LLOYD'S MINIMUM STANDARDS

MS3 – GOVERNANCE

OCTOBER 2017

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MINIMUM STANDARDS AND REQUIREMENTS

These are statements of business conduct required by Lloyd's. The Minimum Standards are established under relevant Lloyd's Byelaws relating to business conduct. All managing agents are required to meet the Minimum Standards. The Requirements represent the minimum level of performance required of any organisation within the Lloyd's market to meet the Minimum Standards.

Within this document the standards and supporting requirements (the "must dos" to meet the standard) are set out in the blue box at the beginning of each section. The remainder of each section consists of guidance which explains the standards and requirements in more detail and gives examples of approaches that managing agents may adopt to meet them.

GUIDANCE

This guidance provides a more detailed explanation of the general level of performance expected. They are a starting point against which each managing agent can compare its current practices to assist in understanding relative levels of performance. This guidance is intended to provide reassurance to managing agents as to approaches which would certainly meet the Minimum Standards and comply with the Requirements. However, it is appreciated that there are other options which could deliver performance at or above the minimum level and it is fully acceptable for managing agents to adopt alternative procedures as long as they can demonstrate the Requirements to meet the Minimum Standards.

DEFINITIONS

CPD - Continuing Professional Development

EIOPA - The European Insurance and Occupational Pensions Authority.

FCA – Financial Conduct Authority

LMA - The Lloyd's Market Association.

Multiple Syndicates Byelaw - This byelaw prohibits an underwriter, whether or not an active underwriter, acting as such for more than one syndicate concurrently without the consent of the Council.

ORSA - Own Risk and Solvency Assessment.

PRA – Prudential Regulation Authority

SCR – Solvency Capital Requirement is the amount of funds that insurance and reinsurance undertakings are required to hold in the European Union.

Shadow Directors – The Companies Act 2006 defines a shadow director as follows:

(1) In the Companies Acts 'shadow director', in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act.

(2) A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity.
(3) A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of - Chapter 2 (general duties of directors); Chapter 4 (transactions requiring members' approval); or Chapter 6 (contract with sole member who is also a director). By reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.

SNP - Senior Nominated Person

SOX - The Sarbanes–Oxley Act of 2002

The Board - Where reference is made to the board in the standards, agents should read this as board or appropriately authorised committee. In line with this, each agent should consider the matters reserved for the board under the Governance Standard, in order to evidence appropriate full board discussion and challenge on these subjects.

SECTION 1 – SYSTEM OF GOVERNANCE

GOV 1.1

Effective System of Governance

Managing Agents shall have in place an effective system of governance which provides for sound and prudent management of the business.

The system of governance shall:

- *be proportionate to the nature, scale and complexity of the operations of the business;*
- *provide for effective cooperation, internal reporting and communication of information at all relevant levels of the business; and*
- *include compliance with the requirements laid down in the SII Framework Directive, Articles 42 to 49.*

Lloyd's expects all managing agents to have an effective governance framework appropriate to their business in place. Under Solvency II there are a number of specific new requirements, including the internal audit, risk management and actuarial functions, as well as more general governance requirements. The principle of proportionality allows managing agents to design their system of governance in a way that meets regulatory requirements while appropriately reflecting their specific risk profile.

This guidance suggests how managing agents may evidence an effective system of governance. This is not exhaustive, but evidence of the governance framework would typically include:

- organisational structure showing accountability – i.e. board, committees, decision making bodies and required functions (actuarial, internal audit, compliance, risk management);
- personnel organisation structure / function organisational charts – i.e. resources;
- matters reserved for the board (see also GOV 3.7) including delegation to committees / decision making bodies;
- terms of reference for the board and each committee / decision making body;
- committee membership (with job title of the individual members);
- board and committee timetable – detailing dates and outline of agenda / matters to be discussed;
- management information – summary details of the MI provided to the board, committees and decision making bodies; and
- governance map (which may cover some of the items listed above).

The governance framework should clearly demonstrate where the following activities are being considered and decisions made:

- underwriting;
- reinsurance;
- claims;
- reserving;
- investment;
- asset liability management;
- liquidity and concentration management; and
- operational risk.

Solvency II Framework directive, Articles 42 to 49

The requirements for an effective system of governance refer to compliance with Articles 42 to 49 and further requirements and guidance relating to these are covered within other sections of the standards and guidance as below:

ARTICLE	TOPIC	REFERENCE IN STANDARDS/GUIDANCE
42	Fit & Proper	GOV 4.1
43	Proof of good repute	n/a – applies to regulator
44	Risk Management	MS4 – Risk Management
45	ORSA	RM 4.1 – RM 4.4
46	Internal Control	GOV 1.3
47	Internal Audit	GOV 6.5 to 6.7
48	Actuarial Function	GOV 6.8 to 6.9
49	Outsourcing	GOV 5.1 to 5.4

GOV 1.2

Review of System of Governance

The system of governance shall be subject to regular internal review.

Managing Agents shall:

- *monitor, and on a regular basis evaluate, the adequacy and effectiveness of their system of governance; and*
- *take appropriate measures to address any deficiencies*.

The board is responsible for ensuring that the system of governance is internally reviewed on a regular basis and should determine the appropriate scope and frequency of the reviews, taking into account the nature, scale and complexity of the business. Whilst the frequency of review is not mandated, Lloyd’s would expect managing agents as a minimum to consider the need to conduct a review on an annual basis in line with the board effectiveness review which must be carried out annually (see GOV 3.8) and record clearly the rationale for any work conducted and/or reliance placed on a previous review.

Conducting the review

The board is also responsible for determining who within the organisation should conduct the review and should ensure that they are suitably independent. Independence does not require the reviewer to be external, but the person(s) conducting the review should be independent from the area(s) they are responsible for reviewing e.g. compliance should not be responsible for reviewing the compliance function.

Typically the approach taken to the review would be documented to ensure that there is clarity over its scope and purpose.

Follow up

Findings and conclusions from the review should be properly documented and reported back to the board. In order to allow an adequate revision of the system of governance appropriate feedback procedures encompassing at least all key functions should be established. Suitable feedback loops are necessary to ensure follow-up actions are continuously undertaken and recorded.

After the feedback reports are presented to the board, discussions on any challenge provided or improvements suggested should be documented as appropriate.

Changes to the system of governance

Managing agents should note that where changes are made to any aspect of the system of governance, it is important to assess any impact this may have on the internal model and whether a model change under the model change policy needs to be implemented. More detailed requirements and guidance relating to model change are set out in Section 5 of MS5 – Scope, Change and Use.

GOV 1.3

Internal Control System

Managing Agents shall have in place an effective internal control system.

The internal control system shall:

- *include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the business and a compliance function;*
- *secure compliance with applicable laws, regulations and administrative processes, the effectiveness and efficiency of operations in view of the business objectives and the availability and reliability of financial and non-financial information; and*
- *ensure that adequate and orderly records of the business and internal organisation are maintained.*

The internal control system needs to be robust and create a strong control environment with control activities that are adequately aligned to the risks of the business and the agent’s processes. A strong control environment should ensure all personnel are aware of the importance of internal control and their role in the internal control system. This will ensure the system is fully embedded within the managing agent’s organisational culture.

Internal controls include the task of identifying and managing any areas of potential conflicts of interest appropriately. A high level of integrity is an essential part of the control environment and managing agents should therefore avoid policies and practices that may provide incentives for inappropriate activities.

A proper internal control system should include internal controls:

- at different levels of the organisational and operational structures;
- at different time periods; and
- with different levels of detail.

Specific requirements and guidance relating to the compliance function are included in GOV 6.3 & 6.4.

Internal Control Policy

Managing agents are required to implement a written policy on internal control (see GOV 2.4) which is approved by the board. The policy should include the means by which senior management implement the internal control system to provide for and maintain the suitability and effectiveness of the internal control system. Internal control combines the following aspects:

- control environment;
- control activities;
- communication; and
- monitoring.

The monitoring mechanisms within the internal control system should provide the board with relevant information for the decision-making process. The effectiveness of the internal control system itself should be monitored on a regular basis, so that any deficiencies of the system can be identified and rectified in a timely manner.

Record keeping

Managing agents should document their internal organisational and operational structures and keep this documentation up to date. They should also maintain adequate and orderly records of their business activities and keep them for an appropriate time frame, taking into account their own prescribed record retention periods.

GOV 1.4

Information systems and security

Managing agents shall establish information systems which produce complete, reliable, clear, consistent, timely and relevant information and shall safeguard the security of information.

