Report

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Review of SRA client financial protection arrangements

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EXECUTIVE SUMMARY

Charles River Associates (CRA) was appointed by the Solicitors Regulation Authority (SRA) to conduct a review of the client financial protection arrangements. CRA was asked to conduct a "root and branch" review considering the different structural models that could be used to deliver professional indemnity insurance (PII) as well as the detailed terms and conditions of that insurance. The review has been prompted by some difficulties arising in the PII market including substantial increases in claims made, as well as an increase in the number of firms that are unable to obtain insurance on the open market.

Methodology

In conducting the analysis we have reviewed evidence on the PII arrangements used by solicitors in England and Wales as well as considering comparable schemes in other countries or other professions. We have conducted over 50 interviews including with 15 lawyers, 8 insurers, 7 brokers, and 3 lenders including their respective representative organisations. Interviews have also been held with the Legal Services Board, the Legal Services Board Consumer Panel, the Office of Fair Trading, representatives from comparable schemes and individuals within the SRA with varying responsibilities.

In addition to the interviews with individual stakeholders, the SRA hosted a roundtable discussion with an External Reference Group, which included the representatives of all the key stakeholders. We also held a round table discussion focused on issues of equality and diversity including representatives from: the Black Solicitors Network; the Society of Asian Lawyers; and the Solicitor Sole Practitioner Group which is the representative of smaller firms – Black and Minority Ethnic (BME) firms are disproportionately smaller firms; and individuals from the BME community.

We have also gathered considerable amounts of data from the Assigned Risks Pool (ARP), from insurers and from the SRA itself. This includes data on the performance of the open market compared to previous forms of financial protection arrangements as well as data on the nature of the current problems experienced in the market.

The objective and the assessment criteria

The first task was to set out the objective of the scheme as a whole and the criteria for assessing different models of financial protection. This was based on an examination of the SRA's regulatory objectives, principles behind comparable financial protection arrangements and evidence on market failures.

The evidence on market failure indicates that there is a need to protect clients who are unable to assess the quality of their legal advisers as well as intervention being needed because of the potential for damage to the industry's collective reputation. We have also identified evidence of market and regulatory failures in respect of the conveyancing process (responsible for around 50% of claims) and strongly recommend that the SRA investigate the conveyancing process more generally in order to assess whether more stringent regulation of the process is required.

There is also concern regarding regulatory failure in respect of setting the boundary of regulation both in respect of those firms that are allowed into the profession as well as the time taken to force firms out of the profession.

Given the market failures identified, the lessons from other jurisdictions, following discussions with the SRA Steering Group, and in the light of the SRA regulatory objectives, it was agreed that:

- The primary objective of the scheme is to protect clients from financial loss caused by impropriety by firms, such as negligence, dishonesty and insolvency;[1] and
- A secondary objective is to protect the reputation of the profession from the actions of individual solicitors.

With agreement from the SRA Steering Group, we have set out eight principles for the assessment criteria against which a system of financial compensation should be examined:

- Principle 1: The scheme should provide a **fair, transparent and accessible** system enabling those covered by the scheme who have suffered loss as a result of breach of duty by a law firm to be promptly and properly compensated.
- Principle 2: The scheme should be the minimum necessary to meet its objective and **cost effective** in providing client protection in the most efficient manner including the transition from the existing system of protection.
- Principle 3: The scheme should encourage **competition** between different legal services providers and allow new entry and innovation in new business models (i.e. Alternative Business Structures - ABSs).
- Principle 4: The scheme should encourage an **independent, strong, diverse and effective** legal profession.
- Principles 5: The scheme should be **targeted**, intervening only where there are clear problems that need to be resolved.
- Principle 6: The scheme should seek to avoid **unintended consequences** in terms of the impact on law firms, clients, insurers or the wider regulated community.
- Principle 7: The scheme should support, but not replace, **regulatory supervision** regarding professional standards.
- Principle 8: The scheme should provide appropriate incentives for lawyers to undertake **risk management** by incorporating an element of polluter pays into the scheme design.

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1 Throughout the report we use the terms "firms" and "solicitors" interchangeably to refer to those entities regulated by the SRA. We explicitly highlight issues that are specific to Alternative Business Structures (ABSs), but otherwise the comments related to solicitors would be expected to apply to ABSs as well.

The criteria set out are then used to assess different potential models that could be used for the delivery of insurance. A high level application of these principles implies that:

- There is no justification for intervening in the market where clients are able to protect themselves. Where clients do not suffer from asymmetric information, the market should result in high quality provision of services. Given legal services are often a repeat purchase for sophisticated clients, corporate clients should be responsible for ensuring their legal service provider has appropriate insurance. This is consistent with the approach taken in other industries and by the Office for Legal Complaints. The definition of "individuals" who should be protected can draw from similar situations.

- We can discount a completely unregulated open market solution. In an unregulated market, many legal services firms will purchase their own insurance (it is even possible that some consumers might purchase insurance). However, some solicitors will not purchase insurance and there may be a danger that the terms and conditions of the insurance do not adequately protect consumers. This was the case in the market prior to regulation in 1976. Following discussions with the SRA's Steering Group, it was identified that models that fail to deliver protection to individual clients would be considered unacceptable as they fail to meet the SRA's regulatory objectives. Given a need to ensure a minimum level of provision and that insurance based models cannot insure dishonesty of sole practitioners, a client safety net (such as the Compensation Fund) is also required.

Range of possible models

The next step was to set out the range of possible models that could be used for the delivery of insurance. Using information from previous schemes in England and Wales and comparable schemes in other countries or professions we have set out the range of models that are, or have been, used in different areas:[2]

- Open market / qualifying insurers – Under this model the legal profession is required to purchase insurance but this is provided through competing insurers. This approach is the most common model currently in place and is used by solicitors in Ireland, RICS, FSA, ICAEW and ACCA as well as being the current model used for England and Wales;

- Master Policy – Under this model, a single insurance policy is agreed that must be used by the profession for the compulsory arrangements. The Master Policy would be underwritten by (multiple) insurers. This is in place for Scotland and the CLC as well as previously being used for England and Wales; and

2 Licensed Conveyancers as regulated by the Council for Licensed Conveyancers (CLC); Surveyors as regulated by the Royal Institute of Chartered Surveyors (RICS); Financial advisers conducting insurance intermediation services as regulated by the Financial Services Authority (FSA); Accountants as regulated by the Institute of Chartered Accountants in England and Wales (ICAEW); and Accountants as regulated by the Association of Chartered Certified Accountants (ACCA).

- Industry self insurance – Under this model, there is a single fund that must be used by the profession for the compulsory arrangements. The fund is underwritten by the profession i.e. collectively the profession is both insurer and insured. This was in place through the Solicitors Indemnity Fund (SIF) previously used in England and Wales and a model of this kind was previously used by RICS.

In the case of the open market arrangements, there may be a use of a safety net for firms that do not purchase insurance from the open market – the ARP. Some open market arrangements have an ARP (RICS, ICAEW, Ireland as well as England and Wales) and some do not (ACCA and FSA).[3] We first considered the type of model and then assessed issues specific to an ARP.

Model assessment

In keeping with the approach that regulatory intervention is only required if there is evidence of a market failure in the delivery of insurance, the burden of proof sits with the alternative models to be demonstrably better than the open market, for intervention away from the open market to be appropriate.[4]

There is strong evidence that the open market model should be retained.

Cost effective (level of premiums): The average cost of insurance under the open market (including the ARP) has been around 1.4% of gross fees in comparison to 2.2% under the Master Policy and 3% under SIF. Over the period 2000/01-2008/09, this implies that the open market has saved the profession around £1.1 billion compared to the Master Policy and £2.1 billion compared to SIF.

Cost effective (variation in premiums): Although there may be a theoretical advantage from a model of self insurance being able to smooth premiums over the cycle, in practice SIF was not able to achieve this. Further, SIF made mistakes of under-pricing and the profession had to suddenly pay for this mistake. Under industry self insurance, the profession would face a risk of similar pricing mistakes. The risk of this was one of the reasons that a similar model in RICS was replaced by the open market. There is also no evidence that the Master Policy in Scotland has been less volatile than the open market in England and Wales.

Risk management: Prices under the open market have been set with reference to a wider range of rating factors than under SIF or the Master Policy. While this does involve the profession providing additional information, it ensures that prices are appropriately matched to risk. Indeed, under SIF, one and two partner firms paid around 22% of contributions but represented 34% the value of claims, whereas firms with 11 partners or more paid 35% of contributions and represented 27% of the value of claims. Such cross-subsidies are economically inefficient and distort competition in the legal market. Cross

3 In the case of Ireland, the ARP was suspended during the 2009/10 indemnity year although it is intended that the ARP will be in place for the 2010/11 indemnity year.

4 This is distinct from a market failure with respect to the asymmetry of information in client understanding of solicitors that leads to a need to have some form of insurance in place.

subsidies are driven out by a competitive insurance market (also leading low risk small firms to gain in comparison to high risk small firms). In addition, the open market can sharpen incentives for risk management by refusing cover for firms.

Targeted: The open market currently provides insurance to around 97% of all firms and 95% of sole practitioners. The reintroduction of a Master Policy or industry self insurance because of a concern about the firms that are not covered by the open market does not satisfy the requirement that intervention be targeted. Even a Master Policy or industry self insurance focused on sole practitioners alone would fail this test.

Competition (static): Competition between lawyers may be distorted under the Master Policy or industry self insurance because this limits their choice of insurance to one source. Master Policies appear to be most appropriately used where there are relatively low values of premiums for relatively few, reasonably-homogeneous, firms - not the characteristics seen in England and Wales. England and Wales has premiums of more than 10 times that of Scotland and around 100 times that of the CLC with similar ratios with respect to the number of people in the respective professions. Similarly, England and Wales has greater diversity in terms of firm size compared to Scotland and greater diversity of work compared to the CLC.

Competition (dynamic): The open market retains the necessary flexibility to deal with new entry by ABSs whereas the Master Policy or industry self insurance may lack this flexibility. This could have particularly detrimental consequence for small firms that wish to exploit the use of ABSs but would face additional costs of obtaining multiple insurance policies where they can currently extend a single policy to obtain additional cover.

Equality and diversity: There is a greater proportion of BME firms in the ARP (28%) than in the profession as a whole (11%). This implies that where there is only the open market with no insurer of last resort there is a risk of some BME firms failing to obtain cover and therefore a detrimental equality impact could arise. All other models (open market with insurer of last resort/ARP, Master Policy, industry self insurance) would retain the ability of all BME firms to obtain insurance. No other equality concerns have been identified with respect to model choice.

Regulatory supervision (setting the boundary): As with the equality and diversity concern, if regulators are to set the regulatory boundary this means that the open market with no insurer of last resort would not meet this principle. As noted, there are concerns of regulatory failure with respect to where this boundary is currently set.

Regulatory supervision (revelation of information): Due to being on risk for run-off (for which currently insurers may not be paid), insurers have an incentive to not report firms to the SRA where they suspect dishonesty. The incentive to report is greater for the Master Policy (unless insurers plan to exit the market entirely) and for industry self insurance (where they continue to face the risk each year). Currently there is little evidence that insurers do report dishonest firms although the SRA has acknowledged that it has not had the necessary infrastructure in place to facilitate this.

Fair, transparent and accessible: We have only weak evidence available on the time taken to deal with claims by the different models. It does not suggest that alternative models deal with claims faster than the open market.

Unintended consequences: If there is a "market-wide-insurance-cycle" distinct from a "solicitors-PII-insurance-cycle", it is possible that an event in an unrelated insurance market could lead to the withdrawal of capacity for solicitors PII market leading some firms to be unable to obtain cover. There is weak evidence on this arising generally (events specific to solicitors PII are the cause of the current increase in the size of the ARP).

Overall, as summarised in Figure 1, the open market model dominates the Master Policy or industry self insurance. However, there are some criteria where there are concerns regarding the open market specifically related to regulatory supervision regarding setting of the boundary, revelation of information to regulators, and equality issues. Each of these have important interactions with the ARP and particular terms and conditions (see below).

Given all of the evidence summarised above **we recommend that the open market model be retained** in preference to the Master Policy or industry self insurance.

Since we do not recommend a movement away from the current position of using the open market, there is no economic impact from our recommendation. Similarly there is no impact from an equality and diversity perspective.

Figure 1: Comparison of models against assessment criteria

	Open market	Open market and ARP	Master policy	Industry self insurance
Examples	Ireland (2009/10), FSA, ACCA	SRA (2000 to date), Ireland (excluding 2009/10), RICS, ICAEW	SRA (1987-2000), Scotland, CLC	SRA (1976-1987), RICS (pre 1996)
Cost effective (level of premiums)	+ + + (1.4% gross fees as per current market)	+ + + (1.4% gross fees)	+ + + (2.2% gross fees)	+ + + (3.0% gross fees)
Cost effective (variation in premiums)	+ + + (based on current market)	+ + + (low volatility)	+ + (based on comparison with Scotland)	+ (high volatility)
Risk Management	+ + + (Premiums are risk reflective and cover can be withdrawn)	+ + (Premiums are risk reflective but cover can not be withdrawn)	+ (premiums set on few criteria, cover can not be withdrawn)	+ (evidence of cross-subsidies, cover can not be withdrawn)
Competition between lawyers - static	+ + + (lawyers free to compete)	+ + + (lawyers free to compete)	+ + (competion may be distorted as heterogeneous profession)	+ + (competion may be distorted as heterogeneous profession)
Competition between lawyers - dynamic	+ + + (lawyers free to innovate)	+ + + (lawyers free to innovate)	+ + (possible restriction of ABSs)	+ + (possible restriction of ABSs)
Targeted	+ + + (allows competitive insurance market)	+ + + (allows competitive insurance market)	+ (disproportionate when 97% of firms are currently served)	+ disproportionate when 97% of firms are currently served)
Equality and diversity need to be maintained	+ + (some firms excluded)	+ + + (all firms allowed in the market)	+ + + (all firms allowed in the market)	+ + + (all firms allowed in the market)
Regulatory supervision - setting boundary	+ + (insurers may set boundary)	+ + + (regulators set boundary)	+ + + (regulators set boundary)	+ + + (regulators set boundary)
Regulatory supervision - aligning incentives on revelation of information	+ (possible misalignment)	+ (possible misalignment)	+ + (alignment of incentives except for firms that plan to exit)	+ + (alignment of incentives)
Efficient in providing compensation -weak evidence	+ + + (based on current model)	+ + + (faster at dealing with claims)	+ + (slower at dealing with claims)	+ + (slower at dealing with claims)
Unintended consequences - weak evidence	+ + (possible withdrawal of cover from external events)	+ + (possible withdrawal of cover from external events)	+ + (possible withdrawal of cover from external events)	+ + + (cover maintained despite external events)

Source: CRA analysis. Note that + + + implies the best option for the criteria, + + implies the second best option, + implies the worst option.

Roles currently undertaken by the ARP

The ARP is currently meeting a number of different roles including:

Rehabilitation of firms in difficulty - we have identified that £3.7 million worth of claims in 2008/09 were due to this role and that 26 firms have successfully returned to the commercial market. This is an upper bound estimate of the number of firms that will survive since in the past around half of firms that have remained in business 12 months after exiting the ARP have subsequently closed. Based on the 26 firms, this implies an average of around £140,000 per firm.

This role flows from the principle that the scheme encourage a diverse profession and that the regulator should set the boundary. It is therefore a regulatory, rather than economic, judgement as to whether the rehabilitation role should be retained. From an equality perspective, BME firms are no more likely to successfully exit than other firms, but BME firms are disproportionately represented in the ARP more generally.

Temporary cover – in 2009/10 around 340 firms were temporarily unable to obtain insurance due to the single renewal date. This is necessary only in so far as it overcomes an unintended consequence of the single renewal date (see below) and because of the rehabilitation role.

Client protection from firms that do not comply with the regulation – around £2.1 million of costs in 2008/09 relate to “non-applied” firms. In part this is linked to regulatory failure of allowing such firms to continue in business or failing to ensure that they have appropriate run-off cover when they close. We recommend that this role remains.

Insurance due to misalignment of incentives - costs of around £3.7 million in 2008/09 arise due to the misalignment of incentives related to insurers failing to reveal information to the regulator about dishonest firms.[5] We set out a range of options leading to better incentive alignment through the imposition of financial consequences on insurers if there is evidence that they failed to report dishonest firms that subsequently enter the ARP.

Orderly run-down and the insurer of last resort for firms that close down and enter run-off - enabling an orderly run down is likely to limit the extent to which additional claims arise from dis-orderly run down. However, claims of around £33.6 million arise in the ARP due to the role of providing insurance for firms that close down and enter run-off. These claims represent claims that would have arisen even if firms in the ARP were not allowed to continue in work, if there were no firms that operated without insurance and if there was no misalignment of incentives between insurers and the SRA’s regulatory oversight. The only way to prevent these claims from arising is to improve the quality of legal services including through more rigorous regulatory oversight.

Funding for the ARP

It is important that firms that are in the ARP contribute to the costs of the ARP. Currently most firms in the ARP pay premiums of 27.5% of gross fees. This acts as a strong incentive to avoid the ARP but brings concerns that it may have the effect of pushing firms towards failure to pay (or failure altogether) since they are not able to afford the premium. We recommend that individual underwriting is conducted (as with RICS and ICAEW). In as far as there are concerns from BME firms that they unfairly end up in the ARP, individual underwriting would alleviate some of their concerns.

