

Is insurance the new banking? Part 3: Inappropriate personal behaviour, and conduct risk, in the Lloyd's Market

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Last month Lloyd's of London “... *announced ... actions designed to make [its] market a place where everyone can feel safe, valued and respected ...*”

This followed findings from “*the largest culture survey ever conducted in the insurance sector*” which showed that of the Lloyd's market participants surveyed:

- “*one in five ... do not believe people have equal opportunities regardless of gender*”
- “*8% ... had witnessed sexual harassment over the previous [year], however just 45% said they would feel comfortable raising a concern*”
- “*24% had observed excessive consumption of alcohol during the past [year]*”
- “*22% ... have seen people in their organisation turn a blind eye to inappropriate behaviour.*”

Lloyd's announcement is significant in view of the Senior Managers & Certification Regime (“SMCR”).

This article addresses the regulatory issues around Lloyd's' evidence of inappropriate personal behaviour (sexual discrimination / harassment, and alcohol / substance abuse). A further article will address the ‘raising a concern’ (ie whistleblowing) issue.

Lloyd's has a unique place in financial services regulation.

Part XIX of the Financial Services and Markets Act 2000 (“FSMA”) provides for the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”) to regulate Lloyd's. In particular, FSMA differentiates between “*the Council*”, “*the Society*” and “*the market at Lloyd's*”. The Council and the Society are bodies specified under the Lloyd's Acts 1871 – 1982: in short,

- the Society comprises the “*members*”, and
- the Council is authorised to issue “*byelaws*” to regulate “*the affairs of the Society*”, including as to its “*members ... brokers, underwriting agents and others*”.

(This article refers to the Society and Council collectively as ‘Lloyd's’.)

The dynamic between the participants in the Lloyd's market has been summarised in *The Society of Lloyd's v Jaffray* [2000] 11 WLUK 128:

“underwriting members ... provide insurance cover for policyholders ... [and] operate through underwriting agents who ... act on their behalf in dealing with brokers, the agents of the assured.”

The Lloyd's Acts have, for the purposes of the regulation of market participants as well as Lloyd's itself, been superseded by FSMA. *R (ex p West) v Lloyd's* [2004] EWCA Civ 506 confirmed that the basis of actions by Lloyd's in regulating its market is “*in contract*” rather than being “*governmental*”. A reasonable analogy is that the Lloyd's market operates as a ‘club’; Lloyd's sets ‘rules’ (in the form of its “*byelaws*”) with which those involved in the club must abide.

In terms of day-to-day activity, Lloyd's' rules apply primarily to 'managing agents' (ie the "*underwriting agents*" referred to in Jaffray). Managing agents are firms permitted pursuant to Article 57 of the [FSMA] Regulated Activities Order 2001 / 544 ("RAO") to manage "*the underwriting capacity of a Lloyd's syndicate*". The RAO further defines a managing agent by reference to the 'permission' of the Council of Lloyd's for such person to act on behalf of a Lloyd's member in:

- "(a) underwriting contracts of insurance at Lloyd's;*
- (b) reinsuring such contracts in whole or in part;*
- (c) paying claims on such contracts ..."*

Pursuant to FSMA s 2B, 22A and the [FSMA] (PRA-regulated Activities) Order 2013/556, managing agents are subject to regulation by both the PRA and FCA.

In December 2018, managing agents became subject to SMCR. The essential provisions of SMCR are at Chapters 2–5, and 22–27 of the FCA's "*Senior management arrangements, Systems and Controls*" sourcebook ("SYSC"), with corresponding provisions in the PRA rulebook.

SYSC contains numerous mentions of "*conduct*" and "*misconduct*" of personnel, not least in relation to provisions in Ch 22 as to the terms of 'regulatory references' and related issues from employment disciplinary proceedings.

Further, the FCA's "*Code of Conduct*" ("COCON") sets out rules for individuals in the financial services markets to "*act with integrity*" and "*observe proper standards of market conduct*".

Neither SYSC nor COCON explicitly addresses inappropriate personal behaviour. Moreover the word 'culture' – as referred to in Lloyd's description of its survey – only appears in the context of:

- "[operational] risk culture" for insurers (SYSC 13.5.1 G (1)) – in particular in relation to "*human resources*" (SYSC 13.6.2 G (1)) and a firm's "*compliance culture*" – and
- firms' "*governance*" fostering a "*supportive risk culture*" (SYSC 21.1.5 G (g)).

Despite the shortage of mentions in its rules and guidance, the FCA has for some time made clear its view that inappropriate personal behaviour is a factor that is a cause or symptom of, or at least is concomitant with, conduct risk – ie the risk that a firm does not put the fair treatment of customers, and the integrity of its market, at the heart of its business.

In September 2018, the FCA sent a letter to the House of Commons Women and Equalities Committee, saying:

"Sexual harassment [is] misconduct which falls within the scope of our regulatory framework. Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the industry in recent history, and we expect firms to foster healthy cultures ..."

The banking industry provided particular "recent history" for that letter. In March 2018 the FCA published a final notice against Paul Flowers, who had been Chairman of the Co-operative Bank plc 2009–2013. The final notice (01.03.18) addressed Mr Flowers' conduct in the period 2011–13, including:

- breach of company policies in relation to IT, such as emailing sexually explicit content; and
- a subsequent conviction for illegal drug possession.

The FCA did not link Mr Flowers' conduct to failings at the bank, nor did it suggest that Mr Flowers was one example of a broader culture there. However, there is extensive publicly available evidence (see eg the PRA and FCA enforcement notices of 10.08.15) as to the decision-making and huge regulatory capital shortcomings of the Co-op Bank 2009–13. The materials relating to the bank may reasonably give rise to an inference of a causal connection – at least equal to an inference of mere coincidence – between the bank's financial difficulties and the FCA's finding that Mr Flowers did not "*demonstrate the highest standards of integrity and probity, and set clear expectations concerning the company's culture, values and behaviours ...*"

The FCA did however indicate a connection between inappropriate personal behaviour and conduct risk – or at least the perception of conduct risk – by stating that: "*Any future involvement by Mr Flowers in the financial services industry risks undermining consumer and market confidence.*"

Lloyd's announcement does not indicate any connection between the evidence of inappropriate personal behaviour in the market and its losses reported in 2017 and 2018 – or even its profits in 2016 and interim profits for 2019.

However, Lloyd's does say that: *"Creating an inclusive marketplace is ... crucial to our long-term success."* It is possible to infer from this that Lloyd's has drawn a connection between:

- cultural failings identified in its market and
 - structural shortcomings identified in the 2017 'London Market Group' publication, to which Lloyd's contributed, which –
1. analysed the *"competitive position of the London Insurance Market"*, and
 2. said that London is *"losing business in emerging markets [and] reinsurance ... [and has] seen no meaningful improvement in talent diversity."*

Lloyd's seems to have linked competitive shortcomings, workforce diversity and insufficient safety, value and respect for that workforce. The FCA may also have done so.

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