Information shall cover:

- *the business activities;*
- *the commitments assumed; and*
- *the risks to which the business is exposed.*

Managing agents shall:

- *establish and implement an approach to safeguarding the security, integrity and confidentiality of information which takes into account the nature of the information in question; and*
- *ensure that they meet the requirements of the Data Protection Act, General Data Protection Regulation (GDPR) and any local data protection regulation based on territories in which they operate or have data subjects.*

The overall information system should be documented and set out which information is to be shared, by whom, and when and allow for information to flow up and down hierarchy levels as well as horizontally between different business units where appropriate. Managing agents should be able to demonstrate that there is clear linkage between individual information systems (i.e. it should be clear how one system feeds another).

Managing agents should decide who needs to have access to these information systems for the purpose of providing input from and to their areas of responsibility and who the relevant personnel are that need to have passive access to the system so as to retrieve data for the proper discharge of their duties.

Information needs to cover all business activities and commitments assumed across the organisation, e.g. acceptance of underwriting risks, other financial commitments etc.

Data Protection

Managing agents should note that the use of all personal data and information is regulated by the Data Protection Act 1998 and any local data protection regulation based on the territories in which they operate or have data subjects.

The EU General Data Protection Regulation (GDPR) will also come into effect from 25 May 2018. The new regulation will introduce additional requirements and managing agents are expected to assess the requirements and implement appropriate controls.

[Link to Data Protection Act 1998 and GDPR can be found in the appendix at the end of the document]

GOV 1.5

Business Continuity & Contingency Planning

Managing agents shall establish, implement and maintain a business continuity programme and take reasonable steps to ensure continuity in the performance of their activities.

The business continuity programme shall aim to ensure, in the case of an interruption to systems and procedures:

- *the preservation of essential data and functions; and*
- *the maintenance of business activities.*

Where the above is not possible, the programme should aim to ensure:

- *the timely recovery of data and functions; and*
- *the timely resumption of business activities.*

Managing agents shall:

- *identify the risks to be addressed by contingency plans based on the areas where they consider the business to be most vulnerable;*
- *conduct a full business impact analysis, identifying business activities, resource requirements including IT and dependencies, as well as associated Recovery Time Objectives (RTO) and Recovery Point Objectives (RPO).*
- *Produce contingency plans to manage an incident and ensure that business activities can continue within agreed RTO and RPO timescales in the event of a denial of access to premises, unavailability of staff, a major IT failure (including hardware or cyber related incident)and/or the failure of service provision by a critical supplier ; and*
- *review, update and test all aspects of their business continuity arrangements on a regular basis.*

The aim of contingency planning is to enable the managing agent to continue the business activity at a predetermined minimum level to protect individuals and tangible property as well as other assets.

Contingency plans

Managing agents should develop and document contingency plans to ensure the business disruption and/or possible losses are limited if there is an unforeseen interruption to their systems and procedures. These might for example arise from natural catastrophes such as floods or earthquakes, from terrorist attacks, serious fires, a breakdown of the IT systems or a pandemic that affects a large number of employees. The plans should document arrangements for managing the initial incident as well as business recovery. Plans should include the following:

- defined roles and responsibilities;
- an appropriate communication strategy for all stakeholders;
- a clear set of actions and owners; and
- the process for recording information and the decisions made.

The plans should be made available to all relevant management and personnel so that every person involved knows their role in advance of any emergency situation. All staff should be made aware of the existence of the plan and be provided with key information that would be useful to them during an incident.

As well as addressing operational business continuity, managing agents should consider other risks for which risk mitigation plans may be needed as part of their risk management system. This may include capital and solvency risk and planning, liquidity arrangements, reinsurance and outsourcing. For those risks identified, as a minimum, managing agents should ensure that they document high level risk mitigation procedures. Whilst it is not necessary that contingency planning should include every business activity, it should take into consideration all significant activities.

Contingency plans include consideration of critical suppliers, of which one is likely to be Xchanging. Lloyd’s would expect an agent to be considering all their critical suppliers as part of their contingency. However, Lloyd’s will look to support and issue future additional guidance and advice where one entity impacts the whole Market.

Testing and review

For all contingency planning arrangements, agents should ensure a robust exercising programme is in place to test their effectiveness. As well as the annual testing of IT capability, there should be annual exercises for crisis and incident management teams to test these arrangements. It is best practice for any workplace recovery provisions to also be tested annually, including those reliant on working from home. Agents should look to take part in the IT Test held by Lloyd’s each year at ExCeL.

Contingency plans should be reviewed on a regular basis, updated as necessary and tested periodically. Regular review and updating ensure that the plans stay effective and suitable, and test runs provide assurance that the plans will work effectively should an emergency arise.

SECTION 2: ORGANISATIONAL STRUCTURE

GOV 2.1

Organisational structure

The System of Governance shall include an adequate transparent organisational structure.

The organisational structure shall:

- *establish, implement and maintain effective decision making procedures;*
- *clearly specify reporting lines that ensure the prompt transfer of information to all persons who need it in a way that enables them to recognise its importance;*
- *allocate functions and responsibilities; and*
- *take account of the nature, scale and complexity of the risks inherent in the business.*

Managing Agents should have a well-defined organisational and operational structure which is geared towards supporting the most important strategic goals and operations of the business. They should be able to adapt the structure to changes in their strategic aims, operations or in the environment within an appropriate period of time.

The organisational structure identifies the business processes involving material risks and sets out how they should be executed, including responsibilities and information flows, to ensure that these processes are adequately monitored and controlled. The operational structure refers to the way in which operations are organised and supports the main functions of the organisational structure (*see also Section 1.1 on evidencing organisational structure*).

Agents should ensure that each key function has an appropriate standing in terms of organisational structure and that their responsibilities and the authority they have to exercise their tasks are clearly set out (*see also section 6.1*). Diagrams and process flow charts may help represent both the organisational and operational structure more clearly but are not mandatory.

It is important that the organisational culture is one which enables and supports the effective operation of the system of governance. This requires a suitable “tone at the top” with the board providing appropriate organisational values and priorities. In order to meet the four-eyes-principle any significant decision concerning the business should be agreed by at least two persons before being implemented. Maintaining a formal schedule of matters referred to the board for decision is a practical way of demonstrating those matters which are reserved for the board (see also GOV 3.7 regarding matters reserved for full board review).

GOV 2.2

Segregation of duties

Managing Agents shall have a clear allocation and appropriate segregation of responsibilities across the organisation.

Managing agents shall ensure that:

- *they employ personnel with the skills, knowledge and expertise necessary to discharge the responsibilities allocated to them properly;*
- *all personnel are aware of the procedures for the proper discharge of their responsibilities;*
- *the performance of multiple tasks by individuals and organisational units does not or is not likely to prevent the persons concerned from discharging any particular function in a sound, honest and objective manner;*
- *they comply with the requirements of the Multiple Syndicates Byelaw with regard to underwriters acting for more than one syndicate concurrently; and*
- *key operational and business processes are properly documented.*

Lloyd's does not wish to unduly restrict managing agents in choosing how to organise themselves as long as they establish an appropriate segregation of duties that in particular ensures the necessary full independence of the internal audit function and sufficient independence of the other key functions (see GOV 6.1).

The duties and responsibilities within the organisational structure should be clearly defined, allocated and coordinated with each other in the managing agents' policies, covering all important duties while avoiding unnecessary overlaps and fostering effective cooperation between functions. Policies and procedures should be clearly documented to ensure all personnel are aware of these. Required functions should be kept separate unless this would be disproportionate in which case agents need to have effective policies and procedures in place to ensure that their independence is not compromised.

An adequate segregation of responsibilities in particular ensures that the persons responsible for performing tasks are not also responsible for monitoring and controlling the adequacy of this performance. There should, however, be an organised process of communication between those responsible for operational activities and the control functions.

GOV 2.3

Conflicts of interest

Managing agents shall ensure that effective systems are in place to prevent conflicts of interest wherever possible and that potential conflicts of interest are identified and appropriately addressed.

Managing agents shall ensure that:

- *procedures are established in order to ensure that those involved with the implementation of the managing agent's strategies and policies understand where conflicts of interest could arise and how such conflicts are to be addressed; and*
- *they act in the best interests of syndicate members*.

Lloyd's recognises that it is not always possible to avoid conflicts of interest, and it is therefore important to ensure that any conflicts are identified and dealt with in an appropriate manner. The types of conflicts that may arise include, but are not limited to:

- internal – director's interests;
- corporate – related parties;
- capital – third party capital; and
- group conflicts.

Conflicts of interest policy/procedure

To ensure that conflicts of interest are identified and appropriately addressed agents should have in place a conflicts of interest policy/procedure. The purpose of the policy should be to ensure that all conflicts of interest are declared and that decisions are taken in full knowledge of those conflicts.