5 It is a coincidence that this figure is similar to the cost of rehabilitation.

We also recommend that firms within the ARP that do not pay premiums are shut down. We note that the inability to pay premiums raises questions about the financial viability of firms and calls into question whether this needs to be regulated more vigorously.

However, even if individual underwriting applies and all firms within the ARP pay their premium, a shortfall in funding the ARP is likely to remain. There are a variety of different options that could be used, each of which has advantages and disadvantages. We provide a summary of the issues in Table 1 below.

Table 1: Assessment of alternative funding models of the ARP

	Current model – market share of qualifying insurers	**Levy as percentage of premium**	**Levy with risk reflective elements**	**Levy as fixed premium**
Incentives for law firms to manage risk	Partially aligned with risk management as small firms are likely to contribute more	Aligned with risk management as payments directly linked to premiums	Aligned with risk management as payments directly linked to premiums	Not linked to risk of firm
Avoidance strategies	Avoidance strategies arising currently	Some avoidance strategies may arise	No avoidance possible	No avoidance possible
Administrative costs	Potential for multiple unpredictable payments from insurers	Predictable payments from insurers	Predictable payments from lawyers	Predictable payments from lawyers
Incentives for insurers to compete for PII business	Reduced incentives	Incentives to compete	Incentives to compete	Incentives to compete

Source: CRA analysis

Of the options set out, it appears as though a levy as a percentage of premiums or a levy with risk reflective elements would be most closely aligned to the principles.

Requiring insurers to face the run-off risk

One option considered is that if firms can not obtain cover, they would be closed down and the previous insurer would be required to face the run-off risk. This may improve incentives to report firms to the SRA and reduce the overall costs of the ARP. However, we would expect it to lead to an increase in the number of non-applied firms, raise difficulties in enforcement and cause insurers to withdraw from serving firms most likely to enter run-off – mainly small firms (with implications for BME firms).

Terms and conditions

As well as examining the models used to deliver insurance, we also consider the minimum terms and conditions (MTC). We recommend some of these should be changed. It is important to note that the changes apply only to the MTC. Lawyers and insurers remain free to adapt arrangements beyond the MTC and extend coverage where appropriate.

Client coverage

Given that intervention is only required where there is evidence of market failures, we recommend that the MTC apply to individual clients leaving lawyers and insurers flexibility on the cover they seek for corporate clients. The impact of this is likely to be most clearly seen in the conveyancing market where we would expect to see:

- Lower premiums for firms that conduct no conveyancing – estimated as 36% of firms;
- Greater coverage for firms that conduct no conveyancing – leading to an increase in the number of small firms (and BME firms) able to obtain cover in the open market;
- Voluntary purchase of lender cover by around 30-60% of firms;
- A reduction in the number of firms that “dabble” in conveyancing;
- A reduction in the number of firms on lender panels– this would be expected to affect small firms in particular, but we note that lenders are already seeking to do this and therefore this would accelerate a pre-existing trend; and
- A reduction in the value of claims paid through the ARP (given that 85% of ARP claims currently relate to conveyancing).

Single renewal date

At present, all solicitors must renew their insurance on 1st October. This has arisen from history since both the previous Master Policy and then SIF had a single renewal date and this was maintained in the open market. We have found no evidence of a market failure for which the appropriate regulatory solution is a single renewal date.

In addition, there is evidence that the current arrangement is causing problems in the market with some insurers and brokers under resourcing constraints and small firms facing short renewal periods preventing them from comparing quotes from different insurers. Removing the single renewal date would:

- Significantly reduce the need of the ARP to provide temporary cover to solicitors (340 firms used this in 2008/09) bringing benefits to small firms (and therefore BME firms);
- Increase the availability of cover from the open market by some firms avoiding the ARP altogether, enabling exit from the ARP, and facilitating entry of new firms; and
- Reduce the cost of insurance: Around 10% of solicitors indicate that they have difficulty in renewing their insurance due to having little time to renew their quote.

Variable renewal dates would be expected to reduce the extent to which firms have a short period of time to consider their quotes and therefore may increase price competition.

Removal of the single renewal date will cause additional requirements related to monitoring firms to ensure that they have the necessary insurance cover in place, but the SRA does not consider this to be prohibitive and many other professions manage similar processes without difficulty. It will be important for the SRA to ensure it will have in place a robust monitoring process for checking compliance with insurance requirements before the single renewal date is removed.

Failure to pay premiums

Under the current arrangements, insurers remain on risk for firms that do not pay their insurance premiums. This is not normal business practice and there is no good reason for this requirement. In addition, the current arrangements cause insurers to have incentives to not report firms to the SRA, but rather wait until the end of the year's coverage, because of the concern that the insurer would remain on risk for run-off cover despite no premiums being received for this. Removing this requirement, for both a normal indemnity year and run-off, would improve these incentives. This is likely to identify problems occurring more quickly and therefore reduce the level of overall claims arising.

Run-off cover

The requirement to have run-off cover is considered to be necessary given that PII operates on a claims-made basis. There is little evidence of claims being made more than 6 years after a firm closes down and this time scale is consistent with that in other professions.

Even if premiums are paid, the provision of run-off cover means insurers have incentives not to report high risk firms to the SRA, but rather to wait until the end of the indemnity year with a high chance that the firm would subsequently fall into the ARP. As noted, the cost of this is estimated at around £3.7 million. We recommend that the SRA scrutinise each firm that enters the ARP. If there is evidence that the previous insurer should have reported the firm to the SRA but failed to do so, then:

- the insurer could be fined for failure to comply with the requirements in the qualifying insurers agreement;
- the insurer could be liable for the claims that arose between the time at which the insurer could reasonably have been expected to report the firm to the SRA and when the firm entered the ARP; or
- the insurer could be liable for the whole run-off cover for that firm (with or without the specified premium being paid to them).

If insurers already report dishonest firms to the SRA there would be no impact from these changes. Alternatively, we would expect to see an increase in the number of firms that are reported to the SRA (potentially over-reporting unless criteria are clear). Depending on the option taken, insurers may withdraw from serving firms likely to go into run-off (small firms and therefore BME firms)

Other terms and conditions

We have reviewed other components of the MTC where the evidence does not suggest that arrangements should be changed. This includes:

- Qualifying insurers: Due to the number of terms and conditions that must be fulfilled and the current funding of the ARP we recommend the retention of the qualifying insurer agreement rather than moving to a purely open market. We conclude that it would not be appropriate to place an additional constraint on insurers (such as the need for a particular credit rating) since the SRA is not the regulator of insurers. Any concerns regarding the stability of specific insurers would be best taken up through discussions with the FSA.

- Level of cover: We find no evidence that the level of cover (£2/3 million) is currently set too low as there is no evidence of client complaints related to this. We do not find evidence that this should be set at a lower level than at present since 23% of claims relate to claims valued at between £1 million and the £2/3 million minimum. It would be useful to ensure that the level of cover is reviewed over time to make sure that it is in line with typical high value claims for individuals.

- Payment of excess: Failure to restrict aspects of the excess could lead firms to apply a very high excess in order to reduce their premiums without taking into account the detrimental effect on clients. This concern necessitates some form of restriction on the level of the excess. All comparable schemes have restrictions in place related to the excess. The SRA's approach whereby insurers are on risk for paying the excess, but can seek redress from the firm, gives insurers and firms flexibility to arrange a suitable level of excess whilst preventing firms from acting against the interest of clients.

- Misrepresentation of information: Insurers are currently prohibited from avoiding or repudiating the insurance on the ground of non-disclosure or misrepresentation of information. Although this is an unusual provision in most insurance markets it is relatively common for PII cover in order to protect clients. As clients need to be protected it is important to asses who is in the best position to limit misrepresentation from arising. The experience of insurers and the fact that they observe proposal forms puts them in the best place to address this suggesting cover should stay as it is. Insurers have not provided any evidence suggesting that non-disclosure or mis-representation of information has caused a substantial amount of concerns.

- Fraud: Currently the cost of fraud (unless it relates to sole practitioners or all the principals in a firm) is covered under the PII policy. Some insurers have indicated that this is an unusual provision for insurance. Discussions with other schemes indicate that similar cover is in place elsewhere and other insurers have indicated that it is not prohibitive to cover these risks. Furthermore, our research finds that many insurers offer top-up insurance that covers fraud in the same way and as many as 40% of 2 partner firms may take out top-up cover. This indicates that the magnitude of the distortion of incentives regarding risk management is not causing serious concerns.

Compensation Fund

Information provided with respect to the Compensation Fund has been limited and therefore the assessment is more indicative. However, we have considered whether it would be appropriate to have a separate Compensation Fund for (different types of) ABSs. We disagree with this suggestion because differentiation on the basis of legal structure is not an appropriate basis on which to have separate funds. Further, the separation of groups on this basis may discriminate against ABSs and in particular could cause problems for those ABSs that are first movers.

There are a number of options that could be considered in respect of the method of contributions to the Compensation Fund including: individuals and firms each making a flat contribution; the addition of a small number of risk rating factors; risk rating applied to all firms on an individual basis; or levies on insurance premiums. There are advantages and disadvantages of each.

Future developments

At present, once firms have met regulatory requirements to enter the legal services market, they have the ability to conduct any type of work within the regulatory boundary. For this reason, we have not recommended changing the requirement that PII cover *all* activities conducted by lawyers on behalf of individual clients.

However, it is worth noting that the regulatory approach itself could change over time. For example, the SRA could move towards “activity based” regulation or make increasing use of the ability to place conditions on licensing arrangements. Such an approach could lead firms to be regulated to conduct particular types of legal services (e.g. conveyancing, probate, personal injury etc) or to operate in particular ways (e.g. not being allowed to hold client money).

If regulation moves in this direction, the MTC could adapt to reflect these developments. We would expect this to lead to additional flexibility in the MTC, enabling more firms to find insurance cover for a more limited range of activities.

In this regard, it is important to recall that there is currently concern regarding regulatory failure in respect of setting the boundary of regulation. This suggests that it may be appropriate for the SRA to overcome the current regulatory failure regarding setting the boundary *before* introducing flexibility in the MTC. To do otherwise would run the risk of introducing the potential for additional regulatory failure across a multitude of boundaries.

Finally, it is not obviously necessary to retain both a Compensation Fund and an ARP over the longer term and it may be possible to move the functions of the latter into the former. We do not recommend this at present. Instead it is appropriate: first to consider which of the functions currently conducted by the ARP should be retained; then to consider how these functions, along with those in the Compensation Fund, should most appropriately be funded; and only then to consider the appropriate structure to use.

Summary of recommendations and options

Table 2 below sets out our overall recommendations for change to the current approach.

Table 2: Summary of recommendations for change

	Recommendation and reasoning	Impact
Client coverage	Require cover for individual clients but not for other clients as market failure is not evident for them (Retroactive cover would need to be in place for work done for commercial clients before the date of the change in MTC)	For firms that conduct no conveyancing we expect lower premiums and greater open market coverage for small and BME firms; voluntary purchase of lender cover by other firms; reduction in "dabblers"; reduction in claims paid through the ARP; continued trend in reduction in the number of (small) firms on lender panels
Single renewal date	Remove restriction of single renewal date. No evidence of market failure for which a single renewal date is an appropriate intervention Evidence of problems particularly for small firms because of resourcing constraints arising from single renewal date	Reduction in need for temporary cover; increased cover in the open market especially for small and BME firm; reduction in cost of insurance. Additional requirements for SRA regarding monitoring
Non-payment of premiums	Remove insurance cover when premiums are not paid (for indemnity year, run-off and in ARP) This is in line with good business practice and prevents payers subsidising non-payers	Enhances risk management; restores incentives for insurers to report firms to the SRA thereby reducing overall claims; no obvious equality and diversity impacts
Funding by firms in ARP	Use individual underwriting in order to reflect risk	Improves risk management; reduces concerns that 27.5% premium is unduly penal; alleviates concerns of BME firms
Compensation Fund	Maintain single Compensation Fund including for ABSs	Legal structure is an inappropriate distinction; separation may distort competition with ABSs and hinder first movers

Source: CRA analysis

Table 3 below sets out the areas where there are a variety of options that could be considered

Table 3: Potential options for consideration

	Potential options and reasoning	Impact
Rehabilitation of firms in difficulty in ARP	Remove this role so that all firms in the ARP are shut down	SRA no longer sets the regulatory boundary; 26 ARP firms not rehabilitated at £140,000 per firm; BME no more likely to exit but disproportionately in ARP
Temporary insurance cover	If rehabilitation role removed, then also remove the provision of temporary cover after 3 years subject to the removal of single renewal date	No additional impact in comparison to the recommendation to remove the single renewal date
Misalignment of incentives re ARP/run-off	Align incentives through financial incentives on insurers through: fines; liability for claims from failure to report to time firms enters ARP; or making insurers liable for run-off	No impact if insurers already report Increase in firms reported to SRA; potential withdrawal from small (and BME firms) depending on approach taken
ARP run-off	Last insurer on risk to accept the run-off cover	May improve reporting to SRA and reduce ARP costs; likely increase in non-applied firms; difficulties in enforcement; withdrawal of insurers from serving firms likely to enter run-off (small and therefore BME firms)
Funding of ARP shortfall	Consider levy as percentage of premium; levy with risk reflective elements; levy as fixed premium	Current funding mechanism distorting incentives for insurers to seek new business and avoidance strategies are observed
Funding Compensation Fund	Consider addition of a small number of risk rating factors; risk rating applied to all firms on an individual basis; or levies on insurance premiums.	Current funding mechanism may not be sufficiently risk reflective

Source: CRA analysis

1. INTRODUCTION

Charles River Associates (CRA) was appointed by the Solicitors Regulation Authority (SRA) to conduct a review of the client financial protection arrangements. CRA was asked to conduct a "root and branch" review considering the different structural models that could be used to deliver professional indemnity insurance (PII) as well as the detailed terms and conditions of that insurance.

The review has been prompted by some difficulties arising in the PII market including substantial increases in claims made as well as an increase in the number of firms that are unable to obtain insurance on the open market. Although there are current difficulties in the market, the objective of the review was to look at arrangements that could be in place in the medium-term. It was not intended to affect the 2010/11 indemnity renewal which was ongoing at the time of writing this report.

1.1. Methodology

The starting point of a root and branch review is to go back to the need for such a scheme and the characteristics of the scheme. In conjunction with the SRA's project Steering Group, we have developed a set of principles drawing upon:

- The regulatory objectives of the SRA;
- Initial interviews with key stakeholders in the market: the Legal Services Board (LSB), the LSB Consumer Panel, The Law Society (TLS), the Association of British Insurers (ABI), the Council of Mortgage Lenders (CML) and the British Insurance Brokers' Association (BIBA);
- Analysis of similar schemes in other countries and other professions; and
- An analysis of extent of market failure for different types of clients.

We have then compared the different models of financial protection on the basis of these principles. In order to fully capture the views from all perspectives, we had 54 interviews with different groups of stakeholders. Table 4 below sets out the number of interviews by category of stakeholders.

Table 4: Number of interviews with stakeholders

Interviewee	Number of interviews
SRA	7
Lawyers and representative association	15
Insurers and representative association	8
Brokers and representative association	7
Mortgage provider and representative association	3

Comparative schemes	8
Other (LSB, LSB Consumer Panel, LCS, OFT, SIF, Capita)	6
Total	54

Source: CRA

In addition to the interviews with individual stakeholders, the SRA hosted a roundtable discussion with an External Reference Group, which included the representatives of all the key stakeholders.

Issues on equality and diversity have been raised as a matter of concern, particularly associated with the Assigned Risks Pool (ARP). In order to ensure the concerns to be included in the assessment, we undertook interviews with representatives from the Black and Minority Ethnic (BME) community. We also held a round table discussion focused on issues of equality and diversity with representatives from: the Black Solicitors Network; the Society of Asian Lawyers; the Solicitor Sole Practitioner Group which is the representative of smaller firms (BME firms are disproportionately smaller firms); and individuals from the BME community.

As well as the interview programme, we also gathered substantial amounts of quantitative data form a variety of sources including:

- Data from the SRA and ARP on the characteristics and performance of the ARP;
- Data from the Solicitors Indemnity Fund (SIF), which was the fund through which PII used to be provided until 2000/01 when the current regime was brought in;
- Data from insurers including from respondents to a CRA survey with the collection of data facilitated by the ABI.

Data was also collected from various interviewees including from comparative schemes and individual brokers and insurers.

It should be noted that due to the time elapsed, less information was available on the Master Policy that was in place before SIF than was available on the other schemes that have been used.

Where the evidence available leads to clear recommendations for change, we set this out in the relevant section and provide details of the expected impact. Where the evidence is less clear we set out the available information putting forward a range of possible options and their expected impacts. In all cases we include both an economic and an equality impact assessment so far as data allows.

1.2. Terminology

Throughout the report we use:

- "Solicitors", "firms", "legal practices", "legal service providers", "lawyers" and "law firms" interchangeably to refer to those entities regulated by the SRA. We explicitly highlight issues that are specific to the development of Alternative Business Structures (ABSs), but otherwise the comments related to solicitors would be expected to apply to ABSs as well;

- "The profession" and "the industry" to refer to solicitors collectively;

- "Insurers" and "Qualifying Insurers" interchangeably to refer to providers of PII insurance. We explicitly consider whether it is necessary to have specific qualification criteria in the report; and

- We use "clients" to refer to the clients of firms regulated by the SRA. We do not use this to refer to solicitors as clients of insurance companies unless explicitly stated as such.

