

MARKET BULLETIN

REF: Y4049

Title	Lloyd's Compensation Scheme – Market Consultation
Purpose	Feedback requested for interested parties
Type	Event
From	Sean McGovern, Director & General Counsel sean.mcgovern@lloyds.com /0207 327 6142
Date	22 August 2007
Deadline	31 October 2007

The Lloyd's Members' Compensation Panel, comprising three nominated members of Council, has recently conducted a review of the Lloyd's Members' Compensation Scheme ("the Scheme") which has remained substantially unchanged since 1989.

The Panel considered various options to amend the Scheme. In particular, the Panel discussed proposals for changing the criteria from making awards, the manner in which claims should be made and how awards should be funded. The Panel also considered alternatives such as introducing compulsory E&O insurance for managing agents. As a result, the Panel has now made its proposals regarding the future of the Scheme and the Panel invites comments on those proposals.

A copy of the Panel's report, including the questions upon which specific market feedback is sought, is attached to this bulletin.

Respondents should also feel free to provide any other information or comments which they believe to be considered before the Panel makes its final recommendations to Council.

Responses should be provided in writing by no later than 31 October 2007 and should be addressed to:

Paul Brady
Manager, Enforcement & Governance
Lloyd's Legal & Compliance
One Lime Street
London EC3M 7HA

or by e-mail to -

paul.brady@lloyds.com

This bulletin has been sent to all managing agents, members' agents, the LMA, the ALM, the High Premium Group and the Cotesworth Action Group Committee.

Director & General Counsel

Consultation paper on the future of the Lloyd's Compensation Scheme

Report and recommendations of the Members' Compensation Panel

1. Background

- 1.1 In February 2006 we were appointed as the Compensation Panel to consider, administer and determine an application made by the Cotesworth Action Group under the terms of the Members' Compensation Scheme ("the Scheme"). In addition, our terms of reference provided that we should "*make any recommendations to the Council for the modification or amendment of the [Scheme] ...*" Our full terms of reference are attached as appendix 1 to this report.
- 1.2 In December 2006 we provided a report to Council regarding the Cotesworth application. Council approved our decision and that application is currently stayed. We have therefore now proceeded to consider whether any modification or amendments are needed to the Scheme going forward. This report contains our recommendations for the future of the Scheme and the specific questions upon which we wish to consult before any final decisions are taken. Respondents are also invited to submit any other information or comments they believe to be relevant.
- 1.3 Respondents to this consultation paper are invited to submit written responses by 31 October 2007 marked for the attention of –

Paul Brady
Manager, Enforcement & Governance
Lloyd's
Legal & Compliance
One Lime Street
London EC3M 7HA

or by e-mail to-

paul.brady@lloyds.com

2. The history of the current Scheme

- 2.1 The current Scheme was implemented as a consequence of a recommendation in the 1986 report of the committee of inquiry into the regulatory arrangements at Lloyd's chaired by Sir Patrick Neill QC. The Neill report stated that *"Names should have at least the same degree of protection as will be available to investors in general under the SIB's compensation scheme"*.
- 2.2 Accordingly, in December 1989 the Council made the Members' Compensation Scheme Byelaw. The Scheme's rules (which remains substantially unchanged today) contain the following important features –
- a. In order for compensation to be payable two conditions need to be met. First, the applicant must show that the underwriting agent is liable to the applicant member as a result of fraud or dishonesty on the part of the agent or its directors/employees or by reason of a "failure to account for or render to him moneys... received by the underwriting agent". Second, that the underwriting agent must be unable, or unlikely to be able, fully to meet the liability.
 - b. Under the terms of the Scheme the Council may, before deciding an applicant is entitled to compensation, *"require him to pursue any civil remedy which in the Council's opinion is still available in respect of the loss to the applicant"*.
 - c. The maximum level of compensation payable to any individual member is £50,000.
 - d. The total annual aggregate limit of payments under the Scheme is £50 million.
 - e. Where compensation is paid under the Scheme it is paid for by the Society but is reimbursed by imposing levies on the market in the following way -
 - i. of the first £16.6 million of any compensation paid, half is levied on all current managing agents and the other half on all current members agents (ie each constituency of agents would bear £8.3 million); and
 - ii. any further compensation (up to the annual £50 million limit) is levied on all individual members of the Society (including Namecos and SLPs).

- 2.3 In June 1998 Lloyd's consulted on proposed changes to the Scheme. The main proposed change was to amend the levying provisions (so that the first layer of £33.3 million would be levied on the members and the second layer of £16.6 million would be imposed on managing and members' agents). Those proposed changes were overtaken by the implementation of the Financial Services and Markets Act 2000 and were not implemented.
- 2.4 In November 1998 the FSA consulted on the future regulation of Lloyd's. As a result, FSA concluded that it was inappropriate for members of Lloyd's to be compensated under arrangements designed for investors in the traditional sense of the word. They also concluded that there was no need for the Society to widen the current scope of the compensation scheme for members. Apart from requiring Lloyd's to (a) extend the scope of the Scheme to cover Namecos/LLPs as well as traditional Names and (b) ensure that the Scheme's governance arrangements were operationally independent from but accountable to the Society, the FSA required no other changes to the existing Scheme. These technical changes were made to the Scheme by Council in December 2001.