GOV 2.4

Required Policies

Managing Agents shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing.

Managing Agents shall ensure that those policies:

- *clearly set out the relevant responsibilities, objectives, processes and reporting procedures to be applied;*
- *are consistent with the overall business strategy;*
- *are implemented;*
- *are reviewed at least annually;*
- *are subject to approval by the board; and*
- *are adapted in view of any significant change in the system or area concerned.*

Agents should note that the policies set out above are explicitly required under the system of governance provisions of Solvency II but this is not an exhaustive list of all policies relevant to Solvency II requirements or the operational policies which Lloyd's would expect managing agents to have in place.

This section sets out general guidance on the required policies. The following sections contain additional specific guidance:

- RM 2.3 – risk management policy;
- GOV 1.3 – internal control policy;
- GOV 6.5 – internal audit charter; and
- GOV 5.2 – outsourcing policy.

Written policies

Whilst specific written policies must be in place, they do not have to be separate and agents may combine these policies as they see fit in line with their organisational structure and processes. All written policies should be in line with the managing agent's overall business strategy and should for each function or process to which they relate, clearly set out:

- the goals pursued with the policy;
- the tasks to be performed and who is responsible for them;

- the processes and reporting procedures to be applied; and
- the obligation of the relevant organisational units to inform the risk management, internal audit, compliance and actuarial functions of facts relevant for the discharge of their duties.

Policies covering key functions should also address the standing of these functions within the managing agent, including their rights and powers.

A proper implementation of the written policies requires that all staff members are familiar with and observe the policies for their respective area of activities and that formal induction and training procedures are in place. It also requires that any changes to the policies are promptly communicated to them.

Approval and review of policies

Written policies should be subject to approval by the board, as should any subsequent changes, unless these are minor, e.g. correcting typographical errors.

The annual review requirement applies to all written policies which managing agents are required to have under the Solvency II framework directive. Any review of the written policies should be appropriately documented and cover:

- who conducted the review;
- any suggested recommendations; and
- actions and decisions subsequently taken by the board (or appropriate committees) in response to the recommendations.

For further requirements and guidance regarding documentation, managing agents should refer to Section 6 of MS5 – Scope, Change and Use.

SECTION 3: BOARD EFFECTIVENESS

GOV 3.1

Effective Board

A managing agent shall be headed by an effective board, which is collectively responsible for the performance of the managing agent and the syndicate(s) under management.

The role of the board shall include:

- *providing leadership and setting business strategy;*
- *establishing a prudent and effective control framework which enables risk to be assessed and managed;*
- *ensuring that adequate financial and human resources are in place;*
- *reviewing management performance; and*
- *ensuring compliance with the laws, regulations and administrative provisions adopted pursuant to the Solvency II Framework Directive.*

Leadership

The Board should ensure that it sets a suitable ‘tone at the top’, providing appropriate organisational values and priorities (see also GOV 2.1).

Board Meetings and committees

The board should meet sufficiently regularly to discharge its duties effectively. Typically managing agents hold full board meetings on at least a quarterly basis and should ensure that these are scheduled sufficiently far in advance to allow for reasonable attendance from all directors. Where non board members attend board meetings, care should be taken to ensure that the reason for their attendance is clear and that they are not acting as ‘shadow’ directors.

The board should also have regular and robust interaction with any committee it establishes as well as with senior management and with other key functions, requesting information from them proactively and challenging it when necessary. Managing agents are responsible for determining the most appropriate committee structure for their business. Committees that are typically seen in a managing agent include the following:

- audit;
- executive management;
- investment;
- operations;
- remuneration;
- reserving;
- risk & capital;
- security & credit; and
- underwriting.

Formally established committees of the board should have clear terms of reference and delegation of responsibilities. The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be considered in deciding the chairmanship and membership of committees.

Committee terms of reference would typically cover the following areas:

- purpose;
- authority;
- composition;
- meeting frequency and quorum;
- responsibilities; and
- reporting arrangements.

Where the standards and guidance refer to board responsibilities it is acceptable for these to be delegated to a properly authorised board committee, unless explicitly stated otherwise. Where responsibilities are delegated in this way the board should still ensure that those responsibilities are met.

Specific board responsibilities under Solvency II

The responsibility for ensuring that a managing agent can continue to meet the Solvency II tests and standards lies with the board of the managing agent. The board must ensure that appropriate documentation and records are maintained to disclose with reasonable accuracy at any time the status of compliance with the requirements. The board is also responsible for notifying Lloyd's as soon as possible if any of the conditions for compliance cease to be met.

Lloyd's requires an annual board confirmation of Solvency II status from all agents, in a standard format as published by Lloyd's, in order to maintain internal model authorisation.

Lloyd's requires each managing agent to nominate a board member with Solvency II and Lloyd's standards responsibilities known as the Standards Assurance Group Senior Nominated Person (SNP). The SNP acts as a central point of contact for Lloyd's for matters relating to Solvency II and the minimum standards.

GOV 3.2

Collective suitability of the board

Managing Agents shall ensure that the members of the board and of each of its committees collectively possess the necessary qualifications, competency, skills and professional experience in the relevant areas of the business in order to effectively manage and oversee the business in a professional manner.

As well as ensuring the collective suitability of the board, managing agents shall ensure that each individual member of the board and its committees has the necessary qualifications, competency, skills and professional experience to perform the tasks assigned. Consideration should be given to the following:

- *size of the board to ensure it is not unwieldy but has an appropriate balance of skills and experience;*
- *the need for a strong executive and non-executive representation;*
- *the need to ensure that all directors are able to allocate sufficient time to the managing agent to discharge their responsibilities effectively; and*
- *the need for directors to regularly update and refresh their skills and knowledge.*

The board should not be so large as to be unwieldy but should be of sufficient size in order that the requirements of the business can be met and changes to the board's composition and that of its committees can be managed without undue disruption.

Managing agents should ensure that all directors are able to allocate sufficient time to discharge their responsibilities effectively. When considering the composition of the board, managing agents should ensure that there is sufficient focus on strategy and key issues.

In addition to fitness with regard to their duties in their specific areas of responsibility, the board of the managing agent must, collectively, be able to provide for the sound and prudent management of the business. The collective knowledge, competence and experience of the board should therefore include, at a minimum, the following areas:

- insurance and financial markets;
- business strategy and business model;
- system of governance, including risk management and control;
- financial and actuarial analysis; and
- regulatory framework and requirements.

Board members are not expected to each possess expert knowledge, competence and experience within all areas of the business, but the collective knowledge, competence and experience of the board as a whole should provide for sound and prudent management of the business. Board members should, however, have at least a base level of knowledge of those areas that fall outside their own immediate area(s) of expertise. For example, all directors should be aware of the key risks the business faces and how these are managed.

Director Responsibilities

When allocating responsibilities, agents should have regard to the span of control of individual directors ensuring it is not excessive. Points to consider include:

- the number of direct reports; and
- areas of responsibility (e.g. wide/ranging/unassociated areas or areas outside of their areas of expertise as well as areas where there may be a conflict – e.g. underwriting and claims).

Individual director terms of reference will provide useful evidence of division of responsibilities.

Directors should ensure that the managing agent is fulfilling its duties of care and responsibilities under the Managing Agents Agreement on behalf of the capital providers on the syndicates which it represents, subject at all times to Lloyd's requirements for managing agents.

Succession Planning

The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience and to ensure progressive refreshing of the board. Managing agents may wish to consider short term contingency planning as well as longer term succession planning.

GOV 3.3

Non-Executive Directors

Managing Agents shall ensure that the board includes a balance of executive and non-executive directors, such that no one individual or group of individuals can dominate the board's decision taking.

All managing agent boards should include at least two independent non-executive directors. As part of their role as members of a unitary board non-executive directors should:

- *constructively challenge and help develop proposals on strategy;*
- *scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance; and*
- *satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible*.

Managing agents should seek to achieve an appropriate balance between executive and non-executive directors to ensure that the views of each are given sufficient weight in board discussions. Where the managing agent is part of a group, consideration should also be given to ensuring that there is a sufficient balance between any group non-executive directors and independent non-executive directors to ensure that group representatives do not dominate discussions unduly. For this purpose a group independent non-executive director would be considered independent if they also sat on the board of the managing agency.

Independent non-executive directors

The role of independent non-executive directors is important as they are able to bring a degree of objectivity to the board's discussions and play a valuable role in monitoring executive management. Lloyd's requires managing agents to appoint at least two independent non-executive directors to ensure that there is sufficient independent scrutiny of the executive management.

