



Financial Services Authority

# Response Paper on Consultation Paper 16: The Future Regulation of Lloyd's

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# FUTURE REGULATION OF LLOYD'S

## Introduction

- 1 The Financial Services Authority (FSA) published Consultation Paper (CP) 16, *The future regulation of Lloyd's*, in November 1998. This described how the FSA intended to exercise its proposed new responsibilities and powers in relation to Lloyd's after the relevant legislation has come into effect (the date we refer to as N2). Responses were requested by 31 March, in particular to twenty-one questions posed in the paper. This Response Paper summarises the responses received and how the FSA will address these, both in the structure of the new regime for Lloyd's and in drafting the relevant sections of its Handbook of Rules and Guidance (the Handbook). The final sections summarise the new regime and the next steps in putting it in place.
- 2 Since last November the FSA has published other consultation papers on issues relevant to the future regulation of Lloyd's. These include:
  - CP 17 *Financial services regulation: Enforcing the new regime;*
  - CP 20 *The Qualifying Conditions for Authorisation; and*
  - CP 24 *Consumer compensation: a further consultation.*The outcome of these consultation exercises, and of others that are planned, will affect the final design and details of the new Lloyd's arrangements.
- 3 CP 16 reflected the provisions of the draft Financial Services and Markets Bill (the Bill) published in July 1998. Since then the Treasury has conducted its own consultation exercise on the Bill and it has been scrutinised by the Joint Parliamentary Committee on the Financial Services and Markets Bill, which reported on 27 April. A revised Bill was introduced on 17 June. There are only minor changes in the clauses directly relating to Lloyd's published last year, although the clauses have been renumbered.

- 4 Since CP 16 was written a number of changes have taken place, or been proposed, at Lloyd's which are relevant to its future regulation. These include the proposal to create a new Lloyd's vehicle (a proportional reinsurance syndicate), the insurance of the Central Fund, and the proposed absorption of Lloyd's advisers into the members' agents category of underwriting agents. Some implications of these developments for the future regulatory arrangements are discussed in the relevant sections of this paper.

## **Responses to CP 16**

- 5 The FSA received written responses to CP 16 from 39 organisations, firms and individuals; these included most types of Lloyd's market participant and some other interested parties from the insurance industry. We have subsequently had a number of discussions with some respondents during which further comments were made. The Council of Lloyd's submitted a single response on behalf of the Society, which has been published. A list of respondents - excluding any who asked for their names to be kept confidential - is in the Appendix.
- 6 There was general support for strengthening the external statutory regulation of Lloyd's and for the powers that the Government proposes to give to the FSA with respect to this market. The main issues which concerned respondents were:
- the future division of regulatory functions between the FSA and Lloyd's;
  - the scope for undesirable, and costly, duplication stemming from Lloyd's continuing regulatory obligations;
  - the scope for harmonising the regulation of Lloyd's and insurance companies in the London market;
  - whether Lloyd's risk-based capital model was a sufficiently robust tool for prudential supervision;
  - what type of rules should apply to the capacity transfer market; and
  - whether Lloyd's policyholders and members should have access to the new single Ombudsman and compensation scheme.
- 7 The comments made, and the FSA's responses, are discussed below, following the order of the twenty-one questions asked in CP 16.

### **General approach**

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

- 8 Most respondents agreed that **market consolidation** would continue although some smaller units were likely to remain. A **diverse capital base** and **non-aligned capital providers** were expected to continue for the present, although there were different views on how significant these were likely to be in the longer-term. A number of respondents made the point that the future structure of the market should be left to market forces and was not an appropriate area for regulatory intervention. However, the current uncertainty over the future shape of the market should be reflected in flexible regulatory requirements which could be changed quickly.
- 9 A number of respondents thought that the **annual venture** and **three-year accounting** were anachronistic; continuous capital and annual accounting would improve transparency for the benefit of all involved in the market. The FSA intends to keep closely in touch with the debate within the market on these issues so that the regulatory implications of any proposed changes can be fully addressed.
- 10 There was general agreement that regulation must remain flexible in order to accommodate **changes in risk management techniques** and the development of **Alternative Risk Transfer**. This was important to Lloyd's competitiveness. For the same reason, there should be consistency with the regulation of the **London market**, with which Lloyd's was likely to become increasingly integrated. It was recognised, however, that complete consistency would not be appropriate as long as Lloyd's retained its unique structure, including the Central Fund on which its licences depend.

### ***The FSA's proposed relationship with Lloyd's***

***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 maximal approach?***

- 11 In CP 16 we stated that the primary concern of the new regulatory arrangements for Lloyd's would be the protection of policyholders against the risk that valid claims might not be paid. Our principal focus would therefore be the prudential supervision of its insurance business. However, the Society's unusual structure - its common security, the provisions of the Lloyd's Acts and its relationship with its members - meant that we would have to adapt our normal supervisory procedures and also have regard to certain other factors, notably the protection of members as consumers of certain financial services.
- 12 To facilitate regulation of the Society's insurance business, clause 288 of the Bill gives the FSA power to pursue its objectives by requiring Lloyd's to exercise its powers under the Lloyd's Acts under the FSA's direction. This will, for example, enable us to enforce the EC solvency test on members without requiring them to be authorised persons. This power could also be used to

ensure that the underwriting activities of the Society's members are conducted and controlled to the standard that we would expect from a major insurance company. Alternatively, the FSA could make, monitor and enforce its own rules to achieve the same result.

