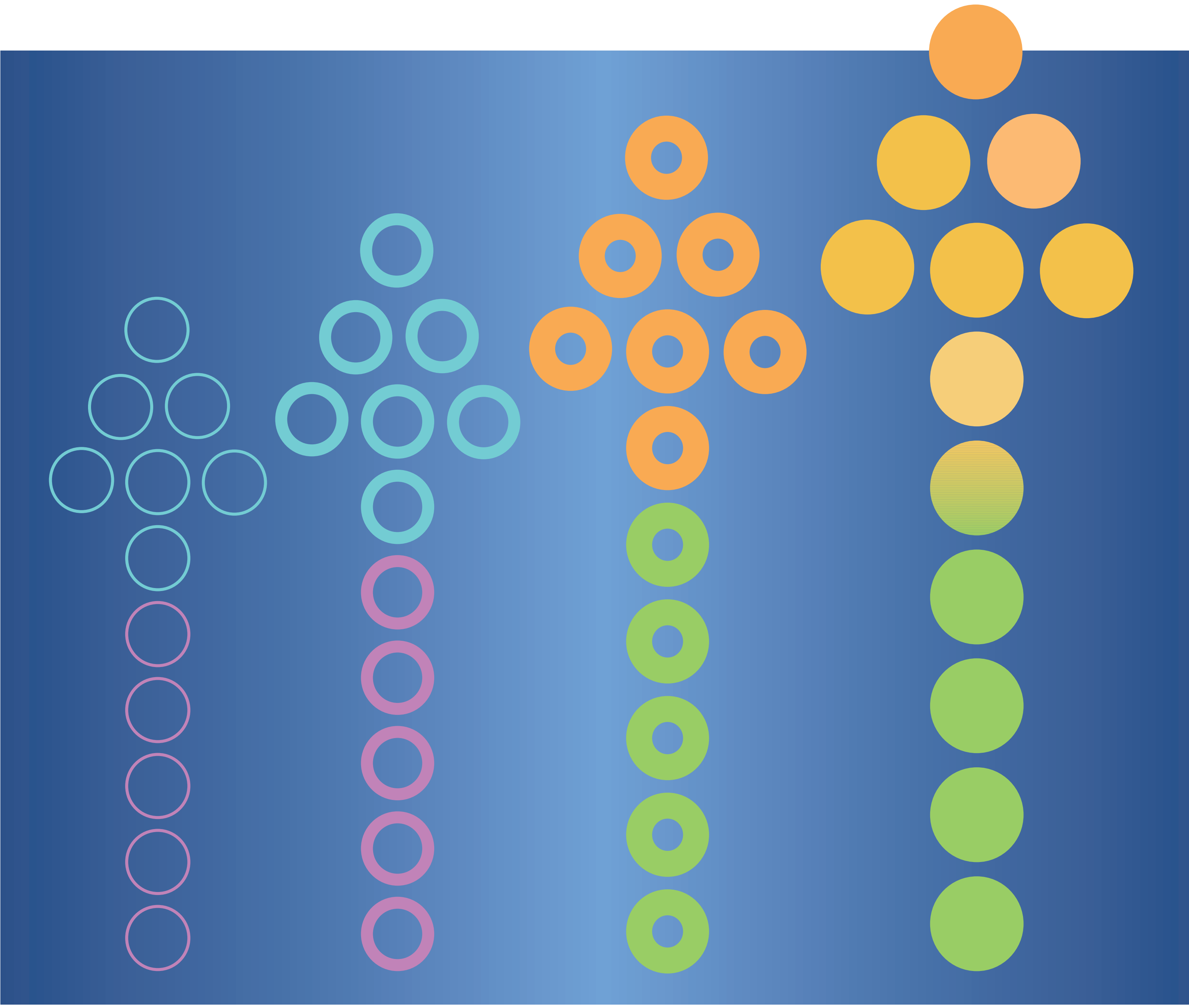
# THE CHAIRMAN'S STRATEGY GROUP

## CONSULTATION DOCUMENT



LLOYD'S

# 1. EXECUTIVE SUMMARY

## 1.1 INTRODUCTION AND AIMS OF THE CSG PROPOSALS

*to transform Lloyd's into a modern, transparent and profitable marketplace*

This document lays out a programme of major change for Lloyd's developed by the Chairman's Strategy Group (CSG) and endorsed by the Council of Lloyd's. The objective of the proposals is to transform Lloyd's into a modern, transparent and profitable marketplace, attractive to capital providers and policyholders as a place to do business. Lloyd's should be the trading platform of choice for specialist insurance and reinsurance business.

Improved, sustainable performance and profitability are at the heart of the CSG proposals. The CSG believes that its proposals will lead to higher operating standards amongst the businesses in the market which, in turn, will help generate better returns to capital providers. Improved, sustainable performance and profitability are equally important for policyholders as they enhance financial strength.

*ensuring Lloyd's is a more attractive market for existing and new capital providers, drawn from a variety of sources*

Modernisation of the Lloyd's market means continuing the work to improve business processes so as to deliver higher standards of service to policyholders. It also means making Lloyd's less opaque and confusing to policyholders, regulators and other key external commentators. The CSG believes that Lloyd's has to be more transparent and more comparable with its competitors. One of the main ways in which this can be achieved is through a move to full annual accounting. Finally, modernisation means creating a governance structure that best supports the achievement of these objectives.

The CSG's proposals are also aimed at ensuring that Lloyd's is a more attractive market for existing and new capital providers, drawn from a variety of sources. The CSG has therefore focused on the efficiency of capital provision and the need for improved returns to all capital providers.

*creating a disciplined marketplace where the standards of the best businesses become the standards of the market as a whole*

The CSG's proposals have been built on the continuing existence of a Lloyd's market of competing and independent businesses, founded on the mutual security of the Central Fund. The CSG believes this model plays to Lloyd's considerable strengths as a market – diversity, choice, innovation and access to underwriting decision makers. However, the results of the poorer performing businesses cannot be allowed to dissipate those strengths by weakening the results and reputation of the whole market and increasing the cost of mutuality to unsustainable levels. That is why the CSG's proposals are aimed at creating a disciplined marketplace where the standards of the best businesses, whose performance has been strong, will become the standards of the market as a whole.

## 1.2 FRANCHISE STRUCTURE

To improve profitability and performance, it is proposed that Lloyd's will move to a franchise structure which will create a disciplined marketplace of distinct, independent businesses, and will place clear obligations on the franchisor to promote the overall profitability of the market. This will be achieved by redefining the relationship between Lloyd's, as franchisor, and managing agents, as franchisees. Specifically:

*redefining the relationship between Lloyd's, as franchisor, and managing agents, as franchisees*

- the new relationship will be defined in a set of Franchise Principles which will detail the objectives of the franchisor as well as the obligations of both the franchisees and the franchisor, and will bring clarity to that relationship
- in operating the franchise, the franchisor will be open, constructive and flexible. The franchisor will:
  - publish franchise guidelines, addressing underwriting, risk management and standards of service
  - set a long-term target level of profitability for the market
  - define a new business planning process for syndicates
  - approve syndicate business plans
  - monitor the performance of each syndicate against its business plan
- although the franchisor's role is intended to be primarily facilitative, the franchisor will be prescriptive and require change when a franchisee does not respond to the facilitative approach or where a franchisee's underperformance threatens the security and the profitability of the Lloyd's market.

It is intended to introduce the franchise structure as soon as possible to improve the results of the market. A Franchise Board will be established later this year and key personnel will be recruited for the franchisor organisation, including the new Franchise Performance Director. Franchisees will be expected to operate their businesses within the guidelines set by the franchisor for the 2003 year of account. Some elements of the new arrangements will, however, need to be introduced on a rolling basis – for example, the new business planning and monitoring process.

Full details of the proposed franchise structure are contained in Section 3.

### 1.3 CAPITAL STRUCTURE

*to improve transparency, move to full implementation of annual accounting*

The CSG's capital structure proposals can be summarised as follows:

- in order to improve transparency, move to full implementation of annual accounting on an International Accounting Standards basis in line with or ahead of the international programme. Target date for implementation is 1 January 2005
- enable early release of surpluses to support ongoing underwriting in the interim period before annual accounting is implemented
- no new unlimited liability members of Lloyd's with effect from 1 January 2003
- continue to work with the Government and Inland Revenue to identify changes to the tax regime to facilitate existing unlimited liability members' conversion to limited liability
- from the end of 2002, cease membership of those members with a Centrewrite Exeat policy covering all their exposures

- drive forward initiatives to accelerate the closure of existing and future syndicate years of account which remain open after the 36 month stage
- support new investment in the Lloyd's market, including investment on a non-membership basis
- consider the introduction of "limited tenancy" capacity for 2003 and amendments to the agency agreements of participants on new syndicates from 2003 onwards to remove the fiduciary duties detailed within the existing standard form agreement
- support the transition of syndicates from spread to Integrated Lloyd's Vehicle (ILV) status by:
  - maintaining the existing transition rules, including the creation of a Capacity Transfer Panel to replace the existing sub-committee of Lloyd's Regulatory Board
  - establishing a panel of mediators to facilitate constructive discussions
  - recognising that offers can be made via a variety of means, not just cash
- review the impact on ILVs of any requirements that are the product of rules developed for spread capital to ensure, wherever possible, that ILVs are not constrained by such requirements.

Full details are contained in Section 4.

### 1.4 GOVERNANCE OF THE SOCIETY

*a new governance structure aimed at delivering independent oversight and clarity of responsibility and accountability*

The CSG believes that a new governance structure aimed at delivering independent oversight together with clarity of responsibility and accountability is required if the franchise arrangements are to work successfully. It is therefore proposed that:

- the Council will establish a Franchise Board to replace the current Lloyd's Regulatory Board and Lloyd's Market Board. The Franchise Board will be tasked with running the franchise. It will be supported by two key committees: a Market Supervision Advisory Committee and a Capacity Transfer Panel
- an Underwriting Advisory Committee will also be set up to advise the Franchise Board on underwriting and risk issues
- the Franchise Board will look to the Lloyd's Market Association and the Lloyd's Motor Underwriters Association to be the primary conduits for obtaining franchisee views
- amendments should be sought to the Lloyd's Acts as soon as possible to fully modernise the governance structure of the Society and to remove unnecessary business restrictions.

Full details are contained in Section 5.

*to undertake the role of franchisor, the Corporation will need to acquire new capabilities and operate differently*

## 1.5 FRANCHISOR ORGANISATION STRUCTURE

To enable the Corporation of Lloyd's to undertake the role of franchisor, changes will be needed to its organisation. It will also need to acquire new capabilities and operate differently to contribute to the transformation of the market. To do this, the following are proposed:

- a new organisation structure with new functions
- the recruitment of new personnel, including the Franchise Performance Director
- cultural change within the franchisor organisation.

Full details are contained in Section 6.

# 2. INTRODUCTION AND BACKGROUND

## 2.1 OBJECTIVES OF THE CHAIRMAN'S STRATEGY GROUP (CSG)

The CSG was established by the Council last year to examine the major strategic threats and opportunities facing Lloyd's. Its specific objective was to determine:

> "The future vision and strategy for Lloyd's which will maximise the wealth of capital providers to Lloyd's over the next 10 years"

The CSG's membership was drawn from all the major market constituencies and is detailed in Appendix 1. The CSG has been supported by Bain & Company, a leading business consulting firm, and has reported back to the Council regularly during the course of its work.

## 2.2 THE CSG'S PROPOSALS

*the CSG is convinced that fundamental change is required if Lloyd's is to compete effectively in the future*

Against the backdrop of the Lloyd's market's recent losses and the increasing competitive pressures within the global insurance and reinsurance industry, the CSG is convinced that fundamental change is required if Lloyd's is to compete effectively in the future. Although the Lloyd's market contains a number of world class businesses, others are damaging the market with unacceptable losses. The CSG believes that Lloyd's needs to continue to raise standards and, in particular, it needs to become more transparent.

Policyholder security will remain at the heart of the proposition Lloyd's offers its customers. Building on that, however, the CSG wants to see:

- dramatic improvement in the profit performance of the market
- better standards of service delivered to policyholders
- increasing flows of new capital into the market
- reduced costs of doing business at Lloyd's, including lower Central Fund contributions
- an improvement in the Lloyd's market security ratings
- a new culture in the Corporation of Lloyd's and within the businesses operating in the market
- a streamlined governance structure.

To meet these objectives, the CSG developed a set of initial proposals which it promulgated to both the membership and the market in January of this year to seek views and feedback. In broad terms, these proposals centred on:

**The development of a Lloyd's franchise**
The intention of the franchise structure was to preserve the advantages which the Lloyd's market derives from being a marketplace of distinct, independent businesses, whilst placing clear obligations on Lloyd's, as the franchisor, to

promote effectively the overall profitability of the market. It aimed to bring clarity to the relationship between the franchisor and the managing agents (the franchisees) and was designed to deliver the step-change in overall market performance that is required for Lloyd's to compete successfully in future in the global insurance marketplace.

The franchise proposal included a new governance structure with the introduction of a Franchise Board to run the franchise.

**Reforms to Lloyd's capital structure**

These included proposals to:

- move to full annual accounting as soon as possible, with annual profit distribution
- phase-out unlimited liability underwriting in an agreed manner
- introduce a new form of participation for third party capital providers (e.g. the Single Reinsurance Syndicate)
- create a transition mechanism (e.g. sale and leaseback) from the current capital structure to the new one.

The proposals were designed to lead to a more intelligible and transparent market capable of attracting new capital.

## 2.3 THE DEVELOPMENT OF THE CSG'S PROPOSALS SINCE JANUARY

*the CSG's initial proposals were the subject of extensive consultation with the membership and the market*

The CSG recognised that the introduction of the franchise and the proposed changes to Lloyd's capital structure would require extensive consultation with the market, the membership and external parties. Since January, the CSG has not only sought views from all interested parties on the original proposals but has also been working with representatives of the market to develop the detail behind the franchise and with representatives of both the market and the membership on the capital structure proposals. The development work has taken into account the feedback received more generally from the market and the membership on the original proposals.

