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I am enclosing for your information a copy of the report of the group that we established last Autumn to review regulatory arrangements at Lloyd's.

I am pleased to be able to report that the Council of Lloyd's this week commended the report and fully supported the principal recommendation for the introduction of additional external regulatory oversight. These reforms are naturally subject to government acceptance as their full implementation would require amendment to existing primary legislation. We shall now be seeking to explore this further with government and with The Securities and Investments Board. The Council has also endorsed the general direction of the other proposals in the report and will now have the particular recommendations examined and taken forward as soon as the necessary analysis and work can be completed.

This report is clear evidence of Lloyd's commitment to ensure that there is a secure regulatory foundation in place to allow business to flourish, with safeguards for the interests of both policyholders and underwriting members.

This report is being sent to the Chairman/Senior Partner and compliance officer of all Underwriting Agencies and Lloyd's Brokers, Underwriters, Council and Board Members, Corporation Managers, Auditors and Corporate Members. Further copies are available on request from Lloyd's Information Centre (Lloyd's extension 5448).

*David Rowland*

LLOYD'S

*Report of  
Lloyd's Regulatory  
Review Group*

MAY 1997

REGULATION AT LLOYD'S

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# *Preface*

I am pleased to present the report of the review group set up to examine Lloyd's regulatory arrangements and recommend how they should develop for the future. This is Lloyd's own review, although it has drawn on and benefited from the experience of a number of people unconnected with the market and with regulatory experience in other fields. The members of the review group, the observers and secretary are all shown in Appendix 2. On behalf of Lloyd's I wish to record our thanks to the members of the group, who gave so generously of their time and expertise over the past months, and to the observers who made a valuable contribution to our discussions. The review group, in turn, has had excellent support from its secretary, Carolyn Williams, for which we express our warm thanks.

The problems of the last few years have been a sobering experience for all concerned. It is right to ask what part regulation may or may not have played in this but it is particularly important to ensure that the lessons are well learned, so as to reduce the chances of anything similar happening again. Underwriting at Lloyd's is a high risk business and no system of regulation can prevent trading losses occurring. It is right however that regulation should aim to prevent them having a systemic effect, to ensure that losses do not occur because of the presence of incompetent or dishonest practitioners and to promote a situation in which risks are fairly evaluated and assumed by those who are competent to do so.

We have reviewed whether the current arrangements provide reasonable safeguards, to a high standard comparable to that provided under other regulatory regimes, to both Lloyd's policyholders and its members who provide the capital to support the business underwritten. In doing this, however, we have become persuaded of the importance of a third, uniting, purpose of regulation - that of ensuring the continued coherence and prosperity of the Lloyd's market - in the interests of *all* its stakeholders, policyholders, members and market professionals together. We conclude that the Council of Lloyd's is best placed to combine these three strands of regulatory activity.

We commend the ambitious programme of regulatory reform that has been pursued by the Council and the Lloyd's Regulatory Board (LRB), particularly in recent years. We have made a number of recommendations that we believe will contribute still further towards improving regulatory effectiveness. All rules come with a price tag attached and we have been mindful of this, particularly the compliance costs to the market, but inadequate regulation has its price too.

Yet we feel that more deep-seated reform is needed. In our consideration of regulatory structures, we have become convinced of the importance of formal accountability to an external, independent body in providing reassurance that regulation is consistent, effective and credible. Whereas the Department of Trade and Industry (DTI) ably fulfils this role in respect of policyholder protection, the current statutory arrangements do not allow for external oversight of the Council in respect of the interests of members of Lloyd's as capital providers or of the management of the trading market.

We are recommending, therefore, that the Council should ask the government to take the appropriate steps to amend the relevant primary legislation to bring in additional external accountability, so as effectively to cover all Lloyd's regulatory activities. We are recommending amendment of the Insurance Companies Act 1982 and the Financial Services Act 1986 to bring this about. We hope that these changes can be incorporated into the new government's legislative timetable as soon as possible. In the interim, regulation should be operated as far as possible so as to reflect best practice elsewhere in the financial sector, recognising that this cannot totally secure the credibility of a structure that has statutory backing.

The Lloyd's market will continue to change over the years to come. New methods of doing business and new capital structures will undoubtedly continue to develop, posing new regulatory challenges. Lloyd's regulatory arrangements must respond to these challenges so as to give confidence that the market remains a most vigorous and attractive place to do business.

Sir Alan Hardcastle  
Chairman of Regulatory Review Group  
May 1997

# 1. Summary

## 1.1 Scope of Review

1.1.1 The regulatory review group was set up towards the end of 1996 to review the regulatory arrangements at Lloyd's. As provided in the Lloyd's Act 1982, regulation at Lloyd's is the responsibility of the Council and includes:

- formulating and implementing regulatory policy eg in respect of conduct of business and financial regulation (solvency, under the supervision of the DTI);
- authorising entities to trade in the market;
- monitoring their compliance with regulatory requirements; and
- enforcing regulation through processes of investigation, discipline and appeals.

1.1.2 We believe the objective of this regulatory activity is to provide reasonable safeguards for Lloyd's policyholders, members and component businesses in order to establish a basis for confidence that Lloyd's is a solvent and soundly managed market in which to do business. We consider that this re-formulation of the objective properly gives greater emphasis to regulation in the interests of the market as a whole.

## 1.2 Statutory Change to Achieve External Accountability

1.2.1 Our most far-reaching recommendation is that while the Council of Lloyd's should retain the primary day-to-day responsibility for regulating the Lloyd's market, additional, formal, external accountability should be introduced in respect of the exercise of its regulatory responsibilities. This will demonstrate that policyholders' and members' interests are sufficiently and impartially safeguarded and that the Council's responsibility to ensure a properly regulated and solvent market is being discharged. This will require statutory change and is hence dependent upon the government accepting the weight of argument in its favour. Our specific recommendations on this subject in this report are based on the existing statutory framework as, at the time of writing, the new government's intentions in this area have not been announced.

1.2.2 We recommend therefore that changes in the primary legislation should be sought to effect external accountability of the Council of Lloyd's to a statutory body, the most obvious candidate being the Securities and Investments Board (SIB), in respect of members' interests,

1.2.3 We are also recommending an extension of the powers of the DTI in order to give it a wider oversight role and in particular to enhance the continuing supervision of the market's solvency, primarily, but not exclusively, for the benefit of policyholders.

1.2.4 We recommend that, until change to the legislative structure can be achieved, the Council should seek to mirror best practice elsewhere in the financial sector. We suggest that a nominated representative of the SIB on the Council of Lloyd's and LRB during this interim period might assist in the achievement of this aim. We also recommend that Lloyd's should discuss with the SIB how, in the interim, Lloyd's might shadow the arrangements that would be formalised when the legislation was amended, as soon as the government has made its intentions known.

## 1.3 Regulatory Board

1.3.1 We recommend that the size of the Regulatory Board be reduced, ideally to 12 people. We recommend that the membership of the 12-member Regulatory Board should be re-balanced to provide one-third drawn from

## *1. Summary - continued*

the market, one-third from the external members of Council, and one-third independent members, drawn from the nominated members of Council plus the Director of Regulation. We recommend that certain market associations (we suggest the LUAA, LOCUS and the LIBC) should be invited to put names forward for the market practitioner places on the Regulatory Board. We recommend that consideration be given to moving to a structure of regulatory standing sub-committees (eg authorisations, enforcement, policy) which would enable the smaller board that we are recommending to concentrate on the higher level policy role that we envisage.

### **1.3.2 Regulatory Complexity and Compliance Costs**

**1.3.3** We recommend that the current byelaw review takes note of the objective of regulation as set out in this report and establishes clearly how each byelaw (and associated regulations, guidance notes etc.) contributes to that objective, considering also the cost to the market and Society of compliance. We also recommend that there is direct input from market practitioners to the review and that experience from outside Lloyd's is drawn upon to provide a fresh and objective approach.

**1.3.4** We are most concerned to reduce regulatory compliance costs in the market and we recommend that the work on the reporting burden on underwriting agencies is taken forward with the aim of producing a significant rationalisation of information demands on both managing and members' agencies. We also recommend that Lloyd's should require information on, and take due account of, the costs and benefits of any regulatory change or development, including the measures proposed in this report.

### **1.4 Regulatory Division**

**1.4.1** We agree with the aim of moving towards a leaner, fitter regulatory division. This must however be based on a realistic and systematic assessment of the regulatory task that Lloyd's is asking that division to undertake, particularly in the light of the changes anticipated over the next few years. We recommend that a manpower plan for the division is produced, on the basis of work study evidence on the nature and extent of the regulatory tasks to be undertaken.

**1.4.2** We recommend that some immediate rebalancing should take place within the regulatory division to ensure that the required top-quality intellectual and analytical skills, and appropriate experience, are available. For the future, we recommend that a review should be undertaken of the effectiveness of the Corporation graduate recruitment and training programme in relation to the needs of the regulatory division.

**1.4.3** While sensitive to the budgetary constraints, we recommend that the lack of competitiveness in the salary arrangements for the regulatory division be addressed in order to ensure that Lloyd's is able to recruit and retain staff of the necessary calibre.

**1.4.4** We are convinced of the importance of appropriate training and we recommend that training budgets for the regulatory division should be drawn up to ensure that the required standards are achieved.

**1.4.5** We recommend that further consideration is given, in consultation with the market, to recovering a greater proportion of the costs of the regulatory division from those firms being regulated, applying the 'user-pays' principle as far as possible, and reducing the members' subscriptions accordingly. Such direct charging should be accompanied by the introduction of realistic regulatory service standards.

## **1.5 Other Recommendations**

- 1.5.1** We consider that the recognition of total market exposure, through aggregation of risk, is a crucial area of regulation for the future and recommend further development of the steps already being taken within the regulatory division to address it. We recommend that Lloyd's should follow the example of other regulators and establish a specialist financial risk assessment unit staffed by suitably qualified individuals to further enhance the computer modelling of market exposures giving rise to risks of a systemic nature.
- 1.5.2** We recommend that the general education and training requirements, including continuing professional education, for underwriters, directors and senior staff of underwriting agencies, are now reviewed in order to focus effort on the most relevant issues for the future.
- 1.5.3** We recommend that regulatory policy towards members' agents and Lloyd's advisers is kept under review to ensure that it is consistent with the approach taken elsewhere in the financial services sector,
- 1.5.4** We recommend that LRB should take the appropriate legal advice and subsequent steps to ensure that the interests of members are properly safeguarded in relation to the giving of general investment advice by members' agents, in the light of uncertainty over the scope of Lloyd's current exemption from the FSA.
- 1.5.5** We also recommend that a detailed comparative review is undertaken by the Council to ensure that the services provided by the Corporation, in particular the Members' Services Unit in relation to the administration of funds at Lloyd's, meet, as far as is reasonably possible, the standards of operation that would be imposed by an SRO upon a member company undertaking business of a similar nature.
- 1.5.6** We recommend that, in the light of the experience of the past years, the scope and operation of the current Lloyd's Members' Compensation Scheme should be reviewed.

## 2. Introduction

### 2.1 Background to Lloyd's 1997 Regulatory Review

2.1.1 We embarked on this review of Lloyd's regulatory arrangements in the autumn of 1996 with two main aims in mind: to assess the effectiveness of the present arrangements and to recommend how they, and if necessary the statutory framework underlying these regulatory arrangements, should be developed in the future.

2.1.2 It has been an appropriate time to review these arrangements, as efforts are turning away from the past and towards securing a successful future for Lloyd's, although considerable change is still underway in the Society. This paper also establishes the position that we recommend Lloyd's should adopt on the changes to its statutory framework, which are likely to be reviewed as part of the new government's consideration of the broad field of financial regulation.

### 2.2 Membership of Review Group

2.2.1 The members of the review group were selected to provide as wide a range as possible of those with an interest in the future regulation of Lloyd's, with the addition of independent members to provide a wider perspective. The membership of the review group and a summary of their Lloyd's and insurance interests is set out in Appendix 2 to this report. We have met on nine occasions.

### 2.3 Terms of Reference

2.3.1 Our terms of reference asked us to examine in particular:

- the activities that should comprise effective regulation of the Lloyd's market and membership;
- the arrangements operated by Lloyd's to ensure that the statutory requirements in the UK and elsewhere for policyholder protection are met;
- the role of the Council and Lloyd's Regulatory Board in supervising regulation and the relationship between Lloyd's Regulatory Board and Lloyd's Market Board;
- the composition of the Lloyd's Regulatory Board;
- whether organisations other than Lloyd's should undertake or supervise any regulatory activities;
- the structure and staffing of the regulatory division of the corporation, including executive reporting lines and the relationship with the Chief Executive Officer (CEO) and management committee; and
- the relationship between the regulatory division and the Lloyd's market and Lloyd's other central activities.

bearing in mind throughout the need to carry out effective regulation at reasonable cost to the Society and Lloyd's market entities.

### 2.4 Timescale and Assumptions

2.4.1 It became clear at the outset of our review that we needed to make the following basic assumptions that would influence the possible regulatory change that we might recommend:

- it might take up to three years for any amendment of the relevant primary legislation concerning Lloyd's regulation to be enacted and come into effect, if that were concluded to be desirable. We have,

therefore, examined both the effectiveness of the current arrangements within the statutory structure that is likely to remain in place for the time being, as well as formulating conclusions for the future;

- underwriting capacity will continue to be supported by capital provided by both individual and corporate members, albeit the mix is likely to change if individual Names exit the market in return for value, or convert to other forms of participation. We have also assumed that corporate members will be both spread and dedicated in nature, though the balance may shift towards the latter structure; and
- the capital structure supporting underwriting will continue to be built around the Central Fund and the maintenance of a single level of security behind all Lloyd's policies - a decision recently confirmed by the Council.

## 2.5 Submissions

2.5.1 The terms of reference and membership of the review group were widely publicised:

- in the November 1996 edition of *One Lime Street*, sent to all members of Lloyd's;
- in a regulatory bulletin on 1 November 1996 to all underwriting agencies, Lloyd's advisers, Lloyd's brokers, recognised auditors and corporate members;
- in a letter from Sir Alan Hardcastle to the chairmen of the four Lloyd's underwriting associations, the LUAA, LIBC, ALM, LCCA, the High Premium Group (HPG) and the Lloyd's Names Association Working Party (LNAWP); and
- in a press release.

2.5.2 Members of the review group met with representatives of the ALM and the HPG to discuss the issues arising during the review and the LUAA arranged an open meeting for the agency and underwriting community with the same purpose.

