Market Bulletin

LLOYD'S

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FROM:	Director, Franchise Performance
LOCATION:	86/G5
EXTENSION:	6711
DATE:	12 August 2003
REFERENCE:	Y3114
SUBJECT:	**2004 ANNUAL FRANCHISEE BUSINESS PLANS ("AFBP")**
ACTION POINTS:	**Managing agents to note**
DEADLINE:	**12 September 2003 for submission of "AFBP" information from non-aligned syndicates** **15 October 2003 for submission of "AFBP" information from aligned syndicates**

1. Purpose

The purpose of this bulletin is to inform managing agents of the requirements for business planning information in respect of the 2004 year of account.

Managing agents are required to produce business planning information in respect of each active syndicate for the 2003 and/or 2004 year of account.

2. Development strategy

The updated AFBP templates, pre-populated with the data already submitted, will be available shortly and will be e-mailed to the contact name submitted in the 20 June 2003 submission.

3. September submission - Annual Franchisee Business Plans

Full Annual Franchisee Business Plans should be submitted by no later than:

> **12 September 2003 – for non-aligned syndicates**
> **15 October 2003 – for fully aligned syndicates, (though any material change to figures supplied in the June submission should be notified by 12 September 2003 in order to update the RBC model).**

The co-ordination of the returns will be handled by Information Services, MSU ("MSU"). The updated software containing the full requirements will be e-mailed to the contact name submitted in the June submission. Returns should be submitted to Lloyd's via the Market Returns L-Net website. Returns will then be collated and data sent to the relevant departments within the Corporation.

4. General

The 2004 template is an Excel workbook. Each section of the plan sits within a separate sheet within that workbook. Each section is intended to be self-contained, and therefore there is no requirement for a user manual. Each section will indicate whether information is required in a prescribed format (for example complete a data table) or can be submitted in alternative formats (for example the attachment of a Word document, Powerpoint presentation etc). Please always use values and not formula when entering data.

The spreadsheet contains macros, and there will be a message flashed onto the screen when the workbook is opened. Please click "Enable macros" to allow the functionality to work.

Where there are data tables or text boxes in the workbook, it may be necessary to increase their size in order to print the document. To do this either use the normal Excel functionality or use the buttons placed immediately to the right of each table or box. Worksheets can be printed off using the normal Excel functionality. Alternatively, there is the option to print any combination of sheets simultaneously, which is available on the "printing" sheet of the template.

5. Changes to previous templates

General Changes

There are some changes to section 3 "Strategic Risk". Two additional questions have been added, covering the LMP principles and the ACORD Standards project.

Managing agents will recall that Lloyd's is committed to the ACORD initiative that produced the new exposure and binding authorities data standards. This is an important project for the market, whose implementation will create efficiency and reduce costs, and the resulting flow of information is key to allowing carriers to monitor risks written and their ultimate exposure liabilities. More information and the implementation guidelines for the standards can be obtained from ACORD by contacting either Bgayton@acord.org or Pbrown@acord.org.

There is one change to section 8 "Financial" and section 18 "UW Targets". An additional column has been added to separate Business Agreement Fees from Brokerage and Commissions.

Related party transactions

The Related Parties Byelaw will be revoked at the end of the year and related party transactions will be dealt with through the business planning process. For all related party transactions the information requested in the appropriate sections of the template should be provided.

Submissions in respect of consent for inwards or outwards reinsurance business for the remainder of 2003 should be made to the Admissions department and include the same information as required by the AFBP. There is no longer a requirement to submit the related parties return in August 2003.

Risk Management

There are a number of sections within the 2004 business plan requirements which directly relate to risk management. The significant change from the 2003 business plan process is the move away from open requests for policy statements in many areas to more specific questions on key issues. The LMA Risk Management Committee has been consulted on these sections of the 2004 plan and changes have been made following its comments.

