LLOYD'S

MARKET BULLETIN

From	Rolf Tolle, Franchise Performance Director (extn 6743) Luke Savage, Finance & Risk Management Director (extn 6711)
Date	6 July 2006
Reference	Y3844
Subject	**The introduction of further Performance Framework components:- Lloyd's Underwriting Management Principles and Minimum Standards ('Lloyd's Underwriting Management Standards') and Lloyd's Risk Management Principles and Minimum Standards ('Lloyd's Risk Management Standards')**
Subject areas	The underwriting of all business in the Lloyd's market. The management of operational risk in the Lloyd's market.
Attachments	Appendix A – Introductory notes concerning Franchise Standards Appendix B – 'Lloyd's Underwriting Management Standards' Appendix C – 'Lloyd's Risk Management Standards'
Action points	- **To confirm the introduction of new Principles and Minimum Standards relating to the management of underwriting and risk across the Lloyd's market** - **All franchisees should review their current procedures to ensure that they meet or exceed these standards during the transition period to the end of 2006**
Deadlines	**'Lloyd's Underwriting Management Standards' and 'Lloyd's Risk Management Standards' are effective from 1 January 2007, allowing for any necessary actions to be taken during the remainder of 2006**

Introduction

This Bulletin attaches the 'Lloyd's Underwriting Management Standards' and the 'Lloyd's Risk Management Standards' which were made by the Franchise Board under the Underwriting Byelaw, all of which come into force on 1 January 2007, following a transition period.

Background

During Q4 2005, the Franchise Board endorsed the requirement for a 'clear and transparent Performance Framework' as an essential component of the future 'Optimal Platform'. The Franchise Board endorsed high level Principles and Minimum Standards for underwriting and risk management at the end of March 2006. To provide greater clarity regarding how the standards could be met 'Guidance' notes have been developed with extensive market input. These minimum standards and 'Guidance' notes are now being published via this Market Bulletin, alongside the existing 'Lloyd's Claims Management Standards' (published under Market Bulletins Y3579 and Y3802).

Market performance in underwriting activities is too variable and the introduction of minimum standards will provide a benchmark for all franchisees to meet or exceed. It is recognised that many franchisees are already operating above the minimum standards.

From the outset this initiative has been taken forward in partnership with the LMA and their relevant committees. In the case of the 'Lloyd's Underwriting Management Standards' market personnel from 18 franchisees (in addition to LMA staff) assisted Franchise Performance personnel to shape the 'Guidance' notes. The 'Lloyd's Risk Management Standards' were developed with the LMA Risk Management Committee.

The LMA Underwriting & Claims Committee (UCC) has ensured that the LMA Board and the market were regularly briefed on these initiatives. Three UCC Forums (open to all managing agents' staff) have been held at monthly intervals at which detailed progress has been provided on the development of the 'Lloyd's Underwriting Management Standards' proposals. The draft 'Guidance' for underwriting was despatched to all Underwriting and Compliance Directors in June (with the previously agreed Lloyd's Underwriting Management Principles and Minimum Standards), requesting any significant concerns.

'Lloyd's Risk Management Standards' have also completed a process of market consultation, coordinated with the LMA.

Consultation feedback

Initial feedback on the 'Lloyd's Underwriting Management Standards' proposals was broadly positive. The feedback has been used to reshape the Introductory notes and 'Guidance' notes. The franchisor has responded to all franchisees regarding their individual concerns, as well as to the market as a whole. The main issues of concern were:

- that 'Guidance' notes were seen in some areas as too prescriptive:- It was accepted that a balance is required between ensuring acceptable levels of performance within all franchisees, while allowing franchisees to adopt their preferred methods to achieve required performance standards. Also, there is no suggestion that franchisees are being encouraged to adopt minimum levels of performance.

- that performance review will focus only on the effectiveness of management processes, to the exclusion of good track records and experienced personnel:- the Introductory notes have been made clearer, confirming that a balanced view of performance will be sought. Franchisor staff will be encouraged to work with franchisees, recognising that franchisees may have a variety of approaches to meet the published standards.

- that pricing and rate monitoring is requested at individual risk level:- it is accepted that the calculations that make up prices may be done at individual risk, portfolio or some other level, taking account of the particular features of a class of business. The franchisor is seeking clarity, not bureaucracy.

While setting out requirements for minimum standards of performance the franchisor is also seeking to assist and encourage franchisees wanting to perform at significantly higher levels and it is intended that superior performance will be recognised over time.

Implementation

During the period of transition to 1 January 2007, the franchisor will be reviewing performance with franchisees. Existing processes will be used where appropriate, including business planning, RDS, reinsurance returns, reviews of coverholders and risk reviews. This activity (including requests for information) will be coordinated to the extent possible, taking account of priorities.

Once these standards are in force the relevant Codes will be repealed in order to create one source of requirements and guidance at Lloyd's, insofar as this is possible. The Minimum Standards relating to Delegated Underwriting have been revised, in line with the working group's recommendation, to clarify requirements without the need for reference to the current Code of Practice.

In a number of areas these standards will be more detailed than any minimum regulatory requirements set by the FSA. This reflects the need to ensure higher levels of performance in the market given the mutual nature of the market's rating, brand and Central Fund.

It is planned to maintain the Franchise Standards and 'Guidance' on Lloyd's.com which will help to make them easily accessible.

It is intended that these standards will be reviewed annually to ensure that they remain appropriate and will be revised where necessary.

The authority to enforce compliance with Franchise Standards is exclusively vested in the Franchise Board.

Enquiries

Any enquiries about 'Lloyd's Underwriting Management Standards' can be addressed to:
Kieran Flynn - 020 7327 5739 (Kieran.Flynn@Lloyds.com)
Any enquiries about 'Lloyd's Risk Management Standards' can be addressed to:
Olly Reeves – 020 7327 6229 (Olly.Reeves@Lloyds.com)

Rolf Tolle, Franchise Performance Director, Lloyd's
Luke Savage, Finance & Risk Management Director, Lloyd's

Appendix A

LLOYD'S

FRANCHISE STANDARDS

INTRODUCTION

Lloyd's is the world's leading specialist insurance market and is committed to being the most competitive platform in the world for the trading of specialist and large insurance and reinsurance property and casualty risks.

Lloyd’s as franchisor provides the trading platform which delivers various benefits to its franchisees, including a common financial strength rating, cost-effective access to the world’s major insurance markets and a global brand. In return, Lloyd’s has stated requirements of each franchisee.

Lloyd's has overall performance objectives for the franchise. Each franchisee must perform to the standard required for the franchise to succeed overall. To ensure that the requirements are clear, Lloyd's has developed the Franchise Standards.

The Franchise Standards set out Lloyd’s requirements of each franchisee. They are driven by Lloyd's Franchise objectives, and take into account the expectations of the FSA.

The Franchise Standards have been produced in consultation with the Lloyd's Market Association, representing all Lloyd’s franchisees. The Franchise Standards reinforce Lloyd's brand, thereby maintaining Lloyd's market reputation and the reputation of all firms trading there.

The Franchise Standards apply to existing franchisees, and new entrants seeking admission. They also apply to Lloyd's as franchisor, where applicable.

APPLICATION OF LLOYD’S FRANCHISE STANDARDS

The Franchise Board has prescribed the following standards and arrangements for the conduct and administration of insurance business at Lloyd’s provided always that failure to comply with these standards and arrangements shall not invalidate or call into question any contract or agreement entered into by or on behalf of a managing agent or syndicate nor shall failure to comply with these standards and arrangements create any right of action or claim in any third party against a managing agent or syndicate, the authority to enforce compliance being exclusively vested in the Franchise Board.

FRANCHISE STANDARDS STRUCTURE

PRINCIPLES AND MINIMUM STANDARDS

These are statements of business conduct required by Lloyd's. The Minimum Standards are established under relevant Lloyd's Byelaws relating to business conduct. The Franchise Standards apply to all businesses, regardless of size, complexity, diversity or organisational structure.

GUIDANCE

The 'Guidance' notes which accompany the Minimum Standards have been developed with extensive market involvement and support. These provide a more detailed explanation of the general level of performance expected. They are a starting point against which each franchisee can compare its current practices to assist in understanding relative levels of performance. These 'Guidance' notes are intended to provide reassurance to franchisees as to approaches which would certainly meet the minimum standards. However, it is appreciated that there are other options which could deliver performance at or above the minimum level and it is fully acceptable for franchisees to adopt alternative procedures as long as they can demonstrate that the required minimum standards can be achieved or exceeded.

ADVICE

Advice may also be issued in the future. This could be tools and practical solutions relating to the required business conduct. Advice may include techniques, templates and worked practical examples which may be adopted by businesses to meet their specific needs.

HOW WILL FRANCHISEES BE ASSESSED AGAINST THE FRANCHISE STANDARDS?

- All franchisees are required to meet the Franchise Standards. These represent the minimum level of performance required of any organisation within the Lloyd's market.

- In assessing performance the franchisor will take account of the historical record of the syndicate(s) managed and the experience of underwriters, as well as the effectiveness of management procedures .

- Franchisees that manage only to the minimum standard required should expect the level of capital within their ICAs to reflect that level of operating risk.

- Franchisees able to demonstrate consistently higher levels of performance, by comparison to the minimum standards, may be able to justify lower levels of capital within their ICAs, reflecting lower operating risk.

- New applicants for admission to Lloyd's will be required to demonstrate their immediate capability to meet the Franchise Standards, as an entry criteria.

MEASUREMENT & MONITORING

- The franchisor will seek assurance that franchisees meet the Franchise Standards, via existing processes of review wherever possible.

- Data will be required to assess performance across the market and every effort will be made to ensure that the number of individual data requests by the franchisor is rationalised and duplication avoided.

- Benchmarking information will be provided to franchisees wherever possible, to assist in the management of their own businesses.

- Franchisees should be able to measure and monitor their performance to demonstrate that the Franchise Standards are being met. Internal reporting should enable each franchisee's board to assess performance and respond to those areas which may need improvement.

- The franchisor will work with franchisees in its 'business partner' role to assist them in identifying and implementing necessary improvements where requested.

- As stated above each franchisee is expected to at least meet the Franchise Standards and there will be adequate time allowed to address any gaps. Thereafter, any persistent and significant underperformance will be addressed in proportion to the issues involved.

Appendix B

LLOYD'S

UNDERWRITING MANAGEMENT

THE FRANCHISEE EFFECTIVELY MANAGES ITS UNDERWRITING IN SUPPORT OF ITS BUSINESS STRATEGY

Responsibility for meeting the Lloyd's Underwriting Principles and Minimum Standards rests with each franchisee's board, whether their underwriting is undertaken in house, whether any underwriting authority is delegated to third party(s), or whether underwriting-related services are procured externally.