2.5.3 The announcement of the review included an invitation to make written submissions, 43 submissions were received from the following sources:

Source	Number of Submissions Received
<b>Market Associations and Groups</b> (LNAWP, LUA, NMA, LMUA, joint market associations, Australian Names, ALM, Australian ALM, HPG, LIBC, LCCA)	11
<b>Members' Agents</b>	2
<b>Managing Agents</b>	11
<b>Individual Members</b> (4 working; 4 external)	8
<b>Brokers</b>	4
<b>Others</b> (eg LPSO, LTC, Ernst & Young, KPMG, Institute of Actuaries)	7
<b>Total</b>	<b>43</b>

## *2. Introduction - continued*

- 2.5.4 We wish to record our thanks to all those who made submissions, the majority of which were constructive and of very high quality. Their contents covered an extremely broad range of topics, often going into considerable detail. Copies of the submissions are available for inspection in the Information Centre at Lloyd's
- 2.5.5 Among those who made submissions there was a high level of agreement about the principal issues to be addressed in the review -though, not unexpectedly, rather less agreement on how some of them might be resolved. These principal issues substantially cover our terms of reference and form the basis for the following chapters in this report. The group has drawn its own conclusions after due consideration of all the views put forward.
- 2.5.6 Many submissions made comments about detailed aspects of regulation and its application. Whilst we agree that the points they raise are important, we have of necessity confined our consideration to the high level structural issues as set out in our terms of reference. Nevertheless, we would expect to see many of these detailed issues addressed over the coming year as part of the ongoing work of the Regulatory Board and the regulatory division to develop and refine Lloyd's regulation.
- 2.6 Approach of this Report**
- 2.6.1 In this report we first consider the purpose of regulation at Lloyd's and then assess how far the current regulatory framework fulfils that purpose. We then set out some issues concerning the current governance structure including the membership of the Regulatory Board and the general approach to and costs of regulation.
- 2.6.2 We have further important conclusions on the introduction of additional external accountability. As these are, by necessity subject to a longer timescale, they are dealt with in a separate chapter at the end of the report.

## 3. *The Objective of Regulation at Lloyd's*

### 3.1 **Towards the Common Good: A Restatement of the Objective of Regulation**

3.1.1 The objective of regulation at Lloyd's has traditionally been expressed in terms of protecting policyholders and members, including (more recently) corporate members. These are valid aims which we feel should continue to serve as underlying goals. We also feel, however, that in the future there should also be even sharper focus on the aim of safeguarding the reputation, integrity and solvency of the Lloyd's market as a whole. This would in turn bring benefits for *all* Lloyd's stakeholders; policyholders, members and those businesses and individuals who work in the market,

3.1.2 **We therefore recommend that the broad objective of regulation at Lloyd's should be re-stated as: to provide reasonable safeguards for Lloyd's policyholders, members and component businesses in order to establish a basis for confidence that Lloyd's is a solvent and soundly managed market in which to do business'**

Our thinking is set out in more detail below.

3.1.3 It is difficult in practice to separate the Council's and Corporation's regulatory activities from those which are concerned with ensuring the normal commercial and competitive operation of the marketplace, including compliance with external regulatory requirements necessary to trade both in the UK and overseas. The above broad definition accepts that regulation is not just carried out by the regulatory division - elements of regulation are also essential to ensuring the commercial cohesion and operation of the marketplace.

### 3.2 **Reasons for Regulation**

3.2.1 One of Lloyd's greatest strengths has always been its structure as a free market of competing, entrepreneurial units, bound together by a set of common standards and, ultimately, by the Central Fund. The operation of market forces can, if properly harnessed, provide the most effective means of driving change for the ultimate benefit of all participants in the market. But we also recognise the risks associated with this approach if completely unchecked.

### 3.3 **The Collective Interest**

3.3.1 The success of individual underwriters, companies and members rests on the strength and support of the market as a whole. We feel that focusing solely on the interests of policyholders or members in isolation can obscure the common interest that all Lloyd's stakeholders, including market firms, have in ensuring that the Lloyd's market is fair, solvent, stable and clean, that unreasonable or reckless activity is prevented and that confidence is maintained.

3.3.2 Regulation seeks to set and enforce standards designed to ensure that:

- the market and those trading in it are solvent;
- those doing business in the market are competent and honest;
- all market users are fairly and impartially treated;
- the market is as transparent as possible; and
- the market is not misled, manipulated or abused.

### *3. The Objective of Regulation at Lloyd's - continued*

All these objectives serve the twin aims of safeguarding policyholders and members but also promote the good of the market as a whole. We think that four-fifths or more of the current regulatory framework primarily serves these purposes.

**3.3.3** Lloyd's is not an insurance company and comparisons with the regulatory regime governing insurance companies should be made with great caution. Lloyd's is a market underpinned by the Central Fund, to which all members subscribe and which will, at the Council's discretion, meet valid claims from policyholders in the event of any member being unable to do so. Sometimes likened to the rope linking together a group of climbers, the role of the Central Fund justifies the regulation of not only the strength of the rope itself, but also the strength, ability and actions of the other climbers. This, together with unlimited liability, mean that there will be a need for a layer of regulation associated with operating at Lloyd's that does not apply to insurance companies.

#### **3.4 Levelling the Playing Field - Protection of Market Participants**

**3.4.1** A significant reason for regulation in many markets is the potential for exploitation to occur if there is a significant inequality of knowledge, information and bargaining power between the parties involved. This is frequently the case in the retail financial and insurance sectors, compounded by the existence of agency relationships, and has justified widespread regulatory intervention. We recognise several situations where such inequalities can exist at Lloyd's:

- between the member and the agent and/or underwriter;
- between different types of capital, most particularly between capital with a direct link to the managing agent/syndicate and independent capital;
- between the policyholder, his broker and the underwriter; and
- between Lloyd's central authorities and any of the organisations or individuals in the market.

In practice concern has focused on the interests of policyholders and of members (individual members in particular).

**3.4.2** Although some degree of 'caveat emptor' must apply, the capability of the parties concerned to protect themselves in these situations varies. The difficulty, for the majority of insurance policyholders of independently determining the solvency and security of their insurer provides the basis for the prudential regulation of insurers by governments in the UK and overseas. Also, dealings between market professionals (sometimes classified as 'wholesale' trading) are generally on a more even footing than where one of the parties is financially 'unsophisticated'. The degree and nature of regulatory intervention must be appropriate to each case.

**3.4.3** We have concluded that we should aim to move towards a situation where the regulatory structure is designed to provide safeguards which assume a reasonable degree of financial sophistication from the Lloyd's member.

## 3.5 Constraints on Regulation

**3.5.1** We have considered what it is reasonable to expect regulation to achieve. It is clear that no system of regulation can, or indeed should attempt to, remove the normal risk of commercial trading losses, Lloyd's is a market in risk and losses are to be expected from time to time. The high risk nature of trading in the Lloyd's market for the member (which accompanies its potential for high return) must never be forgotten and the management of the businesses in the market have a responsibility to control this risk effectively. Regulators will never be able to prevent all imprudent or fraudulent behaviour but the aim should be to see that it is detected early, stopped swiftly and that effective disciplinary measures exist to act as a deterrent,

**3.5.2** We also recognise that there are wider factors that need to be taken into account if regulation is not to stifle the development of Lloyd's as a market. These include:

- **efficiency** - regulation should not hinder the Lloyd's market from providing services to its customers and members in as efficient a way as possible;
- **competitiveness** - regulation should not discourage competition and innovation or foster protectionism;
- **flexibility** - regulation should closely follow and not unnecessarily constrain the process of significant structural change which Lloyd's is undergoing;
- **equity** - regulation should aim to ensure equitable treatment of all market participants but without unnecessarily constraining the natural operation of the market; and
- **cost** - regulators must take into account, and minimise wherever possible, the costs of the different options for meeting the agreed regulatory objectives.

## 3.6 A Final General Observation

**3.6.1** Lloyd's displays a number of unique features which complicate any discussion of regulation and prevent it from fitting easily into any existing regulatory model. That said, we are aware of a tendency to overuse the 'Lloyd's is unique' argument which must be resisted where it leads unnecessarily to the development of a unique (sometimes expensive and inconsistent) approach to a problem. We recommend that the starting point for future regulatory change at Lloyd's should be to look at what is working well elsewhere and attempt to adapt it for Lloyd's, rather than re-inventing the wheel on each occasion.

## 4. Solvency Regulation

### 4.1 The Current Legislative Framework - Focus on Policyholder Interests

4.1.1 Solvency regulation at Lloyd's is subject to external supervision primarily through the need to comply with the statutory solvency requirements of the DTI under the Insurance Companies Act 1982 (ICA), and the requirements of other insurance regulators around the world. These requirements focus on the ability of insurers (Lloyd's and companies) to meet valid claims. The Council of Lloyd's is responsible to the DTI for ensuring that members satisfy these solvency requirements, both individually and collectively.

4.1.2 Following the implementation of the *reconstruction* and *renewal* plan the solvency regime was reviewed by the DTI in consultation with Lloyd's and an additional solvency test, complementing the two existing tests, has been introduced to take effect from 31 December 1997. Every member of Lloyd's will be required not only to prove that they have sufficient assets to cover their liabilities but also to demonstrate a prescribed solvency margin. Lloyd's must demonstrate that it has sufficient centrally held assets to cover any aggregate shortfall from this test.

4.1.3 We feel that in general the current structure provides solvency safeguards for policyholders which are as good as are provided for policyholders of any other UK insurer and up to the highest international standards. The accountability of the Council of Lloyd's to the DTI has ensured that the interests of policyholders have been fully taken into account. These measures have helped to ensure that no valid claim from an external Lloyd's policyholder has gone unpaid, despite the massive losses of recent years, (By contrast, even in the well-regulated UK insurance industry a number of insurance and reinsurance companies have ceased to trade in recent years, and even more have done so in the US market.)

4.1.4 For the future, we agree that comparability with the regulation of insurance companies should be taken further. We would give as examples two areas that would require changes to the ICA that we feel should be considered with the government:

- under the ICA the Secretary of State for Trade and Industry becomes directly responsible for supervising Lloyd's underwriting members primarily in the event that the solvency tests are failed, although the effect of the new margin requirement for each member is to enable the DTI to seek corrective action sooner than hitherto. These intervention powers have never needed to be used. **We recommend that the Secretary of State should be empowered to act at an even earlier stage, should policyholders' interests be considered to be at risk, as is the case in respect of an insurance company;** and
- in the event of default by a member of Lloyd's, the Society has only the status of an ordinary creditor in respect of assets not within the member's funds at Lloyd's. In a similar situation the Secretary of State has more far-reaching powers over the assets of an insurance company including the power to sequester assets and freeze bank accounts. **We recommend that, on the request of, or with the consent of, the Council of Lloyd's, the Secretary of State should be able to exercise these powers in respect of members of Lloyd's and Lloyd's underwriting agents.**

4.1.5 The fact that these powers were available would not mean that they would have to be used, as long as the Secretary of State was satisfied that the Council of Lloyd's was taking the necessary steps to address the problem.

## 4.2 Systemic Risk

- 4.2.1 Notwithstanding our confidence in Lloyd's general solvency regulation, we are concerned that insufficient attention is being paid to the potential for accumulation and concentration of risk within the market. The system of subscription, reinsurance and retrocession within Lloyd's is intended to spread risk. However, recent experience suggests that the same process can, unless controlled, expose the market as a whole to unacceptable risks. Individual underwriters in the market may be making rational decisions about their own exposures but taken on a whole market basis the combined effect of these decisions may be harmful with consequent exposure of the Central Fund.
- 4.2.2 A risk assessment framework is currently being developed within the regulatory division, including the construction of specific realistic disaster scenarios, to help measure syndicate vulnerability to certain major catastrophes. It should also be a central responsibility to monitor the aggregate exposures of the market and to take action if an unacceptable degree of risk to the Central Fund is indicated. We agree with a number of submissions that commented on this need. This would be in the interests not only of policyholders but also of members and the market as a whole.
- 4.2.3 **We consider that the recognition of total market exposure, through aggregation of risk, is a crucial area of regulation for the future and recommend further development of the steps already being taken within the Lloyd's regulatory division to address it. We recommend that Lloyd's should follow the example of other regulators and establish a specialist financial risk assessment unit staffed by suitably qualified individuals to further enhance the computer modelling of market exposures giving rise to risks of a systemic nature.** Such a unit need not necessarily be located in the regulatory division and it could well serve some other valuable purposes than the ones we have identified here.
- 4.2.4 We also recognise that there is a wider aspect to this area of regulation that involves the whole of the London market. It is possible, for instance, that Lloyd's monitoring of insurance and reinsurance activity may indicate problems involving firms that are not within Lloyd's jurisdiction. In this event we would expect information to be shared with other regulators as a matter of course. We would also recommend that appropriate liaison continues to be maintained with other London market bodies.

## 5. Competence of Market Participants

### 5.1 Admission and Monitoring

5.1.1 There was a strong view put to us in submissions that the main emphasis of regulation of the Lloyd's market should be on ensuring the competence of participating firms and individuals, who should then be held responsible for meeting required standards, rather than subject to further detailed rules governing their activity. Although we observe that this view is reflected in the regulatory plans for 1996 and 1997, many market practitioners believe that the process has not gone far enough.

5.1.2 It is clearly in the interests of both policyholders and members, as well as the overall reputation of the market, that those working at Lloyd's should be both competent and honest. The following key aspects of regulation currently seek to address this:

- **authorisation** standards for the admission to the market of underwriting agents - we fully support the current principle that these must be in all relevant respects at least equivalent to those that the DTI require of applicant insurance companies;
- **individual registration** - was a key element of Lloyd's Regulatory Plan for 1996 and brought Lloyd's into line with other regulatory regimes. It involved a detailed character and suitability check of more than 3,000 market practitioners, covering underwriting agents, run-off companies and Lloyd's advisers. Despite initial scepticism from the market, acceptance of this process is already becoming more widespread and we commend the aim which lay behind the change:
- introduction of **core principles**, underpinned by codes of practice and guidance notes, for underwriting agents, mirroring the SIB's core principles for other City markets. We support this approach and the intention to regulate agencies and their management by reference to such principles. The agency community support them too, in principle, but are keen to see a consequent simplification of the existing detailed rulebook (a subject to which we return later); and
- **syndicate and agency monitoring** - there has been a shift in recent years away from a reactive, consent based approach towards a selective, proactive, preventative approach to monitoring. This has been achieved through more on-site inspection visits and vigilance to spot any sign of emerging problems. While to some extent this approach runs counter to pleas for regulation to be less intrusive, we welcome the new approach and the focus on 'at risk' elements which is very similar to that followed by other City regulators. We comment later on staffing implications for the regulatory division of this shift.

