

# **SOLVENCY II**

## **DETAILED GUIDANCE NOTES**

### **MARCH 2010**

## **SECTION 1 - SYSTEM OF GOVERNANCE**





# SECTION 1: SYSTEM OF GOVERNANCE

## Overview

This section outlines the Solvency II requirements for an effective system of governance, including the risk management system.

Lloyd's already expects managing agents to have an effective governance framework in place appropriate to their business. 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.

Lloyd's current risk management requirements for managing agents are set out in the risk management standards. Under Solvency II managing agents will need to ensure that their risk management capability is sufficiently developed to meet the requirements for an effective risk management system.

## Guidance

Managing agents should note that this guidance represents Lloyd's best view of current requirements but is subject to ongoing discussion and change as both CEIOPS proposals and FSA requirements become finalised and Lloyd's own development on Solvency II progresses. Lloyd's will continue to monitor and review progress in these areas and seek to update the guidance as appropriate.

The commentary on proposed level 2 measures attached highlights the relevant sections for the dry run and does not reproduce the full level 2 text. Any additional guidance provided in this document is intended to supplement the level 2 measures, not repeat them, and agents must therefore ensure that they are familiar with all of the requirements and do not rely solely on the additional guidance provided here.

Whilst this document refers to general Solvency II requirements, this guidance is specific to Lloyd's and managing agents in many areas. Due to the unique structure of Lloyd's and the application of the Solvency II directive at society level, some of this guidance will not be relevant to non Lloyd's firms.

## Contents

This section includes the following

- Level 1 directive text and commentary on application of proposed level 2 requirements to Lloyd's managing agents
- Guidance on system of governance
- Guidance on developing the risk management system



# LEVEL 1 AND LEVEL 2 MEASURES

The Level 2 measures set out here are based on CEIOPS paper Doc-29-09 (formerly CP 33), published October 2009. These measures may be subject to modification before they come into force.

## General Governance requirements

### Directive Article 41

1. *Member States shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business.*

*That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 49.*

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

2. *The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.*
3. *Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing. They shall ensure that those policies are implemented.*

*Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management or supervisory body and be adapted in view of any significant change in the system or area concerned.*

4. *Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources and procedures.*
5. *The supervisory authorities shall have appropriate means, methods and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks identified by those undertakings which may affect their financial soundness.*

*The Member States shall ensure that the supervisory authorities have the powers necessary to require that the system of governance be improved and strengthened to ensure compliance with the requirements set out in Articles 42 to 49.*

### Application of proposed level 2 requirements to Lloyd's managing agents

#### Article 41/CEIOPS Doc 29/09: 3.29-3.36

A managing agent must establish and maintain an effective system of governance, such that:

- internal reporting is effective at all levels of the business and there is cooperation and effective communication, as relevant, between all levels of the business.
- there is a clear and well-defined organisational structure with clear, consistent and documented lines of responsibility.
- board members possess sufficient relevant professional qualifications, knowledge and experience to give adequate assurance that collectively they provide sound and prudent management.
- personnel have the skills, knowledge and expertise to fulfil their allocated responsibilities.
- personnel are aware of the procedures to follow in order to discharge their responsibilities properly.
- decision-making procedures are established and maintained.
- where an individual performs multiple tasks there is not, and is not likely to be, any circumstance that prevents that individual from performing those tasks soundly, honestly and professionally.

- information systems produce sufficient, reliable, consistent, timely and relevant information on all business activities, commitments assumed and risk exposures.
- adequate and orderly records are kept.
- the security, integrity and confidentiality of information is safeguarded, taking into account the nature of the information in question.
- reporting lines ensure prompt and appropriate escalation of issues and proportionate action.
- adequate risk management, compliance, internal audit and actuarial functions are established and maintained.

A managing agent should also address the following as part of its governance framework:

- it must identify potential conflicts of interest and establish procedures to ensure personnel can understand where conflicts of interest could arise and how these should be addressed.
- personnel who are responsible for key functions (see fit and proper section) should have direct access to the managing agent's board.
- it must have written policies on risk management, internal control, internal audit and outsourcing which clearly set out responsibilities, goals, processes and reporting procedures and are aligned to the managing agent's and syndicate's business strategy. These policies should be reviewed at least annually.
- it must have processes to ensure regular identification of risks for which contingency plans should be in place, particularly those to which the business is especially vulnerable. Contingency plans should be regularly tested and updated, and must be communicated to relevant personnel.

#### Article 50/CEIOPS Doc 51/09: 3.53-3.62

Managing agents should ensure that they adopt a remuneration policy and practice that is in line with their risk strategy, risk profile, objectives, values, risk management practices and long-term entity wide interests. There should be a clear governance structure around remuneration and it may be appropriate to create a remuneration committee.

## Fit and Proper requirements

### Directive Article 42.1

1. *Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions fulfil the following requirements:*
  - (a) *their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and*
  - (b) *they are of good repute and integrity (proper).*

### Application of proposed level 2 requirements to Lloyd's managing agents

#### Article 42.1/CEIOPS Doc 29/09: 3.56-3.62

A managing agent must ensure that all board members and key function holders meet the 'fit and proper' criteria. Key functions include those prescribed by the FSA or Lloyd's, as well as any others that the managing agent considers important in its system of governance. Lloyd's expects this to include, as a minimum, the chairman, chairman of the risk committee, chairman of the audit committee, senior independent director, finance function, risk management function, compliance function, internal audit function and actuarial function.

Fitness for a role is based on assessment of management competence and technical competence. Managing agents must base their assessments on 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. Assessment of propriety of an individual should be based on their reputation, reflecting past conduct, criminal record, financial record and supervisory experience.

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.



A managing agent must notify Lloyd's and the FSA of those persons who run the business and other key function holders.

## Risk Management

### Directive Article 44

1. *Insurance and reinsurance undertakings shall have in place an effective risk management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.*

*That risk management system shall be effective and well integrated into the organisational structure and in the decision making processes of the insurance or reinsurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions.*

2. *The risk management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement, as set out in Article 101(4) as well as the risks that are not or not fully included in the calculation thereof.*

*The risk-management system shall cover at least the following areas:*

- (a) *underwriting and reserving;*
- (b) *asset-liability management;*
- (c) *investment, in particular derivatives and similar commitments;*
- (d) *liquidity and concentration risk management*
- (e) *operational risk management*
- (f) *reinsurance and other risk mitigation techniques.*

*The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) of the second subparagraph of this paragraph.*

3. *As regards investment risk, insurance and reinsurance undertakings shall demonstrate that they comply with Chapter VI, Section 6 [Investments].*

### Application of proposed level 2 requirements to Lloyd's managing agents

#### Article 44/CEIOPS Doc 29/09: 3.72

A managing agent must have an effective risk management system. This requires the following, as a minimum:

- A clear, defined and documented risk management strategy that is consistent with the agent's business strategy and includes: risk management objectives, key principles, risk appetite and assignment of risk management responsibilities across all the agent's activities.
- Written policies that implement the risk strategy and facilitate control mechanisms. They must include a definition and categorisation of the material risks faced by the agent, by type and the levels of acceptable risk limits for each risk type. These policies must reflect the nature, scope and time horizon of the business and the risks associated with it.
- Processes and procedures to enable identification, assessment, management, monitoring and reporting of risks the agent is, or may be, exposed to.
- Reporting procedures and feedback loops to ensure that information on the risk management system is coordinated and challenged by the risk management function and actively monitored and managed by all relevant staff and the managing agent's board.
- Reports by the risk management function submitted to the board, covering the material risks faced by the business and the effectiveness of its risk management system.
- A suitable ORSA process.