1.3. Current client financial protection arrangements

Client financial protection in respect of solicitors in private practice is currently provided through a combination of four arrangements:

- compulsory PII;

- the Compensation Fund;

- the intervention process (which includes Statutory Trust Account distribution); and

- Inadequate Professional Services (IPS) awards.

The SRA is responsible for the first three arrangements and Legal Complaints Service (replaced by the Office for Legal Complaints as of 6th October 2010) is responsible for IPS awards. We do not examine the intervention process or the IPS awards.

The great majority of the report focuses on PII, how it is delivered and the terms and conditions associated to it. For this reason we set out below a brief overview of some of the key characteristics of the PII market in order to provide context for the rest of the report.

1.3.1. Professional Indemnity Insurance and Assigned Risks Pool

The compulsory PII scheme requires all firms carrying on private practice in England and Wales to have a policy of "Qualifying Insurance", which has to meet set minimum terms and conditions (MTC) and is available through "Qualifying Insurers". Under the MTC:

- PII covers all civil liability arising from private legal practice in England and Wales with only limited permitted exclusions;

- There is a single renewal date for all policies which is the 1st October;

- The minimum level of cover is set at £2 million for sole practitioners and partnerships and £3 million for limited companies and limited liability partnerships. This is on a per claim basis;

- Insurers and firms have freedom to arrange any level of excess (the amount paid by the firm in the case of a claim). If firms do not pay the excess, the insurer must pay this, but can then seek redress from the firm.

- Insurers are prohibited from avoiding or repudiating the insurance on any grounds including non-disclosure, misrepresentation and failure to pay premiums.

- Insurers are exempt from their liabilities to dishonest member(s) of the firm but innocent partners are still covered. Therefore, PII does not cover claims where the sole practitioner or all principals of the firm have been dishonest. (These are covered by the Compensation Fund.)

- If a firm is acquired by another firm, the successor firm then takes over all the liabilities of the acquired firm. If it ceases without a successor practice, the policy is then automatically extended by 6 years to provide run-off cover. The insurer of the firm when the firm ceases has the obligation to provide the run-off cover.

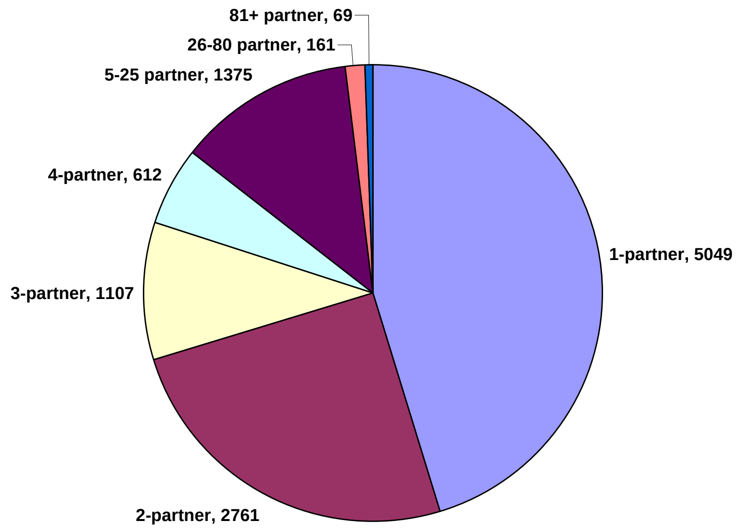
The ARP provides insurance for firms that do not get cover on the commercial market The cover provided by the ARP meets the MTC of Qualifying Insurance. The premium level is set at a high level to discourage firms from entering the ARP. Any shortfall between premiums from ARP firms and claims is paid by Qualifying Insurers in proportion to their market share of premiums for the compulsory level of cover.

If a firm is not covered by either a policy of indemnity insurance or the ARP, any claim that arises will be dealt with under a separate arrangement with the Qualifying Insurers similar to the ARP under which the SRA is the insured.

1.3.2. Market size

There are 11,100 law firms registered in England and Wales. Each of those firms is a potential client of insurers that provide PII.

Figure 2: Number of solicitor firms broken down by number of partner as of 23 July 2010



Source: CRA analysis based on data from SRA as at July 2010

As can be seen from Figure 2 above, small firms constitute the bulk of the market in terms of the number of firms. Sole practitioners and 2-3 partnership firms together account for 80% of the number of firms while those with more than 25 partners only account for 2%.

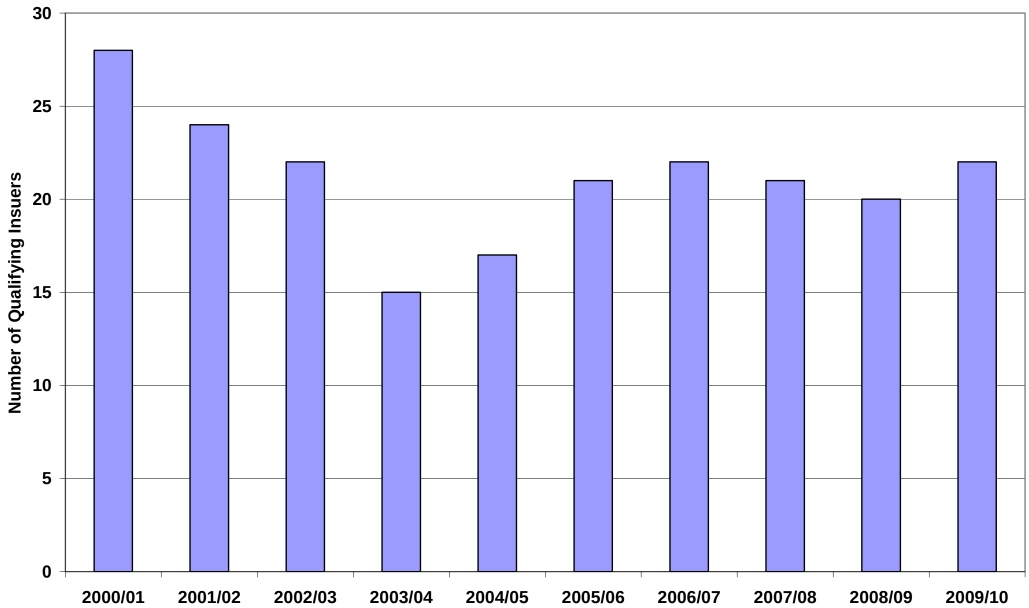
In 2008/09, the value of premiums for the compulsory MTC was £245.6 million. Gross fees for the profession were around £19 billion.

1.3.3. Number of insurers

In this section we set out the number of Qualifying Insurers in the PII market and examine the number of insurers that have entered and exited the market.[6] Figure 3 below sets out the number of qualifying insurers over time.

6 There are a number of cases where insurance companies have been re-named during the course of a year or where firms use multiple different company names for writing the risks. We have therefore combined different entities from the same broad company in order to analyse data on the basis of firms than the individual specific entity. This has the effect of reducing the overall number of qualifying insurers presented in Figure 3. It also reduces the number of firms entering and exiting the market set out in Figure 5. However, this provides a better understanding of the reality of firms entering and exited rather than capturing the effect of firms changing their name or choosing to write business through one entity rather than another.

Figure 3: Number of insurers over time



Source: CRA analysis based on data from SRA

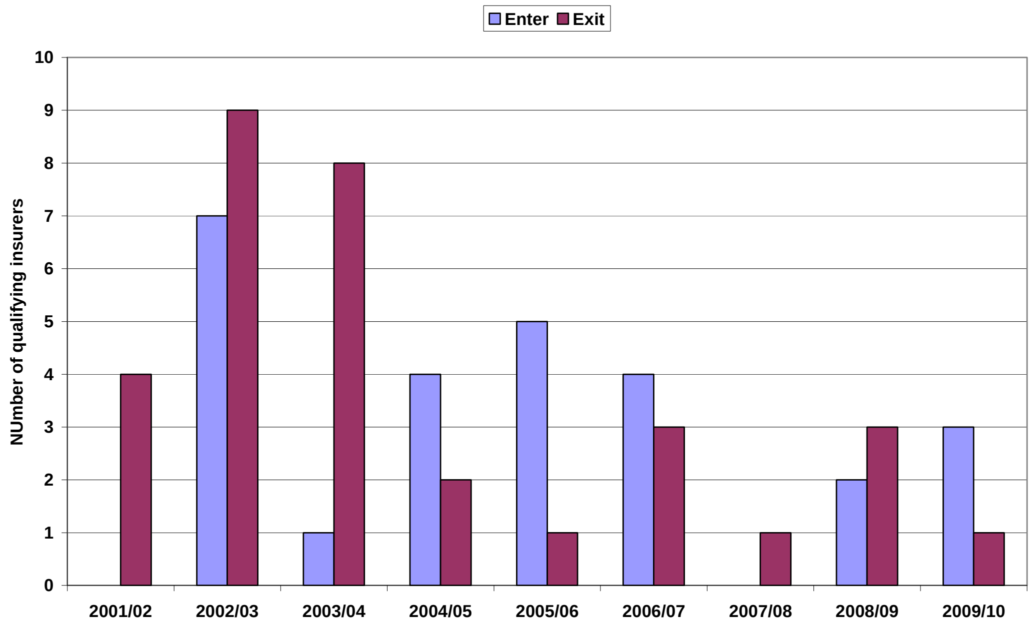
It is clear from Figure 3, that following entry of a large number of insurers in the first indemnity year, there was a subsequent contraction in the number of insurers in the market as this fell from 28 to reach a low of 15 in 2003/04. Since then the number of insurers in the market has increased to fluctuate between 20 and 22 insurers over the last five years.

Entry and exit

As well as examining the total number of insurers in the market it is also useful to consider the number of insurers that have either entered or exited the market. Figure 4 provides data on this.[7]

7 The number of firms that enter in a particular year is based on those firms that did not have a positive market share in the preceding year but do have a positive market share in the particular year. The number of firms that exit in a particular year is based on those firms that were in the previous year and no longer have a positive market share in the particular year.

Figure 4: Number of insurers entering and exiting the market



Source: CRA analysis based on data from SRA

While the total effect of firms entering and exiting shown in Figure 4 reflects the totals given in Figure 3, what is particularly interesting to note is that most years have seen both entry and exit which suggests that there are not significant barriers to entry or exit.

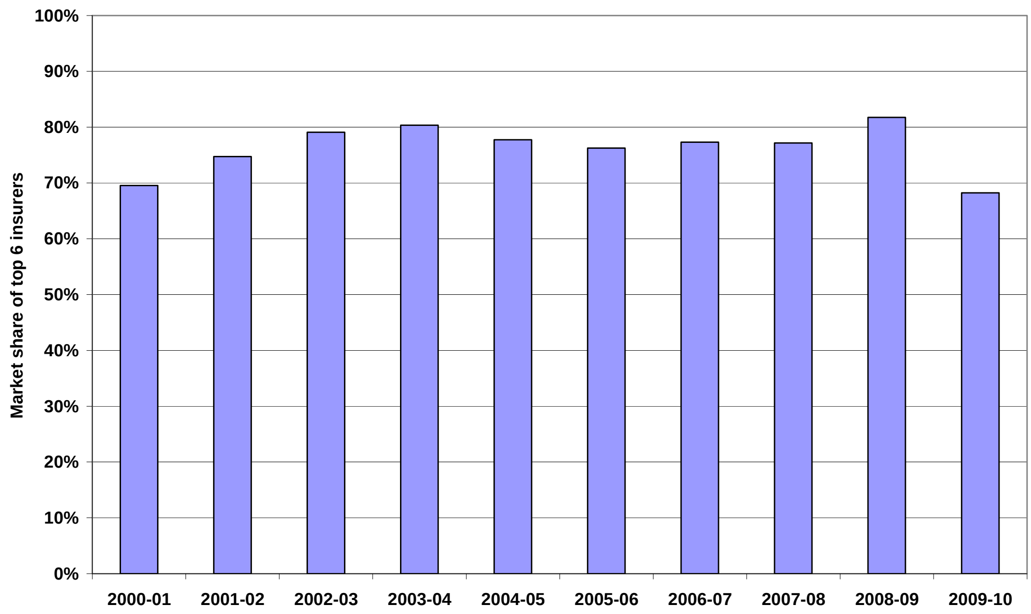
Furthermore, the fact that the market is continuing to attract entry even in 2008/09 and 2009/10 is notable. These years have been years in which substantial values of claims have arisen and in general most market participants would describe these as being “hard” markets. The hard market has meant that some insurers have exited, and others who remain in the market have actively chosen to seek to reduce their market share (such as by offering renewal terms to their existing customers but not actively seeking new customers). Quinn, which insured around 3,000 firms in 2009/10 also announced its exit from the PII market for the 2010/11 indemnity year following its own wider financial difficulties.

However, despite this, some new insurers clearly consider the market still to have profitable opportunities that make entry worthwhile. In the last two years, entry has been seen from: Allianz, Aspen, Lemma, Libra and XL Insurance. In the 2009/10 year, together these firms represented had over 15% market shares. The evidence of such entry (despite exit from others) does not immediately suggest that there are fundamental problems in the market and therefore the concern of insurers in the market needs to be seen in the context of the entry that is arising at the same time.

Concentration

Throughout most of the period, the market share of the top six insurers has fluctuated from 70-80% which is a typical level of concentration for many insurance markets.

Figure 5: Combined market share of top six insurers



Source: CRA calculation based on SRA data

It is worth noting that the firms who are in the top 6 providers has varied over time with some firms falling outside the top 6 and then re-entering the top 6 some years later while other top firms have seen reductions in their market share over time (possibly due to a deliberate strategy). Meanwhile new entrants such as Quinn and XL have been among the top 6 providers despite recent entry. Again this does not suggest that there are major structural difficulties with the market.

1.3.4. ARP

Although there are a large number of insurers competing in the open market to offer PII to solicitors, and despite the new entry that has been observed in the market over the last two years, it is clear that there is considerable pressure arising in the solicitors PII market. This is most easily observed through the ARP.

Historically the ARP has had around 50-70 firms in it but in 2008/09 this increased to 263 and in 2009/10 it increased further to 320 firms.[8] At the same time, the value of claims incurred while firms are in the ARP has also grown substantially from around £5 million per year for much of its existence to over £40 million for the 2008/09 indemnity year.

The very considerable increase in the size of the ARP and the value of the claims in the ARP indicates that there are some issues that need to be addressed in the way that client financial protection is currently delivered.

8 These figures include all firms that are covered by the ARP whereas figures that are often quoted will typically exclude certain categories of firms namely “non-applied” and “ineligible”. Further details can be found in Chapter 5 which focuses specifically on the ARP.

1.4. Structure of the report

The remainder of the report is structured as follows:

- Chapter 2 sets out the objectives of the client financial protection scheme and high level principles that serve as the assessment criteria for alternative models;
- Chapter 3 introduces the range of potential models that could be used drawing on the previous experience in England and Wales as well as an overview of comparative schemes from other countries and other professions;
- Chapter 4 assesses the potential models against the objectives and high level principles discussed in Chapter 2;
- Chapter 5 examines the Assigned Risks Pool and the variety of different roles that it plays;
- Chapter 6 discusses the details of the minimum terms and conditions; and
- The Appendix provides details on comparative schemes.

2. ASSESSMENT CRITERIA

The starting point of the "root and branch" review of the current financial protection arrangements is to set out the objectives of such a scheme. In this chapter, we look at:

- The reason for this review;
- The objectives of the SRA;
- Lessons from the principles behind other compensation arrangements;
- The implications of our assessment of market failure; and
- The resulting set of objectives and principles that can act a guide to compare the different models for financial compensation.

2.1. Reason for the review and approach

It is important to recognise that the objective of the project is to focus on developing a sustainable system for financial compensation that protects clients. As set out in the introduction there have been considerable pressures on the system this year seen in particular through an increase in the number of claims occurring and an increase in the number of firms in the ARP. However, the project is not intended to focus solely on these issues but to undertake an assessment for a sustainable system over the economic cycle (although it is important to understand the lessons from the recent experience to ensure that the system is sustainable). It is also important that we take into account how the system will work in the future given how the profession may change to adapt to the use of ABSs.

While the principles should reflect the intention that the review be focused on the sustainability of the scheme, this does not mean that the transition to any different scheme should be ignored. It will be essential to consider the transitional arrangements regarding how the scheme is altered from the current scheme to a new scheme.[9]

Given the objective of developing a sustainable system it is important to start any root and branch review with the responsibility of the regulator and an assessment of the problem to be solved.

In order to develop these objectives and principles we have drawn on the evidence regarding the structure of the market and the existing academic literature. We have also considered similar arrangements in place in other countries and other sectors. (An

[9] One of the issues that will be important to take into account in this regard is whether changes in arrangements could trigger some firms to fall into the ARP or to enter run-off cover – this may have significant implications for whether or not insurance companies are willing to provide insurance during next year's renewal stage if they believe that they may be caught with substantial increases in firms entering run-off in advance of next year's renewal. As highlighted in section 3.1.2, the decision to move from SIF to the open market led to a sudden influx of claims in the run-up to when the change was made.

overview of these is provided in Chapter 3 and details are out in the appendix). Finally, we conducted early interviews with key stakeholders in the market: the LSB, the LSB Consumer Panel, TLS, the ABI, the CML and BIBA.