### 5.2 Education and Training

5.2.1 We strongly support the action taken in recent years to raise professional standards in the market through the introduction of requirements for professional qualifications and continuing professional education (CPE). These requirements however must be relevant, meaningful and practical in order to be effective and held in high regard.

5.2.2 We understand that a review of the practice and content of the CPE scheme is planned. **We would go further and recommend that the general education and training requirements, including CPE, for underwriters, directors and senior staff of underwriting agencies are now reviewed in order to focus effort on the most relevant issues for the future.** We would suggest that these issues include, inter alia, specific training on the duties of directors and the law of agency.

### **5.3 Disciplinary Arrangements**

- 5.3.1 Recent reforms have improved and speeded up the disciplinary processes, in the face of a number of shortcomings which had become apparent over the years since the Lloyd's Act 1982. The definition of misconduct has been widened to include failure to observe the core principles, the concept of vicarious liability has been introduced, a system of fixed penalties is now available and the summary disciplinary process has been enhanced.
- 5.3.2 We welcome these reforms which bring Lloyd's disciplinary processes more into line with practice elsewhere in the City. They were overdue. The previous procedures were too cumbersome and criticism of them weakened confidence in Lloyd's determination to deal effectively with cases of poor standards.

## 6. *Protection of Members*

### 6.1 **The Current Legislative Framework**

6.1.1 The Financial Services Act 1986 (the FSA) introduced a system to provide a reasonable level of investor protection in financial markets. It established the concept of 'self-regulating organisations' (SROs), the members of which are authorised to carry out investment business and 'recognised investment exchanges' (RIEs). Lloyd's is not an SRO or a RIE for the purposes of the FSA. The Society of Lloyd's and persons permitted by the Council of Lloyd's to act as underwriting agents are, by virtue of section 42 of that Act, exempt persons for the purposes of the FSA in respect of the investment business carried out by them in connection with or for the purpose of insurance business at Lloyd's. This is in line with the fact that members of Lloyd's are sole traders in insurance, and not investors. (Those who invest in Lloyd's corporate members, however, enjoy the normal protections of company law.)

6.1.2 During the passage of the Financial Services Bill through Parliament in 1986 the proposed exclusion of Lloyd's was questioned and the government responded by establishing a Committee of Inquiry into Regulatory Arrangements at Lloyd's, chaired by Sir Patrick Neill, QC. This committee was charged with reviewing whether regulatory arrangements at Lloyd's provided protection for Names comparable to that proposed for investors under the FSA. When the Committee's report was published in 1987, the Council agreed immediately with all the recommendations in the report and on this basis the exemption from the FSA was confirmed. All of the detailed recommendations made to Lloyd's by the Neill Inquiry were implemented by the Council within two years.

6.1.3 Despite Lloyd's introducing more regulations since 1982 than ever before in its history, many members of Lloyd's suffered extreme losses. It is not our role to review in detail the causes of the losses of the 1980s but it should be noted that Lloyd's was not alone in being hit by an unprecedented level of claims associated with asbestos, pollution and natural disasters. We doubt that better regulation would have affected the losses themselves but their impact might have been less severe and, particularly, less concentrated if the problems had been detected earlier and if the general level of competence and control in the market had been higher.

6.1.4 We are convinced that the measures put in place by the Regulatory Board since it was formed in 1993, most particularly those made over the past two years, are addressing these issues. We comment further on this subject in subsequent chapters. We also note that, following the sobering experience of coming so close to disaster, there is greater acceptance of the need for higher professional standards and a much improved culture of compliance in the market. It is essential that the lessons of the past are not discarded in the future.

### 6.2 **Lloyd's Exemption from the FSA**

6.2.1 We feel that the extent of the exemption under section 42 of the Financial Services Act 1986 needs clarification.

6.2.2 Members' agents may be giving what is in effect general investment advice to their members. We can understand the circumstances by which this situation comes about, particularly in relation to conversion arrangements and investments in Lloyd's corporate vehicles. We have no objection to this activity, indeed it may be in the interests of the members that advice can be given on their Lloyd's affairs in the context of their general financial position. We understand that differing advice has been obtained by the market as to whether all of this activity is covered by Lloyd's section 42 exemption.

**6.2.3** Uncertainty as to the scope of the exemption needs to be resolved as a matter of urgency. **We recommend that the LRB should take the appropriate legal advice and subsequent steps to ensure that the interests of members are properly safeguarded.** The longer term approach to this issue may best be addressed as part of the wider statutory changes to bring Lloyd's within the FSA structure as proposed in Chapter 12, which might involve an amendment of section 42.

## **6.3 Corporation Administration of Funds**

**6.3.1** **We recommend that a detailed comparative review is undertaken by the Council to ensure that the services provided by the Corporation, in particular the Members' Services Unit in relation to the administration of funds at Lloyd's, meet, as far as is reasonably possible, the standards of operation that would be imposed by an SRO upon a member company undertaking business of a similar nature.**

## **6.4 Transparency of Information**

**6.4.1** Regulation at Lloyd's relies heavily on disclosure as a tool to ensure that members in particular are given all the information they need to make sensible decisions about their participation in the market. We are conscious however that a proper balance must be struck, so that market firms are not forced by Lloyd's disclosure requirements unnecessarily to reveal commercially sensitive information to competitors, the recipients of such information are not overloaded with immaterial detail and that Lloyd's disclosure requirements are consistent with those of other regulated markets.

## **6.5 Members' Agents and Lloyd's Advisers**

**6.5.1** We recognise that the existence of competent members' agents is a critical factor in ensuring the protection of individual members of Lloyd's. Review visits by the Lloyd's regulatory division monitoring team have placed particular emphasis on the main risk areas for members' agents, namely awareness of the financial strength of members, adherence to the Know Your Principal' code of practice, syndicate monitoring, allocation of capacity, and efficient administration of members' Lloyd's affairs, including auction administration. **We would recommend that regulatory policy towards members' agents and Lloyd's advisers is kept under review to ensure that it is consistent with the approach taken elsewhere in the financial services sector,**

## **6.6 Recognition of Value in Syndicate Participations**

**6.6.1** For many years it was impossible for members of Lloyd's to realise the value attributable to their right to remain on a syndicate. We commend the work that has taken place over a relatively short period of time to devise an auction market in these rights, establishing a members' security of tenure and allowing transfer for value. This was a major step in safeguarding the interests of members of Lloyd's. A number of submissions highlighted shortcomings in the current system but we are satisfied that the vast majority of these are under review. We agree that the Lloyd's auction system should continue to follow the general principles of market operation and regulation that apply to other regulated exchanges in the UK

## 6. Protection of Members - continued

### 6.7 Means of Redress for Members

6.7.1 We have considered whether the Lloyd's regulatory system provides adequate means of redress for members with a grievance against their underwriting agent. The key elements of this process are the existence of proper procedures for dealing with complaints and disputes backed up by measures to mitigate the impact of financial loss beyond normal trading loss. There must, however, be an awareness of the high risk nature of underwriting in the Lloyd's market, recognising the high degree of exposure of members who trade with unlimited liability but also the difficulty in distinguishing normal trading losses from those allegedly resulting from negligence, incompetence or malpractice.

6.7.2 **Complaints Handling** - Lloyd's has in place a system for handling complaints from members against their agents and also administers an arbitration scheme which should be quicker, cheaper and more reliable than litigation. We feel that an effective arbitration scheme is essential and we commend plans by LRB to review these arrangements to ensure they continue to meet the needs of members and the market. There is also a scheme - the Lloyd's Members' Ombudsman - for investigating members' complaints of maladministration by the Corporation of Lloyd's

6.7.3 **Errors and Omissions Cover** - we endorse the Council's recent moves to consult on the question of an affordable system of compulsory comprehensive E&O cover for agents and advisers. It is clearly desirable to have such cover in place, written outside the Lloyd's market. It remains to be seen from the results of the consultation exercise whether or not such cover may be commercially available at the present time.

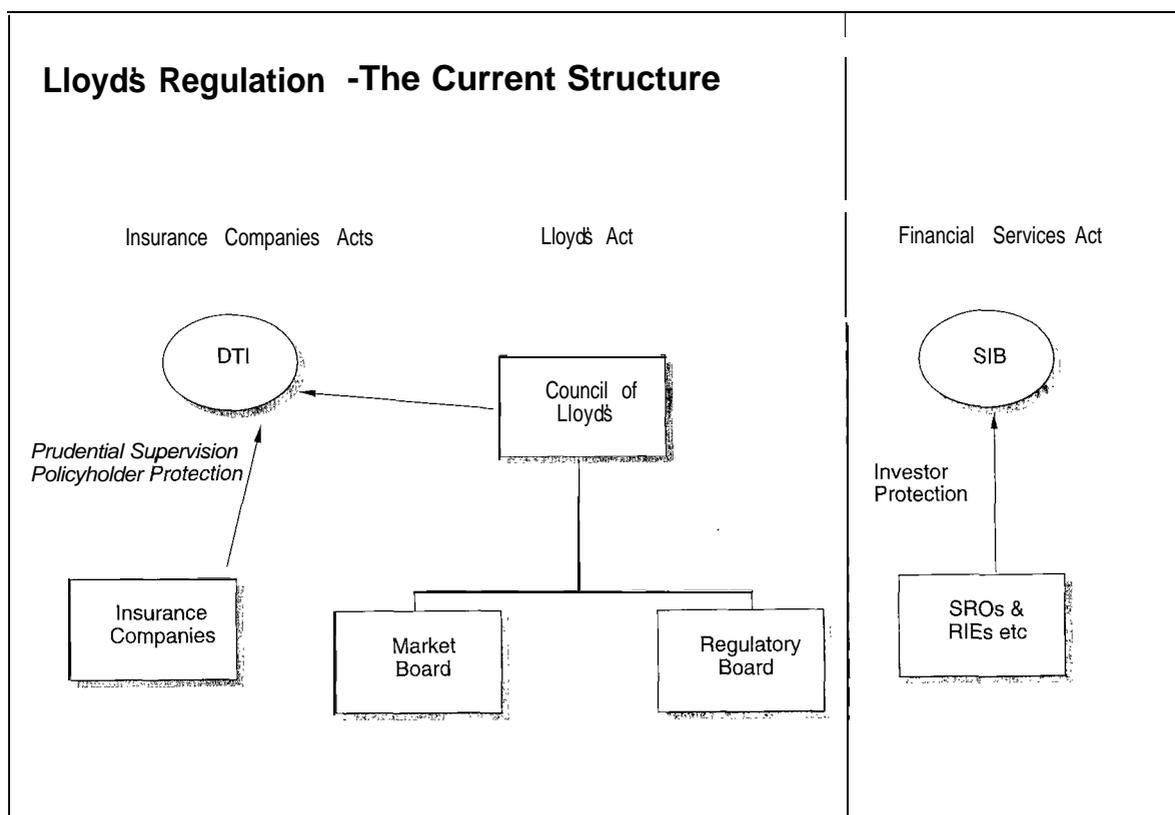
6.7.4 **Compensation Schemes** - the Lloyd's Members' Compensation Scheme was set up to compensate members of the Society who have claims against insolvent underwriting agents in respect of loss caused by fraud or other dishonesty or failure to account for moneys or property received on their behalf. **We recommend that, in the light of the experience of recent years, the current scheme should be reviewed.**

6.7.5 Whereas comparability with the Investors' Compensation Scheme (ICS) for UK investors in general is desirable as a starting point, the special conditions of trading in the Lloyd's market must also be taken into account and a more extensive scheme may be appropriate. We feel that consideration should include the following issues:

- whether such a scheme should apply to all Lloyd's members, corporate and individual - the ICS is available only to private investors;
- under what circumstances compensation might be payable. Lloyd's scheme has been criticised because it may not cover negligence and it only comes into operation when the agent concerned has gone into liquidation. The ICS is operative only on the financial failure of a financial services company where a private investor can prove that they have suffered direct losses as a result of the failure of the company;
- the financial limits of the scheme (the current maximum of £50,000 for the Lloyd's scheme is broadly comparable to the ICS limit of £48,000); and
- the extent to which it should be financed by a levy on agents (who currently fund the first third of the maximum aggregate amount of compensation in any year) or the membership in general (who currently fund the other two-thirds). The ICS scheme is funded by the member firms.

# 7. Lloyd's Council and Regulatory Board

## 7.1 The Current Structure



7.1.1 The current governance structure at Lloyd's consists of the Council, the Regulatory Board and the Market Board,

7.1.2 Under Lloyd's Act 1982 the Council of Lloyd's has control over the management and regulation of the affairs of the Society with power to make byelaws for this purpose. The Council currently comprises eighteen members, made up of six elected working members, who include the Chairman and two Deputy Chairmen, as required by the Act; six elected external members, including one representative of corporate members; and six nominated members, including the Chief Executive Officer (CEO).

7.1.3 The Lloyd's Regulatory Board and the Lloyd's Market Board were established in January 1993. Their establishment stems from the recommendations of the Morse Working Party which proposed the establishment of the two boards under the authority of the Council. These arrangements were a development of the proposals in the 1992 report of the Task Force and were designed for the following purposes:

- to create an expert and impartial body (the Regulatory Board) to act as "an informed monitor and facilitator, putting in place an appropriate regulatory structure for the market's business" to be chaired by a nominated member of the Council;
- to create a second body (the Market Board) with an appropriate range of Lloyd's and outside expertise, to "provide the necessary focus for business leadership", to be chaired by the Chairman of Lloyd's and having as its nucleus the working members of the Council who constitute the Committee of Lloyd's as required by the Act of 1982; and
- to leave the Council with its overall supervisory function as laid down in the Act of 1982, and in that connection carrying out those statutory functions which under that Act cannot be delegated -that is, principally, legislation and confirmation of disciplinary decisions.

## 7. Lloyd's Council and Regulatory Board - continued

7.1.4 The size and composition of the two boards have been varied somewhat since 1993 but their current composition is generally consistent with the principles underlying the Morse Working Party's recommendations.

