

# ICA

## **2009 MINIMUM STANDARDS AND GUIDANCE**



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# INTRODUCTION

## Background

The FSA's requirements for Individual Capital Adequacy Standards (ICAS) for insurers are set out in the General Prudential Sourcebook (GENPRU) and the Prudential Sourcebook for Insurers (INSPRU). GENPRU sets out the FSA's prudential requirements applying generally to banking, investment and insurance firms whilst INSPRU sets out specific prudential requirements for insurers and Lloyd's. These requirements apply directly to managing agents in relation to the syndicates they manage and should be referred to by agents in addition to this guidance document.

GENPRU and INSPRU focus on the FSA's three sub-principles of ICAS which are:

- there must be a coherent and complete assessment of the risks faced by the business
- there should be a clear common definition of survival, ensuring that there is a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities
- the assessment must be sensible and document the underlying reasoning and judgements

The FSA has placed clear responsibilities upon Lloyd's within the ICAS regime. Lloyd's must be able to justify the reliance which it places on a syndicate ICA by being able to demonstrate that it has carried out appropriate checks.

Lloyd's continues to work closely with the FSA in order to ensure that the FSA can build on Lloyd's work and thus avoid duplication of effort wherever possible. Whilst syndicate ICAs may meet the FSA's requirements, as a mutual society, Lloyd's has an obligation to rigorously review syndicate ICAs to ensure that no syndicate poses an undue risk to the central fund. Lloyd's review will therefore seek to focus on risk mitigation in addition to capital. As member level capital setting is dependent on the syndicate ICAs, Lloyd's must ensure that they are all consistent for this purpose. Finally, the overall security of Lloyd's rests on the level of central assets and in determining these, Lloyd's depends on syndicate ICAs as a key source of information.

The best mitigant for this risk is for both Lloyd's and the FSA to be confident that syndicate ICAs are set at the right level. Given the subjectivity of the review process however, Lloyd's cannot exclude the possibility that the FSA may apply individual capital guidance (ICG) assessments to syndicates' ICAs in line with its own risk-based approach.

### Lloyd's Review

Our aim is to be proportionate in our review which will take into account the structure and business profile of the individual syndicate. To this extent, Lloyd's requires that agents highlight and rank their most significant risks and explain how these have been addressed within the ICA.

Lloyd's general approach to reviewing ICAs is to consider the reasonableness of the calculation methodologies and assumptions used

**THE FSA'S REQUIREMENTS FOR ICAS ARE SET OUT IN GENPRU AND INSPRU**

**THE FSA HAS PLACED CLEAR RESPONSIBILITIES UPON LLOYD'S WITHIN THE ICAS REGIME**

**LLOYD'S REVIEW WILL SEEK TO FOCUS ON RISK MITIGATION IN ADDITION TO CAPITAL**

## **LLOYD'S REVIEW WILL CONSIDER BOTH QUANTITATIVE AND QUALITATIVE ISSUES**

as well as the results derived by application of those methodologies and assumptions. Lloyd's keeps an open mind on the majority of calculation approaches used by agents, placing the onus on them to satisfy us that their particular approach is appropriate to their individual circumstances. Lloyd's recognises that not all syndicate ICAs will need to be prepared with the same degree of modelling complexity and the level of sophistication of the calculations should be commensurate with the materiality and nature of the underlying risks.

Our assessment is essentially high level and does not constitute a line by line audit of the calculations. This underscores the importance Lloyd's places on an agent's senior management taking responsibility for their syndicate ICAs.

## **LLOYD'S REVIEW OF ICAs IS NOT A LINE BY LINE AUDIT AND NEW ISSUES MAY ARISE EACH YEAR**

Lloyd's review of syndicate ICAs will consider both quantitative and qualitative issues. Agents should be aware that the Lloyd's review each year is not a full audit and therefore issues may arise which have not been queried in previous years. Where Lloyd's considers the level of capital to be less than adequate it has a responsibility to increase the ICA to a level which is adequate.

