LLOYD'S

Lloyd's Minimum Standards MS5 – Risk Management

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Contents

MS5 – Risk Management

Minimum Standards and Requirements

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

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

Guidance

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

Definitions

ECA: Economic Capital Assessment

EIOPA: The European Insurance and Occupational Pensions Authority

ORSA: Own Risk and Solvency Assessment

SCR: Solvency Capital Requirements. [Where the risk management standards and guidance refer to the SCR this covers both the 1 year and ultimate numbers generated by the internal model]

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

Section 1: Risk Management System

RM 1.1 Effective risk management system

Managing agents shall have in place an effective risk management system.

The risk management system shall:

- comprise strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies;
- be well integrated into the organisational structure and in the decision making processes of the managing agent; and
- cover the risks to be included in the calculation of the SCR as well as the risks that are not or not fully included in the SCR calculation.

Risk management is a continuous process that is used in the implementation of the business strategy and allows for an appropriate understanding of the nature and significance of the risks to which the business is exposed, including its sensitivity to those risks and its ability to mitigate them.

Managing agents should ensure that there is a coordinated and integrated approach to risk management and a common risk language that is understood across the business.

The Board is ultimately responsible for ensuring the effectiveness of the risk management system, setting risk appetite and overall risk tolerance limits as well as approving the main risk management strategies and policies. Whilst risk management is the responsibility of the Board as a whole, Lloyd's requires that the risk management function should report to a nominated director (see GOV 6.1). The current EIOPA guidelines and explanatory notes on the system of governance also propose that at least one Board member is designated to oversee the risk management system on the Board's behalf. The detailed requirements with regard to the risk management function are covered in Lloyd's governance standards (GOV 6.1 & 6.2).

Elements of the risk management system

The standard sets out the features of an effective risk management system at a high level. Further requirements and guidance relating to these are covered within other sections of the standards and guidance as set out below:

Subject	Reference in Standards/Guidance
Risk strategy	RM 2.1
Risk governance structure	RM 2.1
Decision making processes	RM 2.2
Risk identification and assessment	RM 3.1
Risk reporting	RM 3.2

Risk coverage

The risk management system must incorporate all material risks, both those that are included in the calculation of the SCR1 and those that may not be, such as reputational and strategic risk. Consideration should also be given to emerging risks (see RM 3.1 for further detail on processes in relation to emerging risks).

For capital purposes the focus is the 1:200 point of the distribution, but this should not be the sole focus of the risk management system and consideration will need to be given to other points on the distribution as appropriate, for example, comparison with expected or planned performance.

Section 2: Risk Governance

RM 2.1 Risk Management Strategy

The risk management system shall include a clearly defined risk management strategy which is consistent with the managing agent's overall business strategy.

Managing agents shall ensure that the approach to risk management is communicated throughout the organisation and supported by explicit ownership of the risks and a clear allocation of responsibilities for their day to day management.

The risk management strategy shall be documented, including the managing agent's:

- objectives;
- key risk management principles;
- risk appetite and approved risk tolerance limits;
- risk management approaches and processes; and
- assignment of risk management responsibilities across all the managing agent's activities.

Business strategy can be defined as the high-level plans that are developed by a managing agent and are further specified via policies and business plans to ensure implementation in day-to-day business.

The risk management strategy should define and communicate the managing agent’s approach to managing risk by detailing the framework, tools and governance in place to deliver the defined strategy. It should illustrate how this approach is consistent with the overall business strategy. The top level business and risk strategy should be owned and directed by the Board.

Lloyd’s does not prescribe the exact structure and content for managing agents’ risk documentation. However, it is important for managing agents to ensure that they have a comprehensive suite of risk management documentation that covers all the areas expected.

Organisational structure and risk responsibilities

A good organisational structure supports the effective management of risk. The structure should be appropriate to the managing agent 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 together with 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).

Such a structure is commonly referred to as the ‘three lines of defence’ model.

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. Careful consideration should be given to the allocation and communication of roles, responsibilities and accountabilities across the business, and the setting of rules and processes for risk based decision making and reporting to ensure that these are appropriate.

It is important that all relevant parties 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 relevant risk appetites and policies apply to their role). There should also be a clear understanding of the relationships and associated tasks between key business and functional areas to ensure that all relevant parties are able to share relevant information and take account of all relevant and significant factors in order to make informed decisions.