**Franchise structure**

The Lloyd's Market Association (LMA) established a group of market practitioners to work with Lloyd's and with Bain & Company on the development of the franchise proposals. The Franchise Performance Management Group (FPMG – see Appendix 2) was established for this purpose. It also provided input into the proposed governance arrangements under the franchise – for example, the role and composition of the Underwriting Advisory Committee. A full description of the franchise proposals (including the changes that will be required to the structure and culture of the Corporation of Lloyd's to enable it to undertake the role of franchisor) is contained in Sections 3, 5 and 6.

**Capital structure**
Market input into the development of the capital structure proposals was obtained via the Capital Liaison Group, which was also established through the LMA. Its members were drawn from agents managing a range of syndicates with differing types of capital structure and from the members' agency community (see Appendix 2). Membership input was obtained via the Third Party Capital Representatives Group, a combination of representatives from the members' agents, the Association of Lloyd's Members (ALM) and the High Premium Group (HPG) (see Appendix 2). The capital structure proposals are detailed in Section 4.

## 2.4 THE FUTURE OF THE CSG

*the process of reforming the Lloyd's market will be a continuing one*

The CSG recognises that the process of reforming the Lloyd's market will be a continuing one. The proposals outlined in this document are a starting point but more work is required in several areas (for example, long term governance arrangements) and the CSG will remain in existence to assist with the change process by identifying appropriate reforms and helping to ensure they are implemented as quickly as possible.

# 3. FRANCHISE STRUCTURE

*the proposed franchise structure has been designed to address the main issues which the CSG believes have to be overcome if Lloyd's is to compete effectively in future*

## 3.1 BACKGROUND

The proposed franchise structure has been designed to address the main issues identified by the CSG which it believes have to be overcome if Lloyd's is to compete effectively in future:

**Improvement in profit performance**
It is proposed that the Franchise Board will set a target level of profitability for the market over the cycle as well as a risk management strategy.

It is also proposed that guidelines, based on sound insurance industry practice, will be introduced for all syndicates, together with a new business planning and monitoring process. The guidelines will encourage higher standards of underwriting and risk management, thereby improving sustainable profitability and enhancing the financial strength of the market.

**Improved standards of service to policyholders**
The guidelines and the new business planning and monitoring process will also focus on the need to improve service standards. The guidelines will seek to ensure franchisees adhere to the standards defined by the London Market Principles (LMP).

**Increasing flows of new capital into the market**
The improvement in market profitability that the franchise has been designed to deliver will make Lloyd's more attractive to new capital providers.

**Reduced contributions to the Central Fund**
Higher standards of underwriting and risk management are expected to result in fewer drawdowns on the Central Fund. The Central Fund costs should therefore come down.

**Higher security ratings**
The poor profit record of the market has been a negative factor on the market's rating. Improved profitability will be a positive factor.

**A streamlined governance structure**
The Franchise Board, which will have a limited number of supporting committees, will replace much of the current governance structure and will manage the franchise in an objective, independent and unconflicted manner.

**A new culture at the Corporation of Lloyd's and within the businesses operating in the market**
The Corporation will adopt a new organisation structure, introduce new skills and develop a new culture. Franchisees will be encouraged to adopt tighter management and control disciplines.

## 3.2 VISION, OBJECTIVES AND STRATEGY OF THE FRANCHISE

*the vision for the franchise aims to make Lloyd's the preferred market of choice for policyholders, brokers, underwriters and capital*

**Vision**

The CSG proposes the following vision for the franchise:

> "We will be the leading specialist insurance marketplace. Our businesses are independent and operate within a franchise: committed to delivering consistent underwriting profit, benefiting from a common rating and mutual security, and attracting the highest quality management and underwriting talent."

The vision aims to make Lloyd's the preferred market of choice for policyholders, brokers, underwriters and capital.

**Specialist insurance marketplace**

Lloyd's derives considerable strength from being a market offering specialist expertise. The marketplace structure is attractive both to policyholders and brokers, and to underwriting businesses. Specialism and expertise are at the heart of Lloyd's competitive advantage.

**Our businesses are independent and operate within a franchise**

The Lloyd's franchise model is one where franchisees are recognised as independent businesses with the freedom to participate in whichever types of business they choose, provided they operate in accordance with a business plan agreed by the franchisor and drawn up in accordance with guidelines developed by the franchisor.

**Committed to delivering consistent underwriting profit**

Consistent profit does not mean constant profit. Insurance is a cyclical business. However, it is proposed that each franchisee strives to make an underwriting profit each year, consistent with the long-term profitability target set by the Franchise Board, varying the quantity and type of business it writes according to market conditions.

**Benefiting from a common rating and mutual security**

These are two important advantages for those operating in the Lloyd's market but they come at a price. Lloyd's licenses to underwrite insurance in the UK and overseas and the security behind the Lloyd's policy depend, to varying but critical degrees, on the existence of the Central Fund. Lloyd's market security ratings reflect the strength of the chain of security, including the Central Fund. The strength of the rating and the perception of security depend critically on performance. The market therefore pays a reputational price for the performance of the poorest businesses, as well as an economic price in higher Central Fund contributions.

**Attracting the highest quality management and underwriting talent**

Attracting the best people will help the Lloyd's market return to profitability and, more importantly, remain profitable in the future. This in turn will make Lloyd's the most attractive insurance market to work in.

*the main objective of the franchise is to create and maintain a commercial environment in which the long term return to all capital providers is maximised. Rigorous management of the risk profile of the market by the franchisor is essential to this objective*

**Objectives**

The main objective of the franchise is to create and maintain a commercial environment at Lloyd's in which the long term return to all capital providers is maximised. This can best be achieved by creating a disciplined marketplace of well managed businesses.

Rigorous management of the risk profile of the market by the franchisor is essential to this objective. The franchisor will further seek to meet the objective through promoting and protecting:

- the overall profitability of the market
- the brand and reputation of Lloyd's, including standards of service
- the security behind Lloyd's policies, including the mutual security of the Central Fund and the security ratings of the market
- Lloyd's licences to underwrite insurance in the UK and overseas.

*the franchise is designed to attract and accommodate high quality specialist insurance and reinsurance business, including motor and personal lines*

**Strategy**

The franchise is designed to attract and accommodate high quality specialist insurance and reinsurance business, including motor and personal lines. There is no intention of preventing franchisees from writing any classes of business other than those which cannot be justified on prudential or profitability grounds. In particular, the franchisor will recognise that innovation and choice, both of which are reinforced by the Lloyd's market structure, are key elements in attracting the right types of business.

## 3.3 RELATIONSHIP BETWEEN THE FRANCHISOR AND FRANCHISEES

The legal nature of the relationship between Lloyd's, as franchisor, and managing agents, as franchisees, will remain unchanged but it will be clarified by the Principles of Relationship which will set out the respective obligations of the franchisor and the franchisees.

It is intended that the Principles of Relationship will be incorporated into the Underwriting Agents Byelaw. This will done in such a way that each franchisee will undertake to Lloyd's and to its capital providers to act in accordance with the Principles. Originally, the CSG's proposals anticipated that the relationship between the franchisor and the franchisees would be set out in a franchise contract. This is not necessary as the Lloyd's Act 1982 gives Lloyd's all the powers it needs to operate the franchise.

The franchise represents a change to the relationship that exists today between the Corporation of Lloyd's and managing agents. Historically, the Corporation has concentrated on setting regulatory requirements and monitoring compliance against them. To succeed as franchisor, the Corporation will, in addition, adopt a more proactive role in setting the commercial as well as the supervisory framework and applying it to individual businesses.

*the franchisor will identify the less well managed businesses and help prevent them from damaging the franchise*

The Lloyd's market contains some world class businesses but, in the past, others have damaged the market's overall performance with unacceptable losses. The franchisor, through business plan review and quarterly monitoring, will identify these less well managed businesses and help prevent them from damaging the franchise. Although its approach will be initially facilitative, helping to raise risk management and underwriting standards and improve performance, the franchisor will have the power to be prescriptive where necessary, imposing constraints on franchisees in order to protect the market and policyholders.

## 3.4 OBLIGATIONS OF THE FRANCHISOR

It is proposed that the franchisor will:

*the franchisor will operate the franchise in an open, constructive and flexible manner*

- operate the franchise in an open, constructive and flexible manner taking into account the views of franchisees. The new structure will encourage regular dialogue between the franchisor and franchisees
- adopt a cost effective, commercial and efficient approach where any charges are allocated as far as possible on a user pays basis.
- meet agreed service standards (for instance, to specify speed of response to issues raised by franchisees and to provide adequate notice of changes to reporting requirements). The franchise structure will be a two-way relationship. Franchisees should expect the franchisor to deliver high levels of service to them in the same way as they will be expected to deliver high levels of service to policyholders.

More specifically, it is proposed that the franchisor will:

- set a target level of profitability for the market over the cycle: this will be a long-term target, taking into account the cyclical nature of Lloyd's business
- publish guidelines each year with which it expects franchisees to comply: guidelines will cover a range of underwriting and risk management issues (for example, levels of exposure to different types of risk) and service standards (see Section 3.6)
- define a business planning process for syndicates: each syndicate will be asked to submit an annual business plan to the franchisor containing details of the business it is proposing to write (see Appendix 3 for an outline of the proposed contents of the syndicate business plan)
- approve business plans: the process of approving business plans will be the principal mechanism for the franchisor to understand each syndicate's business and to influence it if appropriate (see Section 3.7 for further details on the approval process)
- monitor the performance of each syndicate against business plan: by monitoring performance on a quarterly basis, the franchisor will be able to identify those syndicates which are not performing in accordance with their plan and/or which are also not performing in line with the rest of the market (see Section 3.8 and Appendix 4 for further details of the proposed monitoring process and the contents of the quarterly monitoring return).

To enable the franchisor to meet these obligations, it will need to create a performance culture amongst its employees through a selective programme of new hiring, additional training for staff and by linking senior executives' remuneration more explicitly to the overall results achieved by the market (see Section 6 for further details of the franchisor's organisation structure).

**Confidentiality of information**

The franchisor will respect the confidentiality of all information supplied by franchisees unless that information is already in the public domain. For the franchisor to perform its role, it is essential that franchisees provide it with timely and accurate information. Franchisees must therefore have the utmost confidence that confidential information will neither find its way into the public domain nor be shared with other franchisees. Given the existence of the Central Fund, however, it is appropriate that for every syndicate managed by a franchisee certain financial information (broadly equivalent to the current syndicate quarterly return) is made available to the other franchisees. The level of that disclosure will be considered in the months ahead.

The franchisor will also issue guidance covering the required level of disclosure by franchisees to members' agents and members.

## 3.5 OBLIGATIONS OF THE FRANCHISEES

*each franchisee will owe a duty to the franchisor to operate its business in accordance with the Franchise Principles of Relationship*

The franchise structure will also involve new obligations on franchisees. It is proposed that each franchisee will:

- owe a duty to the franchisor to operate its business in accordance with the Franchise Principles of Relationship. This is the overriding obligation
- promote and protect:
  - the brand and reputation and rating of Lloyd's, including standards of service
  - the security behind Lloyd's policies, including the mutual security of the Central Fund and the security ratings of the market
  - Lloyd's licences to underwrite insurance in the UK and overseas
- prepare an annual business plan for each of its syndicates in accordance with the long term profitability target and the underwriting and risk management guidelines. It will be expected to operate in accordance with that business plan and to report performance against plan as required by the franchisor
- use its best endeavours to alert the franchisor, in advance, of announcements on matters which will affect the franchise. This is particularly relevant where the brand and reputation of the franchise are likely to be affected by such announcements.

**Confidentiality of information**

Mirroring the confidentiality obligations of the franchisor, each franchisee will maintain confidentiality on all information received from the franchisor unless it is already in the public domain.

*the franchisor will publish guidelines with which it expects franchisees to comply covering underwriting and risk management issues and standards of service*

## 3.6 GUIDELINES FOR FRANCHISEES

The franchisor's central goal is to improve the profitability and management of risk in the market. This means that every franchisee should manage its business professionally and responsibly to create attractive returns for all capital providers whilst protecting the interests of policyholders. It also means that each business should control the risks to which it is exposing itself and the market. The CSG recommends, therefore, that guidelines should be provided to franchisees to help them optimise and, where necessary, improve the performance of their syndicates.

The Franchise Performance Management Group (FPMG) was established in February 2002 to develop, amongst other things, these guidelines. The FPMG believes that the guidelines represent simple, straightforward and sensible parameters within which franchisees should operate. They are based on sound business practices seen in the insurance market today. They may change in the future as the insurance industry and the Lloyd's market evolve.

*if a franchisee wishes to operate outside the guidelines, it will need to discuss its position in advance with the franchisor*

It is the CSG's belief that if franchisees operate in line with the specified guidelines, the market's profitability will improve significantly and its exposure to significant catastrophe losses, for example, will be more controlled. Each franchisee, therefore, would be expected, under normal circumstances, to operate its business within the guidelines. If a franchisee wishes to operate outside the guidelines, it will need to discuss its position and agree in advance with the franchisor the way it wants to operate and why it is beneficial to operate outside the guidelines.

It is important to emphasise that it is not intended that the guidelines should be blindly applied by the franchisor to every syndicate, and on every line of business, if they can be shown to be inappropriate. In this context, it should be noted that some of the guidelines may not be appropriate for some market sectors (for example, motor) given the way business is written in that particular sector. Discussions will continue with the Lloyd's Motor Underwriters Association (LMUA) to establish relevant guidelines.

The proposed guidelines are:

**Profitability by product line**
The CSG fully recognises the cyclical nature of insurance and acknowledges that constant profit levels are not a realistic expectation every year. That said, it believes that if a line of business cannot be written profitably through the cycle, there can normally be few reasons for writing it. The first guideline is therefore aimed at profitable underwriting:

> "There should be a reasonable expectation of making a gross underwriting profit on each line of business every year."