Lloyd's will apply a loading to specific risks within the ICA where it is considered that they have not been addressed sufficiently. There are many instances where an agent selects from a range of reasonable assumptions. Where Lloyd's considers that the ICA is based consistently on selection from the optimistic end of each range, this could lead to a concern at the aggregate level.

If Lloyd's considers that an ICA does not adequately address the minimum standards as set out in this document, Lloyd's may be unable to rely on the ICA to set capital levels. In such instances Lloyd's will use the RBC model benchmark number plus a 20% loading to set syndicate capital requirements.

## **LLOYD'S WILL BE UNABLE TO RELY ON AN ICA WHICH DOES NOT ADEQUATELY ADDRESS THE MINIMUM STANDARDS**

Lloyd's intends to adopt a "risk based" approach to the 2009 ICA review process which will result in a more tailored approach to the review of ICAs. This will allow Lloyd's resources to be targeted accordingly and in proportion to the perceived risk posed by each agent.

## **Scope of Guidance**

This guidance relates solely to the preparation of the ICA being the minimum regulatory capital required and does not cover additional requirements for the Economic Capital Assessment (ECA). Syndicates should also refer to GENPRU, INSPRU and the FSA's Insurance Sector Briefing: ICAS Lessons learned and looking ahead to Solvency II, issued in October 2007, as additional sources of information.

This guidance document is split into four main sections as follows:

- this introduction which sets out the required basis and scope for 2009 syndicate ICAs and Lloyd's overall approach to its review work
- a minimum standards section which sets out in brief the main issues and minimum standards required. This should be read by all involved in the ICA process, including the Board members and senior management who are responsible for signing off the ICA
- a detailed technical section split by risk group containing guidance for those responsible for preparing the ICA

## **ALL AGENTS MUST COMPLETE FULL PRO-FORMA AND MINIMUM STANDARDS MAPPING**

- appendices containing formats for the ICA document, minimum standards mapping and the additional pro-forma information required. Although the suggested ICA structure is not mandatory, a submission in this layout will facilitate our internal ICA review and comparison across ICAs. Any agent seeking reduced submission requirements going forward should set out their 2009 ICA in this format. Completion of both the full pro-forma and minimum standards mapping document is a requirement for all syndicates (details are in Appendices 1, 2 and 3)

## **Solvency II**

Whilst there has been significant progress over the last year on Solvency II, the full implications for capital setting are not yet known. Although there will be a strong linkage with the current ICAS framework, agents should be aware that there is likely to be some capital impact and this should become clearer over the next 12 months.

Consultation within the EU on the Solvency II Framework Directive is currently ongoing and Lloyd's will keep agents informed of progress as details become available.

## **Basis for ICA**

The required basis for the preparation of the 2009 ICA is as follows:

- the ICA must provide for all losses, modelled to ultimate, arising after 1 January 2009 on the syndicate's 2009 and prior years of account at a 99.5% confidence level - this includes all losses arising on business earned from 1 January 2009 and the risk that claims reserves as at 31 December 2008 for business earned up to that date prove to be inadequate. This "one year model" only excludes risks attaching to 2010 and future underwriting years of account compared to a multi year model. A one year basis is not restricted to examining losses materialising only in the twelve months to December 2009. If an agent intends to use a multi year model, they should contact their ICA review team leader as soon as possible
- this basis represents the equivalent of minimum regulatory capital and does not represent the economic capital which is the level of capital required to support and maintain Lloyd's ratings
- agents must prepare a separate ICA for each syndicate covering all years of account of the syndicate combined
- the assumptions used in the ICA must be consistent with those used in the Syndicate Business Forecast (SBF)
- the ICA must be based on planned income
- the ICA must be prepared on the assumption that all profits have been distributed and all losses collected or fully receivable

Lloyd's central assets and risks (eg New Central Fund and subordinated debt) and any Funds at Lloyd's (FAL) are outside the scope of a syndicate's ICA and must not be included.