7.1.5 The Regulatory Board currently numbers sixteen members, made up as follows:

**Members:**

External (individual) members of Council	5	
Representative of corporate members (appointed)	1	
	<hr/>	6

**Working members of the market (appointed)** 4

**Independent members:**

Nominated members of Council	4	
Director of Regulation	1	
Part-time appointed member (former head of regulation)	1	
	<hr/>	6
		<hr/>
		16

Four of the six independent members of the Regulatory Board have current or very recent experience as board members or executives of regulatory bodies elsewhere in the City,

7.1.6 The Market Board includes the six elected working members of Council and the external member of Council elected to represent corporate members, as well as other members, appointed by the Council and drawn from leading figures working in the market and from the membership, and certain directors of the Corporation.

### 7.2 Roles of the Boards

7.2.1 The terms of reference and the specific delegations of the Council's powers are reviewed and renewed annually. Broadly, the Regulatory Board is charged with exercising the Council's powers to regulate, save for the making of byelaws, which is reserved by statute to the Council itself, although the Regulatory Board, in most cases, makes the relevant recommendations to the Council.

7.2.2 The Morse Working Party considered a suggestion that there should be a degree of overlapping membership as between the Market Board and the Regulatory Board and concluded that they would not recommend this, as it could, in their opinion, blur the separation of business and regulatory functions. The later Sheldon Working Party, which reviewed members' voting rights and related matters in 1994, envisaged a less rigid division of Council members between the two boards but this, in practice, has resulted in very little change. We comment later on the composition and size of the Regulatory Board in the light of our views on the place of regulation, and its practice, in the future governance of Lloyd's

### 7.3 Executive Responsibility for Regulation within the Corporation of Lloyd's

7.3.1 During 1993, following the establishment of the Regulatory and Market Boards, the staff of the Corporation concerned primarily with regulation were grouped together under the Head of Regulation (now the Director). The structure and staffing of the regulatory division form the subject of Chapter 10 of our report.

**7.3.2** The Director of Regulation is accountable on regulatory matters and on the day-to-day execution of regulatory policy, not to the Chief Executive Officer (CEO) of the Corporation, but to the Regulatory Board through its Chairman. In all other respects, the regulatory staff are Corporation staff, for whom the CEO is accountable to the Council. This separation of responsibility between the Director and the CEO is unusual in organisational terms, but has proved workable.

**7.3.3** It was recognised at the time that the separation of staff and functions needed to be accompanied by satisfactory arrangements for liaison at all levels. Regular meetings between the Chairman of Lloyd's, the Chairman of the Regulatory Board, the CEO and the Director of Regulation and, at the executive level, between the CEO and his senior colleagues, including the Director of Regulation, were among the steps proposed to forestall problems and those suggestions have been followed. The arrangements were also predicated on the basis that, although they would not be concerned with the minutiae of regulation, the Chairman of Lloyd's and the CEO would be responsive to regulation and conversant with its aims and objectives.

**7.3.4** At the Council level, the commitment to the aims and objectives of regulation are signified by the Council's endorsement, before publication, of the Regulatory Board's Annual Report and Plan for the succeeding year - a practice instituted in 1996, which we warmly support.

## **7.4 Effectiveness of the Current Structure**

**7.4.1** While the separation of functions has undoubtedly led to improvements in the approach to regulation at Lloyd's, we have received a number of criticisms, on which we comment below, and which lead us to make certain recommendations for change.

**7.4.2** The composition of the Regulatory Board, and its freedom to act independently, have been the subject of widespread comment in submissions to us. By some, it is seen to be weighted too heavily in the direction of members and against the market, and by others (including the TCSSC) as too susceptible to market pressure whenever there is tension between the two boards. We comment on these issues below.

## **7.5 Retention of LRB**

**7.5.1** It has been suggested that the Council of Lloyd's could discharge its regulatory responsibilities directly through regulatory sub-committees, without the need for a separate Regulatory Board. We consider that the proper time to consider such a change is after the Council of Lloyd's has become subject to additional statutory external accountability, which we discuss in chapter 12. In the meantime, we feel the existence of a separate and effectively constituted Regulatory Board underlines the importance Lloyd's attributes to regulation. Also, it is correct, in our view, that the Council of Lloyd's should be in a position to balance commercial and regulatory policy but supervision of regulatory operations should be seen to be more independent and the separate existence of the LRB supports this approach.

## **7.6 Size and Composition**

**7.6.1** A Regulatory Board of sixteen members is probably too large. We say this in the light of the increasing (and desirable) delegation to regulatory staff of the day-to-day execution of regulatory policy that has been a feature of the past two or three years. We also note that contentious casework, involving registration, de-registration, authorisations and dispensations, for example, is now handled by panels established by the Board and not by the Board itself (this has also enabled members to be selected to deal with such cases who are faced with no conflicts of interest and who can bring particular expertise to bear).

## 7. Lloyd's Council and Regulatory Board - continued

- 7.6.2 The role of the Board, we suggest, should be:
- to establish regulatory policy in accordance with the Council's policy for the development of Lloyd's as a whole and having regard to best practice elsewhere in other regulated areas;
  - to oversee the execution of policy by the staff; and
  - to review the resources deployed and to recommend the requisite budget to Council.
- 7.6.2 For these purposes the Board would probably need to continue to meet monthly and would need to be large enough to provide chairmen for panels and sub-committees for particular cases or subjects. We **recommend that the size of the Regulatory Board be reduced, ideally to twelve people.**
- 7.6.4 The balance of the Regulatory Board also needs to be re-considered. By contrast with regulatory bodies elsewhere in the financial services industry, the proportion of working members (ie those being regulated) appears to be low - currently 25% of the membership. Something nearer one-third of the membership appears to us to be desirable in the Lloyd's context, so as to ensure an appropriate spread of different types of market practitioner (such as underwriters, managing agents, members' agents and brokers) whose expertise is a vital input to the development and practice of regulation.
- 7.6.5 **We recommend that the membership of the 12-member Regulatory Board should be re-balanced to provide one-third drawn from the market, one-third from the external members of Council and one-third independent members, drawn from the nominated members of Council plus the Director of Regulation.**
- 7.6.6 **Market Representatives:** it has been suggested to us that there has been a reluctance on the part of senior market practitioners to participate in the development of regulation as members of the Regulatory Board. Despite this, we have been told that those market practitioners who have served on the Regulatory Board since it was formed have made, in general, a substantial and objective contribution to the Board's work. We acknowledge that it is not always a comfortable role to perform. We firmly believe that in appointing such members the Council must continue to endeavour to appoint practitioners of seniority and high standing so that the significance of regulation to Lloyd's success as a well-run and effective market can be clearly demonstrated and so that policy is influenced by people of real experience and standing. We do not feel that the market practitioners on the Regulatory Board need automatically to be drawn from the working members of the Council. There are significant advantages to be gained, both in terms of spreading the workload and achieving an appropriate breadth of expertise, by appointing non-Council members of the right calibre to the Regulatory Board. **We recommend that certain market associations (we suggest the LUAA, LOCUS and the LIBC) should be invited to put names forward for the market practitioner places on the Regulatory Board.** They may feel it appropriate to nominate their chairman or deputy chairman although, as these positions are commonly a one-year or two-year appointment and the normal period of service on the Regulatory Board is three years, this may be impractical (as well as the increased workload being unduly onerous on the individual concerned). When nominating such individuals the associations should bear in mind the need for these members to be of seniority and high standing in the market.
- 7.6.7 Within the overall Lloyd's market are many specialist markets that operate in different ways in different market conditions and regulation must be sensitive to these differences. For example, motor and personal lines syndicates in particular feel that they are over regulated in comparison with their insurance company competitors. There is at present no automatic representation of particular classes of business on the Council of Lloyd's nor on the LRB, although some attempt to achieve a balance across the market is, and will

continue to be made when selecting the co-opted market members. We believe that there are better ways of ensuring that the voice of particular markets is heard, such as the direct motor forum which brings together representatives of the motor market and the Chairman of Lloyd's on a regular basis, which may be helpful for other sectors too.

**7.6.8 Members of Lloyd's:** we do not accept the argument made to us in some submissions that only a Board consisting wholly of the representatives of external members of Lloyd's would adequately safeguard the interests of those members. This ignores the reality that there are many legitimate stakeholders in the success of the Lloyd's market and it also runs contrary to practice in other fields of regulation where the importance of practitioner and independent input is also recognised. By contrast, we have concluded that the representation of external members on the Regulatory Board is, if anything, slightly overweight at nearly 40%. Moreover, five of the six representatives of capital on the Regulatory Board are representatives of individual members and only one represents corporate members who, in 1997 are providing 44% of stamp capacity. We are recommending that the more appropriate balance for the Regulatory Board would be for one-third of its membership to represent external members of the Society.

**7.6.9** We have noted that a progressive re-balancing of the Council's membership is currently underway in order to implement the recommendations of the Sheldon Working Party to provide more appropriate capacity-weighted representation. We make no additional suggestions at this time therefore regarding the balance between individual and corporate members of the regulatory board.

**7.6.10 Independent nominated members:** the independent element of the Board should continue to be drawn mostly from the nominated members of Council, who will have been selected (and approved by the Governor of the Bank of England) for their independence, wide experience and standing. Certain functions of the Board which may be delegated from time to time will, of necessity, require chairmen who are both independent and experienced. These members of the Regulatory Board will, in addition, bring with them in many cases experience of regulating other areas of business activity. One of the independent members might be a nominated representative of the SIB: we comment further on this in Chapter 12.

## **7.7 Independence**

**7.7.1** Some degree of tension between the Market and Regulatory Boards is inevitable and healthy. However, concern has been expressed to us that the current structure and operation of regulation leads to obstructive tension. We note that the Regulatory Board, in its plan for 1997, has undertaken to lay more emphasis on wide consultation on regulatory proposals with the market and with the membership, including the market board. We endorse this approach. At the same time, it is important to recognise that while the Market Board should be kept well informed of the regulatory agenda, the discussions of proposals with them should not be seen as a substitute either for independent thinking by the Regulatory Board or wider consultation with the market and the membership.

## **7.8 LRB Sub-Committees**

**7.8.1** LRB does not at present operate through standing sub-committees covering, for example, authorisations, enforcement and policy, in the manner of a number of other regulatory bodies. **We recommend that consideration be given to moving to such a structure, which would enable the smaller board that we are recommending to concentrate on the higher level policy role.**

## 8. The Regulatory Approach

Moving on from the overall structure within which regulation operates, in this chapter we review issues relating to the way in which regulation has been applied in recent years.

### 8.1 Regulatory Complexity

8.1.1 The submissions received indicate that there is a widely-held view within the Lloyd's market that regulation is over-complicated, with excessive detail, and needs to be simplified. We generally agree with this view, although note that Lloyd's cannot allow less complex regulation to become less effective regulation. Since the passage of the Lloyd's Act in 1982 the Council of Lloyd's has been engaged in a lengthy programme of introducing, and subsequently refining, byelaws and regulations. There are currently over 200 byelaws in force, supplemented by frequent market or regulatory bulletins. In 1996 there were 345 circulars to the market. Sixty-three of these were regulatory bulletins and the remainder largely market bulletins or letters. In the first quarter of 1997 there were 80 circulars, 27 of which were regulatory. We consider further in chapter 9 the compliance costs imposed on the market.

8.1.2 We are reassured that in more recent years there has been a move to a more streamlined and focused approach, based on high standards of entry to the market and effective monitoring. The emphasis has shifted away from a detailed and prescriptive approach towards one based upon compliance with core principles and codes of conduct - an approach very much in line with what has been happening in other UK financial markets. We feel that it is important that the regulatory structure does not simply focus on rules to prevent misbehaviour but equally encourages best practice. This in turn adds to the confidence of all participants in the market.

8.1.3 This still has some way to go, however, and we particularly commend the work that has already started to undertake a complete review of all the existing byelaws and associated guidance notes and regulations. **We recommend that this byelaw review takes note of the objective of regulation as set out in this report and establishes clearly how each byelaw contributes to that objective, considering also the cost to the market and Society of compliance. We also recommend that there is direct input from market practitioners to the review and that experience from outside Lloyd's is drawn upon to provide a fresh and objective approach.**

8.1.4 We should acknowledge that not all of those making submissions were happy with moves towards the use of general principles that could be applied flexibly. They felt instead that detailed and specific regulation was needed in order to be absolutely clear whether compliance was being achieved or not. We were not convinced by these arguments. We feel that the objective should be to raise the standards of competence of those operating in the market (and those regulating them) so the full benefits to the market of a more flexible approach can be realised.

### 8.2 Communication with the Market

8.2.1 Steps taken recently to improve communication with the market have been acknowledged in some of the submissions to us. The Director of Regulation regularly attends committee meetings of the various market associations, ad hoc market briefings are organised to address particular regulatory issues and a compliance officers group has been established to which senior staff in the Regulatory Division are regularly invited. The Chairmen of the LUAA managing agents and members' agents committee meet on a monthly basis with the Director of Regulation.

**8.2.2** The submissions show a strong wish for advance consultation and resentment at its absence on some occasions. As noted earlier, the 1997 Regulatory Plan commits the Regulatory Board to wider consultation on regulatory policy developments and acknowledges that some policy developments in the past were implemented under time pressures which made proper consultation impractical.

**8.2.3** An annual report and a regulatory plan for the succeeding year are now published as a matter of course.

### **8.3 Impact of Annual Venture Structure**

**8.3.1** We understand that the merits of the annual venture are currently being considered by another Lloyd's working group as part of Lloyd's business strategy development. We agree that decisions on this subject must ultimately be made by the Council on a largely commercial basis but we would note that, whatever its business advantages or disadvantages, the annual venture structure does increase regulatory complexity and hence compliance costs. It means that there is a pressing need to organise underwriting affairs, or get regulatory or other policy in place, in time for a particular underwriting year. This leads naturally to a pre-occupation with deadlines that permeates the organisation and can in some cases lead to hasty policy making with little time allowed for consideration, research or consultation, changes made at short notice, moving deadlines and unco-ordinated requests for information.

## 9. Regulatory Compliance Costs

### 9.1 Compliance Costs in the Lloyd's Market

9.1.1 The cost of regulation<sup>1</sup> was claimed to be a problem by a significant number of the market submissions to the group. Concern centred on compliance costs for underwriting agents and syndicates which were alleged to be putting the trading units at a competitive disadvantage with a perceived lack of significant benefit, although we found that anecdotal evidence and opinion on this subject was as abundant as hard facts were scarce. One person's good business practice was another's unnecessary and costly activity carried out purely to satisfy a regulatory requirement.