PRINCIPLES

1 UNDERWRITING STRATEGY AND PLANNING

The franchisee has an effective process for challenging the annual business plan which itself forms part of the long-term plan for each managed syndicate

2 UNDERWRITING AND CONTROLS

The franchisee has effective systems and controls over each managed syndicate's underwriting

3 DELEGATED AUTHORITY

The franchisee has effective systems and controls wherever underwriting authority has been delegated to another entity

4 PRICING AND RATE MONITORING

The franchisee has appropriate pricing methodologies and effective rate monitoring processes

5 EXPOSURE MANAGEMENT AND ASSESSMENT

The franchisee has effective systems and processes to record, monitor and assess its underwriting exposures

6 REINSURANCE

The franchisee has effective controls over its outwards reinsurance arrangements

7 DATA QUALITY

There are effective systems for the recording and reporting of underwriting-related data to management and the franchisor

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

1 UNDERWRITING STRATEGY AND PLANNING

PRINCIPLE

The franchisee has an effective process for challenging the annual business plan which itself forms part of the long-term plan for each managed syndicate

MINIMUM STANDARDS

The franchisee can demonstrate that it has an effective process for:

- developing, challenging and approving each managed syndicate's annual business plan
- ensuring that the annual business plan is implemented, followed and kept under regular review.

An effective process has the following features:

- the annual business plan and any amendments are approved by the board and its implementation and operation is under the day-to-day control of a nominated director(s)
- it ensures that the board actively tests the key assumptions and targets in the annual business plan, keeps the plan under review at least quarterly and approves any material amendment

UNDERWRITING MANAGEMENT

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2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

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6 REINSURANCE

7 DATA QUALITY

GUIDANCE

1 UNDERWRITING STRATEGY AND PLANNING

Developing, Challenging and Approving the Business Plan

Ownership: The franchisee's board is responsible for the franchisee's business planning process. This will normally be achieved by a director being nominated to take responsibility and ensuring that the director and supporting staff have adequate time and the requisite skills and experience to manage and execute the process effectively. The business plan should be approved by the franchisee's board.

Strategy: To support the business planning process, it is expected that each franchisee will have a written underwriting strategy that:

- explains how it will deliver the targeted returns over the underwriting cycle, to appropriate levels of detail for each syndicate (including gross premium and losses, and key business assumptions) over a three year horizon and
- identifies the franchisee's strengths and weaknesses and
- identifies any significant external factors that either support or inhibit the franchisee's strategy.

Developing the franchisee's Business Plan: The franchisee's business plan will typically contain the following elements:

- a defined risk appetite, both gross and net of reinsurance
- each syndicate's risk accumulations, as included within the ICA. These risk accumulations should be within the existing 'Franchise Guidelines' issued by the franchisor, other than where exceptions have been granted by the franchisor (further detail is included within the Additional Notes that follow)
- a projected % ROC that is reasonable, both gross and net of reinsurance, for each syndicate class of business - capital projections should be on the same basis as the relevant ICA.
- the forecast ultimate loss ratios at an appropriate level of detail. (Ideally, defining the attritional, large and catastrophe loss components)
- a proposed reinsurance programme defined in terms of limit, cost and reinstatement.(Ideally, also setting out,

security by rating tier, recoveries assumed and any other features deemed to be material by the franchisee).

- all material assumptions by each major category of underwriting
- The business plan will normally contain an explicit consideration of the resources required to execute the plan.

A copy of the business plan should be made available to the franchisor on request.

Challenge and Approval: The business plan, including the underlying assumptions, should be subject to rigorous challenge by appropriate staff with significant issues documented, prior to being submitted to the franchisees board. Challenges would typically include stress and scenario testing. The franchisee’s board will normally consider the content and outcome of the challenges as part of their review process, prior to considering approval of their business plan.

The franchisee’s assessment of the adequacy of existing resources and its plans to address any resource shortfalls are likely to include people, processes, skills, operating ‘culture’ and networks.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

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2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

1 UNDERWRITING STRATEGY AND PLANNING

Ensuring that the Business Plan is Implemented and under constant Review

Implementation and Review. Progress against the business plan will typically be reviewed at least monthly by the nominated director.

Key Performance Indicators (KPI's) identifying whether business performance is progressing in line with the business plan should be identified. It is expected that a written record will be kept of performance against these criteria and this will normally be reviewed at least quarterly, with actions taken where appropriate to address variances from plan.

UNDERWRITING MANAGEMENT

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2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

1 UNDERWRITING STRATEGY AND PLANNING

Ensuring that the Business Planning process is Effective

Linking the business plan to related processes*:* The output of the business planning process, both initially and on an ongoing basis, should be integral with other processes operated by the franchisee including:

- Financial Reporting
- ICA review
- Exposure management
- Reinsurance purchase
- Reserving
- Underwriting and Claims Management
- Syndicate Business Forecast (SBF)

[Please note that the SBF return does not constitute the franchisee's business plan].

Franchisee board review: Reports showing progress against KPIs will normally be reviewed at least quarterly by the franchisee's board to ensure that the business plan objectives remain reasonable.

Effective planning process: The effectiveness of the business planning process will be kept under review by the nominated director with recommendations made to the franchisee's board regarding any required changes.

Advising Lloyd's of variances: Material deviations* from the Business Plan should be advised to the franchisor and, if requested to do so, the relevant SBF and ICA should be resubmitted to the franchisor to reflect the deviation as soon as practicable.

[*For example change in the final result, or change in the amount of risk in the plan]

The following Additional Notes are intended to assist franchisees with the implementation of the Underwriting Standards

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

ADDITIONAL NOTES

1 UNDERWRITING STRATEGY AND PLANNING

Strategy:- *is expected to take account of the Business Plan Narrative relating to syndicate strategy set out under Section 21 of the SBF Instructions 2006 (and any revisions contained in subsequent annual instructions).*

Strategic plan horizon:- *Reference is made to strategic planning being to a three year horizon. The intention is that strategic and business plans should be aligned with the ICA and SBF approach and content. It should be noted that the '2007 ICA Guidance and Instructions' make clear that in response to FSA expectations, ICAs from the 2008 year of account will use a three year approach. For the 2007 year of account ICAs may be on a one year or multi year basis.*

Developing the franchisee's business plan:- *the content may include the following, depending upon the categories of underwriting:*

- *renewal ratio in terms of both policy count and premium*
- *anticipated risk-adjusted premium and exposure volume change*
- *new business volume written with both policy count and premium, with the rate adequacy assumed to apply*
- *non renewal ratio in terms of policy count and premium*
- *anticipated changes in loss experience, including claims inflation*
- *for each major category of underwriting, attritional, large and catastrophe loss definition and allocation, together with associated reinstatement premiums inwards and outwards, as well as profit commissions and other loss sensitive acquisition expenses*
- *a review of historical data for each syndicate class of business included in the business plan*
- *underwriting year expectations, based on quarterly progressions.*

Franchise Guidelines relating to risk accumulations:-

- *The maximum gross and net exposures to a single Lloyd's specified Realistic Disaster Scenario (RDS) event for a syndicate are up to 75% and 20% of syndicate capacity respectively*

- *The maximum gross line that a syndicate should have on an individual risk is 10% of capacity*

Key Performance Indicators (KPI's):- *Franchisees are expected to select measures of performance which will allow them to assess progress against their strategy and business plan. In selecting these measures, consideration should be given to KPIs which assess progress at an aggregated level (e.g. current vs. prior year loss ratios at portfolio level - using techniques such as 'Bridge Analysis'). Consideration should also be given to KPIs which assess progress at individual risk level (e.g. weighted average premium rate adequacy for year to date)*

Franchisees are likely to benefit in the following ways from having effective Strategy and Planning processes:-

- *the reasonableness of the business plan will be checked at many stages of its development, so that issues are identified and addressed early*
- *the franchisee will have the resources to achieve the projected business plan targets*
- *the business plan will be developed as part of the franchisee's whole business process, so that any consequent effects of plan changes are considered within all of the related processes above*
- *the process of business planning will itself be subject to continuous review and improvement*
- *the franchisor will be kept informed of progress and will be able to assist as required, in a timely manner.*

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UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSSMENT

6 REINSURANCE

7 DATA QUALITY

2 UNDERWRITING AND CONTROLS

PRINCIPLE

The franchisee has effective systems and controls over each managed syndicate's underwriting

MINIMUM STANDARDS

The franchisee's board should ensure that there are effective underwriting systems and controls in place.

Effective systems and controls have the following features:

- they ensure that underwriting takes into account:
  - the syndicate's annual business plan and underwriting policy
  - the underwriter's terms of reference and authorities pricing policy
  - exposure management information
  - the syndicate's reinsurance arrangements
  - the requirements for contract certainty
  - external regulatory requirements
- they ensure that the franchisee keeps (or has the right to access) all relevant information in respect of each risk underwritten by the syndicate including the slip and the placing documentation
- they ensure that a representative range of risks underwritten by the syndicate is reviewed and assessed regularly by an appropriately qualified individual who is independent of the underwriter of those risks
- they ensure that underwriting decisions are the subject of an appropriate peer review process
- they require the referral of risks or underwriting decisions which are outside an underwriter's agreed levels of authority

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

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3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

2 UNDERWRITING AND CONTROLS

Effective systems and controls - Overview

Effective systems and controls are essential for the delivery of the franchisee's strategic and business plans. To facilitate this it is expected that the franchisee's board will nominate one director to be responsible for the franchisee's underwriting systems and controls and ensure that the nominated director and supporting staff have the requisite skills, experience and available time to manage and execute the controls effectively.

Reference to 'Effective systems and controls' should be interpreted as widely as necessary for the effective management of each syndicate. Controls are seen broadly to sit under two headings:

- Prevention controls - These include, for example, written authorisation and proactive management of each individual's underwriting authority and the proactive management of any variances to prescribed procedures/ authorities.

- Detection controls - These include, for example, internal audit reviews, peer review processes and independent reviews.

Franchisees' controls would normally reflect the levels of value and the degree of risk within their underwriting activities.

It is expected that franchisees will have their systems and controls for the effective management of each syndicate set out in writing.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

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3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

2 UNDERWRITING AND CONTROLS

<u>Syndicate's annual business plan and underwriting policy</u>

The franchisee's underwriting controls will ensure that underwriting is aligned with their strategy, approved business plan and underwriting policy. The underwriting policy will typically contain the following elements:

- each syndicate's line guide details by class of business
- a process for authorising material deviations from the business plan or line guide requirements
- each syndicate's approach to fronting business for other insurers
- each syndicate's approach to ensuring that Contract Certainty is achieved

Franchisees are expected to have controls in place to ensure that regulatory requirements and the scope of Lloyd's market licences are clearly understood and that risks are written within those requirements.