Managing agents should ensure that they provide appropriate risk management tools, that are easily accessible, to support their processes and staff. Appropriate training and development should also be provided, for all staff, surrounding all aspects of the managing agent's approach to risk management.

The risk management framework should be underpinned by a commonly agreed and understood terminology and language for risk that complement the managing agent's culture and business practice, used by, and readily available to, all staff.

The organisational structure should facilitate appropriate risk information flows around the business on a timely basis, and there should be processes in place to escalate risk issues. To be effective, escalation processes would typically be accessible to all and have clearly laid-out procedures, trigger points and escalation points. It is important to ensure that the confidentiality, integrity and availability of information is maintained, particularly relating to those processes critical to the success of the business

There should be unambiguous ownership of every aspect of the risk management process across the business. Ownership involves a range of responsibilities and could be defined using set roles such as:

- risk owner - has responsibility for 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; and
- control/action plan owner - responsible for the management and execution of controls/action plans surrounding a specific risk.

Managing agents should also refer to GOV 2.1 & 2.2 which set out more general requirements with regard to organisational structure and segregation of duties.

Risk management strategy

The risk management strategy should be documented, with further detail of the day to day implementation of the strategy set out in supporting documentation, typically in specific risk policies. The following sections set out more detail of areas that should be covered in the risk strategy and other supporting documentation.

Objectives

The approach to risk management should be consistent with the overall business strategy and therefore the risk strategy objectives should be derived from the actions in place to deliver the overall business plans. Typically the risk strategy objectives would be expressed at a relatively high level setting out broadly how the risk strategy is consistent with the high level business strategy.

Key risk management principles

The risk management principles should underpin the approach to risk management and guide the maintenance and development of the risk management framework. Examples include statements about the approach to risk governance, risk ownership and the risk culture.

Risk appetite and approved risk tolerance limits

Whilst Solvency II refers to both risk appetite and risk tolerances, these terms have not been explicitly defined within current Solvency II requirements or guidance. The following section sets out general guidance in relation to risk appetite and risk tolerances for agents to consider. Lloyd's acknowledges that managing agents may have their own definitions for these terms, which do not align to the descriptions below. Some agents also use the term 'risk capacity' which is seen as a function of financial strength and risk management capability.

The high level risk management strategy documentation should set out the overall approach, with more detail in a supporting risk appetite framework or similar documentation. This section sets out areas for consideration in relation to risk appetite and provides some guidance on how risk appetite and tolerances could be defined.

Risk appetite can be defined as the articulation of the managing agent's willingness to take on risk, and should focus, at a minimum, on the most material risks of the business. Managing agents should define and describe their risk appetite and overall risk limits to manage significant risks from all sources.

Risk appetite addresses the attitude of the Board towards the most significant risks faced by the business. Board level risk appetite metrics should be consistent with strategic high level objectives and also be sufficiently detailed to be applied practically. They may include quantitative assessments in terms of risk and capital, as well as qualitative statements. The metrics should provide the Board with a snapshot of the risk profile of the business against which the Board can judge if risk taking is within acceptable boundaries.

Overall risk tolerance limits can be defined as the restrictions the managing agent imposes on itself when taking risks. This may include detailed limits and triggers supported by monitoring processes and should guide day to day decision making in line with the overall risk appetite metrics

Each risk category needs to be addressed by the combination of risk appetite and tolerances, although there may not be an explicit risk appetite statement for every category. For example, group risk may be considered as part of operational risk with appropriate tolerances set around it, rather than having a separate group risk appetite statement.

It is important that risk appetites and tolerances are clearly communicated to all relevant managers and staff at all levels and cascaded as appropriate throughout the managing agent. They should guide risk acceptance and decision-making throughout the business.

Risk management approaches and processes

The risk management strategy should provide an overview of the risk framework and the approaches and processes in place to manage risk. There should also be supporting documentation such as risk policies and procedure documents which set out more detail of the risk processes in place. More detailed guidance on risk policies and risk processes is set out in sections 2 and 3 of the risk management standards.

RM 2.2 Decision Making

Managing agents shall have a clearly defined procedure on the decision-making process within the framework of the risk management system.

Managing agents shall ensure that:

- risk and risk management issues are addressed by the Board and appropriate committee(s);
- the identification and assessment of risk and control prompts action where necessary; and
- the persons who effectively run the business or have other key functions take into account the information reported as part of the risk management system in their decision making process.

