Dear Sirs

A new approach to financial regulation: the blueprint for reform

I am submitting this response on behalf of Lloyd’s.

We appreciate the opportunity to respond to HM Treasury’s consultation paper “A New Approach to Financial Regulation: The Blueprint for Reform”. We have responded separately to the papers on supervision by the PRA and the FCA, referred to here as “PRA approach to insurance supervision” and “FCA approach to regulation”.

Government thinking on the reform of UK financial supervision has developed since it produced its first proposals in July 2010 and we welcome evidence that it has considered and responded to concerns expressed by Lloyd’s and other interested parties. In particular we welcome recognition of:

- The distinct nature of insurance business and the introduction of a specific insurance objective;
- the need for a separate insurance division within the PRA’s internal structure, headed by an appropriately senior official;
- the fact that insurance firm failure is much less likely to be of systemic importance than failures in the banking sector;
- the need for proper coordination between the PRA and FCA, as well as between these entities and the Bank of England;
- the need for the FPC to have access to insurance expertise; and
- a commitment to consult on regulatory proposals, including cost-benefit analyses.

This response is divided into three sections: overall comments, comments on the regulation of Lloyd’s under the new arrangements and responses to the questions the consultation paper asks.
Overall comments

Timetable for implementation

We believe that the proposed implementation timetable is ambitious. The Government is committed to implementing these reforms as quickly as possible and expects to introduce the Bill before the end of 2011. However, the Joint Committee on the Financial Services Bill is not due to report until 1 December 2011 and Parliament rises less than three weeks later, on 21 December 2011, which gives little time for the Government to produce a response to the Committee’s report.

The Financial Services and Markets Act 2000, which the Financial Services Bill will amend, is a lengthy and complex piece of legislation, introduced to the House of Commons on 17 June 1999 after pre-legislative scrutiny, and receiving Royal Assent on 14 June 2000. It was the first public bill in Parliamentary history to be carried from one session to the next. The Financial Services Bill is not as extensive, but will require some review and adjustment and may not progress rapidly through the Parliamentary process.

We agree that it is important for the new UK regulators to be established as soon as possible and that a lengthy interim period between the old and the new regime is undesirable, but it is also important to ensure that the new regulatory approach is appropriate and the amended legislation is properly drafted.

The financial sector faces a major programme of international regulatory change and reform, creating a massive strain on resources for regulated firms and supervisory authorities alike. Many aspects also require a legislative response: for example, UK financial services legislation will need to be amended to bring it in line with the Solvency II Directive by a prescribed deadline, expected to be 31 December 2012. Implementation of regulatory change in the UK should take this into account.

Effective engagement in Europe and internationally

Most financial services regulations applied by UK supervisors derive from EU legislation. So it is crucial that the UK has a strong and effective voice in the development of financial services regulation and supervisory issues within the new European Supervisory Authorities (ESAs) and other European institutions. We welcome the Government’s recognition of the significance of European and international reform and of its intention to engage proactively with European and international partners.

We remain very concerned that the proposed structure does not provide clarity on which body is responsible for maintaining and enhancing the international competitiveness of UK financial services and how that will be delivered under the new architecture.

International engagement entails commitment at a range of strategic and operational levels. Under the new structure several different entities will be involved in EU policy making – Ministers, HM Treasury, the Bank of England, the PRA, the FCA. Effective UK engagement requires these entities and their management and staff to share a broadly similar vision of desirable approaches and ultimate outcomes – in other words, a shared UK financial regulatory “doctrine”. It will damage the UK’s influence if representatives of different UK entities argue from different bases or present contradictory proposals. The need for a shared vision goes
beyond the simple – and welcome – commitment to collaboration on the exercise of functions relating to EU and international organisations.

This cannot be divorced from considerations of international competitiveness and of national economic policy. The Government does not wish to retain the FSA’s Principle of Good Regulation that explicitly recognises the desirability of maintaining the UK’s competitive position, for either the PRA or the FCA (the FCA’s obligation to promote competition is an entirely different issue). But the Government should appreciate that when UK representatives are engaged in international policymaking they will be talking to representatives of other national supervisors who recognise the desirability of national competitiveness, sometimes because this is explicitly required by their organisations’ objectives.