<u>The underwriter's terms of reference and authorities</u>

It is expected that each underwriter's terms of reference and authority should be written, properly authorised and reviewed annually to reflect his/her experience and knowledge and to ensure alignment with the business plan (It would be good practice for each underwriter to signify agreement by signing his/ her authority details).

<u>Pricing Policy</u>

Franchisees need to have a clear expectation of pricing levels and an audit trail to show how pricing will deliver the projected results within the approved business plan and how pricing will be managed over the relevant underwriting cycle.

<u>Exposure Management Information</u>

The franchisee's underwriting controls are expected to ensure that underwriting activities take account of their updated aggregate exposure management and assessment information and that:

- aggregates are managed within the parameters of the approved business plan
- appropriate reinsurance coverage is in place

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

The franchisee's board should ensure that there are effective underwriting systems and controls in place.

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3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

2 UNDERWRITING AND CONTROLS

Retention of all relevant information

Each franchisee is expected to be able to produce all relevant information regarding each risk written to satisfy audit purposes and to allow the proactive review and management of each risk. Relevant information would include slips and placing information, as well as the rationale for risk acceptance, terms and pricing.

Testing of underwriting controls

Franchisees are expected to test that underwriting controls are working effectively and to produce written reports to demonstrate this at least quarterly, with any variances or control failures highlighted and addressed. The findings from control testing should be shared with relevant underwriting teams and actions relating to variances agreed. It is expected that the findings would also be shared with the franchisee's board. (Testing should ideally include consideration of reinsurance programmes, systems for modelling risks and aggregating exposures and the records supporting pricing).

These reports will normally be built up from the writing of each risk, to enable detailed analysis of identified issues.

Where underwriting authority is delegated and aggregated returns are received by the franchisee it is expected that data at individual risk level will be available to the franchisee to ensure that underwriting controls are working effectively.

UNDERWRITING MANAGEMENT

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- they ensure that a representative range of risks underwritten by the syndicate is reviewed and assessed regularly by an appropriately qualified individual who is independent of the underwriter of those risks

- they ensure that underwriting decisions are the subject of an appropriate peer review process

- they require the referral of risks or underwriting decisions which are outside an underwriter's agreed levels of authority

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

2 UNDERWRITING AND CONTROLS

An appropriate peer review process

The peer review process is expected to review and where necessary challenge individual underwriting decisions to ensure that the franchisee's underwriting policies have been followed and, where necessary, that prompt action to resolve any issues identified is undertaken, including escalation in accordance with the franchisee's required procedures.

The following Additional Notes are intended to assist franchisees with the implementation of the Underwriting Standards

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

ADDITIONAL NOTES

2 UNDERWRITING AND CONTROLS

An appropriate peer review process*: the scope of franchisees' peer review activities should reflect the scale and complexity of their portfolios. Consideration will normally be given to review of all significant underwriting decisions. This could extend to quotations, acceptance of new business, endorsements and renewal terms*

Contract Certainty*: when considering Contract Certainty franchisees should also take account of required Contract Documentation procedures in the Lloyd's market*

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UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

3 DELEGATED AUTHORITY

PRINCIPLE

The franchisee has effective systems and controls wherever underwriting authority has been delegated to another entity

MINIMUM STANDARDS

Effective systems and controls have the following features:

- the franchisee has a clear strategy for writing and managing delegated underwriting business as part of its overall business plan.
- the franchisee carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- the franchisee ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements.
- the franchisee proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

UNDERWRITING MANAGEMENT

1 **UNDERWRITING STRATEGY AND PLANNING**

2 **UNDERWRITING AND CONTROLS**

3 **DELEGATED AUTHORITY**

Effective systems and controls have the following features:

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- the franchisee carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- the franchisee ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements.
- the franchisee proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

4 **PRICING AND RATE MONITORING**

5 **EXPOSURE MANAGEMENT AND ASSESSMENT**

6 **REINSURANCE**

7 **DATA QUALITY**

GUIDANCE

3 DELEGATED UNDERWRITING

<u>Clear Strategy for Delegated Underwriting</u>

- It is expected that franchisees would have written procedures, agreed at board level, for managing delegated underwriting contracts. These procedures should be applied consistently to all syndicates managed by the franchisee and regularly reviewed and updated.

- The competencies needed for managing delegated underwriting arrangements are different to those needed for other methods of acceptance. Franchisees will need to satisfy themselves that they have the controls and resources (both systems and individuals with suitable experience and skills) to enter into and manage delegated underwriting arrangements effectively, taking into account:
    - the number of coverholders;
    - the number of contracts which a syndicate leads or follows;
    - the extent of delegation;
    - the volume of income;
    - the classes of business;
    - the level of exposure (e.g. catastrophe exposure); and
    - the geographical distribution.

UNDERWRITING MANAGEMENT

1 **UNDERWRITING STRATEGY AND PLANNING**

2 **UNDERWRITING AND CONTROLS**

3 **DELEGATED AUTHORITY**

Effective systems and controls have the following features:

- the franchisee has a clear strategy for writing and managing delegated underwriting business as part of its overall business plan.
- the franchisee carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- the franchisee ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements.
- the franchisee proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

4 **PRICING AND RATE MONITORING**

5 **EXPOSURE MANAGEMENT AND ASSESSMENT**

6 **REINSURANCE**

7 **DATA QUALITY**

GUIDANCE

3 DELEGATED UNDERWRITING

Lloyd's Approved Coverholders

- For coverholders that require Lloyd's approval the lead franchisee will need to take into account, as a minimum, the information required to be provided in the Lloyd's coverholder application form when it conducts its own due diligence. In assessing a new coverholder the franchisee needs to consider the suitability criteria for a Lloyd's approved coverholder (see paragraph 6 of chapter 2 of the Underwriting Requirements), including:
  - o the individuals authorised to enter into contracts of insurance, issue insurance documents and agree claims.
  - o the coverholder's reputation and standing
  - o the coverholder's ability to operate a binding authority.
  - o the coverholder's financial standing
  - o the coverholder's underwriting plan for any proposed binding authority which should be reviewed to ensure that it fits with the franchisee's strategy.
  - o the ability of the coverholder to comply with all relevant insurance, fiscal and taxation laws and requirements in the jurisdiction in which it is domiciled, trades or provides services under the binding authority. Franchisees are recommended to liaise with the Lloyd's representative or Lloyd's Market Services to establish local requirements.
- Where franchisees wish to lead a new binding authority or take over the lead of an existing binding authority with an existing Lloyd's approved coverholder they are expected to undertake their own due diligence of that coverholder.
- Franchisees should ensure that, where the binding authority is arranged by a Lloyd's broker, the Lloyd's broker has the necessary resources to administer and service the binding authority effectively.
- Where a binding authority is not arranged through a Lloyd's broker then franchisees require prior Lloyd's approval to

"deal direct". Franchisees should ensure that they have the controls and resources to carry out all aspects of administering a binding authority that would normally be handled by the Lloyd's broker, including:

  - document production
  - premium and claims handling (including payment of local taxes)

  Franchisees should have adequate written procedures for these processes.

- Franchisees should ensure that only authorised personnel take the final decision on entering into a binding authority once all the procedures to assess the financial, compliance and underwriting issues of the coverholder have been completed.
- Franchisees considering a following role on a binding authority with a new coverholder need to satisfy themselves that the necessary due diligence has been undertaken and must make their own decision as to the suitability of the coverholder.

Restricted Coverholders

- Franchisees carrying out due diligence of restricted coverholders to whom they are considering delegating authority will need to adapt the above procedures in accordance with the level and type of delegation.

UNDERWRITING MANAGEMENT

1 **UNDERWRITING STRATEGY AND PLANNING**

2 **UNDERWRITING AND CONTROLS**

3 **DELEGATED AUTHORITY**

Effective systems and controls have the following features:

- the franchisee has a clear strategy for writing and managing delegated underwriting business as part of its overall business plan.
- the franchisee carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- the franchisee ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements.
- the franchisee proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

4 **PRICING AND RATE MONITORING**

5 **EXPOSURE MANAGEMENT AND ASSESSMENT**

6 **REINSURANCE**

7 **DATA QUALITY**

GUIDANCE

3 DELEGATED UNDERWRITING

Clearly Defined Authority

- Franchisees should ensure that there is a clear, consistent and complete contract in place prior to inception of all binding authorities. The contract should comply with Contract Certainty and QA tool requirements and the relevant provisions included at paragraphs 10 to 12 of chapter 2 of the Underwriting Requirements.
- Franchisees of lead syndicates should ensure that contracts have been agreed, signed and dated by the coverholders to whom authority is delegated, and by the lead underwriter, prior to inception of the contract.
- Franchisees should ensure that where there is a series of wholesale or retail producers in the chain who will bind insurances and/or issue documents, they have a direct contract with each party in the chain in accordance with the Delegated Underwriting Byelaw.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

Effective systems and controls have the following features:

- the franchisee has a clear strategy for writing and managing delegated underwriting business as part of its overall business plan.
- the franchisee carries out thorough due diligence of coverholders to which it proposes to delegate authority.
- the franchisee ensures that it has binding authorities in place with each coverholder to which it delegates authority clearly defining the conditions, scope and limits of that authority and which comply with Contract Certainty requirements.
- the franchisee proactively manages delegated underwriting contracts once incepted to ensure compliance with contract conditions.

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

3 DELEGATED UNDERWRITING

Proactive Management

- Franchisees should monitor the performance of the coverholder to whom they have delegated authority. To monitor performance, franchisees should specify which information the entity is required to provide, and its frequency, within the binding authority. Performance monitoring for binding authorities will usually include consideration of:
    - the type, class, volume and quality of business accepted under the binding authority and a comparison of performance against the initial plan;
    - changes in market conditions and the binding authority's profitability;
    - how the coverholder administers and operates the binding authority (including keeping to service standards);
    - significant changes to the coverholders or Lloyd's broker's circumstances; and
    - other problems or potential issues (for example those that may have been revealed by any audit or underwriting visits, complaints or potential litigation or regulatory issues.)
- Franchisees should develop and implement a policy which governs their approach to the use of independent (internal or external) audit of entities to which they delegate authority. This policy will normally address:
    - the frequency of audits based on the managing agent's risk assessment of the entity.
    - the scope for review to be included in the terms of reference for the auditors.
    - the identification of appropriately skilled auditors able to fulfil the terms of reference.
    - the identification of key audit recommendations and their implementation.
- Franchisees should have specific procedures in place to ensure ongoing adherence by the entity to relevant Lloyd's requirements and local regulations.