**Catastrophe exposure**
Lloyd's has experienced significant losses in the past due to catastrophic events. The market should and will continue to underwrite such risks in the

future. However, improved analytical approaches and more controlled risk exposure guidelines are required to limit the exposure of each syndicate and the market as a whole to such catastrophe risks. For the underwriting of catastrophes, the following guidelines are proposed:

> (a) "Catastrophe exposure should be analysed using tools or methods that are approved by the franchisor."

The franchisor will not mandate the use of specific catastrophe modelling tools or software. Each franchisee, however, will be required to show that it uses one, or a selection of, analytical tools or techniques that, together, give a thoughtful and objective picture of the exposures they have.

> (b) "Each franchisee should manage to a minimum return period agreed by the franchisor."

The franchisor will propose a return period for each major class of catastrophe exposed business that each franchisee should manage to.

> (c) "The maximum gross and net exposures to a single Lloyd's specified Realistic Disaster Scenario (RDS) event for a syndicate are up to 75% and 20% of syndicate capacity respectively."

The capacity (and hence capital) of any syndicate should not be threatened to a considerable extent by any one RDS event. Franchisees cannot be allowed in future to risk unreasonable exposures to their syndicates' own capital or the Central Fund in this way.

**Reinsurer selection**

The market uses considerable amounts of reinsurance which is placed principally with external parties. The security of the companies providing this cover is of great importance to both syndicate and market results. Syndicates are obliged to place their reinsurance with reputable, secure providers. To ensure this is the case, the following guideline is proposed:

> "Each franchisee should have an approved reinsurer selection process"

Each franchisee will be required to demonstrate to the franchisor that it has a comprehensive process in place to select its reinsurance providers. The FPMG thought it less effective to specify the minimum ratings required for providers, as there are a number of other criteria that need to be considered in selecting reinsurance cover.

**Gross line size**

The CSG believes syndicates should use their capacity across a relatively large set of uncorrelated risks. Individual risks should not be allowed to threaten large portions of a syndicate's capital. The following guideline is therefore proposed:

> "The maximum gross line that a syndicate should have on an individual risk is 10% of capacity."

### Reinsurance leverage

Excessive use of reinsurance can be against the best interests of the market and policyholders. Large gross exposures for relatively small syndicates are likely to be inappropriate. This is true even if net exposures are small, due to the credit risk associated with the reinsurance cover. Syndicates should principally be concerned with the gross underwriting profitability of the business they write rather than relying on cheap reinsurance cover to compete at uneconomically low premium prices. This will not, however, preclude the purchase of defensive facultative reinsurance to cover specific risks in particular circumstances. The following guidelines are proposed:

(a) "Each syndicate should retain a net minimum amount of exposure on each risk (e.g. 10% of gross line)."

(b) "No syndicate should pursue an aggressive arbitrage strategy (e.g. building business using inadequate pricing on the back of reinsurance)."

### Multi-year policies

The market underwrites a considerable amount of business that covers risks over a number of years. This business has not always been underwritten prudently. Furthermore, where there is no option to cancel a policy, often this business has not been recorded as multi-year business. The following guidelines are proposed:

(a) "Non-cancellable policies covering a period of greater than 18 months should be recorded as multi-year policies."

(b) "Multi-year policies should either have matching reinsurance cover or be limited to the agreed maximum net exposure to the class of business as set out in the syndicate's business plan."

Syndicates will expose themselves and the market to potential losses if multi-year reinsurance is not arranged up-front, or if sufficient capital is not available to cover the gross risks. The risk to the market from multi-year policies is particularly acute when a syndicate goes into run-off.

### Overall market dominance by a franchisee

It is not in the best interests of the market's solvency for any one franchisee to dominate. Such a franchisee could also potentially exert considerable influence over the franchisor and alter the dynamics of the market. Currently, there is no managing agent that is in such a position. The following guideline is proposed:

> "No franchisee should control more than 15% of the overall market capacity without the prior agreement of the franchisor."

### Dealings with brokers

Brokers are important and valuable business partners for franchisees. The financial implications of dealing with brokers are vital to the future profitability of *the CSG believes that if Lloyd's is to offer first class service to policyholders then the LMP initiatives need to be strongly supported and reinforced*

Lloyd's. Franchisees should be constantly aware of the financial impact of both commissions paid and premium income receivables arising out of their broker relationships. The following guideline is proposed:

> "All broker commissions and charges should be included in the profit and loss account submitted to the franchisor."

**Service standards**

The market must strive to provide the best possible service to its policyholders. There is much improvement needed in the areas of policy production and the payment of premiums and claims. The LMP programme has already made considerable progress in identifying the practical steps to achieve this improvement and the CSG believes that if Lloyd's is to offer first class service to policyholders then the existing LMP initiatives need to be strongly supported and reinforced. The following guideline is therefore proposed:

> "Each franchisee should adhere to the service standards covering policy production and premium and claims payment as defined by LMP."

Looking ahead, it is also proposed that the Franchise Board will work with the LMA and the London Market Insurance Brokers' Committee to set specific guidelines around service standards. The FPMG has suggested that one such guideline should be:

> "All policies should contain wording that allows cancellation to be forwarded directly to the policyholder should premiums be overdue (where legally possible)."

The Franchise Board will also consider the impact of other initiatives (for example, lloyds.com) to assess the potential for incorporating them into future guidelines.

Overall, the franchise proposals and the guidelines are designed to improve the market's performance which will provide policyholders with better security and standards of service. Where necessary, Lloyd's will discuss the implementation of the arrangements with the Office of Fair Trading.

### 3.7 THE NEW BUSINESS PLAN

The franchise aims to be a collection of successful, well managed, independent franchisees. Each franchisee will be free to decide which types of business it wishes to write. However, the franchisor will expect each franchisee to plan forward its business mix, resources, activities and financial results. Consequently, it is proposed that each syndicate submit an annual business plan to the franchisor, supported by robust statistical analysis with actuarial input where relevant. Appendix 3 contains an overview of the key contents of the syndicate business plan. Discussions are ongoing with the LMUA to ensure that any necessary adaptations to the content of the business plan to cover motor specific issues are made.

*a major opportunity to rationalise the frequency and manner in which information and data is collected*

**Reduction in the number of returns made to Lloyd's**

The introduction of the new business plan and the quarterly monitoring return has presented a major opportunity to rationalise the frequency and manner in which information and data is collected from managing agents. At present, managing agents are required to make 78 different returns to Lloyd's every year, not including those required by external regulators. Under the new regime, that number is expected to reduce to below 30.

**Compliance with the guidelines**

It is proposed that each franchisee compile its syndicate business plan within the guidelines set by the franchisor. If a franchisee wishes to operate outside the guidelines, it will need to justify its position and obtain approval from the franchisor.

As part of the business planning process, it is proposed that the franchisor will also take a view on where the market is in the insurance cycle and conclude how much business can be profitably written in the year ahead. As a result, it will provide guidance to syndicates on their growth rates. Where a syndicate's business plan indicates that it wishes to increase capacity in excess of that rate, it will need to justify its position.

*business plan parameters will allow a franchisee a reasonable degree of flexibility*

**Business plan parameters**

The CSG recognises that it will be difficult for franchisees to know with certainty the classes and amounts of business that it proposes to underwrite prior to the outset of each underwriting year. The CSG is also concerned not to stifle innovation or prevent subsequent changes or modifications to business plans which are necessary and commercially justified. Accordingly, a franchisee will be expected to specify the parameters within which it proposes to underwrite. The parameters will allow a franchisee a reasonable degree of flexibility, depending on its underwriting record, to modify the business which it actually underwrites. Parameters will cover, but not be limited to, the following:

- an increase in capacity in a line of business
- an increase in both gross and net catastrophe exposure
- the percentage of capacity that the syndicate may want to write in a new line of business.

*the franchisor will review and, if appropriate, approve each syndicate's business plan*

**Approval**

The franchisor will review and, if appropriate, approve each syndicate's business plan. It will compare each plan with historical syndicate results, overall market results and internal and external forecasts. The franchisor will also approve the parameters within which the syndicate may operate, based on, amongst other factors, past performance and the current capabilities of the syndicate. It is likely to approve a more accommodating set of parameters for a historically strongly performing syndicate. Conversely, a new syndicate is unlikely to be allowed such wide parameters within which to operate.

Where the franchisor is concerned about the viability of a syndicate's business plan, it will discuss its concerns with the franchisee, provide information to support them, and review any potential improvements suggested by the franchisee. It is through this facilitative process that the franchisor will be able to help prevent potentially underperforming syndicates from lowering the profitability of the franchise.

### 3.8 PERFORMANCE MONITORING

*underperformance will be identified as early as possible and corrective action taken*

The franchisor will work with franchisees to help them achieve, or exceed, the targets in their business plans. In this way, the performance of the market will be managed in a much more proactive manner than at any time in the past. Underperformance will be identified as early as possible and corrective action taken, if at all possible, to protect capital providers and policyholders.

To do this, there will be regular review and discussion sessions between the franchisor and each of the franchisees. To prepare for these sessions, franchisees will submit a quarterly summary of their actual syndicate results to the franchisor (Appendix 4 contains an overview of the content of the quarterly monitoring return).

The franchisor will monitor each syndicate's actual performance against its approved business plan and against the actual results for similar types of business written elsewhere in the market. The existing tools and techniques used by the Market Analysis Department will play an important role in this process. If the quarterly results of the syndicate are different to those of other similar syndicates, the franchisor will discuss the reasons behind the performance with the franchisee and review any potential improvements suggested by the franchisee. If the franchisee does not respond to this facilitative approach, the franchisor can require the franchisee to take corrective action (see Section 3.9).

Where a franchisee intends to, or has inadvertently begun to, operate outside the agreed parameters in its syndicate's business plan it should notify the franchisor as soon as is practicable.

### 3.9 PRESCRIPTIVE LEVERS AND MARKET LEVERS

*if a franchisee does not respond to the facilitative approach, the franchisor is able to, and will be prepared to, take appropriate action*

The franchisor will provide significant encouragement and assistance to each syndicate to produce profitable business plans that can be achieved. Assistance will also be given to help franchisees improve the results of their underperforming syndicates. If, however, a franchisee does not respond to the facilitative approach, the franchisor is able to, and will be prepared to, take appropriate action. Examples of such action include:

- conduct a detailed and invasive review of the franchisee and its syndicates

- impose suitable constraints on the franchisee, e.g. limit underwriting for the rest of that year on a particular line of business and/or for the subsequent year
- impose other requirements, e.g. require the franchisee to purchase additional reinsurance to cover over-exposure to an RDS on a net basis
- ultimately remove the franchisee from the franchise.

There may also be situations where the overall market becomes exposed to excessive risks. In such instances, the franchisor may take action to protect the market as a whole. An example would be aggregate over-exposure to a particular reinsurer.

## 3.10 DISPUTE RESOLUTION

*a process designed to encourage speedy resolution of problems and grievances*

The franchisor will at all times encourage an open discussion on issues relating to each syndicate's business plan and actual performance. This facilitative approach is critical to the smooth operation of the franchise and is aimed at building a mutually supportive and positive relationship between the franchisor and the franchisees.

In the event that agreement cannot be reached on any issue, it is proposed that a franchisee may pursue the matter further with the Franchise Performance Director. If there is still disagreement, the franchisee can ask the Franchise Board to review the matter. If the Franchise Board believes such a review is appropriate and necessary it will ask the independent directors of the Franchise Board to re-examine the issues and, if appropriate, hear representations from the franchisee before reaching its decision.

This process is designed to encourage speedy resolution of problems and grievances within the normal operation of the franchise. The existing Appeals Tribunal, which ultimately provides franchisees with a limited right of appeal against certain decisions, will remain in place.

## 3.11 TIMETABLE FOR THE INTRODUCTION OF THE FRANCHISE STRUCTURE

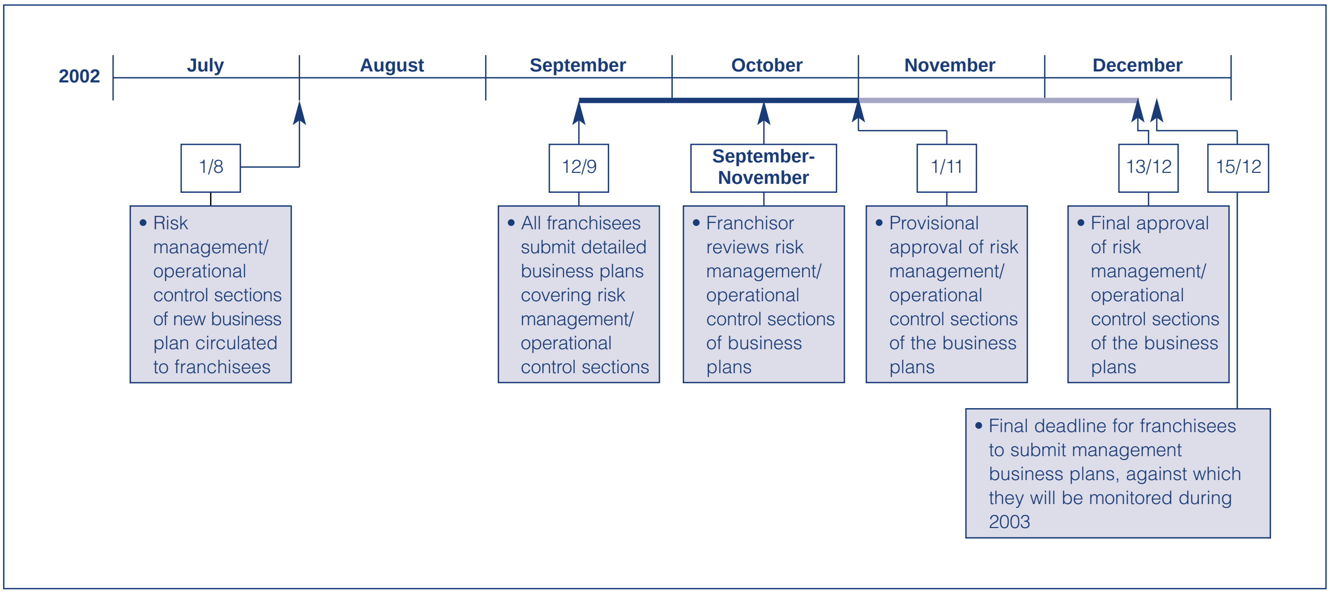
*the new franchise structure should be introduced as soon as possible: franchisees will be expected to operate their syndicates within the guidelines set by the franchisor for the 2003 year of account*

The new franchise structure and all it entails should be introduced as soon as possible to help improve the results of the market. There is a practical limit, however, to the pace at which the necessary changes can be introduced – for example, it is intended that the new business planning and monitoring process will be introduced over the next 18 months.