Ultimately, however, this review is on behalf of the SRA and the principles were agreed with the SRA Steering Group with the aim that they ensure that the financial protection arrangements are viable and sustainable over the long-term, and enable the SRA to meet its regulatory objectives to protect consumers.

2.2. SRA's regulatory objectives

Financial protection arrangements need to meet the SRA's regulatory objectives since ultimately the SRA is charged with ensuring standards such that high quality legal services are provided to consumers.[10]

Within the SRA's business plan for 2009, the SRA articulated a number of key deliverables including consumer protection, enforcement and discipline. In the objectives related to consumer protection this included "ensuring effective professional indemnity and compensation fund arrangements" and tackling "unacceptable professional or organisational performance, misconduct and dishonesty by firm, fair and timely regulatory and disciplinary action".[11]

The SRA also has objectives related to access to justice, transparency and consumer information, in particular to "promote choice, innovation and accessibility in the provision of legal services through various types of business structure" and "to provide information to help consumers to make decisions about legal services and to understand the standards they are entitled to expect".

It is useful to note that, within the SRA's objective there is no requirement to explicitly encourage competition between insurers. However, since insurance is an important cost to solicitors we have implicitly assumed that competition among insurers should be taken into account as it will ultimately affect the cost of legal services and can also affect competition in the provision of legal services itself.

Finally, it is clear from the SRA's objectives that it is important to undertake the assessment of potential arrangements both in terms of the direct effect on consumer protection but also having regard to the impact on access to justice should the financial protection arrangements have a particular effect on certain types of solicitor firms such as BME firms. Hence an examination of the impact on equality and diversity is included within our assessment.

10 SRA Annual Report

11 SRA Business plan 2009 available at http://www.sra.org.uk/sra/strategy/business-plan-2009.page

2.2.1. Principles of good regulation

One of the core principles of the SRA is to operate in accordance with the government's Five Principles of Good Regulation.[12] It is therefore also useful to take these into account in the development of our assessment criteria. The Government's principles of good regulation are as follows:

- Proportionate: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised;
- Accountable: Regulators must be able to justify decisions, and be subject to public scrutiny;
- Consistent: Government rules and standards must be joined up and implemented fairly;
- Transparent: Regulators should be open, and keep regulations simple and user-friendly; and
- Targeted: Regulation should be focused on the problem, and minimise side effects.

Together these principles imply that intervention should only occur where the market would not provide a reasonable outcome. The assessment criteria set out in section 2.5 below draw directly from these well accepted principles of good regulation. The principles of good regulation feed into all of the assessment criteria set out.

2.3. Principles behind other financial protection arrangements

We have also looked at other regulators and the principles they have used to develop their compensation arrangements. Some of the principles appear to be of particular relevance to compensation fund arrangements while others have wider applicability.

Principles in other countries

The American National Client Protection Organisation (NCPO) has set out in detail the principles that it believes should underpin any compensation fund.[13] The role of the NCPO is to provide help and support to protection funds and programs to protect legal consumers from dishonest conduct in the practice of law. It should be noted that this starts from the position of ensuring a system that "truly protects the law clients" rather than the economic position of what compensation scheme best alleviates the market failure taking into account the costs and benefits of the scheme. The result of this is that NCPO identifies four fundamental building blocks for any fund:

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12 Solicitors Regulation Authority Annual Report. These 'Principles of Good Regulation', were published by the Better Regulation Task Force in 2003.

13 http://www.ncpo.org/standards2006.pdf

- An organisational structure that secures the Fund's independence – so that the fund is institutionally independent and focuses only on this activity;
- It has steady, secure and adequate funding – so that it does not need to ask the industry for additional funding. For this reason it advocates the development of a reserve;
- Accessibility – ensuring that clients (and the industry) are aware of this protection. They are also against different eligibility for different classes of persons;[14]
- Responsiveness to the need – with the ultimate goal of the fund to fully reimburse all clients victimized by the dishonest conduct of their lawyers in as timely a manner as possible. They therefore do not advocate limitations on the payment of awards - whether per claim, per claimant, per year or in the aggregate against any one lawyer.

Given the goals of NCPO in supporting protection programmes, this provides a useful set of principles. However, it is clear that the SRA's regulatory objectives require a wider set of consideration to be taken into account.

Other regulators

The industry where there has been the most extensive debate regarding the role of compensation schemes has been financial services. In particular the need for compensation or guarantee schemes has received considerable attention at a UK level through the Financial Services Authority (FSA) and at a European level by the European Commission.

Compensation and guarantee schemes are typically set to provide compensation to consumers when an financial institution is declared unable, or likely to be unable, to meet its financial obligations.[15] For example, the objective of the Financial Services Compensation Scheme (FSCS) is to "provide a compensation fund of last resort for customers of authorised financial services firms. If a firm becomes insolvent or ceases trading we may be able to pay compensation to its customers."[16] These schemes are mostly funded by the private sector through a levy on financial institutions within the scope of the scheme. The activities covered by these vary across countries, but often including banking, insurance and investment services.

There are two principle justifications for the need for compensation or guarantee schemes in financial services:

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14 It should be noted that the NCPO is not explicit as to whether this refers only to individual clients or to all clients although there is little mention of corporate clients in the principles.

15 FSA, A framework for Guarantee Schemes in the EU: A discussion paper, October 2005. Available at http://www.fsa.gov.uk/pubs/other/eu_framework.pdf

16 See details from FSCS available at http://www.fscs.org.uk/

- Asymmetric information and resulting risk aversion: There are two elements that have been identified:

  - Since consumers of financial services are commonly unable to make a full assessment of the risks attached to particular financial institutions, without protection they may take an excessively cautious approach to their interactions with such institutions. This could lead to an economically inefficient allocation of savings; and

  - Individual consumers do not have the resources to assess or manage the risk of firms' insolvency.[17] That is, there is a search cost in making this assessment which means individual consumers will not gather appropriate information (even if they could undertake the assessment).

- Mitigating the impact of contagion: Compensation arrangements can help to reduce the likelihood of financial crises at the systemic level. For example, knowing that compensation arrangements are in place reduces the possibility that consumers see problems with one financial institution as implying that there are similar problems at other financial institutions thereby causing contagious loss of confidence in the financial system as a whole.

In terms of asymmetric information, the analysis in the financial services market appears to have similarities to the legal profession. If customers are unable to assess the risk associated to using different lawyers they are less likely to use their services (this is clearly related to the issue of consumer confidence).[18] The implication of this is that financial services compensation schemes have focused on retail investors who are seen to suffer from asymmetric information but not covered corporate customers who are considered to be in a better position to assess the risks of different providers.[19]

In contrast, the second argument based on concern about contagion appear specific to the financial services industry and is not directly applicable to legal services. That is, if one legal firm is in financial difficulty, clients do not tend to assume that the whole legal profession is in financial difficulty. (This is separate to a question of the reputation of the industry which we consider below in section 2.4.)

Other professions

Few other professions in the UK have explicitly set out the objective of their compensation arrangements and the justification for the way it is arranged. An exception to this is

17 FSA Review (Review of Compensation Scheme and Ombudsman Service Limits and miscellaneous amendments to the compensation sourcebook. Available at http://www.fsa.gov.uk/pubs/cp/cp05_15.pdf.

18 In the financial services industry there is considerable discussion of the problem of moral hazard. If the risk for the consumer is completely mitigated the consumer will have no incentive to choose their provider carefully. This is often used as a justification to impose limits and leave some risk on the consumer.

19 For example, the FSCS focused on assisting private individuals although smaller businesses are also covered; larger businesses are generally excluded.

surveyors. In this case, the Royal Institute of Chartered Surveyors (RICS) explicitly states why it requires firms to have PII which is for the following reasons:

> *"to comply with RICS' public interest role;*
>
> *to comply with the RICS' obligations for self regulation under the terms of the Royal Charter and/or the relevant Bye-Laws and Rules;*
>
> *to provide access to compensation for members of the general public who have suffered loss as a result of the negligence of a Firm;*
>
> *to ensure that Firms and Members themselves are protected in the event of a professional indemnity claim."*[20]

It is clear from the objectives of RICS that the primary objective of the scheme is to protect members of the public using the services of a surveyor but a second objective is to protect the profession itself. This would appear to have a strong parallel to the need for client financial protection arrangements for solicitors.

The lessons from other schemes and countries feed into the development of the assessment criteria in section 2.5. In particular, these feed into the justification for principles 2 and 7.

2.4. Assessment of market failure

From an economic perspective, the justification for intervention in a market is the existence of a market failure. Without a market failure, it is commonly concluded that market forces are the most effective method for ensuring that consumers receive good value products and services. Indeed, the justification for intervention in the financial services market (described above) derived directly from their assessment of market failures. There are a number of potential market failures in the legal market that could justify intervention:

- Asymmetric information: This means that many customers will not understand their need for protection, will not be able to identify the characteristics of a solicitor that is offering "good" protection and will not be able to distinguish high quality solicitors from low quality solicitors;

- The collective reputation of the industry: If some consumers are not protected from poor quality services, this could reduce the willingness of all consumers to approach any solicitor. Therefore minimum standards may be required to protect the reputation of lawyers as a whole from the actions of a small group of low quality lawyers;

- The insurance cycle: It is possible that a global insurance cycle determines the availability of insurance capacity generally and therefore capacity constraints due to the performance of other insurance markets (such as for terrorism or catastrophe risk) could lead to a capacity constraint for solicitors PII. To the extent that this does

20 RICS, Assigned Risk Pool Guidance notes, 1 April 2010.

not reflect the risk of the individual law firm this would be economically inefficient and could imply that firms that are considered fit to participate in the legal market are unable to obtain insurance; and

- Regulatory failure: Where the regulator is not using their privileged information about providers and not taking steps to close down firms that do not meet regulatory standards, this could impose a cost on insurers, harming the efficiency of the insurance market.

2.4.1. Asymmetric information

Information problems arise when the customer does not have full information about the service that is to be provided.[21] In most cases the customer will face an informational disadvantage compared to the lawyer which means that they may be unable to assess the quality of services which they receive.

It is generally accepted that most individual clients of legal services providers are likely to have significantly less information than the providers. For example, research for the Scottish Legal Complaints Commission concluded that,

> *"Most people do not have experience of legal service, they are not experienced consumers of legal services, and so they go to see a solicitor with quite a lot of concern. They know that the law is highly specialised, and they trust a lawyer. Then it goes wrong, and as they had such initial high expectations of the profession, they are completely shocked, horrified."* [22]

In this regard it is notable that only 55% of consumers stated that they would be confident that they could judge how good the service of lawyers is compared to 81% who would be confident that they could judge how good the service of GPs is. This is particularly interesting since consumers would be expected to suffer from an informational disadvantage in respect of GPs as well as in respect of lawyers.[23]

The extent to which clients suffer from asymmetric information varies by type of client. It is common to offer less protection for corporate clients who have the resources and capabilities to assess quality and are often repeat purchasers of services. In contrast, individual consumers will usually require greater protection.

A similar argument can be made for different types of legal services. Where customers are making repeat purchases of legal services we would expect greater awareness of the services provided (frequent purchasers are more likely to understand the process, the outcomes which are desirable, as well as trade-offs between different aspects of the

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21 It is also possible that the lawyer could suffer from asymmetric information with respect to the client, and the insurer may suffer from asymmetric information with respect to the firm – this is considered in section 2.4.4.

22 Stephen F, and A Melville, University of Manchester, Report to Scottish Legal Complaints Commission on the Master Policy and Guarantee Fund Research, June 2009.

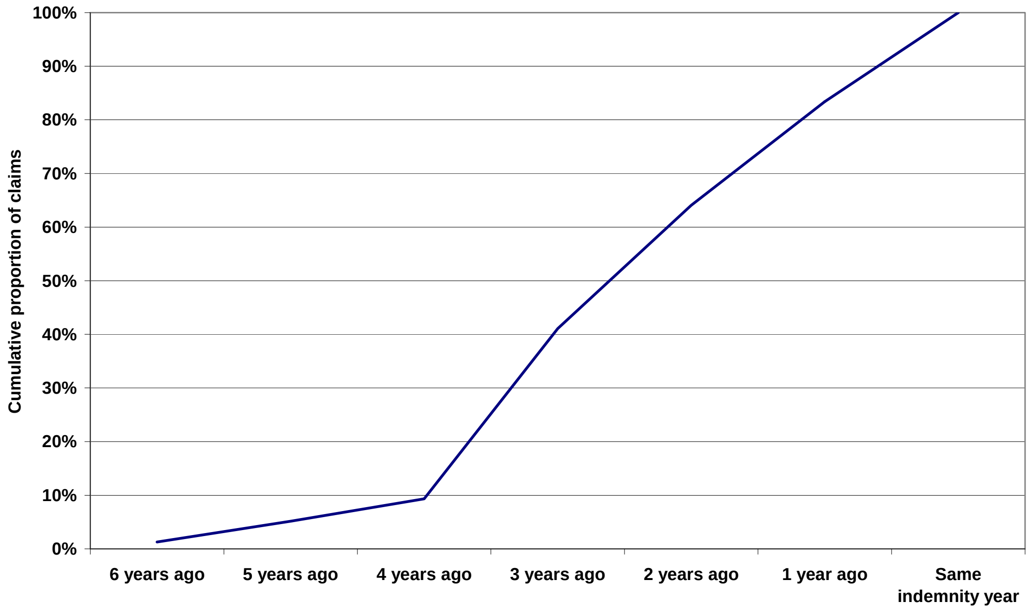
23 YouGov survey results on behalf of the Legal Services Board, Fieldwork conducted December 2009

service provision). Similarly, where repeat customers are common, suppliers would be expected to have more concern about quality issues compared to the situation where purchases are only one-off decisions. So we might expect the problems to be less for certain areas where there is repeat advice provided to the same individual compared to where one-off or infrequent advice is received.

Asymmetric information is exacerbated if it is difficult to assess whether or not the service has been of good quality immediately after it has been delivered. In many cases the quality of legal services is only revealed over time or at a much later point in time. Hence in any particular transaction the problem against which compensation may be required may only be identified many years later.

Indeed, Figure 6 below sets out the timing of the cause of action compared to when the claim was made. The figure is based on data from the 2008/09 indemnity year.

Figure 6: Claims incurred by timing of cause of action



Source: CRA analysis based on data from ARP

Some caution needs to be applied in the interpretation of the data since claims in 2008/09 mainly relate to conveyancing and may therefore be particularly affected by the timing of the property crash in comparison to the 2008/09 indemnity year. Nonetheless, it is clear from Figure 6 that a large proportion of claims that are made relate to work that was conducted some time before the claim. In particular, around 40% of claims relate to work that was done more than 3 years before the indemnity year in which the claim was actually made. This indicates that claims do not arise immediately after the service has been done but rather are revealed over time.

Markets commonly solve this problem through the use of guarantees and brands. At present there are few consumer-recognised brands in legal services although many larger law firms will be recognisable to commercial clients. However, given the length of time before a problem related to something such as conveyancing might usually be identified, it is unlikely to be effective in the short term to assume a similar market solution will solve any concerns related to asymmetric information for individual customers even if consumer brands begin to be developed in the legal profession.

Alternatively, if the market is unable to signal quality ex ante, it may be possible for clients to claim against their lawyer ex post by using existing mechanisms such as through suing the lawyer for negligence. Relying on this source of compensation may not be appropriate since the cost of seeking redress through the courts would be expensive for clients and therefore some bad service would go uncompensated. (We note that in some PII pays out after redress has been sought through the courts so this is not to suggest that this approach is not possible.) If the cost of seeking redress is prohibitive or if lawyers would have insufficient funds to pay out, regulatory intervention through requiring PII would still be needed.

Arguably, the evidence of the level of the value of claims also suggests that there are problems with the current market. Customers are making claims on PII rather than being in the position where they recognise that lawyers have made mistakes during the process with the lawyers then able to correct these mistakes during the course of the provision of services to the client.

2.4.2. Collective reputation

Legal services is an area where consumers are looking for expertise and where there needs to be confidence in the system as a whole. Scandals where consumers are harmed due to negligence or deceit could lower confidence in the whole system and thereby reduce access to justice. We note that at present there have been no widespread concerns regarding the operation of the existing financial protection scheme from the consumer perspective and maintaining this situation will be important. We understand that the level of complaints received by the Legal Complaints Service (replaced by the Legal Ombudsman as of 6th October 2010) on issues related to obtaining insufficient compensation is negligible.

One concern related to collective reputation is that firms may not take into account the cost that their actions impose on the market as a whole (i.e. there may be negative externalities that arise). This is a significant risk in any compensation scheme and suggests some element of polluter pays needs to be incorporated into the system. Polluter pays can be introduced in a number of ways:

- Contributions to financial protection arrangements should be based on an appropriate assessment of risk; and

- A proportion of the compensation should continue to fall on the specific legal service provider to ensure an incentive for risk management.

2.4.3. Insurance cycle

It is well recognised that insurance markets have “insurance cycles” in which the cost of insurance fluctuates in response to past claims, profitability and underwriting capacity. In general:

- periods of low claims are associated to high profitability;
- the high profitability attracts entry which causes premiums to be competed down;
- premiums continue to be competed down until such a point that claims relative to premiums start to increase and profitability is considered to too low;
- the low profitability causes exit and premiums to be increased; and
- this leads to claims compared to premiums to fall, profitability to rise and the cycle begins again.