- Franchisees need to have clearly defined procedures, (including notification to Lloyd's), to be implemented in the event that irregularities (such as fraud and dishonesty) are identified at a coverholder.
- Franchisees are expected to deal with non-renewal or cancellation of a delegated underwriting contract in an appropriate manner.
- Franchisees are expected to have a process to monitor their own management of delegated underwriting arrangements.

The following Additional Notes are intended to assist franchisees with the implementation of the Underwriting Standards

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

ADDITIONAL NOTES

3 DELEGATED AUTHORITY

Delegated Underwriting Byelaw:- *the standards under this section are in line with the requirements of the Byelaw.*

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UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

4 PRICING AND RATE MONITORING

PRINCIPLE

The franchisee has appropriate pricing methodologies and effective rate monitoring processes

MINIMUM STANDARDS

Appropriate pricing and effective rate monitoring processes incorporate:

- a demonstrable and transparent pricing policy
- measurement of the difference between the actual price charged against the benchmark price established by the franchisee
- measurement of pricing movements from the previous year for renewal business
- analysis of the impact of non-renewed business on the current portfolio
- written guidelines setting out the principles to apply in the quantification of pricing movements to ensure consistency of approach between underwriters
- information to be recorded by underwriters with regular internal reviews and checks for data quality
- assignment of responsibility for assessing and calculating the impact that pricing movements, new business and non-renewed business may have on the syndicate loss ratios to a nominated director

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

Appropriate pricing and effective rate monitoring processes incorporate:

- a demonstrable and transparent pricing policy
- measurement of the difference between the actual price charged against the benchmark price established by the franchisee
- measurement of pricing movements from the previous year for renewal business
- analysis of the impact of non-renewed business on the current portfolio
- written guidelines setting out the principles to apply in the quantification of pricing movements to ensure consistency of approach between underwriters
- information to be recorded by underwriters with regular internal reviews and checks for data quality
- assignment of responsibility for assessing and calculating the impact that pricing movements, new business and non-renewed business may have on the syndicate loss ratios to a nominated director

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

4 PRICING AND RATE MONITORING

<u>Appropriate pricing processes incorporate:</u>

Clear Ownership: The franchisee's board would normally nominate one director to be responsible for the franchisee's pricing and rate monitoring procedures. The nominated director and supporting staff will need to have the requisite skills, experience and available time to manage and execute the process effectively. The franchisee's board should be provided with a report comparing the outcome of the pricing and rate monitoring processes against the business plan targets, at least quarterly.

Appropriate Pricing Methodologies: franchisees are expected to have appropriate pricing methodologies which are transparent and consistent for each class of business. This is to ensure that the syndicates they manage generate sufficient premiums in the aggregate to achieve the planned levels of profitability in the business plan approved by the franchisor.

A transparent and consistent pricing process will capture all the relevant elements of the pricing calculation, the methodology used and the evaluation carried out. It will be able to demonstrate:

- the expected loss ratio for each risk (calculated at individual risk, portfolio or other appropriate level) over time
- the rating drivers being used, with the relative value applied to each rating driver

Reviewing pricing activity: It is expected that a process of review will be in place to ensure that the franchisee's pricing methodologies are being adhered to.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

Appropriate pricing and effective rate monitoring processes incorporate:

- a demonstrable and transparent pricing policy
- measurement of the difference between the actual price charged against the benchmark price established by the franchisee
- measurement of pricing movements from the previous year for renewal business
- analysis of the impact of non-renewed business on the current portfolio
- written guidelines setting out the principles to apply in the quantification of pricing movements to ensure consistency of approach between underwriters
- information to be recorded by underwriters with regular internal reviews and checks for data quality
- assignment of responsibility for assessing and calculating the impact that pricing movements, new business and non-renewed business may have on the syndicate loss ratios to a nominated director

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

4 PRICING AND RATE MONITORING

Effective rate monitoring processes incorporate:

Effective Rate Monitoring Process: The use of an effective rate monitoring process represents sound business practice, enabling franchisees to manage syndicates in a well informed and prudent manner. In particular, it enables the franchisee to:

- assess rate adequacy
- monitor pricing movements
- assess the impact that such pricing movements may have on the syndicate's loss ratios
- review and amend a syndicate's business plan.

An effective rate monitoring process is likely to contain the following:

- it records the various elements of the pricing calculation for each risk (calculated at individual risk, portfolio or other appropriate level)
- it monitors the difference between the benchmark price and the actual price at suitable levels (e.g. per risk, risk code, class of business)
- in respect of renewals, it monitors pricing movements against the previous period(s) of insurance
- it provides written guidance for underwriters, setting out how they are to record and quantify pricing movements so as to ensure consistency of approach between underwriters
- it incorporates a regular review process to ensure that the input data is accurate, consistent & reliable
- it allows the actuarial and business planning functions to analyse separately the various elements of any premium, policy cover and exposures as well as external factors such as inflation

The following Additional Notes are intended to assist franchisees with the implementation of the Underwriting Standards

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

ADDITIONAL NOTES

4 PRICING AND RATE MONITORING

1) *The paper entitled "Combating the Insurance Cycle", produced by the LMA Committee of Actuaries in the Lloyds's market (CALM), dated March 2006, is recommended as relevant background to pricing and rate monitoring.*

2) *An **appropriate pricing methodology** will be dependent upon a number of factors including the historical record of the syndicate(s) managed, the size of the franchisee, the experience of the underwriters, the availability of relevant loss and exposure data, the complexity of the class of business and the speed at which pricing calculations need to be carried out.*

3) *In considering pricing methodology, all of the elements of the pricing calculation are expected to be included. For example expected loss cost, CAT load, internal expenses, profit & acquisition costs, the actual price charged and the resultant level of profit anticipated.*

4) *The **'expected loss ratio for each risk'** would normally be projected at an individual risk level. It is recognised that this is not always possible or useful, as in the case of private motor business. Where loss ratios are projected at portfolio or another level, franchisees should be able to explain the rationale.*

5) *Reference to **'benchmark price'** relates to the price for each risk at which the franchisee should deliver their required results, in line with the business plan approved by the franchisor.*

6) *An effective rate monitoring process will normally enable franchisees to:*

   - *obtain a more accurate insight into the current pricing environment*
   - *better review & monitor business plans*
   - *implement better controls over the business*
   - *instil appropriate underwriting disciplines*
   - *review syndicate underwriting strategies and make more timely adjustments to business plans*
   - *allow for better reserving*

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UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

5 EXPOSURE MANAGEMENT AND ASSESSMENT

PRINCIPLE

The franchisee has effective systems and processes to record, monitor and assess its underwriting exposures

MINIMUM STANDARDS

The franchisee can demonstrate that it has effective systems and processes for –

- assessing and modelling exposure for each managed syndicate
- validating the output from those processes and systems
- integrating the output within annual business plans, underwriting controls and the capital setting process
- regular reporting of exposures to the board and to the franchisor to comply with the franchisor's exposure reporting requirements

Effective systems and processes have the following features:

- material and reasonably foreseeable accumulations are considered and the resultant loss potential assessed

- the relevant data to assess and model exposure in different classes of business is identified and obtained when risks are underwritten and input into the relevant system shortly thereafter

- where models are employed, more than one model is used (whether internally developed or externally sourced) to determine exposure. The modelling is carried out by appropriately skilled and experienced personnel

- the output is challenged and tested independently of the underwriting function by individuals who have sufficient knowledge, experience and status

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

The franchisee can demonstrate that it has effective systems and processes for –
- assessing and modelling exposure for each managed syndicate
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6 REINSURANCE

7 DATA QUALITY

GUIDANCE

5 EXPOSURE MANAGEMENT AND ASSESSMENT

- ***Ownership:***
  It is expected that the franchisee's board will approve the approaches being used for exposure management, including loss modelling and will incorporate the modelled outputs within their overall business planning and review process.

- ***Expected features for exposure capture:***
  - 100% of all relevant risks (policies) have been captured in an appropriate manner and
  - each new risk is added to the data being modelled as soon as possible

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

The franchisee can demonstrate that it has effective systems and processes for –
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6 REINSURANCE

7 DATA QUALITY

GUIDANCE

5 EXPOSURE MANAGEMENT AND ASSESSMENT

- ***What constitutes a 'material and reasonably foreseeable accumulation'?***
  As a minimum it is expected that franchisees will put in place a structured process for recording exposure and monitoring accumulations where accumulations represent 10% or more of syndicate capacity (gross of reinsurance).

  It is important to note here that the Realistic Disaster Scenarios (RDS) do not necessarily represent the full range of accumulations to be monitored. Each franchisee is expected to form an independent view of the risks it faces and should manage those risks accordingly.

- ***Choosing the right approach:***
  Amongst franchisees' considerations will be:
  - effective tools used generally in market sectors
  - the capability of in house staff to create appropriate tools and analyse accumulations of exposure.

- ***Importance of loss modelling:***
  At its core is the importance for franchisees to understand their potential for loss, ensure that this is in line with their intended risk appetite and ensure that exposures are managed accordingly. Understanding loss potential should be one element within an integrated approach to managing the business. Significant changes in exposure should be under continuous review and management.

- ***'Modelling' encompasses a variety of possible methodologies:***
  The requirement for assessing and modelling exposure needs to be interpreted taking account of the individual business's scale and risk profile:
  - there is no one approach to the modelling of loss potential, as the methods must suit the class of business. Neither is there a requirement to use external models over those developed by skilled personnel within managing agents - some modelling processes will not involve bespoke computer programmes.
  - dependent upon the nature of the risk accumulations a range of modelling solutions, from the very simple to the highly complex, may be necessary.

- in addition to considering what constitutes an effective model, it is necessary to be clear about how the outputs from such models should be used.
- it is for the franchisee to demonstrate that their choice of modelling approach is appropriate, that the outputs are accurate, relevant and that outputs are used effectively.

- ***A robust process:***
  The modelling process(es) should be documented (including information inputs and use of outputs), the owner(s) specified and the personnel running them should be suitably experienced. The robustness of the process should be audited by suitably experienced personnel. These aspects apply to modelling processes developed ‘in house’ and to processes sourced externally.

