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Financial Services Authority

The future regulation of Lloyd's

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The FSA will assume that your comments are not confidential unless you indicate otherwise.

The future regulation of Lloyd's

Executive summary

Lloyd's has been for many years an important part of the world insurance market, regulating itself under the Lloyd's Acts with only minimal external statutory oversight. In the 1970s and 1980s, however, regulatory standards slipped behind those in other financial markets, and these shortcomings were exposed by the crisis of the early 1990s. Over the last few years Lloyd's has improved its regulatory standards and has also sought wider statutory oversight.

The Government has determined that Lloyd's policyholders should enjoy the benefits of a similar regulatory regime to that applying to insurance companies and proposes to give the Financial Services Authority (FSA) wide powers over the Society of Lloyd's and other participants in the market. These will not cover Lloyd's brokers because the Government has decided not to give the FSA powers over general insurance brokers.

This consultation paper describes, and seeks comments on, how the FSA intends to exercise its new responsibilities and powers immediately after the relevant legislation has been implemented. These proposals have been developed taking account of Lloyd's unique characteristics, its recent history and the current rapid change in this market, especially in its capital structure. The new arrangements will be kept under review in the light of market developments.

We intend to exercise our powers in relation to Lloyd's in ways consistent with our more general approach to the responsibilities we are to be given under the Financial Services and Markets Bill (FSM Bill). Our provisional view is that we should pursue some of our objectives by requiring Lloyd's to exercise its regulatory powers under our direction. In these areas we would set clear standards, closely monitor Lloyd's compliance with these and take enforcement action if necessary. There is an alternative, maximal, approach in which all the regulatory functions we consider necessary would be carried out

directly by the FSA, and other intermediate possibilities. Although our proposals are set out on the basis of our preferred approach, we are also seeking views on the merits of alternatives.

Our primary concern will be the protection of Lloyd's policyholders against the risk that valid claims may not be paid. In carrying out this responsibility we shall take particular account of the risks which can arise from poor underwriting, inadequate monitoring and control of underwriting risk, and concentrations of risk.

We shall also have regard to the position of Lloyd's members, the providers of the market's capital, as consumers of certain advisory and custodial services.

We will have powers in respect of the Society of Lloyd's (which is to be authorised under the FSM Bill) equivalent to those we will have over all regulated firms. We will also have power to require the authorisation of Lloyd's members. Managing agents, members' agents, Lloyd's advisers and anyone outside Lloyd's who offers advice to third parties in relation to participation in Lloyd's syndicates will have to be authorised.

All authorised market participants, including the Society of Lloyd's, will be subject to our requirements for the approval of certain persons and those who acquire influence over regulated firms. They will also be required to comply with our general principles for regulated firms and approved persons, as these apply to the Lloyd's market. Suspected breaches of these, or of the authorisation criteria, will be investigated and enforcement action taken if necessary.

In the area of prudential supervision of Lloyd's insurance operations, we propose to retain broadly the existing statutory arrangements but to enhance these very considerably through the use of both the risk-based capital system which Lloyd's has developed and its arrangements for monitoring risk aggregations. We consider this the best response to the unique supervisory problems posed by the structure of Lloyd's. In this area we propose to require Lloyd's to make many of the detailed rules and carry out most of the monitoring, under our oversight and, where necessary, direction.

Certain other types of activity, notably advisory services for members and custodial functions, will be subject to FSA's general conduct of business rules and we intend to monitor directly compliance with these.

The questions on which we are seeking comments are set out in the text and listed at the end of the paper. The key issues are: whether the currently proposed relationship between the FSA and Lloyd's is appropriate, especially in the area of prudential supervision, or whether more direct regulation by the FSA would be preferable; whether the current proposals adequately address the risks to Lloyd's policyholders and are suitably adapted to the market as it is now developing, and how Lloyd's will be brought into the new arrangements for the handling of complaints and compensation.

Introduction

- 1 The Government has announced that the Financial Services Authority (FSA) will have extensive regulatory responsibilities and powers in relation to the Lloyd's insurance market. These are set out in the draft Financial Services and Markets Bill (FSM Bill) which the Government has published for consultation. Although many of our powers will closely parallel those over other insurers, others will reflect the unique structure of Lloyd's, and our practical arrangements for exercising them will also need to reflect that structure.
- 2 This paper sets out how we expect to discharge our responsibilities for Lloyd's immediately after the new legislation has been implemented - the date we refer to as N2. Lloyd's has changed greatly over the years, and no-one can be sure how it will change in the future. The external environment, for example European insurance legislation, is also evolving. Our regulatory arrangements will therefore need to change over time to enable us to meet the objectives and responsibilities which the Government has set for us.
- 3 In this paper we concentrate on the principles that will govern our regulation of Lloyd's, how we expect to exercise our responsibilities, and the continuing role of Lloyd's itself in regulating the market. We are publishing it for consultation. Specific questions on which we are seeking views are set out in the paper itself and summarised at the end. When the consultation process is complete, we shall draft the detailed rules which we shall need to give effect to the new arrangements, and we shall consult on the details of these, as the new legislation will require.
- 4 We should be grateful for responses to this paper by **31 March, 1999**. Although we shall try to take account of any responses received later, the need to put a full set of rules and guidance into place by N2 means that we shall need to take many key decisions fairly quickly after that date. Some, however, will have to await the outcome of other consultative exercises being undertaken by the FSA.

Structure and operation of Lloyd's

Background and current operation

- 5 The first recorded reference to Lloyd's was in 1688 to a coffee shop in which wealthy individuals met merchants and shipowners and insured their cargoes and ships. By 1774 Lloyd's had made the transition from coffee shop to an insurance market. The Society of Lloyd's was incorporated by section 3 of the Lloyd's Act 1871 and today it is a leading specialty insurer and reinsurer insuring risks world-wide. It is, however, by no means the largest UK insurer, ranking fourth in terms of total business and third in non-life business.

- 6 Until recently, all members of Lloyd's were wealthy individuals who were sole traders in insurance acting with unlimited liability. The affairs of these members ('Names') are looked after by members' agents who place members on syndicates (groupings of members which underwrite policies of insurance under the management of managing agents but which have no legal personality). Typically, members would carry on business on a number of syndicates so as to have a portfolio of different risks. At its peak, membership of Lloyd's grew to over 34,000 but has recently reduced significantly. In 1998 there are around 6,800 individual Names still underwriting.
- 7 Since 1994, Lloyd's has additionally admitted corporate members which carry on business with limited liability. The underwriting of corporate members can be spread across a range of syndicates in the same way as that of traditional members ('spread vehicles'). Other corporate members ('dedicated vehicles') participate only on one or more syndicates managed by a single agent. Some of these have established - or acquired all rights to participate on - their own syndicates, which have a single member and act very like insurance companies. Some owners of corporates have also acquired, or taken interests in, the managing agents for their syndicates. A corporate which owns a managing agent running a syndicate of which it is the only member is referred to as an 'integrated vehicle'. Owners of corporate members range from quoted Lloyd's investment trusts to owners of insurance companies carrying on insurance business outside Lloyd's. Corporate members are not required to have a members' agent if they employ a 'Lloyd's adviser' to carry out the functions of a members' agent.
- 8 With effect from 1 January 1997, Lloyd's has also allowed participation through membership of Scottish Limited Partnerships. Members of the partnerships are able to benefit from limited liability while retaining some of the tax advantages of traditional membership. It is possible that in the future other types of vehicle will appear in the market.
- 9 In the past, members did not have a right to remain on or join a syndicate. This has recently changed. Members now have the right to remain on a syndicate for the following year and to share in any increase in the syndicate's capacity. These rights can be transferred to others and Lloyd's has set up a system of capacity auctions under which members are able to sell their rights of participation on syndicates to other members. The auctions are run by the Corporation of Lloyd's (the executive arm of the Society). In practice, most sellers have been Names wanting to leave the market and most buyers have been corporates seeking additional scope to participate.
- 10 Lloyd's is a market in insurance. Contracts of insurance are entered into personally by the members of the relevant syndicates and each is severally (*not* jointly) entitled to his or her share of the premium and liable for the obligations under the contract. Therefore, a Name at Lloyd's is not an investor

in any traditional sense of that word, but a sole trader in the business of insurance.

- 11 Business is normally brought to the market by brokers, and a large risk will normally be shared between several syndicates, each taking a proportion of the premiums and a corresponding share of any losses. Risks may also be shared on a similar basis between Lloyd's syndicates and the conventional insurance companies ('the London Market') which operate from offices in the same area of London transacting similar business.
- 12 Lloyd's is currently a largely self-regulating market, with powers vested by the Lloyd's Acts in its Council but delegated to a Regulatory Board and the Corporation's Regulatory Division. Market participants, including the syndicates, are subject to a registration process before being allowed to carry on business at Lloyd's. Each member must hold funds under the trusteeship of Lloyd's covering a certain proportion of the maximum amount of gross premiums which may be written on his behalf during each year of account. The adequacy of these funds is kept under review in the light of the risks being incurred.
- 13 A key feature of Lloyd's is the Central Fund, to which all members contribute and which is used to pay policyholder claims if a member is unable to meet his obligations under a contract of insurance. (Although the use of the Central Fund is in principle at the discretion of the Council, failure to use it in this way would have severe consequences for Lloyd's continuing ability to trade.) It is on the basis of this common security that Lloyd's is able to trade in other countries with a single licence in each (rather than its individual units having to be licensed separately). The Central Fund underpins the solvency of the market overall since ultimately it links the interests of all capital providers in the market and therefore those of all their policyholders. This linkage, which falls some way short of full mutualisation of risks, has important implications for the way insurance at Lloyd's is regulated.
- 14 Alongside the insurance business, there are a number of other distinct activities which are carried on in support of that business. These include preparation of policies, collection of premiums, dealing with claims and providing IT systems. Many of these activities are carried out, in whole or in part, by the Corporation.
- 15 Other activities involve an element of investment business. For example, the premiums received by syndicates are held in trust and invested by the managing agents until they are needed to pay claims, generating additional income which is important to the economics of the business. This can be seen as analogous to the investment by an insurance company of its premiums and reserves. However, the Corporation also administers some funds, in particular the deposits provided by members as capital to support their underwriting.

Such deposits are often in the form of bank guarantees, or they are provided in cash or securities which need to be managed, usually on the members' instructions.

Reconstruction and Renewal

- 16 Membership of Lloyd's expanded greatly in the 1970s and 1980s after the criteria for membership (in particular the wealth requirements) were relaxed. The number of Names rose from 6,001 in 1970 to 34,218 in 1989, and this increase caused significant changes in the operation of the market. Regulatory arrangements were also changed during that period, partly to reflect the changing nature of the market and of its membership as well as changes to regulatory arrangements in other financial service sectors. It is clear, however, that the quality of regulation lagged behind that elsewhere and that market pressures were all too often dominant.
- 17 In the mid 1980s and early 1990s Lloyd's experienced heavy losses from a series of man-made and natural disasters, from US asbestosis and pollution claims and from poor underwriting in the 1980s when the market's capacity was high and premium rates low. The scale of the losses was worsened by the manner in which some syndicates reinsured their underwriting within the Lloyd's market and with other London-based reinsurers. This concentrated Lloyd's losses on a few syndicates, some of whose Names proved unable or unwilling to pay, producing a domino effect which impacted on other syndicates. At the same time, there was litigation by some Names against other participants in the market. The effect of these developments taken together was to threaten the solvency, and hence the survival, of Lloyd's as a whole.
- 18 In 1996 Lloyd's implemented its Reconstruction and Renewal plan (R&R). One aspect of this was the setting up of a new reinsurance vehicle, Equitas, to reinsure Names' 1992 and prior year liabilities. This has allowed Names to clear their 1992 and prior year liabilities and to resign from Lloyd's if they so wished. Equitas is regulated under normal insurance company legislation, currently by the Treasury but in the future by the FSA. Another important part of R&R was a Settlement Offer designed to settle litigation by Names against their agents, which involved injecting £3.2 billion raised from various sources around the market (the Corporation, agents and brokers) to ease the burden on Names. This offer was finally accepted by over 94% of Names.
- 19 Many of the changes in the structure and operations of Lloyd's described above occurred during the crisis which preceded R&R and were, in part, a response to that crisis. They are thus fairly recent, and their implications have not yet been fully absorbed.

Possible future developments

- 20 The future evolution of the Lloyd's market is far from clear. Some commentators believe that within a few years all traditional Names will have either left the market or converted their interests to participations in a corporate vehicle of one kind or another. Others believe that there will remain a small number of Names continuing to operate with unlimited liability. There is, however, general agreement that, even if the mixed capital structure does continue, it is unlikely that in the foreseeable future there will be large numbers of new traditional Names joining the Society.
- 21 At present, there appears to be a strong trend towards integrated vehicles, with a number of the spread vehicles moving towards integration. There have also been take-overs leading to somewhat increased concentration in the market. Some commentators have suggested that concentration will continue until Lloyd's membership consists simply of a dozen or so integrated vehicles. It is, however, far from clear that they are right, not only because Lloyd's has so often confounded prediction in the past but also because one of its strengths has been the low barriers to entry, which have allowed enterprising underwriters to establish new syndicates and managing agencies and find capital to back them.
- 22 The Government has made it clear that the new regulatory powers which it is giving us are intended to be flexible, and capable of responding to a wide range of structures and circumstances at Lloyd's. The way in which we use them will depend on how Lloyd's evolves and behaves.