Franchisees will, however, be expected to operate their syndicates within the guidelines set by the franchisor for the 2003 year of account (see Section 3.6). Where a franchisee wishes to operate outside the guidelines, it will need to discuss the matter with, and obtain approval from, the franchisor prior to writing the business.

## Annual business plan

This year, each franchisee will be required to submit the Risk Management and Operational Controls sections of the newly designed business plan for each of its syndicates in September 2002. The Commercial Performance sections of the new business plan will not need to be submitted this year. Instead, each franchisee will submit a management business plan for each of its syndicates for 2003. These plans will show how the syndicates intend to operate next year. This is illustrated below.




The 2002 timetable for the submission of syndicate business forecasts and regulatory business plans and for Risk Based Capital (RBC), capacity auctions and coming into line will operate as previously planned.

The new business planning process will be fully implemented during 2003 (for the 2004 year of account onwards). Consequently, the RBC, capacity auctions and coming into line timetable may need to change slightly to accommodate the new process next year.

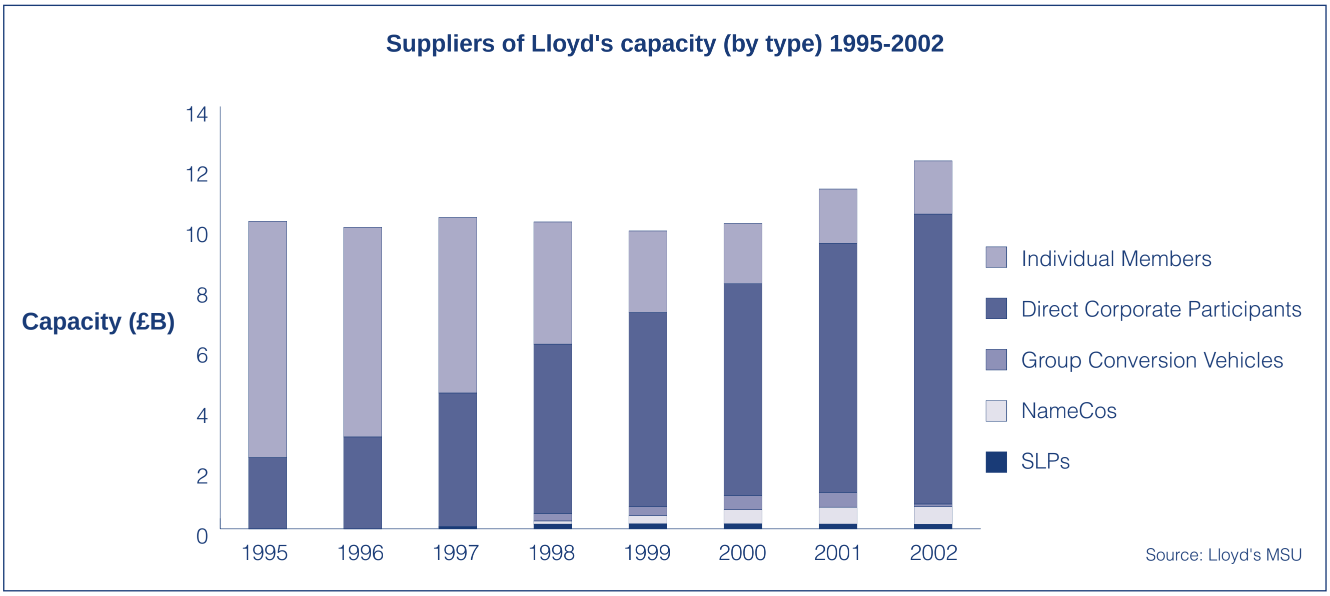
## Quarterly monitoring

In terms of the quarterly monitoring process, the franchisor will begin monitoring in 2003. Each syndicate will be required to submit actual performance information on a quarterly basis via the Risk Management and Operational Controls sections of the quarterly monitoring return. Each syndicate will also be monitored against its management business plan. The full quarterly return, including the Commercial Performance section, will be submitted from 2004 onwards.

# 4. CAPITAL STRUCTURE

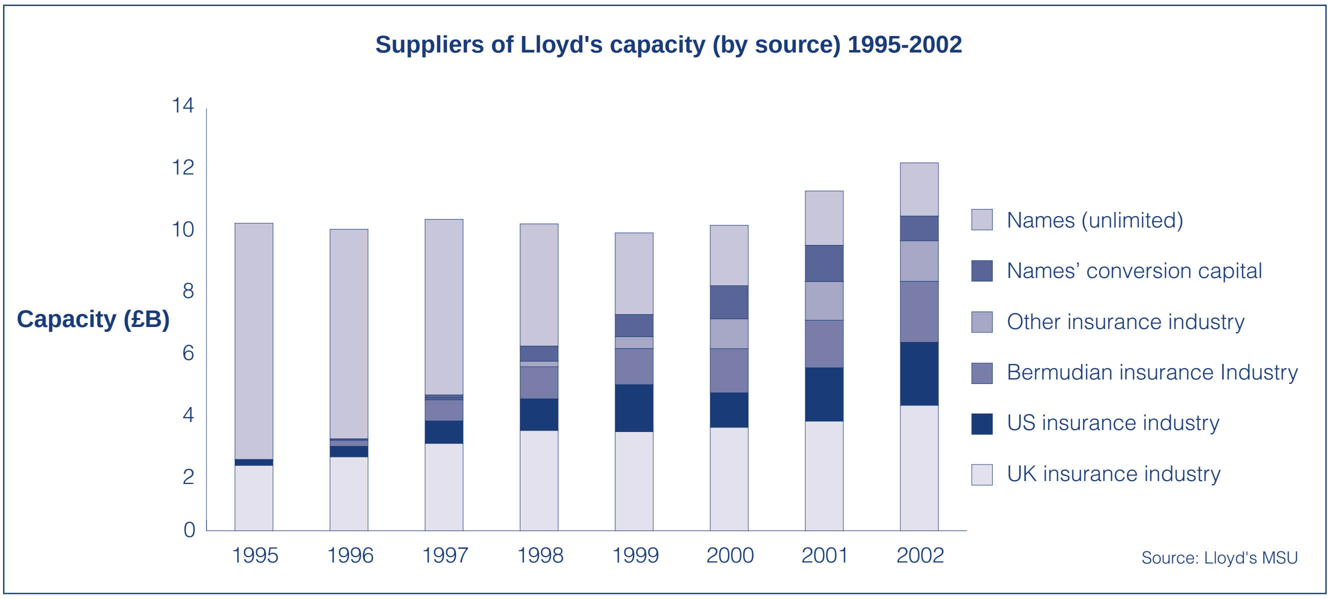
## 4.1 INTRODUCTION

Lloyd's capital structure has changed significantly in recent years:




*Lloyd's must continue to attract a strong capital base from a wide range of sources*

In formulating its original capital structure proposals, the CSG recognised these trends. It also realised that if its overall objective of ensuring Lloyd's competes successfully in the global insurance market was to be achieved, Lloyd's must continue to attract a strong capital base from a wide range of sources.



Some have suggested that the CSG's original capital structure proposals were aimed at removing private capital from the Lloyd's market. That was never the CSG's intention. The CSG's objective was to achieve efficiency of capital provision and improved returns on that capital. In particular, the original proposals were aimed at making the Lloyd's market more transparent and attractive to new capital providers.

The rest of this section sets out the current capital structure proposals resulting from the consultation with the Capital Liaison Group, the Third Party Capital Representatives Group and from wider feedback.

## 4.2 INTRODUCTION OF ANNUAL ACCOUNTING

*Lloyd's should move from the current three-year accounting basis to annual accounting*

The CSG proposed that Lloyd's should move from the current three-year accounting basis for both syndicates and the Lloyd's global accounts to annual GAAP accounting as soon as possible.

**Benefits of annual accounting**

The main benefits of annual accounting are:

- **greater transparency and comparability:** annual accounting will improve the transparency and comparability of Lloyd's syndicates with their global peer group. At present, policyholders, brokers, external commentators and the media often struggle to compare syndicates' three-year results with the annual results of the majority of the peer group and so any positive performance can be obscured. In this context, when Lloyd's reported its global results on a proforma annually accounted basis for the first time earlier this year, it was well received by market commentators and in the press.

  Furthermore, under annual accounting bad results tend to be reported once, compared to three-year accounting where figures in respect of a year of account are reported several times.

- **profit distribution:** under annual accounting, profits may be distributed at the 12 month point of a year of account, allowing a member of a syndicate to receive profits earlier than under the current three-year accounting regime. This is attractive to both existing and new capital providers. In particular, annual accounting enables profits to be used to support ongoing underwriting sooner than the three-year accounting system.

  Whilst it is clearly commercially attractive to receive profits quickly, it is imperative that members of Lloyd's are demonstrably solvent at all times. As a result, any annual distribution of profits would, as now, be subject to members having met all Lloyd's funding and solvency requirements. Furthermore, with the majority of reinsurance costs falling in year 1, much of a syndicate's profit is not capable of recognition until years 2 and 3 of a year of account. Consequently, profit distribution is likely to be accelerated by one year rather than two.

- **reduced workload and costs:** at present, results have to be calculated and reported on at least two bases, sometimes three (UK GAAP, US GAAP, and Lloyd's three-year accounting rules). For syndicates that are fully aligned this could be reduced to a single set of accounts.

*the introduction of International Accounting Standards facilitates the move to annual accounting*

### International timetable for annual accounting

Following the coming into force of the EU Regulation on International Accounting Standards in June 2002, the accounting regime for all EU quoted companies is to change from 1 January 2005 with the requirement that they prepare their consolidated accounts in accordance with International Accounting Standards (IAS). This will require annual accounting even though some of these standards, in particular those applying to insurance contracts, have yet to be finalised. The IAS standard on insurance contracts is expected to be introduced by 2007. Thus, there is expected to be a period (2005-2007) when insurance companies prepare their accounts so far as possible in line with the draft IAS standard, ahead of its formal ratification.

It appears that certain EU Member States (including the UK) may extend the application of the EU Regulation to all regulated entities and this would include both Lloyd's and Lloyd's syndicates. In due course, the EU Insurance Accounts Directive will be amended to be consistent with IAS. Although the timing of these changes is not certain at this stage, a provisional timetable is:

### Provisional timetable for the introduction of annual accounting

| DATE | EVENT |
|---|---|
| June 2002 | EU Regulation imposing IAS on public companies by 2005 (IAS Regulation) |
| 2003 | Publication of exposure draft on IAS Insurance Contracts |
| 2003/2004 | FSA extend IAS requirements to regulated entities |
| 1 January 2005 | IAS Regulation supplements EU Directive for publicly quoted insurance companies (2 year transition period) |
| 2007 | IAS on Insurance Contracts published |
| 2007/2008 | EU Insurance Accounts Directive amended |

Accordingly, irrespective of the CSG proposals, Lloyd's will need to adapt its reporting regime to meet the new IAS or seek exceptions where appropriate.

In general terms, the introduction of IAS (and their extension in the UK to regulated entities) facilitates Lloyd's move to annual accounting. Lloyd's will, however, take a proactive role in the development of the IAS proposals to ensure its provisions are applied logically to the Lloyd's market.

*to ensure the 2005 target is met, Lloyd's will press for amendments to the EU Accounts Directive*

**Proposal for the implementation of annual accounting at Lloyd's**

In light of the above, it is proposed that the main market **reporting** regime will be on an annual accounting basis from 1 January 2005 subject to an amendment to the EU Accounts Directive. All syndicates will operate on a dual reporting basis until the Directive is amended. Syndicates would also adopt the IAS on insurance contracts when it is introduced. Until then, it is proposed they would adopt the extant IAS so far as is practicable.

In terms of the **distribution of profits**, at present the Annex to the EU Accounts Directive requires syndicates to reinsure to close not earlier than at the end of 36 months. This means that profits cannot be distributed until then. It is proposed that this stipulation should be removed. When this is achieved, there will be no Lloyd's specific external rules relating to distribution with which syndicates will have to comply. This will impact members and syndicates in different ways:

- syndicates which are either single member corporate syndicates or whose members are all part of the same group will be able to move to an annual basis of distribution once the relevant provisions of the EU Accounts Directive currently preventing this are removed. Effectively the syndicate would be calculating its distributable result on the same basis as an insurance company.
- syndicates that have spread capital (i.e. where third party capital providers participate) will also be required to move to annual accounting for reporting purposes but for the purposes of distributing profits, they will need to maintain a parallel three year accounting system. The profit for distribution purposes for spread capital would be calculated on the same basis as now, i.e. by striking a reinsurance to close at 36 months.

  In order to enable as many market participants as possible to obtain the benefits of annual accounting, two methods have been identified by which aligned corporate members supporting spread syndicates can also account and distribute on an annual basis: the existing corporate parallel syndicate approach and a dual capacity syndicate approach whereby a syndicate has shared underwriting but split investments. In accounting terms, both these approaches are feasible but the financial, legal and practical implications require further analysis.

