which remains limited. However, by operating a risk-based approach Lloyd's can assess each proposal individually and managing agents are not limited in the type of risks they can write by unduly rigid rules."

He added: "To allow Lloyd's to monitor syndicate exposures against plan, Lloyd's has put in place additional reporting obligations for financial guarantee business. This requires the submission of an additional financial guarantee return for all financial guarantee, credit risk, credit frustration, mortgage indemnity insurance, seafarers abandonment and surety bond reinsurance business as part of the business plan agreement process and six-monthly thereafter.

"The return requires managing agents to provide details of their exposure to certain obligors and for those writing or planning to write GWP (gross written premium) in the aggregate for this business above a threshold, currently set at £10mn for the 2019 underwriting year of account to provide details of their exposures in these classes, including by country, by sector and by exposure over time, per obligor."