Jasmine DeSilva | Ed Saul | Des Potter | Tim Shreeve

LONDON BRIDGE 2:

Debunking the Myths

Artex | Capital Solutions

On 18 April 2023, Artex hosted a webinar, in partnership with Lloyd's and Ariel Re, titled Optimising Access to Lloyd's Through London Bridge 2 PCC Ltd (LB2). It aimed to educate participants on the risk transformation platform and showcase the ways in which investors can increase their participation in the Lloyd's market.

A protected cell company, LB2 was set up in August 2022 with Ariel Re the first sponsor to raise capital through the structure. Since then, it has secured a further $270 million in capital for Syndicate 1910 and SPA 6136 from five new investors.

Much was covered during the well-attended hour-long webinar discussion, but there were a number of outstanding questions our experts did not have time to answer in full.

In this Q&A, compiled after the event, Des Potter, special advisor to Lloyd's, Tim Shreeve, head of platform development at Ariel Re, and Ed Saul, VP of insurance management at Artex Capital Solutions (ACS) go into more detail on the mechanics and structure of LB2, and its position within the global insurance-linked securities (ILS) market. And they also set the record straight on the ease of entering into ILS transactions that have a uniquely Lloyd's 'flavour.'

Q. With the success of LB1/LB2, do you anticipate the launch of competing Lloyd's ILS platforms?

Des Potter. What we've set up here with London Bridge 2 (LB2) is something that's bespoke to Lloyd's and benefits multiple potential participants at Lloyd's. The fact that we've had some early success and have got a very flexible set of regulatory permissions will encourage others to think about similar PCC structures. But it is unlikely that they will be able to replicate the full range of LB2 capabilities.

Ed Saul. There already are risk transformation vehicles, such as PCCs, both in the UK and overseas. From a UK perspective, London Bridge 2 is more developed than the other platforms in place and has the most extensive range of permissions. Its overriding purpose is to deliver capital to Lloyds and deliver a unique offering for the benefit of Lloyd's market participants, and it has direct regulation from the PRA and FCA giving it permissions to do that.

It's a great use case for London and the UK, and it will demonstrate the progression in the regulations and the permissions that the PRA are putting out there. This should encourage the further development of other vehicles in the market. Of course, not every transaction involves Lloyd's, but the success of LB2 is likely to lead to greater utilisation of the UK market for ILS risk transformation vehicles.

Q. What is a corporate member and why does it exist within this structure?

Ed Saul. A member at Lloyd's is the risk-bearing entity, where the solvency capital (i.e., Funds at Lloyd's, FAL) resides in support of the underwriting capacity of the syndicates at Lloyd's. A corporate member is a company incorporated with limited liability admitted to the membership of Lloyd's.

Des Potter. Anyone who wants to participate in the underwriting of Lloyd's—every FAL-related transaction—will need to go through a corporate member because that's the risk-bearing entity within the Lloyd's market, which holds the solvency capital that supports the underwriting of a syndicate.