Q1 Do you have any comments on the likely future development of Lloyd's? What do these imply for the regulation of the market?

Current regulatory arrangements

Insurance Companies Act

- 23 Primary responsibility for supervision of the solvency of Lloyd's rests with the Treasury, whose powers are set out in Part IV of the Insurance Companies Act 1982 ('ICA 1982'). The detailed arrangements are prescribed in the Insurance (Lloyd's) Regulations 1983 (SI.1983/224) which have been amended at various times, most recently in March 1997. Most of the Treasury's functions are due to be contracted to the FSA from January 1999.
- 24 The current arrangements require:
- premiums to be placed in trust funds, with deeds approved by the Treasury;

- an annual auditor's certificate to be provided to the Treasury confirming that there are assets available to meet the liabilities of each member;
- members of Lloyd's taken together to maintain a level of assets which exceeds their insurance liabilities by a margin of solvency (which from 1 January 1998 is calculated on two bases); and
- the Council of Lloyd's to submit an annual statement (the Statutory Statement of Business or SSOB) showing the character of the insurance business carried on at Lloyd's.

- 25 Members of Lloyd's do not need to be authorised to carry on insurance business, and members can resign only if they have reinsured all their residual liabilities. There still remains, however, a theoretical possibility that the reinsurance for some or all outstanding liabilities will fail, in which case the former members would need to be able to carry out their original contracts. Members who resigned from Lloyd's on or after 24 December 1996, having reinsured all their liabilities, are therefore subject to a special, minimal regime intended to provide sufficient protection to policyholders under the contracts of insurance underwritten by those former members.
- 26 These arrangements are substantially less prescriptive than the corresponding requirements for insurance companies. Other aspects of solvency regulation of Lloyd's are a matter for the Council of Lloyd's under section 6 of the Lloyd's Act 1982.
- 27 The Financial Services Act 1986 (FS Act) treats Lloyd's and underwriting agents as 'exempted persons' in respect of investment business carried on by them for the purposes of or in connection with the carrying on of insurance business. The scope of the FS Act does not include general insurance business. Most of Lloyd's activities are therefore outside the scope and coverage of that Act and so the FSA is not currently responsible - directly or indirectly - for capital provider protection or market trading rules. However, the FS Act does apply to Lloyd's-related business in very limited circumstances, for example transactions in the shares of a corporate, where the normal rules would apply.

European Directives

- 28 There are various European Directives relevant to insurance. The most important for the regulation of Lloyd's are the three Non-Life Directives (73/239/EEC, 88/357/EEC and 92/49/EEC). These Directives, which at some points make specific provision for the unique nature of Lloyd's, are implemented in the UK through the legislation mentioned above. There is a corresponding series of Life Directives which apply to the small amount of life business (about 1% of premium income) carried on at Lloyd's. Our rules for Lloyd's will need to ensure that the Directives are fully implemented, and will need to be changed to implement any further Directives that may be agreed.

Overseas regulators

- 29 European law, particularly the Third Non-Life Directive, allows Lloyd's to operate freely in any country of the European Economic Area (EEA) without being subject to local supervision provided that it conforms to any 'general good' provisions which apply to all companies operating in that country.
- 30 In non-EEA countries, Lloyd's is subject to local requirements which vary widely from place to place. They may include submission of financial returns and, in some cases, the provision of trust funds or other deposits. A large amount of Lloyd's business comes from the US, where the New York Insurance Department has a leading role and where there are seven trust funds established for various purposes. Where trust funds are established overseas, the trust deeds may well require the approval of the local regulator, but they also require the approval of the Treasury.

The Lloyd's Acts 1871-1982

- 31 Lloyd's was formally incorporated by the Lloyd's Act 1871, and elements of that Act and the Lloyd's Acts of 1911, 1951 and 1982 are still in force. The Lloyd's Act 1982 is by far the most important in the present context. It imposes some constraints on the structure of Lloyd's, for example that members must operate through underwriting agents and that managing agents may not be owned by Lloyd's brokers. It sets out arrangements for the governance of Lloyd's, including the composition of the Council, and gives the Council a set of regulatory duties and powers. These powers are quite extensive, and embrace aspects of solvency regulation, as well as market integrity and capital provider protection. Lloyd's detailed rules and arrangements covering all three aspects of regulation are set out in Regulations and Byelaws made by the Council. Further details of Lloyd's current regulatory activities are provided in Annex A to this paper.

Brokers

- 32 Substantially all insurance business placed within the Lloyd's market involves a Lloyd's broker acting either as an intermediary between clients or non-Lloyd's brokers and syndicates or as a guarantor of a non-Lloyd's broker. This results from the Lloyd's Act 1982. Policyholders are exposed to risk if their brokers, on whom they depend to place the insurance and who usually handle both premium and claims monies, prove incompetent, dishonest or insolvent.
- 33 Those who call themselves insurance brokers are required by the Insurance Brokers (Registration) Act 1977 to be registered with the Insurance Brokers Registration Council. The Act gives automatic entitlement to registration to those who are accepted by Lloyd's as Lloyd's brokers. Lloyd's rules for brokers are more stringent than those made by the IBRC, and broker regulation is currently an important activity for Lloyd's Regulatory Division.

Practical operation

- 34 Authorisations, conduct of business regulation, monitoring and enforcement are carried out by Lloyd's Regulatory Division which has 160 staff. However, a number of other activities which contribute to the regulation of Lloyd's are carried out in other areas of the Corporation, for example solvency reporting which is undertaken by the Finance Department. The regulatory activities of the Corporation include the regulation of brokers, functions required by overseas regulators, and some functions which in an insurance company would be carried out by the compliance department.

The Government's proposals for the future

Policy

- 35 The Government's policy on the future regulation of Lloyd's was announced by the Economic Secretary to the Treasury on 21 January 1998, and elaborated in a speech the next day. A more recent statement was made in the 'Overview of Financial Regulatory Reform' published on 30 July 1998 as part of the consultation on the draft FSM Bill.
- 36 The Government believes that the first priority of all insurance regulation is the protection of policyholders, and that holders of insurance policies underwritten at Lloyd's should enjoy the benefits of the same kind of supervisory regime as those with policies issued by other insurers. To that end it intends to give the FSA wider powers to prescribe prudential rules for the Society of Lloyd's. The FSA will also be able to use its powers of intervention in a much wider range of circumstances than the Treasury can now. The Society of Lloyd's and managing agents are to be authorised and will be regulated by us. We shall be able to approve and take regulatory action in respect of senior personnel within Lloyd's, including members of the Council and senior management, and those in charge of managing agencies and syndicates. We shall have reserve powers to undertake direct authorisation and supervision of members of Lloyd's, should we consider it necessary in the future, and powers to continue the existing arrangements for former members.
- 37 The Government has said that it expects Lloyd's existing chain of security, including premium trust funds and the Central Fund, to continue, but that we shall have powers to bring Lloyd's within the industry-wide compensation arrangements for policyholders. Lloyd's policyholders will also potentially have access to the new Financial Services Ombudsman Scheme.
- 38 The Government intends that the existing exemption under the FS Act for Lloyd's and Lloyd's underwriting agents will not continue under the new legislation, and that members' agents (and others who advise Lloyd's

members) should be authorised in the same way as other financial advisers. It has also said that we should distinguish clearly between the protection offered to those individuals who continue to underwrite with unlimited liability and corporate members.

- 39 As the FSM Bill will not provide an exemption for Lloyd's, like that in the FS Act, the Society of Lloyd's will need to be either authorised or exempted as a Recognised Investment Exchange for its role in managing the market in syndicate capacity.
- 40 The Government does not intend to bring Lloyd's or other general insurance brokers within the scope of the FSA's regulation. It is currently encouraging the emergence of an effective voluntary system to maintain standards in the selling of general insurance, which would in due course replace the IBRC regime. It is not yet clear whether Lloyd's will be able to rely on the new arrangements to fulfil the responsibilities placed upon it with respect to Lloyd's brokers under the Lloyd's Act 1982.
- 41 The Government has said it intends that there should continue to be scope for a major role for the Council of Lloyd's in ensuring that Lloyd's continues to be well-regulated. It has indicated that it does not intend, as part of its new legislation, to amend the Lloyd's Acts, and the Council of Lloyd's will therefore retain its regulatory powers, including its powers to regulate admission to the market and its powers to regulate Lloyd's brokers. It will, however, have to exercise its powers within the context of the new legislation.

The Financial Services and Markets Bill

- 42 The provisions of the draft FSM Bill which are specific to Lloyd's are to be found in Part XVI and in paragraph 21 of Schedule 2. Part XVI and the accompanying explanatory notes are in Annex B to this paper. The secondary legislation which defines the scope of regulation will also be relevant. Where persons are 'authorised' in the terms of the FSM Bill, our full powers of rule-making, intervention, discipline, etc will be available. These are set out in other parts of the Bill. They will therefore be available from the outset in respect of the Society of Lloyd's, members' agents, Lloyd's advisers and managing agents.
- 43 Most of the provisions give effect to the policy set out in the previous section, and do not need further discussion here. There are, however, a few features to which we should draw attention.
- 44 We shall have a general duty to keep ourselves informed about the affairs of Lloyd's and to keep under review the desirability of exercising our powers. We shall also have the ability, instead of exercising a power directly, to give a direction to the Council of Lloyd's to bring about the same effect.

- 45 We shall be able, without invoking our power to require members of Lloyd's to be authorised, to apply to them some of the core provisions of the FSM Bill. These cover employment in regulated activities, the issue of rules and guidance, information gathering and investigations, influence over authorised persons, powers of intervention, and the appointment of auditors and actuaries. These powers would enable us, for example, to replicate the existing Insurance Companies Act provisions about premium trust funds and individual solvency.

The FSA's approach

- 46 The FSA's general approach to its responsibilities under the new legislation has been described in *Meeting our responsibilities*, published in August 1998. Our objectives, as set out in the draft FSM Bill, are:

- maintaining confidence in the UK financial system;
- promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and
- reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime.

We are also required by the draft FSM Bill to have regard to a number of factors, including cost-effectiveness, the desirability of facilitating innovation, the need to avoid distorting competition, and the competitive position of the UK in international markets.

- 47 We shall have five main kinds of standard setting power:

- to **make rules** applicable to regulated firms;
- to **state principles** applicable to approved persons in regulated firms;
- to **make 'evidential' provisions** which will help demonstrate observance or breach of binding requirements;
- to **endorse codes** or standards issued by others, and to enforce such codes at the other's request; and
- to **issue guidance**.

48 We intend to create a Handbook of rules and guidance which will represent an explicit statement of our expectations of regulated firms, authorised individuals and approved persons, and to construct a coherent architecture in which the relationship between principles, rules, codes of conduct and guidance is apparent to the regulated community. In particular, it will normally be possible for more detailed provisions to be regarded as expressions of sets of high-level principles which will apply to all regulated firms (including Lloyd's and regulated firms within it), authorised individuals and approved persons. The draft principles for regulated firms on which we are currently consulting are as follows.

- A firm must conduct its business with integrity.
- A firm must conduct its business and organise its affairs with due skill, care and diligence.
- A firm must organise and control its affairs effectively.
- A firm must conduct its business and organise its affairs with prudence.
- A firm must observe proper standards of market conduct.
- A firm must pay due regard to the interests of its customers and treat them fairly.
- A firm must keep faith with any customer who is entitled to rely upon its judgment.
- A firm must deal with its regulators in an open and cooperative way.

49 Breach of any of these principles, which are discussed more fully in *The FSA Principles for Businesses* (Consultation Paper 13, published in September 1998), will be a potential foundation for disciplinary action. A consultation paper on the draft principles for approved persons will be issued soon.

50 In translating these principles into detailed regulatory requirements, we aim for those requirements to be simple, clear, coherent, flexible, and appropriate to the different types of consumer and different markets. We also need to ensure that the UK continues to meet its European obligations.

Our general approach to Lloyd's

51 The most relevant of our objectives, in considering the regulation of Lloyd's, are those that deal with the protection of consumers and with maintaining confidence in the UK financial system. The main consumers of financial services in this context are Lloyd's policyholders, current and prospective, but there are also elements of systemic risk, because of Lloyd's involvement in reinsurance. In addition, Lloyd's reputation and international presence mean

that its failure could be more damaging to the UK's economic interests than that of an insurance company of similar size. Capital providers are also consumers of financial services. Unlimited liability Names now provide a minority of Lloyd's capacity. They are by definition relatively rich, and those who have remained as members after recent crises must be assumed to be aware of the risks they face; this does not, however, mean that they should be totally unprotected.