The ICA must be prepared on an ultimate basis and may make appropriate allowance for future investment income. It does not need to recognise reserving strains that would arise in the future under annual accounting.

## **THE ICA MUST PROVIDE FOR ALL LOSSES TO ULTIMATE AT A 99.5% CONFIDENCE LEVEL**

## **ESSENTIAL THAT ASSUMPTIONS USED IN THE ICA ARE CONSISTENT WITH THOSE IN THE SBF**

## **AGENTS MUST EXPLAIN THE KEY PRINCIPLES UPON WHICH THE ICA IS BASED**

Agents must consider all the FSA risk groups in accordance with the minimum standards set out in this document. All minimum standards must be addressed within the ICA and where an agent considers they do not apply or do not necessitate any capital allocation, this must be clearly stated and explained.

In their ICA submission, agents must also explain the following:

- the approach to deriving the ICA and how it links together the business plan, key risks inherent in the business, related risk management processes and practices and the capital required by the risks
- why the methodology chosen is appropriate to the syndicate's business, taking account of its risk profile, risk appetite, track record with respect to risk experience and exposure and the key principles upon which the ICA is based
- the approach adopted towards the quantification of risk and the rationale for this approach
- the stress and scenario tests used and why they are appropriate for the business
- the sensitivity of key assumptions
- the overall ICA figure split by major risk category, before and after diversification

The ICA must set out clearly the allocation of capital across risk groups and the rationale and method used to derive the figures for each. All components, including non insurance risks, must be calculated and the allocation clearly explained. Agents requiring guidance on capital allocation should contact their ICA team leader for sources of information regarding this area.

## **AGENTS MUST PROVIDE AN ANALYSIS OF CHANGE AS PART OF THE 2009 ICA SUBMISSION**

Where an ICA was produced for 2008, agents must provide an analysis of change as part of the 2009 submission. This should be based on the final agreed 2008 ICA number and provide a commentary per risk group explaining any changes in methodology or number and should include any significant changes in the allocation between risk groups.

Agents should also explain movements between the 2008 assumed premium as per the latest 2008 ICA submitted to Lloyd's and the planned 2009 premium used in the 2009 ICA and SBF. The analysis should show separately the change in exposure and the change in rates.

### **Run off syndicates**

ICAs for specialist RITC and run-off syndicates must be prepared on the same basis as those for active syndicates, at a 99.5% confidence level with all losses to ultimate and the assumptions must be consistent with those in their business plan as approved by Lloyd's. Where the business plan uses materially changed assumptions, agents should discuss this with their ICA team leader.

## **RUN-OFF ICAS SHOULD NOT TAKE ACCOUNT OF PLANNED CLOSURE AND SHOULD ASSUME RUN OFF TO NATURAL EXPIRY**

For all run off syndicates the ICA must be calculated on the assumption that the run-off will continue to natural expiry and no account should be taken of planned closure. Specialist RITC syndicates should also assume run-off to natural expiry unless they consider this inappropriate in which case they should contact their ICA team leader at an early stage to discuss an alternative approach.

## Lloyd's charges

When considering Lloyd's central charges in calculating future expenses, agents should plan that members' subscriptions and central fund contributions will each be 0.5% of gross written premium (net of acquisition costs) for 2009.

## Consistency with SBF

It is a requirement that the assumptions used in the ICA are consistent with those used in the SBF and Lloyd's will not accept an ICA which is not prepared on this basis. The pro-forma requires agents to state the SBF submission on which the ICA is based.

It should be noted however that for the purposes of the 2009 ICA submission pro-forma summary (Appendix 3), both the mean and the 1:200 ULRs are requested on the basis that they should include business written in 2009 as well as business written in prior years of account but unearned as at 31 December 2008. For this reason, the mean ULR shown on the pro-forma may differ from that shown in the SBF and agents are therefore requested to provide a reconciliation of the mean ULR between that in the pro-forma and that in the SBF in order to confirm that they have been prepared on a consistent basis.