Q. How long does it take to set up a corporate member and what assistance do you offer?

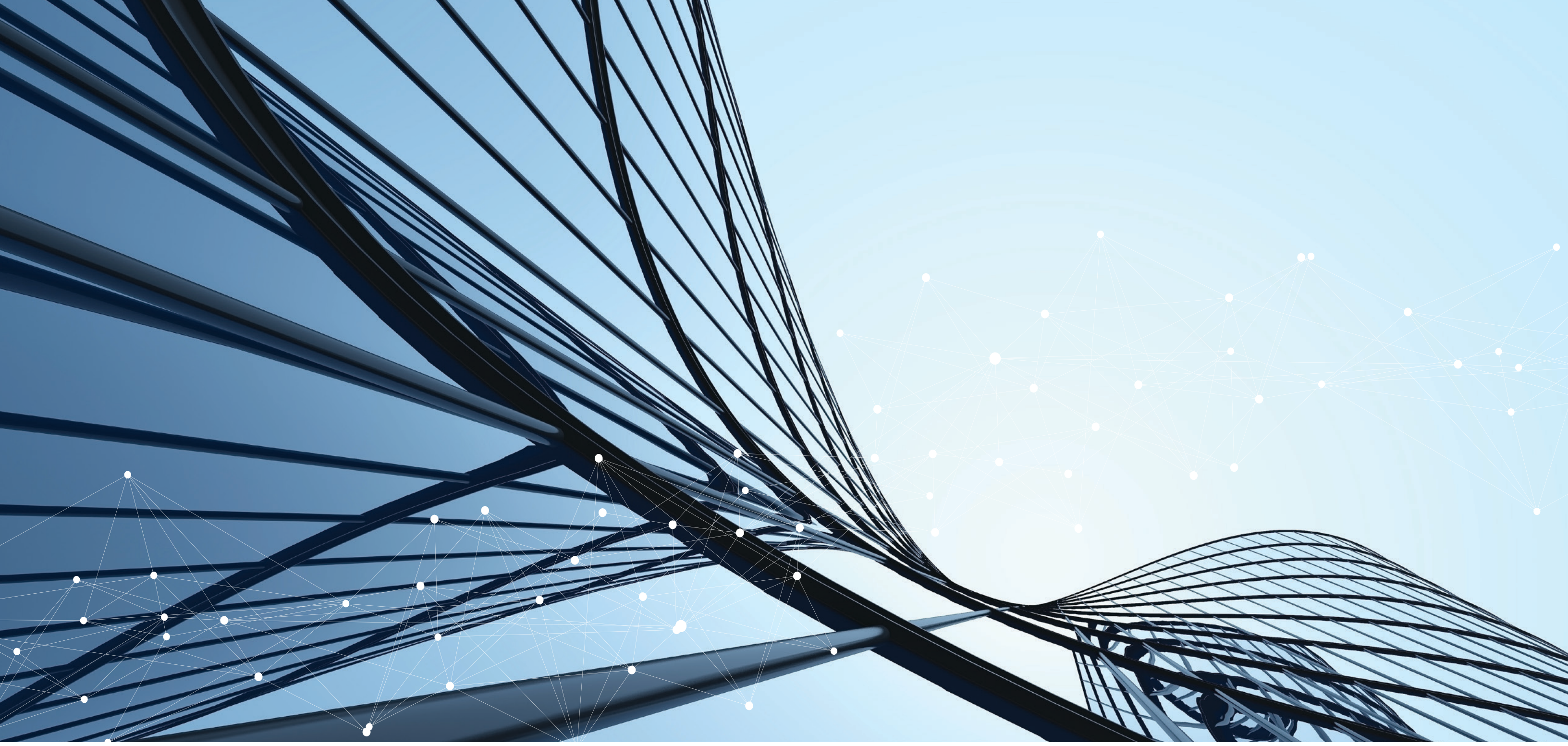
Ed Saul. The creation of a corporate member is outside of the direct remit of London Bridge and may be achieved by a number of routes, including the involvement of a member's agent. The time it takes can be a matter of weeks, however, will be driven by the complexity and KYC process.

Lloyd's works closely with ACS on any transaction involving LB2. Those transactions that deploy FAL by reinsuring a corporate member are more complex than the relatively standard syndicate (re)insurance transactions and to ensure the smooth execution of these FAL transactions, which may require the establishment of a new member, Lloyd's will establish a working group with stakeholders from each Lloyd's team involved in the respective diligence/approval processes.

Q. Is a new corporate member set up for every cell of London Bridge? Or is there an overarching 'London Bridge' corporate member that every cell uses?

Ed Saul. A key regulatory permission of LB2 enables it to reinsure the financial result of a [corporate] member, to enable institutional investors to participate in the underwriting result of the chosen syndicate. For these types of transactions, a corporate member will be required.

Investors can choose to use an existing corporate member or establish a new corporate member. ACS does not provide member services, which are routinely provided by Members Agents.



LB2 also has the regulatory permission to enter into direct syndicate (re)insurance, on a collateralised basis—these types of transactions are bilateral arrangements between LB2 and the syndicate, and do not require the involvement of a member.

Des Potter. Whilst a new corporate member will be needed for every FAL transaction, you don't need a new member for every cell (re)insurance arrangement. We do have certain members transacting with multiple cells. The decision to utilise one or multiple members varies depending on the objective of the end investor, whether that investor wants to support one syndicate or multiple syndicates, and whether the capital is coming in from one fund or multiple funds with common or different investment objectives.

For straightforward collateralised (re)insurance of a syndicate, you don't need a member as that's a commercial bilateral arrangement between the syndicate and the cell.