- 52 In regulating Lloyd's, therefore, our primary concern will be the protection of policyholders against the risk that valid claims may not be paid. This is primarily a matter of prudential supervision and, as for other insurance undertakings, will protect all policyholders. In considering what arrangements should be made for complaints and access to compensation, however, we may wish to recognise that individuals and small businesses are in a weaker position than large companies. Our second concern will be for those who provide capital to the market, in their role as consumers of advisory services and, where appropriate, of custodial services (for example, the management of the funds which they deposit at Lloyd's as security for their underwriting risks). Here we shall pay particular attention to the size and status of capital providers, an issue considered more fully in our discussion paper on the future regulation of inter-professional business, published in October 1998.
- 53 We believe that the key risks to both Lloyd's policyholders and members will continue to arise from poor quality underwriting and from inadequate monitoring and control of underwriting risk. Concentration of risk, arising in particular from excessive reinsurance within the Lloyd's market, was a major factor in the losses which led to the need for a financial reconstruction. Lack of transparency in relation to underwriting exposures can also make it difficult for members, as capital providers, adequately to assess the risks they are incurring. Our proposed regulatory structure will be designed to address these key risks. In creating this we shall draw on the considerable work already done by Lloyd's to identify and monitor risks within the market and to put in place appropriate requirements, notably in relation to management control and financial resources. Although it will, like the corresponding regime for insurance companies, be directed primarily at policyholders, it will also have incidental benefits for members (just as the regime for insurance companies also reduces the risks for shareholders).
- 54 In establishing this regime, we shall recognise that innovation has been a key feature of the Lloyd's market over the years, and that regulation which sought to remove risk entirely would also stifle innovation and involve an unjustifiable level of costs for those in the market. We shall also have regard to the issues of competition, particularly between Lloyd's and the London Market, especially now that large capital providers can choose between doing business at Lloyd's and doing very similar business in the London Market.

- 55 It is clear with hindsight that through the 1970s and 1980s Lloyd's self-regulation did not match the standards of the time in other financial markets, let alone those now expected. Market imperatives all too often took precedence over proper regulatory standards. This was manifested in a number of well-publicised scandals, in the poor quality of advice given to many members and, above all, in the poor appreciation of underwriting risk which led to the crisis of the early 1990s. Lloyd's did improve its own regulation over that period, and in the last few years this has been substantially transformed, as attested by various independent reviewers, including rating agencies. We are determined that this standard should be maintained and, where possible, enhanced, and we shall use our powers to ensure that this is the case.
- 56 We do not deal in this paper with issues of financial crime, although there are possibilities for money-laundering in Lloyd's as in other insurance markets. These issues will be covered in a separate consultation paper.

Our proposed relationship with Lloyd's

- 57 To achieve these regulatory objectives cost-effectively, our provisional view, which is in line with the views expressed by Ministers, is that we should conduct some supervisory functions directly and in other areas should require Lloyd's to exercise its regulatory powers under our direction. Lloyd's has built up valuable expertise over the years and it may well want to maintain a significant regulatory function because participants in the market can expose each other to risk and for reputational reasons.
- 58 In the areas of direct FSA supervision, we shall make rules and issue guidance applying to certain types of activity and market participant, and we shall monitor and enforce these requirements ourselves. Where we believe it would be more appropriate to place requirements on Lloyd's, we shall set clear standards for the Society's regulatory activities, closely monitor its compliance with these, take enforcement action if it fails to meet the standards we have set, and if necessary take back certain functions. We shall keep these arrangements under review to ensure that they remain appropriate in the light of changing market conditions and the standard of Lloyd's regulation.
- 59 We propose to formalise this relationship with Lloyd's in a variety of ways depending on the area concerned. One option will be to make **rules** for the Society of Lloyd's and to leave Lloyd's to make whatever internal arrangements are necessary to comply with these. This will, for example, be our preferred approach to the successor to the Statutory Statement of Business. Under the draft FSM Bill we shall also be able to **direct** Lloyd's to use its regulatory powers to bring about an outcome which we could have achieved instead by using our own powers. This will sometimes be the most

effective way to place requirements on participants in the market - for example, the requirement for an annual audit certificate in respect of each member's underwriting accounts. In practice we will not expect always to need to invoke our formal powers. Where we require information, for example, we will often expect a request to Lloyd's to be sufficient. We will not, however, hesitate to use our formal powers where this is necessary to achieve our objectives.

- 60 In the rest of this paper we describe the various arrangements to be put in place, assuming this underlying approach. We indicate which functions we propose to conduct directly and where we intend to place requirements on Lloyd's. This proposed division of functions is summarised, with respect to each of type of market participant, in Annex C. We shall authorise market participants, approve certain persons and acquirers of influence, and monitor whether these firms and individuals continue to comply with our criteria for authorisation/approval and general principles. In performing these functions we shall draw on information from Lloyd's, including the results of its regulatory monitoring. The other main area where we shall apply our general rules and guidance directly, with certain modifications reflecting the nature of Lloyd's business, is the conduct of advisory and investment-related activities, including the custodianship and management of funds. We shall also monitor and enforce the requirements relating to former members and regulated firms outside Lloyd's which advise on participation in Lloyd's syndicates.
- 61 We propose to place requirements on Lloyd's to use its regulatory powers with respect to the prudential supervision of the insurance business, management controls in managing agents and the conduct of capacity auctions. In these areas Lloyd's already has in place extensive rules, monitoring and enforcement procedures (which will be reviewed in the light of the standards we set, both prior to N2 and on an on-going basis). Lloyd's powers with respect to members and syndicates also provide an efficient means of achieving our objectives in the area of prudential supervision.
- 62 If arrangements along these lines are to work effectively, there will need to be adequate 'gateways' for the FSA and Lloyd's to exchange confidential information for supervisory purposes. Relevant provisions will be included in the FSM Bill when it is introduced.
- 63 There would be formal monitoring and review exercises from time to time to give us the necessary assurance that Lloyd's regulatory standards are being maintained. In addition to this formal relationship, there would continue to be, as now with the Insurance Directorate, a wide range of day-to-day working contacts, and also regular high-level meetings (currently bimonthly) with the Chairman of the Council and other senior officials to discuss such issues as business strategy and market trends.

- 64 There are alternative approaches in which we would place less reliance on Lloyd's. At one end of the spectrum, we could carry out with our own staff all the regulatory activities which we considered necessary. This would include making the necessary rules for managing agents, members' agents and members of the Society, monitoring compliance with them, investigating possible breaches and taking enforcement action as necessary. In this model, the structure of regulation would continue to be along the lines set out below, but the method of delivery would be substantially different. Lloyd's would still be obliged by the Lloyd's Acts to continue to regulate in certain areas (including, for example, broking) where the FSA had no powers, and would require a compliance function akin to that in other regulated bodies. To the extent that it did more, either duplicating or extending our own regulation, that would be a commercial decision.
- 65 The main advantage of such a model is that regulation would be directly under the control of the FSA. We would be able to apply our own standards, with a lower risk that these would over time be eroded by commercial pressures or fail to respond to new regulatory challenges. The main disadvantage is cost, since in practice there might well be overlaps between our work and Lloyd's continuing regulation. For example, in a Society in which members and other market participants can put each other at risk, it may well be that some internal controls, for example over underwriting, would be thought necessary, whatever the externally-imposed regime. It might also be more difficult for us than for Lloyd's to maintain market expertise among our regulatory staff, though this threat can be overstated.
- 66 There are of course intermediate approaches. It is also possible that our approach will change over time, for example in response to perceived regulatory failure by Lloyd's in the future.

Q2 Do our provisionally preferred approach and the allocation of responsibilities proposed in Annex C represent an appropriate basis for the future relationship between the FSA and Lloyd's or should we move closer to the direct regulation approach described above?

Conduct in the market

- 67 Much of Lloyd's current regulatory activity is concerned with the relationships between participants in its insurance market. We have considered carefully what role we should play in this area. We have considered this from the point of view of the risks posed to the two main types of consumer of the services Lloyd's provides: policyholders and capital providers.
- 68 We have borne in mind that Lloyd's is predominantly a professional market, and that strong reasons are needed for the FSA to regulate such markets in

detail, and also the comparisons with the London Market, which at some points has strong similarities.

- 69 The main risks to both policyholders and capital providers are, as we have said, those posed by losses in the insurance business. We set out below the prudential supervision regime designed to address those risks. We have already noted that policyholders are also exposed to risk from their brokers but we do not expect to have any role in this area.
- 70 So far as additional risks to capital providers are concerned, the larger corporates will in general be able to function with limited statutory protection. For small capital providers, we place great weight on the role of the members' agent, particularly given the Government's intention that our rule-making powers over managing agents should be limited to rules for the protection of policyholders. Members' agents will, in particular, be the main protection for members against some of the abuses which have affected Lloyd's in the past. We discuss this role below.
- 71 We currently expect only to make detailed rules in the areas set out below. We accept, however, that Lloyd's as a Society may wish to make rules for its members and other participants beyond those appropriate to the FSA's statutory regulation.
- 72 Nevertheless, all regulated firms (including Lloyd's itself) and all approved persons will be expected to conform to the relevant set of the FSA's general principles. The draft principles for firms are set out above and explained more fully in the consultation paper we have published. Breach of any of these principles will be a ground for disciplinary action including, in serious cases, the withdrawal of authorisation or approval.

Q3 Are there important areas of risk for either policyholders or capital providers which this paper does not recognise, or with which it does not deal adequately?

Authorisation, approval of persons and grandfathering

Authorisation

Society of Lloyd's

- 73 The Society of Lloyd's is to be authorised by a provision in the FSM Bill, with permission to carry on its existing activities. We shall need to issue Lloyd's with a certificate of authorisation. This provision does not limit our ability to revoke, restrict or extend Lloyd's authorisation in the future in exactly the same way as for other regulated firms. Lloyd's will have to comply with the

general rules for regulated firms, including the principles, and with the specific arrangements described in this paper. Lloyd's compliance arrangements will need to satisfy the relevant FSA requirements.

Managing agents

- 74 Once it has demonstrated that it is fit and proper, a managing agent will be authorised by the FSA to carry on specific Lloyd's-related activities. It may also apply to the FSA for approval to carry on other regulated activities. The FSA will assess such applications consistently across the entire regulated community and will be consulting on the operation of this regime in due course. This will involve scrutiny of financial resources, business plans, and the integrity and competence of key individuals. We shall consider all relevant evidence, including any comments that Lloyd's may wish to make, for example on the records of those associated with any new application for authorisation of a managing agent.
- 75 Authorisation will be a necessary, but not a sufficient, condition of being able to operate at Lloyd's. The Society will be able to impose additional requirements or even refuse admission to an agent authorised by the FSA, although it is expected that refusal of admission will be rare. It is intended that, as far as possible, FSA's and Lloyd's application processes will run in parallel and that duplication will be kept to the minimum.

Members' agents and Lloyd's advisers

- 76 Members' agents and Lloyd's advisers (who perform a similar role for some corporate members) will also require authorisation to carry on specific Lloyd's-related activities. They too may also apply to the FSA for approval to carry on other regulated activities. The same comments apply as for managing agents, though the detailed criteria will naturally be different and will be closely aligned with those applying to other types of financial adviser. Similarly, any firms outside the Lloyd's market which offer advice to third parties on participation in Lloyd's syndicates and capacity auctions will require FSA authorisation to carry on these activities.

Approval of persons

- 77 We intend to make a general set of rules specifying which functions performed in relation to carrying on regulated activities are to be regulated functions. Persons performing these functions will require prior approval from the FSA. They will be those whose function either enables them to exercise a significant influence on the conduct of the firm's affairs or involves them in dealing directly with persons who use or may use any of the regulated services provided by the firm. This second criterion will not apply to those who deal with third parties with respect to general insurance business.

Society of Lloyd's

- 78 The Society of Lloyd's will be an authorised person and, because of its unusual structure, the FSA is likely to specify as regulated functions certain functions specific to Lloyd's. We envisage that these will include the posts of:

Chairman
Chief Executive Officer
Council members
Members of the Market and Regulatory Boards
Managing Director, Insurance Services Unit
Managing Director, Members' Services Unit
Director, Regulatory Division
Director, Finance; and
Director, Strategic Planning.

- 79 We shall, however, need to consider whether this list should be extended. This will require further work as the more general rules are evolved in the light of the results of a forthcoming consultation process.

Managing agents, members' agents and Lloyd's advisers

- 80 The general rules on approval of persons will apply, and the FSA will seek information from Lloyd's and elsewhere on the competence and past record of those affected. Lloyd's will be free, if it so wishes, to operate a more extensive individual registration scheme of its own.