Managing agents should ensure that there is clarity over the risk decision making process, in particular which bodies or individuals have decision making authority.

Board and committee responsibilities

The operation of the risk governance structure should provide adequate oversight and challenge to ensure that risks are being appropriately managed in line with the agreed risk appetite. This requires that proper consideration is given to risk issues at Board level as well as appropriate reporting through the committee structure. Managing agents are responsible for determining the most appropriate risk governance structure for their business, taking account of the need to ensure that any forum they have in place has members with relevant and appropriate expertise and experience, appropriate terms of reference and the authority to act on relevant issues. It is usual practice to establish a risk committee with oversight of the entire risk management framework to ensure that risk matters are given sufficient attention and focus.

Whatever risk governance structure is adopted, care should be taken to ensure that the objectives of risk committees are clear, in particular as to whether their role is principally risk oversight or risk management. A risk oversight committee would typically have a majority non-executive membership, whereas a risk management committee would include more executive members with direct responsibility for managing the risks in the business. Well defined committee terms of reference will help to ensure appropriate membership and reporting, and ultimately the overall effectiveness of the committee.

Risk responses

The identification and assessment of risk and control, which is described in more detail in RM 3.1, should prompt appropriate action where necessary. There are a number of ways in which managing agents may respond to risk, 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 approaching or already at risk tolerance limits. This may be appropriate where mitigating the current level of risk is disproportionate to the benefits to be gained by doing so;
- eliminate or terminate; for example by exiting a class of business altogether; and
- amending risk appetite levels or tolerating the breach for a short time (in which case the rationale should be documented).

When determining the appropriateness of risk responses the following could 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 on-going cost of operating the control;
- the qualitative aspects of the risk, such as the impact on reputational risk;
- the need to ensure that 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 overall level of risk in the business 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.

Managing agents should consider how the assurance processes can ensure the effective operation of controls and the implementation of action plans.

Risk information

Managing agents should ensure that there is effective reporting of key risk information to the relevant governance forums to ensure that those involved have all the information that they need to take into account in the decision making process. Section RM 3.2 below sets out more detailed standards and guidance in relation to risk reporting.

RM 2.3 Risk Policies

Managing agents shall have in place written risk management policies.

The risk management policies shall cover the following areas:

- underwriting and reserving;
- asset-liability management;
- investment, in particular derivatives and similar commitments;
- liquidity and concentration risk management;
- operational risk management; and
- reinsurance and other risk mitigation techniques.

Managing agents shall ensure that the risk management policies:

- meet the requirements set out in Lloyd's Governance Standard GOV 2.4;
- define and categorise the material risks by type to which the business is exposed;
- define the approved risk tolerance limits for each type of risk;
- implement the managing agent's risk strategy;
- facilitate control mechanisms; and
- take into account the nature, scope and time horizon of the business and the associated risks.

Whilst this standard refers to separate policies for each area, this does not necessarily mean that separate documents are needed for each. It would be acceptable to have one document covering all risk types or to have separate policies for each risk type. There may also be separate supporting documentation, for example setting out details of the current risk appetite and tolerances or stress and scenario testing framework. Whichever approach is adopted, managing agents should ensure that their documentation covers the areas set out in the standard.

The standard requires managing agents to define and categorise their material risks by type. Here, the term 'risk type' can be used interchangeably with 'risk category' (see section 3.1 below for further guidance on risk categories).

Risk management policy

The risk management policy is one of the governance policies required under Lloyd's Governance standards and general requirements and guidance is set out in GOV 2.4.

The risk management policy would typically:

- define the risk categories and the methods to measure the risks;
- cover all material risks, including emerging risks, quantifiable or non-quantifiable and reputational and strategic risks where relevant;
- outline how the managing agent manages each relevant category and area of risk;
- consider potential accumulation and interactions of risk;

- specify risk tolerance limits within all relevant risk categories in line with the managing agent's overall risk appetite; and
- set out the process and frequency of regular stress and scenario tests, and describe the situations that would warrant special stress and scenario tests.

Managing agents need to ensure that their documentation covers the areas set out in Solvency II, level 2, Article 260 paragraphs 1(a) to (g) with regard to the following:

- underwriting and reserving risk;
- asset-liability management;
- investment risk;
- liquidity risk;
- concentration risk (i.e. aggregation of risk exposures within and between risk categories);
- operational risk; and
- reinsurance and other mitigation techniques.