It is possible to see a similar pattern arise in the solicitors PII market. For example, the PII market was seen as reasonably profitable in the period 2002-2005 in the light of relatively low levels of claims.[24] This led to subsequent increases in underwriting capacity as insurers entered the market (Figure 4 in section 1.3.3 shows that 2004/05-2006/07 were associated with more insurers entering the market compared to those exiting the market). In 2007/08, when premiums were still falling there was some comment that the reduction in premiums was unsustainable with new entrants potentially writing risks at levels which may have been below the appropriate risk reflective level.[25] An increase in the number of claims relative to the value of premiums has led these premiums to increase in 2008/09 and 2009/10.

It is important to consider whether the variation in premiums for solicitors PII reflects:

- risks that are specific to the solicitors PII market; or
- reflect a wider, external effect through an “insurance-sector-wide-cycle”

Discussions with interviewees have suggested that when participants in the solicitors PII market refer to the insurance cycle they are primarily referring to the cycle specific to the solicitors PII market rather than to wider insurance cycle events. For example, it is understood that the annual review of pricing of solicitors PII have nearly always related to conditions that are specific to the solicitors PII market. In addition, renegotiation of PII cover in other markets where there are Master Policies has focused on the performance of the specific Master Policy in view rather than wider market issues.

However, this does not mean that the solicitor PII market is immune from an “insurance-sector-wide-cycle”. For example, insurance companies have a range of opportunities regarding which specific market they invest in and this will be affected by the returns that they would expect to receive. One of the reasons that firms exit particular insurance markets where profitability is reduced (as described above in relation to a generic insurance cycle) is because they are able to find alternative, more profitable opportunities

24 Tough conditions: Conditions in the professional indemnity market are some of the most challenging ever seen, Post magazine, 25 March 2010.

25 Solicitors’ PI renewals 2007 – The end is nigh, Post Magazine, 1 November 2007.

elsewhere. Hence the solicitor PII market is likely to be affected by the return on capital in other parts of the wider insurance market.

Similarly, it is possible that specific catastrophe risk could lead to a removal of underwriting capacity or a readjustment of insurers expectation of risk. One such example of this was the events of September 11th 2001 where the terrorist attacks both removed capacity from the market (as insurers had to pay out claims) and also altered their expectations of terrorism risks more generally. It is thought that this had a (temporary) affect on many individual insurance markets including those that were not specifically linked to catastrophe or terrorism risk.

If the cycle is determined by external events this could lead to the potential that the removal of insurance capacity generally would lead solicitors to be unable to obtain insurance cover and would then be forced out of the industry. This could provide a justification for intervention to provide an alternative source of cover in this situation (although it may not strictly be a market failure).

However, in general, the solicitors PII market appears to follow a pattern which is typical of other insurance markets. The insurance cycle alone has not usually been used as evidence of a market failure that might justify regulatory intervention.

It should also be stressed that interviewees do not consider that it is some “market-wide-insurance-cycle” effect that is causing firms to enter the ARP currently, but rather that this is linked specifically to issues within the solicitor PII market and the value of claims that are arising – this is particularly linked to the role of conveyancing which is examined below.

2.4.4. Adverse selection

As well as the asymmetric information explained in section 2.4.1 where clients do not have full information about their lawyer, it is also the case that insurance companies do not have full information about the lawyer that they are considering insuring. One of the implications of this is that insurers can suffer from adverse selection in which they are unable to identify whether firms are low risk or high risk firms. This can cause insurers to fail to offer insurance to any firm (within a particular group) because of their concern about ending up with only high risk firms. One concern for insurers would be that in a market without any regulatory intervention there could be a risk that the only firms that seek insurance would be high risk firms but that these firms would try to portray themselves as low risk firms.

This is a typical problem in insurance markets and in order to overcome the problem, insurers will usually apply screening techniques or use various characteristics within the insurance policy in order to identify which firms are likely to be more risky than others. Hence regulatory intervention is not particularly usual from the perspective of overcoming adverse selection concerns for insurers.

However, we note that the solicitors PII policy may itself limit the extent to which insurers have flexibility to apply screening techniques. In addition, the regulatory failures that have been identified in the market (see section 2.4.5 below) may also lead insurers to face greater adverse selection risks. In particular, if as some insurers are suggesting, the regulatory does not intervene against the most risky firms, then insurers are exposed to the risk that they may end up insuring these firms because they are not able to screen them out. One implication of this is that insurers may be unwilling to offer insurance to a whole group of firms (such as sole practitioners or 2-3 partner firms) because they are unable to identify which of those firms will be particularly risky. The adverse selection problem would be expected to be somewhat lessened when regulators close down the firms at the extreme end of the risk spectrum.

2.4.5. Regulatory failures

As well as examining whether there are any market failures, it is also important to consider whether there are failures of regulation that may be causing difficulties for the solicitors PII market. Regulation is itself typically there to address the underlying problems (i.e. market failures). However, regulation can be more or less effective at this. Furthermore, in the context of the client financial protection arrangements, it may be that some issues are best addressed through dealing with the underlying market failures rather than through altering the approach to solicitors PII. There are two main issues which have been highlighted which suggest evidence of regulatory failure including:

- The approach to the conveyancing market; and
- Setting the regulatory boundary.

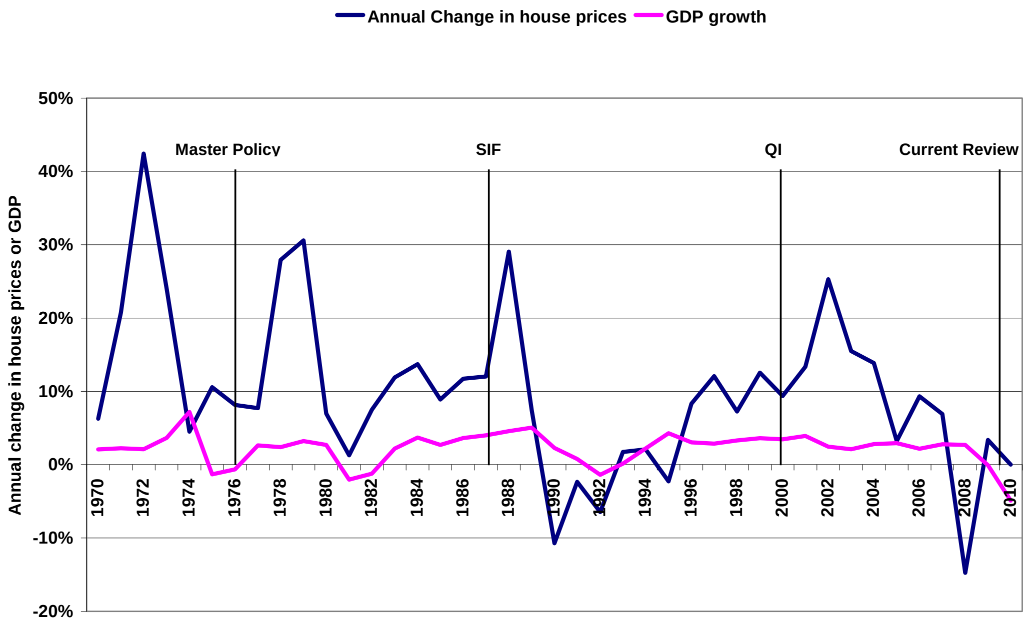
Conveyancing

There is a considerable amount of evidence indicating that the conveyancing process is causing problems in terms of generating a large number and value of claims within the solicitors PII market. In addition, it appears as though the link between the conveyancing process and the property cycle and the impact that it has on the solicitors PII market has have been in place for a number of years.

There is also some evidence to suggest that the impact of conveyancing claims was one of the factors that led previous regimes for the delivery of solicitors PII to come under pressure and be replaced by alternative regimes.

In order to examine this in detail, it is useful to consider the relationship between the economic cycle (as proxied by GDP growth), house prices and changes in the financial protection regime in England and Wales. This is illustrated in Figure 7 below.

Figure 7: Impact of the economic and property cycle



Source: ONS, Nationwide house price index

Figure 7 shows the change in house prices and GDP growth compared to the dates at which different financial protection regimes were brought in. (Details on the different regimes are set out in section 3.1.)

There is not a straightforward relationship between house price slumps and problems with financial protection. It appears as though:

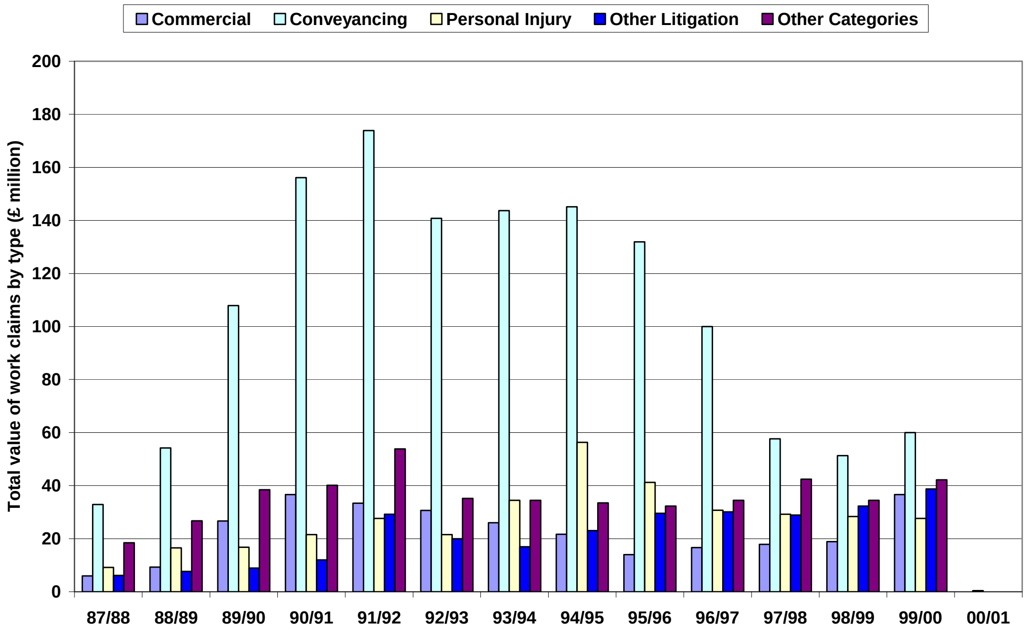
- the house price correction in 1974 may have been linked to the introduction of compulsory insurance in 1976 because of concerns that clients were not sufficiently protected. Unfortunately, given the time that has elapsed since then it has not been possible to assess whether the property market played an important role in that decision; and
- the house price correction in 2008 is linked to the pressure that is arising in the solicitors PII market.

However, the link between changes in the property market and review of the client financial protection regime is slightly more complicated for the introduction of SIF and the introduction of the qualifying insurers regime where there appears to have been a lag between the house prices adjustments compared to the change in the regime.

Discussions for this project with members of the SRA and other market participants who were actively involved at the time have indicated the recession of the early 1980s had led to an increase in the number of claims, particularly related to conveyancing (some with a time lag), which led the underwriters to face losses. The continuing losses that they faced in the mid 1980s led to difficulties in obtaining full cover in the 1986 renewal which subsequently led to a switch to SIF.

Evidence is available on the level of conveyancing claims that arose during the years in which SIF was the insurer. Figure 8 shows the pattern of claims from 1987 to 2000 (when the open market took over from SIF).

Figure 8: The importance of property related claims under SIF



Source: SIF

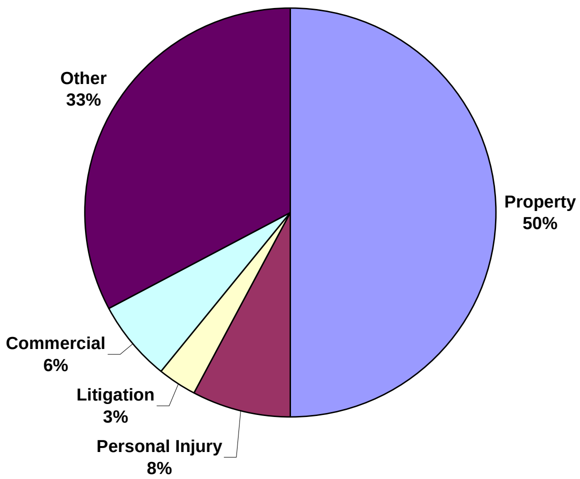
There are two main issues to note. Firstly it should be noted that conveyancing claims represent by far and away the largest proportion of claims compared to all other categories. Indeed, over the whole period conveyancing claims represented around 50% of all of the value of claims.

Second, Figure 8 shows the conveyancing claims increasing in importance during the decline in property prices and subsequent recession but that the claims also develop over a number of years i.e. there is a lag related to many of the claims. Given the importance of conveyancing claims, it appears as though they were one of the causes that led (at least to an extent) to the mis-pricing by SIF (identified in early 1997) that ultimately caused SIF to be replaced by the open market.

It is not surprising that the value of conveyancing claims would increase following a decline in house prices. This is because conveyancing problems will often be identified when houses are sold. If they can be sold for a price greater than the purchase price (or value of the mortgage), the householder (or lender) may not be concerned about any conveyancing mistakes that have arisen. However, if the house can not be sold for a price greater than the purchase price (or value of the mortgage), there is a greater incentive to seek redress from the lawyer in the case of any mistakes.

It is also useful to consider the role of conveyancing claims in the current market where we set out below information on different types of claims for the indemnity year 2007/08.[26]

Figure 9: Total claims incurred by type of work in indemnity year 2007-08



Source: CRA analysis based on survey of ABI members. Note that the total claims incurred is measured as value of claims paid and reserved as at 30 September 2009

Once again it is clear that conveyancing claims represent around 50% of the value of claims arising. The importance of these claims was also highlighted in the majority of interviews with market participants. On average lender claims are found to represent around 26% of overall claims in the open market i.e. around half of the conveyancing claims are lender claims.[27]

Furthermore, a similar pattern is seen in respect of the claims within the ARP where, for the period since 2005/06, conveyancing claims have represented 85% of the value of claims.[28] Lender claims are found to represent around 50% of all claims (i.e. around 60% of all conveyancing claims) within the ARP.[29]

In addition, it is clear that claims related to property transactions are primarily focused on small firms as seen in Figure 10 below.

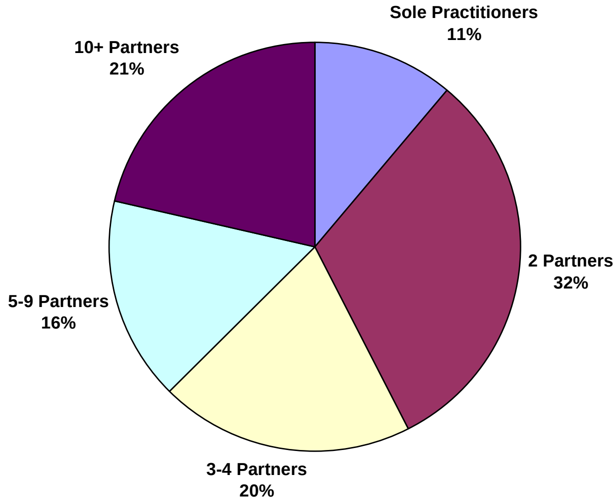
26 This is the most recent year for which we have data.

27 CRA analysis based on survey of ARBI members.

28 Not all claims before 2005/06 were categorised by type of claim.

29 CRA analysis based on data from the ARP.

Figure 10: Total claims incurred in property work area by firm size in indemnity year 2007-08



Source: CRA analysis based on survey of ABI members. Note that the total claims incurred is measured as value of claims paid and reserved as at 30 September 2009

Claims generated from work on property have been disproportionately focused at the smaller end of the industry. As is clear from Figure 10, law firms with less than five partners have generated 64% of the value of all property claims. This contrasts to the fact that such firms represent 14% of the number of lawyers as measured by the number of practising certificates. In addition, no firms has been identified in the ARP that has more than 5 partners indicating that claims arising in the ARP are also linked to small firms.

In summary, the evidence presented in this section indicates that conveyancing claims have consistently represented around 50% of all claims arising in the solicitors PII market. These claims have been clearly linked to the decline in property markets and may have been a key element in previous decisions to alter the financial protection arrangements. The persistency of these problems suggests that there has been a regulatory failure in grappling with the underlying regulation related to the conveyancing process.

We also note that a number of interviewees, and indeed the regulator, has expressed concern about firms that "dabble" in conveyancing. In particular these firms may not be up to date with the latest requirements or may simply forget certain stages in the conveyancing process leading to claims arising.

While examining the conveyancing process is beyond the remit of this report we strongly recommend that the SRA investigate the conveyancing process more generally in order to identify whether more stringent regulation of the conveyancing market is necessary. In as far as the underlying problems in the conveyancing process are addressed, we would expect there to be a positive effect on the solicitors PII market.

Setting the regulatory boundary

During the course of discussions with various market participants (particularly insurers), numerous interviewees have raised concerns that the regulatory boundary set by the SRA is not optimal. There are three areas that have been mentioned most commonly:

- SRA rules enable individuals with three years post qualification experience (PQE) to set up on their own whereas insurers have stated that their evidence indicates that individuals with only three years PQE are statistically more risky than others and that this boundary should be moved to five years PQE;

- SRA rules enable lawyers with qualifications from overseas to take the Qualified Lawyers Transfer Test (QLTT) in order to be qualified to offer services in England and Wales. Insurers have expressed concern that these transfer qualifications are not sufficiently rigorous and that lawyers with the QLTT are statistically more likely to cause claims;

- Concerns that the SRA does not close down firms or remove practising certificates from individual practitioners quickly enough when there is statistical evidence of substantial problems within the firms leading to increases in the value of claims; and

- Concerns that some firms are not financially viable and therefore impose additional costs on the other members of the profession specifically through being unable to pay for their premiums (including for run-off).