- 13 In CP 16 we said that our "preferred" approach was to carry out fully certain functions - including authorisation, approval of persons, and regulation of advice given by members' agents - but in other areas - principally prudential regulation and the secondary market in syndicate capacity - to require Lloyd's to use its powers under our direction. In reaching this view we took account of the requirements which Lloyd's already has in place to protect its market and the Central Fund, and which it intends to maintain as long as the Society preserves its common security. We contrasted this with the "maximal" approach in which we would carry out all necessary functions in all areas ourselves.
- 14 This was an issue that attracted strong interest from respondents. Numerically they were about equally divided between the "preferred" and "maximal" approaches but the weight of opinion and argument, including Lloyd's own view, favoured the "preferred" approach. Those favouring the "maximal" approach generally did so for one of the following reasons: full regulation by the FSA would enhance external perception of the quality of regulation; it would help minimise costly duplication; or they lacked confidence in Lloyd's regulatory track record either in the early 1990s or more recently because of perceived conflicts of interest between commercial and regulatory objectives. The latter concern prompted suggestions, which we do not believe to be practicable, that, although regulatory functions might continue to be carried out by Lloyd's Regulatory Division, Lloyd's Regulatory Board should report to the FSA instead of to the Council.
- 15 Respondents who argued for the "maximal" approach did not, however, in general recognise the extent to which functions characterised within Lloyd's as "regulatory" are in effect functions that in a normal insurance company would be carried out by central management or the compliance area. There are therefore strong arguments in favour of Lloyd's continuing to perform them. As with any insurance company, we shall monitor its performance to ensure that it continues to meet our high level requirements for regulated firms.
- 16 We have reviewed the proposals in CP 16 in the light of the responses and we set out in the rest of this paper how we consider we should approach each area of the new regulatory regime. Where we intend to require Lloyd's to use its powers under our direction, we shall set clear standards in the Handbook, which will be at least comparable to those we apply elsewhere. We shall closely monitor Lloyd's compliance with these requirements and be prepared to perform more functions ourselves if necessary. We shall also expect the

Council to maintain appropriate internal governance of its regulatory functions and to ensure that we have direct access to those charged with responsibility for them.

### **Conduct in the market**

*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?*

- 17 A number of respondents thought that CP 16 failed to pay sufficient regard to the **interests of members**, notably non-aligned capital providers. It was argued that the administration of their agency relationships, notably with managing agents, had not kept pace with recent changes in market structure. This was not an area in which members' agents were able to protect members' interests and it should be reflected in relevant parts of the FSA's rules. We accept that this is a cause of considerable concern to non-aligned members, which Lloyd's has endeavoured to address through guidance and amendments to its byelaws. We set out elsewhere in this paper the action we propose to take in areas relevant to these concerns, notably the capacity transfer market.
- 18 Other respondents thought that insufficient attention had been paid to certain areas of **market risk**, including reinsurance to close, reinsurance risks and the risks associated with 100% lines. We shall take account of these comments in developing our prudential supervision tools for this market.

### **Authorisation, approval of persons and grandfathering**

*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?*

- 19 Authorisation and the approval of persons and those who acquire influence over market participants were identified by many respondents as areas where there was considerable potential for undesirable duplication between the FSA and Lloyd's. In the interests of cost effectiveness, some suggested this work should be fully delegated by the FSA, whilst others argued that the FSA should have sole responsibility for certain processes, notably individual registration.
- 20 We appreciate the force of these arguments. However, these functions, especially controlling authorisation to conduct Lloyd's-related regulated activities, are central to achieving several of the FSA's statutory objectives and are not capable of being delegated in the manner suggested. Similarly, Lloyd's has to satisfy itself about these matters because participants in the market can expose each other to risk and for reputational reasons. We shall, nevertheless, work closely with Lloyd's as we prepare the relevant sections of the Handbook

to ensure that our procedures are co-ordinated as far as possible and unnecessary duplication is avoided. We shall also co-operate closely after N2.

### **Authorisation**

- 21 In March the FSA published *The Qualifying Conditions for Authorisation* (CP 20), which explained how we intended to address our responsibility to ensure that applicants for permission to conduct regulated activities satisfy the conditions set out in the Bill. The consultation on these proposals, which will apply to Lloyd's market participants, closed on 18 June and it is therefore too early to report on its outcome. This will be done in due course. A further consultation paper is to be issued on the operation of the permission regime.
- 22 One respondent to CP 16 argued it would be inappropriate for the **Society of Lloyd's** to be authorised by a provision in the Bill; it should have to satisfy the Qualifying Conditions for Authorisation (QCAs). However, the statutory authorisation the Government proposes will not absolve Lloyd's from having to meet the QCAs at N2 and on a continuing basis thereafter, as will all other regulated firms. As pointed out in paragraph 73 of CP 16, the statutory authorisation will not limit the FSA's ability to take enforcement action if Lloyd's fails to comply with the QCAs or any other of its requirements.
- 23 In its response Lloyd's suggested that the Society and the FSA should deal with the authorisation of **managing and members' agents** as quickly as possible, with agreed performance standards and full sharing of relevant information. These points will be addressed in the preparation of the FSA's Authorisation Manual. The Bill requires the FSA to complete its determination of an application within six months of receipt of a completed application and in any event within a twelve-month period. In due course the FSA will publish service standards, setting out how long the application process is expected to take, and will publish its performance against those standards.
- 24 In April the Council of Lloyd's issued a consultation document, *Private capital at Lloyd's: proportional reinsurance syndicates*. This proposed the creation of a new Lloyd's vehicle, the Proportional Reinsurance Syndicate, which would be managed by a new category of underwriting agent, a **PRS manager**. If this proposal proceeds, such agents would require authorisation by the FSA as of N2.

### **Approval of persons**

- 25 Several respondents suggested other posts within the **Corporation of Lloyd's** which should fall within the definition of regulated functions, mainly in the compliance and regulatory areas. Another urged that the FSA's approval regime for persons employed by **members' and managing agents** should have a higher threshold than that of Lloyd's individual registration system and that its requirements should be more precise as regards coverage and less detailed in

terms of the information requested. Flexibility was also required to cover changes in job specification and the use of contractors.