The gross premium assumptions and planned reinsurance arrangements must be the same within the SBF and the ICA.

## Enhanced Capital Requirement (ECR)

It is an FSA requirement under GENPRU and the ICAS regime for all insurers to calculate an ECR as part of the ICA process. This applies equally to Lloyd's syndicates and agents are required to calculate an ECR as at 31 December 2008. Whilst the ECR is a factor based calculation and therefore not necessarily directly comparable with the ICA, the FSA does use the ECR as a benchmark when assessing the level of a firm's ICA and ICG is set as a percentage of ECR.

Comparison of ECR and ICA is a key focus for the FSA and agents must include a comparison of the two within their submission and provide an explanation in support of any material differences, particularly where the ICA is lower than ECR.

Agents are also required to include details of the ECR requirement as at 31 December 2007 based on final year end data as part of the pro-forma information.

## Approach and Methodology

Agents must ensure that there is a clear audit trail from the impact of any financial calculations to the relevant risk capital allocation in the ICA, whatever modelling approach is adopted. Agents must also include an explanation of the basic assumptions and key drivers of the ICA in their submission.

Where considerations of particular risk issues have been made, an agent must state specifically the issues considered, how it considered them and the reasons behind the conclusions and findings.

**AGENTS SHOULD PROVIDE A RECONCILIATION BETWEEN THE MEAN ULR IN THE ICA PRO-FORMA AND THE SBF**

**COMPARISON OF ECR AND ICA IS A KEY FOCUS FOR THE FSA AND AGENTS MUST EXPLAIN MATERIAL DIFFERENCES**

**AGENTS MUST EXPLAIN THE BASIC ASSUMPTIONS AND KEY DRIVERS OF THE ICA**

**AGENTS SHOULD CLEARLY DEMONSTRATE THE LINK BETWEEN THEIR RISK FRAMEWORK AND THE ICA**

**Link to risk framework**

Three key objectives of the ICAS regime are; to ensure that senior management focus on risk management; that there is a link between risk and capital-setting; and that this is demonstrated through clear documentation of all prudential risks, processes and controls.

In making an assessment of capital adequacy, agents should first identify the significant risks facing their business and subsequently quantify how much capital is required. Central to this process should be the agent's risk management framework. In calculating a syndicate's ICA, agents must clearly demonstrate the link between their risk framework and the ICA calculation.

**DEMONSTRATE THAT THE IMPACT ON THE ICA IS ASSESSED WHEN MAKING STRATEGIC DECISIONS**

**Embedding and the 'use test'**

There is increasing focus on how agents are embedding the ICA. The FSA has commented that significant work is still required to embed ICAs into firms' risk management frameworks, particularly if they are to meet the expected Solvency II requirements for internal model approval. Firms that appear to have embedded the ICA most effectively can demonstrate that the impact on the ICA is assessed when making strategic decisions. The extent to which the ICA is embedded in the business will also be a focus of Lloyd's reviews.

**UNDERWRITING RISK ELEMENT WITHIN ICAS WILL INCREASE AS A PROPORTION OF PREMIUM**

**Market conditions**

Lloyd's three-year plan 2008-2010 document was published in December 2007 and highlights managing the cycle as a key priority during a period of softening market conditions.

Lloyd's anticipates that the underwriting risk element within ICAs will increase as a proportion of premium during the plan period if managing agents properly take into account the prevailing market conditions in their capital assessments.

**GAPS IN PERFORMANCE AGAINST FRANCHISE STANDARDS MUST BE ADDRESSED IN ICA**

**Lloyd's Performance Framework – Franchise standards**

The Lloyd's Performance Framework comprises a set of standards that make clear Lloyd's requirements of each managing agent and enable Lloyd's to maintain and enhance the Lloyd's platform. The first three sections of the performance framework (Underwriting Management, Claims Management and Risk Management) came into operation on 1 January 2007. The remaining three sections (Effective Operational Processes, Governance and Protecting Lloyd's Reputation and Brand) came into effect on 1 January 2008.