Grandfathering

- 81 When it is introduced, the FSM Bill is expected to provide for existing members' and managing agents and Lloyd's advisers authorised by Lloyd's to be grandfathered at N2 in relation to any authorised business which they are carrying on at that date, subject to the usual right for us to require reapplication. Once the FSM Bill has at least reached its latter stages in Parliament, we shall review the records of all agents to allow us to determine whether any should be required to reapply.
- 82 We expect the FSM Bill to provide that persons performing regulated functions for grandfathered firms who are subject to approval by the FSA will be grandfathered, subject again to a right for us to require reapplication. This will cover those performing regulated functions for members' and managing agents and Lloyd's advisers. Our review will also embrace such persons.
- 83 The position of the Society of Lloyd's is somewhat different because the persons concerned have not previously been registered in their roles at Lloyd's. Where key persons in the Society are required to be approved, we shall

conduct the full approval process prior to N2 (in so far as the final FSM Bill allows this).

Controllers and influence

- 84 European legislation provides that those who acquire 10% or more of the capital or voting rights of an insurance undertaking, or a holding which allows them to exert significant influence over the management of that undertaking, have to be notified to the supervisory authority, which must have a power to object. There are also provisions relating to agreements relating to the exercise of influence and to increases in holdings above certain thresholds. Similar provisions exist for other kinds of financial services firms, and the FSM Bill therefore includes general provisions covering the acquisition of influence over all types of regulated firm; these are in Part X of the draft.
- 85 We do not expect that the application of these provisions to members' agents, managing agents, Lloyd's advisers or, if necessary in the future, to members of Lloyd's will cause any special problems. They mean that we shall need to approve changes of control or the acquisition of significant shareholdings in members' or managing agents and Lloyd's advisers, the criteria being: whether the acquirer is fit and proper; whether the interests of those using the services of the regulated firm would be threatened; and whether the conditions for authorisation would continue to be met.
- 86 The provisions will also apply to the Society of Lloyd's. The structure and governance of Lloyd's are unusual, but the provisions are written to cope with a wide range of circumstances. In this instance, we expect persons to be notifiable if they can exercise, or control the exercise of, 10% or more of the voting power at a general meeting, or exercise significant influence over the management of the Society by virtue of their voting power.

Q4 Do you have any comments on the proposed arrangements for authorisation and for the approval of persons and those who acquire influence over participants in the market?

Criteria for extension of authorisation to members

- 87 We do not intend to invoke our discretion to require members of Lloyd's to be authorised at N2. In deciding whether to do so in the future we must have regard to the criteria set out in clause 191(3) of the FSM Bill. We shall consider in particular the strength of Lloyd's own regulation for the protection of policyholders and the extent to which that protection depends on the resources available to the Society as a whole. For example, it is possible to envisage a situation in the future in which the resources available to Lloyd's centrally were small in relation to the business transacted, and in which Lloyd's itself had little control over the risks assumed and the assets held by a

few large corporate members. Were such a situation ever to occur, it is likely that we should wish to authorise and regulate those members direct. On the other hand, we have no wish to add to regulatory costs and burdens by authorising members while the resources and regulatory activities of the Society provide a satisfactory level of policyholder protection.

Q5 Under what circumstances should the FSA extend the authorisation requirement to some or all members of Lloyd's?

Former members

- 88 The draft FSM Bill currently provides for authorisation to be given to members resigning from Lloyd's on or after 24 December 1996 to allow them to carry out the contracts of insurance which they underwrote while they were members. This effectively reflects the existing position of former members under the ICA 1982. We will not need to issue those former members with certificates of authorisation. Former members who wish to carry on other regulated activities will need to apply to the FSA in the normal way.

Prudential supervision of Lloyd's as an insurance undertaking

Introduction

- 89 This section is concerned with the prudential supervision of Lloyd's as an insurance undertaking. There will also need to be capital adequacy regimes for members' and managing agents, which are in a sense prudential, but, since these businesses do not put their capital at risk as insurers, their capital adequacy regimes do not interact with that for Lloyd's as a whole. These requirements are discussed later in this paper.

Principles

- 90 Prudential supervision of any insurance undertaking is aimed at minimising the risk that it will be unable to pay valid claims as they fall due. This clearly requires consideration of assets, liabilities, potential liabilities and other risks. Our aim is that the prudential supervision regime for Lloyd's should be at the leading edge of insurance regulation internationally. The creation of the FSA also gives us the opportunity to draw on the best of prudential regulatory practice in other sectors, such as banking (just as those sectors will be able to learn from insurance supervision). In banking in particular, models have been developed which explicitly recognise and evaluate risk, and in certain circumstances supervisors have accepted the use of models created by regulated entities, rather than imposing their own. Similarly insurance supervisors will often review a company's capital allocation model as part of their consideration of whether it is soundly and prudently managed, and in

some countries, notably the US, a risk-based capital system is applied explicitly.

- 91 European legislation requires all insurance undertakings to hold adequate reserves to cover their liabilities, together with a solvency margin calculated by reference to premium income or claims (whichever leads to the higher figure). It also requires assets to be held in appropriately secure ways and the undertaking to be soundly and prudently managed. These requirements are implemented through the ICA 1982, which provides supervisors with a wide range of means of intervention if they consider that the interests of policyholders may be at risk. Supervisors will have at least equivalent powers under the FSM Bill, and the full range of powers will apply to Lloyd's.
- 92 In practice, supervisors in the UK would, as a matter of sound and prudent management, expect any company doing similar business to Lloyd's to hold well above the minimum margin of solvency.
- 93 Although insurance undertakings may be restricted as to the classes of business they may undertake, European law does not allow member states to require prior approval or systematic notification of policy conditions, scales of premiums or forms of contract. The FSA therefore has no power (and would not wish to have) to approve new products introduced at Lloyd's or by other insurers, beyond ensuring that insurers carry on only those classes of business for which they have authorisation. We shall, however, have a duty to keep ourselves informed about developments at Lloyd's, and where there are significant changes in Lloyd's business we shall naturally consider what implications these may have for prudential supervision. This will be particularly important given the changes under way in insurance more generally, for example the development of alternative risk transfer schemes. In considering the implications of new developments for our objective of protecting policyholders, we shall have regard (as the draft FSM Bill requires) to the desirability of facilitating innovation, in insurance as in other financial services. One benefit of the creation of a single regulator will be to enable a more flexible and swift response to innovations which cross the conventional borders between different types of financial activity.
- 94 Prudential regulation of Lloyd's is complicated by the fact that Lloyd's consists of many individual insurers whose assets are not pooled and most of whom would not have the financial resources to be acceptable to supervisors as stand-alone insurers transacting similar levels of business. It is the existence of centrally-held resources, in particular the Central Fund, that underpins a high level of security for Lloyd's policies. The Lloyd's crisis of the late 1980s and early 1990s showed how adverse developments combined with poor underwriting practices in some syndicates could erode the resources of many individual members and thus impose a burden on the Central Fund sufficient to threaten its existence, and thereby the whole market. The unwillingness or

inability of some members to pay their losses also exposed the fragility of the assumption that personal wealth held outside Lloyd's could be relied upon as backing for the market. More recently, we have seen the advent of corporate capital and limited liability. Some corporate members now concentrate their underwriting on a single syndicate so any losses on that syndicate will immediately hit their Funds at Lloyd's, without the possibility of being offset by profits on other syndicates. It is also clear that the scale of underwriting by some corporates means that they could also default on a scale much larger than a conventional Name ever could. For this reason, good prudential supervision of Lloyd's in the future must look at the potential threats to central resources, and the ability of those resources to respond. We discuss below how this might be done.

Solvency tests

- 95 Our prudential supervision of Lloyd's must, as a minimum, meet the requirements of European legislation. The key requirement is that the members of Lloyd's, taken together, should have assets sufficient to meet their liabilities plus the minimum margin of solvency. The legislation defines, in considerable detail, categories of assets acceptable for this purpose. (The EC is currently reviewing its solvency margin arrangements, but although there are expected to be some detailed improvements, applying to Lloyd's as to other insurers, we do not at present expect radical change.) We shall place a formal requirement on Lloyd's to replicate fully this so-called 'global solvency test', and the associated Treasury rules on the valuation of assets and liabilities. These last have recently been revised, and in some ways go beyond the European minimum requirements, for example by requiring an actuarial opinion on the liabilities of each syndicate.
- 96 In addition to the global solvency test, two other solvency tests are applied. One is the 'individual solvency test' which requires each member of Lloyd's to have assets available at least equal to their liabilities. We propose to retain it.
- 97 The third test, called the 'combined solvency test', was introduced in 1997 and attempts to remedy a defect in the global solvency test. That test implicitly assumes that all the admissible assets of the members of Lloyd's are available to meet all the liabilities. This is not the case; a member in surplus has no obligation to meet the liabilities of a member in deficit. The combined solvency test therefore requires each member individually to have assets sufficient to meet their liabilities plus a (slightly simplified) European minimum solvency margin. If a member is in deficit on this test, Lloyd's must be able to earmark sufficient centrally-held resources to bring them up to the standard, without taking account of any surpluses held by other members. This test also, by giving the supervisors discretion in the extent to which credit is allowed for inter-syndicate reinsurance, provides them with some limited

ability to inhibit the spiral of reinsurance which was one feature of the Lloyd's crisis. This too is a useful test and we propose to retain it.

Q6 Do all three Lloyd's solvency tests remain appropriate? Are there improvements which could be made, consistent with our European obligations?

Statutory Statement of Business

98 Lloyd's is required to produce annually a Statutory Statement of Business (SSOB) in which it sets out an analysis of its business over the previous year and also demonstrates how it complies with the solvency tests. The SSOB, which is published by Lloyd's, is the Lloyd's analogue of the Annual Returns which authorised insurance companies are required to submit to the Treasury, and which are placed in the public domain. As part of the convergence with more general insurance regulation, the SSOB will need to be brought more closely in line with those Annual Returns.

Q7 Do you have proposals for improving Lloyd's Statutory Statement of Business (SSOB)?

Risk-based capital (RBC) system

- 99 Simple replication of the ICA 1982 statutory regime will not, in our view, provide by itself the level of protection for Lloyd's policyholders which the Government wishes to achieve. It does not relate capital requirements to the types of risk assumed, as does good prudential supervision of insurance companies. More importantly, it does not capture the interactions between risks and resources at member level and hence the risks to the Central Fund.
- 100 Lloyd's risk-based capital (RBC) system is a more sophisticated system of assessing the capital levels members should maintain to back their Lloyd's risks. Despite some acknowledged weaknesses, it is a better regulatory tool for the Lloyd's market than the solvency tests or any likely development of them. As we have recognised above, RBC is a familiar supervisory tool in some countries and some of its ideas are used by UK supervisors in looking at prudent capitalisation of companies with diverse or volatile risk portfolios. In the particular circumstances of Lloyd's, the continued operation and development of the RBC system are, and are likely to remain, important factors in giving us confidence that Lloyd's is soundly and prudently managed.
- 101 Lloyd's RBC model analyses the types of risk to which each member is exposed on each of the syndicates in which he participates, the volatility associated with those risks, and the extent of diversification both within and between syndicates. It also takes into account the quality of syndicate management. On this basis it attempts to calculate the capital that each member should hold at Lloyd's on the basis that this should be directly

proportional to the risk that member poses to the Central Fund. At present, it is effectively used only to set higher than normal levels of Funds at Lloyd's for a small proportion of members with particularly risky portfolios, but it is not in principle limited to this. A fuller description of the system is at Annex D to this paper.

- 102 If we are to place reliance on the Lloyd's RBC model, we shall need to understand its operation in more detail, and to seek improvements where necessary. This will involve a detailed review, with our actuarial advisers, of:
- the components that make up the RBC charge;
 - the data used to assign values to the various components, and the reliability of that data;
 - the rationale behind any judgmental adjustments to values derived from the data;
 - the details of any other judgmental factors (for example loadings or discounts for factors such as 'management competence'); and
 - the way in which the various components are combined to arrive at the RBC charge.
- 103 We shall also need to examine the valuation methods used to calculate the value of members' assets and outstanding liabilities, though we should expect them to be the same as for the solvency tests (including, normally, an opinion by an actuary on the valuation of each syndicate's liabilities).
- 104 We shall pay particular attention to the evaluation of management controls within managing agents and syndicates. Syndicate business plans, properly formulated underwriting policies, and management controls to ensure that these plans and policies are adhered to are vital elements of control in a culture as strongly underwriter-led as that of Lloyd's.
- 105 Confidence in the model itself will need to be supported by assurance that the system is functioning as described. This would take the form of a periodic audit of the RBC process, examining internal controls, conducting sample reviews for reasonableness, and detailed walk-through tests for some components for some members. The system also needs to safeguard compliance with the RBC capital requirements. In essence, this comes down to monitoring compliance with syndicate business plans and underwriting policies, and reviewing the impact of any deviations from them. We should expect our audit to embrace: tests of the information flows used to assess compliance to confirm the reliability of data; review of Lloyd's compliance checks; and review of the actions taken in cases of non-compliance.