- 26 The FSA plans shortly to issue a consultation paper on the principles and code of practice with which all approved persons will have to comply. The detailed requirements for Lloyd's market participants will be determined in the light of the results of that consultation and will be set out in the Handbook.

### ***Grandfathering***

- 27 Some respondents argued that grandfathering of Lloyd's underwriting agents should be avoided as far as practicable. The Treasury has stated, however, that it is not the intention that firms authorised to carry on business under existing legislation should have to apply for authorisation. Those authorised when the Bill comes into force will have the right for their authorisation to be grandfathered. We therefore expect the amended Bill to provide for this, subject to a right for the FSA to require reapplication within two years.
- 28 Similar arrangements are expected to apply for individuals who perform regulated functions for such agents and who are currently approved by Lloyd's. Any person whose role brings them within the scope of the FSA's approved persons regime but is not currently approved by Lloyd's would have to apply to the FSA for approval by a specified date.

### ***Controllers and influence***

- 29 One respondent suggested that the threshold for FSA approval of changes in the control of **members' agents** should be 5%, rather than 10%, and that approval should be subject to specific safeguards being in place to cover possible future claims from members (ie, adequate Errors & Omissions cover or funds held in escrow).
- 30 As noted in paragraph 84 of CP 16, the 10% threshold stems from European legislation applying to other regulated firms. This requirement is also discussed in more detail in *The Qualifying Conditions for Authorisation*. It has been adopted in the Bill as an appropriate and practicable threshold for this purpose and the business of members' agents appears to have no special characteristic which would justify a lower threshold. When considering proposed changes of control, the FSA will take account of the interests of past, current and prospective customers. E&O cover for members' agents is mentioned later in this paper.

### ***Criteria for extension of authorisation to members***

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

- 31 Respondents were divided on whether some or all members of Lloyd's should be authorised either from N2 or in the future. Some argued that there was no need for authorisation because they were external investors. Others argued in favour of an immediate authorisation requirement for various types of member: for example, working members; all members writing in excess of a certain amount; all corporate members; large dedicated corporates; corporate members from overseas territories where there were question marks over the quality of regulation; or any member with a significant market share. Other respondents thought authorisation of members would be appropriate if the market became fully integrated and corporate members were wholly aligned with managing agents.
- 32 Lloyd's argued that there was no need to authorise members as long as the Society maintained a properly managed admission system and an adequate Central Fund. It would want to continue controlling the admission of members as long as it retained a Central Fund, global licences and a valuable brand name.
- 33 We have not been persuaded that requiring members to be authorised by the FSA as of N2 would bring sufficient additional regulatory benefits. Some of the concerns which lie behind the authorisation categories suggested should be adequately addressed by Lloyd's membership procedures or some of the FSA's other requirements, including the authorisation of managing agents and the approved persons regime. We are also satisfied that the Council has adequate powers with respect to members, which we could direct it to use if circumstances were to warrant this. We therefore intend to proceed as set out in paragraph 87 of CP 16, keeping the need for member authorisation under review in the light of any structural changes affecting the protection available to policyholders.

## **Prudential supervision of Lloyd's**

### ***Solvency tests***

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

- 34 Several respondents argued that the "combined" solvency test had made the others - the "global" and "individual" solvency tests - redundant and that retaining the global test was seriously misleading because it implicitly assumed - incorrectly - that all members' admissible assets were available to meet all the liabilities. We accept the validity of these criticisms and therefore propose to retain only the "combined" solvency test provided this can be made compatible with the requirements of European law. We believe that the current "combined" test can be amended to remove the effect of the

simplification mentioned in paragraph 97 of CP 16. If this is done, the test will effectively embrace the “global” solvency test, thus satisfying European requirements. We intend that this change should come into effect at N2.

- 35 Other respondents suggested more radical changes in the solvency tests, including calculating these in relation to risk-based factors, such as probable maximum loss, rather than premium income and taking account of past results and the spread of risk. Changes of this kind would not, however, be compatible with current European requirements. Nevertheless, we intend to take account of such factors in our prudential supervision through the use of other tools, as described in the following sections of this paper.
- 36 The EC’s Insurance Groups Directive (98/78/EC) was published in December 1998 and must be implemented by 5 June 2000. Insurance undertakings will be required to provide group returns and additional information on intra-group transactions with effect from their financial years beginning on or after 1 January 2001. The FSA is currently considering with the Treasury how this directive should be implemented with respect to the Society of Lloyd’s. Some members will be required to submit additional information to the FSA because they are part of insurance groups.

### ***Statutory Statement of Business***

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

- 37 Views were requested on whether the SSOB was adequate and whether it could be improved. In general there was a consensus in favour of change, which we support. Respondents thought that the SSOB should be more informative and useful, providing a level of detail analogous to that found in insurance company returns.
- 38 Because of the distinctive features of Lloyd’s, it will take some time to explore and identify the format that is likely to yield the most useful information. There is also a significant task to identify whether an expanded return will require additional information from the market and, if so, for market participants to get ready to report. We do not therefore expect that an expanded SSOB will be formally in place before the year beginning 1 January 2001. We shall consult the market on our detailed proposals.
- 39 Our first thoughts, following preliminary discussions with Lloyd’s and others, are that there would be value in a return which reported at market level on solvency, trading results and assets and at syndicate level for the detailed technical analysis.
- 40 This proposal aggregates reporting to the most appropriate level. Assets and solvency are shown at the global level illustrating Lloyd’s partial mutuality of resources. Underwriting decisions are made at syndicate level and reporting

by Lloyd's at this level will give an insight into the relative performance of syndicates and their reserve strength.