Furthermore, the size, structure and product mix of the UK’s financial services sector means that regulatory proposals may have a significant impact in the UK and a much lesser or different impact in other EU member states. UK representatives will need to decide whether they take into account such UK-specific impacts – part of the UK financial sector’s international competitiveness – or concur with regulatory outcomes that other EU member states consider appropriate, notwithstanding risks that they cause disproportionate damage to the UK financial sector.

EU and international regulatory policymaking is not a straightforward technical exercise, in which national and international representatives work together objectively to design and implement perfect regulatory solutions. Considerations of national competitiveness, of national advantage and disadvantage are bound to intrude, as well as questions of varying impacts in different countries for structural, cultural or other reasons. The Government should determine the extent to which it wants UK representatives to take this into account and to act as “national champions”, notwithstanding the absence of recognition of UK competitiveness in the new authorities’ strategic and operational objectives.

It is desirable that UK supervisory entities develop their approaches to EU and international policymaking in consultation with industry. Industry groups have been established to provide input on particular international topics (such as the FSA’s Insurance Standing Group and HM Treasury’s Industry Working Group in relation to Solvency II) and it is important that the new financial supervisory structure continues to consult relevant UK financial sectors on international policy issues.

Even though there is more to international policymaking than technical expertise, it is nevertheless important that UK involvement deploys appropriate technical knowledge, as well as strong negotiating and influencing skills. This should be taken into account when selecting UK representatives on the ESAs, who must possess appropriate skills and political awareness, as well as sufficient seniority to exert the kind of influence that the Government may consider appropriate.

The regulation of Lloyd’s

General comments

We welcome the Government’s intention to make the PRA lead regulator of Lloyd’s as a whole and to make the PRA prudential regulator of the Society of Lloyd’s and Lloyd’s managing agents. We continue to believe that the efficacy of the overall supervisory arrangements would
be enhanced by making the PRA prudential regulator of the small number of Lloyd’s members’ agents as well.

The PRA will be responsible for prudential and organisational rules applying to Lloyd’s, including those ensuring the adequacy of members’ resources and Lloyd’s central assets. We are pleased to note that neither the HM Treasury paper nor “PRA response to insurance supervision” propose to change existing arrangements for the supervision of Lloyd’s. We therefore understand that the PRA’s supervision of Lloyd’s will continue to take account of Lloyd’s oversight of risk within the market and its role in ensuring capital adequacy.

**Authorisation of the Society of Lloyd’s**

Clause 35(4) of the Financial Services Bill proposes a new section 315 in the Financial Services and Markets Act 2000 (“FSMA”). The new wording does not carry forward the existing statutory language that “The Society [of Lloyd’s] is an authorised person”.

We understand that the reasons for this are technical. The draft Bill does not specify which authorised persons will be regulated by the PRA and FCA and which will be regulated by the FCA only, as secondary legislation will specify this. It would be an unnecessary time- and resource-intensive exercise for all concerned to require the Society of Lloyd’s to apply to the new supervisory authorities for permission to carry on regulated activities and we welcome assurances from HM Treasury that this is not the intention.

**Memorandum of Understanding (MoU)**

We welcome the statutory requirement for the PRA and FCA to prepare and maintain a MoU describing their respective roles in relation to the regulation of authorised persons and how they will comply with their duty to coordinate the exercise of their respective functions. We are pleased that functions under Part 19 (Lloyd’s) are included in the indicative list of issues that the MoU will cover.

The Government has asked the Bank of England and the FSA to produce a draft version of the MoU before the Bill is introduced to Parliament. We believe that the MoU’s efficacy will be enhanced by the engagement of regulated firms in its development and we hope that it is intended to invite such engagement. It is particularly important that Lloyd’s and Lloyd’s firms are consulted on arrangements to coordinate their supervision and that such arrangements draw on experience of existing supervisory approaches.

**Co-operation Agreement**

“PRA response to insurance supervision” says that

“In due course, the PRA, FCA and the Society of Lloyd’s will enter into new co-operation arrangements to ensure that the new regulators’ interfaces with Lloyd’s market discipline functions and its oversight of the market as franchisor are suitably clear.”