Q. Are you able to confirm that there will be no corporation tax levied in connection with London Bridge?

Ed Saul. The company is expected to come within the rules set out in the UK Risk Transformation (Tax) Regulations 2017, which provide that, so long as certain conditions are met, there should be no UK corporation tax on profits arising within a cell and no withholding tax on distributions made from a cell. However, this tax treatment does require that one of the main purposes of the transaction is not tax avoidance.

HMRC has provided guidance that the use of a UK risk transformation vehicle [that is free of corporation tax] is not considered a tax avoidance main purpose. In all cases, transaction parties should seek their own independent tax advice, although Lloyd's does have a panel of advisors that are familiar with these transactions and can assist transaction parties with the required advice.

Des Potter. The PCC operates within a very competitive tax environment. Obviously, we're not tax advisors, but the legislation is very clear. On the condition that the main purpose of the transaction is not to avoid tax, the vehicle is free from UK corporation tax. It should also benefit from no withholding tax on the distributions or stamp duty on the securities issued by the cell.

But each investor would need to seek its own independent tax advice because the ultimate tax cost of an LB2 investment will be determined by the tax regulations in the host jurisdiction of the investor.

FOCUS ON OPERATIONAL EFFICIENCY

Q. Who are Lloyd's competing against in this area and how does the market compare to other jurisdictions?

Des Potter. We don't compete directly with Bermuda, which is a leader in the ILS risk transformation space. LB2's establishment is about offering something different for Lloyd's market participants and ILS investors. If you're a syndicate and you want to do a quick small to mid-size CAT bond, for instance, you don't necessarily want to go to Bermuda to issue the transaction and the requisite governance/board requirements. If investors want something other than property CAT they can get it here at Lloyd's, and they have the comfort of the corporation overseeing the underwriting and how their capital is deployed.

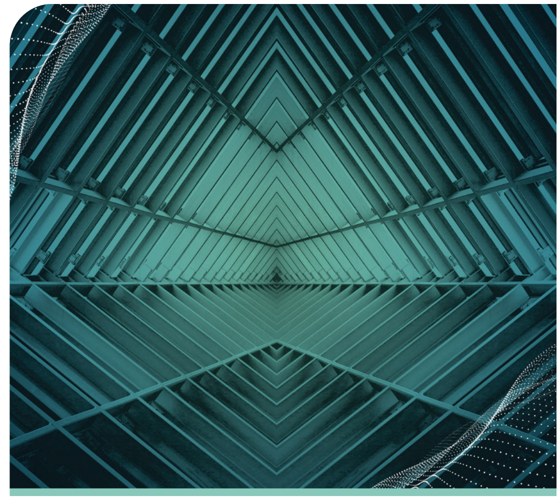
There are still some negative perceptions about how challenging it is to work with Lloyd's, or how difficult it is to use the UK in terms of ILS. Most of those perceptions are based on hearsay rather than actual experience. Lloyd's has had some really good, positive experiences with the UK regulator, during the last 18 months, who has been really supportive of what we're trying to achieve.

We need to keep up the momentum and I'm really hopeful that we will have a really good set of transactions this coming renewal season. The ultimate ambition is that London Bridge runs itself, without advocacy from the corporation, because participants come to know how good and efficient the entity is.

I genuinely believe that London Bridge is unique in the world of ILS risk transformation. We have the ability to have multiple cells to support multiple potential issuers. Lloyd's is a marketplace of c50 managing agents and c100 syndicates.

What differentiates London Bridge from a Bermuda segregated account or a Guernsey ICC is the link with Lloyd's, and the capital efficiencies and breadth of underwriting risk Lloyd's can offer the ILS market.

Ed Saul. Lloyd's does not own or control London Bridge, it is independently managed by its own board. In setting up the London Bridge vehicles, Lloyd's sought to provide further optionality to market participants to enable them to access institutional investor capital to support their growth plans and/or risk transfer needs in a simplified and cost-effective way.



The protected cell structure of LB2 is very similar to the segregated account structures that exist in Bermuda, however, LB2 does benefit from a set of regulatory permissions that enable it to respond quickly to transaction opportunities with, we believe, a comparable efficiency to other established risk transfer domiciles.

Q. How does the speed, ease and cost of access of LB2 compare to Bermuda-based ILS structures?

Des Potter. For collateralised (re)insurance, it takes around two to four weeks comfortably. For FAL deals with new corporate members, it's probably a little bit longer at around four to six weeks. It varies in terms of the complexity of structure and the preparedness of the managing agents and investors.