*two methods have been identified by which aligned corporate members supporting spread syndicates can also account and distribute on an annual basis*

To ensure the 2005 target is met, it is proposed that Lloyd's will press for amendments to the EU Accounts Directive (more specifically, to the Annex to the Directive) with both the UK Government and the European Commission as a precaution against delays in the EU/IAS timetables for change. These discussions will take into account the need to ensure certain existing provisions relating to Lloyd's structure in the Annex are retained, irrespective of the fact that the provisions relating to the accounting regime will be superseded by the IAS.

*it remains the intention to permit the early release of surpluses for use as underwriting capital prior to the full introduction of annual accounting*

**Interim measures before annual accounting is fully introduced**

As part of its recommendation on annual accounting, the CSG suggested that the early release of surpluses for use as underwriting capital should be considered as an interim measure to be introduced before annual profit distribution is available.

Lloyd's is currently considering the coming into line requirements for the 2003 year of account in liaison with members' agents and major corporate investors. The impact of any amendment to the requirements is being modelled and Lloyd's is in frequent liaison with the Financial Services Authority (FSA) on the matter. Lloyd's will advise the membership of the coming into line requirements and timetable for 2003 by the end of July.

With respect to the coming into line exercise for 2004 and 2005, ideas under consideration include:

- **cash release:** under the terms of the Premiums Trust Deed, surplus assets held at syndicate level may be transferred to a member's personal reserve fund provided the managing agent is satisfied that it is prudent. These funds can be used to support ongoing underwriting and to pay losses, but cannot be released to the member. This type of mechanism was used successfully in 1994 and 1995.
- **credit in the Risk Based Capital (RBC) calculation:** for coming into line purposes, a credit for future profits may be included in the RBC calculation, reducing the level of funds at Lloyd's that the member would have to provide for the next year, assuming that the RBC was higher than the minimum requirement. There would be no direct liquidity impact for the syndicate but it would not assist the member with the payment of losses.

The final choice will depend upon a variety of factors, some of which cannot be fully assessed until closer to the time of implementation (for example, the impact of the coming into line requirements for the 2003 year of account). Consequently, although it remains the intention to permit the early release of surpluses for use as underwriting capital prior to the full introduction of annual accounting, it is proposed that the exact mechanism is agreed with the FSA closer to the time of implementation.

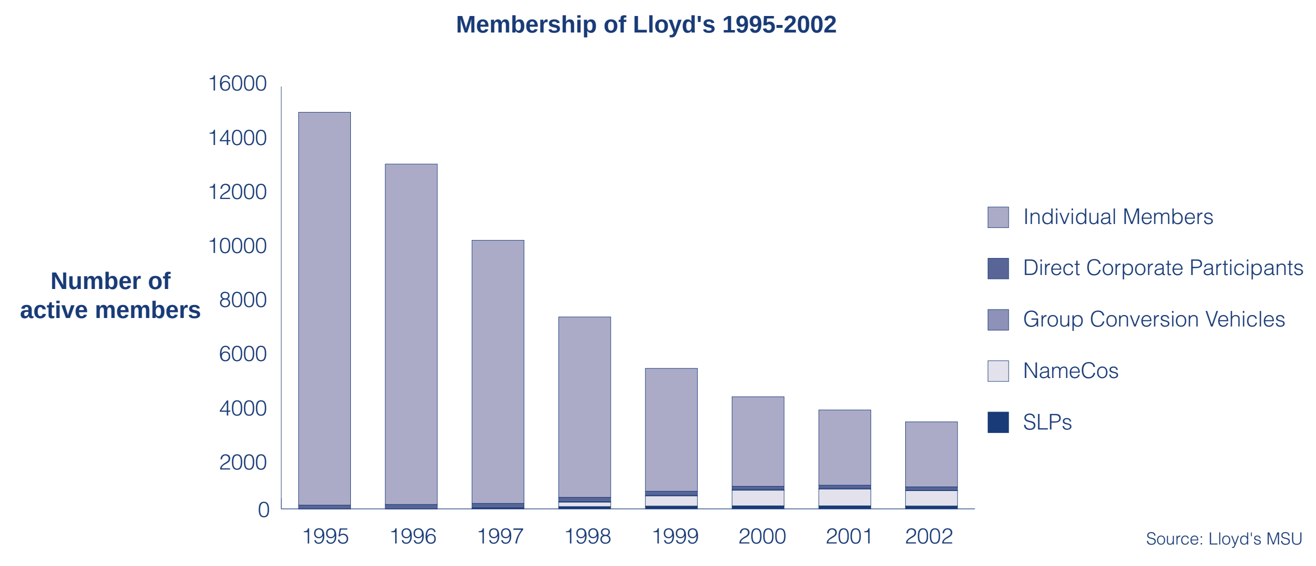
**Move to annual accounting – transition process**

It is intended that the 2005 calendar year will be the first year when distribution will be on an annual accounting basis. To achieve this, transitional provisions will be needed to clarify the rules applying to the 2003 and 2004 years of account. Various approaches to this transition will be considered in detail in the months ahead, balancing the impact on syndicates and members to ensure a fair solution is implemented.

*there is general acceptance that it is appropriate to stop admitting new unlimited members from 1 January 2003*

## 4.3 AN END TO PARTICIPATION ON AN UNLIMITED LIABILITY BASIS

The CSG is of the view that it is no longer appropriate for members to put all their personal wealth at risk given the risk profile of the global speciality insurance and reinsurance business. The presence of both limited and unlimited members in the Society also creates complexities and tensions as a consequence of the financially mutualised nature of the market.
The number of members participating on an unlimited liability basis has been in steep decline since the introduction of limited liability membership. Although the decline in the number of individual members appears now to have levelled off, no new unlimited members are being attracted to Lloyd's.




The CSG's original proposals were that:

- no new unlimited liability members would be admitted to the market from 1 January 2003
- no member would be able to participate on an unlimited liability basis from 1 January 2005.

**No new unlimited liability members**
Initial consultation revealed that in recent years members' agents have not actively recruited new unlimited liability members and they have no plans to do so in the future. Members' agents have noted that individuals with the wealth to become members are no longer prepared to take on unlimited liability. As a consequence, there is a general acceptance that it is appropriate to stop admitting new unlimited members of Lloyd's from 1 January 2003.

**Existing unlimited liability members**
The proposal to require existing unlimited liability members to convert to limited liability forms of participation has proved more difficult to achieve quickly.

Consultation established that the UK tax system is a major factor inhibiting individual members from converting to limited liability, most notably the inability to carry forward unused tax losses against income derived from limited liability underwriting. Work on a sample of individual members showed that, on various assumptions, a substantial minority of UK resident members and a majority of overseas members were likely to have unused UK trading losses after the closure of the 2004 year of account. If these losses cannot be relieved, they act as a substantial disincentive to convert to limited liability participation.

This was not the only tax issue that was raised during consultation but it was the one raised most often. As a result, Lloyd's has discussed the issue with HM Treasury and with the Inland Revenue pointing out that most unincorporated sole traders who transfer their business to a company are able to carry losses forward against their future income from that company. Lloyd's will continue to press for a satisfactory change in tax law to facilitate the conversion of unlimited liability members.

The consultation process also established that there was little support amongst members or agents for mandatory conversion of unlimited members by 2005. Consequently, it is proposed that Lloyd's should concentrate its efforts on removing the obstacles that inhibit voluntary conversion.

### 4.4 A NEW MECHANISM FOR THE PARTICIPATION OF THIRD PARTY CAPITAL

The CSG's original proposals included the introduction of a new vehicle through which third party capital providers would participate in the market from 2005. The requirement for this new vehicle was driven by the view that a move to annual accounting would preclude third-party capital providers from participating directly on syndicates in the way that they do today.

The CSG considered that it was important that the new form of participation should as far as possible retain the key features of an individual member's current trading status whilst removing the existing agency relationship between the managing agent and the third party capital providers. The Single Reinsurance Syndicate (SRS) structure was identified as most closely meeting these objectives.

Under the SRS proposals, from 1 January 2005 each existing syndicate would have been supported by a single capital provider, or 'host' member. Third party capital providers would have participated on a bespoke basis through the SRS that would have provided fixed term (for example, two year) whole account quota share reinsurance contracts to host syndicates. Third party capital providers' reinsurance contract with the relevant host syndicate would have been brought to an end and exit achieved either when the reinsurance contract was commuted or by novation during the term of the contract.

*a new vehicle for existing third party capital providers is not required*

During consultation, several significant issues were raised both by managing agents and third party capital providers regarding the SRS structure. In light of these concerns and bearing in mind that the evolution of the annual accounting proposals means that third party capital can continue to participate on syndicates alongside aligned capital, the CSG recognised that a new vehicle for existing third party capital providers is not required.

### 4.5 A TRANSITION MECHANISM FROM THE CURRENT CAPITAL STRUCTURE

To facilitate the implementation of the other capital structure proposals, the CSG recommended a transition from the current basis of capital provision, based on the agency agreements and direct participation of third party capital, to a new basis in which all agents and syndicates would become integrated Lloyd's vehicles (ILVs). The suggested approach was "sale and leaseback", a deferred buy-out of all third party capacity (i.e. existing third party capital's security of tenure) with effect from 1 January 2003.

Consultation elicited clear feedback that the sale and leaseback proposal should not be taken further. A number of concerns were raised by both managing agents and third party capital providers. Most notably, there was a perceived substantial difference of opinion between third party capital providers and managing agents on the fair value of syndicate capacity.

*the original "one size fits all" approach has been replaced by one in which the specific needs of different groups of managing agents are matched with the requirements of capital providers*

Taking account of the feedback, the original "one size fits all" approach has been replaced by one in which the specific needs of different groups of managing agents are matched with the requirements of capital providers. Specifically, it is proposed that:

- the capacity offer and minority buy-out rules remain unchanged
- for 2003 and beyond, changes should be introduced, intended to facilitate migration by aspirant ILVs to full alignment, as follows:
  - as part of the new franchise structure, a new Capacity Transfer Panel will be created to exercise Council's existing byelaw powers (see Section 5)
  - mediation will be encouraged in order to assist the negotiation process before an offer is made. Lloyd's will create a central panel of potential mediators to assist with negotiations
  - new ways of structuring offers for capacity have been recognised and will be accommodated under the existing or amended rules. These include "earn-out" arrangements (whereby agents acquire capacity by achieving agreed future profit targets), sale and leaseback arrangements at syndicate level (i.e. a deferred buy-out with an up-front agreed cash payment) and the use of put and call options to price capacity (i.e. a put price at which members can require the managing agent to buy their capacity and a call price at which the managing agent can require the sale of that capacity).

*Lloyd's recognises the need for a review of the options for closure of run-off years*

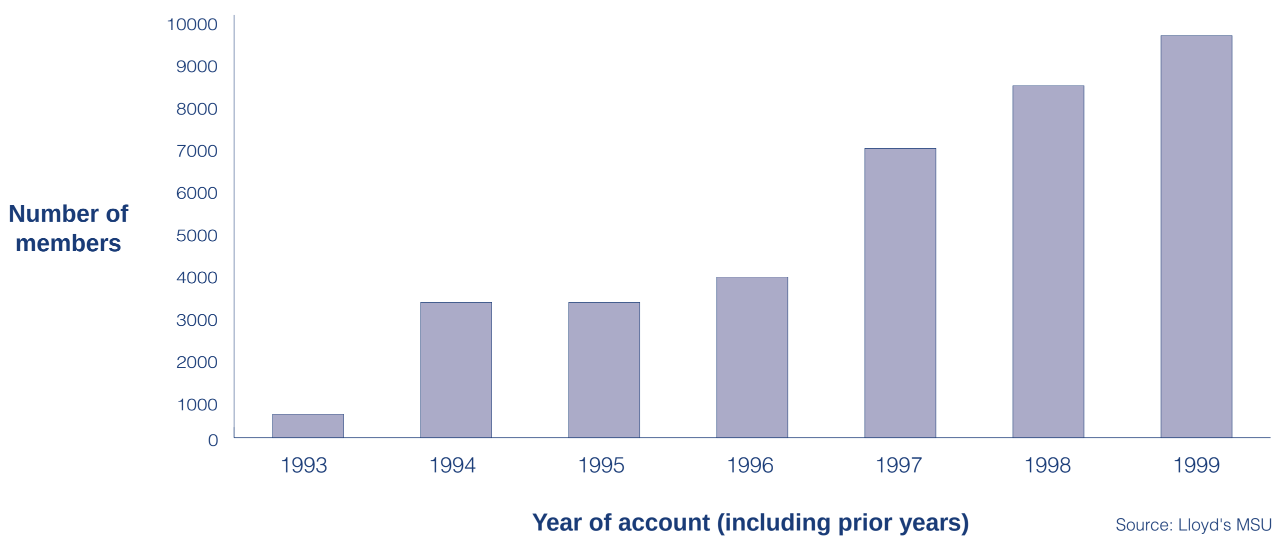
## 4.6 RUN-OFF YEARS

The number of run-off years (i.e. years of account which are left open after 36 months rather than being reinsured to close in the normal way) has increased recently. Managing agents have found themselves unable to close certain years of account, principally as a consequence of inherent uncertainties relating to the quantification of liabilities and dispute resolution. As at 31 December 2001, there were 75 run-off years of account. The losses on the 2000 and 2001 years of account are likely to cause an increase in the number of run-off years.

Lloyd's recognises the need for a review of the options for closure of these run-off years. In particular, their closure will:

- allow resigned members only on run-off years to cease their membership and have their funds at Lloyd's released
- free the market from the administrative and financial consequences of the accumulation of run-off years, particularly in relation to administration costs
- act as an incentive to new capital to enter the market
- enable the whole market to focus on the future.

**Cumulative number of members affected by run-off years (as at 31 December 2001)**




Source: Lloyd's MSU

The chart above shows the number of members affected by run-off years. It demonstrates, for example, that by closing the nine 1996 and prior run-off years of account as at 31 December 2001 nearly 4,000 of the 9,500 members, who have resigned and have only run-off years, could be released from Lloyd's once all their remaining liabilities have been met.