These arrangements should build on the existing formal co-operation agreement between the FSA and the Society of Lloyd’s (copy attached): we strongly advocate that a similar formal agreement is drawn up, between the PRA, the FCA and the Society of Lloyd’s and look forward to working with the PRA and FCA on developing such an agreement.
The existing agreement ensures that duplication is minimised and that the FSA and Lloyd’s maintain an effective working relationship on authorisation, supervision and enforcement for firms and individuals operating within the Lloyd’s market. The agreement recognises that the FSA, as part of its oversight of the market, utilises Lloyd’s extensive systems and controls in respect of the monitoring of managing agents and syndicates.

*Conduct regulation at Lloyd’s*

We have set out our views on conduct regulation at Lloyd’s in our response to “FCA approach to regulation” (copy attached). We remain unclear about where the boundary between conduct regulation and prudential regulation of the Lloyd’s market will lie and therefore of how much engagement the FCA will seek with the Society of Lloyd’s and Lloyd’s managing agents.

Clearly protection of Lloyd’s policyholders will continue to entail the same controls as the protection of the policyholders of other UK insurers. We agree with the FCA’s proposed “differentiated approach”, which implies recognition of the different regulatory protection expectations of, for example, UK personal lines policyholders and international reinsurance purchasers.

We are not clear on the extent to which activities related to membership of Lloyd’s will be viewed as “conduct”, since the FSA currently regulates such activities as part of its prudential supervision of Lloyd’s. For example, members’ capacity transfer is currently supervised by the FSA’s Lloyd’s Market Supervision team. There is an organised process, with rules in the FSA’s Prudential Sourcebook for Insurers (INSPRU Rule 8.4 (*the Capacity Transfer Market*)). Inclusion of these rules in INSPRU reflects the FSA’s judgement that, as capacity transfer is not day-to-day conduct of business between Lloyd’s and its customers, it more naturally fits with prudential regulation and not with conduct of business rules.

Conduct regulation at Lloyd’s should be low impact and should take account of Lloyd’s existing and extensive controls over market conduct. We look forward to establishing a dialogue with the FCA to ensure that its supervision of Lloyd’s is proportionate, efficient and does not create unnecessary compliance or cost burdens.

**Responses to questions**

**Q1. Do you have any specific views on the proposals for the FPC as described in paragraphs 2.6 to 2.24 and in Chapters 3 and 4?**

At least one FPC member should have experience in insurance, to provide input to the operation of the Committee. We therefore welcome the Government’s commitment to ensure that the FPC has access to the expertise of various sectors of the financial services industry.

The interim FPC is likely to be operational for some time before a permanent FPC is appointed and will be a significant influence on the FPC’s future direction. We are therefore concerned that the only external member with any exposure to insurance is Alastair Clark, who had some exposure to insurance at the Bank of England (he co-authored the 2006 G30 Reinsurance and International Financial Markets Report), but whose right to be considered properly “external” is questioned by the Treasury Select Committee. Ideally, we would like to see an additional external appointment to the interim FPC, of someone with direct experience of the insurance sector.
Q2. Do you have any specific views on the proposals for the Bank of England’s regulation of RCHs, settlement and payment systems as described in paragraphs 2.32 to 2.40 and in Chapters 3 and 4?

Lloyd’s does not have any comments on this question.

Q3. Do you have any comments on:
   - the proposed crisis management arrangements; and
   - the proposals for minor and technical changes to the Special Resolution Regime as described in paragraphs 2.41 to 2.44 and in Chapters 3 and 4?

We agree with these proposals and the commitment to produce a crisis management MoU.

The paper refers to technical changes to the special resolution regime under the Banking Act 2009, but does not refer to resolution arrangements for insurers. “PRA approach to insurance supervision” does refer to insurers’ resolution arrangements and says that the PRA will consider whether Recovery and Resolution Plans should be introduced for insurers. Any such plans must take into account the existing resolution mechanism for EU insurers, the Winding-Up Directive (2001/17/EC). This Directive harmonises the reorganisation and winding-up of (re)insurers in the EU and provides for claims arising from insurance contracts to be given preferential treatment over other creditors. Both the PRA and the FCA should therefore recognise that the Winding-Up Directive already provides a resolution mechanism for insurers.