One of the issues is not so much the Lloyd's approval processes, which does take time, particularly for new syndicates, but the KYC processes for a new investor.

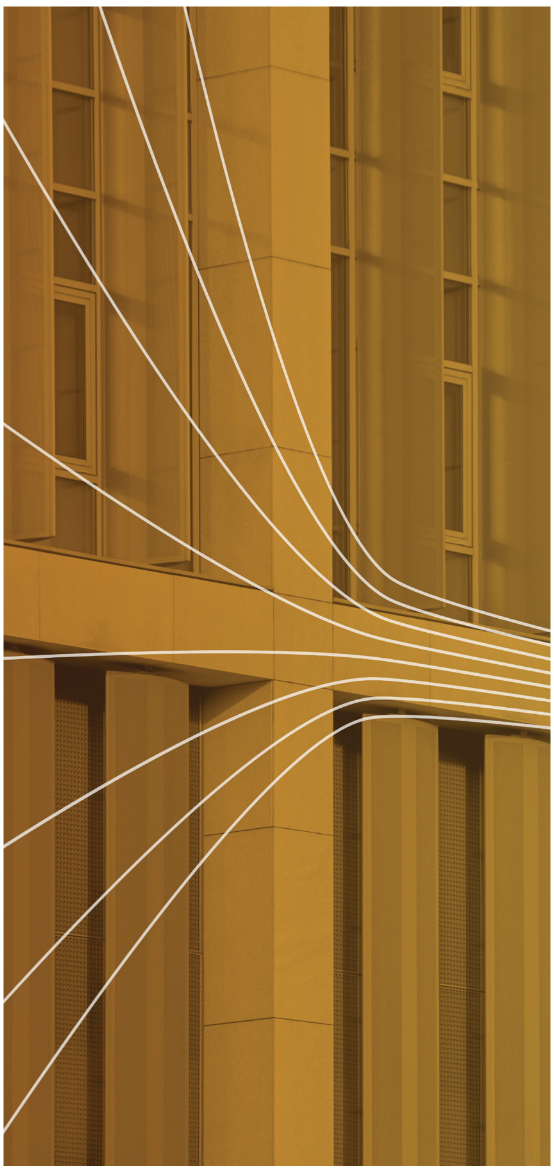
It's strategically important for Lloyd's to make itself more accessible to new investors. We're very motivated to make sure that the internal stakeholders that need to be involved in executing the transaction are briefed as early as possible. They each have different work streams and processes they need to go through, but they are all working toward a common objective and timeline.

On the cost side, we've still got a little way to go, but we're making good progress. LB2 is not only smooth in terms of operational efficiency, but also cost effective as well. The piece where the transaction costs are still a little high is on the legal side, but once we do more of these deals we will see more efficiency on the legal costs. We are also trying to get more banks involved so that we don't get overly dependent on one bank for some of these transactions.

Ed Saul. The short answer is that we are comparative and competitive in terms of ease and cost of access. The scope of permissions we have from the PRA allows us to enter into transactions on an inform-only basis, which means we don't have to wait for any approval. And then it really just comes down to the mechanics of the transaction.

This means that the time needed to complete the transaction process is largely operational, including factors such as KYC, banking setup and the development of transaction documents. At a cell level, this can be achieved in a matter of weeks. LB2 also aspires to be competitive from a cost perspective.

Lloyd's has done a lot of work in the areas where they are involved, whether that's the onboarding of the investor or actually in the setup of the corporate member, to streamline their deal processes. They have specific deal processes in place that allow them to move very quickly and some of the recent transactions I've seen have been impressive.



We believe that LB2 delivers unique competitive advantages, including good governance supported by Lloyd's, effective coordination with Lloyd's and UK (onshore) offering. There are other factors to consider for transaction process timing, such as setting up a corporate member (where appropriate), any logistics at the syndicate level and general terms negotiation. ACS can help discuss the objectives of any given transaction, to guide participants on timing considerations that may apply.

Q. Does ACS work/advise both the syndicates and the investors?

Ed Saul. ACS is an ILS/(re)insurance service provider, covering multiple jurisdictions. In the context of London Bridge 2, ACS acts as an insurance manager, delivering strategic development, acting as "go-to" for interested parties, facilitating the transaction process at the LB2 cell level, reporting on transaction financial performance as well as managing the operations of the PCC itself.