It is important to note that the current environment is very different to that experienced by Lloyd's in the early 1990's, immediately prior to the creation of

Equitas. At that time, there were a number of specific problems affecting a large number of syndicates (e.g. long-tail asbestos and pollution liabilities), whereas today the run-off challenge facing Lloyd's is the result of a more varied set of issues impacting fewer syndicates. Consequently, an 'Equitas-type' solution is not applicable. Nevertheless, it is recognised that some of the techniques adopted by Equitas during and since its formation may usefully be applied to streamline the cost and improve the effectiveness of run-off activity.

**Run-off proposals**

The aim is to achieve a commercial solution, with run-off years being dealt with on a rolling basis as the relevant years mature and as the key issues preventing an equitable resolution are addressed and more accurate quantification of liabilities is achieved. A fair reinsurance to close (RITC) can then be effected. Close attention will be paid to years of account which appear to be left open for administrative, cashflow or capital reasons.

The principal elements of the proposed strategy, underpinned and facilitated by central intervention where necessary, are to:

- facilitate prompt closure of the 1996 and prior run-off years of account through an RITC proposal covering all these years
- develop a structure to facilitate the equitable and prompt closure of the later years
- strengthen Lloyd's oversight of run-off management.

A dedicated team of Lloyd's staff, supported by a firm of brokers with relevant expertise is taking this work forward.

## 4.7 OTHER RELATED ISSUES

**The future for Integrated Lloyd's Vehicles (ILVs)**

Much work has already been done over the course of the past three years to introduce changes for ILVs. The franchise proposals offer a new opportunity for the franchisor to manage its relationship with franchisees on a more flexible basis – for example, the new business plan could be submitted later in the year than under the current business timetable. This will allow franchisees greater time to plan future business.

*a further review to minimise the impact on ILVs of those requirements that are a product of the rules developed for spread capital will be undertaken*

It is proposed that a further review of the impact on ILVs of those requirements that are a product of the rules developed for spread capital will be undertaken. This will ensure that, wherever possible, ILVs are not constrained by such requirements. These and other initiatives should allow more scope for ILVs to achieve a more streamlined interface with Lloyd's than they have hitherto experienced.

**Centrewrite and membership**

A Centrewrite Exeat policy is a personal reinsurance policy covering all of a run-off member's outstanding exposure. It is not a formal RITC and therefore does not result in the cessation of the purchaser's membership of Lloyd's. As a *it is proposed to cease the membership of members who have bought Centrewrite Exeat policies or do so in the future*

result, there are around 3,000 members of Lloyd's who, having purchased an Exeat policy, retain a vote on issues regarding the future of Lloyd's but have no economic interest in the Society.

Moreover, the informal consultation process has shown that there is some confusion amongst members who have bought a Centrewrite Exeat policy, in some cases several years ago, regarding their membership status. A significant number of this group understand their membership to be ceased and many have expressed a wish not to be troubled with further communication regarding their reinsured Lloyd's interests.

Consequently, it is proposed to clarify this position by ceasing the membership of members who have purchased Exeat policies or do so in the future.

**The future for new capital**

One of the CSG's original objectives was to develop a market that would be attractive to new capital providers. In the context of new third party capital, the recent consultation process has revealed that investment at Lloyd's via 'non-membership' schemes is potentially attractive.

*investment at Lloyd's via "non-membership" schemes is potentially attractive*

The term non-membership scheme is used as a generic reference to structures through which third party capital is provided to the Lloyd's market by way of financial support for a Lloyd's corporate member. The third party capital provider is therefore not a member of Lloyd's but is an investor in a member. The financial support may be provided in a variety of ways, including shareholding and loan structures, and may be fully paid-up or through the use of letters of credit. The corporate member would itself be subject to the normal capitalisation and solvency rules for a business operating in the Lloyd's market, and a shareholders' agreement, partnership agreement or similar would typically govern the arrangement between the various financial supporters, including an aligned corporate investor where applicable.

Lloyd's role in this process will be largely facilitative:

- generic forms of non-membership participation will be identified and disseminated
- background information on the market relevant for investment decisions will be made available to potential investors
- web-links will be provided to agents in the market who are promoting schemes.

Franchisees, members' agents and third parties will be responsible for the development and marketing of non-membership schemes, with Lloyd's available to assist with structural issues as appropriate. Some market participants are already developing such schemes with a view to making them available for the 2003 year of account.

Lloyd's will not approve or recommend any particular scheme, nor will it develop a centrally sponsored scheme. Lloyd's will, however, seek to ensure that the inherent risks of investing in the market are adequately explained to new investors. Lloyd's will develop a guide outlining standards for Lloyd's businesses relating to this type of capital raising and the promotion of schemes that involve investing in similar vehicles that participate at Lloyd's. It will be for the promoters of schemes to ensure that the offering and sale of the schemes comply with applicable financial services, securities, insurance and other relevant legislation in those jurisdictions in which they are to be offered or sold.

**Limited tenancy capacity**

Consideration is being given to the introduction of limited tenancy capacity in 2002 for the 2003 underwriting year. Agents would be permitted to offer capacity with finite security of tenure, which would at the end of its term revert for no consideration to the managing agent. Council will need to agree to parties amending the relevant standard form agency agreements to reflect the limited term of the relationship created and certain byelaws may need to be amended.

*the form of the agency agreement that will apply to participants on new syndicates from the beginning of 2003 will be reviewed*

More generally, the form of the agency agreement that will apply to participants on new syndicates from the beginning of 2003 will be reviewed. In particular, consideration will be given to removing the fiduciary duties detailed within the existing standard form agreement.

# 5. GOVERNANCE OF THE SOCIETY

*since the passing of the Lloyd's Act 1982 there has been almost continual debate as to whether the governance structure set out in the Act is satisfactory*

## 5.1 BACKGROUND

The current governance structure of the Council is enshrined in the Lloyd's Act 1982. Under this Act, the Council must comprise three constituencies: elected working members, elected external members, and nominated members who are appointed by the Council itself, with the approval of the Governor of the Bank of England.

Since the passing of the 1982 Act there has been almost continual debate as to whether the governance structure set out in the Act is satisfactory. In 1992 the Task Force Report and the Morse Report both concluded that the Council did not convincingly constitute a capable and effective decision making forum. Morse recommended that the Council's responsibilities should be confined only to those things which it could not delegate under the 1982 Act and that it should establish the current sub-committees of the Council; the Lloyd's Market Board (LMB) and the Lloyd's Regulatory Board (LRB). Since that time the LMB and LRB have themselves established a multitude of committees such that today there are 21 committees involved with the running of the Lloyd's market.

In 1998 the Kent Report commented that the experience of the current governance structure and the split of responsibilities between the Council, LRB and LMB was not ideal. The two principal difficulties identified to the Kent Committee were that:

- Council has been unwilling or unable to restrict its remit to those matters reserved for it by the Act. Its meetings have often been very long and focused on detailed technical matters rather than on the real strategic issues facing Lloyd's.
- the LMB, in particular, found it difficult to function in the absence of clear and certain delegation of authority. In addition, experience had shown that there is much duplication of effort with proposals having to pass through several committees before ultimately being considered by the Council itself.

The Kent Report concluded that the tri-partite structure worked "adequately" and should be retained for the short term. It did, however, conclude that "Lloyd's interests are likely to be served by a single governing body at some point in the future".

## 5.2 THE FRANCHISE GOVERNANCE STRUCTURE

*to manage the risk profile of the Society effectively and to maintain and grow Lloyd's position in the world insurance market requires strong leadership*

Lloyd's as an institution has suffered in the past from being very inward looking, an attitude embedded in the Society's constitution. In addition, decision making has been slow and based on trying to build consensus amongst constituencies with diverse interests. To manage the risk profile of the Society effectively and to maintain and grow Lloyd's position in the world insurance market requires strong leadership. This needs to exist within a structure which provides the necessary accountability, control and independent oversight.

*the proposals aim to deliver external and independent oversight and clarity and accountability*

Until the Lloyd's Act 1982 is amended, the Council remains the governing body of the Society with statutory responsibilities under Lloyd's Acts and the Financial Services and Markets Act 2000. The CSG does not believe that the existing governance structure is optimal or sustainable in the longer term and it has made some outline recommendations for changes to the Lloyd's Acts, which are set out in Section 5.10. More immediately, the CSG believes that the performance of the market in recent years means that Lloyd's cannot wait for a change to the Act in order to streamline and modernise the governance structure. The CSG therefore recommends strengthening the corporate governance of Lloyd's within the constraints of the Act as an interim step to seeking an amendment to the Act.

The proposed governance structure is aimed at delivering the following key principles of good corporate governance:

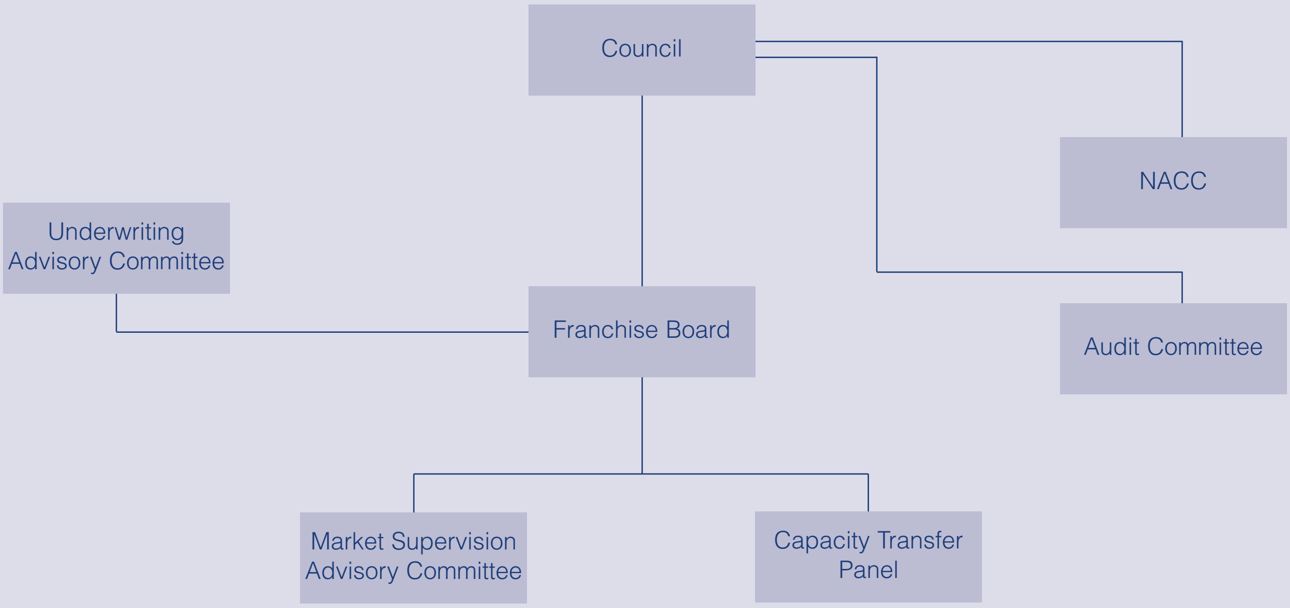
- **external and independent oversight:** the Lloyd's Act 1982 requires the majority of the Council to be drawn from the market or the membership. Likewise, the membership of LRB and LMB is largely drawn from the same constituencies. The CSG believes that to manage the risk profile and commercial strategy of the market, key bodies should be composed of a majority of non-conflicted individuals. This will help to remove actual, potential and perceived conflicts of interest from all levels of Lloyd's decision making.
- **clarity and accountability:** with over 21 committees involved with the management of the market there is considerable overlap which results in a lack of clarity of authority and not enough ownership and accountability. The CSG believes that any delegation of authority from Council should be clear, unambiguous and coupled with effective monitoring and accountability. Bodies with delegated authority, including the executive, should be more accountable.

In light of these aims, the CSG considered whether there was a need to continue with the division of responsibilities between a regulatory board and a market board. Whilst the CSG recognises that the LRB has been instrumental and successful in driving the development of Lloyd's supervision framework and raising standards, ultimately the bifurcation of LMB and LRB and the associated committee structure at Lloyd's has not delivered the necessary improvements in market performance. Therefore, the CSG recommends a unitary structure combining risk and commercial management.

A key reason for CSG reaching this conclusion is the new and important role played by the Financial Services Authority (FSA) in the Lloyd's context. Since 30 November 2001, the Society itself and the underwriting agents in the market have been regulated by the FSA. This additional level of external oversight of both the Society and underwriting agents gives members of Lloyd's and policyholders additional reassurance. Like any regulated entity Lloyd's has had to (and must continue to) demonstrate to the FSA that it can effectively discharge and comply with its responsibilities. The CSG believes that the strong and effective governance structure it is proposing will mean the Council is in a better position to discharge its obligations to policyholders, members and the FSA.

The proposed structure represents a significant streamlining of the current Lloyd's committee structure whilst retaining the necessary apparatus of good corporate governance.

**Proposed Governance Structure**




## 5.3 THE COUNCIL

The Council is the statutory body responsible for the management and supervision of the market under the Lloyd's Act 1982. The FSA also holds the Council responsible for carrying out its responsibilities under the Financial Services and Markets Act 2000. The CSG recognises that the Council will remain in place and is making no proposals to change the constituencies or mechanisms for election. Under the requirements of the Lloyd's Act 1982, Council remains responsible for making byelaws and taking those decisions that require a special resolution (for example, setting Central Fund contribution rates).

*the Council will appoint a new Franchise Board*

It is proposed, however, that the Council will appoint a new Franchise Board to replace the current LRB and LMB and will delegate all its functions to that Board other than those reserved to the Council by the Lloyd's Act 1982 and any others it believes it needs to retain. This will be considered in further detail in the months ahead.