### ***Risk-based capital (RBC) system***

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

- 41 A majority of respondents agreed that additional tools were required; the solvency tests were backward looking, not transparent and of limited value. Effective prudential supervision needed to identify "pressure points" within the Lloyd's market, for example, aggregations and concentrations of risk. Others argued that the solvency tests and the SSOB were comparable to the current prudential supervision tools for insurance companies and that European law limited the extent to which additional solvency requirements could be imposed on insurers.
- 42 The FSA recognises this constraint but continues to believe, as stated in paragraph 92 of CP 16, that sound and prudent management will in practice require companies doing similar business to Lloyd's to hold well above the minimum margin of solvency. Tools will be needed to enable it to make similar judgements with respect to Lloyd's.

#### ***Q9 If so, are the Lloyd's risk-based capital (RBC) system and aggregation analyses the most appropriate and cost-effective tools?***

- 43 Most respondents thought that Lloyd's **RBC system** provided a reasonable starting point but, because it had been developed for different purposes, it needed further development if it was to be an appropriate regulatory tool. It should be more transparent and take better account of reinsurance, the need for flexibility in business plans, RITC factors, and the insurance cycle.
- 44 In paragraphs 102-105 of CP 16 we said we would be asking our actuarial advisers to examine in more detail the RBC model and how it operates in practice. We have now received their initial report on the model. Their preliminary conclusions are broadly similar to the views expressed by respondents: the RBC model has a number of imperfections but it forms a better basis for assessing risk at Lloyd's than the standard solvency tests. Further work is to be done by our advisers to evaluate the quality and value of the data input to the model.
- 45 A number of respondents supported continued development by Lloyd's of **aggregation analyses** and suggested that more "risk of ruin" **stress testing** should be done. They also argued that disclosure of the results of testing should be improved, especially to capital providers. We recognise the importance of aggregation analyses, and in our work with Lloyd's we shall also promote the continued development of stress testing.

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

- 46 Most respondents thought the FSA should follow up its analysis of the RBC model with regular reviews, suggestions for improvement, and random audits to ensure no systematic divergences from business plans. A minority of respondents argued that the FSA should take over the development of the model and apply this concept throughout the insurance market.
- 47 Although we shall continue to consider how techniques for assessing capital requirements based on the risks assumed can help in the supervision of the whole insurance market, we do not believe that it would be appropriate for us to assume control of the development of Lloyd's RBC model, which is not primarily a supervisory tool. We shall, however, discuss with Lloyd's over the period to N2 how it might be improved. We shall also expect to be fully consulted about its future development and after N2 we shall monitor, in the light of the guidance given in the Handbook, how the model is operated in practice.

**Regulation of underwriting agents**

***Managing agents***

- 48 Some respondents were concerned that the FSA did not intend to make, or require Lloyd's to make, rules for managing agents which would be designed to protect the members of Lloyd's. They argued that the agency relationship between members and managing agents implied a regulatory responsibility; the position of capital providers was in this respect analogous to that of other investors. In the light of these comments, we propose to review the relevant contractual relationship in more detail and to consider, taking account of the final provisions of the legislation, whether we should make any specific rules to supplement the obligations on managing agents stemming from the FSA's high level principles. Any proposed rules will be the subject of consultation during the preparation of the Handbook.
- 49 Paragraph 115 of the consultation paper said that the FSA would be consulting during 1999 on the appropriate capital requirements for firms involved in regulated activities as agents, including Lloyd's managing agents. This will now be done as part of the consultation on the Prudential Sourcebook, one of the modules of the Handbook. Lloyd's are currently consulting on proposed changes to their financial resource requirements for underwriting agents. We shall take account of these, and some points made by respondents about financial resource requirements for managing agents which are part of Integrated Lloyd's Vehicles, when deciding whether any modifications are necessary to meet the FSA's standards.

## ***Members' agents***

***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?***

- 50 Some respondents suggested that the distinction between members' agents and Lloyd's advisers should be removed or clarified. Lloyd's has now addressed this issue; Lloyd's advisers are to be brought within the scope of the Underwriting Agents Byelaw but will be subject to some specific conditions relevant to their type of business.
- 51 Support was expressed for the principle that for members' agents the FSA should make rules on quality of advice and execution which paralleled as closely as possible those applying to other financial advisers. Some respondents thought it would be helpful if some, or all, members could be treated as "expert" investors. The FSA has published a response to its discussion paper on the future regulation of inter-professional business published last October. This endorses the development of a counterparty classification regime as the prime means of achieving an appropriate differentiation in the application of conduct of business requirements. A consultation paper on the overall framework for counterparty classification will be issued towards the end of this year.
- 52 Some respondents expressed concern that members' agents would also continue to be subject to certain Lloyd's rules, arguing that it would be unnecessarily burdensome for firms of this size to have to comply with two sets of rules. We shall take account of these concerns when drafting the Handbook, although we expect that any rules made by Lloyd's will largely relate to practical aspects of the maintenance of members' solvency (for example, "coming into line" procedures) or capacity transfers. There was support for as much as possible of the monitoring of members' agents to be undertaken by the FSA.
- 53 Paragraph 122 of the consultation paper said that the FSA would be consulting during 1999 on the appropriate capital requirements for firms involved in regulated activities as agents, including Lloyd's members' agents. This will now be done as part of the consultation on the Prudential Sourcebook, one of the modules of the Handbook. Lloyd's are currently consulting on proposed changes to their financial resource requirements for underwriting agents and we shall take account of these when deciding whether any modifications are necessary to meet the FSA's standards.
- 54 A number of respondents argued that for members' agents capital requirements were less important than adequate Errors & Omissions cover.

The FSA is considering its policy with respect to requirements for professional indemnity insurance more generally.