All three of these issues point to concerns by insurers that the regulatory boundary is set at a point beyond where insurers believe statistical evidence suggests it should be set.

In general, discussions with both insurers and the SRA have indicated that the SRA has not previously collected as much information on firms as that which is collected by insurers. This may well indicate that the SRA does not have enough information on firms to enable an appropriate assessment of the risk profile of firms. As a result, it is possible that some of the firms within the boundary set by the SRA and permitted to practice by the SRA are considered as firms too risky to offer insurance cover by insurers. Since it is the insurers that currently have the greater amount of information on firms, it would seem appropriate for the SRA to take into consideration any statistical evidence provided by the insurers with respect to setting the regulatory boundary until such a time as the SRA has sufficient information to undertake its own statistical assessment.

The SRA is aware of the problem and has been seeking to improve the situation. In respect of data collection, we understand that the SRA is planning to collect additional information from law firms and will use many of the questions that insurers have in their proposal forms. In addition, the SRA set up their Risk Centre in 2008 to take the role of analysing the data and other intelligence and evaluating the risk profile of firms for the reference of regulatory action recommendations. The SRA is also enhancing the enforcement of regulation by stepping up its inspection efforts of firms.

It is expected that these various courses of action will enable the SRA to more effectively police the regulatory boundary. It would be expected that this would lead to a number of individuals being forced to exit the profession because they do not meet the necessary regulatory standards. In as far as this occurs, this would be expected to reduce the value of claims (particularly through the ARP).

2.4.6. Summary on market failures

The assessment of market failure has important implications for the principles:

- The scheme should protect consumers who can not assess the quality of solicitors and who would not otherwise be able to determine if they had appropriate recourse to the solicitors. The targeting of the scheme should be based on an assessment of asymmetric information.

- There is a potential market failure arising from damage to the industry's collective reputation. This provides an additional justification for intervention to ensure a minimum level of protection by all lawyers such that individual lawyers do not damage the reputation of others.

- The argument that the cyclicality of the market represents a justification for intervention, does not appear strong from an economic perspective.

The principles set out below draw directly from assessment of market failure. In particular, these are the primary justification for principles 2, 5, 6, and 8.

2.5. Resulting objectives and assessment criteria

Given the market failures identified, following discussions with the SRA Steering Group, and in the light of the SRA regulatory objectives, it was agreed that:

- The primary objective of the client financial protection arrangements is to protect clients from financial loss caused by impropriety by people and firms regulated by the SRA, such as negligence, dishonesty and insolvency; and

- A secondary objective is to protect the reputation of the profession from the actions of individual solicitors.

With agreement from the SRA Steering Group, we have set out eight principles that a system of financial compensation should meet:

- Principle 1: The scheme should provide a **fair, transparent and accessible** system enabling those covered by the scheme who have suffered loss as a result of breach of duty by a law firm to be promptly and properly compensated.

- Principle 2: The scheme should be the minimum necessary to meet its objective and **cost effective** in providing client protection in the most efficient manner including the transition from the existing system of protection.

- Principle 3: The scheme should encourage **competition** between different legal services providers and allow new entry and innovation in new business models (i.e. ABSs).

- Principle 4: The scheme should encourage an **independent, strong, diverse and effective** legal profession.

- Principles 5: The scheme should be **targeted**, intervening only where there are clear problems that need to be resolved.

- Principle 6: The scheme should seek to avoid **unintended consequences** in terms of the impact on law firms, clients, insurers or the wider regulated community.

- Principle 7: The scheme should support, but not replace, **regulatory supervision** regarding professional standards.

- Principle 8: The scheme should provide appropriate incentives for lawyers to undertake **risk management** by incorporating an element of polluter pays into the scheme design.

The criteria set out above are used Chapter 4 to assess different potential models that could be used for the delivery of insurance.

2.6. Implications of the principles

It is possible to directly apply these principles to provide a high level guide as to the structure of the financial protection arrangements. In particular, the principles imply:

- Some form of client safety net is required; and

- The scheme should focus on the clients who suffer most from asymmetric information. This suggests that it should focus on individual clients rather than corporate clients.

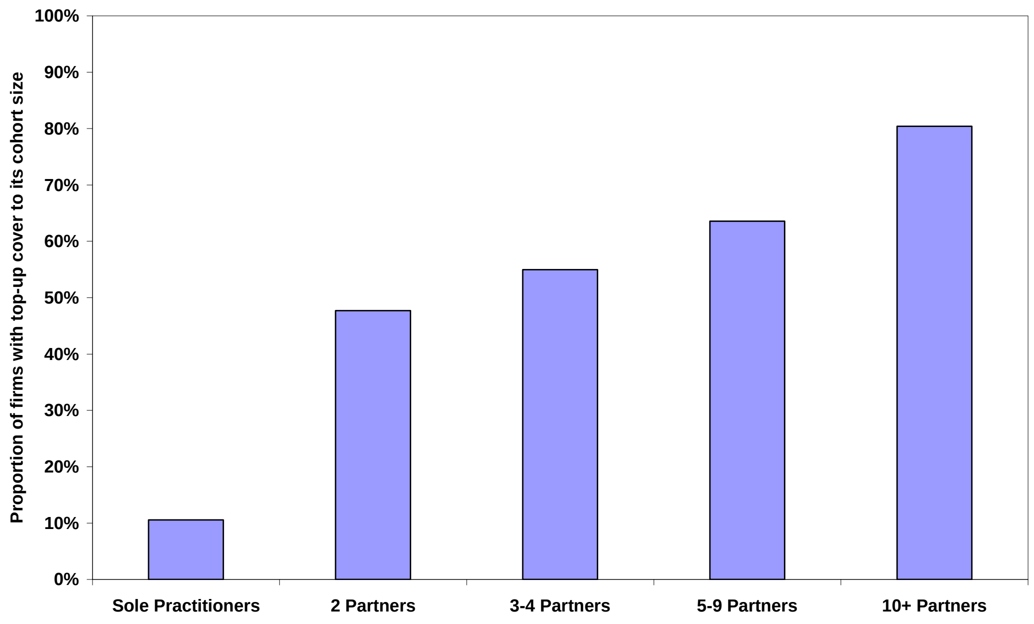
2.6.1. Case for intervention

Without any form of intervention, some firms and some clients will choose to obtain their own insurance. It is therefore useful to assess whether this is likely to overcome any need for intervention.

Purchase of insurance without regulatory requirements

At the very least, those firms that choose to purchase insurance above and beyond today's MTC would be expected to obtain insurance in the absence of regulatory intervention. Figure 7 sets out the proportion of different types of firms that obtain top-up cover.

Figure 11: Firms with top-up cover

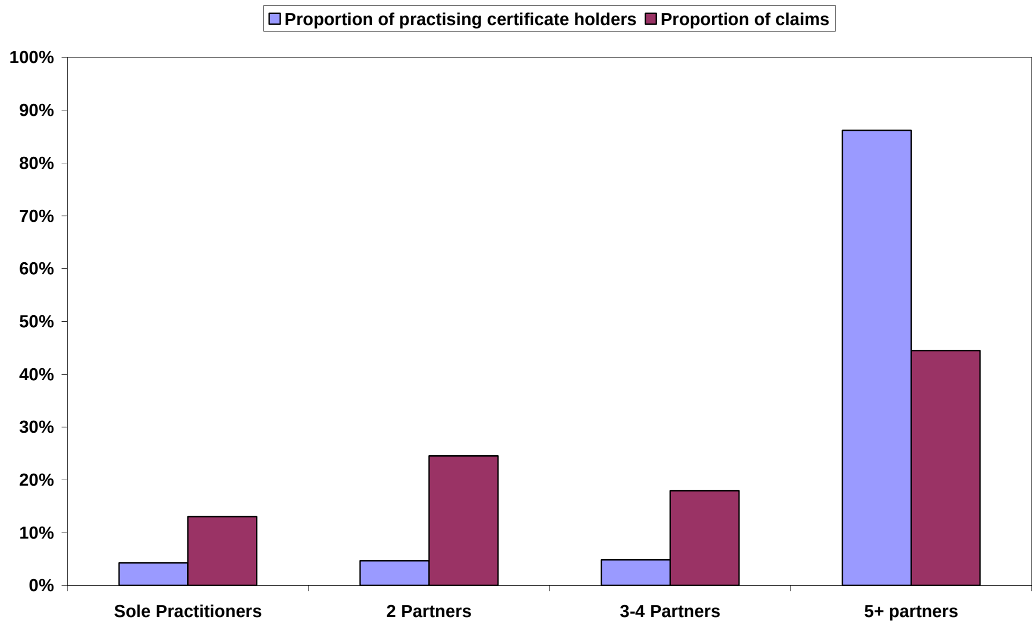


Source: CRA analysis based on data from ABI members.

The expectation that at least some firms would continue to obtain insurance is consistent with evidence of the market prior to the development of the Master Policy when some firms obtained cover and some did not (see section 3.1).

As seen in Figure 11 it is clear that the larger firms are likely to continue to purchase insurance. Indeed, interview evidence has highlighted that their corporate clients often require that they have insurance well beyond the MTC. However, there is less evidence that small firms would continue to purchase insurance. Furthermore, as shown in Figure 12 below, small firms are responsible for a greater proportion of the value of claims than the proportion of practising certificates that they represent.

Figure 12: Claims by size of firms



Source: CRA analysis based on data from ABI members.

In addition to this, firms in the ARP firms face difficulty in obtaining insurance suggesting that these firms may be the ones most likely to fail to obtain insurance in the absence of regulation. As noted in section 5.1.6, there is a very high level of claims associated to firms in the ARP suggesting that the extent to which clients would be expected to suffer from a lack of protection is not trivial.

There is therefore considerable risk that without a requirement to purchase insurance, the take-up of insurance will not be universal and some clients will not be covered.

Consumers taking out their own insurance

It is also possible that the insurance market would innovate to develop insurance products aimed directly at consumers. One such example of this is the Home Owners' Protection Policy (HOPP). HOPP is similar to a Canadian scheme introduced in 1995. The idea behind this is that consumers purchase insurance themselves because:

- It providers quicker access to compensation (the legal process can take several years);
- The insurance is no-fault and therefore negligence does not need to be proved in order to make a claim on the insurance policy; and
- The coverage of the policy goes beyond that available through solicitors PII.

While it is interesting to note that such policies have been developed, at present it does not appear as though the penetration of such products is sufficient to ensure universal coverage of consumers. Furthermore, we note that this product is specific to the conveyancing process and we are not aware as to the availability of similar products that would cover other legal processes.

Summary

Even with many legal firms purchasing insurance and with some consumers purchasing their own insurance, given the asymmetric information there will be a group of consumers that will not be covered. As this outcome would not satisfy the requirements of the primary objective, it was agreed with the SRA Steering Group that the option of having no safety net at all was unacceptable (for clients for whom regulatory protection was deemed necessary – see section 2.6.2 below for consideration of the definition of these clients).

As well as indicating that regulatory intervention is required, this also leads to the conclusion that a safety net is needed for risks that the insurance market is unable to cover. In particular, insurance policies never provide cover in the context of an individual sole practitioner's own fraud since to do so would be to provide insurance to an individual who commits the fraud. Since this risk can not be covered by the insurance market (however that insurance is delivered), it is therefore also necessary to have a separate fund that can cover this risk – we consider this further in Chapter 7 on the Compensation Fund.

2.6.2. Scope of clients that should be protected

At present the MTC ensure that there is PII cover in place for all clients of lawyers. The main argument in favour of maintaining the current rules regarding coverage is that this ensures that there is no situation where the client believes they are protected but in fact they are not (at least for some specified level of cover). However, the arguments against the current rule are that:

- As discussed above, regulatory restrictions should be applied only where there is a market failure. While there is a concern about asymmetric information for individual clients, this does not appear to apply to the use of solicitors by corporations. Many of these firms use solicitors on a repeated basis, will have internal legal departments who are able to monitor the services offered by the solicitor and will have sufficient information to determine the risks that they face. Indeed, interview evidence supports the fact that corporate clients commonly require solicitors to take out additional protection (hence showing that the MTC are not binding on the market for these types of clients); and

- It may prevent innovation in insurance coverage for the corporate market or for sophisticated individual clients. Since all insurance contracts must have the MTC built into them this may prevent new types of coverage developing.

Based on the nature of the market failure, there is justification for intervention on behalf of individual clients but not for corporations. Therefore it seems appropriate that terms and conditions focus on the provision of insurance for individual clients rather than corporate clients. We consider the impact of this, as well as definitions regarding who should be treated as individual clients, in section 6.1

Finally, we note that the desire to protect clients also implies that additional terms and conditions will be required. A requirement that firms need PII without further detail may lead firms to take out such limited PII cover as to not provide any effective protection to individual clients. The details of key terms and conditions are covered more generally in Chapter 6.

2.6.3. Insurance market

As highlighted above, there is evidence regarding a market failure with respect to the asymmetry of information in client understanding of solicitors that leads to a need to have some form of insurance in place.

However, the evidence that there is market failure with the insurance market itself is much weaker. The solicitors PII market appears to follow a pattern which is typical of other insurance markets and the insurance cycle alone has not usually been used as evidence of a market failure that might justify regulatory intervention. Interviewees do not believe that then current difficulties in the solicitors PII market are linked to some wider insurance market cycle beyond the solicitors PII market.

In general it is desirable for firms to have incentives to undertake good risk management practices and to reduce their overall level of risk. Having a market based scheme in which insurance companies set prices according to the expected risk of groups of firms would generally help to set out these incentives. For example, if insurance companies gather information on claims and complaints made against solicitors and alters prices according to these issues, then this would be expected to lead to firms having the incentive to provide high quality advice in order to limit their risks.

In keeping with the approach set out above, regulatory intervention is only required if there is evidence of a market failure. In particular, the burden of proof therefore sits with alternative models to be demonstrably better than the open market, for intervention away from the open market to be appropriate.

In terms of the alternative models that could be used for the delivery of insurance this implies that there must be:

- evidence of market failure with the delivery of insurance through the open market; and
- evidence that alternative models would overcome these market failures bringing benefits greater than the costs that arise from intervention (net benefits). Given that the open market is in place, the costs of intervention would need to include the transitional costs associated with moving from the open market to an alternative model.

These issues are considered further in Chapter 4 where we assess the different models that could be used for the delivery of insurance.

3. POTENTIAL MODELS

In this section we set out the range of potential models that could be used for delivering insurance for the purpose of client financial protection. This is based on examining models used by:

- solicitors in England and Wales as set out in section 3.1;
- solicitors in other countries (Scotland and Ireland). An overview of these schemes is provided in section 3.2 with the details set out in the Appendix in section A.1; and
- other professions (licensed conveyancers, surveyors, financial advisers and accountants). An overview of these schemes is provided in section 3.2 with the details set out in the Appendix at section A.2.

The other professions chosen were selected because they have similar characteristics to lawyers in respect of having significant information asymmetry between the consumers and the provider of the services. The quality of the services is often difficult for clients to assess in advance or even to assess after the service has been provided. These schemes were also the professions most commonly mentioned during early interviews for the project.

Section 3.3 draws together the lessons from different models and Section 3.4 then sets out the range of models that we examine in more detail in the rest of the report.

Information on the comparative schemes also feeds into the assessment of the different models in Chapter 4, the role of the ARP in Chapter 5 and the consideration of different terms and conditions in Chapter 6.

3.1. Models used for solicitors in England and Wales

Before 1976, there was no compulsory requirement for PII for solicitors in England and Wales and coverage was left to the open market. Some solicitors voluntarily purchased insurance cover while some did not and the terms of cover between policies varied.[30] TLS came under pressure from the Government which believed considerable numbers of deserving claimants were going uncompensated because of the lack of compulsory protection.[31] Meanwhile, the profession was concerned that the insurance wording provided by insurers did not provide them with proper protection. Following the necessary legislation, TLS decided to implement a Master Policy scheme.

30 Data on the proportion of the market that was covered by PII before 1976 is not available.

31 Based on information from SRA, "History of the Indemnity Scheme". The document, which refers to the situation prior to 1976, is understood to date from 1995. It certainly dates from before 2000 since the document makes reference to SIF being in place. The authorship is unclear. Unless otherwise sourced, information on the Master Policy set out in section 3.1.1 derives from this source.

3.1.1. Master Policy (1976-1987)

Participation in the Master Policy became compulsory from 1st September 1976. The scheme covered the entire profession and over the course of time was underwritten by a varying group of Lloyds syndicates and commercial insurers. At the time, the advantages of the Master Policy were believed to be:

- That the rates of insurance through the Master Policy were favourable compared to rates in the open market;
- Cover was wider than in the open market as it covered innocent solicitors from liability arising from the dishonesty of other partners, and cover was for each and every claim;
- The application process was simple avoiding the need for detailed proposal forms; and
- The claims handling process was thought to enable claims to be dealt with in a sympathetic way and there would no longer be a risk of policies being repudiated because of failure to notify a claim (or circumstances). Administration and claims handling was outsourced to London Insurance Brokers (LIB).