Managing agents are invited to a presentation on August 22nd at 12.00 in the Old Library where members of Risk Management will explain the risk management development work and the thinking behind the risk management sections of the business plan. (Please contact Kathy Taylor on 0207 327 5768 if you wish to attend the presentation).

A key element to this work is the development of a risk management framework which will underpin all risk management activity. Further information about the framework being developed for the Franchise is set out in Appendix 1.

Outsourcing is an issue that represents a potential operational risk to businesses. This has been the subject of a recent questionnaire and is currently under review by the Risk Review department. In future years, this will form part of the content of the Risk Management section.

6. Queries

Any queries regarding the functionality of the spreadsheet should be directed to Ash Shah on 0207 327 6858.

Any queries relating to the content of the returns should be sent to the general business planning mailbox, businessplans@lloyds.com, or Lloyds-Businessplans via the GAL.

Alternatively, queries relating to the "General" and "Performance" sections of the return can be directed to David Roe or David Indge, on extensions 6518 and 5716 respectively.

Queries relating to the "Risk Management" sections of the return can be addressed to Philip Whittingham, Stephen Moore or Andrew Gurney on extensions 6229, 6984 and 6194 respectively.

The requirements set out in this bulletin and the business plan template have been made under part C of the new Underwriting Byelaw.

This bulletin is being sent to all active underwriters, managing agents, members' agents, recognised accountants, market associations and corporate members.

Rolf Tolle
Franchise Performance Director

Appendix 1

Risk Management Framework

The Franchise Board has set a strategic commercial imperative that there should be an outstanding risk management capability throughout the Franchise, in respect of both franchisees and the franchisor. The Board therefore sees it as fundamental that Lloyd's as a whole and the franchisees participating in the market develop the necessary capabilities to meet this objective.

General requirements to operate risk management systems also arise from both Lloyd's codes of practice and the FSA's Integrated Prudential Sourcebook.

Lloyd's requirements[1]:

"the existence of risk management systems which are based on the nature, size and complexity of the business, and which measure the risks incurred in all the agent's activities including market, credit, operational and legal risks and which incorporate control mechanisms to alert management where risks become unacceptably high, e.g. exception reports."

[Draft] FSA requirements[2]:

"...firm to take reasonable care to establish and maintain such systems and controls as are appropriate to its business. This includes appropriate systems and controls by a firm over activities that give rise to significant market, credit, insurance, operational or group risk."

"Depending on the nature, scale and complexity of its business, it may be appropriate for a firm to have a separate risk assessment function responsible for assessing the risks that the firm faces and advising the governing body and senior managers on them."

"The organisation and responsibilities of a risk assessment function should be documented. The function should be adequately resourced and staffed by an appropriate number of competent staff who are sufficiently independent to perform their duties objectively."

It is therefore expected that franchisees will strive towards best practice risk management in order to fit with the Franchise Board's goal of maintaining and developing an outstanding risk management capability throughout the Franchise and to meet the other requirements.