- ***Validating loss modelling outputs:***
  Outputs are expected to be `validated (regardless of ‘custom & practice’ or historical effectiveness) and this can be done in various ways, dependent upon the nature of risks involved:

  - peer review by suitably experienced personnel
  - checked against the outputs from one or more different modelling approaches – where two approaches generate significantly different results franchisees should establish what is creating the variance
  - following a material event, franchisees should review their existing model’s underlying assumptions and should recalibrate their models if necessary, as soon as practicable.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

The franchisee can demonstrate that it has effective systems and processes for –
- assessing and modelling exposure for each managed syndicate
- validating the output from those processes and systems
- integrating the output within annual business plans, underwriting controls and the capital setting process
- regular reporting of exposures to the board and to the franchisor to comply with the franchisor's exposure reporting requirements

Effective systems and processes have the following features:
- material and reasonably foreseeable accumulations are considered and the resultant loss potential assessed
- the relevant data to assess and model exposure in different classes of business is identified and obtained when risks are underwritten and input into the relevant system shortly thereafter
- where models are employed, more than one model is used (whether internally developed or externally sourced) to determine exposure. The modelling is carried out by appropriately skilled and experienced personnel
- the output is challenged and tested independently of the underwriting function by individuals who have sufficient knowledge, experience and status

6 REINSURANCE

7 DATA QUALITY

GUIDANCE

5 EXPOSURE MANAGEMENT AND ASSESSMENT

- ***Consistency of approach:***
  The inputs and outputs should be entirely aligned with other management processes, as well as being used consistently. Any inconsistency between output from exposure modelling and input to ICA calculations will need to be understood.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

6 REINSURANCE

PRINCIPLE

The franchisee has effective controls over its outwards reinsurance arrangements

MINIMUM STANDARDS

Effective controls include**:**

- a clear and comprehensive plan for the reinsurance of each syndicate managed, agreed by the board**,** which takes into account the franchisee's risk appetite for retained insurance risk and the potential for the accumulation of risk and multiple losses
- systems and controls for the management of all elements of the outwards reinsurance programme for each managed syndicate
- a clear definition of authority to purchase and reporting lines
- a clearly defined approach to using non-standard reinsurance

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING POLICY AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND MODELLING

6 REINSURANCE

Effective controls include:

- a clear and comprehensive plan for the reinsurance of each syndicate managed, agreed by the board, which takes into account the franchisee's risk appetite for retained insurance risk and the potential for the accumulation of risk and multiple losses
- systems and controls for the management of all elements of the outwards reinsurance programme for each managed syndicate
- a clear definition of authority to purchase and reporting lines
- a clearly defined approach to using non-standard reinsurance

7 DATA QUALITY

GUIDANCE

6 REINSURANCE

Reinsurance plan

The franchisee's reinsurance strategy is expected to clearly define its approach to managing the reinsurance process

The franchisee should regularly review its reinsurance arrangements to ensure that:

- all significant risks related to the arrangements, and the residual risks borne by the firm, have been identified
- appropriate risk mitigation techniques have been applied to manage and control those risks
- there is full and regular analysis of the effect of the reinsurance plan on its exposure to insurance risk, its underwriting strategy and business plan, and its ability to meet regulatory obligations
- specific consideration has been given to the risks associated with the use of shared reinsurance arrangements

All material amendments or adaptations to the reinsurance arrangements should be reported to the franchisee's board, the relevant underwriters, and to the franchisor

The franchisee is expected to report its reinsurance arrangements to the franchisor in accordance with the requirements of the Syndicate Reinsurance Return

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING POLICY AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND MODELLING

6 REINSURANCE

Effective controls include:

- a clear and comprehensive plan for the reinsurance of each syndicate managed, agreed by the board, which takes into account the franchisee's risk appetite for retained insurance risk and the potential for the accumulation of risk and multiple losses
- systems and controls for the management of all elements of the outwards reinsurance programme for each managed syndicate
- a clear definition of authority to purchase and reporting lines
- a clearly defined approach to using non-standard reinsurance

7 DATA QUALITY

GUIDANCE

6 REINSURANCE

Systems and Controls

Effective systems for the management and control of all elements of the reinsurance process should be in place

The reinsurance process is expected to be explicitly considered in the business planning, underwriting and ICA processes

There should be a documented process for the selection and approval of a reinsurer and any intermediary used in the placement of reinsurance

The franchisee should monitor and assess the security of, and exposure to reinsurers and intermediaries on all reinsurances. A process should exist to give consideration to the level of exposure to each reinsurer

Any Qualifying Quota Share arrangements or amendments should be agreed with the franchisor in advance

All terms (including signed down lines) of all outwards reinsurance contracts are expected to comply with the principles of Contract Certainty

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING POLICY AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND MODELLING

6 REINSURANCE

Effective controls include:

- a clear and comprehensive plan for the reinsurance of each syndicate managed, agreed by the board, which takes into account the franchisee's risk appetite for retained insurance risk and the potential for the accumulation of risk and multiple losses
- systems and controls for the management of all elements of the outwards reinsurance programme for each managed syndicate
- a clear definition of authority to purchase and reporting lines
- a clearly defined approach to using non-standard reinsurance

7 DATA QUALITY

GUIDANCE

6 REINSURANCE

Authority to purchase

Individuals are expected to have written authority to purchase reinsurance from the franchisee's board.

It is the responsibility of the franchisee's board to ensure that those with authority to purchase reinsurance have the necessary skills and capabilities, and purchase in accordance with the reinsurance plan.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING POLICY AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND MODELLING

6 REINSURANCE

Effective controls include:

- a clear and comprehensive plan for the reinsurance of each syndicate managed, agreed by the board, which takes into account the franchisee's risk appetite for retained insurance risk and the potential for the accumulation of risk and multiple losses
- systems and controls for the management of all elements of the outwards reinsurance programme for each managed syndicate
- a clear definition of authority to purchase and reporting lines
- a clearly defined approach to using non-standard reinsurance

7 DATA QUALITY

GUIDANCE

6 REINSURANCE

Non-standard reinsurance

The franchisee's board are expected to approve the use of non standard reinsurance

All non-standard reinsurance arrangements should be submitted to the franchisor for prior approval, with confirmation by the franchisee's auditors that the contract conforms to applicable accounting and regulatory requirements

The following Additional Notes are intended to assist franchisees with the implementation of the Underwriting Standards

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

ADDITIONAL NOTES

6 REINSURANCE

Definition of non standard reinsurance - a soon to be published FSA definition will be used as a reference point.

UNDERWRITING MANAGEMENT

1 UNDERWRITING STRATEGY AND PLANNING

2 UNDERWRITING AND CONTROLS

3 DELEGATED AUTHORITY

4 PRICING AND RATE MONITORING

5 EXPOSURE MANAGEMENT AND ASSESSMENT

6 REINSURANCE

7 DATA QUALITY

7 DATA QUALITY

PRINCIPLE

There are effective systems for the recording and reporting of underwriting-related data to management and the franchisor

MINIMUM STANDARDS

- The franchisee should have the necessary management information to determine whether it is meeting its strategic plan, budgets and forecasts
- The franchisee should have systems and processes in place to produce timely and accurate returns to the board and ultimately to the franchisor in the required format
- The franchisee should have systems and processes in place to ensure the appropriateness, completeness and accuracy of management information

The 'Data Quality' section will be developed further during Q3 2006 taking account of the information requirements within other sections of this document

LLOYD'S

RISK MANAGEMENT

THE FRANCHISEE EFFECTIVELY MANAGES OPERATIONAL RISK IN SUPPORT OF ITS BUSINESS STRATEGY

PRINCIPLES

1 RISK GOVERNANCE

The approach to risk management is communicated throughout the organisation and supported by explicit ownership of the risks and a clear allocation of responsibility for their day to day management.

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

The organisation has a process by which it can identify, assess and mitigate the significant risks to the achievement of its business objectives.

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

The organisation has a process for monitoring its risk profile and identifying and responding to significant issues and events. The risk profile is a key input to setting and re-setting business objectives, policies, risk appetite and the internal control environment.

4 CAPITAL ALLOCATION

The organisation's risk management framework is integrated with the capital modelling process and methodology, allowing management effectively to assess overall capital needs, enhance capital allocation and measure the return on risk.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

1 RISK GOVERNANCE

PRINCIPLE

THE APPROACH TO RISK MANAGEMENT IS COMMUNICATED THROUGHOUT THE ORGANISATION AND SUPPORTED BY EXPLICIT OWNERSHIP OF THE RISKS AND A CLEAR ALLOCATION OF RESPONSIBILITY FOR THEIR DAY TO DAY MANAGEMENT.

MINIMUM STANDARDS

- The organisation has a clearly defined policy or approach for risk management setting out its strategy and objectives and the approaches and processes the organisation adopts to achieve them.
- The organisation has a clear understanding of its capacity and appetite to bear risk.
- Risk and risk management issues are addressed at an appropriate Board, Committee or equivalent.
- The organisation has a structure for governance in place that supports risk management by providing clearly defined accountabilities, expectations and reporting requirements for all relevant parties.
- There is unambiguous ownership of every aspect of the risk management process across the organisation.

RISK MANAGEMENT

1 RISK GOVERNANCE

- There is a clearly defined policy or approach for risk management
- There is a clear understanding of the organisation's capacity to bear risk
- Risk issues are appropriately addressed
- There is a governance structure in place
- Risk management ownership is unambiguous

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

1 RISK GOVERNANCE

THE ORGANISATION HAS A CLEARLY DEFINED POLICY OR APPROACH FOR RISK MANAGEMENT SETTING OUT ITS STRATEGY AND OBJECTIVES AND THE APPROACHES AND PROCESSES THE ORGANISATION ADOPTS TO ACHIEVE THEM.

- **An effective risk policy should:**
  - **cover each risk category** (e.g. operational risk) and reflect the nature of each;
  - **clearly articulate the organisation's risk bearing capacity and appetite for risk**; and
  - **be subject to regular review and assurance** to ensure adherence.

- **And would typically:**
  - **be aligned with the business objectives and set out key principles** to guide actions and decision making;
  - **set out clear risk definitions**;
  - **clearly explain the risk governance framework**; and
  - **consider regulatory requirements** (e.g. FSA), legal (e.g. Sarbanes-Oxley act) and listing rules (e.g. Combined code) where applicable.

LINKS TO TOOLKIT:

- **Section 4 – Risk Policy:** guidance and worked examples, formats, templates and policy statements to assist in the expression of a risk policy.