Section 3: Risk Processes

RM 3.1 Risk Identification & Assessment

The risk management system shall include processes by which a managing agent can identify, assess and mitigate the significant risks to the achievement of its business objectives.

Managing agents shall ensure that:

- their processes are proportionate to the nature, scale and complexity of the risks inherent in the business;
- they consider the risks to which they are or could be exposed in the short and long term;
- formal risk identification is undertaken at least annually, and updated regularly;
- risk is assessed using appropriate qualitative and/or quantitative techniques, which include consideration of risk aggregations and correlations;
- there are internal controls in place, designed to manage risks to acceptable levels and the effectiveness of controls is regularly considered in managing and balancing risk and appetite;
- details of all significant risks and controls are documented, e.g. in a risk register;
- they include the performance of stress tests and scenario analysis, including reverse stress tests, with regard to all relevant risks faced by the business in their risk management system;
- their processes do not place undue reliance on third party information and that, where relevant, they take steps to verify the appropriateness of any such information as part of their risk management; and
- they have a process to identify, assess and manage emerging risks.

Managing agents should ensure that they adopt processes for risk identification and assessment that are appropriate given the nature, scale and complexity of risks inherent in the business. It is important to ensure that the appropriate individuals from across the business are involved and that they understand the relevant aspects. The identification and assessment of risks should be clearly documented.

Risk identification

Risk identification is a key component of a robust risk management framework. As an initial step in this process managing agents should ensure that they have a clear understanding of their risk universe. This can be defined as documenting the various types of risk the business may face.

An effective risk identification process would typically:

- identify the significant risks to the achievement of the business objectives;
- identify all types of risk, associated major components and controls currently in place, from all sources, across the entire scope of the managing agent's activities;
- identify risks around opportunities as well as threats, to increase the managing agent's chance of maximising the benefit of those opportunities when they arise;
- ensure that the managing agent is aware of its major risks at any point in time, and include elements to update its understanding of risk on an ongoing basis, such as key indicators;
- focus on the root causes and influencing factors of risk, both internal and external, as well as its effects and outcomes: financial, reputational and other; and
- look forward, as well as drawing on past experience, by including elements such as horizon scanning.

Risk categories aid effective, systematic and comprehensive risk identification, forming the basis for a more detailed identification process to ascertain individual risks and their components. Managing agents should consider carefully the risk categories that they adopt and there should be clarity over how these map to Solvency II risk categories.

Managing agents 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.

Risk assessment

Risk assessment enables a greater understanding of risk, and is vital to the process of making risk-based decisions, by providing:

- comparison of risks against each other, thereby helping to prioritise risks in terms of the focus and attention that should be given to individual risks;
- comparison against appetite, prompting remedial action and providing assurance towards the “in control” status of the organization;
- cost versus benefit analysis of risk taking activities and alternative control options; and
- valuable input into the capital assessment process.

An effective assessment of risk would typically be reviewed regularly to ensure it stays relevant and appropriate to the nature and level of risk within the business. The frequency of review should reflect the risk profile of the business, and might typically be quarterly or six-monthly. Managing agents should also look to ensure that their risk assessments identify potential aggregations of risk and risks that interact or correlate either positively or negatively across the business.

It is up to managing agents to decide on the most appropriate risk assessment process for the risks that they face, which may not necessarily be the same for all risk categories. For example, the processes followed for operational risk and insurance risk are likely to be different, given the nature of the information available to support the assessment.

Qualitative and quantitative assessment

Managing agents should ensure that they use an appropriate assessment method which might be qualitative or quantitative, or a combination or both. The appropriate method will depend on a number of factors, including the nature of the risk and the managing agent’s risk policy. Whatever methods are chosen, the managing agent should be able to demonstrate the effectiveness and appropriateness of its assessment criteria and techniques.

Qualitative methods are often used to facilitate risk assessment and encourage discussion e.g. in risk workshops. They are also used when there is insufficient data to perform more quantitative assessments or where more subjective judgement is needed. When using qualitative assessment methods it is important to be aware of the need to use the right people, with the appropriate competence and experience.

Where self- assessment methods are being used, there should be procedures to provide challenge and oversight to ensure judgement 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. Given the subjective nature of such assessments, key indicators and loss analysis may be of benefit to corroborate or challenge them.