## Areas to be covered by a risk management system

The areas that an undertaking's risk management system must cover are set out in Directive article 44(2) (see above). The application of proposed level 2 measures to managing agents is set out below.

### Underwriting and reserving

#### Article 44/CEIOPS Doc 29/09: 3.887-3.889

Underwriting risk refers to the risk of loss, or of adverse change in the value of insurance liabilities, due to inadequate pricing and reserving assumptions.

Underwriting and reserving risk includes fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the undertaking at the time of underwriting. This risk can also refer to fluctuations in the timing and amount of claims settlements.

A managing agent must:

- Have processes and procedures to ensure the reliability, sufficiency and adequacy of statistical and accounting data used in underwriting and reserving processes.
- Ensure that all underwriting policies and procedures are applied consistently across all distribution channels for which they are relevant.
- Have in place adequate claims management procedures, covering the overall cycle of claims: receipt, assessment, processing and settlement, complaint and dispute settlement and reinsurance recoverables.

### Asset liability management (ALM)

#### Article 42.1/CEIOPS Doc 29/09: 3.102-3.106

Asset-liability management (ALM) is the management of a business in such a way that decisions on assets and liabilities are coordinated in order to manage the exposure to the risk associated with the variation of their economic values.

A managing agent must have an ALM framework that not only recognises the interdependence between assets and liabilities but also takes into account correlations of risk between different asset classes and between different products and business lines. Agents must also have regard to any off-balance sheet exposures.

A managing agent must have a written ALM policy that takes into account interaction between different risks, such as market risk, credit risk, liquidity risk and underwriting risk and that establishes ways to manage the possible effects of options embedded in insurance products. The ALM policy must provide for:

- Structuring of the assets to ensure that sufficient cash and/or marketable assets of an appropriate nature, term and liquidity are in place to meet obligations as they fall due.
- A plan to deal with expected cash outflows, or changes in expected cash flows; and
- The identification of mitigation techniques and their impact on embedded options, and the assessment of the possible effects these can have throughout the life of the (re)insurance contracts.

The ALM policy should reflect the needs of different products and business lines and combine so as to optimise the overall ALM framework.

### Investment

#### Article 44/CEIOPS Doc 29/09: 3.130-3.135

A managing agent must define its investment policy in line with what a competent, prudent and expert manager would apply in order to pursue the chosen investment strategy.

The investment policy must:

- Take into account the syndicate's business, its overall risk tolerance levels, long-term risk versus performance requirements, its solvency position and its gross and net underlying asset exposures.



- If an agent uses derivative products or investment instruments with the characteristics of derivatives, its investment policy must take into account their purpose in the portfolio, their contribution to efficient portfolio management, the procedures in place to evaluate their suitability for purpose and the risk management principles applied.
- Consider how to prudently manage liquidity risk in the short, medium and long term, taking into account investment strategy, underwriting strategy and claims management strategy
- Include quantitative limits on assets or exposures, including off-balance sheet exposures.
- Include special management, monitoring and control procedures, in particular in relation to investments not quoted in a market and to complex structured products.

## **Liquidity risk management**

### **Article 44/CEIOPS Doc 29/09: 3.142-3.143**

Liquidity risk refers to the risk that undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due.

A managing agent must have sound liquidity management practices, covering both short and long term considerations and including stress and scenario analyses.

A liquidity contingency plan must be in place, including as a minimum:

- monitoring of the agent's debt position and analysis of its debt capacity;
- identification of financing options (including reinsurance);
- regular review and testing of these options, both in normal and adverse situations.

## **Concentration risk management**

### **Article 44/CEIOPS Doc 29/09: 3.56-3.62**

Concentration risk means all risk exposures with a loss potential which is large enough to threaten the solvency or the financial position of undertakings.

A managing agent must define relevant sources of risk concentration and manage them through the use of internal limits, thresholds and other appropriate tools.

A managing agent must have in place adequate procedures and processes for active monitoring and management of concentration risk, to ensure that policies and limits are not breached and mitigating action can be taken as required. This monitoring must include possible contagion effects.

## **Operational risk management**

### **Article 44/CEIOPS Doc 29/09: 3.166-3.169**

Operational risk refers to the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.

A managing agent must have a well-documented operational risk assessment and management system, with clearly assigned responsibilities. The system must include a process to regularly identify, document and monitor exposure to operational risk and track operational risk data, including near misses. The agent's board must be aware of major aspects of operational risks as a distinct risk category and must approve, oversee implementation and regularly review the operational risk management framework.

The operational risk management framework must be integrated into the broader risk management framework. Its output must be integral to the monitoring and controlling of the operational risk profile.

## **Reinsurance and similar risk mitigation techniques**

### **Article 44/CEIOPS Doc 29/09: 3.181-3.183**

A managing agent must have, as part of its reinsurance management strategy, adequate procedures and processes for the selection of suitable reinsurance programmes. The sophistication of these processes should

reflect the nature, scale and complexity of syndicate risks and of the agent's capability to manage and control risk mitigation techniques used.

The reinsurance management strategy should have regard to the following:

- Identification of the level of risk transfer appropriate to the syndicate's risk appetite.
- Identification of the types of reinsurance most appropriate to the syndicate's risk profile.
- Principles for the selection of reinsurance counterparties.
- Procedures for assessing the creditworthiness and diversification of reinsurance counterparties.
- Procedures for assessing effective risk transfer;
- Concentration limits for reinsurance counterparties and appropriate systems for monitoring concentration exposures.
- Liquidity management over the period between paying inwards claims and collecting associated reinsurance recoveries.

If Special Purpose Vehicles are used, the following principles should be considered (as well as specific requirements set out in CEIOPS-DOC-32/09):

- the fully funded requirement should be actively monitored.
- Any residual risk should be taken into account within the risk management system and reflected in the calculation of regulatory capital requirements.

### **Financial risk mitigation techniques**

#### **Article 44/CEIOPS Doc 29/09: 3.188-3.190**

- A managing agent must only use financial risk mitigation techniques where they are appropriate as part of the agent's overall risk management policy and reinsurance management strategy. Both qualitative and quantitative features shall be appropriately considered.
- Financial risk mitigation techniques must not be applied with the primary aim of achieving a reduction in the SCR. Rather, they should be part of a managing agent's broader risk management system, having regard to its desired risk profiles, assumed and retained, both in benign and in stressed situations. Managing agents should assess this as part of their ORSA.
- Managing agents must assess which type of financial mitigation technique is appropriate according to the nature of the risks assumed and its capability to manage and control the risks associated with the technique.

### **Credit risk management**

#### **Article 44/CEIOPS Doc 29/09: 3.198-3.199**

- An agent's risk management framework must be capable of identifying, mitigating and measuring credit risk, according to internally defined limits.
- Credit ratings should be monitored and probabilities of default evaluated, including for unrated exposures. Exposure to speculative assets should be limited and syndicates with significant exposure to assets bearing credit risk should be capable of hedging that exposure.