RISK MANAGEMENT

1 RISK GOVERNANCE

- There is a clearly defined policy or approach for risk management
- There is a clear understanding of the organisation's capacity to bear risk
- Risk issues are appropriately addressed
- There is a governance structure in place
- Risk management ownership is unambiguous

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

1 RISK GOVERNANCE

THE ORGANISATION HAS A CLEAR UNDERSTANDING OF ITS CAPACITY AND APPETITE TO BEAR RISK.

- **Having a full understanding of risk capacity and risk appetite typically includes:**
  - **capacity to bear risk being a function of an organisation's financial strength and risk management capability,** (i.e. what capital is available and its ability to raise further capital, and the strength of operational processes, organisational structure, human capital / competencies, system and processing resources and the operating culture);
  - **a clear articulation of the willingness to take on risk (i.e. risk appetite)** given its ability to take on risk (i.e. risk capacity); and
  - **clearly defined, prudent policies and statements of risk appetite and risk limits** in place to manage an organisation's significant risks from all sources.

- Statements about risk capacity, appetite and limits would typically:
  - address each category of risk (e.g. operational risk);
  - clearly express the levels and types of acceptable and/or unacceptable risk taking as defined by the Board or senior management;
  - be expressed through risk limits, thresholds, indicators and/or qualitative statements which are relevant and understandable for the business;
  - be clearly communicated to managers and staff at all levels and cascaded throughout the organisation; and
  - guide risk acceptance and decision-making throughout the organisation.

LINKS TO TOOLKIT:

- **Section 3 – Risk Appetite:** guidance, worked examples and insurance specific expressions of appetite to assist in the expression of risk appetite.

RISK MANAGEMENT

1 RISK GOVERNANCE

- There is a clearly defined policy or approach for risk management
- There is a clear understanding of the organisation's capacity to bear risk
- Risk issues are appropriately addressed
- There is a governance structure in place
- Risk management ownership is unambiguous

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

1 RISK GOVERNANCE

RISK AND RISK MANAGEMENT ISSUES ARE ADDRESSED AT AN APPROPRIATE BOARD, COMMITTEE OR EQUIVALENT.

- **To be an effective forum would typically require:**
  - **risk and risk management issues to be addressed** as a regular item;
  - **members with relevant and appropriate expertise** and experience; and
  - **the forum to have appropriate terms of reference,** the authority to act on relevant issues and there to be an appropriate assurance process in place to ensure its effective operation.

LINKS TO TOOLKIT:

- **Section 5 – Risk Governance:** guidance and possible structures to assist in the consideration of appropriate roles and responsibilities.

RISK MANAGEMENT

1 RISK GOVERNANCE

- There is a clearly defined policy or approach for risk management
- There is a clear understanding of the organisation's capacity to bear risk
- Risk issues are appropriately addressed
- There is a governance structure in place
- Risk management ownership is unambiguous

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

1 RISK GOVERNANCE

THE ORGANISATION HAS A STRUCTURE FOR GOVERNANCE IN PLACE THAT SUPPORTS RISK MANAGEMENT BY PROVIDING CLEARLY DEFINED ACCOUNTABILITIES, EXPECTATIONS AND REPORTING REQUIREMENTS FOR ALL RELEVANT PARTIES.

- **A good organisational structure supports the effective management of risk.** The structure should be appropriate to the organisation but typically would provide for three levels of governance with respect to risk:
  - **direct responsibility for the management and control of risk** (i.e. staff and management working within or managing operational business units and the Board);
  - **co-ordination, facilitation and oversight of the effectiveness and integrity of the risk management framework** (e.g. the risk committee and risk management function); and
  - **provision of 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).

- **An effective structure would typically:**
  - **have clear accountability and expectations** which will help achieve business objectives and ensure decisions are co-ordinated and consistent with stated risk appetite and policy. The following should be carefully considered:
    - **appropriate allocation and communication of roles, responsibilities and accountabilities** across the business, and the setting of appropriate rules and processes for risk based decision making and reporting;
    - **all relevant parties to understand their roles, responsibilities and accountabilities,** including what is expected of them and their authority for decision making and reporting (i.e. each relevant individual is able to explain who they are accountable to, in what manner and how the risk appetite and policy applies to their role); and
    - **all relevant parties to understand the relationships and associated tasks between key business and functional areas,** share relevant information and take account of all relevant and significant factors in order to make informed decisions.

  - **have a commonly agreed and understood terminology and language for risk** that compliment the organisation's culture and business practice, used by, and readily available to, all members of the organisation;

- **ensure that appropriate risk information flows** around the organisation on a timely basis, and that there are processes in place to escalate risk issues. To be effective, escalation processes would typically:
    - be accessible to all;
    - have clearly laid out procedures, trigger points and escalation points; and
    - enable escalation through authority levels.
- **maintain the confidentiality, integrity and availability of information,** particularly relating to those processes critical to the success of the business;
- **provide appropriate risk management tools,** that are easily accessible, to support its processes and its staff; and
- **provide appropriate training and development,** for all staff, surrounding all aspects of the firms approach to risk management (i.e. policies, terminology and tools).

LINKS TO TOOLKIT:

- **Section 5 – Risk Governance:** guidance, worked examples and possible structures to assist in the consideration of appropriate risk governance structures, roles and responsibilities.

RISK MANAGEMENT

1 RISK GOVERNANCE

- There is a clearly defined policy or approach for risk management
- There is a clear understanding of the organisation's capacity to bear risk
- Risk issues are appropriately addressed
- There is a governance structure in place
- Risk management ownership is unambiguous

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

1 RISK GOVERNANCE

THERE IS UNAMBIGUOUS OWNERSHIP OF EVERY ASPECT OF THE RISK MANAGEMENT PROCESS ACROSS THE ORGANISATION.

- **Ownership involves a range of responsibilities** and could be defined using set roles such as;
  - **Risk sponsor** – has overall accountability for the management of a risk;
  - **Risk owner** – has responsibility of managing and co-ordinating all aspects of the risk, ensuring that relevant information is available and assessed, and that relevant individuals are aware of the risk and involved in decision-making;
  - **Control/action plan owner** – responsible for the management and execution of controls / action plans surrounding a specific risk.

LINKS TO TOOLKIT:

- **Section 5 – Risk Governance:** guidance, worked examples and possible structures to assist in the consideration of appropriate governance structure, roles and responsibilities.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL AND MITIGATION

PRINCIPLE

THE ORGANISATION HAS A PROCESS BY WHICH IT CAN IDENTIFY, ASSESS AND MITIGATE THE SIGNIFICANT RISKS TO THE ACHIEVEMENT OF ITS BUSINESS OBJECTIVES.

MINIMUM STANDARDS

- The organisation has a process to identify all significant risks to the achievement of its business objectives. Formal risk identification is undertaken at least annually, and updated regularly – in line with the changing risk profile of the organisation.

- The organisation assesses risk using appropriate qualitative and/or quantitative techniques, which include consideration of risk aggregations and correlations. Risk assessment considers both the likelihood that the risk could occur and the impact were it to occur. The organisation assesses inherent risk (i.e. risk before controls) and residual risk (i.e. risk after controls).

- The organisation has in place internal controls designed to manage its risks to acceptable levels. The organisation should regularly consider the effectiveness of controls in managing risk and balancing risk and appetite.

- The identification and assessment of risk and control prompts action where necessary.

- The organisation captures details of all significant risks in a risk register, typically including:
    - a description of the risk;
    - the assessment of risk and control;
    - causes and influencing factors, both internal and external;
    - effects and outcomes – financial, reputational, or other; and
    - controls and actions currently in place to manage elements of the risk.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

- There is a process to identify all significant risks
- Risk is assessed using appropriate techniques, and includes assessment of impact and likelihood
- There is a system of internal control that balances risk with appetite
- Identification and assessment prompt action
- Risk details are captured in a risk register

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

THE ORGANISATION HAS A PROCESS TO IDENTIFY AND UNDERSTAND ALL SIGNIFICANT RISKS TO THE ACHIEVEMENT OF ITS BUSINESS OBJECTIVES. FORMAL RISK IDENTIFICATION IS UNDERTAKEN AT LEAST ANNUALLY, AND UPDATED REGULARLY – IN LINE WITH THE CHANGING RISK PROFILE OF THE ORGANISATION.

- **Lloyd's expects its businesses to be "in control" of significant risks**. This means:
  - understanding the risk profile and identifying and assessing the significant risks contained within it. Where it has been concluded risks are "under control" (i.e. managed to within appetite), having controls that are documented, appropriate, and work consistently and effectively; and
  - where risks have been assessed as not being under control, the factors contributing to this are known and plans to manage them are in place.
- **Risk identification is a key component of a robust framework**. In the absence of a risk identification process, the organisation is unable to effectively manage its key risks and demonstrate whether they are "in control".
- **An effective risk identification process would typically:**
  - identify the significant risks to the achievement of its business objectives;
  - identify all types of risks, associated major components and controls currently in place, from all sources, across the entire scope of the organisation's activities;
  - identify risks around opportunities as well as threats, to increase the organisation's chance of maximising the benefit of those opportunities when they arise;
  - ensure that the organisation is aware of its major risks at any point in time, and include elements to update the organisation's understanding of risk on an ongoing basis, such as key indicators; and
  - be systematic, disciplined and documented, i.e. methodical and well-organised and in a format that is capable of being communicated and understood by all.

- **It may also be worth considering;**
  - focussing on the root causes and influencing factors of risk, both internal and external, as well as its effects and outcomes: financial, reputational or other; and
  - looking forward, as well as drawing on past experience, by including elements such as horizon scanning.
- **The organisation should consider carefully the risk categorisation that it adopts.** Risk categories aid effective, systematic and comprehensive risk identification:
  - when categorising risk, an organisation should understand how its categories map to those of the FSA;
  - each of these categories then forms the basis for a more detailed identification process to ascertain individual risks and their components.
- Organisations may wish to employ a combination of "bottom up" (typically starting with data analysis, building up into an aggregate view) and "top down" (e.g. starting with the consideration of influencing factors or risk groups) tools according to the size and complexity of the business.

LINKS TO TOOLKIT:

- **Section 6 – Self Assessment:** guidance on the identification of risk through risk and control self assessment, and on risk registers.

- **Section 2 – Risk Language:** guidance on risk categories.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

- There is a process to identify all significant risks
- Risk is assessed using appropriate techniques, and includes assessment of impact and likelihood
- There is a system of internal control that balances risk with appetite
- Identification and assessment prompt action
- Risk details are captured in a risk register

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

THE ORGANISATION ASSESSES RISK USING APPROPRIATE QUALITATIVE AND/OR QUANTITATIVE TECHNIQUES, WHICH INCLUDE CONSIDERATION OF RISK AGGREGATIONS AND CORRELATIONS. RISK ASSESSMENT CONSIDERS BOTH THE LIKELIHOOD THAT THE RISK WILL OCCUR AND THE IMPACT WERE IT TO OCCUR. THE ORGANISATION ASSESSES INHERENT AND RESIDUAL RISK.