Agents should ensure that where they do not fully meet these standards this is reflected in the risk register and the associated risk is captured in the ICA to ensure that adequate capital is in place. Agents should consider gaps in performance identified by any Lloyd's reviews, as well as those highlighted by self assessment exercises.

The ICA submission should identify clearly where capital has been allocated as a result of any areas where the agent does not yet meet the minimum standards. Where agents consider that they fully meet the standards, their submission should confirm this.

## Stress and scenario vs modelled ICAs

There are two broad approaches available to agents when calculating a syndicate ICA, namely:

- stress and scenario tests
- economic capital models (also known as stochastic models or Dynamic Financial Analysis (DFA))

Although these are significantly different in application, they are not in principle different as a stochastic model is based on stress and scenarios weighted by probabilities. In a DFA model, stress tests are generated automatically and often cannot be “seen”. Both methods are acceptable for the 2009 ICAs.

It takes time to develop a stochastic model that is sufficiently robust. It is also important that management understands and “buys in” to the model. Even where a stochastic model has been used, stress tests are needed to validate the model output for reasonableness and to help with calibrating assumptions. Lloyd’s expects agents to demonstrate within the ICA that checks or reasonableness tests have been performed on the outputs in addition to the detailed review of the model inputs. Agents must ensure that the stress and scenario tests which they undertake are relevant to their business and sufficiently extreme to represent the 1:200 level.

Example stress tests for “reasonableness checks” are set out in the detailed sections on each risk group where applicable. This list is not exhaustive and is not a substitute for stress tests relevant to each individual business. The schedule is not prescriptive, however, where Lloyd’s is unable to get comfortable with the stress tests used by an agent, these are example stress tests that Lloyd’s may require the agent to perform to support the conclusions in the ICA.

## Parameter uncertainty

Uncertainty in the parameters used to assess the capital required has many potential sources, but the most common is lack of credible relevant data on which to base the main assumptions.

Agents should ensure that sufficient data over and above a syndicate’s own data is considered where appropriate. Additional stress tests should also be performed on uncertain assumptions.

Agents should highlight within their submission any assumptions or areas of modelling which are deemed to be prudent. The adoption of prudent assumptions in the ICA will be taken into account in Lloyd’s review and will increase the credibility of the assessment.

Where agents are aware of areas of weakness or optimism in the submission, these should be explicitly addressed. Agents should not make a general statement that these are offset by prudence elsewhere.

## Sensitivity analysis

As a minimum standard and part of the validation and sign off process, all ICAs must be subject to sensitivity analysis.

Given the uncertainty surrounding parameters, agents should not view the final set of assumptions as somehow ‘correct’. Management should understand the uncertainty in setting parameters and agents will be expected to have undertaken sensitivity testing and for sensitivity analyses to have been communicated to the Board and senior

**STRESS TESTS ARE  
NEEDED EVEN WHERE A  
MODEL HAS BEEN USED**

**ALL ICAs SHOULD BE  
SUBJECT TO SENSITIVITY  
ANALYSIS**

management. Sensitivity testing can also help the Board to collectively agree the ICA by highlighting the key assumptions in the model, quantifying the sensitivity of the result to these assumptions and assessing the relative importance of any difference of opinion.

The ICA submission should identify which of the parameters are the most critical to the ICA value, and give indicative movements in the ICA value for the most sensitive parameters.

### **Board understanding and challenge**

A significant issue for both Lloyd's and the FSA in reviewing ICAs is the integration of capital and risk management, particularly the level of involvement of senior management and the Board in deriving and challenging the capital assessment.

Consequently, Lloyd's requires agents to describe how they have engaged their senior management and the Board in the process, and in particular, the steps they have taken to educate the Board so that they are able to provide informed challenge as part of the sign-off process. This is particularly key where an external model has been used or part of the ICA has been outsourced to external consultants.