When determining whether a non-executive director can be regarded as independent, the board should consider whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could affect, the director's judgement.

There are a number of relationships and circumstances which should be considered when determining independence, including if the director:

- has been an employee of the managing agent or group within the last five years;
- has, or has had within the last three years, a material business relationship with the managing agent either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the managing agent;
- has received or receives additional remuneration from the managing agent apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the managing agent's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; and

- has served on the board for more than nine years from the date of their first election.

Where any of the cases above apply, it is not necessarily a bar to a director being regarded as independent, but the board must be able to state the reasons why it believes the director should be considered independent, notwithstanding those circumstances.

Appointment of non-executive directors

Non-executive directors should be appointed for specified terms subject to re-election and should have clear terms of reference on appointment.

GOV 3.4

Division of board responsibilities

There should be a clear division of responsibilities at the head of the managing agent between the running of the board and the executive responsibility for running of the managing agent's business.

- *To ensure a clear division of responsibilities the roles of Chairman and Chief Executive should not be carried out by the same individual;*
- *The Chairman is responsible for leadership of the board and ensuring its effectiveness in all aspects of its role;*
- *All directors must take decisions objectively in the interests of the managing agent and in the interests of the syndicate(s) which they manage; and*
- *No one individual should have unfettered powers of decision.*

Chairman and Chief Executive Roles

The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role. This includes setting the board’s agenda and ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues. The chairman should also promote a culture of openness and debate by facilitating the effective contribution of non-executive directors in particular and ensuring constructive relations between executive and non-executive directors.

For the appointment of a chairman, a job specification should be prepared including an assessment of the time commitment expected, recognising the need for availability in the event of crises. Lloyd’s regards it as good practice that the Chairman should be an independent non-executive director. Where this is not the case, there will be increased focus from Lloyd’s on the degree of independence across the board as a whole.

The detail of the CEO’s responsibilities will vary between one managing agent and another, but the main responsibilities of the role include development of strategy, in conjunction with the Chairman and the rest of the board; implementation of the strategy and oversight of the day to day operations of the managing agent.

Both the Chairman and the CEO should have documented terms of reference.

GOV 3.5

Appointment of new directors

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

- *Appointments to the Board shall be made on merit and against objective criteria;*
- *Managing agents shall ensure that new directors have sufficient time available to devote to the role; and*
- *All directors should receive induction on joining the board.*

New directors

Managing agents should have clearly documented procedures for the appointment of new directors and a formal induction policy and process for induction should be in place. The search for board candidates should be conducted, and appointments made, on merit, against objective criteria (i.e. taking account of the capabilities required for the particular appointment in terms of skills, experience, independence and knowledge) (*see also section 4 on fit & proper requirements).*

GOV 3.6

Adequate information at Board level

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its responsibilities.

Managing agents shall ensure that:

- *the board receives adequate information on performance and operational matters; and*
- *adequate board attention and focus is given to strategy and operational/business processes.*

The chairman is responsible for ensuring that all directors receive accurate, timely and clear information but directors should seek clarification or amplification where necessary.

Lloyd's would expect board reports to be written rather than verbal and care should be taken to ensure that the content and level of detail is appropriate. Board papers may be provided to board members in either hard or soft copy format and should be circulated sufficiently far in advance to enable adequate review and preparation for meetings.

The board should review strategy on at least an annual basis and set its priorities for the forthcoming year. Progress against the strategy and priorities should be monitored and reported to the board on a regular basis.

As well as development and oversight of the business strategy, the board would typically receive information on at least the following areas:

- underwriting;
- actuarial technical provisioning (through the Actuarial Function Report (see GOV 6.9));
- claims;
- reinsurance;
- finance;
- compliance;

- risk management;
- IT/operations; and
- reporting from committees of the board, particularly on issues not covered by any of the above.

Where operational/business processes are outsourced to either internal or external service providers the board should retain oversight of these areas. GOV 5.2 includes further detail regarding monitoring and reporting on outsourcing arrangements.

GOV 3.7

Matters reserved for full board review

Managing agents shall ensure that they have a clear schedule of matters that are required to be approved by the full board.

Managing agents shall ensure that as a minimum the following areas are approved at the full managing agency board:

- *Long term objectives, commercial strategy and key strategic decisions;*
- *Risk Management & Control Framework;*
- *ORSA Report to be submitted to Lloyd's;*
- *Syndicate's business plan which in turn would also encompass:*
    - *Reinsurance programme; and*
    - *Realistic Disaster Scenarios.*
- *Lloyd's Capital Return;*
- *Report and Accounts;*
- *Major internal model changes;*
- *Confirmation statements as required by Lloyd's e.g. Solvency II compliance, minimum standards compliance;*
- *Reserves for both financial accounting and solvency; and*
- *Conduct Risk Strategy.*

The list above defines the items that Lloyd's would expect to be discussed, challenged and approved by the managing agent's full board*. It should not be regarded as a definitive list of everything that an agent may take to its full board for approval, simply a list of the minimum areas that Lloyd's expects to be discussed and challenged at this level. Where full board discussion and challenge has been limited (it is not acceptable for this to be nil) then the agent will be expected to evidence how the full board takes comfort from the discussion and challenge undertaken through its authorised committees.

It would not be appropriate for an authorised committee to approve these items and then report the decision to the board; the full board is required to play an active role in the process. Minuted discussion and challenge should be available for review when the agent is requested to evidence full board approval.

The level of full board discussion and challenge will vary from agent to agent, dependent on the governance process for the particular subject matter. For instance, an ORSA that has been reviewed and discussed by a Risk and Capital Committee will require less board discussion and challenge than an ORSA that the authors have passed directly to the full board for sign off ahead of its submission to Lloyd's. For those items listed above, that are directly derived from the minimum standards, please also review the guidance attached to those standards specifically in order to further understand the expectations e.g. reserving.

**The full board refers to the body involved (i.e. the managing agent's board of directors) and is not a requirement that each and every board member is required to be present. The full board should be operating as agreed within its terms of reference.*

GOV 3.8

Annual board effectiveness review

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

- *The review should be carried out on at least an annual basis and can be internal or external;*
- *The results of the review and any recommendations should be reported to the Chairman; and*
- *The Chairman should monitor the implementation of any recommendations.*

Lloyd's would expect that the board effectiveness review should be the responsibility of the Chairman as executive directors will be conflicted. The non-executive directors should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

Conducting the review

The review may be conducted by internal or external resource provided the agent can demonstrate that they are sufficiently independent and that the review itself is rigorous and robust. The review need not follow the same format each year and where internal resource is generally used to conduct the review, Lloyd's would expect agents to consider conducting a periodic external review.

Evaluation of the board is likely to consider:

- the balance of skills, experience, independence and knowledge of the company on the board;
- how the board works together as a unit; and
- other factors relevant to its effectiveness.

In addition to the board effectiveness, the review should provide a view of the operation and effectiveness of its committees. The review will also form part of the regular review of the wider system of governance (see GOV 1.2). The approach to the board effectiveness review should be documented and this may be part of an overall document setting out the approach to the review of the system of governance. The outcome of a managing agent's internal performance and evaluation process and considerations of any nominations committee in terms of board constitution and appointments are likely to contribute to the overall review.

Follow up

The chairman should act on the results of review by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

The evaluation of individuals should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties).

SECTION 4: FIT & PROPER

GOV 4.1

Fit and proper requirements for individuals

Managing agents shall ensure that all persons who effectively run the business or have other key functions are at all times fit and proper.

Managing agents shall establish, implement and maintain documented policies and adequate procedures to ensure that all persons who effectively run the business or have other key functions are at all times fit and proper.

The assessment of whether a person is 'fit' shall:

- *include an assessment of the person's professional and formal qualifications, knowledge and relevant experience within the insurance sector, other financial sectors or other businesses and whether these are adequate to enable sound and prudent management;*
- *take account of the respective duties allocated to that person and, where relevant, the insurance, financial, accounting, actuarial and management skills of the person; and*
- *in the case of board members, take account of the respective duties allocated to individual members to ensure appropriate diversity of qualifications, knowledge and relevant experience to ensure that the business is managed and overseen in a professional manner.*

The assessment of whether a person is "proper" shall:

- *consider whether they are of good repute and integrity; and*
- *include an assessment of that person's honesty and financial soundness based on evidence regarding their character, personal behaviour and business conduct including any criminal, financial and supervisory aspects relevant for the purpose of the assessment.*

The PRA's Senior Insurance Managers Regime (SIMR) was implemented in 2016 and reflects regulatory changes under the Solvency II Directive. Under SIMR managing agents must ensure that those individuals performing controlled functions (SIMFs and CFs), key function holders and persons performing key functions are fit and proper on an ongoing basis.