Quantitative tools rely on the availability of a sufficient amount of reliable historical data. Where there is insufficient internal data, the use of an external loss database may provide some benefit. Managing agents should however give careful consideration as to whether that external data is appropriate to their risk profile, and relevant to the particular risks being assessed. Furthermore, they should also take into account that they have relatively little control over the completeness and accuracy of information compiled in an external database.

The use of internal databases 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 the potential changes to the risk and control environment, risk causes, impacts and probabilities over time.

Managing agents 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.

Impact and probability

The approach to risk assessment may involve consideration of the impact and probability of risks on both an inherent and residual basis. Assessment of impact and probability of risks should be based on metrics or scales that are:

- suitable and appropriate to the business;
- commonly understood across the organisation; and
- in line with the managing agent's risk policy.

Consideration of inherent risk (before controls) can provide a number of benefits:

- assisting the understanding of exposure level in the event of a significant control failure;
- helping identify key controls and their effectiveness;
- providing better understanding of the nature of interaction between risks and their associated controls; and
- providing 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 risk profile of the business 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; as it may not be necessary or appropriate to associate a monetary value to the risk.

Internal controls

Control activities operate at all levels within the business to mitigate risks within acceptable levels. 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 business in order to provide cost effective risk mitigation;
- a normal part of day to day activity, systems and procedures management and decision making processes throughout the business;
- co-ordinated across the business;
- 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, e.g. planning and strategy setting, authorisation and data input controls; and
- detect - controls identify occurrences of risk events after they have occurred and enable remedial action to be taken to limit the extent of damage, e.g. exception alerts and reports, and reviews of actual results against expectation.

Risk assessment will need to consider the effectiveness with which controls 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; and

- 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.

Risk documentation

All significant risks should be documented, for example in a risk register. A risk register brings together the output of the risk identification process and should reflect 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 consistent with the capital requirements of the managing agent;
- assists in developing a portfolio view of risk;
- 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.

Stress & scenario tests

Managing agents should use stress and scenario tests as tools in their risk assessment process to determine the expected financial consequences of adverse circumstances and events arising. The overall approach should include stress tests, scenario analyses and reverse stress testing.
Stress tests are generally defined with reference to movements in key financial parameters (such as interest rates, asset values or liability values), whereas scenario tests may make reference to the cause of the adverse developments, such as material natural catastrophe or major industrial incident.

Stress tests should be tailored by the managing agent to their risk profile. To this purpose managing agents should identify possible short and long term risks and possible events or future changes in economic conditions that could have an unfavourable effect on their overall financial standing and determine their capital impact.

Scenario analyses should be based on a range of events, including extreme but plausible events, and take into account any material second order effects which may arise.

Reverse stress tests are those that require a managing agent to assess scenarios and circumstances that would render its business model unviable, thereby identifying potential business vulnerabilities. Reverse stress testing starts from an outcome of business model unviability and identifies circumstances under which this might occur. This is different to general stress and scenario testing which tests for outcomes arising from particular events or changes in circumstances. Reverse stress tests need to focus not only on the capital impact of potential events but also on other elements which could make a business model unviable e.g. loss of business, profitability or reputational impacts of certain events. As a result it should be noted that the reverse stress tests used within the risk management framework and for ORSA purposes should not solely be driven by model output at the point of capital depletion but should consider the impact of other less quantifiable risks such as reputation.

A firm's business model is described as being unviable at the point when crystallising risks cause the market to lose confidence in the firm. A consequence of this would be that counterparties and other stakeholders would be unwilling to transact with or provide capital to the firm and, where relevant, existing counterparties may seek to terminate their contracts. Such a point could be reached well before regulatory capital is exhausted.

The content of all stress and scenario tests and reverse stress tests should be documented, along with conclusions drawn and any follow up actions agreed.

Reliance on third party information

Lloyd's recognises that there may be a need for managing agents to use external data. Where external data is used managing agents should ensure that it is appropriate and relevant to their business and that they do not place undue reliance on any external assessments (e.g. external credit assessments, as set out in Solvency II level 2, article 259, paragraph 4).

Emerging risks

Emerging risk can be defined as a risk that is perceived to be potentially significant but which may not be fully understood or allowed for in insurance terms and conditions, pricing, reserving or capital setting. Managing agents need to ensure that their risk processes cover the identification, assessment and management of emerging risks in a way that is appropriate for their business. Consideration should be given to:

- governance structure i.e. governance groups involved in the process;
- internal and external information sources;
- PRA/FCA publications and supervisory statements *([1])*;
- documentation of emerging risk information and assessments; and
- reporting on emerging risks.