9.1.2 We also observed a difference in perspective on what is understood by 'regulation'. If a firm or individual wishes to operate in the Lloyd's market, then as in any market, they must comply with the market's practices and procedures. Some of these arise, or are enforced by, the departments grouped together as the regulatory division of the Corporation; others come from different areas, for example, market reporting and solvency, market finance or Lloyd's Policy Signing Office (LPSO). To many of those obliged to comply however, they are all regulation<sup>1</sup> and are judged not by their origins but by their impact on the business and the market.

9.1.3 For the purposes of the regulatory review, however, we felt that it was important to establish a more reliable and factual basis to the market's understandable concern about costs. We therefore commissioned KPMG to undertake a short study to obtain further information, on a sample basis. This information would assist us in determining the general impact of regulatory costs and identifying the priority areas for attention. KPMG's full report is reproduced with permission as Appendix 3. We would particularly like to thank the agencies that participated in this study at a particularly busy time of year,

### 9.2 General Findings

9.2.1 **Overall cost burden:** the study gave us some estimates of the cost to Lloyd's underwriting agents of regulatory activities, expressed as a percentage of their total expenses. A broad definition of 'regulatory' activities, based on the agents' own views of what was 'regulatory', was used, encompassing not only those requirements emanating from the regulatory division but also others relating, for example, to reporting requirements. Although the sample size was small, in general these estimates were not significantly out of line with similar indicators that have been published for other financial markets<sup>1</sup> on a reasonably comparable basis the securities industry appears to have compliance costs of, on average, around 3% of total net operating expenses (within a range extending from 1.0% to 7.4%); and the investment management sector around 8% (within a range of 1.3% to 27.5%). These compare with a range from around 2% to 13% of total expenses for those Lloyd's managing agencies and 1% to 3% for those members' agencies included in the study. The ratio for Lloyd's managing agencies is markedly affected by the size of the agencies with the compliance burden clearly falling heavily on the smaller agencies.

9.2.2 **Benefits of regulation:** the sample was asked to comment on the benefits of regulation as they perceived them and the following factors emerged:

- many regulatory requirements were acknowledged to be consistent with good business practice;
- agencies may benefit from a more probing and challenging approach to regulation. Some agencies interviewed, however, felt that the approach adopted by the monitoring teams was insufficiently risk-based, although we have noted in Chapter 10 that it is a stated aim of the monitoring teams to adopt a

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<sup>1</sup>Data from City Research Project Final Report (March 1995) - see Appendix 3 for full details

risk-based approach and they are in practice doing so. It may be that the agencies interviewed had not yet experienced a monitoring visit in the new style and were commenting on previous experience. A need for improved communication to the market about the new approach may be indicated; and

- it would be beneficial to agencies if the staff of the regulatory division were of the highest quality. (We pick up this point in chapter 10).

**9.2.3** While we have found no evidence that Lloyd's compliance costs are excessive, on a comparative basis, we are acutely aware that maintaining a low cost base is essential for Lloyd's commercial success. We believe that there is scope for reducing the regulatory burden by improving the quality of regulation and we explore this further below.

### **9.3 Key Cost Issues**

**9.3.1** The short study demonstrated that the two main problems that needed to be addressed in relation to compliance costs were:

- the complexity of regulatory requirements; and
- the reporting burden

**9.3.2 Rationalisation of regulatory requirements:** we were told that a major driver of cost is the complexity of regulatory requirements arising from a multiplicity of sources. We have already commented on regulatory complexity in chapter 8 and this finding underlines the importance of our recommendations on this subject, particularly the byelaw review project. It is vital that Lloyd's achieves a consolidated and significantly less complex framework within a relatively short time.

**9.3.3 Rationalisation of information reporting:** we were most concerned at the comments from agencies about the costs imposed on them by Lloyd's reporting requirements. Lloyd's is alleged to demand information which is unnecessary, duplicated, gathered at an inappropriate time and in an unco-ordinated fashion. It is clear that, although they may be regulatory in nature, the majority of the information demands are not made by the regulatory division, which points to the need for a Corporation-wide approach to the problem.

**9.3.4** We note that an internal report has recently been completed which analyses the burden on managing agencies and reaches similar conclusions (Review of Reporting Burdens: Phase 1 - Managing Agencies). **We recommend that this work is taken forward with the aim of producing a significant rationalisation of information demands on both managing and members' agencies.** The solution must involve the appropriate and intelligent use of IT (eg a common database, possibly utilising the opportunities offered by the Lloyd's Intranet) to ensure that information demands are kept to the necessary minimum, are properly co-ordinated and yet still yield the information that is required for Lloyd's to perform its regulatory functions both in the UK and overseas. We support the proposal that there should be a single central co-ordination unit for information requests to the market.

**9.3.5** Under the FSA there is a responsibility placed on regulatory organisations to have satisfactory arrangements in place for taking account, in the framing of their rules, of the compliance costs borne by those to whom the rules apply, relative to the regulatory benefits. Guidance issued by the SIB indicates that the degree of rigour with which this should be pursued should be commensurate with the significance of the proposals. **We recommend that Lloyd's should require information on, and take due account of, the costs and benefits of any regulatory change or development.** This requirement would not be restricted to the work of the regulatory division but would extend to any demand with which the market would have to comply.

# 10. Regulatory Division Structure and Staffing

Regulatory policy is put into effect by the staff of the regulatory division of the Corporation of Lloyd's. This chapter comments on organisational and resource issues.

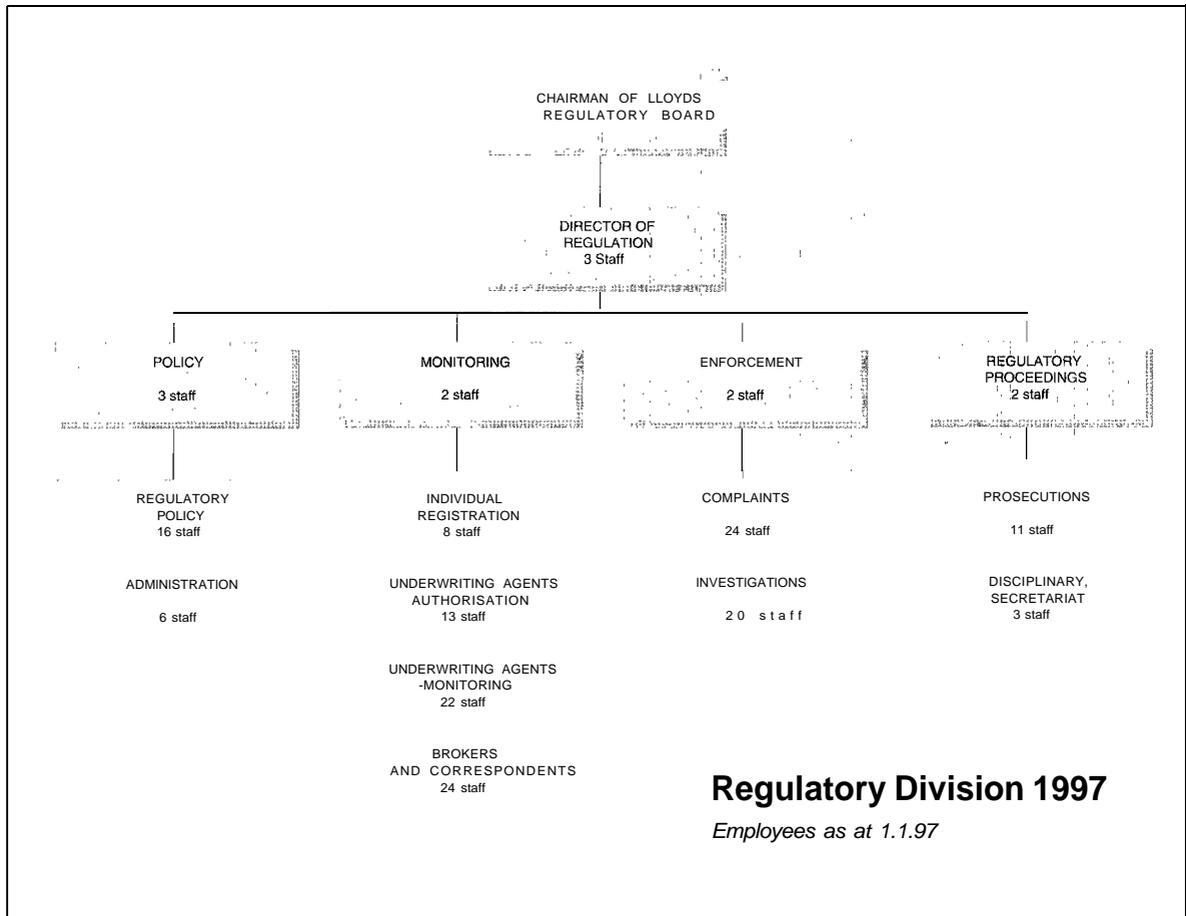
## 10.1 The Regulatory Division

10.1.1 The regulatory division has the primary responsibilities of:

- assisting the Regulatory Board 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.

LRB has set the target of delivering a standard of regulation equal to the best that is found elsewhere in the financial services sector. We believe this is the appropriate aim for the division.

10.1.2 Headed by its director, who reports to the LRB through its chairman, the regulatory division has an establishment of 163 staff. The staff are organised into key functional groups - policy, monitoring and enforcement, plus a regulatory proceedings group - in common with many other City regulators. An organisation chart is shown below.



## **10.2 Regulatory Policy Group**

**10.2.1** 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 LUAA, and the underwriting associations. In order to help keep abreast of current regulatory thinking elsewhere, meetings with all other City regulators enable the sharing of experiences on emerging policy issues, a number of which are similar across the City.

## **10.3 Monitoring Group**

**10.3.1** 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, ensuring that only those of suitable standing are allowed entry.

**10.3.2** 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, however, recommendations for regulatory action will be presented to the Regulatory Board 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.

## **10.4 Enforcement Group**

**10.4.1** The enforcement group encompasses complaints, investigations, and from 1 January 1997, the regulatory proceedings team. The move of this team brought the disciplinary process under the direct control of the LRB for the first time. The complaints department deals with both policyholder and members' complaints and enquiries.

**10.4.2** Several submissions argued that policyholder complaints handling is essentially a commercial function which should not be part of the regulatory division. We feel, however, that at Lloyd's the efficient handling of policyholder complaints is an essential feature of the market's promise to pay valid claims and, in addition, an effective complaints handling function is an important element in a well-informed enforcement regime,

**10.4.3** Complaints from members largely relate to difficulties with their agents. Staff in the enforcement group also administer the Lloyd's Arbitration Scheme which is available to members in such cases. As noted earlier in this report, we understand that a review of the scheme will be undertaken in 1997 with a view to ensuring that arbitration cases are handled as efficiently and effectively as possible.

**10.4.4** We approve the intention to introduce revised service standards in 1997, to reduce processing times for complaints, and to develop a code for claims handling by syndicate claims managers in order to reduce the number of complaints made directly to Lloyd's. It is also intended to establish more formal links with overseas regulators and with Lloyd's overseas representatives to ensure that complaints dealt with locally are properly reported to Lloyd's, in order that any necessary regulatory or disciplinary action can be taken. We commend these moves.

## 10. Regulatory Division Structure and Staffing - continued

**10.4.5** Over the past five years 38 formal independent loss reviews have been conducted and published to reveal the detailed reasons for major syndicate losses. These have been a rich mine of information for regulators, as well as assisting the Names contemplating civil action against their agents. Forensic accounting was an essential element in this process and the investigations department developed and applied these skills. In future this department will focus on allegations of current misconduct to establish whether disciplinary action is necessary. The regulatory proceedings team works closely with the investigations department to prepare disciplinary cases for consideration by the Investigations Committee.

### 10.5 Regulatory Functions Carried Out in Other Corporation Departments

**10.5.1** A certain amount of the work carried out by other Corporation departments not within the regulatory division could be (and certainly is by some sections of the market) 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 a particular way which are certainly 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.

**10.5.2** The dual role of the Council in both operating and regulating the market means that executive responsibility for the proper operation of the market has to be shared between the Director of Regulation and the CEO. It is essential that duplication of effort is avoided as far as possible and that, from the point of view of the market, the returns required from the various parts of the Corporation are efficiently co-ordinated. We commend the steps currently being taken by the CEO and directors of relevant Corporation departments to reduce the duplication of the reporting burden faced by agencies, and regard this as one of the most important steps in reducing the costs of compliance (together with the simplification of the byelaw structure referred to in para **8.1.3**).

### 10.6 Staffing Issues

**10.6.1** Many submissions commented on the qualities needed in regulatory staff. The general view, which we support, was that Lloyd's needed regulators of the highest standards, with sufficient qualifications, technical knowledge and experience to give them authority in the market. The joint market submission - which also argued for more responsibility to be assumed by agents and more focus only on major problems by regulators - argued for fewer staff; those remaining needing to have higher qualifications and experience, and to be better paid.

**10.6.2** We agree with the aim of moving towards a leaner, fitter regulatory division. This must however be based on a realistic and systematic assessment of the regulatory task that Lloyd's is asking that division to undertake, particularly in the light of the changes anticipated over the next few years. **We therefore recommend that a manpower plan for the division is produced, on the basis of work study evidence on the nature and extent of the regulatory tasks to be undertaken.** We believe that it will be of great assistance to the development of the capabilities of the regulatory division if a detailed independent review of its activities and processes is undertaken. A tightening of the focus of regulation, together with the streamlining of process that can be achieved by improving the quality of the staff, should enable the division to produce more effective and economic regulation, in line with the obligations placed on regulatory bodies elsewhere in the financial sector.

**10.6.3** We feel that the balance of skills within the regulatory division also needs some immediate attention. Although many of the staff of the division are well qualified, (of the 132 non-clerical staff in the division 57% are graduates, 15% accountants, 11% ACII or FCII and 8% lawyers) they may lack experience, particularly of the Lloyd's market. We have also been persuaded in particular that there are not enough people with the very top quality intellectual and analytical abilities, plus relevant experience in the Lloyd's market and associated professions, necessary to drive forward the complex regulatory issues that will need to be addressed over the coming months and years. Those staff in place who do have those skills are seriously over-stretched. We have noted that this has been a general problem across the Corporation over the past few years as the function of the organisation started to change from reactive support and administration to more active business partnership. The critical nature of the reconstruction and renewal project brought this issue to a head and forced the recruitment of a number of high-quality people in a number of key areas. **We recommend that some immediate rebalancing should take place within the regulatory division to ensure that the required top quality intellectual and analytical skills and appropriate experience are available.**

**10.6.4** For the future, **we recommend that a review should be undertaken of the effectiveness of the Corporation graduate recruitment and training programme in relation to the needs of the regulatory division.** Our impression is that the calibre of graduates recruited to the general programme is very high and that the first year's training forms a good general grounding. We question, however, whether there is sufficient focus on the longer term needs of the regulatory function within the current arrangements. We also feel that there should be a more explicit continuing responsibility to structure the career path of the graduates (together with other staff who have shown themselves of equivalent calibre) after their training year.