- **Risk assessment provides greater understanding of risk**, and is vital to the process of making risk-based decisions, by enabling:
  - comparison of risks against each other, thereby helping to prioritise risk events;
  - comparison against appetite, prompting remedial action and providing assurance towards the "in control" status of the organisation;
  - cost v benefit analysis of risk taking activities and alternative control options; and
  - valuable input into the ICA process.

- **An effective assessment of risk would typically:**
  - **assess the impact and probability of risks**, using metrics or scales that are suitable and appropriate to the business, commonly understood across the organisation, and in line with its risk policy;
  - **be reviewed regularly** to ensure it stays relevant and appropriate to the nature and level of risk within the organisation. The frequency of review should reflect the risk profile of the organisation, and might typically be quarterly or six-monthly;
  - **use an appropriate assessment method which might be qualitative or quantitative, or a combination of both**. The appropriate method will depend on a number of factors, including the nature of the risk and the organisation's risk policy. Whatever methods are chosen, the organisation should be able to demonstrate the effectiveness and appropriateness of its assessment criteria and techniques; and
  - identify potential aggregations of risk and risks that interact or correlate either positively or negatively across the organisation.

- **Qualitative methods** are often used to perform initial screenings of risks due to low cost and time requirements. They are also used when there is insufficient data to perform more scientific assessments. Factors to consider when employing qualitative assessment techniques include:
    - the need to use the right people, with the appropriate competence and experience;
    - if self assessment methods are being used, there should be procedures to provide challenge and oversight to ensure judgment is being consistently applied across the organisation. This is important as there can be a significant diversity in judgmental perceptions of risk from person to person; and
    - key indicators and loss analysis may be of benefit to corroborate or challenge judgmental assessments.

- **Quantitative tools** rely on the availability of a sufficient amount of reliable historical data. Factors to consider when employing quantitative assessment techniques include:
    - where there is insufficient internal data, the use of an external loss database may provide some benefit. Careful consideration should however be given as to whether that external data is appropriate to the risk profile of the organisation itself, and relevant to the particular risks being assessed. Furthermore, an organisation has relatively little control over the completeness and accuracy of information compiled in an external database.
    - the use of internal data should also be treated with an element of caution since historical performance is not necessarily an indication of future events. Consideration should therefore be given to potential changes to the risk environment, risk causes, impacts and probabilities over time.
    - the organisation should also be able to demonstrate that parameters and assumptions used in modelling techniques are suitable and robust, and that time horizons are appropriate, and consistent with related strategy and objectives.

- **The organisation assesses both inherent risk (before controls) and residual risk (after controls).** Assessment of inherent risk provides a number of benefits:
    - it assists the understanding of exposure level in the event of a significant control failure;
    - it helps identify key controls and their effectiveness;
    - it provides better understanding of the nature of interaction between risks and their associated controls; and
    - it provides assistance in the development of effective key indicators as well as controls.

- **A sensible assessment of inherent risk** would be one that is appropriate to the organisation's risk profile as well as the type and complexities of the appropriate risks. Such an assessment would typically be:
    - practical and commensurate;
    - relative to other risks; and
    - more qualitative / subjective; it may not be necessary or appropriate to associate a monetary value to the risk.

LINKS TO TOOLKIT:

- **Section 6 – Self Assessment:** guidance on the assessment of the key risks to the business objectives.
- **Section 8 – Internal Loss Events:** guidance on and examples of the tracking of actual, potential and 'near miss' loss events.

- **Section 9 – External Loss Data:** guidance on the use of loss data from other organisations.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

- There is a process to identify all significant risks
- Risk is assessed using appropriate techniques, and includes assessment of impact and likelihood
- There is a system of internal control that balances risk with appetite
- Identification and assessment prompt action
- Risk details are captured in a risk register

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

THE ORGANISATION HAS IN PLACE INTERNAL CONTROLS DESIGNED TO MANAGE ITS RISKS TO ACCEPTABLE LEVELS. THE ORGANISATION SHOULD REGULARLY CONSIDER THE EFFECTIVENESS OF CONTROLS IN MANAGING RISK AND BALANCING RISK AND APPETITE.

- **Effective risk management aims to manage risk to within acceptable levels,** finding a suitable balance between the positives (opportunity and reward) and negatives (threats and losses), in line with the agreed risk appetite.
- **Risks that exceed capacity form an immediate threat to the viability of the organisation** and should be identified and dealt with immediately.
- **Risks that exceed appetite form a threat to the successful achievement of the organisations objectives** and consideration should be given to the required response.
- Control activities operate at all levels within the organisation to mitigate risks to risk appetite. Controls may include policies, procedures, systems and processes in place throughout the organisation. Effective controls are typically:
  - appropriate and commensurate with the key risks faced at all levels across the organisation in order to provide cost effective mitigation of those risks to risk appetite;
  - a normal part of day to day activity, systems and procedures, management and decision making processes throughout the organisation;
  - co-ordinated across the organisation;
  - subject to regular evaluation (i.e. are the controls effective at mitigating the key risks, did they work throughout the period under review, and if not, identify corrective action); and
  - subject to an overall assurance process, which also addresses the wider control environment.
- **The control environment encompasses the wider governance approach**, management style, organisational structure and culture within which control activities take place.

- **Controls are often categorised into two broad types** although a combination will usually be needed:
  - **Prevent** – controls reduce the likelihood of a risk event occurring in the first place. They include planning and strategy setting, authorisation limits and data input controls;
  - **Detect** – controls identify occurrences of risk events after they have occurred and enable remedial action to be taken to limit the extent of damage. Examples include exception alerts and reports, and reviews of actual results against expectation.
- **Assessment of controls is typically done by assessing the effectiveness with which they mitigate risk**. One method is to consider the design of a control and its performance:
  - **Design** – considers how well the control should work if it is always applied in the way it is intended to work.
  - **Performance** – considers the way in which the control is operated in practice; if it is applied when it should be and in the way intended by its designer.

LINKS TO TOOLKIT:

- **Section 6 – Self Assessment:** guidance on the identification and assessment of the key controls which are in place to mitigate risk.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

- There is a process to identify all significant risks
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- Risk details are captured in a risk register

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

THE IDENTIFICATION AND ASSESSMENT OF RISK AND CONTROL PROMPTS ACTION WHERE NECESSARY.

- The organisation can respond to risk in a number of ways, including:
  - **Transfer** part of the risk elsewhere; for example by buying insurance or reinsurance;
  - **Treat** or mitigate the risk; i.e. reduce the likelihood and/or impact of it;
  - **Accept** or tolerate the current level of risk, where risk is already at a level that is within appetite. It may also sometimes be appropriate to accept the current level of risk where the cost of mitigating it is disproportionate to the benefits to be gained by doing so;
  - **Eliminate** or terminate; for example by exiting a class of business altogether
- When determining the appropriateness of risk responses the following should be considered:
  - the feasibility and relative costs (direct, indirect and opportunity) and benefits of alternative risk response options, the cost to design and implement a new control, and the ongoing cost of operating the control;
  - how to ensure responses are based on a comprehensive understanding of risk and its components, particularly the causes of risk to ensure that they are addressed;
  - how risk events and their controls interact with one another. In determining the most appropriate response a portfolio view of risk and control can enable management to determine whether the organisation's overall level of risk is commensurate with its risk appetite; and
  - whether risks that cannot be controlled to within acceptable levels should be avoided, or contingency plans developed.
- **Action plans are typically developed and implemented to address** unacceptable levels of risk and/or remediation of control weaknesses.
- The organisation should consider how the assurance processes can ensure the effective operation of controls and the implementation of action plans.

LINKS TO TOOLKIT:

- **Section 6 – Self Assessment:** guidance on the assessment of the key risks to the business objectives.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

- There is a process to identify all significant risks
- Risk is assessed using appropriate techniques, and includes assessment of impact and likelihood
- There is a system of internal control that balances risk with appetite
- Identification and assessment prompt action
- Risk details are captured in a risk register

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

GUIDANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

THE ORGANISATION CAPTURES DETAILS OF ALL SIGNIFICANT RISKS IN A RISK REGISTER.

- **A risk register** brings together the output of its risk identification process and that reflects the size and complexity of the business and its risk policy. An effective risk register typically:
  - gathers together risk information to enable effective sharing and communication of that information;
  - focuses attention on the key risks and therefore drives action;
  - is linked to the capital requirements of the organisation;
  - assists in developing a portfolio view of risk;
  - forms the core of an organisation's risk knowledge database and is the basis for risk analysis and reporting;
  - facilitates monitoring and review;
  - evidences a systematic and comprehensive approach to risk identification; and
  - is subject to regular review and update.
- **With respect to significant risks, a risk register typically captures:**
  - a description of the risk;
  - the assessment of risk and control;
  - causes and influencing factors, both internal and external;
  - effects and outcomes, financial, reputational and other; and
  - controls and actions currently in place to manage elements of the risk.

LINKS TO TOOLKIT:

- **Section 6 – Self Assessment:** guidance and example templates to assist in the production of a risk register.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

3 RISK MANAGEMENT PROCESS – MONITORING AND REPORTING

PRINCIPLE

THE ORGANISATION HAS A PROCESS FOR MONITORING ITS RISK PROFILE AND IDENTIFYING AND RESPONDING TO SIGNIFICANT ISSUES AND EVENTS. THE RISK PROFILE IS A KEY INPUT TO SETTING AND RE-SETTING BUSINESS OBJECTIVES, POLICIES, RISK APPETITE AND THE INTERNAL CONTROL ENVIRONMENT.

MINIMUM STANDARDS

- The organisation has a process for the regular update of its risk profile for changes to its internal and external risk environment.
- The organisation has in place sufficient measures and checks to enable the ongoing monitoring of its internal and external risk environment, for example risk and control indicators.
- The organisation reports key risk information via the governance structure in place.
- The risk management process is linked to the business planning and assurance processes, including internal audit and compliance.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

- There is a process for ongoing monitoring of the risk profile
- There are sufficient measures and checks in place to monitor changes in the risk environment
- The organisation reports key risk information via it's governance structure
- The risk management process is linked to the business planning and assurance processes

4 CAPITAL ALLOCATION

GUIDANCE

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

THE ORGANISATION HAS A PROCESS FOR THE REGULAR UPDATE OF ITS RISK PROFILE FOR CHANGES TO ITS INTERNAL AND EXTERNAL RISK ENVIRONMENT.