([1]) https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319.pdf?la=en&hash=7BA9824BAC5FB313F42C00889D4E3A6104881C44

(Climate change supervisory statement Section 3 sets out PRA expectations in relation to governance, risk identification and measurement, risk monitoring, risk management and mitigation, risk reporting, scenario analysis and disclosure).

NB – this PRA supervisory statement should not be assumed to be the only item for consideration and Managing Agents should carry out their own due diligence

RM 3.2 Risk Monitoring & Reporting

The risk management system shall include reporting procedures and processes which ensure that information on the material risks faced by the business and the effectiveness of the risk management system are actively monitored and analysed.

Managing agents shall ensure that:

- they have processes for regular monitoring and update of their risk profile for changes to the internal and external risk environment, and identifying and responding to significant issues and events;
- they have sufficient measures and checks in place to enable ongoing monitoring of the internal and external risk environment;
- key risk information is reported via the governance structure;
- risk analysis prompts appropriate modifications to the risk management system where necessary; and
- the risk profile is a key input to setting and re-setting business objectives, policies, risk appetite and the internal control environment.

It is important that managing agents have processes in place to ensure that they maintain an accurate, current view of their risk profile. Appropriately detailed regular reporting should be in place across all relevant levels of the business. The frequency and content of reporting to the Board should ensure that it has all necessary current information for decision taking, at an appropriate level of detail.

Monitoring the risk profile

An effective process for the regular review and update of the risk profile would typically:

- take into account all risks identified by the business, 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 risk environment, both internal and external.

Monitoring the risk environment

Managing agents should ensure that they have sufficient measures and checks in place to enable them to monitor the internal and external risk environment. This should enable them 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. The process of monitoring and review could be prioritised to focus on:

- risks posing the greatest probability of damage to the business, including projects with significant risks attached; and
- key controls relied on in achieving an acceptable level of residual risk.

Monitoring and review practices should be appropriate to the business. Practices might include:

- continuous monitoring via routine measures and checks, including risk and control indicators;
- risk and control owner reviews;
- analysis of actual losses and near misses; and
- internal and external audit checks of processes, systems and controls.

Effective monitoring typically includes undertaking regular inspection of actual performance for comparison with pre-set objectives, expected or required performance. It will also involve input from across the organisation, providing a link between individual teams and the risk management function.

Managing agents should also ensure that their processes include consideration of any relevant changes in the external environment, e.g. changes in economic conditions, industry losses, changes in the regulatory environment etc.

Risk reporting

Timely and accurate management information assists management to:

- understand the risk profile of the business and how this has changed over time;
- determine whether risk exposures are being managed in accordance with the risk appetite and high level standards set by the Board;
- assess the “in control” status of the business (i.e. where risks are within appetite the control environment is effective, or if not, the contributing factors are understood and there are plans in place to manage them); and
- take action to mitigate unacceptable exposures to risk.

Key risk information should be reported via the governance structure (see RM 2.1 for more detail on risk governance) and is likely to cover a range of reports including:

- updates/changes to the risk profile;
- risk appetite reporting and key risk indicators;
- actual/ potential losses and near miss events;
- control effectiveness; and
- action plan progress.

Managing agents should ensure that appropriate action is taken in response to the issues reported (refer to RM 2.2 for further guidance).

SECTION 4: OWN RISK & SOLVENCY ASSESSMENT

RM 4.1 ORSA Scope

As part of its risk-management system every managing agent shall conduct its own risk and solvency assessment.

The ORSA should cover each syndicate under management and should include at least the following:

- the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy;
- the compliance, on a continuous basis, with the regulatory capital requirements, and with the regulatory requirements regarding technical provisions; and
- the significance with which the risk profile of the managed syndicate(s) deviates from the assumptions underlying the Solvency Capital Requirement calculated with the internal model.

The ORSA can be defined as 'the entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks a (re)insurance undertaking faces or may face and to determine the own funds necessary to ensure that the undertaking's overall solvency needs are met at all times' [EIOPA: ORSA Issues Paper, 27 May 2008].

The ORSA requires managing agents to consider their own assessment of the risks and associated economic capital required to meet the strategic objectives of the managed syndicate(s). The ORSA should allow management to obtain a real and practical understanding of the risks which each syndicate is exposed to, or could face in the future, and the capital and/or mitigating actions required to cover those risks. As such the ORSA should consider risk, capital, performance and strategy processes and should provide management with information required to make key decisions regarding the overall risk and capital profile of the syndicate(s).