Aggregation of risk at market level

- 106 The RBC model will not, by itself, be sufficient. Because it operates with categories of risk, one potential problem which it does not address is aggregations of risk across the market. These may be exposures to a single event (e.g. a major earthquake) or to a class of problem (e.g. Year 2000 risks). They may also occur on the asset side of the balance sheet, for example exposure to a single reinsurer or holdings of securities issued by a particular company. Lloyd's Market Risk Unit currently conducts a range of analyses to address such problems. These will also help to underpin our confidence that Lloyd's is soundly and prudently managed. We shall wish from time to time to audit their continued operation, to see key results, and also from time to time to discuss with Lloyd's particular topics on which special analyses would be desirable.

Alternative approaches

- 107 We have described above our preferred approach to the prudential supervision of Lloyd's which, in addition to the existing solvency tests and the SSOB, relies heavily on the RBC system and Lloyd's own analyses of aggregation of risk. This is not the only possibility. It would, for example, be possible to work up an approach based on notional allocation of members' capital between the syndicates on which they write, together with FSA approval of syndicates' annual business plans and controls on risks assumed at syndicate level (which would be achieved through our powers over managing agents). Rules on these, and on asset holdings and reinsurance programmes, might be such as to inhibit risk aggregations, which the FSA might also monitor directly. We should welcome views on whether this or any other approach would provide more cost-effective regulation than our currently-preferred model.
- 108 In addition, if we do rely on Lloyd's RBC model and aggregation analyses as important elements of supervision, we need to be clear as to the FSA's exact involvement with them. There are several options. Our involvement could be purely informal; we could recognise that Lloyd's does these things, and draw comfort from them, without any formal rule-making. At the other extreme, we could mandate by rules the details of the model and of the analyses to be performed. One possible intermediate position would be to require Lloyd's to maintain an RBC system and monitoring of risk aggregations, acceptable to the FSA, but without specifying any detail.
- 109 In all this, we recognise that Lloyd's may well wish to offer a very high level of security to policyholders, and hence to retain resources well in excess of those that we should regard as necessary for a well-run insurance company doing a similar mix of business. There are many companies around the world which follow a similar strategy. Our proposed approach is not intended to preclude this. Our aim will be to ensure that Lloyd's has an appropriate and effective

system in place to manage the relationship between its underwriting risks and its capital, and that this is producing a level of security at least as good as we should expect of a well-managed company operating in similar areas.

Q8 Do we need additional tools for the prudential supervision of Lloyd's beyond solvency tests and the SSOB?

Q9 If so, are the Lloyd's RBC system and aggregation analyses the most appropriate and cost-effective tools?

Q10 What should be the FSA's formal involvement with the RBC system (or any alternative you consider more appropriate)?

- 110 Having outlined above the kind of prudential supervision regime we think may be appropriate, we now turn to the way that regime might be implemented through FSA rules. We do not deal here with rules made for other purposes, for example the protection of capital providers; these are considered later in this paper.

Lloyd's members

- 111 We propose to require Lloyd's to make rules for members to replicate the existing arrangements whereby premiums must be carried to trust funds with deeds approved by, currently, the Treasury and in future the FSA. We also intend to require Lloyd's to replicate the existing solvency tests, rules for valuation of assets and liabilities, and audit arrangements. In order to achieve this we intend to make a direction to the Council of Lloyd's, of the kind envisaged in clause 193 of the draft FSM Bill.

Role of Lloyd's

- 112 The FSA's ability to direct Lloyd's to use its own regulatory powers to bring about an outcome which the FSA could have achieved instead by using FSA powers is an attractive option in the area of prudential supervision, where it will save us making highly detailed rules covering large numbers of people. We therefore intend to use our powers of direction to require Lloyd's to set in place the necessary detailed provisions for the solvency tests. We shall also need to make rules for the Society of Lloyd's to require the annual SSOB.
- 113 Effective operation of the RBC system, and Lloyd's own supporting arrangements for the protection of its central resources, will require it to make rules over both managing and members' agents. We believe that, in the present state of affairs (and whichever option we adopt for our formal involvement with the RBC model), we can leave Lloyd's to make those rules and shall not need to make similar or parallel rules ourselves.

Managing agents

- 114 As referred to above, our powers to make, or require Lloyd's to make, rules for managing agents will be restricted to rules which are for the protection of policyholders. We shall not be involved in making rules, or requiring Lloyd's to make rules, for managing agents which are designed to protect the members of Lloyd's. We shall require Lloyd's to make rules to ensure the effective maintenance of members' resources to support underwriting. Managing agents will also need to fulfil the obligation, created by European law, for syndicates to publish accounts broadly similar to those required of insurance companies.
- 115 Lloyd's already requires managing agents to have adequate capital to support their businesses. The FSA will be consulting next year on the appropriate capital requirements for firms involved in regulated activities as agents. This consultation will cover managing agents and we shall decide in the light of its results whether any modifications to Lloyd's existing capital adequacy requirements are necessary.
- 116 To the extent that managing agents undertake any regulated activities which are not Lloyd's-related, the relevant FSA requirements will apply.
- 117 Our monitoring arrangements for managing agents will not duplicate Lloyd's own arrangements, so long as these remain satisfactory. We shall therefore rely on Lloyd's own reports in areas such as management controls, and seek to confine direct FSA monitoring to any regulated activities outside the ambit of Lloyd's.

Former members

- 118 We expect to make rules paralleling the existing set of Orders under the ICA 1982, which impose on former members a minimal set of requirements confined in practice to keeping Equitas, as agent for the Treasury, informed of any changes of address. The FSA will require to be notified of such changes.

Members' agents and Lloyd's advisers

- 119 Members' agents play a key role as advisers to small capital providers at Lloyd's. It appears likely that some of the declining population of members' agents will by N2 be in the process of recasting themselves as general financial advisers and investment managers to high net worth individuals. Members' agents and Lloyd's advisers will be supervised by the FSA direct. This will not, of course, preclude Lloyd's making additional rules if it deems them necessary; and we propose to require Lloyd's to make rules relating to the conduct of capacity auctions (as opposed to advice on trading in these), which will affect members' agents and Lloyd's advisers.

- 120 We shall make all the rules which we consider necessary to discharge our functions and will establish monitoring arrangements to ensure these are being complied with. We will not expect Lloyd's to monitor these rules. Most of them will be concerned with quality of advice and execution, and parallel those for financial advisers and managers more generally. For these purposes, firms may be able to treat some members as non-private customers because of the extent of their experience and knowledge of the market; this may result in a less detailed set of rules. Indeed, over much of the area our general high-level rules for financial advisers and investment managers may well be appropriate and sufficient, though we shall no doubt need to supplement them with market-specific guidance. This guidance will emphasise the need for members' agents to be well-informed about syndicates and the managing agents who operate them, and not to advise members to join syndicates where they judge information to be inadequate or where they consider that members may be exposed to inappropriate risks. This would include risks of abuse.
- 121 Rules directed at members' agents may be necessary relating to the mechanics of maintaining resources to support members' underwriting and the provision of information about members for the purposes of prudential regulation of the insurance business. In this area, however, as indicated above, we expect to require Lloyd's to make appropriate rules.
- 122 Lloyd's already requires members' agents and Lloyd's advisers to have adequate capital to support their businesses. The FSA will be consulting next year on the appropriate requirements for firms involved in regulated activities as agents. This consultation will cover members' agents and we shall decide in the light of its results whether any modifications to Lloyd's existing capital adequacy requirements are necessary.

Q11 Do the above proposals represent an appropriate approach to the supervision of members' agents and Lloyd's advisers? In particular, should we make the rules relating to quality of advice and execution or should we leave some of this rule making to Lloyd's?

Syndicate capacity market

- 123 The syndicate capacity market is problematical largely because its future development is unclear. Many believe that the current organised market will fade away sooner rather than later, though this would not preclude bilateral trading, just as unlisted shares in small companies can be traded outside an organised market. The new recognition requirements for Recognised Investment Exchanges have not yet been announced but we do not believe that the syndicate capacity market would meet the current requirements, particularly in areas such as liquidity and transparency, and it appears unlikely that it will move in that direction. The implication of this is that Lloyd's

authorisation will in all probability need to cover the operation of this market (as the draft FSM Bill provides) and that the FSA will need to review Lloyd's rules for these auctions to ensure they are consistent with its principles and promote its smooth functioning.

- 124 The draft FSM Bill provides us with strong powers against market abuse, such as misuse of inside information and attempts to manipulate prices. These include a power to impose civil fines, which will apply to anyone who breaches these provisions, whether or not they are regulated by the FSA. Following a consultation process, secondary legislation will set out the markets, and the instruments traded on those markets, to which these powers will apply. The Government has, however, indicated that at the outset coverage will extend only to Recognised Investment Exchanges and related off-market trading.

Q12 How do you expect the syndicate capacity market to develop? What type of rules will be necessary to its effective operation, and by whom should these be made?

Custodianship and management of funds

- 125 Removal of the exemption provided in the FS Act for Lloyd's-related activities will bring within the FSA's scope various arrangements under which Lloyd's participants hold and manage funds belonging to others.
- 126 To the extent that members' agents hold client funds, they will be acting in a way similar to other financial advisers and managers and will be subject to the normal FSA regime for such firms.
- 127 Members' Funds at Lloyd's are the funds deposited at Lloyd's to support underwriting. These, and the special reserves individual members may maintain, are held by Lloyd's and, where necessary, managed in accordance with members' instructions on an execution-only basis. In respect of these funds Lloyd's will be subject to the normal FSA regime for custodianship and administration of funds.
- 128 The premium trust funds held, and managed actively, by Lloyd's or by managing agents are the direct equivalent to the reserves of a normal insurance company. As noted above, in order to ensure that these remain available to meet policyholder claims, they are subject to trust deeds approved by the Treasury (in future by the FSA) and this regime includes restrictions on permissible investments similar to those for insurance company reserves. We believe that this regime is broadly correct and that the regime for PTFs should continue to parallel that for insurance company reserves.

129 There is, however, an important legal difference in that PTFs are in law the property of members rather than of the managing agents or Lloyd's itself. Absent any action on our part, therefore, they would fall under our general rules for investment management. We intend in fact that they should be subject to our high-level rules on custodianship and management of funds but that the more detailed rules should be disapplied in favour of broadly the existing arrangements.

Q13 Does this represent an appropriate approach to the management of funds in the special circumstances of Lloyd's?

Investigations, discipline and enforcement

130 The FSA is issuing a consultation paper setting out its approach to the exercise of its enforcement powers. In relation to the Society of Lloyd's and Lloyd's participants these will include the full range of its powers of information gathering and investigation, intervention and discipline.

- First, the FSA will be able to use its powers of information gathering and investigation to look into concerns about Lloyd's or any of the FSA-authorized participants in Lloyd's. This will include enquiries into managing agents, members' agents and Lloyd's advisers, together with persons connected with, or individuals employed by, them.
- Secondly, the FSA will be able to use its powers of intervention against Lloyd's and managing agents, members' agents and Lloyd's advisers, for instance when it has concerns about the fitness and properness of a firm or about its compliance with FSA principles or the FSA rules which apply to it.
- Finally, the FSA will have power to discipline Lloyd's or any of the FSA-authorized Lloyd's participants for breaches of FSA principles or applicable FSA rules or requirements. It will also be able to discipline approved persons employed by Lloyd's or authorized participants for breaches of FSA principles applying to approved persons.

The FSA's powers of investigation, intervention, and discipline are discretionary powers. Consequently, when considering whether to exercise those powers in relation to a concern or set of concerns about a particular firm or individual, the FSA may take into account the availability and relative effectiveness of Lloyd's own powers to investigate, intervene or discipline in relation to the concern or concerns.

131 In general, investigations, discipline and enforcement should follow rule-making: that is, any suspected breach of a rule should be pursued by the body that made that rule. The FSA will therefore have three functions in relation to discipline and enforcement:

- an indirect supervisory responsibility in relation to the Society of Lloyd's exercise of its own investigation and disciplinary powers (derived from the FSA's proposed general duty under the FSM Bill);
- a direct responsibility for intervening against, investigating and disciplining the Society of Lloyd's as a regulated firm for breaches of FSA rules etc; and
- a direct responsibility for intervening against, and disciplining, other Lloyd's participants who are regulated firms for breaches of FSA rules etc.

Annex C to this paper sets out in tabular form the FSA's proposed responsibilities in respect of the two latter enforcement functions, plus the areas in which we expect Lloyd's to exercise its powers of enforcement.

132 In order to fulfil its responsibilities, the FSA will require Lloyd's to provide it with regular information about the commencement and progress of:

- informal investigations carried out by the Investigations Department;
- formal investigations carried out by the Regulatory Proceedings Department; and
- formal disciplinary proceedings brought by the Regulatory Proceedings Department.

133 As the scope of the FSA's monitoring of Lloyd's participants will be limited in comparison to its monitoring of other authorised persons, the FSA may choose in individual cases to rely on Lloyd's Regulatory Proceedings Department to make preliminary (and sometimes more extensive) investigations into matters of concern about firms, and to report its findings to the FSA. If those findings reveal possible breaches of FSA principles or rules, the FSA may decide to intervene against or discipline the firm based on the information and evidence obtained by Lloyd's Regulatory Proceedings Department, supplemented by any additional information and evidence obtained from its own enquiries.