### **Risk management function**

#### **Directive Article 44 (extract)**

4. *Insurance and reinsurance undertakings shall provide for a risk management function which shall be structured in such a way as to facilitate the implementation of the risk management system.*
5. *For insurance and reinsurance undertakings using a partial or full internal model approved in accordance with Articles 112 and 113 the risk management function shall cover the following additional tasks:*

*(a) to design and implement the internal model;*

- (b) to test and validate the internal model;
- (c) to document the internal model and any subsequent changes made to it;
- (d) to analyse the performance of the internal model and to produce summary reports thereof;
- (e) to inform the administrative, management or supervisory body about the performance of the internal model, suggesting areas needing improvement, and updating that body on the status of efforts to improve previously identified weaknesses.

## **Application of proposed level 2 requirements to Lloyd’s managing agents**

### **Article 44/CEIOPS Doc 29/09: 3.220-3.222**

A managing agent must have a risk management function in place, which must be embedded in the managing agent’s organisational structure. Its reporting lines must ensure objectivity, whilst leaving it free from influence from other functions and from the agent’s board

The risk management function must do the following:

- Assist the board and other management in the effective operation of the risk management system, particularly through specialist analysis and quality review.
- Monitor the risk management system.
- Maintain an aggregated view of the risk profile of the business.
- Report risk exposures to the board and advise the board on the risk aspects of strategic affairs.
- Identify and assess emerging risks.

The risk management function must 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.
- Assessment of the internal model as a risk management tool and as a means of calculating the SCR.

## **Internal Control**

### **Directive Article 46**

1. *Insurance and reinsurance undertakings shall have in place an effective internal control system.*

*That system shall at least include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the undertaking and a compliance function.*

2. *The compliance function shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive. It shall also include an assessment of the possible impact of any significant changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk.*

## **Application of proposed level 2 requirements to Lloyd’s managing agents**

### **Article 46/CEIOPS Doc 29/09: 3.254-3.258**

A managing agent’s internal control system must secure its compliance with applicable laws, regulations and administrative processes and the effectiveness and efficiency of operations in view of its objectives, as well as the availability and reliability of financial and non-financial information.

The managing agent must have in place a suitable control environment, appropriate control activities, effective information and communication procedures and adequate monitoring mechanisms.

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.

Intended compliance activities must be set out in a compliance plan. The plan must ensure all areas of the business are covered to a depth proportionate to their exposure to compliance risk.

The compliance function must promptly report any major compliance issues identified to the board.

## Internal Audit

### Directive Article 47

1. *Insurance and reinsurance undertakings shall provide for an effective internal audit function.*

*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.*

2. *The internal audit function shall be objective and independent from the operational functions.*
3. *Any findings and recommendations of the internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions shall be taken with respect to each of the internal audit findings and recommendations and shall ensure that these actions are carried out.*

### Application of proposed level 2 requirements to Lloyd's managing agents

#### Article 47/CEIOPS Doc 29/09: 3.276-3.279

The internal audit function is an independent function within the organisation which examines and evaluates the functioning of the 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.

A managing agent must have an internal audit function. The internal audit function must:

- Carry out its assignments with impartiality.
- Be able to exercise its assignments on its own initiative in all areas of the undertaking.
- Be free to express its opinions and present its findings to the whole board.
- Have the complete and unrestricted right to obtain information, which includes the prompt provision of all necessary information, the availability of all essential documentation and the ability to look into all the agent's activities and processes, as necessary to discharge its responsibilities, as well as having direct communication with any member of staff.

Every activity and unit of the managing agent is within the internal audit function's scope. Internal audits will take place according to a risk-based internal audit plan, drawn up by the function itself.

At least annually, the internal audit function must produce a written report of its findings for the agent's board. This report must cover issues identified with the internal control system and failures observed in following internal processes and procedures. It must include recommendations on how to remedy inadequacies and follow up on the actions taken by the managing agent in response to issues raised in previous reports.

## Actuarial Function

### Directive Article 48

1. *Insurance and reinsurance undertakings shall provide for an effective actuarial function to:*

- (a) *coordinate the calculation of technical provisions;*
- (b) *ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;*
- (c) *assess the sufficiency and quality of the data used in the calculation of technical provisions;*
- (d) *compare best estimates against experience;*
- (e) *inform the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions;*
- (f) *oversee the calculation of technical provisions in the cases set out in Article 82;*
- (g) *express an opinion on the overall underwriting policy;*

- (h) *express an opinion on the adequacy of reinsurance arrangements;*
- (i) *contribute to the effective implementation of the risk management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5 and to the assessment referred to in Article 45.*
2. *The actuarial function shall be carried out by persons who have knowledge of actuarial and financial mathematics commensurate with the nature, scale and complexity of the risks inherent in the business, and who are able to demonstrate their relevant experience with applicable professional and other standards.*

## **Application of proposed level 2 requirements to Lloyd's managing agents**

### **Article 48/CEIOPS Doc 29/09: 3.328-3.343**

A managing agent must have an actuarial function, which must have access to the resources and information necessary for it to discharge its responsibilities. Its responsibilities are set out below.

#### **Coordinating the calculation of technical provisions**

In coordinating the calculation of technical provisions, the actuarial function must, at a minimum:

- Apply methodologies and procedures to assess the sufficiency of technical provisions and ensure that their calculation is consistent with the underlying principles.
- Assess the uncertainty in the estimates.
- Apply judgement as appropriate, using any relevant information and the knowledge and expertise of the individuals involved.
- Ensure that problems related to data quality are dealt with appropriately and that, where there are deficiencies in data quality, appropriate alternative methods are applied, subject to proportionality.
- Ensure that risks are appropriately categorised into homogeneous risk groups.
- Factor in relevant market information.
- Track against previous estimates and justify any material differences.
- Ensure appropriate allowance is made for embedded options and/or guarantees.

With regard to technical provisions, the actuarial function must also:

- Ensure that methodologies and models used to calculate the technical provisions are appropriate, both in themselves and with regard to the specific lines of business they are applied to, taking into account the way the business is managed and the available data.
- Ensure that management actions included in the calculation of technical provisions are objective, reasonable and verifiable.
- Assess whether the IT systems used in the actuarial reserving procedures are adequate for that purpose.
- Review revised best estimates against past best estimates and use the insights gleaned to improve the quality of current best estimates.
- Compare observed values against the assumptions used in the calculation of technical provisions, in order to evaluate the appropriateness of the data used and the methods applied in their estimation.
- Inform the board on the reliability and adequacy of the calculation of technical provisions, on the degree of uncertainty in the ultimate outcome and the circumstances that might lead to a significant deviation from the best estimate. It must clearly set out how it arrived at its opinion and explain any concerns it may have as to the sufficiency of technical provisions.
- Determine when data is of insufficient quality to apply a standard actuarial method and a case-by-case approach should be followed instead. It must apply judgment to establish assumptions and safeguard the accuracy of the results.

Current level 2 advice expects that CEIOPS will issue European actuarial guidelines with respect to the actuarial methodologies and techniques used in determining technical provisions. There will be a development process

for these guidelines which will include the approval/endorsement by CEIOPS of the guidelines developed by relevant expert groups and professional bodies, following a period of public consultation.