The ORSA should be seen as an ongoing process, rather than purely a point in time report. RM 4.3 covers the ORSA process, with detail on the ORSA report included in RM 4.4.

Overall solvency needs

Determining overall solvency needs should contribute to assessing whether to retain or transfer risks and how best to optimise capital levels

The assessment of overall solvency needs should:

- reflect the managing agent's management practices, systems and controls, including the use of risk mitigation techniques;
- assess the quality of processes and inputs, in particular the adequacy of its system of governance, taking into consideration risks that may arise from inadequacies or deficiencies;
- connect business planning to solvency needs;
- include explicit identification of possible future scenarios;
- address potential external stress; and
- take account of management actions that may be adopted in adverse circumstances.

Compliance with regulatory capital requirements and technical provisions

The assessment of compliance on a continuous basis with the regulatory capital requirements should include, at least, an assessment of:

- potential future changes in the risk profile and stressed conditions;
- the quantity and quality of its own funds over the business planning period; and
- the composition of own funds across tiers and how this composition may change as a result of redemption, repayment and maturity dates during the business planning period.

The actuarial function should provide input on continuous compliance with the requirements regarding the calculation of technical provisions and the risk arising from this calculation. This should be in line with the information contained in the annual report of the actuarial function. The ORSA report should make reference to this, but only needs to include high level commentary.

Deviation from assumptions underlying the SCR

Where differences occur, managing agents should be able to explain the reasons for any difference between the assumptions underlying the ORSA and the SCR calculation, for example deviations in risk profile or timing differences.

Lloyd’s ORSA guidance

Lloyd’s has issued separate guidance notes designed to assist managing agents with understanding the requirements and Lloyd’s expectations of syndicate ORSAs. Managing agents should refer to these documents for additional detailed guidance.

[Link to Lloyd’s ORSA Guidance notes, September 2011, May 2012 & December 2015 can be found in the Appendix at the end of this document]

RM 4.2 ORSA Policy

Managing agents shall have a written ORSA policy.

The ORSA policy shall comply with the general provisions set out in Lloyd's governance standards for required policies (GOV 2.4). It shall also cover at least the following areas:

- a description of the processes and procedures in place to conduct the ORSA including how the forward looking perspective is addressed;
- consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs;
- how stress tests, sensitivity analyses or reverse stress testing are to be performed and how often they are to be performed;
- information on data quality requirements; and
- the frequency and timing for the performance of the regular ORSA and the circumstances which would trigger the need for an ORSA outside the regular timescales.

The ORSA policy should describe the overall ORSA process, how this is integrated with the strategic and business planning processes of the managing agent and the role of the Board and managing agent in running the ORSA. Where managing agents have other specific documents that cover the areas set out in the standard it is appropriate to include high level detail in the ORSA policy with cross reference to the relevant documents.

The ORSA policy should be subject to approval by the Board (or an appropriate formal sub-committee of the Board which has delegated authority to approve policies), as should any subsequent changes, unless these are minor.

RM 4.3 ORSA Process

Managing agents shall have an effective ORSA process in place.

Managing agents shall ensure that:

- their process includes consideration of both the SCR risk measure and any internal risk numbers, where different;
- the ORSA is an integral part of the business strategy and shall be taken into account on an ongoing basis in the managing agent's strategic decisions;
- the ORSA is performed regularly and without any delay following any significant change in their risk profile; and
- they maintain a record of each ORSA.

An effective ORSA process requires adequate, robust processes for assessing all the risks inherent in the business and determining the corresponding capital needs, while ensuring that the output is embedded into the managing agent’s decision making process. This will require input from across the business. Standards and guidance on risk assessment are covered under RM 3.1.

The ORSA process should operate continuously throughout the year but must be accompanied by periodic formal ORSA reporting (see RM 4.4 below for more detailed guidance on the ORSA report).

ORSA risk measures

The ORSA process must include consideration of the SCR calculated using the internal model as well as an assessment of economic capital needs (ECA) based on the actual and potential risks faced both in the coming year and over the strategic planning horizon. Where managing agents use their SCR plus the economic capital uplift applied by Lloyd’s as their managed syndicate(s) ECA they should be able to outline why they consider that this is appropriate. This does not mean that Lloyd’s expects agents to justify the Lloyd’s uplift; rather they should be able to explain why they are comfortable that the level of ECA is appropriate for them.