3. Our review

- 3.1 As required by our terms of reference, and in light of our recent experience dealing with the Cotesworth Action Group claim, we have reviewed the current Scheme and have concluded that amendments need to be made to the Scheme. We have also had the benefit of reviewing submissions made by the Action Group and by the ALM regarding the future of the Scheme. In reviewing the Scheme we asked ourselves the following questions –
- a. is a compensation scheme still necessary?
 - b. should the criteria and procedure for determining applications be changed?
 - c. how should the compensation scheme be funded going forward?
 - d. should the current limits on compensation be raised?
 - e. should Lloyd's reintroduce compulsory E&O cover for managing agents?
- 3.2 Given the importance of the Scheme to the membership we wish to invite feedback from the market before we make our final recommendations to Council regarding the Scheme. Accordingly, we set out below both our views on the future of the Scheme and also the specific questions upon which we would welcome feedback.

4. Our recommendations

a. Is a Compensation Scheme still necessary?

- 4.1 The FSA sourcebook currently requires Lloyd's to have a compensation scheme. In particular it provides that "*the Society must maintain byelaws establishing appropriate and effective arrangements to compensate individual members... if underwriting agents are unable,, or likely to be unable, to satisfy claims by those members relating to regulated activities carried on in connection with their participation in Lloyd's syndicates.*" (COMP 1.5.8)
- 4.2 Accordingly, to remove the Scheme entirely would require the agreement of the FSA and the removal of the associated requirements contained in the FSA sourcebook. The FSA would need compelling arguments to be satisfied that there were grounds to remove these requirements. We do not believe such compelling arguments exist especially since members would not otherwise qualify to be compensated under the Financial Services Compensation Scheme as they are not regarded by FSA as "investors". Instead we are of the firm view that the Lloyd's Scheme should continue to exist to cover acts of fraud or dishonesty on the part of Lloyd's managing agents. The existence of the Scheme promotes confidence in the market and helps demonstrate that there is no place for fraud or dishonesty at Lloyd's.

Market Consultation Question 1 - do you agree that the Scheme should continue to exist ?

b. Should the criteria and procedure for determining applications be changed?

- 4.3 We considered whether the Scheme should be extended to cover, for instance, acts of negligence on the part of the underwriting agent, but we are of the view that the current criteria (that the underwriting agent should be found liable for fraud or dishonesty or a failure to account and that it should be unable to meet the claim) remain correct. Members of Lloyd's are not retail investors and we do not believe that the protection afforded by the Scheme should extend beyond the requirements of the FSA.
- 4.4 However, we believe that a change should be made to the procedural aspects of bringing a claim. Under the terms of the Scheme the Council may, before deciding an applicant is entitled to compensation, "*require him to pursue any civil remedy which in the Council's opinion is still available in respect of the loss to the applicant*". We recommend that the presumption should be that an applicant will first obtain judgment in Court proving fraud or dishonesty before making a claim under the

Scheme. The administrative and non-adversarial procedures for a Scheme such as this make it an unsuitable forum for making determinations of fraud or dishonesty in any but the most straightforward of cases (see 4.5 below). To make findings of fraud or dishonesty a robust process needs to be adopted to test evidence, for example through cross-examination of witnesses. These are processes best undertaken through Court proceedings, and it seems appropriate that this should be made abundantly clear by the terms of the Scheme.

4.5 However, we are also of the view that the Council should have discretion in suitable cases to waive the precondition that a judgment be obtained. An example might be where an underwriting agent is prepared to make admissions of fraud in the absence of a Court finding or where there already exists a related judicial finding such as a criminal finding of fraud.

4.6 We also considered who should take decisions to make awards under the Scheme. We believe that the Council remains the appropriate body to make determinations of compensation under the Scheme but that it should do so through a Compensation Panel comprising a majority of nominated members of Council. This mechanism ensures that Lloyd's complies with the relevant FSA guidance that Lloyd's Compensation Scheme should "*have a governance structure that it is operationally independent from the Society, but which is nevertheless accountable to the Society for the proper administration of the compensation arrangements*".

Market Consultation Question 2 – do you agree that the current criteria for making an award under the Scheme (that the underwriting agent should be found liable for fraud or dishonesty or a failure to account and that it should be unable to meet the claim) remain correct ?

Market Consultation Question 3 – do you agree with our proposal that there should be a presumption that an applicant will first seek judgment in Court to prove fraud or dishonesty before making a claim under the Scheme, but that Council should have the discretion to waive the requirement ?

Market Consultation Question 4 - do you agree that the Council remains the appropriate body to make determinations of compensation under the Scheme but that it should do so through a Compensation Panel comprising a majority of nominated members of Council ?

c. How should the Compensation Scheme be funded?