### **Providing an opinion on underwriting policy and reinsurance arrangements**

The actuarial function's opinion on underwriting policy must include the following issues, at a minimum.

- Sufficiency of premiums to cover future losses.
- Considerations regarding inflation, legal risk, changes in mix, anti-selection and adequacy of bonus-malus systems implemented in specific lines of business.

The actuarial function's opinion on the adequacy of reinsurance arrangements must include:

- The adequacy of significant reinsurance arrangements.
- Expected cover under stress scenarios in relation to underwriting policy.
- The adequacy of the calculation of technical provisions arising from reinsurance.

In forming its own actuarial view and providing opinions, the actuarial function must be objective and free from influence from other functions and the board. It must therefore be constituted by persons with a sufficient level of independence.

The actuarial function must provide written reports to the board at least annually. These reports must document the tasks undertaken and highlight any shortcomings identified, and how such deficiencies could be remedied.

## **Outsourcing**

### **Directive Article 49**

1. *Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.*
2. *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:*
  - (a) *materially impairing the quality of the system of governance of the undertaking concerned;*
  - (b) *unduly increasing the operational risk;*
  - (c) *impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;*
  - (d) *undermining continuous and satisfactory service to policyholders.*
3. *Insurance and reinsurance undertakings shall, in a timely manner, notify the supervisory authorities prior to the outsourcing of critical or important functions or activities as well as of any subsequent material developments with respect to those functions or activities.*

### **Application of proposed level 2 requirements to Lloyd's managing agents**

#### **Article 49/CEIOPS Doc 29/09: 3.376-3.382**

A managing agent 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.

If a function is outsourced to an undertaking within the same group, the managing agent may take account of the extent to which it controls, or has influence over, the service provider.

When choosing a service provider for any critical or important functions (i.e. functions that are fundamental to carrying out the core business), the managing agent must ensure that:

- a detailed review is performed of the potential service provider's ability to deliver the required functions satisfactorily;
- the service provider has ensured that no actual or potential conflicts of interest with the managing agent will impair its ability to deliver to the standard required;

- it enters into a written agreement with the service provider which clearly allocates the respective rights and obligations of the managing agent and the service provider;
- the terms of the outsourcing agreement are authorised and understood by the managing agent's board;
- the outsourcing does not breach data protection regulation or any other laws; and
- the service provider applies equivalent provisions to those the managing agent would have to apply in respect of the confidentiality of client data.

The managing agent is responsible for ensuring that the terms of the outsourcing agreement are consistent with its obligations under the Solvency II Framework Directive. To this end, the written agreement between the managing agent and the service provider should clearly state the following requirements:

- the duties and responsibilities of each party;
- the service provider's commitment to comply with all applicable laws and regulations and to cooperate with the FSA in connection with the outsourced function or activity;
- that the service provider discloses any developments that may have a material impact on its ability to carry out the outsourcing;
- that the service provider can only terminate the contract under a notice period that is sufficiently long to enable the managing agent to find an alternative solution;
- that the managing agent can terminate the outsourcing arrangement, with a reasonable notice period, should the service provided prove to be inadequate;
- that the managing agent reserves the right to information on the outsourced activities and the service provider's performance of them, as well as the right to issue guidelines or instructions as to what is taken into account when performing the outsourced activities;
- that the service provider protects any confidential information relating to the managing agent or its clients;
- that the managing agent, its external auditor, and the FSA can access all information relating to the outsourced activities, and are able to access the service provider's premises if an on-site inspection is to be performed; and
- that the FSA has the right to question the service provider directly.

To ensure that outsourcing of any critical or important activities does not materially impair the managing agent's governance system:

- the managing agent must ensure that the service provider has an adequate risk management and internal control system;
- the outsourced activities must be adequately included in the managing agent's risk management and internal control system; and
- the managing agent must establish a contractual right to information about the outsourced activities and a contractual right to issue instructions about the activities.

In order to ensure against an undue increase of operational risk when outsourcing critical or important functions or activities, the managing agent shall:

- verify that the service provider has adequate financial resources to take on the tasks to be outsourced and to properly and reliably perform its duties towards the managing agent, and that the service provider's staff is chosen on the basis of criteria that give reasonable assurance that they are sufficiently qualified and reliable;
- verify that the service provider properly isolates and identifies the information, documentation and assets belonging to the managing agent and its clients in order to protect their confidentiality; and
- make sure the service provider has adequate contingency plans in place to deal with emergency situations or business disruptions and has periodic testing of backup facilities where that is necessary having regard to the activity outsourced.





# SYSTEM OF GOVERNANCE

Lloyd's already expects 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.

## General governance requirements

This guidance suggests how agents may evidence an effective system of governance. This is not exhaustive, but Lloyd's would expect agents to be able to provide the following as evidence of their governance framework:

- 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
- Committees and decision making bodies and lines of responsibility
- Matters for the board 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

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
- Operational risk

The following sections provide further explanation of how agents may evidence that they are able to meet specific aspects of the governance requirements under Solvency II.

## Conflicts of interest

To ensure that conflicts of interest are identified and appropriately addressed agents should have in place a conflicts of interest policy/procedure. Examples of the types of conflict that could be considered include:

- Internal – director's interests
- Corporate – related parties
- Capital – third party capital
- Group conflicts
- Other areas identified

## Contingency plans

As well as addressing operational business continuity agents should consider other risks for which risk mitigation plans may be needed. This may include capital and solvency risk and planning, liquidity arrangements, reinsurance and outsourcing. For those risks identified, as a minimum, agents should ensure that they document high level risk mitigation procedures.

## Fit and proper requirements

'Fit and proper' policies and procedures should be in place for directors, senior staff and those holding key functions. Under Solvency II key functions are those considered critical or important in the system of governance and include at least the risk management, compliance, internal audit and actuarial functions. Other functions may be considered key functions according to the nature, scale and complexity of the business or the way it is organised.

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
- Training and CPD

## Risk management

Under Solvency II agents will need to ensure that their risk management capability is sufficiently developed to meet the requirements for an effective risk management system. A separate section, 'Developing the Risk Management System under Solvency II', provides agents with some practical guidance on areas they will likely need to address as part of their risk management development.

## Compliance function

Agents may provide the following as evidence of the role and operation of their compliance function:

- Terms of reference / framework detailing the operation of the compliance function within the business e.g. unfettered access, reporting structure.
- Compliance plan – this should detail the timetable of compliance activities undertaken by the function on a "risk based" approach
- Compliance report to Board – should include report on compliance with laws, regulations and administrative provisions from regulators (including Lloyd's) and possible impact of changes in the legal environment and the assessment of compliance risk.

## Internal audit function

Agents will need to ensure that they have an independent and objective internal audit function. Lloyd's view is that it will be acceptable to outsource the internal audit function, provided it is subject to effective in-house oversight and challenge. This would include 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.

The following sections provide an overview of internal audit good practice in a number of key areas.

### Internal audit terms of reference/charter

The internal audit charter is a formal written document defining the internal audit function's purpose, strategic approach, authority and responsibility. It also establishes the position of internal audit within the organisation and authorises internal audit to access records and personnel relevant to the work performed.