- **An effective process for the regular review and update of the risk profile** would typically:
  - take into account all risks identified by the organisation, with more rigorous review of significant risks;
  - identify, respond to and escalate, to appropriate parties, significant changes in the risk profile;
  - be continuous and iterative to ensure the risk profile is up to date; and
  - be triggered by changes in the organisation's risk environment, both internal and external.

LINKS TO TOOLKIT

- **Section 7 – Key Risk Indicators:** guidance on and examples of indicators as predictors of changes in the risk profile of the organisation.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

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4 CAPITAL ALLOCATION

GUIDANCE

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

THE ORGANISATION HAS IN PLACE SUFFICIENT MEASURES AND CHECKS TO ENABLE THE ONGOING MONITORING OF ITS INTERNAL AND EXTERNAL RISK ENVIRONMENT.

- **Monitoring changes in the internal and external risk environment** enables the organisation to obtain information that may signal a need to re-evaluate objectives, policies and appetite for risk, internal control, information needs or related information systems.
- **Monitoring involves the determination of the effectiveness and appropriateness of management strategies** and systems set up to implement effective controls, the risk management plan and system as a whole.
- **The process of monitoring and review can be prioritised** to focus on:
  - risks posing the greatest probability of damage to the organisation, including business projects with significant risks attached;
  - key controls relied on in achieving an acceptable level of residual risk;
  - more effective or lower cost RM alternatives, such as by the use of technology; and
  - business projects where the incidence of change is high.
- **Monitoring and review practices should be appropriate to the organisation.** Practices might include:
  - continuous monitoring via routine measures and checks, including risk and control indicators;
  - line management reviews of risks and their controls;
  - analysis of actual losses and near misses; and
  - internal and external audit to check processes, systems and controls.
- **Effective monitoring typically includes undertaking regular inspection** of actual performance for comparison with preset objectives, expected or required performance.

LINKS TO TOOLKIT

- **Section 7 – Key Risk Indicators:** guidance on and examples of indicators as predictors of changes in the risk profile of the organisation
- **Section 8 – Internal Loss Events:** guidance on and examples of the tracking of actual, potential and 'near miss' loss events
- **Section 9 – External Loss Data:** guidance on the use of loss data from other organisations

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

- There is a process for ongoing monitoring of the risk profile
- There are sufficient measures and checks in place to monitor changes in the risk environment
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4 CAPITAL ALLOCATION

GUIDANCE

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

THE ORGANISATION REPORTS KEY RISK INFORMATION VIA THE GOVERNANCE STRUCTURE IN PLACE.

- **Timely and accurate management information assists management to:**
  - understand the risk profile of the franchise and how this has changed over time;
  - determine whether the organisation's exposure to risk is being managed in accordance with the risk appetite and high level standards set by the Board;
  - assess the "in control" status of the organisation; and
  - take action to mitigate unacceptable exposures to risk.
- **An effective governance structure will typically:**
  - facilitate the accurate flow of information throughout the organisation;
  - ensure the monitoring process identifies and responds to significant issues; and
  - enable the escalation of key information to the relevant parties in a timely fashion.
- **Key information is likely to contain a range of information including:**
  - updates / changes to the risk profile;
  - key risk indicators;
  - actual / potential losses and near miss events;
  - control effectiveness; and
  - action plan progress.

LINKS TO TOOLKIT:

- **Section 10 – Management Information:** guidance on and examples of risk information.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

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4 CAPITAL ALLOCATION

GUIDANCE

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

THE RISK MANAGEMENT PROCESS IS LINKED TO THE BUSINESS PLANNING AND ASSURANCE PROCESSES, INCLUDING INTERNAL AUDIT AND COMPLIANCE.

- **An effective risk management process can help to drive and inform the business and operational planning processes by** ensuring that significant risks are considered and addressed in the organisation's business and operational plan.
- **Consideration should be given to:**
    - **the appropriate level of interaction between risk management and internal audit. This could take the form of a "feedback loop"** to help provide the following:
        - risk management helping to drive the audit planning process to ensure significant risks and controls are given priority in internal audit plans; and
        - internal audit feeding back findings on risks and controls to aid the risk management process in updating and improving ineffective controls.
    - **ensuring regular and appropriate communication** between the risk management and business planning and assurance functions; and
    - **the independence of risk management and internal audit,** where these two functions are combined.

LINKS TO TOOLKIT:

- **Section 5 – Risk Governance:** information on links between risk management and assurance.
- **Section 6 – Self Assessment:** guidance on assessment of risk exposures compared to appetite.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

4 CAPITAL ALLOCATION

PRINCIPLE

THE ORGANISATION'S RISK MANAGEMENT FRAMEWORK IS INTEGRATED WITH THE CAPITAL MODELLING PROCESS AND METHODOLOGY, ALLOWING MANAGEMENT EFFECTIVELY TO ASSESS OVERALL CAPITAL NEEDS, ENHANCE CAPITAL ALLOCATION AND MEASURE THE RETURN ON RISK.

MINIMUM STANDARDS

- Capital assessment is demonstrably driven by the key risks within the organisation's business plan and risk register, and is an integral part of the management of the organisation.
- The organisation has a capital assessment methodology that is conceptually sound, appropriate to the organisation and realistically takes into account the organisation's risk profile and ability to manage risk.
- The organisation understands the key drivers of its capital requirements, and seeks to ensure that the capital implications of business decisions are considered and understood.

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

- Capital assessment is driven by the key business risks
- The organisation has a sound and appropriate capital assessment methodology
- The organisation understands key drivers of its capital requirements

GUIDANCE

4 CAPITAL ALLOCATION

CAPITAL ASSESSMENT IS DEMONSTRABLY DRIVEN BY THE KEY RISKS WITHIN THE ORGANISATION'S BUSINESS PLAN AND RISK REGISTER, AND IS AN INTEGRAL PART OF THE MANAGEMENT OF THE ORGANISATION.

- **Capital assessment should be:**
  - demonstrably driven by the key business risks within the business plan and risk framework (i.e. the risk register, risk and control assessment and risk profile);
  - expressed in terms of risk categories which are aligned to the business and consider all FSA risk groups;
  - transparent, in explaining how the key risks contribute to the ICA value; and
  - an integral part of normal risk management processes, i.e. meaningfully tied to the ongoing processes for identification, measurement, monitoring, assessment and management of risk, in use throughout the franchisee business.

FURTHER INFORMATION CAN BE FOUND IN ICA GUIDANCE

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

- Capital assessment is driven by the key business risks
- The organisation has a sound and appropriate capital assessment methodology
- The organisation understands key drivers of its capital requirements

GUIDANCE

4 CAPITAL ALLOCATION

THE ORGANISATION HAS A CAPITAL ASSESSMENT METHODOLOGY THAT IS CONCEPTUALLY SOUND, APPROPRIATE TO THE ORGANISATION AND REALISTICALLY TAKES INTO ACCOUNT THE ORGANISATION'S RISK PROFILE AND ABILITY TO MANAGE RISK.

- **The assessment should address extreme unexpected loss events**, rather than expected events.
- The assessment process should be conducted at a frequency consistent with the rate of change in the organisations risk profile, in order to reflect significant changes.
- **There are two main approaches to assessing syndicate capital** requirements for ICA purposes, namely:
  - stress and scenario tests, which may be used for all risk groups; and
  - economic capital models (normally stochastic), which may be used where appropriate distributions are known, and which are most often used for insurance risk, credit and market risk.
- **Consideration should be given to the level of complexity required**. The degree of sophistication of the organisation's capital assessment should be commensurate with the materiality of the underlying risks and the maturity of any stochastic modelling that is being developed. It should be noted that:
  - it takes approximately 24 months to develop a stochastic model that is sufficiently sophisticated and robust;
  - it is important that management fully understands and 'buys in' to any models used and their output; and
  - in time, all organisations will be expected to use some degree of stochastic modelling supplemented by stress tests.
- **Where stochastic modelling is used, organisations should demonstrate checks or reasonableness tests, such as stress and scenario tests, have been performed** on the outputs in addition to the detailed review of model inputs. Stress and scenario tests are used.

Where reliance is placed on internal controls when assessing capital requirements, objective evidence is needed to justify that the organisation is in control and that the controls have been effective.

- **An appropriate aggregation tool is needed to aggregate the results of stress and scenario tests and stochastic modelling**, with a clear justification of the subjective correlations and dependencies selected by franchisees. As a minimum, a correlation matrix approach should be used.

LINKS TO TOOLKIT

- **Section 11 – Stress and Scenario Tests:** practical guidance, key steps, suggested workshop participants, examples of scenario generation, potential stress and scenario tests, example templates for tests, example scenario aggregation tool.

FURTHER INFORMATION CAN BE FOUND IN ICA GUIDANCE

RISK MANAGEMENT

1 RISK GOVERNANCE

2 RISK MANAGEMENT PROCESS – IDENTIFICATION, ASSESSMENT, CONTROL & MITIGATION

3 RISK MANAGEMENT PROCESS – MONITORING & REPORTING

4 CAPITAL ALLOCATION

- Capital assessment is driven by the key business risks
- The organisation has a sound and appropriate capital assessment methodology
- The organisation understands key drivers of its capital requirements

GUIDANCE

4 CAPITAL ALLOCATION

THE ORGANISATION UNDERSTANDS THE KEY DRIVERS OF ITS CAPITAL REQUIREMENTS, AND SEEKS TO ENSURE THAT THE CAPITAL IMPLICATIONS OF BUSINESS DECISIONS ARE CONSIDERED AND UNDERSTOOD.

- **In order to fully understand the key drivers of capital and the capital implications of business decision**, the organisation should consider the following;
  - **sensitivity analysis** can help an organisation to understand the key drivers of capital requirements, for example high risk business classes or key model parameters, as part of ongoing measurement and monitoring of capital adequacy throughout the business cycle. Along with an understanding of expected returns across the business classes, this provides a sound basis to maximise the return on capital;
  - **efficient allocation of capital would typically be done in the context of factors such as the risk profile of the organisation**, regulatory requirements, rating agency expectations and the expectations of capital providers; and
  - **the level of sophistication in modelling risk and capital** has potential implications for returns.

LINKS TO TOOLKIT

- **Section 11 – Stress and Scenario Tests:** practical guidance, key steps, suggested workshop participants, examples of scenario generation, potential stress and scenario tests, example templates for tests, example scenario aggregation tool.

FURTHER INFORMATION CAN BE FOUND IN ICA GUIDANCE