4.7 Currently awards under the Scheme are funded by the Society but the Society is reimbursed by making levies on the market in two layers. Under the first layer members' agents and managing agents each bear 50% of the total claims in any

year up to a limit of £16.6 million. The balance of any claims (up to an annual limit of £50 million) are levied on individual members of the Society¹. Those arrangements were put into place in 1989 in circumstances where there were 159 members' agents and 154 managing agents². As of today there are only 2 members' agents and 47 managing agents. Accordingly, the levying provisions now represent a disproportionately greater burden on those remaining underwriting agents.

- 4.8 Instead we believe that the most appropriate, fair and effective mechanism for making payments under the Scheme would be through the New Central Fund ("NCF"). We are advised that this would be a permissible use of the NCF under the NCF byelaw.
- 4.9 Furthermore, we are of the view that where payments were made from the NCF it should be possible for the Council to impose suitable levies on the market to make good some or all of the payments made. We believe that this should be a discretionary power on the part of Council so that it can determine on a case by case basis whether a levy is appropriate.
- 4.10 Where the Council decides to exercise its discretion to levy the market we believe that it should also be able, in the light of the specific circumstances of the case, to determine who should be subject to that levy. For instance, Council might wish to take into account the effect that the levy would have on the relevant section of the market being levied. We would anticipate that the Council would impose levies on either of the following sections of the market (or a combination of both) –
- a. on managing agents that manage syndicates with individual members. In that case the amount of any levy on a managing agent should be proportionate to the percentage of unaligned capacity on the relevant syndicate. These potential levies would therefore only apply to managing agents who manage syndicates with "mixed capital" and can be properly be regarded as a cost of transacting business on the Lloyd's platform. (In these circumstances the managing agent would not be able to pass the levy onto members as a syndicate expense); and/or
 - b. on all current individual members (not corporate members) as only individual members may make claims under the Scheme.

¹ references in this report to "individual members" includes "quasi-individual members" such as Namecos and SLPs

² figures including combined agencies

Market Consultation Question 5 – do you agree that awards made under the Scheme should be made through the New Central Fund ?

Market Consultation Question 6 – do you agree that the Council should have the discretion to impose levies on the market where an award has been funded through the New Central Fund?

Market Consultation Question 7 – if “yes” to Question 6 do you agree that the Council should have the discretion in each specific case to impose levies on (a) managing agents that manage syndicates with individual members and/or (b) individual members.

d. Should the Compensation limits be raised?

- 4.11 The current compensation limit is capped at £50,000 per member. Under the Financial Services Compensation Scheme the maximum limit of compensation payable to an investor in respect of a designated investment is £48,000. Accordingly, we are of the view that the current per member limit under the Lloyd’s Scheme is in line with the FSCS limit, remains appropriate and does not need to be amended.
- 4.12 In addition, the current annual aggregate limit of payments under the Scheme is £50 million. We see no basis for concluding that the limit should be changed.

Consultation Question 8 – do you agree that the current compensation limit of £50,000 per member remains appropriate?

Consultation Question 9 – do you agree that the current annual aggregate compensation limit of £50 million remains appropriate?

e. Should Lloyd’s require managing agents to hold E&O insurance?

- 4.13 The Panel also debated a proposal as to whether E&O insurance should be made a mandatory requirement for managing agents to cover acts of negligence on the part of underwriting agents. This had been a requirement but had been revoked in 1993.
- 4.14 Having carefully considered this, the Panel came to the view that Lloyd’s should not re-impose the requirement to hold E&O cover. It is clear that very limited cover is currently available to be purchased. To the extent that cover for underwriting risk may be available it is expensive to purchase and its availability and the terms on which it may be available uncertain and unlikely to cover the wrongdoing for which the Scheme exists. In any event, as stated above, we do not believe that

underwriting losses caused by negligence are losses that should properly be part of a Lloyd's compensation scheme.

Market Consultation Question 10 – do you agree that Lloyd's should not introduce a requirement that managing agents must hold E&O insurance ?

Bill Knight, Deputy Chairman of Council
(Chairman of the Panel)

Judith Hanratty
nominated member of the Council of Lloyd's

Andreas Prindl
nominated member of the Council of Lloyd's

August 2007

Terms of reference of the Compensation Panel

The Council hereby resolves, in accordance with paragraph 7(5) of the Members' Compensation Scheme Byelaw and paragraph 3 of the Quorums and Appointment of Committees and Sub-Committees Byelaw, to appoint with immediate effect the Members' Compensation Panel.

1. The Members' Compensation Panel shall –
 - a. consider and administer the application made by the Cotesworth Action Group ("the application")
 - b. determine the procedure for and any procedural matters arising in connection with the consideration, administration and determination of the application;
 - c. provide one or more written reports to the Council; and
 - d. determine the application (save that it shall not make any final determination of the application before it has provided a report to the Council indicating the nature of the decision it is minded to take).
 - e. make any recommendations to the Council for the modification or amendment of the Members' Compensation Scheme (either in respect of the application of the Members' Compensation Scheme to the current application or generally).
2. The Members' Compensation Panel may exercise on behalf of the Council any power, discretion or function of the Council contained in the Members' Compensation Scheme Byelaw, and shall exercise the Council's duties under the Scheme.
3. The Members' Compensation Panel shall comprise Bill Knight (Chairman), Judith Hanratty and Andreas Prindl.

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