The insurers quoted a premium for the profession and TLS was responsible for apportioning the premium across the profession. Originally this was done on a per partner basis (with sole practitioners paying slightly more than others), gross fees per partner were introduced in 1984/85 with other factors subsequently introduced including partner/staff ratio, the location of offices and type of work.

Discussions for this project with members of the SRA and other market participants who were actively involved at the time have indicated that the Master Policy came under increasing pressure in 1984-1987. These discussions have indicated that the recession of the early 1980s had led to an increase in the number of claims, particularly related to conveyancing (some with a time lag), which led the underwriters to face losses. Indeed for the period 1981-1986, the claims paid and reserved two years after each indemnity year was never less than 150% of the premiums.[32] Due to the claims experience, many insurers sought to reduce their participation in the Master Policy.

The renewal negotiations with the underwriters for 1986/87 were particularly difficult. Indeed, it was stated that,

> *"At the 1986 renewal, LIB had difficulty in placing 100% of the cover. In the event, this was achieved only be adding two foreign insurers to the market 'slip'. Fears as to the ability to place the cover in future years were one of the main reasons why it was decided to move to a self-insured fund"*[33]

32 SIF First Annual Report.

33 The Solicitors Indemnity Fund, Briefing Paper for Council Members, March 1995. The authorship is unclear.

This then led to a switch away from the Master Policy and to the Solicitors Indemnity Fund.

3.1.2. Solicitors Indemnity Fund (1987-2000)

The Solicitors Indemnity Fund (SIF) commenced its coverage of the profession on 1st September 1987. The existing extent and level of cover as well as the outsourced claims-handling structure under the Master Policy were broadly maintained.[34] However, instead of having commercial insurers underwrite the policy, the profession became its own insurer (although SIF sought to re-insure some of the risk). The main reasons given by the President of TLS at the time for switching to SIF were:[35]

> *"(a) The number of professional indemnity insurers was decreasing and the level of premiums they required was continuing to rise.*
>
> *(b) The lead insurers had restricted their percentage of the total risk of the Master Policy, thereby pointing to the possibility that in future years, insufficient insurers might be found to underwrite the total risk.*
>
> *(c) If any future renewal quotation proved unacceptable, any self-insurance scheme would have to be constructed hastily and under pressure at a time and in a manner not of the Council's choosing.*
>
> *(d) It made financial sense for the full amount of the profession's contribution plus investment income to be available for the benefit of the profession, i.e. without having to bear an insurer's profit margin."*

Over time a number of problems emerged regarding SIF including:

- Concerns about cross-subsidisation: Interviewees have indicated that there was a perception among the profession that the method of calculating contributions to the fund did not fully reflect the risk management level of individual firms. This led to concern that firms with good risk management processes in place cross-subsidised those that had bad claims records. In addition, the calculation of premiums led to large firms cross-subsidising small firms (the evidence for this is set out in section 4.2.1).

- Inability to obtain stop-loss cover: Alongside the fund itself, SIF took out "stop-loss" cover which would pay out if the total value of claims exceeded a certain level. This was in place between 1987 and 1990 during which time the claims were made against the stop-loss policy. The value paid out through the policy exceeded the premiums paid by SIF which reported that for the 1990/1991 indemnity years the stop loss insurers suffered a total loss of £50 million.[36] Following the recession of the early 1990s, increases in claims (primarily, but not solely, conveyancing claims) and

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34 History of the Indemnity Scheme

35 SRA, "SIF/History", p3.

36 SIF Annual Report 1995.

the fact that SIF had claimed on its stop-loss cover meant that SIF was subsequently unable to obtain stop-loss cover between 1990 and 1996.

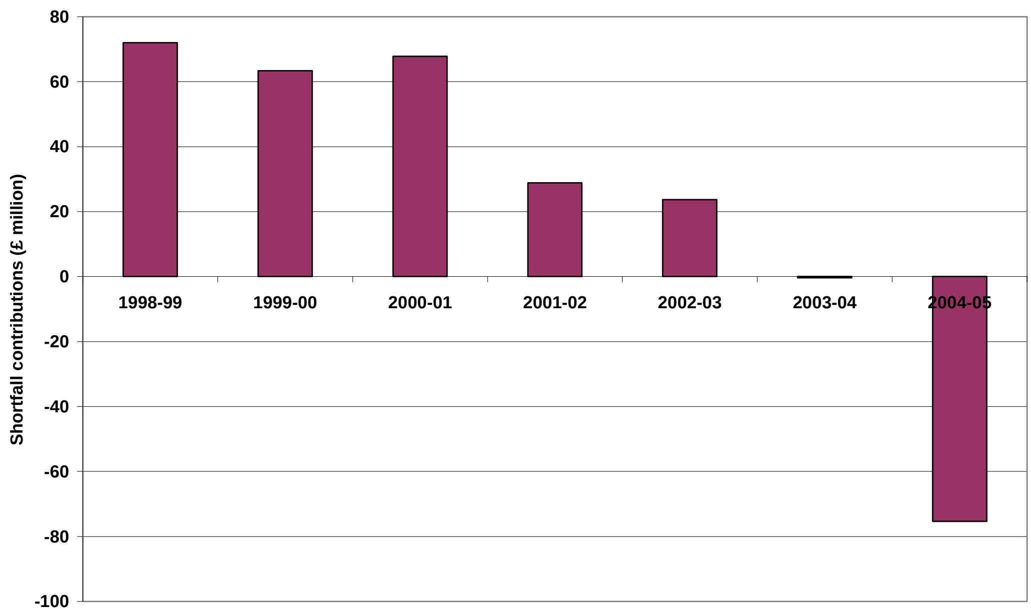
- Shortfall in the fund: The increase in claims also led to the identification of a shortfall in the fund in early 1997. This was initially estimated as around £250 million and subsequently revised to £450 million.[37] The shortfall related to deficits which went back to 1989/90, but the 1991/92 year was especially bad with a prediction of a deficit of £110 million relating to that year alone. Since the profession was the insurer as well as the insured, this shortfall needed to be funded by the profession.

Ultimately the significant shortfall identified, together with the concerns regarding cross-subsidisation prompted the profession to vote for moving away from SIF and to a scheme relying wholly on the commercial market in which firms had freedom of choice.

The loss was made up through additional contributions which were taken from the profession. The intention was that this would be done over the course of seven years with £76 million in the first year and £65 million each year afterwards.

In the event, the predicted shortfall did not materialise to as great a degree as was predicted (i.e. some claims settled for less than expected). This meant that there had been an over-recovery of the shortfall contributions which, since ongoing insurance had moved to the open market, led some of the value to be returned to the profession and TLS as noted in Figure 13 below. Overall, the cost of the shortfall contributions was £180 million.

Figure 13: Shortfall contributions



Source: CRA analysis of SIF Annual reports

37 SIF Annual Report 1996 and 1997.

It is also important to note that in the last few months of SIF there was a sudden increase in the notifications of claims made to SIF before SIF closed and ongoing insurance was provided by qualifying insurers. The total number of notifications related to the 1999/2000 year was 36,000 which far exceeded the 12,000 which would otherwise have been expected.[38] Within a year, over 30,000 of them were subsequently closed at no cost.[39]

Claims that were notified to SIF continued to be dealt with for some considerable time. In 2004, SIF entered into an Adverse Loss Development Programme (ALDP). This provided cover for £205 million of which SIF would meet the first £90 million with the balance paid by the provider of re-insurance.[40] We understand from discussions with those involved in SIF that it is unlikely that claims will exceed the £90 million and therefore all losses arising out of SIF will be met by existing reserves.

As part of the current arrangements SIF is being used as the vehicle for providing "post six year run off" (i.e. claims which arise more than six years after a firm has entered run-off).[41] This applies for a block period of ten years commencing on 1st September 2007 and ending on 30th September 2017.[42] As with standard PII policies, cover is on a claims made basis and therefore will include only claims notified up to the termination date of 30 September 2017. We understand that the policy was arranged as part of the ADLP and was provided at little, or no, extra cost.

3.1.3. Qualifying insurers (2000 to date)

The current scheme of having qualifying insurers came into effect on 1st September 2000 and has been in operation ever since then. According to those involved in setting up arrangements at the time, the scheme was designed to replicate SIF as much as possible in terms of the coverage the profession received. Compared to the Master Policy and SIF there are a number of differences:

- Solicitors in England and Wales are required to have an insurance policy that meets the MTC set out by the Solicitors' Indemnity Insurance Rules. Chapter 6 examines the details of the terms and conditions that are currently in place and therefore we do not consider the detail of these here;

- Solicitors purchase insurance cover from any of the insurers who have agreed to offer policies that meet the MTC and have signed the Qualifying Insurers Agreement (QIA);

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38 SIF Annual Report 2000

39 SIF Annual Report 2001

40 SIF Annual Report 2005

41 SIF Annual Report 2005

42 1st September 2007 was the earliest date at which post six year run off would be required since all run-off claims would have previously been covered through SIF or the Master Policy but qualifying insurers covered only six year run-off.

- If solicitors can not obtain insurance directly from one of the qualifying insurers, they can obtain cover through the ARP, which is designed to be the insurer of last resort for law firms. Chapter 5 examines the ARP in detail so we will not duplicate the discussion in this section.

As already highlighted in section 1.3.4, the current arrangements with qualifying insurers have also come under pressure in recent years in the light of increases in the number and value of claims, especially those related to the conveyancing sector. The pressure has mainly been apparent in the growth in the number of firms in the ARP as well as from the growth in the value of claims in the ARP.

3.2. Models in other countries and other professions

In addition to looking at the models that have been applied in England and Wales, we can also learn from the experiences of models applied for solicitors in other countries where models in Scotland and Ireland were most commonly identified as important comparators during early discussions with market participants. The other professions which we consider are:

- Licensed Conveyancers as regulated by the Council for Licensed Conveyancers (CLC);
- Surveyors as regulated by the Royal Institute of Chartered Surveyors (RICS);
- Financial advisers as regulated by the Financial Services Authority (FSA);
- Accountants as regulated by the Institute of Chartered Accountants in England and Wales (ICAEW); and
- Accountants as regulated by the Association of Chartered Certified Accountants (ACCA).

The details of the various schemes are set out in the Appendix but Figure 14 sets out the key characteristics of the various schemes. In general we will refer to the schemes either by the name of the country or by reference to the regulator.

Figure 14: Comparison of schemes

	Law Society Ireland	Law Society Scotland	CLC	Surveyors	Financial Advisers	ICAEW	ACCA
Type of PII cover	Qualifying insurers	Master policy	Master policy	Qualifying insurers who must be rated B+ by AM Best or BBB by Standard and Poors	EEA regulated insurer	Participating insurers	Any reputable insurer
Size of profession	8.300 practising certificates	10,400 practising certificates; 1,200 firms	200 firms	10,000 firms	10,000 firms	18,000 practising certificates; 12,000 firms	20,000 individuals; 5,000-5,500 firms
Value of premiums	€42 million (£35 million)	£15-20 million	£2.5 million	£50 million	£40 million	£30 million	£15 million
Premium basis	Insurer determined	Set by lead underwriter with discounts and loadings	Set by Master Policy underwriters mainly based on turnover with adjustments for claims and excess	Insurer determined	Insurer determined	Insurer determined	Insurer determined
Renewal	Single renewal 1 Dec	Renewed 1 Nov	Renewed 1 Jul	No fixed date	No fixed date	No fixed date	No fixed date
Level of cover	€1.5m for each and every claim	£2m (claims attributable to the same act are regarded as one claim)	£2 m for any one claim	£0.25m for turnover less than £0.1m; £0.5m for turnover of £0.1-0.2m; £1m for turnover above £0.2m. Cover is on an each and every claim basis	£1.12m single and £1.68m aggregate	£1.5m or 2.5 times gross fee income with £0.1m minimum. For any one claim and in total	Minimum varies subject to 2.5 times income, 25 times largest fee, aggregate of £0.3m and total income. Each and every claim
Excess	None specified	£3,000 per partner with a 15 partner cap (i.e. £45,000)	Residential conveyancing must be no more than £3,500 or the sum of: 5% fees for fees of £0- £0.2m; 3% fees for fees of £0.2m-0.5m; and 2% fees on fees between £0.5m and £1m. Firms with fees over £1m can apply to increase the excess	Maximum of £10,000 or 2.5% of sum insured	Not more than £5,000 unless additional capital is held	Not more than £30,000 per principal	Lower of £20,000 per principal and 2% of indemnity fo each and every claim
Significant exclusions	Undertakings in commercial conveyancing excluded after 1 Dece 2009, to be banned after 1 Dec 2010. Financial institutions excluded when material non-disclosure.	None	Insurers can avoid for non-disclosure or mis-representation unless free of fraudulent intent (insured to prove) and for false or fraudulent claims	Mis-representation must be free of any fraudulent conduct or intent to deceive (which is for the insured to prove).	Specific lines of business can be excluded subject to additional capital being held	Misrepresentation leads to avoidance of claim unless free of intent to deceive	None
Fraud	Fraud and dishonesty is not covered	Fraud and dishonesty covered. Cover for clients of firms who fail to pay premiums	Fraud is not covered	Fraud and dishonesty must be covered	Not specified	Fraud and dishonesty must be covered	Fraud and dishonesty must be covered
Run off	Two years	Provided through Master Policy for unlimited duration	Six years	Six years	None specified. Continuous cover of relevant activity.	Two years although the guidance recommends six years and firms must make "best endeavours". Retroactive cover for six years	Six years
Assigned Risks Pool	Suspended for 2009-10	Not required	Not required	ARP in place with participating insurers required to subscribe to it.	None	ARP in place with participating insurers required to subscribe to it.	None
ARP access	N/A	N/A	N/A	Firms must demonstrate (constructuve declinature) from current and three other insurers. Maximum of 3 years in the ARP.	N/A	Firms must demonstrate (constructive) declinature. Cover for up to two years declinature. ARP can provide cover for up to two years (with discretion for exceptional extensions)	N/A
ARP shortfall funding	Market share of qualifying insurers	N/A	N/A	Market share of qualifying insurers	N/A	Market share of qualifying insurers	N/A
Client fund	Compensation fund	Guarantee Fund	Compensation Fund - also covers run-off and is insured	Client money protects against fraud for £50,000 or £5m in any year	Compensation Scheme	None	None

Source: CRA analysis

3.3. Lessons from different models

There are a number of lessons that can be drawn from the different schemes that are in place and have been used both for lawyers as well as for other professions.

3.3.1. Overall model used

Range of models

First it is useful to note that the following overall models are, or have been, used in different areas:

- Open market / qualifying insurers – this approach is the most common model currently in place and is used by Ireland, RICS, FSA, ICAEW and ACCA as well as being the current model used for England and Wales;
- Master Policy – this is in place for Scotland and the CLC as well as previously being used for England and Wales;[43] and
- Industry self insurance – this was in place through SIF and was previously used under RICS.

It is interesting to note that none of the countries reviewed and none of the professions considered are in the situation where there is no regulatory requirement to have PII in place. This provides further support of the analysis in section 2.6 which ruled out no regulatory intervention as an option because this would fail to meet the SRA's objectives.

Common conditions for Master Policies

Second, there appear to be common conditions under which Master Policies are most suitable:

- Relatively low values of total premiums – CLC has premiums of £2.5 million and Scotland has premiums of £15-20 million. This compares to England and Wales which has premiums of around £250 million;
- Relatively few firms covered – CLC covers around 200 firms and Scotland covers 1,200 firms whereas England and Wales covers around 12,000 firms;
- Homogeneity of those covered – CLC members undertake only conveyancing and probate work. Solicitors in Scotland are believed to represent a more homogeneous set of firms than those in England and Wales since the largest firm in Scotland has fewer than 50 partners whereas England and Wales has greater diversity in terms of the size of firms.

43 We understand that Master Policies are also used by the Law Society in Northern Ireland and The Isle of Man Law Society although we have not examined these schemes.

As explained further in the details in section A.1.2 in the Appendix, the OFT investigated the Scottish Master Policy between 2003 and 2005 although it concluded that there was no evidence that the Scottish Master Policy was distorting competition between lawyers. Interviews have indicated that the relatively small size of the Scottish legal profession, the large proportion of small solicitors (including a large geographical spread across islands) and the bargaining power that LSS could exercise on behalf of its members were important elements in the OFT's decision. We note that the England and Wales scheme does not share these characteristics and therefore it seems likely that the OFT would have concerns about the use of a Master Policy (or industry self-insurance) in England and Wales.

Sustainability of models

Third, we note there are lessons regarding the sustainability of different schemes:

- No model is immune from coming under strain – This is particularly illustrated by the examples in England and Wales in which first the Master Policy, then SIF and now the open market have all faced pressures. Similarly, we note that many of the schemes have been affected by the economic downturn although none of them appear to have suffered an increase in the number and value of claims to the same extent as solicitors in England and Wales;

- Master Policies are not inherently unstable - The Scottish Master Policy has been in place since 1978 and the CLC Master Policy since 1988. Both have been able to endure the economic cycle; and

- Industry self-insurance is no longer in place in any of the markets considered – England and Wales moved away from SIF partly because of pricing mistakes that led to the requirement for shortfall contributions highlighting the fact that the profession were the insurers as well as the insured. RICS moved away from an industry-wide scheme because of a concern regarding a similar issue that any catastrophic risk would have to be funded by the profession.