### **Capacity transfer market**

*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?*

- 55 Most respondents thought the current syndicate capacity auctions were likely to fade in significance and volume over the next few years as market consolidation continued. They might in due course prove self-eliminating, although the timescale for this could not yet be foreseen. Most respondents thought that other methods of capacity transfer - for example, bilateral deals and acquisitions - would become dominant in future. One unknown factor was how, if proportional reinsurance syndicates were introduced, capacity in these would be transferred; a special auction mechanism might be appropriate.
- 56 A number of respondents representing individual members argued that the future role of non-aligned capital at Lloyd's depended on the Council and the regulators providing a level playing field for different types of capital providers. The rules applied to the auctions and other types of capacity transfer were an important aspect of this. Others argued that the rules could be developed to promote an orderly end to the auctions, leaving parties free to negotiate bilaterally.
- 57 Respondents were generally in favour of Lloyd's continuing to run the capacity transfer market, subject to FSA oversight and consultation on rule changes. However, Lloyd's current rules governing auctions, bilateral deals and general offers were criticised as unnecessarily complex and unclear in places. A number of respondents representing individual members argued that the FSA should require Lloyd's to make rules for the auctions which were as transparent, and of as high a standard, as in a recognised investment exchange, even though this market would not qualify for recognition. They suggested that certain of the principles underpinning the new civil fines regime (and endorsed in the proposed Code of Market Conduct) should apply to this internal Lloyd's market, including provision for reversal of transactions and disgorgement. It was also suggested that there should be provision for timely action, as taken by the Panel on Takeovers and Mergers, and that Lloyd's rules relating to minority buy-outs should mirror those in the Companies Acts.
- 58 In the light of these representations, we have had further discussions with Lloyd's about the rules currently in place and the surveillance undertaken by the Regulatory Division. Our initial impression is that their rules and surveillance are already tailored to the unusual characteristics of this market and have regard to standards applied in other markets.

- 59 We have nevertheless concluded that the FSA should play a greater role with respect to this market than we had previously envisaged. We now intend to direct Lloyd's to make appropriate rules for conduct in this market, which must take account of the standards of conduct expected in financial markets and conduct of business provisions with respect to handling conflicts of interest. We shall review the rules which Lloyd's has in place to oversee the functioning and mechanics of this market and shall monitor how these are operated in practice, taking account of any complaints received. If necessary, we shall consider whether Lloyd's has breached our rules or guidance and/or whether the conduct of any other market participant may have breached the FSA's high level principles. If these arrangements failed to achieve our regulatory objectives, we would consider assuming a more direct role with respect to this market.

### **Custodianship and management of funds**

#### *Q13 Do our proposals represent an appropriate approach to the management of funds in the special circumstances of Lloyd's?*

- 60 Respondents were broadly content with our proposed general approach to the management of the various funds held by third parties in connection with business at Lloyd's. It was pointed out that these funds were now substantially under the control of trustees or non-Lloyd's firms authorised to conduct investment business and hence already subject to appropriate requirements.
- 61 There was also general agreement that broadly the existing arrangements relating to **premium trust funds** should continue but be kept under review as the structure of the market evolved, seeking consistency as far as possible with the equivalent rules applied to insurance companies. Some respondents regarded the preparation of the new rules as an opportunity to re-examine the categories of eligible investments and procedures relating to amending premium trust deeds. We shall bear these comments in mind when drafting the relevant sections of the Handbook.
- 62 Several respondents noted that rules would be required to cover the holding of funds by **members' agents**, for example, for the payment of members' personal expenses. The FSA will consider what sort of safeguards should be put in place, taking account of those which will apply to other similar regulated firms.

### **Investigations, discipline and enforcement**

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

- 63 Most respondents agreed with the principle that investigation, discipline and enforcement should in general follow rule making. However, concerns were expressed that the proposed division of responsibilities between the FSA and Lloyd's could result in delay, unnecessary duplication of effort, and possible double jeopardy. It was suggested that this could be minimised if the FSA and Lloyd's developed effective arrangements for liaison and reciprocal exchanges of information and if they agreed appropriate performance criteria for the handling of disciplinary cases. It was seen as important that the FSA should ensure consistent disciplinary standards across the insurance industry.
- 64 We shall take full account of these comments when preparing the relevant sections of the Handbook and deciding how we shall work with Lloyd's with respect to disciplinary matters. Where Lloyd's itself makes enforcement decisions in relation to Lloyd's participants, we shall need to be satisfied that it has appropriate procedures in place to manage conflicts of interest. It is therefore our intention to issue guidance applicable to Lloyd's on managing such conflicts in regulatory decision making. This guidance will build on the existing informal guidance given to recognised bodies by the Securities and Investments Board in 1993.
- 65 It was also suggested that the FSA and Lloyd's might jointly adjudicate alleged rule breaches, with the possibility of such proceedings resulting in more than one penalty. We consider that this would not be possible or desirable because of the different legal bases of the two regimes, and the different parties, issues and facts that might be involved in the concurrent proceedings. We believe that concerns over possible duplication and double jeopardy can be effectively addressed by applying the principles set out at the start of paragraph 134 of CP 16.
- 66 Some respondents expressed concern about Lloyd's disciplinary record and suggested that the FSA should review all investigations terminated by Lloyd's without a conclusion and should be prepared to continue these if it disagreed with Lloyd's decision not to pursue them. As explained in paragraph 131 of CP 16, the FSA will have an indirect supervisory responsibility in relation to Lloyd's exercise of its own investigation and disciplinary powers (derived from the FSA's proposed general duty under the Bill). However, we expect to have direct responsibilities only in relation to suspected breaches of the FSA's own rules.
- 67 A number of respondents also expressed concern about the wide scope of the enforcement powers which the FSA would be given under the Bill. Other commentators have made similar points, notably in response to *Financial services regulation: Enforcing the new regime* (CP 17, published in December 1998).
- 68 The Government and the FSA have already sought to address these concerns in a number of ways. In March the Treasury published its Progress Report on

the draft Bill. In that Report, the Treasury clarified the role of the proposed statutory tribunal as a tribunal of first instance and indicated some proposed changes to the enforcement decision making process. The revised Bill now contains three important sets of provisions in this regard.