As a facilitator, ACS is focused on the delivery of transactions which includes guiding those parties involved through the process. Those parties would include investors, any sponsors, cedants and advisors.

ACS is not permitted to advise/broker for investors or insurers (including syndicates), there are often brokers, investment advisors and deal counsel involved in transactions who provide the relevant advice in these circumstances.

Q. Who does Artex tend to use as custodian of funds raised? Or is it entirely down to the fund's management?

Ed Saul. LB2 is able to support a range of custodians and banks, which allows flexibility for the user. There is of course a need for such providers to have the means to deliver the appropriate service, and as such, ACS has worked closely with a number to help educate them on the LB2 transaction requirements so that they can be prepared to support the market. We are able to provide a list of such providers as well as assist participants with getting a preferred provider on board.

Q. What are the additional costs associated with using London Bridge?

Ed Saul. Cell-specific costs are as follows (as of August 2023):

- Insurance management £35,000[1] per annum, per cell, depending on complexity and frequency of reporting reduced by 50% for development-only years, where there is no active participation in an open year of account.
- One-off setup fee of £10,000[1] to cover initial transaction services.
- Facility fee (contribution to expenses of the core) of £10,000 per annum.[2]
- Banking and custodian fees may vary depending on the complexity of the transaction and service provider(s).

BUY-SIDE/SELL-SIDE INSIGHTS

Q. What is Lloyd's doing to encourage third-party capital investment through LB2?

Des Potter. Our role is one of education and advocacy, explaining to investors how the market works and how they can translate the terminology of Lloyd's into a language they understand. Also, to give the investors comfort. The corporation has a very important role, in overseeing underwriting activities, approving, reviewing and monitoring plans, governance frameworks, determining capital, agreeing reserve positions, challenging loss ratios, and approving capital releases, etc.

There's a similarity between the way a managing agent operates and the way a fund manager operates, but at Lloyd's you have the added benefit of that market oversight by the corporation.

Q. Could rising interest rates reduce the attractiveness of the insurance industry to third-party capital and therefore constrain growth potential in this space?

Des Potter. If interest rates go up, but underwriting returns are stable or go down, your return on a unit of risk on the underwriting side is not as attractive as your return on a unit of risk on the investment side. But we're a long way away from that, even with increased interest rates.

The property and casualty (P&C) market has got some of the most attractive underwriting conditions that it's had for many years. So the opportunity for good underwriting returns is still very attractive, and there is the added benefit that risk in underwriting has a relatively low correlation with what goes on in the stock and bond market.

So even with higher interest rates, insurance as an asset class is still a compelling proposition. You can write more premium in Lloyd's per unit capital than you can anywhere else in the world, and that helps investor returns.

Tim Shreeve. We do not believe rising interest rates change the attractiveness of an insurance-linked investment in and of itself. What may be an advantage of LB2 over some other ILS offerings however is that if there

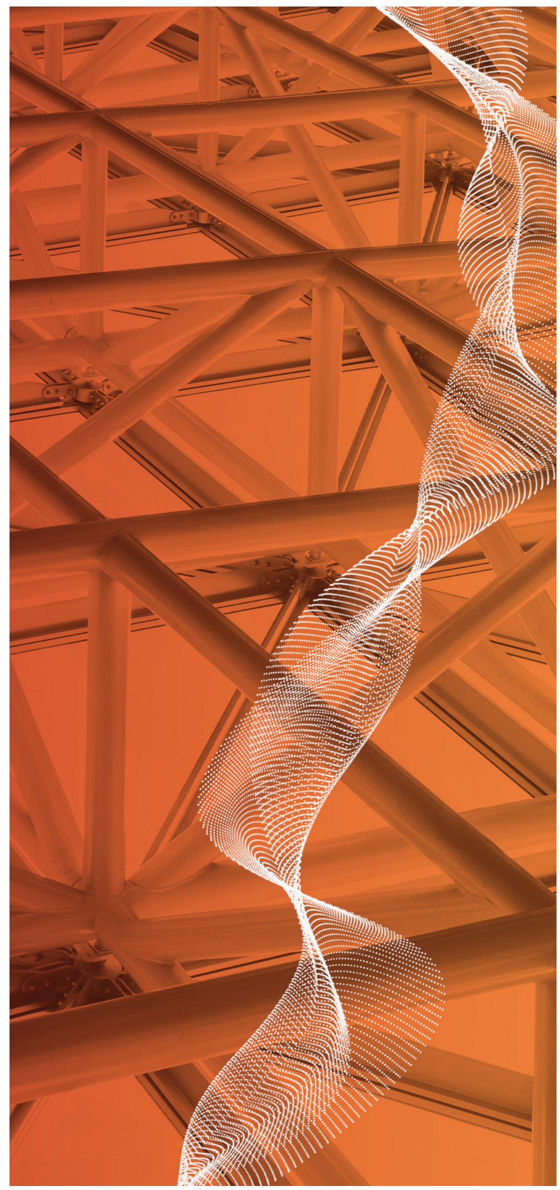
[1]Not including VAT.
[2]Facility fee is used to cover ongoing expenses in relation to the PCC itself, this fee will reduce as more cells are taken on.