## **10.7 Remuneration Policy**

**10.7.1** Compensation packages must be sufficiently competitive to attract and retain people, as well as being internally equitable and cost effective. Paying the right rate for the job is also an essential step towards achieving a more efficient and effective regulatory division with fewer, higher quality people, as proposed in several submissions.

**10.7.2** External consultants have been used to provide advice on current compensation practice within the regulatory environment outside Lloyd's. We understand that the analysis shows 39% of regulatory staff receiving remuneration within a competitive range, 3% above, and 58% below. These comparisons are with the median of the regulators and accountancy firms comparator group. Comparisons with the Lloyd's market show a still greater discrepancy. Some flow of good staff from the Corporation to the Lloyd's market is inevitable, must be planned for and is probably of benefit to the community in general, but this must not be at the expense of the quality of Lloyd's regulation. We see very few people coming the other way: salary differentials are a significant barrier.

**10.7.3** We are very concerned that this lack of competitiveness will act as a real obstacle to the recruitment and retention of high calibre regulatory professionals with experience of the Lloyd's market and other regulatory bodies. Our concerns are realised in the turnover figures for the division which are running at rates between 20% and 25% -we consider this level to be unacceptable.

**10.7.4** **While sensitive to the budgetary constraints, we recommend that the lack of competitiveness in the salary arrangements for the regulatory division is addressed in order to ensure that Lloyd's is able to recruit and retain staff of the necessary calibre.**

## *10. Regulatory Division Structure and Staffing - continued*

### **10.8 Qualifications and Training**

10.8.1 The move away from a purely legislative framework (ie byelaws and regulations) towards core principles, and the development of the risk assessment framework for assessing the appropriate level of funds at Lloyd's for each corporate member, and as a focus for planning monitoring visits, lays more emphasis on the exercise of professional judgment by regulatory staff. Furthermore, reviews of agents and syndicates will continue to become less focused on compliance with byelaws than they have been in the past, and more on the adequacy of systems and methodologies to record, monitor and competently analyse risks underwritten. With this in mind, there is clearly a need for regulatory staff to be well trained and qualified in order that they may be able to exercise such judgment.

10.8.2 It is not only important that the regulatory work force are professionally qualified, from the point of view of the knowledge that those qualifications bring, but also that the regulatory division is perceived as fully equipped for their task by the entities which they regulate, by means of adequate training and updating.

10.8.3 The key objectives for training for 1997 within Lloyd's regulatory division are:

- to ensure that staff within the regulatory division receive relevant training and development in order to enable them to meet the objectives within the 1997 Regulatory Plan. Such training and development (of both a technical and a non-technical nature) should be in the most cost-effective manner possible; and
- to encourage and support an increase in the level of professional qualifications and experience among staff within the regulatory division.

10.8.4 The regulatory division's training budget for 1997 is £135,000. Spread across 163 positions, this equates to approximately £830 per head, a typical figure for the Corporation. We understand that other City regulators spend significantly more per head (in some cases twice this amount) although the regulatory division can take advantage of the Lloyd's Training Centre which, through central provision, can provide general and insurance based training at costs significantly below outside rates.

**10.8.5 We are convinced of the importance of appropriate training and we recommend that training budgets for the regulatory division should be drawn up to ensure that the required standards are achieved.**

### **10.9 Secondments**

10.9.1 There was a view expressed in some submissions that more experienced market practitioners, auditors, accountants and lawyers should be recruited or seconded as regulators (although practical obstacles, not least salary discrepancies, were acknowledged).

10.9.2 We note that steps are being taken to enable the regulatory division to obtain secondees from the market for periods of up to one year in order to enhance the input of market experience to the development of regulatory policy and practice. It is not, however, anticipated that it will be practical to second market participants into the monitoring teams for reasons of confidentiality. We feel strongly that market firms should recognise, in the interests of the market as a whole, the value of co-operating with these initiatives.

## **10.10 Location and Accommodation of Regulatory Staff**

**10.10.1** Arguments have been advanced to us that the regulatory division should be permitted to organise its own accommodation at a modest distance from the Lloyd's building. This would have the following effects:

- it would underline the independence of the regulatory function from the market; and
- it would permit the use of much lower cost accommodation

**10.10.2** Such a move would also have its drawbacks:

- it may cause difficulties in relation to Lloyd's overall property strategy which, in the absence of alternative tenants, relies on the current levels of cross charge to its Corporation tenants;
- it could be irritating to members of the market and other Corporation staff who need contact with the regulators and who are accustomed to having them in close proximity; and
- the benefits of proximity to the market for intelligence purposes would be lost.

**10.10.3** We do not recommend such a move, even if it became a practical possibility at this time, as, on balance, we feel that the importance of contact between the regulators and the market outweighs the cost advantages of moving.

## **10.10.4 Cost of Regulatory Division**

**10.10.5** Total costs for 1997 are budgeted at £9.5 million, after certain recoveries and including accommodation and other charges for Corporation services. If the additional costs of the disciplinary functions transferred into the division at the beginning of 1997 are not taken into account, costs in 1997 would have been some 12½% lower than in 1996.

**10.10.6** In comparison with other regulatory organisations, Lloyd's regulatory division does not appear unduly expensive. Strictly comparable data is hard to come by but in March 1995 the City Research Project Final Report gave some estimates of central regulatory costs in various sectors. Cost per regulator ranged from £84,000 in the unit trust sector to £130,000 in the securities sector. On a similar basis Lloyd's cost per regulator is around £58,000 (based on 1997 figures).

**10.10.7** We are satisfied that the central costs of Lloyd's regulation are not out of line with those of other regulated markets. We are more concerned about the cost of compliance of the market, which is covered in chapter 9.

## **10.11 Charging for Regulation**

**10.11.1** The £9.5m net cost of the regulatory division (excluding the costs of broker regulation, which is covered by a levy on Lloyd's brokers) is largely funded from members' subscriptions. Many other City regulators recover their costs from the regulated entities, thus making it possible to relate the charges more closely to the costs incurred. This is often on the basis of size or by identifying costs and making charges for specific activities such as approval of a director or for certain complex applications.

## *10. Regulatory Division Structure and Staffing - continued*

- 10.11.2** We agree that there is some logic in collecting a proportion of the costs of the regulatory division from the membership to the extent that regulatory activity is carried out in their interests. However, they are not the only ones that benefit and in the interests of fairness **we recommend that further consideration is, given, in consultation with the market, to recovering a greater proportion of the costs of the regulatory division from those firms being regulated, applying the user-pays principle as far as possible, and reducing the members' subscriptions accordingly. Such direct charging should be accompanied by the introduction of realistic regulatory service standards.**

# *11. Regulation of Lloyd's Brokers and Intermediaries*

## **11.1 Consultative Document**

**11.1.1** We have noted that a consultative document from a Lloyd's working group is likely to be released shortly. We understand that this document is likely to set out in detail the issues in relation to the future regulation of Lloyd's brokers and intermediaries, although it quite rightly will start from the broader commercial perspective of future distribution channels for the Lloyd's market. We do not intend to duplicate the work being undertaken by that group, or prejudge its findings.

**11.1.2** We would hope however that the proposals for the development of broker regulation that will emerge after the consultation process take account of the basic principles for regulation that we have been emphasising in this report, namely:

- the need to maintain confidence of all concerned in the Lloyd's market as a solvent and soundly managed place in which to do business;
- flexible, clear approach, based on high standards of competence and codes of conduct rather than detailed rules;
- consistency between different types of intermediary and with other regulatory regimes;
- high degree of consciousness of compliance costs; and
- a regulatory structure which includes external accountability, through Lloyd's, to ensure objectivity and independence.

## *12. Introduction of External Accountability*

In the previous chapters we have made a number of recommendations that, we believe, will add to the effectiveness of Lloyd's regulatory approach within the current statutory structure. We feel strongly, however, that more needs to be done.

### **12.1 The Reasons for Change**

**12.1.1** Most of the activities that comprise regulation at Lloyd's (perhaps as much as four-fifths or more) are concerned with solvency, standards and competence and with the operation of a fair, stable and clean market. Other regulatory activities (perhaps a fifth) are undertaken by the Council specifically with the aim of ensuring that members' interests are safeguarded although members also have a considerable interest in the benefit derived from regulatory activities aimed at securing the integrity of the market.

**12.1.2** We have emphasised earlier in this report the need to ensure the proper balance between policyholder interests, members' interests and market management. We feel that the Council of Lloyd's is best-placed to perform this co-ordinating role with efficiency and effectiveness and it would be difficult to achieve this critical balance if any of these responsibilities were severed and wholly transferred to an external body. We would also be most concerned about the additional costs of establishing a separate regulatory body, with unavoidable duplication and bureaucracy.

**12.1.3** However, it was clear from the submissions made to us that many practitioners in the market, as well as members, wish to see greater impartiality introduced to the regulatory arrangements at Lloyd's. Solvency is already subject to external oversight by the DTI under statute (as explained in chapter 4). The rest of the Council's regulatory activities are undertaken for the benefit of all those having a financial interest in the market, under authority of the Lloyd's Acts, but without formal external accountability.

**12.1.4** The benefits suggested to us of greater external accountability included:

- **objectivity in handling conflict between different parts of the Society** - there is a perception that the current structure is dominated by market insiders and can lack objectivity in dealing with conflict. Conflicts of interest can never be removed entirely, but external accountability can provide comfort to policyholders, members and market participants alike that an objective view will be taken;
- **assurance to individual members that their interests are being taken into account** - despite their representation on Council and LRB, individual members in particular feel that their interests have not been adequately safeguarded. Accountability to an external statutory body would help significantly to address this problem. In particular there has been concern expressed about changes in the market such as 'corporate ownership' (where certain syndicates are effectively closed to outside capital) and the workings of the secondary market (the auction) in syndicate participations. It is clear that individual Names in particular want the opportunity for an independent, objective view to be expressed on major market changes affecting their interests;
- **consistency with other regulated markets** - independent external oversight is normally a key component of the regulatory structure of other markets and it is difficult to see why the principle should not now apply equally to Lloyd's. Although the way in which regulation is now being developed and applied at Lloyd's follows closely the approach in other such markets, we believe that the existence of external oversight would help ensure that such consistency is maintained; and

- **restoration of confidence in the regulation of the Lloyd's market**—the commercial benefits of being perceived as a solvent, clean and well-regulated market are very significant and external oversight would give substance to this perception. There is a general willingness to make fundamental changes to restore that confidence.

**12.1.5 We recommend, therefore, that while the Council of Lloyd's should retain the primary day-to-day responsibility for regulating the Lloyd's market, additional, formal, external accountability should be introduced in respect of the exercise of its regulatory responsibilities. This will demonstrate that policyholders' and members' interests are sufficiently and impartially safeguarded and that the Council's responsibility to ensure a properly regulated and solvent market is being discharged.**

## **12.2 External Accountability - Key Features**

**12.2.1** We have already described how the Council of Lloyd's (principally through the LRB) undertakes and supervises a range of regulatory activities in the following areas:

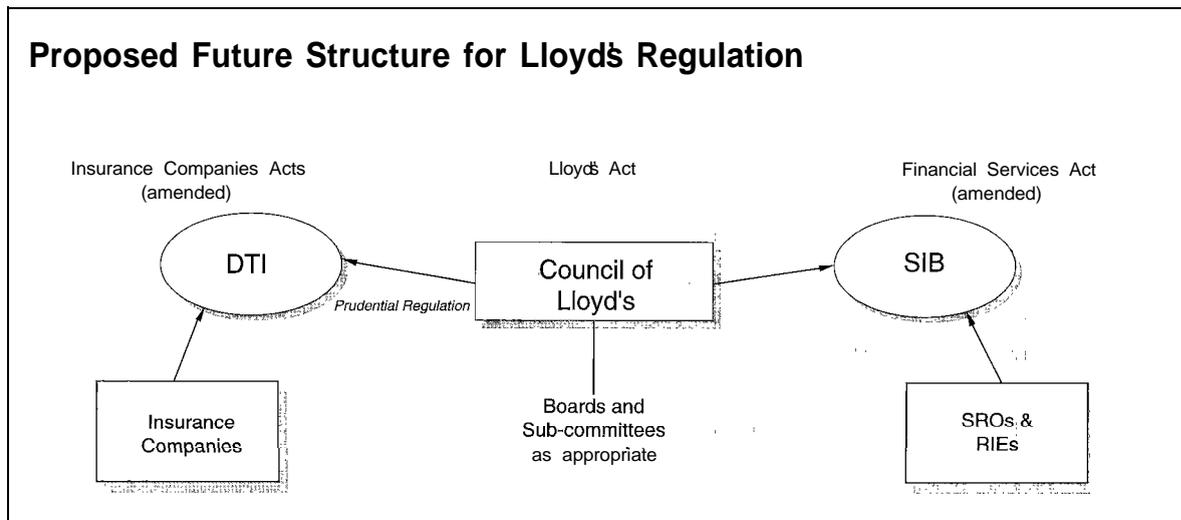
- formulating and implementing regulatory policy eg in respect of conduct of business and financial regulation (solvency);
- authorising entities to trade in the market;
- monitoring their compliance with regulatory requirements; and
- enforcing regulation through processes of investigation, discipline and appeals.

**12.2.2** We feel that, given the current structure of the relevant legislation, appropriate external oversight is likely to come from two distinct directions, focusing respectively on the interests of the policyholder and of the Lloyd's member. In relation to policyholders' interests, we believe that the powers of the DTI should be extended to achieve greater comparability with the arrangements which apply to insurance companies. The basis on which we reached this conclusion, and our recommendations, are set out in chapter 4.