- First, the FSA will be required to publish, and comply with, a statement of its procedures for decision making when exercising its enforcement powers. The Bill requires that those involved in making the decisions have not been involved in establishing the evidence on which that decision is based.
- Secondly, the FSA's decisions in relation to disciplinary cases will not take effect unless the firm or approved person accepts that decision. If not, the case is referred to the tribunal, and the decision will not have effect until the conclusion of the tribunal proceedings or any subsequent appeal.
- Thirdly, the tribunal will be able to consider all facts and evidence relevant to the FSA's decision and the FSA's reasons for reaching that decision. The tribunal's powers will include power to confirm, vary or set aside the disputed decisions referred to it.

69 In CP 17 we proposed to establish an Enforcement Committee with a quasi-judicial role to make decisions on intervention and discipline. Following the Treasury's Progress Report, the inclusion of new provisions in the Bill, and the responses that we received to CP 17, we now propose that, in general, the FSA's Enforcement Committee will have more of an administrative decision making role rather than the quasi-judicial role envisaged in CP 17. The FSA will shortly be publishing a Response Paper on CP 17, which will discuss these issues in more detail.

## **Complaints**

*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?*

- 70 Most respondents agreed that, if Lloyd's Complaints Department failed to resolve a complaint, Lloyd's personal policyholders should have broadly the same access to the Financial Services Ombudsman Scheme as they currently have to the Insurance Ombudsman Bureau.
- 71 Some concern was voiced about the cost to market participants of having a two-tier complaints procedure, and one respondent argued that, in view of inherent conflicts of interest at Lloyd's, the Ombudsman should assume responsibility for all complaints in the interests of impartiality. The FSA continues to believe that it is important that regulated firms should have adequate procedures for responding to customer complaints and that it would be inappropriate, and probably not cost-effective, for complaints to be referred direct to the Ombudsman. In the case of Lloyd's it would be possible

for complaints to be dealt with initially at underwriting agent level but we believe that the Complaints Department currently provides a more effective mechanism.

- 72 The Financial Services Ombudsman will take on functions currently performed by the Insurance Ombudsman. The jurisdiction and funding of the new scheme will be the subject of a detailed consultation paper in the autumn.

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

- 73 Some members and their representatives felt that Lloyd's existing dispute-resolution arrangements had serious deficiencies. They were slow and had too restricted a remit, especially in respect of complaints about actions of the Council. Lloyd's did not use its discretion to order loss reviews freely and the Lloyd's Arbitration Scheme had not proved as successful as hoped.
- 74 Some of these respondents suggested that the FSA should become directly involved in the handling of complaints, especially those relating to the conduct of members' agents. Others argued that members should be given access to the Financial Services Ombudsman after Lloyd's dispute-resolution procedures had been exhausted.
- 75 We have not been persuaded by these arguments that the current arrangements cannot secure appropriate redress for members, who are not investors in the traditional sense of that word. We intend, however, to include in the Handbook a formal requirement for adequate dispute-resolution arrangements; guidance will be given on the standards we shall expect and we shall monitor compliance with them. We shall also discuss with Lloyd's the weaknesses in the current arrangements which respondents alleged during the consultation process.

**Compensation**

- 76 The FSA has recently published a consultation paper (CP 24) on aspects of the proposed new single compensation scheme. Comments are requested by 10 September. The new scheme will replace the various existing compensation schemes, including the Policyholders Protection Scheme and the Investors Compensation Scheme. The paper considers who should be eligible to receive compensation from the new scheme, how much they should be able to claim and how the costs of paying compensation and administering the scheme should be allocated to firms. This paper did not address compensation issues relating to Lloyd's policyholders and members because these were discussed in CP 16.

## ***Policyholders***

### ***Q17 Should Lloyd's policyholders have access to the Financial Services and Markets Compensation Scheme (FSMCS) on a similar basis to policyholders of other authorised insurers?***

- 77 A large majority of respondents thought there was no need for Lloyd's policyholders to have access to the new compensation scheme because the Central Fund provided a higher and wider degree of protection than was currently available under the Policyholders Protection Acts. Some respondents thought this should be conditional on the Central Fund being protected by a transparent risk-based capital system, the FSA having adequate powers to take effective action if the Central Fund appeared likely to be exhausted, and the Fund being available only to compensate policyholders.
- 78 The company market also indicated a preference for Lloyd's policyholders to be excluded from the new compensation scheme and for their compensation arrangements to continue to be ring-fenced. It was also pointed out that it was ultimately for policyholders to decide which security arrangements best satisfied any concerns they might have over the possible non-payment of claims.
- 79 Since CP 16 was published, Lloyd's has announced it has arranged excess cover of the Central Fund with a consortium of six major reinsurance groups. Cover took effect from 1 January 1999 and will last for five years. It has an annual limit of £350mn, and an aggregate maximum payment of £500mn. It comes into effect after Lloyd's has paid £100mn from the Central Fund in any one year. This arrangement has enhanced Lloyd's security.
- 80 In the light of respondents' comments, we have decided that the Central Fund can offer Lloyd's policyholders equivalent protection and there is currently not a strong case for giving them access to the new compensation scheme on a similar basis to policyholders of other authorised insurers. This decision will be kept under review. Lloyd's will be required to give the FSA access to information about the Central Fund and to consult fully on decisions affecting the security it provides for policyholders. Consideration will also be given to ensuring that personal policyholders are informed that they are covered by Lloyd's security arrangements not by the new compensation scheme.

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

- 81 Lloyd's suggested that any funding required from members for the new compensation scheme should take account of the protection for Lloyd's policyholders already provided by the Central Fund. Other respondents argued that managing agents with syndicates writing relevant business should pay levies to the new scheme but not contribute to the Central Fund in respect of this business. They recognised this would be complicated and could raise

difficult issues about distributing part of the existing Central Fund and about the alignment of the funding of the new compensation scheme to different classes of insurance business. In addition, it would breach the principle of common security for Lloyd's policies, which we concluded in paragraph 144 of CP 16 was not a practicable option.