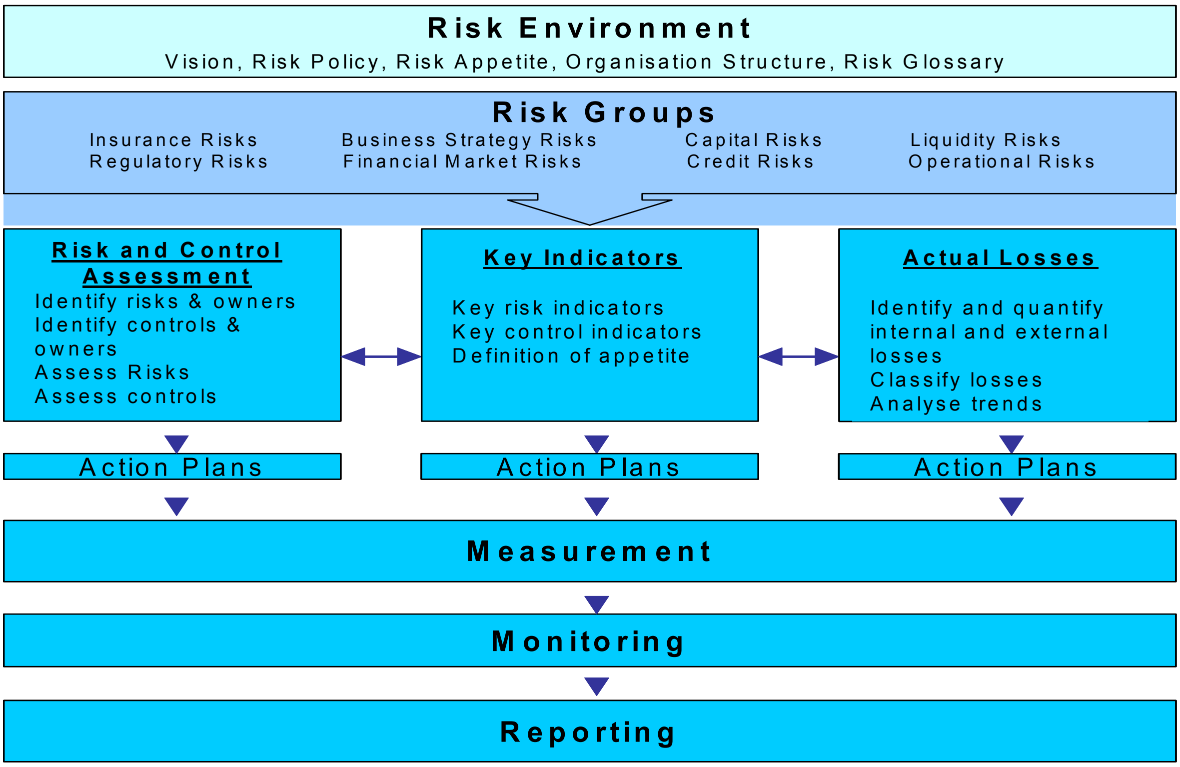
[1] Lloyd's Code for Managing Agents: Sound and Prudent Management.
[2] [Draft] FSA Integrated Prudential Sourcebook PRAG 6.5 (Prudential Systems and Controls).

Risk Framework

Successful risk management is so fundamental to the success of the Franchise that a significant amount of work is being undertaken to raise the risk management capability within Lloyd's. A key element to raising the risk management capability within Lloyd's is the development of a risk management framework which is intended to underpin all risk management activity. The introduction of a risk management framework in Lloyd's will help raise the risk management capability by:

- Ensuring that all major risks to the Franchise objectives are tracked, quantified and risk management strategies are defined;
- Ensuring that all major risks are owned and responsibilities are defined;
- Providing key risk management information to appropriate parties, including reporting on the risk profile of the Franchise;
- Encouraging the consideration of risk appetite for key risk areas;
- Enhancing communication on risk;
- Ensuring consistency in risk terminology across the Franchise; and
- Integrating Franchisees' risk management processes.

The Risk Management Division is developing a risk framework that it considers appropriate for the key risks facing the Franchise, and which sets out the key stages of the risk management process. This is being developed with reference to the joint risk management industry standard prepared by the Association of Insurance and Risk Managers ("AIRMIC"), The National Forum for Risk Management in the Public Sector ("ALARM") and the Institute of Risk Management ("IRM") and other risk management models and frameworks. The Risk Management Division has coordinated an initial risk and control assessment exercise, which is discussed further below. Later stages of the development work will focus on key indicators for risks and controls and monitoring of actual losses. The framework that is being developed for the Franchise is represented in the diagram below.



<u>Elements of the Risk Framework Explained</u>

Risk - A risk is the threat that an event or action will adversely affect the achievement of the Franchise Objectives resulting in, for example, financial loss or reputational damage.

Risk Environment - It is essential to develop and define risk policy and risk appetite, as well as a terminology that will be used consistently throughout the Franchise. The Risk Environment is dynamic, for example, the risk appetite set by the Franchise Board may need to be updated as the insurance cycle changes.