## **Audit committee**

Agents will not be required to have an audit committee under Solvency II, but in Lloyd's view it is good practice to have an audit committee in place in order to provide effective oversight and monitoring of the internal audit function.

The audit committee should be responsible for ensuring that management has developed and followed an adequate system of internal control. 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 should include independent non-executives. It is also important that those non-executives have the required skills. 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 should be responsible for:

- 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 scope of audit work
- Determining if audit resources are adequate

## **Internal audit reporting lines**

The objective of internal audit is to provide independent assurance over the effectiveness of operations within an entity, with particular emphasis on systems of control and the control environment. The internal audit function provides assurance to management and the board through the audit committee. The internal audit function should report directly to the audit committee in order to maintain its independence.

- Internal audit should not be responsible for delivery of business projects but may sit on project teams to advise
- Internal audit should not be responsible for implementation of audit recommendations – this is the responsibility of management

## **Audit planning**

The internal audit plan should provide a clear rationale for the audit work scheduled to be completed in a given time period. The following should be considered in preparing the audit plan:

- The process of developing the internal audit plan should involve discussions with management, although management should not dictate the audit plan. The internal audit plan should be based on the risks facing the business and as such a key input to building the plan will be the business's risk register. However, the internal audit plan should remain 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 information on risk. Indeed, the internal audit plan should also, at some stage, include an audit of the risk management framework and risk register itself.
- The audit plan should include current and future years (generally current year and two following years)
- The basis on which the audit areas have been prioritised should be clearly explained in the audit plan. The audit cycle approach (how the frequency of audits of specific areas is determined) should also be explained.
- The timetable for delivery of audits should be defined within the audit plan
- The audit plan should be approved by the audit committee
- Progress in delivering the audit plan should be reported to the audit committee

## **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 scope of the audit should be clearly linked to the work performed to demonstrate that the scope of the audit has been met by the work performed.
- 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.
- There should be a clear audit trail from the work performed to the final audit report.

## **Audit findings**

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.
- Detailed audit findings along with appropriate recommendations including timescales for implementation of recommendations and persons responsible.
- The report should be presented to the audit committee and the internal auditor should be prepared to respond to questions and challenge by the audit committee. The distribution list for audit reports should include the audit committee, senior management of the area being audited, external auditors and the risk management function.

## **Issue tracking**

It is imperative that all issues raised are followed up to ensure that recommendations made by the internal auditors 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 audit recommendations through testing and discussion with management on a regular basis, e.g. quarterly.

The audit committee should be kept informed of the status of audit recommendations.

Progress on implementing audit recommendations 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.

## **Sarbanes Oxley (SOX)**

SOX is not a Solvency II requirement, however a number of US owned managing agents are subject to SOX requirements. 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 operational controls 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 Solvency II.

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.

## Actuarial function

The directive refers to an actuarial function and not a function holder, i.e. it does not refer to one person. The actuarial function does not have to be internal, but Lloyd's view is that if it is entirely outsourced it will be more difficult for agents to demonstrate that the use test is met and that the actuarial function contributes to the implementation of the risk management system.

Solvency II introduces a requirement for the actuarial function to provide formal written opinions on the underwriting policy and the adequacy of reinsurance arrangements. The actuarial profession continues to develop its view of what will be required and the Groupe Consultatif has issued initial views on the subject which agents may wish to refer to.

Lloyd's is not intending to introduce any requirements going beyond the general view of the profession. In the meantime, agents should ensure that they consider how they will address the requirements, based on the information currently available.





# DEVELOPING THE RISK MANAGEMENT SYSTEM UNDER SOLVENCY II

## Introduction

Lloyd's existing risk management standards currently require all managing agents to have in place a clear approach to risk management and processes for risk identification and assessment, monitoring and reporting. Under Solvency II agents will need to ensure that their risk management capability is sufficiently developed to meet the requirements for an effective risk management system. This will include ensuring that there is a formal risk management strategy covering all risk categories, risk appetite is defined for all risk types and, linked to this, there is an established escalation process for risk issues. Agents will need to ensure that they have a comprehensive view of the risks facing the business and that risk management is embedded across all areas, including links with the internal model and strategic decisions.

Lloyd's is currently reviewing and enhancing its own risk management structures and processes in order to ensure that it meets Solvency II requirements. This document draws on Lloyd's development of its own risk management system to provide agents with some practical guidance on areas that they will likely need to address in enhancing their own risk management capability. This guidance does not prescribe any particular approach or detailed contents of agents' risk management systems and therefore we have summarised at the end of each section the outcomes that we would expect all agents to be able to demonstrate as they move towards Solvency II compliance.

## Risk Universe

In order to develop a risk management system that applies effectively and consistently across all areas of the business as a first step it is important that agents have a clear understanding of their risk universe.

### Definition

The risk universe can be defined as a complete view of all possible types of risk that the business may face. As such, it is likely to be articulated at a higher level than the risk register and focuses on identifying possible risk types, rather than risk assessment.

### Why is it important?

Defining the risk universe will ensure that agents have a clear and complete view of all the types of risk that could potentially impact their business, taking account of their own particular business profile.

An agreed schedule of all risks in the risk universe can also assist in making the link between risk management and the internal model on a consistent basis. It can be used to ensure that there is clarity on which aspects of the risk universe are included in the internal model and how they are incorporated.

The risk universe should underpin development of a comprehensive risk appetite framework, which will need to ensure that all risks are covered on a consistent basis. Similarly, when reviewing and refining the risk governance structure it will be important to ensure that all possible areas of risk are addressed within the governance framework.

### Suggested approach

The following steps provide a guide as to how the exercise of defining the risk universe could be carried out in practice.

- Individual known categories of risk and their sub-components should be used as the starting point. This can be taken from the existing risk framework, FSA risk categories as well as Solvency II requirements, but the key objective is to ensure that all classifications of risk relevant to the business are addressed.
- This schedule of risks should then be reviewed and refined in the context of the nature of the business to produce a full set of risk types and risk components.

- To ensure that a comprehensive view of the risk universe is obtained it is important to seek input from across the business. This will likely involve input from those at a relatively senior level, given that the purpose of the exercise is to develop an understanding of the types of risk faced by the business, rather than carrying out a detailed risk assessment.

### Lloyd's risk universe

As part of its Solvency II programme. Lloyd's has defined its own risk universe as set out below using a number of recognised industry sources. Lloyd's does not expect agents to have an identical risk universe, although there will clearly be many common areas of risk.