- 82 These comments confirm the difficult nature of the funding issues that would arise if Lloyd's policyholders were given access to the new compensation scheme. These strengthen our view that this would not be appropriate in current circumstances.

### **Members**

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

- 83 The majority of respondents thought this was the only conclusion consistent with individual members being sole traders in the business of insurance. A significant minority argued, however, that a member's relationship with his members' agent or other Lloyd's adviser was analogous to that of an investor with a discretionary fund manager and should entitle him to similar treatment as regards compensation. Other factors cited in support of access to the new compensation scheme for members were the absence of compulsory Errors & Omissions cover for agents (mentioned above) and the exclusion of negligence under Lloyd's members compensation scheme.
- 84 Lloyd's supported access to the new compensation scheme for individual members in respect of claims against members' agents or where they had taken out policies (for example, stop loss and estate protection plans) in connection with their Lloyd's membership. Such policies are regarded as reinsurance and members are therefore not eligible for compensation under the Policyholders Protection Acts; it is expected that reinsurance will continue to be excluded under the new compensation scheme.
- 85 We remain of the view that it would be inappropriate for members to be compensated under arrangements designed for investors in the traditional sense of that word, especially since they already have access to compensation arrangements and these are funded by the constituency likely to fund any access for them to the new scheme. This is consistent with our approach to members' complaints. It is for Lloyd's to determine the scope and terms of its members compensation scheme. Nevertheless, we intend to place a formal requirement on Lloyd's to maintain appropriate compensation arrangements for individual members; guidance will be given on the standards we shall expect and we shall monitor that these are met.

## **Consumer and practitioner involvement**

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

- 86 Respondents welcomed the creation of the FSA's Consumer Panel and Practitioner Forum to provide advice to the FSA and contribute to its dialogue with consumers and practitioners. It was suggested that the Consumer Panel might usefully include representatives of personal policyholders and of the Association of Insurance and Risk Managers. Following earlier consultation on consumer involvement, the FSA has decided that Consumer Panel members should sit on the Panel as individuals rather than as representatives of any organisation. Panel members have been appointed to represent a broad range of consumer interests following an open recruitment process based on Nolan principles.
- 87 Lloyd's suggested the formation of a separate FSA consultation panel to consider Lloyd's-related issues and a place on the FSA Board for a senior representative of the market. The Treasury has, however, decided that appointments to the FSA Board should not reflect particular interest groups. Lloyd's also wished to see market practitioners continue to be closely involved in market supervision and regulation under the direction of the Council; its regulatory committees should continue to play a role.
- 88 The FSA recognises the importance of practitioner and consumer involvement, especially with respect to such a specialised market, and will develop ways to achieve this, starting with an important role in the preparation of the Handbook. In areas where the FSA uses its power to direct the Society to exercise its regulatory powers, it will largely be for the Council to decide how to deliver what is required. As noted above, we shall expect it to maintain appropriate internal governance of its regulatory functions and to ensure that we have direct access to those with responsibilities in this area.
- 89 The FSA was also urged by respondents to talk more to the Lloyd's market associations and larger market practitioners. We intend to increase our contact with all sections of the market as a result of our new responsibilities.

## **Costs, charging and cost benefit analysis**

### *Q21 Do you have any comments on the costs and benefits of the proposals in CP 16?*

- 90 There was support for the publication of compliance cost assessments for all proposed regulatory changes, a principle that the FSA endorses and with which it will be required to comply. Respondents also suggested that total regulatory costs should be analysed periodically, probably in an annual plan, and be justified from a zero base.

- 91 A number of respondents argued that the costs of the new regime to the Lloyd's market should be broadly similar to those borne by its London market competitors. This may not, however, be an entirely appropriate analogy. Exact comparisons are difficult but Lloyd's market structure may mean that regulatory costs are higher than for the company market. As stated in paragraph 157 of CP 16, the work the FSA will do will add to the total cost of Lloyd's regulation.
- 92 Several respondents thought there was insufficient information in CP 16 about the relative costs and benefits of the "maximal" and "preferred" approaches. Although it was generally accepted that some duplication between the FSA and Lloyd's was inevitable, even under the "maximal" approach, respondents thought this could be minimised in various ways, for example, by drawing a clear distinction between rules required to protect the public and those made to facilitate the operation of the market. There was also scope for streamlining Lloyd's regulatory byelaws in the light of the FSA's requirements and for targeting regulatory resources where risk was perceived to be greatest.
- 93 The FSA plans to publish a consultation paper on how its costs will be allocated between regulated firms after N2. Cost benefit analyses will also be published as part of the consultation process on the Handbook.

## **Outline of future regulatory structure**

- 94 The following paragraphs summarise the FSA's future regulatory structure for Lloyd's as we currently expect this to be after the Financial Services and Markets Act comes into effect at N2. This will be kept under review in the light of market developments and our practical experience of operating these arrangements. We shall not hesitate to make any adjustments which prove necessary in order to achieve our regulatory objectives and to ensure that Lloyd's is regulated to the standards we expect in other areas of financial services.

### ***Entry to the market***

- 95 **Managing agents and members' agents** will have to apply to the FSA for permissions to conduct Lloyd's-related regulated activities and will have to satisfy its Qualifying Conditions for Authorisation. The FSA will be required to give decisions on applications within certain time periods. Existing underwriting agents are expected to be grandfathered, ie given permission to carry on activities conducted prior to N2, although the FSA is expected to have the right to require firms to reapply within a period of two years.
- 96 Applicants to be managing agents and members' agents will have to gain admission to the market from Lloyd's as well as authorisation from the FSA. They will thus become subject to relevant Lloyd's byelaws. Applications will

normally be considered in parallel and every effort will be made to minimise duplication in the application process. Lloyd's will also continue to operate an approval system covering certain employees of such firms.