134 In some circumstances the FSA and the Society of Lloyd's may both have an interest in investigating and/or disciplining for a concern or set of concerns about a Lloyd's participant. This will arise where the suspected wrong-doing appears to involve breaches of FSA principles, rules or authorisation criteria as well as Lloyd's byelaws. In these circumstances, the FSA and the Society of Lloyd's will discuss which of them should use their powers based on the following principles:

- the Lloyd's participant should not be subject to more than one investigation or set of disciplinary proceedings for the same alleged wrong-doing, unless it is appropriate for two bodies to exercise their different powers against the firm or the investigation or discipline relates to different aspects of the misconduct;

- in consequence, disciplinary action will not usually be taken by both bodies concurrently, though there may occasionally be instances where consecutive action is appropriate (for example deauthorisation proceedings by the FSA following discipline by Lloyd's);
- the body whose powers are most appropriate to discipline a firm for, or otherwise deal with, the apparent wrong-doing should in most cases be responsible for leading the investigation of the concern;
- however, another important factor will be the relative effectiveness of the FSA's or Lloyd's powers to obtain the required information and evidence;
- if the FSA is investigating a concern about a Lloyd's participant it may request Lloyd's Regulatory Proceedings Department to assist it by providing technical advice, information and documents, or by carrying out its own enquiries and reporting its findings to the FSA;
- if appropriate, the FSA may formally appoint a member of Lloyd's Regulatory Proceedings Department together with a member of the FSA's staff or another competent person to investigate concerns about a Lloyd's participant;
- the FSA will always have power to carry out such investigations itself and take disciplinary action as it considers appropriate; and
- cases of joint interest will be reviewed regularly as they develop, to determine whether the lead responsibility should be transferred from Lloyd's to the FSA or (occasionally) vice versa.

Q14 Do the proposed arrangements for investigations, enforcement and discipline represent an appropriate division of responsibilities between the FSA and Lloyd's?

Appeals

- 135 The normal mechanisms for appeal to the Financial Services Tribunal will be available in any case where the FSA takes formal enforcement action. We expect Lloyd's to retain their current appeal arrangements.

Complaints

- 136 Lloyd's Complaints Department deals with complaints from both policyholders and members and attempts to ensure that syndicates and agents deal with these in an acceptable manner. Lloyd's wish to maintain their existing complaints mechanisms and we support this in principle for the time being. However, the establishment of the new Financial Services Ombudsman

Scheme, on which the FSA recently issued a policy statement, may require some changes in the handling of complaints falling within its remit. There is to be further consultation on the scope of the Scheme in due course.

Policyholders

- 137 As an authorised body, the Society of Lloyd's will become a member of the Financial Services Ombudsman Scheme. So far as complaints by policyholders are concerned, we intend that Lloyd's policyholders should have recourse to the Financial Services Ombudsman Scheme, on the same basis as for other insureds if they satisfy the Scheme's eligibility requirements. This will broadly replicate the current position; Lloyd's is a member of the Insurance Ombudsman Bureau and complaints relating to personal insurance policies issued in the UK can be referred to the IOB if the complainant is not satisfied with Lloyd's response.

Q15 Do you agree that policyholders should have the same access to the Financial Services Ombudsman Scheme as they currently have to the Insurance Ombudsman Bureau?

Members

- 138 The other potential source for complaints is Lloyd's members. At present if Lloyd's Complaints Department cannot resolve a member's complaint against a members' or managing agent, this may be referred to arbitration by the Lloyd's Arbitration Scheme. If a member has a complaint about alleged maladministration by the Corporation of Lloyd's, this may be taken to the Lloyd's Members' Ombudsman.
- 139 We consider that these arrangements provide adequate safeguards for members, but we intend to keep them under review.

Q16 Do you agree that Lloyd's existing dispute-resolution arrangements provide adequate protection for members?

Compensation

- 140 We shall be establishing a single compensation scheme, the Financial Services and Markets Compensation Scheme (FSMCS), to compensate consumers when a regulated firm is no longer able to meet its liabilities. We shall be consulting separately on proposals for the establishment of sub-schemes and business sectors and on such matters as funding mechanisms. Until this consultation is complete it is difficult to draw firm conclusions for Lloyd's.

Policyholders

- 141 At present, when an insurer fails, compensation may be provided to policyholders under a statutory scheme administered by the Policyholders Protection Board. The Scheme is governed by the Policyholders Protection Acts. Benefits of protection are subject to tests on whether: an insurance company is an authorised company carrying on business in the UK; the policy issued qualifies (reinsurance, marine, aviation and transport insurance business do not); there is a qualifying private (unincorporated) policyholder, and where the risk is situated. The scheme is funded by levies on authorised insurance companies based on relevant premium income. Lloyd's is excluded from this scheme. The question is whether it should be similarly excluded from the FSMCS after N2.
- 142 At present, if a member of Lloyd's is unable to meet his liabilities to policyholders, these will be met by Lloyd's Central Fund, to which all members contribute annually in proportion to their overall premium limits. In 1998 the contribution rate was 1% for individual members and 1.5% for corporate members. The Central Fund currently stands at £216 million. Lloyd's also has the right to make a pro rata call of £200 million from the premium trust funds without seeking the consent of members. Further calls can be made with the consent of members.
- 143 The issue, from a consumer protection standpoint, is whether the Central Fund offers protection roughly equivalent to that enjoyed by a policyholder of a normal authorised insurance company with access to the FSMCS. Lloyd's argues that it does, and that the correct comparison is between default of an individual underwriter with access to the Central Fund, and default of an insurance company with access to the FSMCS. The counter-argument is that individual underwriters at Lloyd's are much less secure than an authorised insurance company; that it is the Central Fund which makes the security of Lloyd's as a whole roughly equivalent to that of a good insurance company, and that, if certain policyholders of good insurance companies are judged to require additional protection, then that should also be available to policyholders of Lloyd's.
- 144 We have considered whether there are alternative models. One possibility would be to give relevant Lloyd's policyholders access to the FSMCS but deny them access to the Central Fund. This would, however, breach the principle of common security for Lloyd's policies. In equity to the other contributors to the FSMCS, if for no other reason, we would also need to ensure that the security offered by the individual underwriters of those policies was equivalent to that offered by an authorised insurance company. We have concluded this is not a practicable option.

- 145 The choice appears to lie, therefore, between continuing to exclude Lloyd's from the industry-wide compensation arrangements or giving eligible policyholders access to the FSMCS if the Central Fund were unable to meet their claims. If the coverage of the new scheme were broadly similar to the existing scheme - and this has yet to be decided - about 15% of Lloyd's business, primarily motor policies, might potentially be covered. Lloyd's is estimated to have a 10% net share of the UK domestic general insurance market and 15% of the UK motor market.
- 146 On the face of it, it appears desirable for Lloyd's policyholders to have access to similar compensation arrangements to those available to other policyholders. There are, however, several issues relating to funding which need to be considered.
- 147 If Lloyd's policyholders were to be included in a single insurance sub-scheme of the FSMCS, then, in the event of a failure by another insurer, the assumption would be that Lloyd's would contribute to any levies raised. If Lloyd's were to fail, i.e. the Central Fund were to be exhausted, other insurers would contribute to compensating its relevant policyholders. However, funding arrangements along such lines could be unwelcome both to the relevant Lloyd's members, who will continue to contribute to the Central Fund, and to the other members of the scheme. The funding, as well as the coverage, of the FSMCS will be addressed in more detail in a forthcoming consultation paper on compensation but we are seeking comments now on the issues relating to Lloyd's discussed above.

Q17 Should Lloyd's policyholders have access to the FSMCS on a similar basis to policyholders of other authorised insurers?

Q18 If Lloyd's policyholders were to be given access to the FSMCS, what funding arrangements should apply?

Members

- 148 Since our intention is that advice relating to participation in Lloyd's syndicates will be governed by FSA conduct of business rules, there may be a case for giving individual members access to the new compensation scheme, on a similar basis to investors but only in the event of default by their members' agent or other regulated adviser occurring after N2 and not in respect of misconduct prior to that date. This reflects the policy set out above, that members should be protected from bad advice but not from underwriting losses. Their degree of access to the FSMCS would be subject to the financial limits established under the scheme and might depend on the status of the member, for example whether he is a non-private client, reflecting our general philosophy that consumer protection should reflect the expertise and experience of consumers and hence their ability to contribute to their own protection.

- 149 However, as noted above, members of Lloyd's are sole traders in the business of insurance not investors in any traditional sense of that word. The FSA's provisional view is that it would be inappropriate for them to be eligible for compensation under arrangements designed for investors.

Q19 Do you agree that individual members of Lloyd's should not have access to the FSMCS?

- 150 Those who use any non Lloyd's-related services provided by members' and managing agents (for example, the investment advice which some members' agents may offer in the future) will have the same access to compensation as similar persons taking similar services from other regulated firms.

Consumer and practitioner involvement

- 151 We have already announced our intention to take account of the views of consumers and practitioners in formulating regulatory policy and practice, including the creation of a consumer panel and a practitioner forum. This principle of openness will apply to our regulation of Lloyd's. In its case there are several overlaps between consumers and practitioners; for example, individual members are generally insurers, consumers of insurance and consumers of financial advice, and many also work in the market. Lloyd's already has well-established arrangements for taking account of the views of the various market participants and we do not intend to disturb or duplicate these. We will, however, continue to consult all interested parties about major changes in our regulatory arrangements for Lloyd's and intend to draw on the expertise of market participants for advice in framing some of our detailed requirements.

Q20 Do you have any comments on our proposals for consumer and practitioner involvement?

Costs and charging

- 152 Our increased responsibilities for Lloyd's will inevitably require more resources than the equivalent of about five full-time staff which the Insurance Directorate currently spends on Lloyd's-related work (not all of which is supervisory in nature). We are, however, committed to ensuring that duplication between our regulatory activities and Lloyd's is minimised. We believe that, if our current assessment of the effectiveness of Lloyd's regulatory procedures is correct and we were to adopt the preferred approach set out above, we would initially require at least the equivalent of fifteen full-time staff at the FSA after N2, at an approximate cost of £1.3 million (including overheads) per annum. About a quarter of this work would be done in the

authorisation, approvals and enforcement areas, and the rest in the supervision divisions.

- 153 In the maximal model, we would expect to need a staffing level roughly equivalent to that which Lloyd's devotes to the areas of regulation in question, though there are some areas (for example, approval of individuals) where Lloyd's goes further than our likely general approach would suggest. On the assumption that Lloyd's continues to maintain its complaints-handling arrangements, and that we are content that Lloyd's should continue to deal with individual members (for example about the details of their compliance with the solvency tests), then we think that we would need the equivalent of some 80 staff at a cost of around £6.4 million per annum. As we have noted above, intermediate approaches are possible.
- 154 Decisions have yet to be taken on how the FSA's costs will be allocated between regulated firms and organisations after N2. There will be a consultation process. In the case of Lloyd's, managing agents, members' agents and Lloyd's advisers will be likely to pay some fees directly to the FSA whilst other charges will be levied on the Society itself.
- 155 Costs relating to Lloyd's may also be incurred by the Financial Services Ombudsman and Financial Services and Markets Compensation Schemes but these cannot be estimated until decisions have been taken on the extent of access to these schemes by Lloyd's policyholders and members. Both schemes are to be separately funded.

Cost benefit analysis

- 156 Oversight of the Lloyd's market by the FSA should bring significant regulatory benefits to market users. They will be able to be confident that the general standards the FSA is establishing with respect to admittance to the market have been applied and will be maintained there. Policyholders will benefit from the independent validation of Lloyd's prudential supervision of its insurance business. Standards for the advice and custodial services given to capital providers will parallel those established for financial advisers and managers more generally; and users of the capacity auction market will benefit from the FSA's review of the rules under which these operate.
- 157 The work the FSA will do will add to the cost of regulation, as described in the previous section of this paper. However, the net increase in the direct regulatory costs borne by market users will also depend on the resources which Lloyd's judges it will need to satisfy the FSA's requirements and its obligations under the Lloyd's Acts. The balance between costs incurred by the FSA and by Lloyd's may also change over time as the new regulatory arrangements evolve.