Fitness

Fitness for a role should be based on assessment of management competence and technical competence. Managing agents should base their assessments on:

- the individual's previous experience, knowledge and professional qualifications; and
- demonstration of due skill, care, diligence and compliance with the relevant standards of the sector the person has worked in

Propriety

Assessment of propriety of an individual should be based on their reputation, reflecting:

- past conduct;
- criminal record;
- financial record; and
- supervisory experience.

The current EIOPA guidelines and explanatory notes on the system of governance include guidance on relevant matters to be considered in the assessment of an individual's propriety, including criminal offences, disciplinary and enforcement actions.

Fit and Proper Policy

The fit and proper policy should set out:

- responsibilities for managing the fit and proper policy and applying its requirements;
- criteria that will be used in assessing whether an individual is fit and proper, both initially and on an ongoing basis, and whether there are different levels of checks for board members/function holders/other staff;
- a description of situations that give rise to re-assessment of fitness and propriety (recognising that this will not be an exhaustive list); and
- procedures for dealing with instances where an individual's status may change such that they can no longer be judged to be fit and proper.

The following may be regarded as evidence of procedures to ensure the adequacy of skills and experience:

- recruitment procedures;
- performance review/appraisal process;
- board evaluation process – including review and mitigation; and
- training and CPD.

It is important that managing agents retain evidence to demonstrate that the checks have been applied to relevant individuals and that, where issues have been identified, appropriate action has been taken.

Fit & Proper and outsourcing

The EIOPA guidelines on the system of governance propose that where a key function is outsourced, the fitness and propriety requirements should apply to the individuals employed by the service provider to perform the outsourced functions.

An individual within the managing agent should be designated with overall responsibility for the outsourced function. The designated individual should be fit and proper and possess sufficient knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider.

SECTION 5: OUTSOURCING

GOV 5.1

Outsourcing functions or insurance/reinsurance activities

Managing agents remain fully responsible for meeting all of their obligations when they outsource functions or any insurance or reinsurance activities.

Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:

- *materially impairing the quality of the system of governance of the managing agent;*
- *unduly increasing the operational risk;*
- *impairing the ability of Lloyd's to monitor the compliance of the managing agent with its obligations; and*
- *undermining continuous and satisfactory service to policyholders.*

Managing agents shall ensure that the service provider(s) have:

- *adequate risk management and internal control systems;*
- *the necessary financial resources to perform the outsourced tasks;*
- *sufficiently qualified and reliable staff involved in providing the outsourced functions or activities; and*
- *adequate contingency plans to deal with emergency situations or business disruptions and periodical testing of back up facilities where necessary.*

Managing agents shall ensure that they adequately take account of outsourced activities in their risk management and internal control systems.

Outsourcing definition

Outsourcing can be defined as an arrangement of any form between a managing agent and a service provider, by which the service provider performs a process, service or activity, whether directly or by sub-outsourcing, which would otherwise be performed by the managing agent itself.

Critical or important functions

Managing agents should determine and document whether an outsourced function is a critical or important function on the basis of whether the function is essential to the operation of the business, i.e. it would be unable to deliver its services to policy holders or members without the function.

The EIOPA explanatory notes to the guidelines on the system of governance include the following examples of functions that would be considered critical or important:

- the design and pricing of insurance products;
- the investment of assets or portfolio management;
- claims handling;
- the provision of regular or constant compliance, internal audit, accounting, risk management or actuarial support;
- the provision of data storage;
- the provision of on-going, day-to-day systems maintenance or support; and
- the ORSA process.

The EIOPA explanatory text also suggests that the following activities should not be considered critical or important operational functions or activities:

- the provision of advisory services to the business, and other services which do not form part of the its insurance or reinsurance activities, such as legal advice, the training of personnel and the security of premises and personnel;
- the purchase of standardised services, including market information services and the provision of price feeds;
- the provision of logistical support, such as cleaning or catering; and
- the provision of elements of human resources support, such as recruiting temporary employees and processing.

Managing agents are required to consider whether any proposed outsourcing arrangement will unduly increase operational risk. In Lloyd's view this would occur when the increase in operational risk is disproportionate to the benefits to be gained from the outsourcing arrangement. Managing agents should also consider the impact in relation to their own risk appetite.

Whilst there is no specific requirement to notify Lloyd's of new outsourcing arrangements or changes to existing arrangements, managing agents should consider whether Lloyd's should be informed where any significant new outsourcing arrangements or changes to existing arrangements are planned.

Outsourcing and Delegated Underwriting

When an insurance intermediary who is not an employee of the managing agent is given authority to underwrite business or settle claims in the name and on account of the managed syndicate(s) the activity should be subject to the outsourcing requirements under Solvency II. Further guidance on the application of requirements to Market Agreements can be found in the LMA Solvency II Committee's January 2013 Outsourcing paper.

[Link to LMA Solvency II Committee Outsourcing paper can be found in the appendix at the end of the document]

[Link to MS1.3 – DELEGATED AUTHORITY]

Xchanging

Lloyd's recognises that Xchanging contracts for the market are agreed centrally and Lloyd's works with the LMA to ensure that the wording is consistent with Solvency II requirements.

GOV 5.2

Outsourcing policy

Any managing agent which outsources or proposes to outsource functions or any insurance or reinsurance activity to a service provider shall establish a written outsourcing policy.

The outsourcing policy shall take into account:

- *the impact of outsourcing on the business; and*
- *the reporting and monitoring arrangements to be implemented in cases of outsourcing.*

Where a managing agent outsources or proposes to outsource functions or activities it must have an outsourcing policy which includes consideration of the impact of outsourcing on its business and the reporting and monitoring arrangements to be implemented in case of outsourcing. The policy must be assessed and updated regularly.

The outsourcing policy or supporting procedures should document:

- the process for development and approval of outsource contracts, including the managing agent's governance arrangements over the determination of, firstly, whether outsourcing is appropriate and subsequently over the approval of the contract;
- the minimum requirements for any outsourcing agreement (see GOV 5.4). Managing agents may wish to include a template for outsourcing agreements as an appendix to the policy;
- the process for reporting and performance monitoring, including establishing key performance indicators; and
- business contingency plans, including exit strategies.

GOV 5.3

Outsource provider selection

When choosing a service provider for any critical or important operational functions or activities, the board shall ensure that it meets the requirements set out in Solvency II Level 2 Article 274 paragraph 3.

Where the managing agent and the outsource provider are members of the same group the managing agent shall, when outsourcing critical or important operational functions or activities, also take into account the extent to which it controls the service provider or has the ability to influence its actions.

Managing agents should refer to the Solvency II text (Level 2, Article 274, paragraph 3) for full details of the areas that need to be considered when choosing a service provider for any critical or important functions. At the point of selection managing agents need to ensure that they have the competence and ability at an appropriate senior level within the business to assess whether the service provider delivers according to contract. This will need to be maintained so that the managing agent is able to effectively monitor the arrangement on an ongoing basis.

Group outsourcing

Where functions or activities are carried out elsewhere in the group, managing agents should consider carefully whether the arrangements fall within the definition of outsourcing. Where this is the case, the standards and requirements relating to outsourcing will apply. However, the managing agent may take account of the extent to which it controls, or has influence over, the service provider and the examination of the service provider may therefore be less detailed. In such cases managing agents should ensure that there is a written agreement in place with the service provider setting out the duties and responsibilities of both parties. This could take the form of a service level agreement as the arrangement is unlikely to be subject to formal negotiations in the same way as an external outsource arrangement. Managing agents will retain responsibility for the outsourced functions and need to be able to demonstrate robust management of the arrangement(s) with, for example, business contingency plans.

GOV 5.4

Outsourcing agreements

Managing agents shall ensure that the terms and conditions of the outsourcing agreement are consistent with the managing agent's obligations under the Solvency II Framework Directive.

The written outsourcing agreement to be concluded between the managing agent and the service provider shall clearly state the requirements set out in Solvency II Level 2 Article 274 paragraph 4.

Managing agents should refer to the Solvency II text (Level 2, Article 274, paragraph 4) for full details of the areas that need to be included in outsourcing agreements. As well as these specific requirements managing agents may also wish to include explicit provision in outsourcing agreements for the performance of periodic audits of outsourced activities.

It is good practice to maintain a central record of all outsourcing arrangements and key details of each relevant agreement. This could also include a record of the individual within the managing agency with responsibility for each agreement.

Section 5.3 includes further guidance on agreements for group outsourcing arrangements.