#### Risk type

Level 1	Level 2	Level 3	Level 4	
Financial	Insurance	Underwriting risk		
		Reserving risk		
		Claims risk		
		Reinsurance risk		
		Aggregation risk		
		Run-off risk		
		Insurance operational risk		
	Credit	Insurance counterparty default risk	Reinsurance credit risk	
			Insurance credit risk	
		Broker credit risk		
		Investment credit risk		
	Financial Markets	Credit operational risk	Interest rate risk	
			Exchange rate risk	
			Equity risk	
			Other investment risk	
			Concentration risk	
			Asset/liability matching risk	
			Financial markets operational risk	
	Liquidity	Liquidity operational risk	Liquidity risk	
Regulatory liquidity risk				
Liquidity operational risk				
Non-financial	Operational	Employee practices risk		
		Systems and information risk		
		Business disruption risk		
		Processes risk		
	Reg. and legal	Financial crime risk	Internal financial crime risk	
			External financial crime risk	
		Other legal risk		
		Regulatory compliance risk	UK regulatory compliance risk	
			US regulatory compliance risk	
	O/s regulatory compliance risk			
	Unattractive supervisory environment risk			
	Strategic	Strategic operational risk	Failure to set and maintain appropriate strategy	
			Failure to implement strategy	
			Failure to exploit market changing event	
	Group	Group operational risk	Group risk	
			Pension fund risk	
Other	Capital	Inappropriate capital calculation risk		
		Insufficient capital risk ('too little' capital)		
		Inefficient capital risk ('too much' capital)		
		Inadequate quality of capital risk		

## Desired outcomes

- Comprehensive categorisation of all possible types of risk that could affect the business broken down into sub elements at such a level that is meaningful yet not overcomplicated
- Documented and agreed reference that is understood by the board and across the organisation
- Consistent set of terminology to be used in all aspects of risk management

## Risk appetite

### Overview

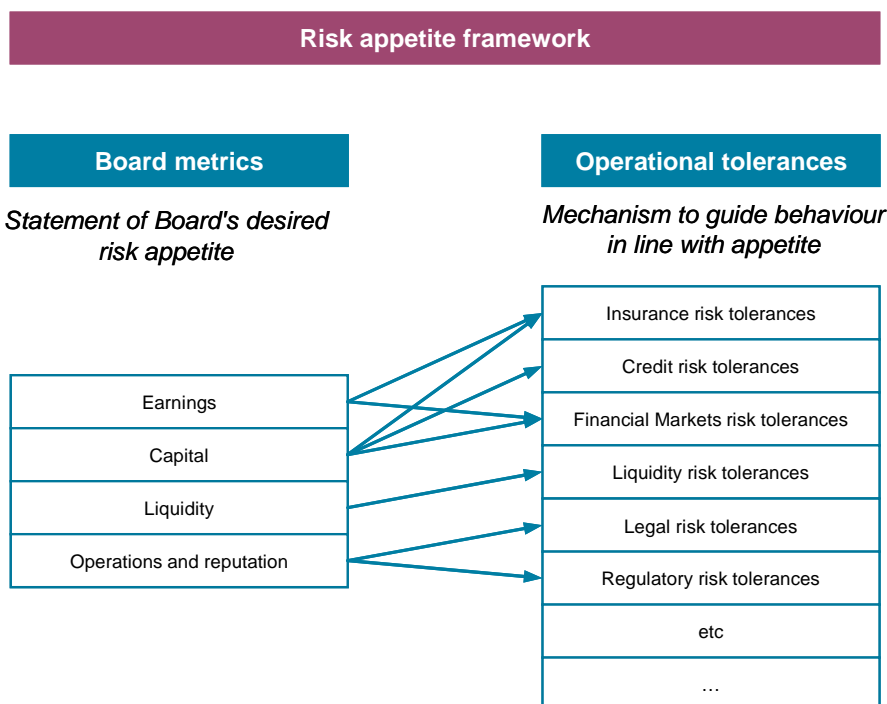
Solvency II requires both Lloyd's and managing agents to evidence an effective risk appetite framework and this is a key element of Solvency II implementation programmes across the market. The following guidance provides insight into Lloyd's approach to risk appetite which, whilst being tailored to the unique structure of Lloyd's, may be useful to managing agents as they shape their own risk appetite process.

### Lloyd's risk appetite framework

The Lloyd's risk appetite framework sets the boundaries within which risk taking should remain in order to meet stakeholder expectations. It will articulate the key set of risk management metrics against which the business is managed and will cascade in a pragmatic way between a 'top level' view and day to day decision making. The framework underpins the risk management framework and, as such, is one of the areas of the Solvency II implementation which has been prioritised

The framework consists of two core components, as shown below:

- Board metrics
- Operational tolerances and processes



## Board metrics

A concise set of metrics which provide a snapshot of the risk profile of the business and against which the board can judge if risk taking is within acceptable boundaries. Lloyd’s has articulated 15-20 metrics with associated tolerances structured across four key dimensions:

- Earnings
- Capital
- Liquidity
- Operations and reputation

Metrics are articulated in this way to provide the board with a tangible sense of how risk taking will impact the business. Lloyd’s has used the above four types of impact to link appetite measures to its strategy. More detailed tolerances sitting below each metric are seen as the root causes of risk that will cause these impacts – these are merely grouped under the above four headings to aid board understanding of their downsides.

## Operational tolerances and processes

A set of more detailed limits, triggers and monitoring processes which are designed to guide day to day decision making in line with Board metrics. Within the Lloyd’s risk appetite framework, operational tolerances and processes are defined on a risk-type basis, i.e. for each defined risk category, a clear set of tolerances are in place to ensure risk taking is managed in line with the boundaries defined by the board.

Additionally, an escalation process is clearly defined for each risk category such that, if an operational tolerance is breached, this breach is communicated through appropriate governance channels and action is taken to resolve it.

## Worked examples

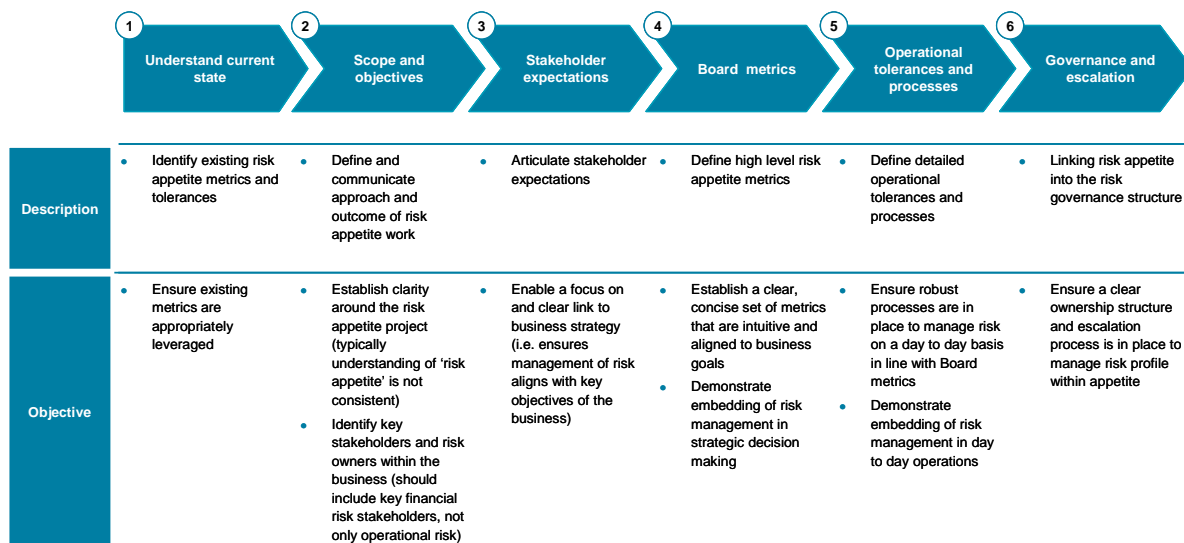
The table below provides illustrative examples of how the risk appetite framework may operate in practice, demonstrating how a key set of risk appetite metrics can cascade into day to day decision making.