- 158 It is difficult to quantify the net change in regulatory costs because it is not clear how much regulation Lloyd's would continue to do, especially in the maximal model. In our currently preferred model, it is likely that there will be modest savings at Lloyd's, but that most of the FSA's costs will be incremental. This suggests a net increase in costs of the order of £0.7 million per annum (though since Lloyd's is not charged the full cost of Insurance Directorate's current activity the increase in costs to the market may be somewhat higher). In the more radical maximal model, much will depend on how far Lloyd's is prepared to rely on the FSA's work, especially in prudential regulation, but it is likely that the net increase in costs will be rather greater.
- 159 As regards compliance costs, we do not believe that the burden on participants in the Lloyd's market other than the Society would change significantly if we were to adopt our provisionally preferred approach. Some changes in the details of Lloyd's existing rules may be necessary but at this stage we do not believe they will result in significant additional compliance costs. There may, however, be some areas (for example, the application of FSA conduct of business rules to advice on participation in Lloyd's syndicates, and the proposed compensation arrangements) where the impact on some market participants may be more significant. We may need to undertake some more detailed cost benefit analysis when we are preparing the detailed rules to be applied and to share the results of this work when we consult those affected on the new rules.
- 160 To the extent that we moved towards the maximal approach, compliance costs would be likely to increase since, to the extent that there were overlapping functions, firms would need to deal with an additional set of regulators.

Q21 Do you have any comments on the costs and benefits of the proposals in this paper?

Transition process and timetable

- 161 We shall consider all the responses to this consultation paper and discuss these with Lloyd's. We hope to be able to announce our decisions on the future regulatory structure by the end of the second quarter of 1999, although in some areas final decisions may not be possible until the outcome of other consultation exercises being undertaken by the FSA is known. In the meantime work will begin on preparing the rules and requirements which will bring these arrangements into effect at N2. We intend to discuss drafts of these with Lloyd's and the relevant market participants during the second half of 1999. These will then be published.
- 162 As noted above, the FSM Bill as introduced is expected to provide for existing managing and members' agents and Lloyd's advisers to be 'grandfathered' into the new structure as regulated firms. Grandfathering is also expected to apply

to the persons connected with them who carry out functions subject to approval by the FSA. The latter will, however, have the right to require any such firm or person to apply for authorisation or approval under the new requirements. When the timetable for the grandfathering process has been determined, we shall decide whether any firms or persons should be required to reapply. They will then be notified of this decision.

Questions for consultation

- Q1 Do you have any comments on the likely future development of Lloyd's? What do these imply for the regulation of the market?
- Q2 Do our provisionally preferred approach and the allocation of responsibilities proposed in Annex C represent an appropriate basis for the future relationship between the FSA and Lloyd's or should we move closer to the direct regulation approach described above?
- Q3 Are there important areas of risk for either policyholders or capital providers which this paper does not recognise, or with which it does not deal adequately?
- Q4 Do you have any comments on the proposed arrangements for authorisation and for the approval of persons and those who acquire influence over participants in the market?
- Q5 Under what circumstances should the FSA extend the authorisation requirement to some or all members of Lloyd's?
- Q6 Do all three Lloyd's solvency tests remain appropriate? Are there improvements which could be made, consistent with our European obligations?
- Q7 Do you have proposals for improving Lloyd's Statutory Statement of Business (SSOB)?
- Q8 Do we need additional tools for the prudential supervision of Lloyd's beyond solvency tests and the SSOB?
- Q9 If so, are the Lloyd's risk-based capital (RBC) system and aggregation analyses the most appropriate and cost-effective tools?
- Q10 What should be the FSA's formal involvement with the RBC system (or any alternative you consider more appropriate)?
- Q11 Do our proposals represent an appropriate approach to the supervision of members' agents and Lloyd's advisers? In particular, should we make the rules relating to quality of advice and execution or should we leave some of this rule making to Lloyd's?

- Q12 How do you expect the syndicate capacity market to develop? What types of rules will be necessary to its effective operation, and by whom should these be made?
- Q13 Do our proposals represent an appropriate approach to the management of funds in the special circumstances of Lloyd's?
- Q14 Do the proposed arrangements for investigations, enforcement and discipline represent an appropriate division of responsibilities between the FSA and Lloyd's?
- Q15 Do you agree that policyholders should have the same access to the Financial Services Ombudsman Scheme as they currently have to the Insurance Ombudsman Bureau?
- Q16 Do you agree that Lloyd's existing dispute-resolution arrangements provide adequate protection for members?
- Q17 Should Lloyd's policyholders have access to the FSMCS on a similar basis to policyholders of other authorised insurers?
- Q18 If Lloyd's policyholders were to be given access to the FSMCS, what funding arrangements should apply?
- Q19 Do you agree that individual members of Lloyd's should not have access to the FSMCS?
- Q20 Do you have any comments on our proposals for consumer and practitioner involvement?
- Q21 Do you have any comments on the costs and benefits of the proposals in this paper?

Lloyd's: current regulatory activities

The Regulatory Division

Lloyd's regulatory division has the primary responsibilities of:

- assisting Lloyd's Regulatory Board (LRB) in formulating regulatory policy;
- authorising entities to trade in the market;
- ensuring that regulated entities and individuals comply with Lloyd's regulations through a process of inspection visits; and
- investigating allegations of misconduct to ensure that proper regulatory or disciplinary action is taken.

Headed by its director, who reports to the LRB through its chairman, the regulatory division has an establishment of 160 staff. The staff are organised into key functional groups - policy, authorisations, monitoring and enforcement, plus a regulatory proceedings group.

Regulatory Policy Group

The policy group formulates regulatory policy for consideration by the LRB. Much of this work results from the direction set by the LRB and from the need to respond to the changing marketplace. The staff in this group are in frequent discussion with agents, the Lloyd's Underwriting Agents' Association and the underwriting associations. It also keeps abreast of current regulatory thinking elsewhere through meetings with other regulators.

Authorisations Group

All regulated entities and individuals are subjected to a thorough registration process before being allowed to carry on business at Lloyd's. After the initial registration, certain changes in the circumstances of both firms and individuals

require approval. Registrations and subsequent approvals are carried out by the underwriting agents, brokers and individual registration departments.

Monitoring Group

To ensure that the required standards of good management continue to be met, the underwriting agents and brokers departments of the monitoring group carry out inspections of compliance and business practices. Emphasis is put on those aspects of the business, such as premiums and claims control, underwriting or advice to members, which carry the greatest risk for members or policyholders. Following an inspection visit, any shortcomings are reported, with a remedial plan agreed with the firm concerned. If appropriate, recommendations for regulatory action will be presented to the LRB and, if disciplinary action is required, the case will be referred to the investigations team prior to consideration by the Lloyd's Investigations Committee and, if necessary, a disciplinary tribunal.

Enforcement Group

The enforcement group encompasses complaints, investigations and the regulatory proceedings team. The complaints department deals with both policyholder and members' complaints and enquiries. The regulatory proceedings team works closely with the investigations department to prepare disciplinary cases for consideration by the Investigations Committee.

Regulatory functions carried out in other Corporation departments

A certain amount of the work carried out by other Corporation departments not within the regulatory division could be regarded as 'regulatory'. In particular, some of the activities of the market reporting and solvency department, the market financial services department, the members' services unit and the international department involve making demands upon the market to supply information or organise their affairs in particular ways which are perceived as 'regulatory', although they are largely concerned either with ensuring compliance with external solvency obligations or with the operational requirements of the Lloyd's market.

Extracts from the draft Financial Services and Markets Bill and Explanatory Notes

Extract from the draft Financial Services and Markets Bill

PART XVI

LLOYD'S

General

189. The Authority must—

Authority's
general duty

- 20 (a) keep itself informed about the affairs of Lloyd's and the activities
carried on at Lloyd's; and
(b) keep under review the desirability of exercising its powers under, or
in connection with, this Part.

The Society

190.—(1) The Society is an authorised person.

The Society:
authorisation and
permission.

25 (2) Section 27 applies to the Society as if it were authorised as a result
of an application under section 22.

(3) The Society—

- 30 (a) has permission to carry on a regulated activity of any of the
following kinds—
(i) arranging deals in contracts of insurance written at Lloyd's
("the basic market activity");
(ii) arranging deals in participation in Lloyd's syndicates
("the secondary market activity"); and
35 (iii) an activity carried on in connection with, or for the
purposes of, the basic or secondary market activity; and
(b) must be issued by the Authority with a certificate of authorisation.

40 (4) The power conferred on the Authority by section 37 may be exercised in
anticipation of the coming into force of the Society's permission (or at any
other time) so as to impose any limitation of a kind contemplated by section
34(4).

(5) The Society is not subject to any requirement of this Act concerning the registered office of a body corporate.

PART XVI ***Power to apply Act to Lloyds underwriting***
Direction by
Authority.

191.—(1) The general prohibition or (if the general prohibition is not applied under this section) a core provision applies to the carrying on of an insurance market activity by—

(a) a member of the Society, or 5

(b) the members of the Society taken together,
only if the Authority so directs.

(2) In subsection (1)—

“core provision” means a provision of this Act mentioned in section 192;
and 10

“insurance market activity” means a regulated activity relating to
contracts of insurance written at Lloyd’s.

(3) In deciding whether to give an insurance market direction, the
Authority must have particular regard to—

(a) the interests of policy holders and potential policy holders; 15

(b) any failure by the Society to satisfy an obligation to which it is
subject as a result of a provision of the law of another EEA State
which—

(i) gives effect to any of the insurance directives; and
(ii) is applicable to an activity carried on in that State by a 20
person to whom this section applies;

(c) the need to ensure the effective exercise of the functions which the
Authority has in relation to the Society as a result of section 190.

(4) An insurance market direction—

(a) must be in writing; 25

(b) must specify each core provision, class of person and kind of activity to
which it applies;

(c) may apply different provisions in relation to different classes of
person and different kinds of activity;

(d) may not be made unless the Authority has first consulted, in the way it
considers appropriate, persons appearing to it likely to be affected
by the proposed direction (except where the Authority considers
consultation impracticable or inappropriate). 30

(5) An insurance market direction has effect from the date specified in it
(“the effective date”), which may not be earlier than the date on which it is
made. 35

The core provisions.

192.—(1) The core provisions are—

- (a) Part V;
- (b) Part VIII;
- (c) Part IX;
- (d) Part X;
- (e) Part XI;
- (f) any provision of Part XVII.

40

PART XVI

(2) References in an applied core provision to an authorised person are (where necessary) to be read as references to a person in the class to which the direction applies.

5 **193.**—(1) The Authority may, instead of exercising a power conferred on it by section 191, direct the Society (acting through the Council) to exercise a power of its own with a view to bringing about the result intended by the Authority.

Exercise of powers through Council.

10 (2) A direction may also be given under subsection (1) in respect of managing agents or members' agents as if they were among the persons mentioned in section 191(1).

(3) A direction under this section—
15 (a) does not, at any time, prevent the exercise by the Authority of any of its powers;
(b) is subject to the same requirements as are applied to an insurance market direction by section 191(4).

Former underwriting members

194.—(1) “A former underwriting member” means a person ceasing to be an underwriting member of the Society on, or at any time after, 24 December 1996.

Former underwriting members.

20 (2) A former underwriting member is an authorised person.

(3) Section 27 applies to a former underwriting member as if he were authorised as a result of an application under section 22.

(4) A former underwriting member—
25 (a) has permission to carry out each contract of insurance that he has underwritten at Lloyd's (without that affecting his right to make an application under section 35(1)); but
(b) need be issued with a certificate of authorisation only if he receives an additional permission.

Supplemental

- 30 **195.**—(1) In this Part— Interpretation
“arranging deals”, in relation to the investments to which this Part
applies, has the same meaning as in paragraph 3 of Schedule 2; and
“participation in Lloyd’s syndicates”, in relation to the secondary market
activity, means the investment described in sub-paragraph (1) of
35 paragraph 21 of Schedule 2.
- (2) A term used in this Part which is defined in the Lloyd’s Act 1982 has 1982 c. xiv.
the same meaning as in that Act.

Extract from the draft Explanatory Notes

PART XVI: LLOYD’S

This Part concerns the extent to which the provisions of the Bill will or may apply to the Society of Lloyd’s (the “Society”). It also confers a power to enable the Authority to direct the Council of Lloyd’s (the “Council”), the governing body of the Society, to use its rule making powers under the Lloyd’s Acts 1871-1982 in relation to the Lloyd’s community.

Clause 189: the Authority’s general duty

This clause gives effect to the intention that while Lloyd’s should not, at least at the outset, be subject to full regulation by the Authority, the Authority should keep the regulatory arrangements for Lloyd’s under review.

Clause 190: The Society: authorisation and permission

This clause makes the Society an authorised person so that the Authority will be able to make rules and exercise its powers of intervention and discipline sanctions against it.

Subsection (3) has the effect of limiting the activities for which the Society has permission to arranging deals in insurance contracts, syndicate participation and connected activities. *Subsection (4)* gives the Authority a power to vary the Society’s permission (under clause 37) by imposing any conditions it considers necessary before this provision comes into force.

Clause 191: Direction by the Authority

This clause confers on the Authority power to give directions in relation to “insurance market activities”. This power can be used in relation to a member of Lloyd’s, or members taken together, though they will not, at least at the outset, be authorised persons. Directions under this clause can specify the extent to which the “core provisions” of the Bill, as set out in clause 192, will apply to them.

Subsections (3) and (4) make provisions about the exercise of the power to give directions. In particular, they require a direction to be given in writing and to specify the activities, persons and specific requirements under the core provisions to which it relates.