Q4. Do you have any comments on the objectives and scope of the PRA, as described in paragraphs 2.46 to 2.61 and in Chapters 3 and 4?

We welcome the introduction of a specific insurance objective for the PRA, which recognises differences in business models between insurers and other financial services. Whereas insurers and regulators must ensure that policyholders are adequately protected, we are unclear how this duty can be extended to those who ‘may become policyholders’ and what the regulatory implications are for ensuring the adequate protection of this undefined category.

The Bill sets out a general objective for the PRA: “promoting the safety and soundness of PRA-authorised persons.” It says that this is to be met primarily by reference to the stability of the UK financial system, making systemic risk a key consideration for the PRA. It is therefore important for the PRA and insurers to develop a shared understanding of the extent to which insurers are considered to represent systemic risks.

We agree with “PRA approach to insurance supervision” that “in general, firms carrying out traditional insurance activities do not pose risk to the system in the same way as banks”. As the failure of such firms is less likely to be of systemic importance, their supervision requires a different and less intrusive approach.

However, we are concerned by statements in “PRA approach to Insurance Supervision” which suggest that reinsurance failure can be readily equated to the failure of, for example, an investment bank. We do not believe that the core activities of reinsurers present a threat to the financial stability of the UK or the international financial system and we are aware that this view is shared by major European reinsurers. The pattern, timing and settlement of claims, amongst other things, for reinsurers, both when active and in run-off, is typically very different from financial demands faced by investment banks in similar circumstances.
A considerable amount of detailed analysis in support of these views has been undertaken by the reinsurance industry and provided to the International Association of Insurance Supervisors (IAIS). We are anxious therefore to ensure that statements made on the subject should be grounded on strong analysis and evidenced.

This section of the consultation paper deals with the regulation of Lloyd’s and we welcome the Government’s confirmation that:

- the PRA will be the lead regulator for Lloyd’s as a whole;
- the PRA will be the prudential regulator for the Society of Lloyd’s and Lloyd’s managing agents;
- further provision as to the allocation of regulatory responsibility in relation to Lloyd’s will be included in the order to be made by the Treasury under new section 22A; and
- regulatory arrangements will be adapted to Lloyd’s unique structure by allowing the PRA to regulate the prudential aspects of the Lloyd’s operations although Lloyd’s names are not authorised persons.

Q5. Do you have any comments on the detailed arrangements for the PRA described in paragraphs 2.62 to 2.78 and in Chapters 3 and 4?

In principle we welcome the application of judgement-led regulation within a legislative framework, provided it is applied by suitably-trained and experienced personnel. However, UK regulatory requirements have to comply with EU directives containing detailed, technical rules and we are unclear how the proposed judgement-led approach will conform with such EU rules. EU directives are designed to deliver harmonisation in the regulatory requirements applied within Europe and Lloyd’s supports such harmonisation. There is a risk that supervisory discretion and judgement could be used to create national super-equivalence on a range of issues in a way that is non-transparent and not subject to consultation. Safeguards should be put in place.

The process of making supervisory judgements must be transparent. Firms should be able to provide input into that process and should feel that their representations have been fully considered before final decisions are taken. Supervisors should not confront firms with unexpected decisions with no proper forewarning, which are difficult to challenge and reverse.

We welcome the Government’s intention not to amend the Tribunal’s scope of review of PRA supervisory decisions. To ensure fairness of the process, it is important that an independent review process is available to parties subject to supervisory decision-making.

We support the Government’s proposals on the PRA’s governance framework and relationship with the Bank of England. The PRA board should include non-executive directors with relevant experience of the financial sector, including insurance expertise.

We agree that existing FSMA consultation requirements should remain largely unchanged and that there should be no exception for rules originating from Europe.
Q6. Do you have any views on the FCA’s objectives – including its competition remit – as set out in paragraphs 2.80 to 2.90 and in Chapters 3 and 4?