Integration with business strategy

The central aim of the ORSA is to provide managing agents with a mechanism through which the Board and management can assess the risks faced and determine the level of economic capital required to meet the strategic objectives of the syndicate(s). Managing agents should have processes in place that support the ORSA by providing the information required to make key decisions regarding the overall risk and capital profile of the syndicate(s).

Capital planning should be considered in both the short and long term and should consider alternatives to ensure that capital requirements can be met even under unexpectedly adverse circumstances.

[See Also MS1 – Business Planning and Portfolio Management]

Frequency of the ORSA report

Managing agents should ensure that they bring together the outputs from the underlying processes into a formal ORSA report on at least an annual basis. The appropriate timing for this and any scheduled interim updates should be agreed by the Board, for example, a full annual report with quarterly updates. The ORSA policy should also set out the circumstances which would require the ORSA to be re-run, e.g. when there is a significant change in the risk profile.

Record of the ORSA

The ORSA and its outcome should be appropriately evidenced and internally documented. Whilst the periodic ORSA report is part of the record of the ORSA, this requirement also extends to being able to evidence the ongoing ORSA process.

Managing agents should refer to Lloyd's ORSA guidance documents for additional detailed guidance.

[Link to Lloyd's ORSA Guidance notes, September 2011, May 2012 & December 2015 can be found in the Appendix at the end of this document]

RM 4.4 ORSA Report

Managing agents shall prepare an ORSA report at least annually.

The ORSA report shall:

- cover each syndicate under management;
- be submitted to Lloyd's at least annually; and
- be prepared in line with Lloyd's requirements.

Lloyd's has previously issued separate guidance notes designed to assist managing agents with understanding the requirements and Lloyd's expectations of syndicate ORSAs and managing agents should refer to these for more detailed guidance on ORSA reports.

[Link to Lloyd's ORSA Guidance notes, September 2011, May 2012 & December 2015 can be found in the Appendix at the end of this document]

Whilst Lloyd's has not prescribed a specific format for ORSA reports, it is expected that the following fundamental principles will be met within syndicate ORSA reports.

Syndicate focus

Managing agents must provide sufficiently detailed risk and capital information about each syndicate under management so that clear conclusions and decision making can be demonstrated specific to each syndicate.

Clear conclusions and management actions

The report should provide a summary of the key conclusions drawn from underlying processes and not solely duplicate existing documentation in place. The ORSA report should also clearly outline mitigating actions currently in place or planned.

Detailed capital assessment

The capital assessment must clearly set out each syndicate's capital requirements including an explanation of the difference between regulatory (SCR) and economic capital assessments. The report should state an "own" assessment of economic capital required for each syndicate with supporting rationale.

Stressed risk and capital profile

The ORSA report should clearly summarise the results of any quantitative and qualitative analysis conducted of potential "shocks" or risks the business may face, both over the one-year and longer-term horizon. This assessment should include anticipated future risks along with an associated impact on capital assessments and performance. This assessment does not require managing agents to have a "multiyear" internal model.

Board approval

The ORSA report should be Board approved before being submitted to Lloyd's and should include clear "as at" dates. Whilst Lloyd's recognises that EIOPA's current level 3 guidelines allow for an internal ORSA report as well as a supervisory report, our preference is that the Board should receive and use the same version of the report that is submitted to Lloyd's.

Format and length

The ORSA report should be a sufficiently concise document, providing details of the overall result of ORSA processes and reference to supporting information. The document should be of a length that is appropriate for use by the managing agent's Board and senior management.

The May 2012 Lloyd's guidance notes (see link above) include additional detail on what Lloyd's would expect to see from managing agents ORSA reports to address Solvency II requirements in the following areas:

- risk profile and appetite;
- assessment of capital;
- stress and scenario testing; and
- forward looking assessment.

Managing agents should ensure that information on the results and conclusions from the ORSA is communicated to all members of staff to whom the information is relevant. This does not necessarily mean that the full ORSA report has to be circulated, but the relevant information, conclusions and follow-up actions need to be shared as appropriate.

Appendix – Links

- Lloyd's ORSA Guidance notes, September 2011, May 2012 & December 2015

  http://www.lloyds.com/the-market/operating-at-lloyds/solvency-ii/information-for-managing-agents/guidance-and-workshops/governance-risk-management-and-use