Appointments to the Franchise Board will be upon the recommendation of the Nominations, Appointments and Compensation Committee of the Council (NACC). The Chairman of the Council and the Chief Executive Officer will also serve as Chairman and Chief Executive Officer of the Franchise Board and the NACC will make recommendations to the Council regarding their remuneration following input from the non-executive directors of the Franchise Board.

As the Council will remain responsible to the FSA and other interested parties for the actions of the Franchise Board and the executive, it is imperative that the Council has sufficient oversight of, and is able to monitor the activities of, the Franchise Board. This will be achieved in a number of different ways:

- at each of its meetings the Council will receive a report from the Chairman and CEO on the key activities of the Franchise Board, its committees and the executive. Council members will serve on the Audit Committee (see Section 5.4) and the Market Supervision Advisory Committee (see Section 5.7) alongside Franchise Board members. It is also possible that some members of Council may sit on the Franchise Board
- the Audit Committee (see Section 5.4) will be responsible for monitoring the effectiveness of the delegation of authority and internal systems and controls
- all members of the Franchise Board and the Council will meet twice a year. Once, to consider the proposed franchise plan for the following year, and then to review progress against that plan.

The Council will meet as often as necessary to properly carry out its functions. It is anticipated that initially there will be at least eight meetings per year.

The CSG recognises that the Lloyd's Act 1982 requires the Council to establish a Disciplinary Committee and an Appeals Tribunal. These bodies will therefore remain in place.

## 5.4 THE AUDIT COMMITTEE

*the Council should use the Audit Committee to establish and monitor the effectiveness of the delegation of authority to the Franchise Board and its accountability to the Council*

The Council should, as now, appoint an Audit Committee with responsibility for reviewing the annual financial statements, global results and principal regulatory filings of the Society. The Audit Committee will continue to be responsible for monitoring the effectiveness of systems of internal controls within the Corporation of Lloyd's. The CSG recommends that the role of the Audit Committee should be significantly enhanced and that the Council should use the committee to establish and monitor the effectiveness of the delegation of authority to the Franchise Board and its accountability to the Council.

Given that part of the Audit Committee's brief relates to operational issues (e.g. reviewing the annual financial statements), the CSG believes that it is appropriate for some members of the Audit Committee to be drawn from the Franchise Board. The clear majority, however, should be Council members and it should be chaired by a Council member (other than the Chairman or CEO). The minority who are also members of the Franchise Board will be excluded from all discussions relating to the Audit Committee's role in monitoring the effectiveness of the delegation of authority from the Council to the Franchise Board. The Audit Committee will report to Council.

*the Franchise Board's task will be to manage the Lloyd's franchise; its focus will be on primarily strategic and policy issues*

## 5.5 THE FRANCHISE BOARD

The CSG proposes that the Council establish a Franchise Board with the following responsibilities and composition.

### Responsibilities

The Council will set the terms of reference of the Franchise Board. The Franchise Board's task will be to manage the Lloyd's franchise; its focus will be on primarily strategic and policy issues and a relatively small number of key operational issues. The implementation of the policy of the Franchise Board and the running of the day to day operations of the franchise will be delegated by the Franchise Board to the executive team. The issues for which the Franchise Board will be responsible are, for example:

### Strategic and policy

- identifying and evaluating the major risks facing the market and agreeing actions to mitigate them
- setting a long-term market profitability target
- determining the franchise view on the key levers and drivers of profitability at different stages of the insurance cycle in the light of global economic developments and insurance/reinsurance trends
- setting capitalisation ratios for the market (including RBC at member level and the relationship between capitalisation at member level and the Central Fund)
- setting the market supervision framework, in compliance with FSA requirements
- setting prudent solvency policy, in compliance with FSA requirements
- setting policy for admitting new franchisees and removing existing ones

### Operational

- admitting and removing franchisees
- determining the guidelines for franchisees
- approving the annual plan and budget of the franchisor
- executive appointments and roles
- executive compensation.

### Composition

The Lloyd's Act 1982 means that the Council itself cannot fully comply with best corporate governance practice. The CSG intends that the Franchise Board should. No constituencies of the Lloyd's market or membership will have guaranteed membership of the Board and the majority of the Board will be free from conflicts of interest. The NACC will select the "best people for the job" whilst recognising that in order to effectively manage the market it is necessary to draw on experience from inside and outside the market. The Board will also *the Board must contain very significant insurance and reinsurance knowledge and expertise*

comprise Lloyd's executives to enhance the sense of executive involvement and accountability.

The CSG proposes that the Franchise Board membership should be as follows:

- Chairman of Council as Chairman
- 3 executive members comprising CEO, Finance Director, and Franchise Performance Director
- 7 non-executive independent directors comprising a maximum of 3 insurance professionals connected to the Lloyd's market and 4 fully independent directors.

Appointment of the independent directors should be based on the relevance of their experience and expertise. In this context, the Board must contain very significant insurance and reinsurance knowledge and expertise which will be a key factor in determining its composition.

In order to carry out its functions the Franchise Board will establish a number of key sub-committees. In addition, the current Investments Committee should continue but as a committee of the Franchise Board.

### 5.6 THE UNDERWRITING ADVISORY COMMITTEE

*the UAC will be a "think tank", providing intellectual leadership and an external perspective on market and risk developments*

The CSG recommends the establishment of an Underwriting Advisory Committee (UAC) to provide the Franchise Board and the executive with a regular, structured, internally and externally informed view on the insurance cycle and strategic underwriting and risk issues. The UAC will in effect be a "think tank", providing intellectual leadership and an external perspective on market and risk developments.

Specifically, the UAC should provide its views as an input to the following Franchise Board deliberations:

- identifying and evaluating the major risks facing the market together with actions to mitigate them
- setting the long term profitability target for the Lloyd's market
- determining the key levers and drivers of profitability at different stages of the insurance cycle in the light of global economic developments and insurance/reinsurance trends
- determining the guidelines for franchisees.

In order to allow the market properly to understand the context for the strategy set by the Board, some of the UAC's views will be distributed to franchisees.

The composition of the UAC should be decided from time to time by the Franchise Board. However, it is proposed that the initial composition will be:

- an independent Chairman
- 8-9 other members:
  - market input will be gained from 3 members drawn from franchisees and brokers. Franchisee members will not be representatives of any constituency
  - broader insurance industry input will be gained from 3 people with insurance, reinsurance and actuarial experience. It is critical that these members are not conflicted. Other input will be given by 2-3 expert members (e.g. economics and social trends experts).

The Franchise Performance Director (see Section 6 below) will not be a member of the UAC but will be in attendance at all meetings.

All members of the UAC will be appointed by the Franchise Board with franchisee members being proposed by the LMA and LMUA.

The UAC will be able to use Lloyd's Market Analysis and Strategy teams to provide data and analytical capability as required. In addition, the UAC will be able to invite relevant parties to attend meetings, or to commission reports from external parties.

### 5.7 THE MARKET SUPERVISION ADVISORY COMMITTEE

*the Market Supervision Advisory Committee will provide independent advice to executives of the franchisor on certain key decisions*

The role of the Market Supervision Advisory Committee (MSAC) will be to provide independent advice to executives of the franchisor on certain key decisions, particularly those which have a significant impact on one or more franchisees and their capital providers. These decisions will, for instance, encompass contentious business conduct issues (for example, reviewing the application of the agency circumstances regime). The executive will determine the types of decisions where the advice of the MSAC is to be sought.

The Committee will be chaired by a fully independent member of the Franchise Board and include two nominated members of the Council and one senior or retired market practitioner. It will meet as necessary. At the option of the MSAC or the executive, an affected franchisee or capital provider will be able to attend and discuss the relevant issue with the MSAC and executive together.

The MSAC will receive reports of the final decisions taken in respect of matters discussed with them. In addition, the minutes of the meetings of the MSAC will be circulated to the Franchise Board.

Whilst the role of the MSAC is to advise rather than to make decisions its independent input will be important where key decisions are being made. In addition, it will provide a useful mechanism for both the Council (through the nominated members) and the Franchise Board to have oversight of important operational decisions.

It is also intended that the MSAC will fulfil the role of the current Investigations Committee. In this capacity, it will be undertaking a decision making rather than advisory role and will be answerable to the Franchise Board.

The role of the MSAC will be reviewed in two years time.

## 5.8 THE CAPACITY TRANSFER PANEL

*an independent Capacity Transfer Panel should be established*

As mentioned above, business conduct issues will be covered by the MSAC's remit. As for Council's existing powers in relation to transfers of syndicate capacity and, in particular, mandatory offers and minority buy-outs (both of which are currently exercised by the Business Conduct Committee), it is proposed that the Franchise Board should establish an independent Capacity Transfer Panel (CTP) to undertake this work.

The CSG is not proposing any change to the rules for conducting mandatory offers and minority buy-outs. Any future change would be for the Franchise Board and, where a change to a byelaw is required (which would normally be the case), the Council to decide.

The CTP will comprise three independent members – a nominated member of the Council as Chairman, a lawyer and a financial expert – and one nominee put forward by the LMA and one by third party capital providers. The LMA and third party capital nominees could change on a case by case basis.

The CTP will meet at appropriate times during the capacity transfer season.

## 5.9 FRANCHISEE INPUT

*the LMA and LMUA will be the primary routes through which franchisees will contribute to the work of the Franchise Board*

The LMA and LMUA will be the primary routes through which franchisees will contribute to the work of the Franchise Board. In addition, franchisee views will be captured through membership of the UAC.

The LMA and LMUA will be the first point of contact where market-wide franchisee input is required by senior executives of the franchisor. It is expected that they will have to organise accordingly to undertake this role. Franchisee views will also be gathered on an ad hoc basis either through individual discussions, the business plan review and quarterly monitoring process or market-wide surveys.

## 5.10 FUTURE GOVERNANCE PROPOSALS

The proposals set out above represent an interim step towards a stronger, more streamlined and independent governance structure.

Lloyd's constitution is enshrined in primary legislation. This means that the decision whether or not to change the constitution is not simply a decision for the Society but is ultimately one for Parliament. Assuming consensus can be built within the Society for proposed reforms it could take several years, *the CSG proposes that the Council should seek amendments to the Lloyd's Acts*

significant management time, public debate and uncertainty to achieve change. Nonetheless, the CSG proposes that the Council should seek amendments to the Lloyd's Acts, a process that should begin immediately with the aim of a new Act being passed in 2004.

The CSG is not making any detailed recommendations regarding amendments to the Lloyd's Acts. It has looked at the key areas of the current statutory framework that should be reviewed and where amendments should be considered. Any proposed amendment to the legislation will be the subject of a separate consultation exercise and the draft bill would need the approval of a specially convened EGM of members. Parliamentary procedures require that any proposed bill is approved by 75% in number of the members present in person or proxy at such a meeting. The CSG recognises that it will take time to develop and consult on the detail of any proposals but the aim should be to complete that process by November 2003.

The CSG believes that the aims of any reform should be:

**A flexible constitution**

Lloyd's should follow the lead of other statutory corporations and move from having a very specific and detailed constitution specified under private act. Instead, while maintaining its incorporation under private act, it is proposed that Lloyd's should adopt either "articles of association" or alternatively deal with constitutional matters (including any necessary minority protections) by way of byelaws. This would give the Society the flexibility to alter its constitution without the need for parliamentary approval.

**A modern governance structure**

The majority of the members of the current governing body are elected which tends to entrench conflicts between constituencies. In addition, the working and external members of the Council and its committees bring with them actual, potential or perceived conflicts of interest. Only one member of the full time executive (the CEO) is a member of the Council. The structure of the Council under the Lloyd's Act 1982 does not enable the Council structurally to comply fully with good corporate governance principles and makes it difficult for the Council to give the Society effective strategic leadership.

The CSG believes that the aims of any amendments to the Lloyd's Acts should be to deliver a single, strong and effective governing body for the Society capable of providing leadership whilst fulfilling the requirements of significant independent oversight and accountability.

**Clarification of "ownership"**

The existing constitution lacks clarity on how assets might be distributed to members and on what basis. In addition, members have the statutory right to challenge a byelaw made by the Council on a one – member, one – vote basis. In terms of underwriting capacity, this puts significant and broad reaching power in the hands of minorities or inactive members which could be used to the detriment of the active and economically affected majority.

The Lloyd's Acts largely ignore the role and contribution to the Society of managing agents. They have no direct "ownership" entitlement and although they can be represented on Council through the working member constituency, managing agents have no voting rights at general meetings of the Society. It is of course the case that managing agents who are aligned with a corporate member have such rights through that member.

The CSG believes that, given the changes in the capital base, the time has come to reform the voting rights embedded in the Lloyd's Act 1982.

**Removal of unnecessary business interference**

The divestment provisions of Lloyd's Act 1982 prevent a managing agent being associated with a Lloyd's broker. This restriction is anomalous. Whilst insurance companies are permitted to be associated with insurance brokers, managing agents are prohibited from developing distribution channels through integration with Lloyd's brokers. It is also an impediment to attracting new investment from Lloyd's brokers or investors associated with Lloyd's brokers. This places Lloyd's, its businesses and members at a competitive disadvantage. The CSG believes that that the Council should seek a reversal of the divestment provisions.

In addition, the CSG believes that the requirements of the Act for business to be placed at Lloyd's only through a Lloyd's broker and underwritten only through an underwriting agent should be reviewed.

## 5.11 FUTURE RELATIONSHIP WITH THE FSA

Lloyd's has discussed the CSG proposals with the FSA. The FSA considers that the proposals represent an important change to both the relationship between Lloyd's and the businesses that operate in the Lloyd's market and to the governance structure at Lloyd's. The direction of these changes is fundamental and lasting in nature.

The CSG proposals come at a time when the FSA's approach to insurance regulation generally is undergoing a fundamental reappraisal with the adoption of a risk based and proactive approach. The FSA has issued a number of recent publications that describe the details of how this will work in practice and plans to issue further papers later in the year within the scope of the Insurance Regulation Project ("Tiner Project").