The HM Treasury document “A new approach to financial regulation: the blueprint for reform” released in 2010 said of the conduct regulator (then the CPMA): “there will be no in-built tensions between different objectives and a dedicated focus on the importance of proper conduct.” However, under the Bill, the FCA has one strategic objective, three operational objectives and six regulatory principles, as well as two further issues (promoting competition; minimising financial crime) which it must take into account.

We can understand the reasons why the FCA has been given this list of different aims, but we question how easy it will be to satisfy them all. The FCA will sometimes need to reconcile different and possibly conflicting principles, issues and objectives and should develop a culture enabling it to do so fairly and transparently, so that financial customers and firms alike know what to expect. At the same time, the FCA should expect its behaviour to be measured against the full list of objectives and principles and should not disregard particular principles on a regular basis in pursuit of its objectives.

Lloyd’s, like other regulated entities, is interested in ensuring that the FCA’s supervisory regime is cost effective and proportionate. We therefore particularly welcome the regulatory principles recognising:

- The need for the FCA to use its resources in the most efficient and economic way; and
- Proportionality – the principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits that are expected to result.

We think that the proper application of these principles in particular will immensely strengthen the effectiveness of the FCA’s supervisory regime.

Q7. Do you have any views on the proactive regulatory approach of the FCA, detailed in paragraphs 2.91 to 2.110 and in Chapters 3 and 4?

We welcome the Government’s recognition that the new product intervention power is unlikely to be appropriate in relation to the protection of professional or wholesale customers.

We remain concerned about the FCA publishing information on warning notices issued in relation to individual financial firms in circumstances where the outcome of the case has not been determined. This may have severe reputational implications for firms in the event that the enforcement action is later discontinued or unsuccessful.

Q8. What are your views on the proposal to allow nominated parties to refer to the FCA issues that may be causing mass detriment?

Lloyd’s does not have any comments on this question.

Q9. What are your views on the proposal to require the FCA to set out its decision on whether a particular issue or product may be causing mass detriment and preferred course of action, and in the case of referrals from nominated parties, to do so within a set period of time?
Lloyd’s does not have any comments on this question.

Q10. Do you have any comments on the competition proposals for the FCA set out in paragraphs 2.111 to 2.119 and in Chapters 3 and 4?

Lloyd’s does not have any comments on this question.

Q11. Do you have any views on the proposals for markets regulation by the FCA, described in paragraphs 2.120 to 2.123 and in Chapters 3 and 4?

As Lloyd’s will be prudentially regulated by the PRA, these proposals will not apply to Lloyd’s, so we do not have any comments on this question.

Q12. Do you have any comments on the governance, accountability and transparency arrangements proposed for the FCA, as described in paragraphs 2.124 to 2.132 and in Chapters 3 and 4?

Lloyd’s does not have any comments on this question.

Q13. Do you have any comments on the general coordination arrangements for the PRA and FCA described in paragraphs 2.138 to 2.149 and in Chapters 3 and 4?

Effective cooperation between the regulatory authorities is crucial to the smooth operation of the new supervisory system. We welcome the requirement for the PRA and FCA to conclude a MoU. Please see our earlier comments on this subject.

Q14. Do you have any views on the detail of specific regulatory processes involving the PRA and FCA, as described in paragraphs 2.150 to 2.195 and in Chapters 3 and 4?

We are pleased that a single authority (the PRA for dual-regulated firms) will manage the process of applying for authorisation. It is important that the need for consultation between authorities does not lead to delays.

We welcome the requirement that the new authorities consult each other before introducing rules and regulations. This should help minimise risks of compliance confusion among regulated firms.

Q15. Do you have any comments on the proposals for the FSCS and FOS set out in paragraphs 2.196 to 2.204 and in Chapters 3 and 4?

The Government’s first consultation on financial regulation, published in July 2010, suggested that arrangements under which the PRA and FCA had separate rule-making powers for the FSCS could lead to an end in the current cross-subsidy between different classes of levy payers. This was not mentioned in the Government’s February 2011 consultation or the current consultation paper. We continue to support the ending of cross-subsidy.
Please do not hesitate to contact me should you have any questions on our response.

Yours sincerely

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