- 97 The **Society of Lloyd's** will be given a number of permissions specifically tailored to its activities.
- 98 Persons who perform certain functions in connection with the regulated activities of the Society, managing agents and members' agents will require prior approval from the FSA. The scope of our **approved persons** regime is yet to be determined. We expect individuals who are currently approved by Lloyd's to be grandfathered, although the FSA will have the right to require reapplication.
- 99 Those who wish to **acquire influence** over the Society, a managing agent or members' agent will also be subject to prior approval by the FSA. Influence will be defined in the Act but will include acquiring 10% or more of the capital or voting rights or a holding which otherwise allows the exertion of significant influence over the management of the relevant undertaking.
- 100 **Any person outside Lloyd's** who gives advice on participation in a Lloyd's syndicate will have to apply for permission to conduct this regulated activity.

#### ***Continuing requirements***

- 101 The FSA will have a **general duty** to keep itself informed about the affairs of Lloyd's and to keep under review the desirability of exercising its powers.
- 102 All firms with permission from the FSA to conduct regulated activities relating to the Lloyd's market must comply on an on-going basis with the Qualifying Conditions for Authorisation and the FSA's high-level principles for firms, as must Lloyd's itself. Approved persons must comply with the statements of principle and code of practice for individuals. The FSA will investigate any suspected breaches of these requirements and, if necessary, take enforcement and disciplinary action. If any alleged breaches of FSA rules may also involve breaches of Lloyd's byelaws, the FSA will liaise closely with Lloyd's Investigations and Regulatory Proceedings Departments in the interests of efficiency and to avoid double jeopardy.
- 103 The FSA's detailed requirements will be set out in the various modules of its Handbook, which will contain both rules and related guidance. The provisions of most relevance to participants in the Lloyd's market will be the following.
  - **Prudential supervision of Lloyd's insurance business.** European solvency margin requirements are expected to be satisfied by a single test, an amended version of the current "combined" solvency test. To provide additional tools for prudential supervision, we shall require Lloyd's to

continue to: maintain a risk-based capital model; monitor marketwide aggregations of risk; approve and monitor syndicate business plans; and monitor underwriting controls in managing agents. The FSA will set standards for Lloyd's in these areas and check that it is meeting them. If necessary, enforcement action will be taken.

- **Capital requirements.** The FSA will require managing agents and members' agents to have adequate financial resources.
- **Conduct of business rules.** Members' agents and those outside Lloyd's with relevant permissions will be subject to conduct of business rules with respect to advice given on participation in Lloyd's syndicates. Conduct of business rules will also apply to the custodianship and management of funds belonging to others by the Society, managing agents and members' agents.
- **Capacity transfers.** The FSA will require Lloyd's to continue to make rules for conduct in this market and it will give guidance on the principles to be applied. It will monitor Lloyd's compliance with these requirements.

104 **Former members** who resigned on or after 24 December 1996 will be required to notify changes in their addresses.

### ***Complaints***

105 Lloyd's policyholders will have access to the single Ombudsman if Lloyd's Complaints Department fails to resolve their disputes. Members will not have access to the Ombudsman but the FSA will require Lloyd's to maintain adequate complaints arrangements for members and will monitor that this is done.

### ***Compensation***

106 Lloyd's policyholders will not have access to the new compensation scheme but will instead continue to look to the Central Fund to safeguard payment of their claims. Members will also not have access to the new compensation scheme. The FSA will require Lloyd's to maintain adequate compensation arrangements for members and monitor that this is done.

### ***Fees***

107 Decisions have yet to be taken on how the FSA's costs will be allocated after N2; there will be a consultation process. Managing agents and members' agents will be likely to pay some fees directly to the FSA whilst other charges will be levied on the Society itself.

## Next steps

- 108 Work has already begun on the Handbook, which will contain all the FSA's rules and guidance relating to the carrying on of regulated activities. In the case of Lloyd's, these are expected to include any directions given by the FSA to the Council relating to the exercise of the latter's powers. The Handbook will be split into a number of modules covering various supervisory processes or types of requirement. As far as practicable, material will be presented on a cross-sectoral basis; for example, rules relating to the prudential supervision of Lloyd's insurance business will be set out alongside rules relating to the prudential supervision of insurance companies, friendly societies, credit institutions and investment firms. This presentation is intended to help in achieving the harmonisation of requirements that will be one of the benefits of a single regulatory authority. Appropriate indexing will be provided.
- 109 The modules of the Handbook which will be of most relevance to Lloyd's market participants are the:
- High-level Principles
  - Authorisation Manual
  - Supervision Manual
  - Prudential Sourcebook
  - Conduct of Business Sourcebook
  - Training and Competence Manual
  - Enforcement Manual; and
  - Complaints Code.
- 110 To ease the transition to the new regime for regulated firms, an Interim Prudential Sourcebook will come into effect at N2, to be followed by the Final Prudential Sourcebook after a further period of consultation. Because the FSA will have new responsibilities with respect to Lloyd's, the Interim Prudential Sourcebook will contain all the prudential elements of the new regime, although some changes may be made in the Final Prudential Sourcebook to increase harmonisation with the rules applying to other regulated firms.
- 111 When drafting Lloyd's-related material for the Handbook the FSA will seek comments from relevant Corporation staff. It also plans to set up a representative panel of market participants, policyholders and members to comment on the draft rules and guidance prior to wider consultation on them. It is hoped that the relevant sections of the Handbook will have reached final draft form several months before N2 to enable those affected to prepare for the new regime.

# List of respondents

ACE Global Markets Ltd  
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Association of British Insurers  
Association of Lloyd's Members  
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Lloyd's  
Lloyd's Market Association  
Lloyd's Names Association  
Members' Agents' Committee, Lloyd's Underwriting Agents' Association  
National Association of Insurance Commissioners  
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