Senior management and the Board should in particular:

- consider the evidence and rationale behind subjective elements of assumptions
- focus on the most material elements and use sensitivity testing to understand these
- ask for reasonableness checks to confirm the extent to which the ICA results match other information about the firm
- get an illustration of the loss scenarios relevant to the firm and
- test the robustness of operational risk assessments.

For the 2009 year of account, agents will be required to submit a full ICA document based on the provisional SBF submitted to Lloyd's in June or July. Board members should ensure they are aware of all issues raised during the review process and recognise that following Lloyd's review of the ICA, revision may be required to the initial submission. The final ICA and submitted figure must be approved by the Board.

Formal Steering Group feedback will be provided to agents based on the final ICA number. Agents will recognise the limited time available to agree capital for 2009. Consequently, the initial ICA submitted should be a full document so that any key issues can be addressed prior to the final submission.

### **Reporting Requirements**

The following documents will be required for each ICA submission:

- ICA document with full mapping and audit trail (see Appendix 1)
- minimum standards mapping document (see Appendix 2)
- pro-forma information summary (see Appendix 3)

A syndicate ICA is required for all syndicates. Where the last open year of a syndicate is expected to close into another as at 31 December 2008 (the 'as at' date of the ICA calculation) then agents may choose not to produce an ICA for the closing syndicate year provided that:

**SENIOR MANAGEMENT AND BOARD MUST BE INVOLVED IN DERIVING AND CHALLENGING ICA**

**THE INITIAL ICA SUBMITTED TO LLOYD'S SHOULD BE A FULL DOCUMENT**

**THE FINAL ICA AND SUBMITTED FIGURE MUST BE APPROVED BY THE BOARD**

- the ICA of the receiving syndicate includes the risk exposure of the closing syndicate
- the agent intends that the closure/merger will take effect by the year-end. If there is material doubt as to the closure taking effect then the agent should produce a separate ICA

Separate ICAs are not required for quota share syndicates or parallel syndicates but agents must include any exposure within the main syndicate ICA. This is subject to the “host” syndicate providing an ICA that includes sufficient information to cover both the “host” and quota share syndicate.

Where the business underwritten by a special purpose syndicate differs significantly from the “host” syndicate, a separate ICA may be required and agents should contact their ICA review team leader in the first instance to determine requirements.

Agents should seek clarification from their ICA review team leader if they are unsure as to whether a syndicate counts as a quota share or parallel syndicate for ICA purposes.

### **New syndicates**

Lloyd’s recognises that new syndicates are unlikely to be able to produce a full ICA document prior to commencing underwriting. Initial capital requirements will therefore be set using the RBC model benchmark number which will include a 20% new syndicate loading. Agents will then be asked to submit a full ICA document to Lloyd’s at the next formal submission date although Lloyd’s may request a provisional submission prior to this to permit feedback to agents ahead of the full submission.

In addition to areas covered in the guidance for new classes of business, we would expect the ICA for a new syndicate to include some allowance for reserving risk going forward - this is in line with the benchmark which adds some back year data to produce a reserving risk number and prevent sharp increases in capital over the first 2-3 years. The ICA should also consider additional operational risks for a new business, including any potential management stretch which may arise and consider the risk of early cessation of the syndicate if business does not go to plan.

### **Ongoing reporting requirements**

In line with the principles of the FSA’s ICAS regime, Lloyd’s considers it an agent’s responsibility to keep all key risks and drivers under regular review and assess their impact on the syndicate’s capital requirement. Where the risk profile of the syndicate has changed materially or a new SBF is submitted during the year, the agent must provide an amended ICA to Lloyd’s. Minimum filing requirements for re-submissions are as follows:

- revised SBF
- ICA pro-forma summary information
- ICA summary of change document

The summary document must provide details of the change(s) impacting capital needs and set out clearly an analysis of change from the previous ICA. Any amended ICA is subject to the same Board approvals as the original submission.