### Example metrics and tolerances – ILLUSTRATIVE ONLY

Board metric	Operational tolerances and processes
<p>1) <b>“We do not expect to expose our capital to potential losses of more than [x] in a [1 in y] year scenario”</b>                      Focussing the risk appetite framework on key business metrics will support alignment of business strategy and risk management</p>	<ul style="list-style-type: none"> <li>• Use of Solvency II internal model to assess potential losses of capital through the business planning process</li> <li>• Monitoring of variance against business plan and resulting exposure</li> </ul>
<p>2) <b>“We do not expect to lose more than [x] more often than once every [y] years from investment income”</b>                      A key source of earnings volatility is likely to be investment income, hence it may be useful to define parameters within which performance deviation is acceptable</p>	<ul style="list-style-type: none"> <li>• Portfolio diversification limits</li> <li>• Single name and other concentration limits</li> </ul>
<p>3) <b>“We have no appetite for failure of material systems or processes which may cause significant business disruption”</b>                      As well as financial risks, it will be important to consider tolerances to non-financial risks such as system risk</p>	<ul style="list-style-type: none"> <li>• Target system and process recovery times for key activities</li> <li>• Strength of business continuity processes</li> <li>• System and process downtime metrics</li> </ul>
<p>4) <b>“We have no appetite for unprofitable classes of business”</b>                      There should be a reasonable expectation of making an underwriting profit on each line of business</p>	<ul style="list-style-type: none"> <li>• Target loss ratios by class of business</li> </ul>
<p>5) <b>“We seek to ensure an appropriate degree of quality and diversification in reinsurance coverage”</b>                      Aim to have clear objectives set for the extent to which a syndicate is reliant on particular reinsurers</p>	<ul style="list-style-type: none"> <li>• Limits per reinsurer on concentration and credit rating</li> </ul>
<p>i) <b>“We have no appetite for significant deviations in earnings driven by reserving deficits”</b>                      Focus on the degree to which reserve deteriorations may affect the syndicate</p>	<ul style="list-style-type: none"> <li>• Measure extent of impact on combined ratio from reserve deterioration</li> </ul>

## Our approach and getting started

Lloyd's has adopted a simple six-stage process to design its risk appetite framework, as shown below.



## Tips for managing agents

### Key challenges and considerations

Whilst the risk appetite frameworks and metrics of each managing agent will naturally differ, the process of formalising and enhancing the risk appetite framework of Lloyd's has provided a number of lessons which may support the development process for agents.

<b>Focus on materiality</b>	<ul style="list-style-type: none"> <li>Risk appetite should focus, at a minimum, on the most material risks of the organisation</li> <li>As the framework will be owned by the Board, it is likely that key metrics will focus on the risk taking activities which may materially impact the performance of the firm</li> <li>Day to day decision taking around risk may be guided by operational tolerances</li> </ul>
<b>Leverage existing material</b>	<ul style="list-style-type: none"> <li>A significant amount of existing processes and metrics should already be in place – this is likely to be a good starting point to develop a risk appetite framework</li> <li>Existing processes and metrics may be able to slot into the risk appetite framework or may crystallise the current view of the organisation's tolerance to risk taking</li> </ul>
<b>Clearly link risk appetite to strategy</b>	<ul style="list-style-type: none"> <li>Risk appetite should support the achievement of business strategy, hence there should be a clear link between the two processes</li> <li>The degree of risk taking which is acceptable within two managing agents may be significantly different and this will be reflected</li> </ul>

### Programme dependencies

As a large and complex transformational programme, there are a large number of interdependencies between individual elements of Solvency II implementation. Furthermore, to ensure a risk and capital management perspective is embedded within business decision making, dependency between Solvency II work streams is essential. Based on Lloyd's implementation plan, we have highlighted below the key interdependencies with risk appetite which may require consideration.

## Key risk appetite dependencies

Solvency II element	Dependencies to consider
<b>Internal model</b>	<ul style="list-style-type: none"> <li>Many risk appetite metrics are likely to be produced by the internal model hence risk appetite will impact specification of the internal model</li> <li>Conversely, given risk appetite metrics are likely to contain tolerances against specific internal model outputs, final parameterisation of the risk appetite framework may not be able to be completed until the model is producing reliable outputs</li> </ul>
<b>Governance framework</b>	<ul style="list-style-type: none"> <li>Ownership of the risk appetite framework and metrics should be clearly documented within the governance framework</li> <li>Similarly, escalation processes should be documented and evidenced within the risk governance structure</li> </ul>
<b>Internal reporting/ MI</b>	<ul style="list-style-type: none"> <li>Risk appetite is likely to drive a significant proportion of the risk management information, hence Board or other risk committee reports should include this specification</li> </ul>

Desired outcomes
<ul style="list-style-type: none"> <li>Risk appetite framework, consisting of top level risk appetite statements that are easily understood and communicated and that cover areas of material risk to the business.</li> <li>Operational tolerances that can be translated into day to day accountability and decision making</li> <li>Risk appetite measures that are concise and not overly complicated or detailed and that are readily supported by appropriate MI to enable regular reporting.</li> </ul>

## Risk governance

All agents have an existing risk governance structure in place, but it is important that this is reviewed and refined as necessary to ensure that all aspects of the risk universe and risk appetite are addressed.

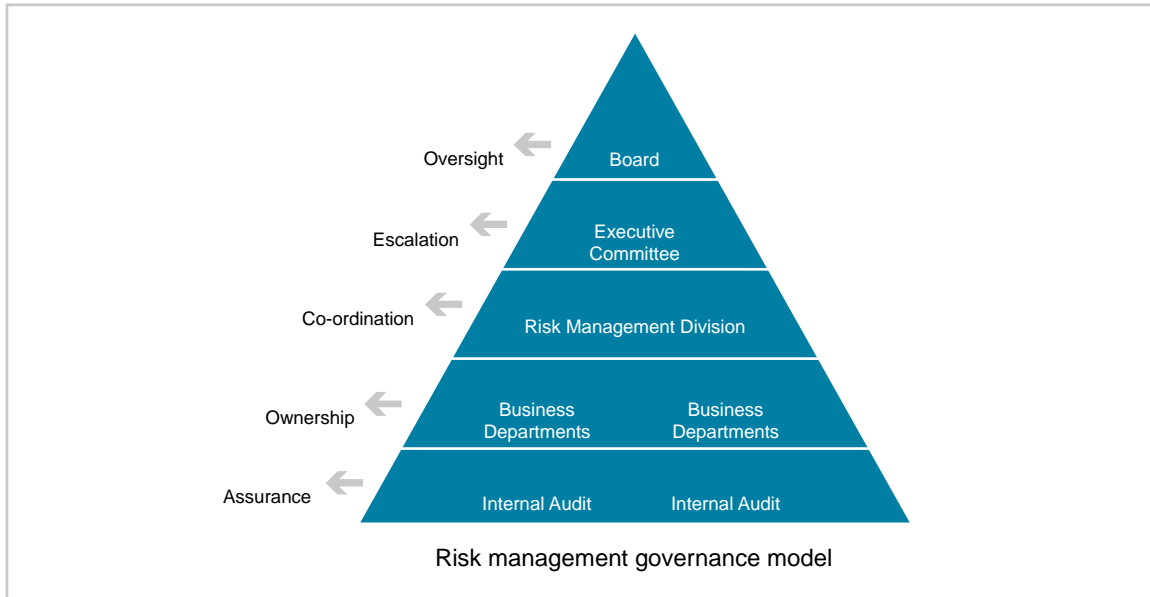
Details of Lloyd's own proposed risk governance structure are not included in this guidance. The structure is still under development and final internal approval is expected in May 2010. We do not expect managing agents to follow the same structure as Lloyd's, as this structure will be unique, given Lloyd's responsibilities for oversight of both syndicate and Lloyd's level risk.