Clause 192: The core provisions

This clause sets out the core provisions which may be applied to members of Lloyd's under the power to give directions in clause 191. The core provisions relate to employment in regulated activities, rules and guidance, information gathering and investigations, influence over authorised persons, powers of intervention and auditors and actuaries.

Clause 193: Exercise of powers through the Council

This clause gives the Authority some discretion as to the way it exercises its power of direction under clause 191. Instead of directing the members of Lloyd's themselves, the Authority can direct the Society of Lloyd's, acting through its Council, to impose obligations on its members. The Council of Lloyd's can then implement any requirements (using its byelaw making powers under the Lloyd's Act 1982).

Subsection (2) also allows the Authority to exercise its powers through the Council in respect of managing and members' agents, rather than exercising powers against them directly as authorised persons.

Subsection (3) makes it clear that if the Authority chooses to give directions in this alternative form, it is not precluded from giving other directions which impose obligations directly on the market participants.

Clause 194: Former underwriting members of Lloyd's

This clause deems former members of Lloyd's, including members who decide to leave in the future, to be authorised for the purposes of this Bill in relation to the insurance business carried on by them while they were members of Lloyd's. This will enable the Authority to exercise its powers of intervention to the extent it considers it necessary until all liabilities under any contracts of insurance underwritten by former members have been discharged. The authorisation arrangements under this clause do not prevent a former member of Lloyd's obtaining permission from the Authority in relation to any other regulated activities.

Summary of proposed division between the FSA and Lloyd's of regulatory responsibilities in respect of the various participants in the market

Participants	Regulated activities	Proposed responsibilities of the FSA	Responsibilities of Lloyd's	
			Under Lloyd's Act 1982*	Imposed by the FSA
Society of Lloyd's		<p>Authorisation by virtue of clause 190 of FSMB.</p> <p>Approval of certain persons.</p> <p>Approval of acquirers of influence over Lloyd's.</p> <p>FSA Principles.</p> <p>General duty to keep informed about the affairs of Lloyd's.</p>	<p>Powers to regulate and direct the business of insurance at Lloyd's, including investigative and disciplinary powers.</p> <p>Responsible for steps and undertakings necessary to secure authorisations worldwide.</p>	<p>Compliance function in respect of the FSA's requirements and rules.</p>
	<p>Arranging contracts of insurance.</p>	<p>Requirement for Lloyd's to make rules for the global and combined solvency tests, including valuation of assets and liabilities and actuarial opinions.</p> <p>Rules for the annual Statutory Statement of Business (SSOB).</p> <p>Requirement for Lloyd's to maintain an acceptable risk-based capital regime.</p> <p>Requirement for Lloyd's to monitor marketwide aggregations of risk.</p> <p>General FSA rules relating to safe custody and administration of securities.</p> <p>General FSA rules relating to safe custody and administration of securities.</p> <p>Requirement for Lloyd's to make appropriate rules for capacity auctions.</p>		
	<p>Administration of premium trust funds.</p> <p>Custody and administration of members' funds at Lloyd's.</p> <p>Arranging capacity auctions.</p>	<p>Monitoring compliance by Lloyd's and approved persons with above requirements, Principles and rules.</p> <p>Investigating suspected breaches of the above by Lloyd's and approved persons, and any consequent enforcement action.</p>		

Participants	Regulated activities	Proposed responsibilities of the FSA	Responsibilities of Lloyd's	
			Under Lloyd's Act 1982*	Imposed by the FSA
Members		Reserve power to require authorisation.	Admission to market. Rules prescribing terms of underwriting agency agreements.	
	Concluding and carrying out contracts of insurance.	Requirement for Lloyd's to make rules relating to premium trust funds, with deeds to be approved by the FSA. Requirement for Lloyd's to make rules imposing the individual solvency test specified by the FSA, with asset and liability valuation rules and audit arrangements, both approved by the FSA.	Rules relating to resources to support underwriting, including individual solvency test and risk-based capital regime.	Rules relating to premium trust funds.
		Monitoring compliance by Lloyd's with above requirements. Investigating any breaches of the above by Lloyd's and consequent enforcement action.	Monitoring compliance by members with above rules. Enforcement in respect of members' breaches of above rules.	
Former members who resigned on or after 24/12/96		Authorisation by virtue of clause 194 of FSMB. FSA notification requirements for changes of address.		
	Carrying out contracts of insurance in the event that reinsurance for outstanding liabilities fails.	FSA Principles (taking into account that no regulated activity is being conducted unless, and until, an obligation to carry out contracts of insurance arises). Enforcing compliance with notification requirements		
		Authorisation. Approval of certain persons. Approval of acquirers of influence over managing agents. Capital adequacy rules (or requirement for Lloyd's to impose such rules). FSA Principles.	Admission to market. Registration of certain individuals, including approval of underwriters. Requirements prohibiting control by Lloyd's brokers.	
Managing agents				

Participants	Regulated activities	Proposed responsibilities of the FSA	Responsibilities of Lloyd's	
			Under Lloyd's Act 1982*	Imposed by the FSA
Managing agents continued	Arranging contracts of insurance.	Requirement for Lloyd's to approve and monitor syndicate business plans.	Approval and monitoring of syndicate business plans, including approval of major transactions.	Powers to appoint substitute agents.
	Administration of premium trust funds.	Requirement for Lloyd's to monitor management controls in managing agents.	Monitoring of management controls.	Monitoring of management controls.
	If applicable, advising on, and making arrangements relating to, non Lloyd's-related investments.	Requirement for Lloyd's to make appropriate rules relating to safe custody and administration of securities.	General FSA rules on conduct of non Lloyd's-related regulated activities.	Rules relating to prudential supervision of the Society and its members.
Members' agents and Lloyd's advisers		Monitoring compliance of Lloyd's with above requirements; and compliance of managing agents and approved persons with Principles and above rules.	Monitoring syndicates' and managing agents' compliance.	
		Investigation of suspected breaches of above requirements by Lloyd's and of above Principles and rules by managing agents and approved persons.	Investigating suspected breaches and any enforcement action.	
		Authorisation. Approval of certain persons. Approval of acquirers of influence over members' agents and Lloyd's advisers. Capital adequacy rules (or requirement for Lloyd's to impose such rules). FSA Principles.	Admission to market. Registration of certain individuals.	

Participants	Regulated activities	Proposed responsibilities of the FSA	Responsibilities of Lloyd's	
			Under Lloyd's Act 1982*	Imposed by the FSA
Members' agents and Lloyd's advisers continued			Powers to appoint substitute agents.	
	Advising on, and making arrangements relating to, participation in Lloyd's syndicates and capacity auctions.	General FSA rules on advice relating to participation in Lloyd's syndicates and on capacity auctions.	Rules on the information to be given to prospective members.	Rules on the provision of information for the prudential supervision of the Society and members.
	If applicable, advising on, and making arrangements relating to, non Lloyd's-related investments.	General FSA rules on conduct of non Lloyd's-related regulated activities.	Rules on the maintenance by members of resources to support underwriting.	
		Monitoring compliance of Lloyd's with above requirement; and compliance of members' agents, Lloyd's advisers and approved persons with Principles and above rules. Investigating suspected breaches of above requirement by Lloyd's and of Principles and rules by members' agents, Lloyd's advisers and approved persons; and any consequent enforcement action.	Monitoring members' agents and Lloyd's advisers' compliance.	Investigating suspected breaches and any enforcement action.
Regulated firms outside Lloyd's		General FSA requirements relating to authorisation, approval of certain persons, approval of acquirers of influence, capital adequacy etc.		
	Advising on participation in Lloyd's syndicates and capacity auctions.	General FSA rules on advice relating to participation in Lloyd's syndicates and capacity auctions.		
		Monitoring of compliance with above rules and requirements; investigating suspected breaches and any consequent enforcement action.		

Note * Lloyd's also has powers under the Lloyd's Act 1982 to regulate Lloyd's brokers, Lloyd's correspondents and Lloyd's agents worldwide.

Lloyd's risk-based capital (RBC) system

Background

The origin of Lloyd's commitment to a risk-based capital (RBC) system dates back to the Walker report (1992) on the London Market Excess of Loss (LMX) spiral. This report recommended the development of a series of risk weightings to measure volatility and risk in different categories of business and then to use this to place an upper limit on the total capacity a member might write in specific high-risk categories. The current system has taken these concepts further and applies a capital requirement to all categories of business, not just specific high-risk categories.

Objectives

The RBC system is designed to show what level of Funds at Lloyd's is reasonably expected to meet a member's liabilities. The quantum of those funds is calculated by reference to the expected loss and volatility of each type of business in each member's portfolio.

For those members with an underwriting portfolio that is well diversified, the RBC calculation will, most likely, have little or no effect since the Lloyd's minimum capital requirement (see below) will apply. For those with an underwriting portfolio which is concentrated, perhaps in higher risk classes of business, the Funds at Lloyd's will, in general, be based on the RBC calculation since the calculated amount is likely to exceed the minimum level.

Relation to Central Fund

Currently, the RBC system operates to promote equity in terms of the potential benefits which could be derived from the Central Fund in respect of different categories of business, i.e. to determine levels of capital so that all types of business are likely to impose an equal expected loss to the Central Fund per unit of net premium. The model is currently calibrated so that,

before the application of the minimum, the mathematical expected loss to the Central Fund is approximately £8mn.

The RBC aims to assess the risk that claims will be higher than expected. In order to provide an understanding of the way in which the RBC model captures this risk, and therefore the level of capital provision for each member, the insurance risk needs to be analysed further and may be sub-divided by reference to the risk arising from the following distinct sources.

(a) Class of business risk

This risk depends only on the nature of the business written and drives the profitability of the business and the uncertainty of achieving that profit. The class of business risk can be further sub-divided into underwriting risk and reserving risk.

(b) Management risk

This risk arises as a result of management actions and will vary depending on the quality of management and the syndicates' circumstances.

The RBC formula evaluates each of these sources of risk based upon historical Lloyd's data combined with input from market practitioners.

Operation of system

The underwriting portfolio of every member is assessed for underwriting risk and reserving risk, adjusting for:

- business mix;
- managing agent spread; and
- reinsurance credit.

Credit is also given for the number of years underwriting in the portfolio.

Setting the RBC requirement

To the base RBC number obtained as above, loadings are applied. For the 1999 year of account the current system has three types of loading.

The first loading comes from the monitoring work performed by Regulatory Division staff. All agents and syndicates are awarded a rating from 1 (least good) to 4 (best), based on a regulatory review of their competence, systems of internal control, compliance culture and a range of other factors. Those with a rating of 3 or 4, which represent the majority of the market, are not affected by the loading process. Those with 1 or 2 ratings are subject to a 20% or 10% loading, respectively.

The second type of loading is a new syndicate loading. This loading is particular to syndicates which have been in existence for less than three years and usually results in an increased capital requirement based on projections calculated by Lloyd's centrally.

The third loading is being introduced for the first time for the 1999 year of account. This loading aims to reflect the additional risk associated with current market conditions and that historical data supporting the RBC system may provide capital ratios that are too low. A series of tests was constructed based upon syndicates' expected results under different disaster scenarios. Loadings of up to 15% of capacity have been applied to individual syndicate RBC ratios for 1999 calibration

The risk-based capital formula calculates a Funds at Lloyd's requirement using parameters based on all Lloyd's data. Hence a capital charge for any particular category of business is based on the overall market claims and loss experience for that category. By definition, therefore, the use of the formula involves averaging. In effect, the capital charge for any given business type will be the charge which, on average, is adequate (as determined by the calibration of loss to the Central Fund) to support that business type. In reality, however, there is no such thing as an average syndicate or an average underwriting portfolio. Indeed some syndicates have consistently out-performed the market average because of better management or more effective use of reinsurance, for example.

In order to overcome the effects of the strict averaging approach, Lloyd's has developed a mechanism by which the syndicates' own data may modify the formula-generated RBC ratio. This is performed by constructing a hypothetical syndicate which is deemed to have written exactly the same business as the syndicate supplying its own experience, but with a 'market-average' result for each of its classes of business. Any improvement to the syndicate's own results over and above the market average will be reflected in the ratio. The syndicate submitting the data does, however, run the risk of the hypothetical syndicate having a better series of results than the actual syndicate. In such circumstances the syndicate would be required to increase its capital requirement.

Final adjustments

There are a number of prudential margins applied to the formula before the final Funds at Lloyd's figure is determined. The first of these assumes that for the proposed underwriting year 100% of the capacity will be utilised rather than the level indicated in the syndicate's business plan. Also, there are currently minimum levels of capital based on the proposed capacity of a member. For a limited liability member the minimum level is 50% of capacity,

except for those supporting predominately UK motor business where a lower figure applies. For unlimited liability members, the 1999 minimum capital requirements are 35% Funds at Lloyd's plus 10% Other Personal Wealth. A lower minimum in respect of UK motor underwriting also applies to these members.