SECTION 6: REQUIRED FUNCTIONS

GOV 6.1

Required functions - general provisions

Managing agents shall have effective risk management, compliance, internal audit & actuarial functions and ensure these are incorporated into the organisational structure in a way which ensures that each function is free from influences which may compromise its ability to undertake its duties in an objective, fair and independent manner and in the case of the internal audit function in a fully independent manner.

Managing agents shall ensure that:

- *each function operates under the ultimate responsibility of, and reports to the board and has a clear reporting line to a nominated board member;*
- *where appropriate, each function cooperates with the other functions in carrying out their roles;*
- *individuals performing a function are able to communicate at their own initiative with any staff member and have the necessary authority, resources and expertise and that they have unrestricted access to all relevant information necessary to carry out their responsibilities; and*
- *the individuals performing a function promptly report any major problem in their area of responsibility to the board.*

Managing agents should ensure that all of the required functions have sufficient resource and expertise as well as access to the Board and other personnel as required to fulfil their roles. The staffing of the functions listed in the standard will not necessarily correspond directly to existing departments given the nature of their responsibilities. For example, the risk management function is likely to need actuarial knowledge to fulfil its responsibilities on the internal model, whereas the risk management department may not include or require this resource to fulfil its day to day duties.

The functions should be integrated into the organisational structure in a way that ensures that there is no undue influence, control or constraint exercised on the functions with respect to the performance of their duties and responsibilities by other operational or key functions, senior management or the board. The functions should retain responsibility for taking the decisions necessary for the proper performance of their duties without interference from others.

Independence & segregation

Managing agents should seek to ensure that there is as much independence between functions as possible. This does not mean that the functions have to be completely segregated, with the exception of the internal audit function, provided that managing agents can demonstrate that the approach they adopt is proportionate to their risk profile. There are specific requirements around the independence of the internal audit function included in GOV 6.4 and further guidance is set out in that section.

Reporting

The key functions should be able to report their results and any concerns and suggestions for addressing these directly to the board without restrictions as to their scope or content from anybody else. This does not however preclude that the reports are subject to comments by relevant functions within the business before they are passed on.

Lloyd’s expects each function to have a reporting line to a nominated board member, to ensure that there is clarity over accountabilities at board level. This does not mean that each function must report to a different director, but there should be a clear reporting line to a specific individual, rather than to the board as a whole. In the case of internal audit, the head of internal audit will usually report into the audit committee. They are likely to have a direct reporting line to the audit committee chair, and may also have a secondary executive reporting line.

Role of the board

The board is ultimately responsible for deciding how to react to the results, concerns and recommendations presented by the key functions. For example, it could resolve not to act or act differently from suggestions on the findings of a key function. However, it should not exert influence to suppress or tone down key function results in order that there should be no discrepancy between the findings of key functions and the board’s actions.

GOV 6.2

Risk management function

Managing agents shall have an effective risk management function.

The tasks of the risk management function shall include:

- *assisting the board and other functions in the effective implementation and operation of the risk management system;*
- *monitoring the risk management system;*
- *monitoring the general risk profile of the business as a whole;*
- *detailed reporting on risk exposures and advising the board on risk management matters, including in relation to strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments; and*
- *identifying and assessing emerging risks.*

For agents using an internal model, the risk management function shall cover the following additional tasks:

- *to design and implement the internal model;*
- *to test and validate the internal model;*
- *to document the internal model and any subsequent changes made to it;*
- *to analyse the performance of the internal model and to produce summary reports on its performance;*
- *to inform the board about the performance of the internal model, suggesting areas needing improvement and updating the board on the status of actions to improve previously identified weaknesses;*
- *liaise closely with the users of the outputs of the internal model; and*
- *co-operate closely with the actuarial function.*

Managing agents should structure their risk management function in the most appropriate way for their business and organisation, ensuring that the function is embedded in the organisational structure and taking account of the standards and guidance in GOV 6.1. In practice, the risk management function is unlikely to be carried out by one individual or team in the business. There may be a risk management team or department but this will not necessarily include all areas that would be considered part of the risk management function.

Responsibilities

The risk management function is responsible for coordination of risk management activities across the business and ensuring the correct implementation of the risk policies. Its role will cover a number of activities including:

- specialist analysis and quality review of the design and effectiveness of the risk management system;
- monitoring the risk management system in order to identify any material failure of the system that impairs its effectiveness and outlining possible solutions for addressing such problems;
- reporting risk exposures to the board in the context of the agreed risk appetite and advising the board on the risk aspects of strategic affairs. This includes providing internal information on the outcome of the ORSA. It also covers reporting on risk exposures that have been identified as potentially critical and preparing reports on specific areas of risk according to requests from the board;
- suggesting ways to deal with emerging risks; and
- reporting to the senior management and other persons who require information, as well as to the board. The information will need to provide a comprehensive and objective representation of the business's risks and contain analyses of changes in the risks.

Internal model responsibilities

Lloyd’s expects all managing agents to have an internal model and the risk management function has specific responsibilities in relation to the model, which should be covered in its terms of reference. There are limited cases where it may be acceptable for agents to operate without an approved internal model, for example where the managing agent and/or syndicate is newly established. Lloyd’s will discuss these on a case by case basis with the managing agent concerned and agree an appropriate approach in each instance.

Within the risk management function, responsibility for design and implementation of the internal model should be separate from the responsibilities to test and validate the model. This should not present difficulties in practice as the risk management function is not necessarily the same as the risk management department, as outlined in the section above.

The risk management function should also be responsible for the following tasks in relation to an internal model:

- integration of the internal model into the risk management system and its day-to-day operations; and
- assessment of the internal model as a risk management tool and as a means of calculating the SCR.

Link to Risk Management Standards

The Governance Standards and guidance set out above cover the overall role of the risk management function. Managing agents should also refer to the Risk Management Standards and supporting guidance which contain further detail on the risk management system and specific risk areas.

GOV 6.3

Compliance function

Managing agents shall have an effective compliance function.

The compliance function shall include:

- *advising the board on compliance with the laws, regulations and administrative provisions adopted pursuant to the Solvency II Framework Directive, Lloyd's rules/requirements and other relevant regulatory requirements;*
- *an assessment of the possible impact of any significant changes in the legal environment on the operations of the business;*
- *the identification and assessment of compliance risk;*
- *assessing the adequacy of the measures adopted by the business to prevent non-compliance; and*
- *a compliance policy that defines the responsibilities, competencies and reporting duties of the function.*

Managing agents shall appoint a compliance officer who is:

- *a director or Company Secretary of the managing agent (in the event that a proposed compliance officer does not meet this requirement, the managing agent would need to discuss this with Lloyd's prior to appointment); and*
- *responsible for compliance with Lloyd's Acts 1871 to 1982 and the managing agent's duties to the members for whom it acts.*

The agent's compliance function must be able to communicate directly with any staff member on its own initiative and be able to access any records necessary for it to fulfil its role.

Compliance policy

The compliance policy should set out the role and operation of the compliance function including details of its operation within the business e.g. unfettered access, reporting structure. The compliance policy should also address the areas set out in GOV 2.4 (required policies).

Responsibilities

Compliance is typically seen as a 'second line' activity in a three lines of defence model, with responsibility for monitoring and oversight of compliance with laws, regulations and administrative provisions. Compliance activities typically include the following areas:

- developing the compliance plan (see GOV 6.4);
- drawing up guidelines and procedures for staff relating to compliance matters;
- enhancing staff awareness and ensuring continuous training of staff on compliance matters;
- recording any incident that must be reported and ensuring that the managing agent fulfils its obligations regarding notification to third parties (e.g. securities and financial market authority, etc.);
- investigating and following up breaches of the laws and regulations;
- advising on new products, services and markets from a compliance perspective;
- monitoring projected revisions of legislation and plans to introduce new regulation and assessing their potential impact on the business and monitoring the relevant court decisions;
- coordinating the money laundering reporting process; and
- regular reporting.

Reporting

The compliance function should report regularly to the board on compliance issues, covering compliance with laws, regulations and administrative provisions from regulators (including Lloyd's), as well as the possible impact of changes in the legal environment and the assessment of compliance risk. The compliance report should also cover progress against the compliance plan (see GOV 6.5).

The compliance function should ensure that any major compliance issues identified are reported promptly to the board.

GOV 6.4

Compliance plan

Managing agents shall have an effective compliance plan.

The compliance plan shall:

- *set out the planned activities of the compliance function; and*
- *take into account all relevant areas of the activities of the business and their exposure to compliance risk.*

Intended compliance activities should be set out in a compliance plan detailing the timetable of compliance work to be undertaken. The plan should cover at least the next business year in detail and may also provide information on planned activities and areas to be considered in future years. The plan would typically cover:

- regular monitoring activities;
- specific projects or tasks planned for the year;
- all areas of the business to a depth proportionate to their exposure to compliance risk;
- narrative comment on the state of the compliance 'environment', to put the detailed timetable of activities into context; and
- liaison with the PRA/FCA and Lloyd's.