is a healthy interest rate environment, and yields on securities have risen, Lloyd's rules allow investors to hold assets that may not be possible within other ILS structures. This is an advantageous feature and one that gets highlighted in a rating environment like the one we are currently in.

Q. So investors won't suddenly turn their backs on ILS in favour of other asset classes?

Des Potter. Portfolio managers have always got investor needs to meet. And so there is always that risk that they may feel insurance offers a less attractive return opportunity than another asset class. But for the more strategic allocators, it's not a question of, "I'm all in, or I'm all out." It's more whether they allocate 1%, 2% or 3% depending on the risk-return characteristics of comparable alternative investment assets.

Investors in property CAT have had a pretty poor return over the last four or five years, so they've probably lost some confidence in the market's ability to price and manage that risk. This plays to Lloyd's strengths as the market has a lot more to offer than just property CAT risk. If you like the allocation to insurance and feel you're overweight in property CAT and you want other things, short or medium tail, Lloyd's has them. Managing Agents can package them and include them in an offering.



Q. Have there been any LB2 investment vehicles accessing multiple syndicates via one fund?

Des Potter. Yes, absolutely, and that's what happened with Ontario Teachers' Pension Plan (OTPP). They were the first investor using the London Bridge vehicles and they support seven or eight syndicates now through one corporate member and one cell. So it certainly has that capability.

Q. Why would someone choose to provide collateralised (re)insurance through London Bridge, rather than how it is currently done now, outside the platform?

Des Potter. London Bridge hasn't been set up to undermine good, collateralised (re)insurance arrangements with vehicles in Bermuda, or wherever they might be domiciled. The reason we've gone down the collateralised (re)insurance route is because we want to offer as much capability as we can through this one platform.

There are a lot of things that London Bridge can offer that are ready to go and that syndicates, of all sizes, can utilise so they don't have to diligence a new vehicle, form a new relationship or set up a new issuance vehicle. London Bridge is ready to go for any syndicate that wants to do a sidecar, a CAT bond or a new collateralised (re)insurance transaction with a new market.

The documentation is in outline form so syndicates can move quite quickly. And they have the benefit of knowing that the transformer vehicle has been set up and run within governance standards that have been approved by Lloyd's and the PRA.

Tim Shreeve. Ariel has issued a sidecar offering and may do so in the future. At the present time though, we want to pursue more traditional FAL-like investments with investors looking at accessing our space and us as a manager within it on a longer-term, partner-like basis and less just as a potential transaction.

We believe the way the rules at Lloyd's work for capital are advantageous for investors that want to make long-term allocations to insurance. Much of our communication time is spent on educating capital about what to expect over time and why a longer-term outlook makes sense. This is not comparable to a sidecar.

Ed Saul. The use of a risk transformation vehicle such as LB2 provides a framework for institutional capital to gain access to uncorrelated pure insurance risk. The regulatory permissions of LB2 do not have any restrictions on the classes of business that can be reinsured from a Lloyd's syndicate, although some classes are more suitable for collateralised (re)insurance than others.

We believe that as a UK-domiciled risk transformation vehicle, LB2 delivers unique competitive advantages as its governance and policy standards were drafted by Lloyd's before being adopted by the board of LB2. This should ensure the vehicle diligences well for investors and managing agents who utilise the collateralised markets.

LB2 was not established to undermine the existing collateralised relationship between syndicates and ILS fund-owned risk transformation vehicles that work well for managing agents.