There is no one structure for risk governance that is 'correct' and risk governance can be structured in a variety of ways. Whatever structure is adopted, agents should ensure that it provides the best fit with their own risk universe and risk appetite framework. The structure does not necessarily need to be complex, provided it is clear where risk issues are being addressed.

Two alternative approaches to a risk governance framework are outlined below.

### Example 1

A high level example of a possible **risk governance framework** is illustrated below.



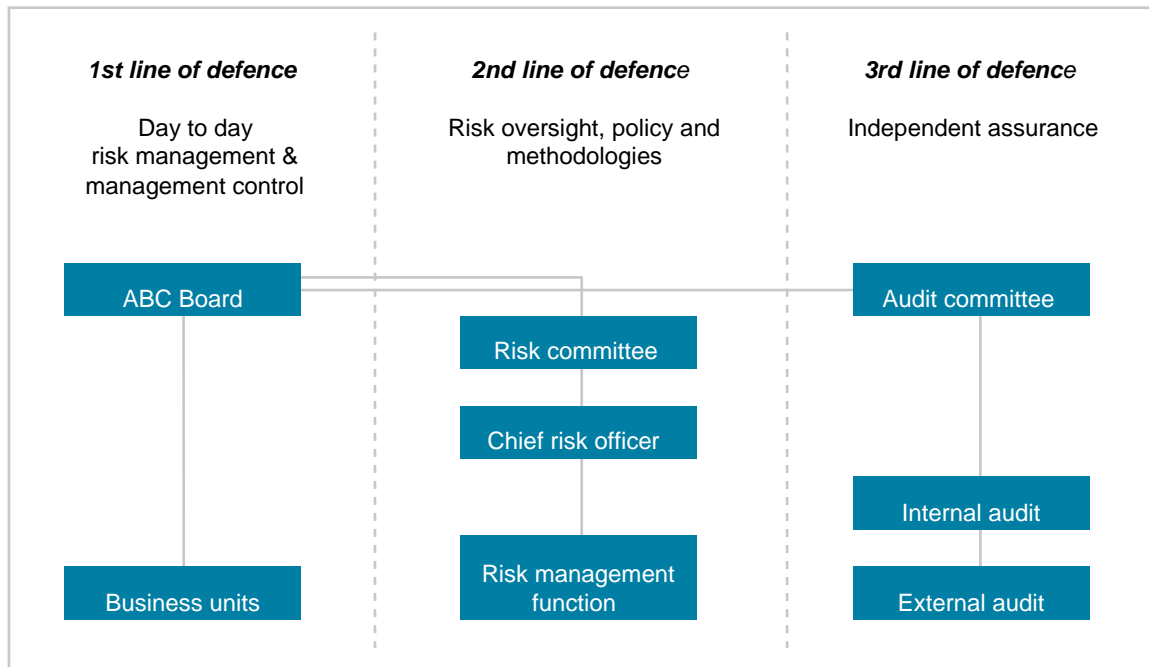
In this illustrative model, each party has the following roles:

- The Board has the ultimate accountability for the risk and related control environment, and is responsible for approving and reviewing risk policies;
- The Executive Committee is responsible for reviewing and challenging risk information and escalating issues to the Board;
- The Risk Management Division is responsible for the facilitation and co-ordination of risk management activity across the organisation;
- Business Departments are the “risk-takers” and are responsible for identifying, assessing, measuring, monitoring and reporting risk associated with their businesses or functions; and
- Internal Audit is responsible for independently assessing the effectiveness of risk management processes and practices and for providing timely objective assurance on the control of risk. It is possible to view risk management as providing pro-active control over risk and internal audit as providing more reactive control over risk.



## Example 2

One common governance model is the “**three lines of defence**” model, which is illustrated in the following diagram. This model may assist agents by providing a basis to develop and document the risk governance framework.



The **three lines of defence** framework operates as follows:

### 1<sup>st</sup> Line of Defence

Staff in the first line of defence have direct responsibility for the management and control of risk (i.e. staff and management working within or managing operational business units and the board).

As primary decision making authority, the 1st line of defence should focus on:

- Operational decision making to execute and implement strategic objectives
- Facilitation and oversight of the business and delivery against goals
- Management of activities
- Management of the risk profile of the business, in line with board expectations

### 2<sup>nd</sup> Line of Defence

Staff in the second line of defence co-ordinate, facilitate and oversee the effectiveness and integrity of the risk management framework (i.e. the risk committee and risk management division).

As a key input to decision making, the 2nd line of defence should focus on:

- Assurance to the board that the risk profile of the business is in line with expectations
- Escalating all material risk and capital issues to the board
- Provide input to, challenge and oversight of first line decision making where appropriate – i.e. the input of risk & capital information to aid effective decisions

The risk committee sits in the second line of defence. Many agents already have a risk committee in place, or a number of committees split by risk type. Where this is not the case, consideration should be given to establishing a risk committee/committees to provide effective oversight of risk management, leaving escalation to the board for the most significant issues.

Consideration should also be given to how the risk management system is brought together in its wider context, including actuarial and compliance, and the role that the risk management function plays in enabling this.

### 3rd line of Defence

Staff in the third line of defence provide independent assurance and challenge across all business functions in respect of the integrity and effectiveness of the risk management framework (i.e. internal and external audit).

<b>Desired outcomes</b>
<p>A risk governance structure that provides for:</p> <ul style="list-style-type: none"> <li>• clear ownership and accountability for risk</li> <li>• complete coverage of risks</li> <li>• interaction between those with appropriate expertise where necessary e.g. addressing risks where there are significant dependencies in the same forum</li> <li>• different levels of monitoring, reporting and management, including</li> <li>• top level oversight (e.g. the board), with focus on key risk issues and ability to consider interdependency between risks</li> <li>• link to internal model/strategy</li> <li>• sufficient detail of discussion and reporting of risks, which may be delegated to operational levels</li> <li>• appropriate escalation of risk issues from operational to higher levels</li> <li>• engagement from across the business, including 'first line' risk takers such as underwriters, to enable effective escalation and reporting of risk issues</li> </ul>
<p>Risk governance structure that is agreed and documented in advance of its use</p>

### Documentation

Under Solvency II agents will need to ensure that they have a documented risk strategy and written risk policies and these will need to be in place in advance of their use. In Lloyd's view agents' priority should be to first agree the framework for the risk management system, including addressing the components outlined in this guidance, and to ensure that this has appropriate internal approval and sign-off. Completion of the required documentation should then follow on from this design stage.