## **AGENTS SHOULD CONTACT THEIR ICA TEAM LEADER TO DETERMINE REQUIREMENTS FOR SPECIAL PURPOSE SYNDICATES**

## **A NEW SYNDICATE ICA SHOULD CONSIDER ADDITIONAL OPERATIONAL RISKS**

## **AGENTS MUST KEEP ALL KEY ICA RISKS AND DRIVERS UNDER REGULAR REVIEW**

## Remaining adequately capitalised

The free funds available to a member to meet its capital requirements may fall below the required level for two reasons:

- increases to syndicate ICAs following a material change to the risk profile of the business
- the erosion of funds due to losses

Board and senior management should ensure that this is kept under continuous review and that the syndicate remains adequately capitalised.

In either case, the timetable for recapitalisation and the intervention by Lloyd's will depend on the extent of the shortfall. All members are subject to bi-annual Coming into Line (CIL) in June and November, where members are required to hold free funds at their economic capital level. Lloyd's has powers to require members to meet their ECA at all times, but will normally permit recapitalisation in accordance with this bi-annual timetable, provided that members' free funds remain above their ICA.

Where a member's funds fall below their ICA level, Lloyd's would expect members to inject additional capital outside of the normal CIL timetable. Where there is material exposure to the central fund and policyholder security, underwriting restrictions or other measures may be imposed to mitigate the risks until capital is lodged at Lloyd's.

In accordance with the continuous solvency regime, where a member's free funds fall below the level of regulatory solvency (underwriting losses plus required minimum margin), the existing powers to immediately suspend underwriting or any other measures deemed appropriate by Lloyd's may be used.

**THE BOARD SHOULD  
ENSURE THAT THE  
SYNDICATE REMAINS  
ADEQUATELY CAPITALISED**

## MINIMUM STANDARDS

### AGENTS ARE REQUIRED TO CONSIDER AND ADDRESS ALL MINIMUM STANDARDS

This section of the guidance gives an overview by risk group and advises agents of the minimum required standards to be considered when calculating the capital requirements for each risk group. Agents must consider and address each of these and further explanations as applicable are contained in the detailed sections of the guidance for each risk group. Where an agent considers that any of these areas are not applicable to their business, the justification for this must be clearly set out within the ICA.

Some risk groups will, by default, cross over with and pick up risks from other groups, eg credit risk and insurance risk, operational risk and insurance risk. Agents should provide details and cross reference these where applicable.

### Insurance Risk

#### Definition

Insurance risk is defined as the risk of loss arising from the inherent uncertainties about the occurrence, amount and timing of insurance liabilities and premiums.

#### Scope

Insurance risk includes the risk of loss arising from prospective underwriting and the development of prior years. It should also cover the risk associated with potential for increased operating expenses. Whilst there are numerous dependencies between these risks and other risk groups, such as credit risk and operational risk, the assessment of insurance risk can be considered under the headings of underwriting, reserving and reinsurance.

These three components are mutually dependent, and this must be recognised. Agents should also recognise the link between operational risk and insurance risk and this is explained in more detail within the operational risk section.

The assessment of reinsurance as part of insurance risk should relate to mismatch, dispute, exhaustion etc and not the associated credit risk which should be identified separately as part of the assessment of credit risk within the ICA.

#### Minimum Required Standards

The following minimum standards apply equally to underwriting and reserving risk and have therefore been grouped together within this overview section under insurance risk. Agents should address these when assessing both underwriting and reserving risk and the detailed section of this document provides further guidance on each of these under separate headings as appropriate. Minimum standards specific only to either underwriting risk or reserving risk are shown separately under the relevant headings in this section:

- unexpired risks on 2008 and prior years of account (YOA) and 2009 YOA risk
- catastrophe losses
- large individual risk losses

### UNDERWRITING RISK, RESERVING RISK AND REINSURANCE RISK ARE MUTUALLY DEPENDENT

- attritional loss experience
- new syndicates and/or new classes of business
- application of reinsurance programme
- operating expenses
- use of syndicate data and benchmarking
- allowance for trends such as inflation
- dependence between underwriting years
- operational risks associated with insurance risk

### Underwriting

Within insurance risk, underwriting risk relates to losses arising from business earned from 1 January 2009 for all 2009 and prior years of account business. The risk of loss is to ultimate.