The compliance function should monitor progress against the plan and report on this to the board.

GOV 6.5

Internal audit function

Managing agents shall have an effective internal audit function which is objective and independent from the operational functions.

- *The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance; and*
- *The managing agent shall ensure that individuals carrying out the internal audit function do not assume any responsibility for any other function.*

GOV 6.1 requires the internal audit function to be objective and fully independent. The requirement for independence from the operational functions effectively means that there should be a separate unit or individual within the managing agent with responsibility for internal audit. The internal audit function should operate under the oversight of the board, reporting directly to the board or to an audit committee (see below for more detailed guidance on audit committees).

Lloyd's view is that it is acceptable to outsource the internal audit function, provided it is subject to effective in-house oversight and challenge. This includes having a nominated senior individual responsible for liaison with the internal audit provider as well as ensuring that there is adequate reporting and oversight of internal audit matters at audit committee and/or board level. This is consistent with the general guidance on outsourcing set out in GOV 5.3.

To ensure that internal audit independence is maintained, managing agents should consider the following:

- periodic rotation of internal audit staff assignments whenever practicable, to avoid any conflicts of interest;
- avoiding internally recruited auditors auditing activities or functions they performed in the recent past;
- ensuring that internal audit is not responsible for the delivery of business projects, although internal audit representative(s) may sit on project teams in an advisory capacity; and
- ensuring that internal audit is not responsible for implementation of audit recommendations – this is the responsibility of management.

Role and responsibilities

The role of the internal audit function is to examine and evaluate the functioning of internal controls and all other elements of the system of governance, as well as the compliance of activities with internal strategies, policies, processes and reporting procedures.

Managing agents need to ensure that there is clarity over the role and responsibilities of internal audit for example by formally documenting in an internal audit charter. The internal audit charter would typically:

- define the internal audit function's purpose, strategic approach, authority and responsibility;
- establish the position of internal audit within the organisation;
- authorise internal audit to access records and personnel relevant to the work performed; and
- be approved by the audit committee and/or board.

Audit committee

Managing agents are required to have an audit committee under PRA requirements (for further information see [Implementing audit committee requirements under the revised Statutory Audit Directive – PS16/16 | Bank of England]).

There should be a defined terms of reference for the audit committee including key information such as membership of the committee, attendance at meetings, frequency of meetings, authority and duties.

In order to maintain an appropriate degree of independence, the audit committee would typically comprise independent non-executives. It is also important that the non-executives have the required skills and/or knowledge for their role as members of the committee. For example, one of the roles of the audit committee is to review the financial statements; therefore there should be appropriate financial skills amongst the audit committee members.

The audit committee's responsibilities in relation to internal audit should include:

- assessing the effectiveness of internal audit;
- approving the audit plan and monitoring delivery of the audit plan;
- reviewing and challenging all internal audit reports;
- providing input to the scope of audit work;
- determining if audit resources are adequate; and
- appointment or removal of the Head of Internal Audit.

Where Lloyd's minimum standards make reference to board responsibilities for internal audit, it is acceptable for those matters to be covered in detail at audit committee level provided they are also reported to the board. For example, the audit plan is likely to be discussed in detail at audit committee level, but should also be reported to the board following agreement by the committee.

Impact of Sarbanes Oxley (SOX)

SOX is not a Lloyd's requirement, however a number of US owned managing agents are subject to SOX requirements through their ownership by US public companies. In order to demonstrate SOX compliance, organisations must identify and test controls over inputs to their financial statements. Given the resources required to carry out this work, internal audit are often called upon to assist and this may divert audit effort away from the audit plan. SOX testing focuses on controls around the inputs to the financial statements and not on other areas of operational risk e.g. underwriters operating within their authority limits. It is therefore insufficient for an entity to rely solely on SOX testing as a means of testing the entire control environment or meeting the internal audit requirements of Lloyd's minimum standards.

Internal audit may place reliance on testing of financial controls carried out during SOX compliance work. If reliance is to be placed on this work it is important that the testing has been carried out independently of management.

Chartered Institute of Internal Auditors Guidance

Managing agents should ensure that they are aware of the 'Effective Internal Audit in the Financial Services Sector' guidance issued by the Chartered Institute of Internal Auditors (IIA) in July 2013 **[Link to IIA guidance can be found in the appendix at the end of the document]** which covers the following areas:

- role and mandate of internal audit;
- scope and priorities of internal audit;
- reporting results;
- interaction with risk management, compliance and finance;
- independence and authority of internal audit;
- resources;
- quality assessment; and
- relationships with regulators.

GOV 6.6

Internal audit planning

The internal audit function shall establish implement and maintain an audit plan.

Managing agents shall ensure that the internal audit function:

- *adopts a risk-based approach in deciding its priorities;*
- *sets out in the audit plan the work to be undertaken in upcoming years, taking into account all activities and the complete system of governance of the managing agent and syndicate(s);*
- *carries out audits which are not included in the plan where necessary; and*
- *reports the audit plan to the board.*

There should be a clear methodology for developing the internal audit plan and the following areas should be considered in preparing the plan.

Before completing the detailed internal audit plan, internal audit should set its overall scope i.e. the audit universe of all areas that should be considered when formulating the plan. The audit universe will drive the audit plan, with areas prioritised according to the associated level of risk. A detailed audit plan should be completed for the forthcoming year, including details of timing and internal audit resource for each assignment. A less detailed schedule of audits to be completed over the following two years should also be prepared. The basis on which the audit areas have been prioritised should be clearly explained in the audit plan, along with the audit cycle approach (i.e. how the frequency of audits of specific areas is determined).

The process of developing the internal audit universe/plan should involve discussions with management, although management should not dictate the contents. The risk register will be a key input to internal audit's assessment of the risks in the business. However, internal audit should take an independent approach to assessing the risks in the business and the risk register should therefore not be relied upon as being the only source of risk related information. Indeed, the annual internal audit plan should include sufficient work to ensure that the internal audit function is able to assess the overall effectiveness of the governance and risk and control framework of the managing agent.

The audit plan should be approved by the board/audit committee and progress in delivering the audit plan should be reported to the board/audit committee.

Where the internal audit sections of Lloyd's governance standards refer to reporting to or approval by the board, Lloyd's recognises that this may also be achieved by reporting to or approval by the audit committee, which in turn reports to the board.

Audit fieldwork

Audit work should be scoped to determine the areas that will be covered during the course of the audit. This should be based on the risks faced by the business and knowledge of any areas where there may be concerns about the effectiveness of controls.

- the work performed should be clearly linked to the audit scope to demonstrate that the scope of the audit has been met;
- the records of testing carried out during the course of the audit should clearly define the objective of the test, the sample selection basis and the testing performed, as well as test results; and

- all audit procedures forming part of the audit assignment should be documented in working papers and there should be a clear audit trail from the work performed to the final audit report.

Chartered Institute of Internal Auditors Guidance

Managing agents should ensure that they are aware of the 'Effective Internal Audit in the Financial Services Sector' guidance issued by the Chartered Institute of Internal Auditors (IIA) in July 2013 **[Link to IIA guidance can be found in the appendix at the end of the document]** (see section 6.5 above for an outline of the areas covered by this guidance).

GOV 6.7

Internal audit reporting & follow up

Any findings and recommendations of the internal audit function shall be reported to the board.

The internal audit function shall:

- *issue recommendations based on the result of work carried out in accordance with the internal audit plan; and*
- *submit a written report on its findings to the board on at least an annual basis.*

Management actions proposed with respect to each of the internal audit findings shall be subject to review and challenge by the board. The internal audit function shall verify compliance with the actions agreed on the basis of its recommendations and report its findings to the board.

Internal audit should prepare a clear and concise report of the work performed during the course of an audit. The report should include actions agreed by management. This report should clearly state:

- a summary of the work that has been performed linked to the scope of the audit;
- an overall conclusion (this may incorporate a specific rating);
- summary of key findings; and
- detailed audit findings and appropriate recommendations including timescales for implementation of recommendations and persons responsible.

A rating may be applied to each audit finding, which will assist in indicating the relative importance of the findings and associated recommendations. Where relevant, the report should also comment on how past findings and recommendations have been addressed.

The report should be presented to the audit committee or board and the internal auditor should be prepared to respond to questions and challenge by the relevant forum. The distribution list for audit reports should include the audit committee or board, senior management of the area being audited, external auditors and the risk management function.