**12.2.3** We have considered how external accountability in respect of the safeguarding of members' interests might best be introduced. We consider that the FSA should be amended to bring oversight of members' insurance business carried on at Lloyd's within the ambit of the SIB. This would involve the Council of Lloyd's becoming a recognised body under the FSA, although it does not fit into the SRO or RIE model, and the underwriting activities of members are not analogous to investments. The Council thus would become accountable to the SIB in relation to those regulatory issues concerning the safeguarding of members' interests,

**12.2.4 We therefore recommend that changes in the primary legislation should be sought to effect external accountability of the Council of Lloyd's to a statutory body, the most obvious candidate being The Securities and Investments Board, in respect of members' interests.**

## 12. Introduction of External Accountability - continued



- 12.2.5 We would foresee that both the SIB and the DTI would have an interest in many areas of Lloyd's regulation and a degree of overlap would be inevitable. Suitable arrangements would need to be put into place to minimise undue duplication and ensure effective communication between the two bodies and the Council of Lloyd's
- 12.2.6 As we have emphasised earlier, it would be important for the day-to-day operation of regulation to remain the responsibility of the Council of Lloyd's and thus close to the market. We would, however, expect those overseeing the Council to undertake the following activities in respect of the key regulatory areas as set out in 12.2.1:
- setting basic regulatory principles;
  - approving the 'rulebook' developed by the Council of Lloyd's;
  - periodically reviewing and monitoring the Council's regulatory performance; and
  - ensuring that complaints from policyholders or members about the discharge by the Council of its regulatory duties were properly handled, satisfying itself that the correct procedures had been followed.
- 12.2.7 We would also expect standards of operation consistent with those imposed by the SIB on an SRO or RIE to be imposed on the Council of Lloyd's in respect of its regulatory activities (whether these were carried out by the regulatory division or other parts of the Corporation). This would ensure that there was an effective mechanism in place for 'regulating the regulator,' as was called for in a significant number of the submissions we received.
- 12.2.8 In order to be effective, external oversight would need to be backed up by powers and sanctions. It needs to be recognised that the external supervisors would have the powers to:
- call for information and papers;
  - monitor the regulatory activities of the Council;
  - issue directions;
  - seek compliance orders through the courts;

- pursue investigations in regulated firms; and
- withdraw recognition, *in extremis*. (In practice of course it is to be hoped that the existence of statutory powers and sanctions would act as a powerful incentive to find a solution before this stage was reached.)

**12.2.9** We are convinced that this additional oversight is necessary but we would note that we are also concerned to see that it does not in practice become a bureaucratic impediment to the efficient operation and development of regulation at Lloyds.

12.2.10 There would of course be a requirement to reimburse those undertaking external oversight for the additional costs incurred by them in discharging their oversight function. However, we feel that this option, building as it does on existing structures, would still be the least costly of the realistic alternatives. We should not lose sight either of the commercial benefits that would accrue to the whole market of strong, independent regulation.

**12.2.11** At the time of writing, the legislative priorities of the new government are not yet clear. It is unlikely however that the required statutory changes to give effect to the above arrangements can be effected in the very short term.

**12.2.12** We have considered what action can be taken in the interim to achieve some of the same objectives, benchmarking against other relevant regulators. **We recommend that, until change to the legislative structure can be achieved, the Council should seek to mirror best practice elsewhere in the financial sector. We suggest that a nominated representative of the SIB on the Council of Lloyd's and on the LRB during this interim period might assist in the achievement of this aim. We also recommend that Lloyd's should discuss with the SIB how, in the interim, Lloyd's might shadow the arrangements that would be formalised when the legislation was amended, once the government has made its intentions known.**

### **12.3 Alternative Structures**

**12.3.1** We also considered a number of alternative structures for Lloyd's regulation and these are set out below. Although some would bring greater independence to Lloyd's regulation, all have drawbacks that lead us to conclude that none are as practical or logical as our preferred solution.

### **12.4 Direct Regulation by the DTI**

**12.4.1** There was a view expressed in some submissions that all of the regulatory activities of the Council and Regulatory Board could be somehow handed to the DTI to operate directly. This arises from an understandable concern about operating on a level playing field with insurance companies who, it is perceived, have a lighter regulatory burden. There is also a view, less widely held than in the past, that such a system would be cheaper and that the DTI would bear the cost. There are several points to note with this approach:

- the regulatory requirements imposed on the market by the Council/LRB in respect of policyholder interests are prescribed by the ICA and do closely mirror in content those already applied by the DTI to insurance companies;
- it would create a unique position for members of Lloyd's which would be consistent neither with the arrangements established for insurance companies nor those established for investors or other market traders in the City.

## *12. Introduction of External Accountability - continued*

- the additional layer of regulation with which managing agencies must comply, in comparison with insurance companies, relates largely to their participation in an insurance market underpinned by the Central Fund and would continue to be required even if supervised by the DTI; and
- even if the relevant functions and staff were transferred to the DTI, the full cost would be likely to be levied on Lloyd's

### **12.5 Bringing Lloyd's fully within the FSA**

**12.5.1** Several submissions have argued that Lloyd's regulation should be brought as fully as possible into the framework of investor protection regulation provided by the FSA in its present form. This would imply the establishment of a new, free-standing and constitutionally separate SRO to look after the interests of members of Lloyd's (or a transfer of this function to an existing SRO) and, arguably, the definition of the secondary market in syndicate participations as a separate recognised investment exchange (RIE). Alternatively, some new sort of hybrid body might be defined. The Council of Lloyd's would be left with the role of organising and running the primary insurance market and ensuring its overall solvency; the DTI would retain its oversight role in respect of solvency.

**12.5.2** We have rejected this option because:

- the FSA and the current regulatory structure governs investments and investment business, whereas members of Lloyd's are not investors but traders in insurance;
- the benefits of combining commercial and regulatory responsibilities in one body - the Council of Lloyd's - would be lost, and decision-making would be fragmented;
- agents would variously be required to register with the Lloyd's insurance market, the secondary capacity market (RIE) and with the SRO;
- the change required would be the most disruptive of all the options we have considered - separate constitutions, governance and executive structures for the new SRO and RIE would be required; and
- were the present structure of the FSA to be altered so as to merge the SROs and the SIB, further constitutional change might then be required in order to bring Lloyd's within the new arrangements.

### **12.6 An Independent Regulator**

**12.6.1** It has been suggested, for example in the 1995 Treasury and Civil Service Select Committee report, that a new independent regulator should be created with responsibility for the Lloyd's market in its entirety. The TCSSC proposed that such a body should be free-standing and answerable not to the SIB, but to the Treasury (although it also saw the DTI as continuing its oversight of solvency). It also proposed that in the longer term such a body could take wider responsibility for wholesale business in the London insurance market, The TCSSC saw the need for the amendment of primary legislation to transfer responsibility from the Council of Lloyd's to this new independent body.

**12.6.2** The TCSSC did not repeat this recommendation in the light of the government's response to its report. Nevertheless we would observe that such a body could be unduly costly to set up and operate if it were solely regulating the Lloyd's market. If its scope were extended however to cover the rest of the London market it might become more feasible but this would require major change to the manner in which insurance is regulated in the UK and significant change to primary legislation. It could also be ineffective if it was insufficiently close to the Lloyd's market that it was attempting to regulate. For these reasons, we believe that

it would be preferable for the Council of Lloyd's to be accountable to any such body rather than replaced by it, thus retaining the advantages of proximity while ensuring independent oversight.

**12.6.3** We do not explore this option further in our review since we feel that, as it directly impacts on all participants in the UK and London insurance market, further investigation must involve all parties concerned.

## **12.7 The Wait and See Option**

**12.7.1** There is an argument that, given the length of time that might expire before any statutory change can be accomplished, and the surrounding uncertainties, Lloyd's should not even embark upon seeking to change primary legislation for a significant period. Although it is a reasonable assumption that a mixed market of individual and corporate members will be sustained for the 3-5 year timescale, there is greater uncertainty about the composition of the market beyond that time and hence the appropriate regulatory structure. Hasty action now, it is argued, could prove unnecessary and costly in the longer run.

**12.7.2** We consider, however, that to put off addressing the problems in this way would not be acceptable. We have identified areas that call for improvement and consider these should be expressed in order that such recommendations may assist any external review. We are firmly of the view that clear external accountability needs to be introduced as soon as practicable.

# Appendix 1

## Glossary of Acronyms

ABI	Association of British Insurers
ACII	Associate of the Chartered Insurance Institute
ALM	Association of Lloyd's Members
CII	Chartered Insurance Institute
CPE	Continuing Professional Education
DTI	Department of Trade and Industry
FCII	Fellow of the Chartered Insurance Institute
FSA	Financial Services Act (1986)
HPG	High Premium Group
IBRA	Insurance Brokers (Registration) Act 1977
IBRC	Insurance Brokers Registration Council
ICA	Insurance Companies Act (1982)
ICS	Investors Compensation Scheme
LCCA	Lloyd's Corporate Capital Association
LIBC	Lloyd's Insurance Brokers Committee
LMB	Lloyd's Market Board
LNAWP	Lloyd's Names Association Working Party
LPSO	Lloyd's Policy Signing Office
LOCUS	Lloyd's Committee of Underwriters
LRB	Lloyd's Regulatory Board
LTC	Lloyd's Training Centre
LUA	Lloyd's Underwriters' Association
LUAA	Lloyd's Underwriting Agents Association
(LU)NMA	Lloyd's Underwriters' Non-Marine Association
MSU	Members' Services Unit (of the Corporation of Lloyd's)
RIE	Recognised Investment Exchange
SIB	The Securities and Investments Board
SRO	Self-Regulating Organisation
TCSSC	Treasury and Civil Service Select Committee (now the Treasury Select Committee (TSC))

# Appendix 2

## Members of Review Group

### **SIR ALAN HARDCASTLE (CHAIRMAN)**

CHAIRMAN OF LLOYDS REGULATORY BOARD  
NOMINATED MEMBER OF THE COUNCIL OF LLOYDS  
MEMBER OF THE BOARD OF BANKING SUPERVISION

### **JONATHAN AGNEW**

ELECTED EXTERNAL (CORPORATE) MEMBER OF COUNCIL OF LLOYDS  
MEMBER OF LLOYDS MARKET BOARD  
CHAIRMAN OF LONDON INSURANCE MARKET INVESTMENT TRUST plc  
DIRECTOR, BANKSIDE SYNDICATES LTD  
DIRECTOR, JANSON GREEN LTD

### **DAVID BRAYSHAW**

EXTERNAL MEMBER OF LLOYDS  
FORMER EXECUTIVE DIRECTOR OF GERRARD AND NATIONAL HOLDINGS plc

### **RAYMOND DUMAS**

UNDERWRITER  
MARINE SYNDICATE 1028 H R DUMAS (WELLINGTON)

### **ALEXANDER FOSTER**

MANAGING DIRECTOR, ROBERTS AND HISCOX LTD (MEMBERS' AGENT)  
DIRECTOR, HISCOX SELECT INSURANCE FUND plc AND  
UNIVERSAL SALVAGE plc

### **RODNEY GALPIN**

FORMERLY EXECUTIVE DIRECTOR OF BANK OF ENGLAND, RESPONSIBLE FOR BANKING SUPERVISION (1984-88)  
CHAIRMAN OF THE CODE OF BANKING PRACTICE REVIEW COMMITTEE  
CHAIRMAN OF ALPHA AIRPORTS GROUP plc  
DIRECTOR OF CATER ALLEN HOLDINGS

### **DAVID GITTINGS**

LLOYDS DIRECTOR OF REGULATION  
FORMERLY DIRECTOR OF SURVEILLANCE, SECURITIES AND FUTURES AUTHORITY

### **JOHN KENNEDY**

NON-EXECUTIVE DIRECTOR OF THE SECURITIES AND INVESTMENTS BOARD  
CHAIRMAN OF LLOYDS CORPORATE CAPITAL ASSOCIATION (to 29 April 1997)  
CHAIRMAN OF ANGERSTEIN UNDERWRITING TRUST plc  
CHAIRMAN OF THE LAW DEBENTURE CORPORATION plc  
FORMER SENIOR PARTNER OF ALLEN & OVERY

### **MICHAEL KIER**

CHAIRMAN, LLOYDS BROKING GROUP C E HEATH  
DEPUTY CHAIRMAN, LLOYDS INSURANCE BROKERS' COMMITTEE

### **ROBERT MANKIEWITZ**

FINANCE DIRECTOR, COTTRELL & MAGUIRE (MANAGING AGENCY)  
LLOYDS UNDERWRITING AGENTS' ASSOCIATION COMMITTEE MEMBER

### **ELVIN PATRICK**

CHAIRMAN, BANKSIDE UNDERWRITING AGENCIES LTD

### **SIR ADAM RIDLEY**

DEPUTY CHAIRMAN, ASSOCIATION OF LLOYDS MEMBERS  
TRUSTEE AND CHAIRMAN OF TRUSTEES OF EQUITAS GROUP OF COMPANIES  
CHAIRMAN OF NAMES COMMITTEE 1995-96  
EXECUTIVE DIRECTOR, HAMBROS AND HAMBROS BANK PLC

### **DAVID SHIPLEY**

UNDERWRITER  
NON-MARINE SYNDICATE 362 HARVEY BOWRING

### **JOHN YOUNG**

NOMINATED MEMBER OF COUNCIL OF LLOYDS  
NON-EXECUTIVE DIRECTOR OF THE SECURITIES AND INVESTMENTS BOARD  
FORMER CHIEF EXECUTIVE OF THE SIB AND THE SECURITIES AND FUTURES AUTHORITY

### **ANDREW DUGUID (OBSERVER)**

LLOYDS DIRECTOR OF STRATEGIC PLANNING AND SECRETARY TO THE COUNCIL OF LLOYDS

### **STEPHEN WALTON (OBSERVER)**

INSURANCE DIRECTORATE  
DEPARTMENT OF TRADE AND INDUSTRY

### **CAROLYN WILLIAMS (SECRETARY)**

# Appendix 3

## Lloyds Costs of Regulation Study: Report by KPMG to the Regulatory Review Group

### 1. Introduction

KPMG was commissioned to undertake for the Regulatory Review Group (the group) a study on the costs of regulation as part of the Lloyds 1997 Regulatory Review. The purpose of the study was to obtain some detailed information, on a sample basis, about the market's estimate of regulatory costs and benefits to assist the group in determining the extent of these costs and the priority areas for review.

This was a short study, conducted to a very tight timetable at a particularly busy time of year for the agencies. One result of this was that the analysis at the end of the study had to be squeezed into a relatively short time period.

Following preliminary discussions with two agencies (one managing agency and one combined agency, the latter covering both its managing and members' agencies), indications of regulatory costs/benefits of market participants were gathered through a programme of structured interviews with a sample of eight managing and two members' agencies of various capacity sizes. The selection was made by ourselves but on the basis of information supplied to us by the regulatory division, and the interviews took place on a non-attributable and confidential basis.