The current supervisory regime for Lloyd's was designed over three years ago. In light of its review of insurance regulation and the CSG proposals, the FSA considers that the regime needs to be reviewed and that the FSA should take steps to exercise more directly its responsibility for the prudential regulation of the Lloyd's market. This does not mean that the FSA should assume all of the functions currently carried out by the Lloyd's Regulatory Division, many of which relate to risk management and performance management in addition to monitoring compliance with both Lloyd's and the FSA's requirements. Equally, it does not mean that Lloyd's should cease those activities where the FSA exercises its responsibilities more directly.

In the short term, the FSA proposes to apply full risk-based regulation to Lloyd's and the market, subject to the confines of the current FSA Handbook. In the medium term, the FSA intends to work closely with Lloyd's to develop improvements to the regime, where appropriate, in the context of other changes the FSA has committed to arising from the Tiner Project and any relevant EU developments. The FSA will consult widely on any proposals for rule changes in due course. This process of consulting on new rules will allow the FSA time to assess how its short term measures have worked and how the implementation of the CSG proposals has developed. It will also help the FSA place the changes arising from the CSG in the context of the other changes which the FSA may wish to make. Of course, any changes to the FSA regime for Lloyd's will need to be justified on cost benefit grounds.

# 6. FRANCHISOR ORGANISATION STRUCTURE

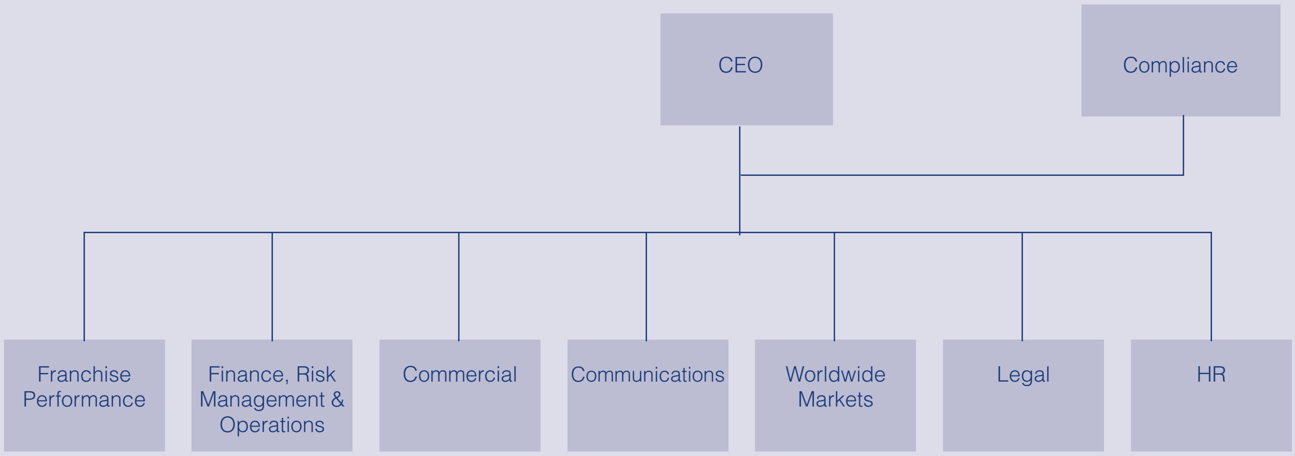
## 6.1 NEW ORGANISATION STRUCTURE

*the Corporation will need to change, acquire new capabilities and operate differently*

The franchise structure will require both the franchisor and the franchisees to become more effective and to perform some new roles. The Corporation of Lloyd's will need to change, acquire new capabilities and operate differently if it is to fulfil the role of franchisor and contribute to the transformation of the market and to its future success.

The following high level organisation structure is proposed to be implemented as soon as possible:

**Franchisor Organisation Structure**




The new Franchise Performance team is key to the franchise structure. The Franchise Performance Director (FPD) will need to have significant experience of underwriting issues as will the key members of his or her team. The team will work with the franchisees to help improve the commercial performance of the market. It will also work in co-operation with a restructured Risk Management function within Finance, Risk Management and Operations.

## 6.2 DECISION MAKING RESPONSIBILITIES OF THE EXECUTIVE

*the executive will be responsible for the implementation of Franchise Board policy and the day to day operations of the franchise*

The Lloyd's executive team will work with the market to achieve the franchise strategy and profitability targets set by the Franchise Board. The executive will be responsible for the implementation of Franchise Board policy and the day to day operations of the franchise. The power to do this will be delegated to the executive by the Franchise Board although certain key decisions and responsibilities will be reserved to the Board (see Section 5). The executive will be clearly accountable to the Chairman and to the Franchise Board and will be expected to be a professional and decisive group, highly motivated to raise the performance of the market.

The decision making responsibilities of each executive and each key sub-function have been determined to establish clear responsibilities and accountabilities under the new structure.

### 6.3 ADDRESSING KEY SKILL AND CAPABILITY GAPS

It is recognised that the franchisor will require additional skills and capabilities over those of the existing Corporation to carry out its new responsibilities and activities. Acquiring these capabilities quickly is an immediate priority.

The CSG, in discussions with the Corporation management team, has identified a number of skill and capability gaps that need to be addressed to achieve the strategic imperatives of the franchisor. It will be necessary, for example, to recruit the FPD and key members of his or her team. The recruitment process has begun.

### 6.4 ADDRESSING KEY CULTURE GAPS

*aligning the culture of the Corporation with the franchise objectives is an integral and extremely important part of the implementation process*

In addition to skill and capability gaps, the CSG and Corporation management believe there are significant gaps between the culture of the Corporation today and the culture required for the franchisor to be successful. Aligning the culture of the Corporation with the franchise objectives is viewed as an integral and extremely important part of the franchise implementation process.

The focus will be on achieving a culture that, amongst other things, is more results orientated. Given the complexity and depth of cultural change required, initiatives will be implemented over the course of 2002 and 2003.

As part of the cultural change, the franchisor will more closely align its remuneration structure with the franchise objective of "creating and maintaining conditions in which long term return to capital providers can be maximised". This will include an assessment of the measures that could be used to help evaluate performance and will take into account long-term and prudential measures as well as market profitability. Proposals will be put forward to the NACC for approval.

### 6.5 INCREMENTAL COSTS OF IMPLEMENTING THE NEW STRUCTURE

*the franchisor will incur some additional costs but the likely return appears to be extremely attractive*

The CSG believes that the potential economic benefits from implementation of the franchise structure will be very significant. It is inevitable, however, that the franchisor will incur additional costs in performing the duties required under the new structure. The likely return on these costs, however, appears to be extremely attractive.

Preliminary estimates indicate that the ongoing net costs of the franchisor are expected to increase by between £1.5m and £7.5m with a base case estimate of £3.8m, or 3% a year. Ongoing costs are entirely related to additional staff required to perform the franchisor's new roles and have been estimated after taking into account potential savings that could accrue with the move to the new organisation structure. The range of the estimates is primarily driven by the salary ranges of new personnel and the amount of incremental resource required in the Franchise Performance function, particularly in the light of the future regulatory requirements of the FSA. Senior management will be recruited first and resource estimates will be revisited in the light of experience.

One-time costs of approximately £3.0m are estimated to be required to implement the new structure. These mainly relate to the recruitment of personnel and Board members, with the balance attributable to redundancy costs and IT and legal costs.

# APPENDIX 1

## COMPOSITION OF THE CHAIRMAN'S STRATEGY GROUP

| | |
|---|---|
| Sax Riley (Chairman) | Chairman of Lloyd's |
| Nick Prettejohn | Chief Executive Officer, Lloyd's |
| Julian Avery | Chief Executive, Wellington Underwriting plc; Member of Council; Deputy Chairman, LMA |
| Andrew Beazley | Chief Executive Officer, Beazley Furlonge Limited |
| Stephen Catlin | Chairman, Catlin Underwriting Agencies Limited; Member of Council; Chairman, LMA |
| Michael Dawson | Group Chief Executive, Cox Insurance Holdings plc; Member of LMB |
| Michael Deeny | Chairman, ALM (resigned from CSG January 2002) |
| Judith Hanratty | Nominated Member of Council; Member of LMB |
| Bill Loschert | Director, ACE Underwriting Agencies Limited and ACE Capital Limited; Member of Council and LRB |
| Peter Morgan | Member of Council and LMB; ALM Board Member |
| Tim Riddell | Chief Executive Officer, SOC Group plc (resigned from CSG January 2002) |
| Graham White | Chairman, CBS Private Capital Limited; LMA Board Member; Chairman, LMA Members' Agents Committee (appointed to CSG January 2002) |
| Gavin Steele | Secretary to the CSG |

# APPENDIX 2

## COMPOSITION OF THE FRANCHISE PERFORMANCE MANAGEMENT GROUP

**Franchisee Liaison Group**

| | |
|---|---|
| Edward Creasy (Chairman) | Chief Executive Officer, R.J.Kiln & Co Limited; Treasurer, LMA |
| Ken Acott | Chairman, Acott & Tilley Holdings Limited; CEO, Acott & Tilley Capital Limited; Director of Underwriting, Zenith Syndicate Management; Member of the LMUA Committee |
| Robert Childs | Director of Underwriting, Hiscox Syndicates Limited; Deputy Chairman, LMA |
| Jeremy Cooke | President of Markel International Limited; Managing Director of Markel Syndicate Management |
| Nick Furlonge | Director of Risk Management, Beazley Furlonge Limited |
| Andrew Kendrick | Director of Underwriting, ACE Global Markets; LMA Board Member |
| Peter Williams | Underwriting Director, Wellington Underwriting plc; LMA Board Member |

**Corporation executives**

| | |
|---|---|
| Andrew Moss | Director, Finance and Operations |
| Henry Johnson | Head of Market Risk and Reserving |
| Steve Manning | Head of Market Supervision |
| Sean McGovern | Head of Legal Services |
| Quentin Moore | Head of Research |
| Peter Spires | Solicitor |
| Gavin Steele | Secretary, Chairman's Strategy Group |

In addition, other relevant Lloyd's executives attended meetings as required.

## COMPOSITION OF THE CAPITAL LIAISON GROUP

| | |
|---|---|
| Charles Philipps (Chairman) | Chief Executive, Amlin plc; Member of Council and LMB; LMA Board Member |
| Andrew Annandale | Managing Director, SOC Private Capital Limited |
| Philippa Curtis | Chief Financial Officer, ACE Global Markets |
| Ewen Gilmour | Managing Director, Chaucer Holdings plc |
| Nigel Hanbury | Chief Executive, Hampden Agencies Ltd; Member of LMB; ALM Board Member |
| Nick Marsh | Chief Executive, Atrium plc; LMA Board Member |
| Bronek Masojada | Chief Executive, Hiscox plc; Deputy Chairman of Lloyd's and Member of Council |

## COMPOSITION OF THE THIRD PARTY CAPITAL REPRESENTATIVES GROUP

| | |
|---|---|
| Michael Deeny | Chairman, ALM; Deputy Chairman, Equitas Trustees |
| Lady Rona Delves Broughton | Member of LRB; Chairman HPG |
| Kevin Farr | HPG Board Member |
| John Francis | Director, Hampden Private Capital Limited |
| Marcus Johnson | ALM Board Member |
| Paul Kelly | Member of Council and LRB; Treasurer, ALM; Director, Navigators Underwriting Agency Ltd |
| David Robson | Chairman, Anton Private Capital Ltd; Member of Council and LRB |
| Billy Whitbread | HPG Board Member |
| Graham White | Chairman, CBS Private Capital Limited; LMA Board Member; Chairman, LMA Members' Agents Committee |
| Anthony Young | Chief Executive, ALM |

# APPENDIX 3

## OVERVIEW OF THE CONTENT OF THE BUSINESS PLAN

The syndicate business plans submitted by franchisees will have 17 sections:

| A. Commercial performance | B. Risk management | C. Operational controls |
|---|---|---|
| 1. Long term strategic plan | 5. Catastrophe exposure | 10. Franchisee structure |
| 2. Specific long term plans | 6. Reinsurance policy | 11. Capital structure |
| **3. Financial performance, forecasts and targets** | 7. Multi-year policies | 12. Underwriting capabilities and incentives |
| **4. Underwriting performance, forecasts and targets** | **8. Information regarding brokers** | 13. Use of binding authority |
| | 9. Reserving and solvency | 14. Operations and systems (benchmarking) |
| | | 15. Investment policy |
| | | 16. Underwriting controls |
| | | 17. Fees and commissions |

Note: Reporting to external regulators will be dealt with separately

It is currently proposed that the sections of the business plan in bold will be submitted in a prescribed format to enable the franchisor to compile meaningful market averages and to be able to assess risks at a market level. All other sections of the business plan can be submitted in the form which franchisees choose. This will be confirmed in a ‘sample business plan’ currently being developed, which will give an indication of the level of detail which should be included in franchisee business plans.

# APPENDIX 4

## OVERVIEW OF THE CONTENT OF THE QUARTERLY MONITORING RETURN

The franchisor will monitor syndicate performance against 8 sections of the business plan and 2 additional sections on a quarterly basis:

### A. Commercial performance

**3. Financial performance, forecasts and targets**

**4. Underwriting performance, forecasts and targets**

### B. Risk management

**5. Catastrophe exposure**

**6. Reinsurance policy**

7. Multi-year policies

**8. Premium outstanding with brokers**

9. Reserving and solvency

**18. Reinsurance recoverables**

19. Reinsurance erosion

### C. Operational controls

13. Use of binding authority

Note: Reporting to external regulators will be dealt with separately

It is currently proposed that the sections of the quarterly monitoring return in bold will be submitted in a prescribed format to enable the franchisor to compile meaningful market averages and to be able to assess risks at a market level. All other sections of the quarterly monitoring return can be submitted in the form which franchisees choose. This will be confirmed in a 'sample quarterly monitoring return' currently being developed, which will give an indication of the expected level of detail which should be included in the quarterly return.

LLOYD'S