Issue tracking

It is imperative that all issues raised are monitored to ensure that agreed management actions are implemented in order to strengthen the control environment. There should be a record maintained of all audit issues raised and their status (implemented / outstanding etc).

Internal audit should verify the implementation of agreed management actions through testing and discussion with management on a regular basis, e.g. quarterly, and the audit committee or board should be kept informed of the status of agreed management actions.

Progress on implementing audit actions will also be an important factor in the regular review of the risk register. For this reason reports on such progress should also be tabled whenever the risk register is formally reviewed.

Where internal audit reports include suggestions for business improvements, they may not be subject to the same formal monitoring and verification as actions taken to address identified control weaknesses.

Reporting to the Board

There should be sufficient reporting to the board from the internal audit function and/or audit committee to ensure that the board is aware of the key issues.

In practice there is a variety of approaches to reporting, for example:

- a written annual internal audit summary report for the board, as well as regular reporting from the audit committee;
- regular written internal audit reports provided to the audit committee and board, e.g. on a quarterly basis; and
- audit committee minutes and papers made available to all board members, with summary written or verbal report (from the audit committee chair) to the board.

Where the audit committee chairman provides a verbal update to the board, this should be in sufficient detail to ensure that the board has an awareness of the key issues and the associated board minutes should reflect the detail of the verbal report and subsequent discussion.

Whichever approach is adopted, the reporting should cover issues identified with the internal control system and failures observed in following internal processes and procedures. It should include agreed management actions to remedy inadequacies and follow up on the actions taken by the managing agent in response to issues raised in previous reports. The report should also include information on the extent to which the internal audit function's objectives, the execution of the audit plan and the follow up of agreed management actions have been achieved.

Where the internal audit sections of Lloyd's governance standards refer to reporting to or approval by the board, Lloyd's recognises that this may also be achieved by reporting to or approval by the audit committee, which in turn reports to the board.

Chartered Institute of Internal Auditors Guidance

Managing agents should ensure that they are aware of the 'Effective Internal Audit in the Financial Services Sector' guidance issued by the Chartered Institute of Internal Auditors (IIA) in July 2013 **[Link to IIA guidance can be found in the appendix at the end of the document]** (see section 6.5 above for an outline of the areas covered by this guidance).

GOV 6.8

Actuarial function

Managing agents shall have an effective actuarial function.

The actuarial function shall be carried out by individuals who have knowledge of actuarial and financial mathematics commensurate with the nature, scale and complexity of risks in the business and who are able to demonstrate their relevant experience with applicable professional and other standards. The responsibilities of the actuarial function include:

- *co-ordinating the calculation of technical provisions;*
- *ensuring the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;*
- *assessing the sufficiency and quality of the data used in the calculation of technical provisions;*
- *comparing best estimates against experience;*
- *informing the board on the reliability and adequacy of the calculation of technical provisions;*
- *overseeing the calculation of technical provisions in the cases set out in Article 82;*
- *expressing an opinion on the overall underwriting policy;*
- *expressing an opinion on the adequacy of reinsurance arrangements; and*
- *contributing to the effective implementation of the risk management system, in particular with respect to the risk modelling underlying the calculation of the capital requirements.*

Managing agents shall ensure that they comply with the detailed requirements set out in Level 2 Article 272.

Lloyd's Actuarial Function Guidance (March 2017) includes further guidance on the requirements of the syndicate actuarial function and should be read in conjunction with the summary below.

[Link to Lloyd's Actuarial Function Guidance can be found in the Appendix at the end of this document]

Syndicate actuarial function requirements

Managing agents are responsible for ensuring that those carrying out the actuarial function have appropriate skills and knowledge, and for defining and operating appropriate governance surrounding their actuarial functions. As such, syndicate actuarial functions can be provided by either internal or external parties.

The actuarial function does not necessarily need to be a nominated person or single department; however the constitution of the actuarial function should be well defined in the governance and risk management structure established in the entity. Notably the provision of opinions on underwriting policy and adequacy of reinsurance arrangements may be provided by teams not usually considered "core actuarial" (and not necessarily made up of actuaries) which are deemed to have the appropriate expertise in each of these areas. The actuarial function can discharge the duties with opinions being collectively provided by more than one individual or by one person who is then relying on the work done by others but remaining responsible for the opinion. The exact constitution of the actuarial function will vary by syndicate but syndicates are reminded to consider the independence of the actuarial function from the normal operation of the syndicate and the management and administrative bodies.

GOV 6.9

Actuarial function report

The actuarial function shall produce a written report to be submitted to the board, at least annually.

The actuarial function report shall:

- *document all tasks that have been undertaken by the actuarial function and their results;*
- *clearly identify any deficiencies and give recommendations as to how such deficiencies should be remedied; and*
- *be submitted to Lloyd's at least annually.*

Lloyd’s Actuarial Function Guidance (March 2017) includes further guidance on the requirements of the syndicate actuarial function report, including:

- calculation of technical provisions;
- opinion on the overall underwriting policy; and
- opinion on the adequacy of reinsurance arrangements.

[Link to Lloyd’s Actuarial Function Guidance can be found in the Appendix at the end of this document]

SECTION 7: REMUNERATION POLICY

GOV 7.1

Remuneration policy

Managing agents shall adopt a written remuneration policy.

When establishing and implementing the policy managing agents shall ensure that:

- they comply with the principles around its governance and application set out in Solvency II Level 2 Article 275, paragraph 1;
- identify board members, persons who effectively run the business, key function holders and other staff whose activities have material impact on the risk profile; and
- for PRA Category 1 and 2 managing agents they must comply with the principles around the basis of remuneration set out in Solvency II Level 2 Article 275 paragraph 2 while PRA Category 3 and 4 must include rationale to ensure that the specific arrangements are applied proportionally and amended where required in line with the size and nature of the business.

Remuneration Policy

Managing agents should refer to the Solvency II text (Level 2, Article 275, paragraph 1) for full details of the principles they should comply with when establishing and applying their remuneration policy. The areas covered by these principles include the following:

- alignment of the policy with the business and risk management strategy, risk profile, objectives, risk management practices and the long-term interests and performance of the business as a whole;
- the need to ensure that the policy does not encourage risk-taking that exceeds the risk tolerance limits of the syndicate;
- application of the policy to the business as a whole, with specific arrangements for the various categories of staff whose professional activities have a material impact on the risk profile of the business e.g. board members, key function holders etc;
- board responsibility for control and implementation of the policy;
- the need for clear, transparent and effective governance with regard to remuneration;
- establishing a remuneration committee, where considered appropriate in relation to the significance of the business in terms of its size and internal organisation; and
- disclosure of the policy to each member of staff.

Executive remuneration

Managing agents should seek to ensure that levels of remuneration are sufficient to attract, retain and motivate directors of the quality required to run the company successfully. There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Managing agents should refer to the Solvency II text (Level 2, Article 275, paragraph 2) for full details of the principles they should apply when establishing and applying their remuneration policy for board members, persons who effectively run the business, holders of key functions and other categories of staff whose professional activities have a material impact on the risk profile. All managing agents are required to identify these staff although only PRA Category 1 and 2 managing agents are required to apply the totality of the principles. PRA Category 3 and 4 managing agents are expected to include rationale to ensure that the specific arrangements are applied proportionally and amended where required in line with the size and nature of the business, The areas covered by the principles include the following:

- consideration of fixed and variable components of remuneration schemes;
- basis for performance related variable remuneration;
- deferred payment of variable components of remuneration;
- criteria for assessing individual performance;
- termination payments; and
- the need for staff to commit to not using any personal hedging strategies or remuneration and liability-related insurance.

APPENDIX – LINKS

- **Data Protection Act:**

  http://www.legislation.gov.uk/ukpga/1998/29/contents

- **General Data Protection Regulation:**

  http://ec.europa.eu/justice/data-protection/reform/files/regulation_oj_en.pdf

- **LMA Solvency II Committee outsourcing paper:**

  http://www.lmalloyds.com/CMDownload.aspx?ContentKey=75a079ba-19cd-4253-8ac4-8dce67e085b5&ContentItemKey=34cde2c4-1e02-46a8-9356-f22a4cf573f5

- **Chartered Institute of Internal Auditors Guidance:**

  https://www.iia.org.uk/media/1558662/Effective-internal-audit-in-Financial-Services-sector.pdf

- **Lloyd's Actuarial Function Guidance (March 2017):**

  https://www.lloyds.com/~/media/files/the-market/operating-at-lloyds/solvency-ii/2017-guidance/actuarialfunctionguidance2017.pdf?la=en