Risk Appetite - The appetite is the tolerance that a business has for the risk in its day to day and strategic business activities.

Risk Groups - Risks are identified and grouped in order to facilitate monitoring and reporting.

As part of the framework development, eight risks groups have been identified which can be used to summarise risks faced by the Franchise. Each risk group contains risks that might result in financial loss to, or damage to the reputation of, the Franchise.

Insurance Risk - the risk of loss arising from the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities
Business Strategy Risk – the risk of loss arising out of Lloyd's market position, strategic direction and commercial interests
Operational Risk – the risk of loss, resulting from inadequate or failed internal processes, people or systems, or from external events
Financial Market Risk – the risk of loss resulting from adverse financial market movements such as interest rates or exchange rates
Credit Risk – the risk of loss arising from the inability of a counterparty to fulfil its payment obligations. For Lloyd's the key counterparties are reinsurers, brokers and insureds
Capital Risk – the risk of loss arising from inappropriate levels or sources of capital
Regulatory Risk – the risk of loss arising out of Lloyd's dealings with both UK and overseas regulators
Liquidity Risk – the risk that sufficient liquid financial resources are not maintained to meet liabilities as they fall due

<u>Risk and Control Assessment</u>

Definition of Assessment: risks and controls are identified and given an intuitive high level score.

Control – a preventative or detective process intended to manage the inherent risks identified within a business. This will normally involve reduction in the impact and/or likelihood of a risk, but may also involve acceptance, transfer or elimination.

For Lloyd's centrally, risks and controls have been identified in relation to the Franchise objectives, via a number of risk identification sessions. All risks and controls identified have explicit owners who have direct responsibility for the management of the risks and controls.

Both risks and controls have been assessed at a high level in order to quantify the inherent risk (before the application of controls) and the residual risk (after the application of controls). Risks have been assessed in terms of impact and probability. Controls have been assessed in terms of design and performance.

Assessment of Risk Impact:

A No material impact
B Material impact, no significant lasting risk to Society
C Significant risk to Society
D Potential Society failure

Assessment of Risk Probability (probability of occurrence within the next 12 months):

1 <5 % likelihood
2 5% to 25% likelihood
3 25% to 50% likelihood
4 >50% likelihood

Assessment of Control Design:

Green - designed to reduce risk entirely
Yellow - designed to reduce most aspects of risk
Amber - designed to reduce some areas of risk
Red - very limited or badly designed, even where used correctly provides little or no protection

Assessment of Control Performance:

Green - control is always applied as intended
Yellow - control is generally operational but on occasions is not applied as intended
Amber - control is sometimes applied correctly
Red - control is not applied or applied incorrectly

Key indicators – This component of the risk framework will monitor the risks and controls to show movements in the impact or likelihood of risks or in the design or performance of the controls. Risk indicators will also monitor whether a risk event has occurred and the control indicators will also monitor whether a failure in control has occurred. The risk appetite will be reflected by using key indicator tolerance levels. Key indicator parameters will be updated as risk appetite changes.

Actual Losses – This component of the risk framework will monitor actual internal or external loss events. Actual loss events will then be linked to control failures or inaccurate risk assessments. This process will ensure that risk and control assessments can be challenged.

Action Plans - Risk management strategies, primarily arising out of risk and control assessments, but also from key indicators and losses, will be formalised and assigned to individuals who will then be accountable for this action within a specific timeframe. Action plans might be based on strategies to mitigate risk, however, alternatives might include risk transfer, capitalisation or retention of the risk.

Measurement - This is likely to involve detailed modelling and the measurement of key risks in financial terms.

Monitoring - Risk information will be recorded at all stages of the process within a risk management system so that the risks identified, the outcome of the risk and control assessment, analysis of key indicators/losses and progress against action plans can be tracked via the framework.

Reporting - Regular standardised reports are distributed to a number of individuals or groups according to requirements. A key standard report is the quarterly risk map which is produced for the Franchise Board.