We have analysed (a) the "soft" general comments and insights provided during the preliminary discussions and structured interviews and (b) the "harder" more detailed written estimates supplied by agencies of the total man-days effort and costs of specific "regulatory" activities. The process of analysis has included discussions with regulatory division of the implications of specific information and examples gathered. The study was concerned with the direct cost of regulation and not with indirect costs which may arise from the agency system of the Lloyds market, nor with opportunity cost. The accent was on providing broad information on cost, rather than detailed costing information.

We have also conducted very limited desk research on costs of regulation in other financial services markets. This research was based on readily accessible information, to draw on any possible comparisons with the regulatory cost burden elsewhere in the financial services industries.

The study was confined to the costs of regulation of managing and members' agencies - it did not cover the costs of regulation of Lloyds brokers or the costs of the central "regulatory" functions of the Corporation. To put the study in perspective, it should be noted that there are a total of 89 active underwriting agencies (67 managing, 21 members' and one combined agency) and 202 brokers (source: regulatory division, figures as at 1 April 1997).

### 2. Results of preliminary discussions and structured interviews

#### 2.1 General comments

All the agencies interviewed were most helpful - at what was for them a particularly busy time of year - and provided useful "soft" general comments and insights. This information is very briefly outlined below, analysed according to the common themes which emerged during the course of the study.

#### 2.2 Common themes: benefits of regulation

As a starting point, we identified three benefits of regulation, which are set out below. The first of these is a "current" benefit, the other two are "potential" benefits for the future:

- many "regulatory" requirements are acknowledged to be consistent with the requirements of good business practice;

- agencies may benefit from a more probing and challenging approach to regulation: some agencies perceived a lack of a risk-based approach in regulatory visits and monitoring; and
- quality of regulatory division staff: agencies would benefit if the division had access to staff of the highest quality, particularly those with market experience (closely related to previous point).

### 2.3 Common themes: major drivers of costs of regulation

We identified six major drivers of costs of regulation, which are set out below:

- the multiple sources of ‘regulatory’ requirements and expectations cause great confusion and uncertainty;
- low level of perceived co-ordination between Lloyd’s staff involved with regulation;
- suspicions that Lloyd’s gathers ‘regulatory’ information which is (a) not used or not meaningful, (b) gathered at an inappropriate time, or (c) duplicated;
- new ‘regulatory’ requirements often introduced, and deadlines moved forward, at short notice and/or with greater frequency;
- many ‘regulatory’ requirements are highly formal, detailed and prescriptive; and
- high level of evidencing prescribed for compliance with ‘regulatory’ requirements.

### 2.4 Other comments

We identified three other areas of less concern to the agencies in the sample, which are set out below:

- individual registration: a one-off cost particularly burdensome to smaller agencies;
- agency staff training and competence: agencies were supportive of CPE but concerned at the cost of involvement of expensive staff such as board directors and underwriters; and
- use of IT by Lloyd’s: desirable to have access to a central Lloyd’s database.

## 3. Analysis of written estimates of “regulatory” costs supplied by managing agencies

### 3.1 Results

We have received written estimates of ‘regulatory’ costs from seven of the ten agencies interviewed. The motor agency has not responded, nor have two other agencies (one large and one small) been able to respond by the deadline. The results of the analysis are set out in Table 1 below.

It should be noted that ‘regulatory’ costs were determined by each agency estimating the total man-days effort and costs of specific ‘regulatory’ activities and then indicating what percentages of those costs, *in the opinion of the agency*, were ‘regulatory’.

This was therefore a highly (and unavoidably) subjective process. However, in section 3.2 below we comment on the degree of consistency between the opinions of the individual agencies as to the percentages of the costs of individually defined activities which were felt to be ‘regulatory’.

**Table 1: Managing agencies**

Agency Reference Number	Size of agency (in ascending order of 1996 capacity)	Total "regulatory" costs	Total "regulatory" costs as % of total expenses (exc. tax, dividends, exceptional items)	Total "regulatory" costs as a % of total revenues (exc. profit comm.)	Total "regulatory" costs as a % of total revenues (inc. profit comm.)
1	Small (<£80m)	£15,821	13.2%	13.2%	8.5%
2	Small	£61,646	12.5%	15.5%	15.5%
3	Small	£11,642	7.0%	2.1%	0.3%
4	Large (>£80m)	£182,070	3.4%	8.2%	2.8%
5	Large	£185,517	4.0%	8.5%	1.2%
6	Large	£133,678	2.0%	6.8%	0.6%
7	Large	£160,218	2.2%	3.1%	0.5%

Generally speaking, the 'regulatory' cost as a percentage of total expenses falls markedly as the size of the managing agency increases, ie there is a greater burden on small agencies. The highest percentage 'regulatory' cost (13.2% of total expenses) was recorded by a small agency, while typical percentages (around 2-4% of total expenses) were all recorded by large agencies.

The implied greater 'regulatory' burden for the smaller agencies in the sample arises in part from their organisational structure; there may be fewer support staff, thus causing the regulatory workload to fall on directors and other senior, and more costly, staff.

'Regulatory' costs expressed as a percentage of revenues (including profit commission) appear to be high for agency 2: it should be noted that this agency did not record any profit commission in the year ended December 1996.

US regulatory requirements merit separate comment as they represent substantial 'regulatory' costs which fall outside the control of the Lloyd's regulatory division. The range of cost figures quoted by the agencies in the sample reflected differing volumes of business conducted in the USA. Annual costs ranged from £720 to £73,650, with the average annual cost of the US 'regulatory' burden being £20,400.

### 3.2 Identification of "regulatory" activities

Areas of cost identified by all respondents as being incurred wholly to meet 'regulatory' requirements were: SQRs; NYIID/NAIC reporting; 'fit and proper' requirements; and regulatory division visits. In addition, all respondents agreed that business plans (including RDSs), and syndicate annual accounts include 'regulatory' costs, which account for approximately 30% of the total costs incurred. With the exception of one respondent, the sample also agreed that RITC and Central Fund and Premiums Trust Fund management include 'regulatory' costs, amounting to 30-45% of total costs for each of these areas.

Fewer respondents considered open year forecasting, premium income monitoring, or 'globals' (including

audited and unaudited solvency returns) costs to have a 'regulatory' element. There was no agreement about whether corporate capital vehicles' reporting costs include a 'regulatory' element but there was complete agreement that almost all complaints handling costs are incurred for commercial reasons.

Respondents were also asked for figures to indicate the amount by which the 'regulatory' burden could be reduced. There was only a limited response to this request - for each area of 'regulatory' cost the return was completed by only 2-3 respondents. However, some indications of possible reductions of costs emerge: for example, it was believed that both business plans (including RDSs) and syndicate annual accounts could be reduced by around 2550%. Respondents who supplied figures considered that NYIID/NAIC requirements, 'globals' (including audited and unaudited solvency returns), corporate capital vehicle reporting and SQRs could be reduced by 90-100%. This sample size is too small to be relied on and those respondents who did not supply figures have not offered consistent explanations. There is a risk that analysis of such a small sample will be highly skewed, as it may be those respondents who feel most strongly about the desirability of reducing costs who have supplied figures.

### **3.3 Lloyd's Review of Reporting Burdens**

We note that an internal report has recently been completed which analyses the reporting burden on managing agencies ('Review of Reporting Burdens: Phase 1 - Managing Agents').

To quote from this report (on page 5), "47 information flows were identified,...Sixteen are collected by the finance directorate, of which a number are collected on behalf of external regulators. Eighteen are collected by the regulatory directorate. Eleven are collected by members' services. Two are collected by the strategic planning directorate."

We have not reviewed this report and in particular we have not attempted to analyse which of the 47 information flows would have been regarded as containing a 'regulatory' element by the respondents in our study. However, it is clear that such 'regulatory' information flows are not all collected by regulatory division.

This is illustrated by taking as examples SQRs and NYIID/NAIC reporting -which, as noted in Section 3.2 above, were included in the areas of cost identified by all respondents in our study as being incurred wholly to meet 'regulatory' requirements - and noting that the listing of information flows in the internal report shows that these items are collected by the finance directorate.

## **4. Analysis of written estimates of "regulatory" costs supplied by members' agencies**

### **4.1 Results**

We have received written estimates of 'regulatory' costs from all three members' agencies interviewed. This is a very small sample and may not be representative of the market. The analysis is set out in Table 2 below.

As before, it should be noted that 'regulatory' costs were determined by each agency estimating the total mandays effort and costs of specific 'regulatory' activities and then indicating what percentages of those costs, *in the opinion of the agency*, were 'regulatory'.

Once again, this was therefore a highly (and unavoidably) subjective process. However, in Section 4.2 below we comment on the degree of consistency between the opinions of the individual agencies as to the percentages of the costs of individually defined activities which were felt to be 'regulatory'.

## Appendix 3 - continued

Agency Reference Number	Size of agency (in ascending order of 1996 capacity)	Total "regulatory" costs	Total "regulatory" costs as % of total expenses (exc. tax, dividends, exceptional items)	Total "regulatory" costs as a % of total revenues (exc. profit comm.)	Total "regulatory" costs as a % of total revenues (inc. profit comm.)
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6	Large	£133,678	2.0%	6.8%	0.6%
7	Large	£160,218	2.2%	3.1%	0.5%

Generally speaking, the "regulatory" cost as a percentage of total expenses falls markedly as the size of the managing agency increases, ie there is a greater burden on small agencies. The highest percentage "regulatory" cost (13.2% of total expenses) was recorded by a small agency, while typical percentages (around 2-4% of total expenses) were all recorded by large agencies.

The implied greater "regulatory" burden for the smaller agencies in the sample arises in part from their organisational structure; there may be fewer support staff, thus causing the regulatory workload to fall on directors and other senior, and more costly, staff.

"Regulatory" costs expressed as a percentage of revenues (including profit commission) appear to be high for agency 2: it should be noted that this agency did not record any profit commission in the year ended December 1996.

US regulatory requirements merit separate comment as they represent substantial "regulatory" costs which fall outside the control of the Lloyd's regulatory division. The range of cost figures quoted by the agencies in the sample reflected differing volumes of business conducted in the USA. Annual costs ranged from £720 to £73,650, with the average annual cost of the US "regulatory" burden being £20,400.

### 3.2 Identification of "regulatory" activities

Areas of cost identified by all respondents as being incurred wholly to meet "regulatory" requirements were: SQRs; NYIID/NAIC reporting; "fit and proper" requirements; and regulatory division visits. In addition, all respondents agreed that business plans (including RDSs), and syndicate annual accounts include "regulatory" costs, which account for approximately 30% of the total costs incurred. With the exception of one respondent, the sample also agreed that RITC and Central Fund and Premiums Trust Fund management include "regulatory" costs, amounting to 30-45% of total costs for each of these areas,

Fewer respondents considered open year forecasting, premium income monitoring, or "globals" (including

**Table 2 3: FSA compliance costs***(expressed as a percentage of net operating expenses)*

Type of firm	Minimum	Maximum	Mean
Securities (sample size: 9)	1.0%	7.4%	3.0%
Investment management (sample size: 13)	1.3%	27.5%	8.0%

The costs referred to here exclude direct payments to regulators but include staff, systems and in-house costs and the "additional regulatory burden", ie "incremental compliance costs [which] represent the amount by which compliance costs exceed the costs that would be incurred in the course of normal good business practice".

In their paper, "The Rationale of Financial Services Regulation: is the Current Structure Cost-Effective and Working?" (June 1995), Professor Alan Peacock and Graham Bannock suggest that compliance costs for all "regulated firms" in the retail financial services arena may be as much as ten times the cost of the central administrative/regulatory department.

Two further points merit consideration here: (i) the commercial element of the "regulatory" burden and (ii) the appropriateness of the "regulatory" burden.

Firstly, the City Research Project commented that the securities firms estimated that on average about 25% of the identified compliance costs would still be incurred in the absence of regulation. The corresponding figure for the investment management firms was 35%.

Secondly, the Financial Services Act, Schedules 2-4, requires regulators under that Act to take account of the cost of compliance. We are not aware of any similar requirements placed on Lloyd's to control the cost of compliance with its regulatory requirements.

The Financial Services Act, Schedule 2 (Requirements for recognition of self-regulating organisation), Section 3A, states that, "*The organisation must have satisfactory arrangements for taking account, in framing its rules, of the cost to those to whom the rules would apply of complying with those rules and any other controls to which they are subject*". Similar wording is used in the Requirements for recognition of professional body (Schedule 3).

## 6. Issues arising and recommendations

### 6.1 Rationalisation of regulatory requirements and expectations to reduce confusion and uncertainty

We are aware that Lloyd's wishes to move towards less detailed rule writing and that there is a proposal to complete a review of regulatory byelaws during 1997, with the objective of achieving a consolidated and less complex framework. Our study has identified problems in this area and we fully endorse the urgent need for such a review.

### 6.2 Rationalisation of system of information reporting by agencies to Lloyd's

It was evident to us that Lloyd's gathers a very large amount of information from agencies, in accordance with regulatory requirements which are often highly formal, detailed and prescriptive. These information requirements are sufficiently burdensome on the agencies to give rise to suspicions that Lloyd's gathers

## *Appendix 3 - continued*

regulatory information which is either not used or not meaningful, or gathered at an inappropriate time, or duplicated on various different forms.

We referred in Section 3.3 above to the recently completed internal report analysing the reporting burden on managing agencies and commented that it is clear that these “regulatory” information flows are not all collected by regulatory division. Our study clearly supports the need for a rethinking of who needs what information, when, in what form and what the mechanics should be to achieve this.

Another aspect of reporting requirements is their timing. It was suggested to us that the annual business timetable should be issued earlier, before the start of the year to which it relates, and that it should include both market and regulatory items, reflecting a more co-ordinated approach by the various Lloyd’s business units involved with “regulation”.

### **6.3 Perceived lack of risk-based approach to regulation**

As noted in Section 2.2 above, some agencies perceived a lack of a risk-based approach in regulatory visits and monitoring. Some agencies may prefer a more probing and challenging (rather than “box ticking”), business-orientated approach by the regulator, based on greater market knowledge and expertise of regulatory staff.

The more sophisticated approach to monitoring and supervision of agencies, moving away from “box ticking”, that we understand that the regulatory division is adopting; is not being perceived by the agencies. Their perceptions may simply reflect the legacy of a past style of regulation, or they may indicate that further thought needs to be given to the process of communicating developments in the approach to regulation.