This definition will assist Lloyd's in its benchmarking and review work to provide a consistent allocation by syndicates between "underwriting risk" and "reserving risk".

### Minimum Required Standards

When assessing underwriting risk, agents must consider and address, as a minimum, each of the areas listed below in addition to those under insurance risk above:

- underwriting cycle
- unearned profits
- reasonableness checks on extremity of gross and net ULRs at 1:200 confidence level
- breakdown of gross and net ULRs between catastrophe, large and attritional losses
- breakdown of premium movements
- growth through additional exposure

### Reserving

Reserving risk is the risk that claims reserves set as at 31 December 2008 for business earned up to that date prove to be inadequate. The ICA must consider the ultimate position.

The forecast claims technical provisions as at 31 December 2008 should be based on the latest set of reserves on which an actuarial opinion has been obtained. Assumptions made for the run-off of the business over the period between the latest set of reserves and the valuation date (including assumptions regarding business expected to be earned by the valuation date as well as that already earned) should be stated clearly and justified. Agents should also ensure that they incorporate the latest claim information available to the syndicate prior to submission. For example, if future claims during 2008 are expected to be incurred in line with SBF assumptions, these assumptions should be stated and shown to be still valid against latest claim information. If large losses have occurred in the year agents should address these specifically.

Reserving risk includes reserving inadequacy and over-reserving if it causes a loss. Any requirement under GAAP to hold technical provisions

## UNDERWRITING RISK RELATES TO LOSSES ARISING ON BUSINESS EARNED FROM 1.1.09

## ASSUMPTIONS MADE FOR THE RUN-OFF OF THE BUSINESS SHOULD BE CLEARLY JUSTIFIED

## RESERVING RISK RELATES TO THE ADEQUACY OF CLAIMS RESERVES FOR BUSINESS EARNED AS AT 31.12.08

which exceed the best estimate of ultimate provisions may be ignored. As the ICA models all risks to ultimate, the GAAP reserving basis only affects intermediate assessments, not the final position.

### Minimum Required Standards

When assessing reserving risk, agents must consider and address, as a minimum, each of the areas listed below in addition to those under insurance risk above:

- modelling (eg bootstrapping)
- reserve margins
- investment income/discounting of reserves
- latent claims
- regulatory changes

### Reinsurance

Agents must consider the risks associated with the use of, and potential reliance on, reinsurance linked with underwriting and reserving risk within insurance risk. This must cover the areas set out below but should not include the risk of reinsurer failure which falls into credit risk.

### Minimum Required Standards

Agents must consider and address, as a minimum, each of the areas listed below:

- non matching reinsurance
- exhaustion
- post loss impact on cost and availability
- concentration of reinsurers
- dispute
- structured and/or multi year reinsurance policies
- Industry Loss Warranties (ILW)/Original Loss Warranties (OLW) basis risk

### Credit Risk

#### Definition

Credit risk refers to the risk of loss if another party fails to perform its obligations or fails to perform them in a timely fashion. For syndicates, key counterparties include reinsurers, brokers, insureds, reinsureds, coverholders and investment counterparties.

#### Scope

Any financial transaction with a counterparty may expose a syndicate to credit risk. Agents should take into consideration all potential areas of credit risk, in particular reinsurers, brokers and coverholders. When considering reinsurance credit risk, agents should not include exhaustion and dispute; these should fall into insurance risk. Agents should however consider the dependency between dispute risk and credit risk.

When assessing the appropriate level of capital for credit risk, agents should exclude credit risk in respect of central assets, including Additional

**REINSURER FAILURE  
SHOULD BE INCLUDED IN  
CREDIT RISK**

**REINSURANCE EXHAUSTION  
AND DISPUTE RISK SHOULD  
BE INCLUDED IN INSURANCE  
RISK**























































































































