Q. Through LB2, investors can participate in specific portfolios run by syndicates. Can this access also be structured to link external capital with coverholders' innovative portfolios?

Des Potter. London Bridge is a risk transformation vehicle, it does not act as a managing general agent (MGA) or coverholder. Typically a coverholder arrangement binds business on behalf of multiple different underwriters. LB2 can reinsure the portfolio of risk underwritten by a syndicate that participates in the coverholder arrangement, but you can't reinsure a coverholder or consortium arrangement.

Tim Shreeve. This should be possible. The Lloyd's system allows for portfolios to be carved up and an investor participant can access a silo through a specific arrangement in a special purpose account (SPA). An SPA can also be funded via LB2. The other features that LB2 makes possible is the participation type that is possible. Structures can be excess of loss and not just proportional, and the investment type may be debt versus (re)insurance contracts.

Q. Who decides FAL? Is there a managing agent involved, or is it between the capital provider and Lloyd's to come to some arrangement?

Des Potter. It's a bottom-up approach. The initial assessment of the capital to support a syndicate is determined by the managing agent. They do their modelling, work out what the solvency capital requirements and add the 35% economic capital uplift. They submit that to Lloyds who review it and approve it, and then this syndicate economic capital requirement gets allocated at a member level.

Members do get adjustments for diversification credit across multiple syndicates, and potential benefits relating to capital inter-availability across multiple open years of account, before you determine the final member capital requirement (i.e., FAL).

Q. What does collateralised mean for a quota share?

Des Potter. Collateralised (re)insurance for quota share is more difficult than for excess loss. It does require someone to determine what the limit of liability under the (re)insurance agreement is.

In the Lloyd's context, what usually happens is that the managing agent will work out, using an EP curve, what they believe would be the acceptable level of security. In property CAT, for instance, a quota share would probably be collateralised up to the one-in-250 annual exceedance point. That would be the limit of liability.

It's a commercial negotiation because it's got to be set at a level whereby the managing agent feels they've got acceptable security (because once you go through that capital, the risk goes back to the syndicate) whilst providing the investor with a decent return on capital for the risk they are assuming.

Jasmine DeSilva

Commercial Director, Artex Capital Solutions

Prior to joining Artex, Jasmine served as the Business Development Manager for Risk and Insurance Solutions at the Bermuda Business Development Agency (BDA). Before joining the BDA, she spent more than a decade as an Assistant Vice President Casualty underwriter and was responsible for a large portfolio of Fortune 500 accounts. Bermuda Re and ILS recently awarded Jasmine the title of Unsung Hero. She holds a certificate in Leading Economic Growth from Harvard Executive Education, and achieved her Chartered Property Casualty Underwriter (CPCU) designation in 2010, becoming a member of the Bermuda CPCU Society where she served as President from 2012-2013. Jasmine holds a B.A. degree from the University of Toronto where she did a Specialist degree in Political Science and graduated with distinction.

Ed Saul

Vice President, Insurance Management, Artex Capital Solutions

Ed has a portfolio of client entities both in the UK and Bermuda. His role includes leading the service delivery for London Bridge, covering day-to-day operations, new deal management and strategic development. Ed holds UK regulatory-approved CEO, CFO and director-level roles on a number of UK ISPVs. Prior to his current role, Ed worked in Guernsey where he led the risk management functions of two rated reinsurers.

Des Potter

Special Advisor, Lloyd's of London

Des is a banker by profession, with over 20 years of experience in the (re)insurance/ILS market. He is currently a special advisor to Lloyd's with a focus on easing the access of institutional investors to support underwriting at Lloyd's. Previously Des was managing director at GC Securities where he structured and placed over USD5 billion of insurance-linked securities and was a member of the LMG Taskforce that advised the UK government on its risk transformation legislation.

Tim Shreeve

Head of platform development, Ariel Re

Tim focuses on the development and operation of Ariel's underwriting platforms. Prior to joining Ariel Re, he spent nearly ten years in various roles across operations, underwriting and planning at Nephila Capital in Bermuda. Tim is a qualified accountant and spent several years in public practice in London before moving to Bermuda with Deloitte in 2008. He has a Bachelor of Science degree in Economics and Asian Studies from the University of Birmingham, UK.

THE ART OF RISK

At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science—where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.

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