Insurer of last resort / ARP

Fourth, the presence or otherwise of an insurer of last resort through an ARP is something where there is considerable variation between different schemes:

- Scotland and the CLC do not have an ARP since their Master Policies cover the whole profession. Similarly, RICS did not have an ARP under their previous industry-wide scheme and England and Wales did not have an ARP under the Master Policy or SIF;

- The ACCA and FSA do not have an ARP;

- RICS, ICAEW and Ireland have an ARP as well as England and Wales. In the case of Ireland, the ARP was suspended during the 2009/10 indemnity year although it is intended that the ARP will be in place for the 2010/11 indemnity year.

Amongst those professions that have an ARP, there are some differences in various aspects of the ARP:

- Access to the ARP – Under ICAEW and RICS firms must demonstrate declinature or constructive declinature of qualifying insurers before they are able to enter the ARP whereas this condition does not apply for England and Wales;

- Length of time in the ARP – RICS allows firms to be in the ARP for a maximum of three years, ICAEW for two years. The maximum time in the ARP for England and Wales was been reduced from two years to one year from the 2009/10 indemnity year; and

- Size of the ARP – ICAEW has never exceeded 15 firms in the ARP and RICS had a maximum of 16 firms in the ARP in 2001/.02 which subsequently fell to a low of 2 in 2008/09 although it currently stands at 14. For England and Wales, the ARP has historically fluctuated at around 50-70 firms but increased rapidly in the last two years reaching 320 for the 2009/10 indemnity year.

3.3.2. Terms and conditions

As well as variation in the overall model used in different markets, there are also lessons to be learned regarding the detailed terms and conditions that apply.

It is notable that all schemes require that certain minimum terms and conditions be in place i.e. no scheme simply requires “suitable” or “appropriate” PII and then leaves firms and insurers to negotiate the detail of the terms and conditions. Instead, all schemes impose additional requirements, although the detail of these varies.

Level of cover

All schemes impose a minimum level of cover although there is variation in:

- The basis on which the level of cover is set – the ICAEW and ACCA set the minimum as a function of gross fees, while other schemes have a fixed value in place; and

- Whether the minimum cover is on an “each and every” claims basis – the ICAEW sets the same limit in total as for a single claim, the FSA sets an aggregate limit as well as a limit for a single claim.

A number of schemes have raised the minimum level of cover over time although this appears to have arisen on a sporadic basis to overcome the effects of inflation. The exception to the sporadic nature of this is the level of cover which applies for financial advisers who are insurance intermediaries which is set through a European Directive. The Insurance Mediation Directive (IMD) prescribes that the level of cover will be increased every five years on the basis of changes in consumer prices.

Single renewal date

Scotland and the CLC which have Master Policies in place both have a single date on which these schemes are renewed. Among those schemes that use the open market, Ireland is unusual in being the only other scheme (along with England and Wales) that has a single renewal date. Other markets allow freedom on the timing of renewal dates.

Excess

All of the schemes, with the exception of Ireland, impose some form of constraint on the level of excess that is allowed. This is based on:

- A fixed amount for the FSA (although this can be altered if firms hold additional capital);
- A fixed amount per principal or partner for Scotland and ICAEW;
- A proportion of fees for CLC;
- A combination of a fixed amount and a proportion of fees for RICS; and
- A combination of a fixed amount per principal and a proportion of the indemnity cover for ACCA.

The example of the FSA indicates that there are trade-offs between different areas of regulation. In the particular case of the FSA the trade-off arises through enabling higher levels of excess to be taken if firms hold additional capital (out of which the additional excess can then be paid).

It is also interesting to note that there is much variation in the method by which constraints on the excess are imposed. The approach taken in England and Wales, which gives flexibility to insurers to agree any level of excess with the insured, but where the insurer is on risk should the insured not pay the excess, is different again to the approaches taken in other schemes.

Fraud and compensation fund

In respect of fraud, it is noted that no insurance scheme allows individuals to insure against their own fraud. However, there is a mixture in whether or not the minimum terms and conditions require that innocent principals in firms are insured against the fraud committed by others in the firm.

Given the inability to insure against an individual's own fraud, most schemes have some form of compensation fund in place which provides clients with protection in the case of fraud. This applies for Ireland, Scotland, CLC, RICS, and the FSA as well as for England and Wales.

Such compensation funds are not in place for either ICAEW or ACCA. In respect of ICAEW it is understood that this reflects the relatively modest amount of client money typically held by accountants on behalf of their clients (which may be limited to money received through tax reclaims). It is also understood that cases of loss of client money are rare. The ACCA notes that it does not provide compensation and indicates that clients may seek redress through the courts.

Run-off cover

Run-off cover is required by all of the schemes in place with the exception of the FSA. In most cases run-off is required for six years with the exceptions being:

- Ireland where this is only required for two years;
- RICS where firms are required to have run-off for two years and to make "best endeavours" to obtain it for six years; and
- Scotland where the Master Policy provides run-off cover for an unlimited duration.

3.4. Range of models for review

As set out in section 3.3.1, there are three main types of models that are observed across all of the professions which are:

- Open market / qualifying insurers;
- Master Policy; and
- Industry self insurance.

Co-incidentally each of these three models have been used at some stage for solicitors in England and Wales.

Given that these models encompass all of the professions examined in the research, and following agreement with the SRA Steering Group, these are the models that we take forward for detailed consideration in Chapter 4.

As set out in section 3.3.2, the different schemes also demonstrated a variety of approaches to different terms and conditions which feeds into our examination of these different elements in Chapter 5.

In addition to the three main models, under the open market option, some schemes (including England and Wales) have an ARP acting as an insurer of last resort. The ARP is not necessary under either the Master Policy or a model of industry self insurance since both of these models encompass all firms in the profession and therefore there is no need for a separate pool to act as an insurer of last resort.[44] Given that the open market option can operate with, or without, an ARP we primarily examine this separately in Chapter 5. However, there are some aspects of the assessment of potential models which interact with whether or not there is an ARP and for this reason, we also consider the role of the ARP in Chapter 4 where this is relevant.

In all three options, the inability to insure against an individual's own fraud means that client protection would be lacking in the absence of some form of Compensation Fund

44 Although there may be a question as to where certain other types of risk should be covered such as the provision of cover for clients of firms that are non-compliant and do not take out insurance.

which provides clients with protection in the case of fraud. There is no evidence from the various comparative schemes that the need for a Compensation Fund is related to the underlying model used for the delivery of insurance. For this reason, we examine the role of the Compensation Fund separately in Chapter 7.

4. ASSESSING POTENTIAL MODELS

As set out in section 3.4, there are three main types of models that we examine in detail in this chapter:

- Open market / qualifying insurers – with or without an ARP;[45]
- Master Policy; and
- Industry self insurance.

In practice it is also possible that a combination of these could be used such as by allowing the open market for some firms but requiring the use of a Master Policy or industry self insurance for other firms. Where relevant to the particular assessment factor we also consider this in the chapter.

Throughout the chapter, we review how each of the models perform relative to the assessment criteria developed in Chapter 2. It should be noted that in keeping with the approach explained in Chapter 2, regulatory intervention is only required if there is evidence of a market failure. As explained in section 2.6.3 the implication of this is that for each of the criteria against which models are assessed, and for the overall comparison between models, the burden of proof sits with the alternative models to be demonstrably better than the open market for intervention away from the open market to be appropriate.

4.1. Cost effective

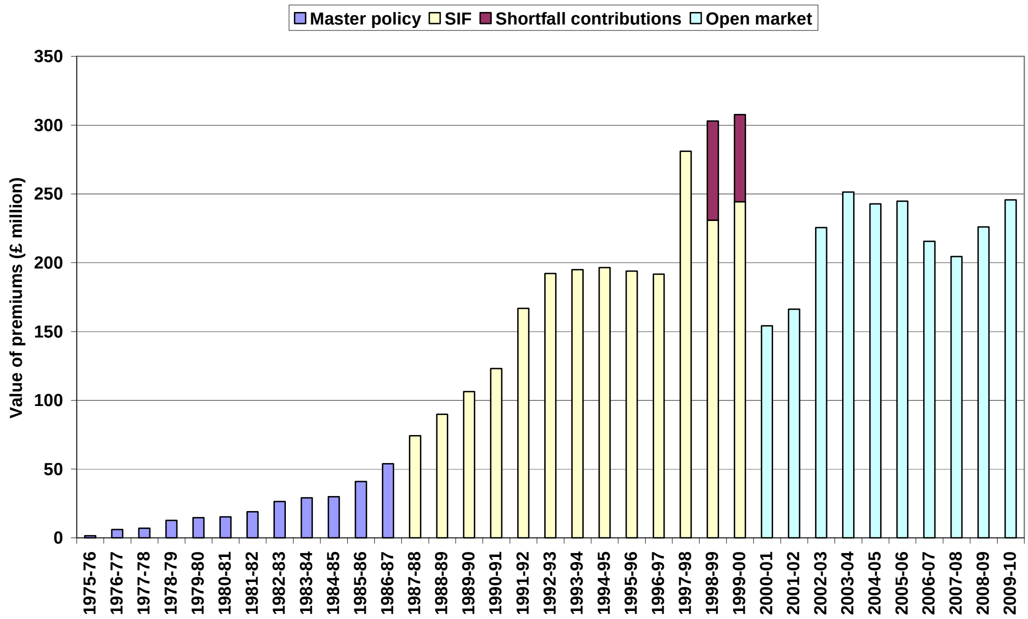
In this section we consider the cost effectiveness of the different models. We examine both the overall level of premiums and also measures of volatility in these premiums.

4.1.1. Value of premiums

Solicitors in England and Wales have used three different models for the delivery of insurance and hence it is possible to compare how they performed. Since these models have been sequential, it is not possible to undertake a direct comparison of one model against another allowing for the specific conditions in place at the time). Although technically firms paid "contributions" under SIF and the Master Policy rather than "premiums", we use the term premiums throughout for convenience. Figure 15 shows the value of premiums over time. The premiums relate to the cost of policies with the MTC and exclude the cost of any top-up cover that is taken out.

45 We consider the distinction between a purely open market and using a qualified insurer agreement in section 6.1.

Figure 15: Value of premiums



Source: CRA analysis based on data from the SRA and SIF Annual Reports. Note that the shortfall contributions have been included in the figure only for 1998/99-1999/2000 so as not to distort the picture after this time when the open market was in place.

It is clear from Figure 15 that the switch away from SIF and towards the open market led to a sudden drop in the value of premiums across the market. Some of the drop in premiums may have arisen because of the transition from SIF to the open market itself.[46]

Some care must be taken when examining the premiums between the Master Policy/SIF and the open market. In particular, run-off cover was provided within the Master Policy/SIF whereas this would be expected to involve the payment of a separate premium in addition to those set out in Figure 15.[47] Similarly, in the open market, many firms will choose to use a broker and payments to intermediaries acting as agent of the firm are excluded from the value of premiums collected by the ARP.[48]

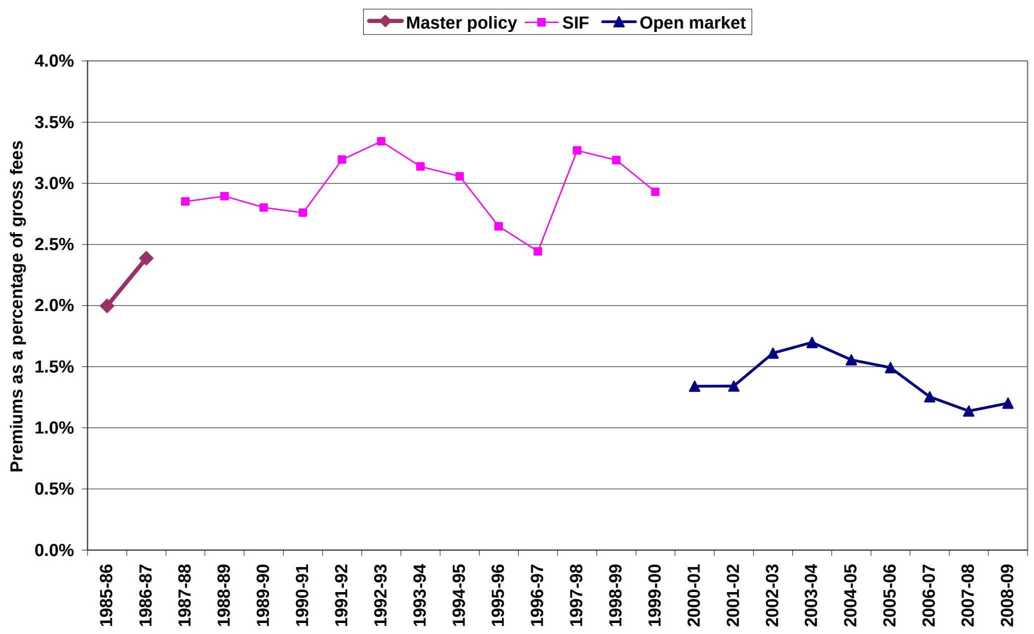
46 As noted in section 3.1.2, a large number of claims were notified to SIF once it was known that the model would be moving to the open market. This may therefore have reduced the number of claims that qualifying insurers expected to receive in the subsequent year.

47 Costs associated to firms that go into run-off without paying their premium for this either in the ARP or in the open market, would implicitly be covered through the premiums shown given that ARP contributions are paid via the insurers at present and therefore priced into their overall premiums. The data in sections 5.10.1 and 6.10 suggest that this may include the majority of firms who enter run-off.

48 Brokers may often act as the agent of the insurer rather than the insured in which case payments would be included in the value of premiums collected. In general, broker costs could represent around 20% of premiums for small firms, but would be a smaller proportion for larger firms (who would also be more likely to pay on a fee basis). Furthermore, even under the Master Policy and SIF, firms that required top up cover would typically have engaged a broker to assist with this indicating that not all of the costs of brokers involved in the solicitor PII market is additional compared to under alternative models.

It is also important to note that the size of the legal profession has increased over time with the value of gross fees (which is one of the key rating factors in determining the cost of insurance) nearly doubling since PII has been delivered through the open market.[49] In order to allow for this we have calculated the value of premiums as a percentage of the value of gross fees charged by the profession. Figure 16 below shows the premiums as a percentage of gross fees over time. For the Master Policy, this was only available for 1985/86 and 1986/87.

Figure 16: Premiums as a percentage of gross fees for SIF and open market



Source: CRA analysis based on data from the SRA and SIF Annual reports from various years. Note that the SRA did not collect information on the total gross fees for the indemnity years 2003/04-2007/08 hence these have been estimated through linear interpolation.[50]

It is clear from Figure 16 that premiums have been substantially cheaper through the open market than under either the Master Policy or SIF. Indeed, as shown in Table 5 below, the average premium under the open market has been less than half of that in SIF and around two-thirds of that under the Master Policy. The substantial difference between

49 The level of cover in the minimum terms and conditions was also increased over time to reflect the impact of inflation.

50 Given the lack of data on the value of gross fees, linear interpolation of the data on gross fees is a reasonable approach to take. If, instead, we assumed that there had been no growth in gross fees for the years in which data is missing (followed by a sudden jump up in 2008/09), the average premium would have peaked in 2003/04 at 1.80% (rather than 1.70%). If the growth in gross fees had been faster than assumed, the average premiums would have been lower than those shown in Figure 16. Neither of these alternatives would have changed the conclusions drawn. It is possible that the impact of the recession is that previous years had higher fees than 2008/09. If this is correct the average premiums for these years would have been lower than those shown in Figure 16. Again this would not change the conclusions.

the costs under different models more than overcomes any concerns about differences in the data regarding issues to do with run-off or payments to brokers.

Table 5: Average premiums in SIF and open market

	Average premium as a percentage of gross fees
Master Policy (1985/86-1986/87)	2.2%
SIF (1987/88-1999/2000)	3.0%
Open market (2000/01-2009/10)	1.4%

Source: CRA analysis based on data from the SRA and SIF Annual reports from various years. Note that the SRA did not collect information on the total gross fees was not available for the indemnity years 2003/04-2007/08, hence these have been estimated through linear interpolation

As noted in section 3.1.2, the premiums in SIF were affected by the application of the shortfall contributions in the last few years. However, in 1995/96 and 1996/97, when there was believed to have been under-pricing, these two years still represented years in which the premiums were around 2.5% of gross fees which remains well above premiums for the open market.[51]

Given the differences identified between the schemes, it is interesting to estimate the cost of premiums if different models had been used. Table 6 below sets out the comparative costs under the different models using the average percentage of gross fees in Table 5 and calculating the predicted cost of premiums for 2008/09 (the last year for which information on gross fees is available) had the Master Policy or SIF been in place. We also provide an estimate of the value of premiums saved by having the open market from 2000/01- 2008/09 rather than the alternative models.

Table 6: Estimate of relative costs of different models

	Cost of premiums 2008/09	Saving for 2000/01- 2008/09 from open market rather than alternative
Master Policy (1985/86-1986/87)	£412 million (predicted)	£1.1 billion
SIF (1987/88-1999/2000)	£557 million (predicted)	£2.1 billion
Open market (2000/01-2009/10)	£226 million (actual)	-

Source: CRA calculations

Data is not available on the value of gross fees for other comparative sectors and therefore it is not possible to asses the cost of premiums per gross fees for these other sectors. However, the results in Table 5 and Table 6 provide clear evidence that the

51 It is also the case that the cost of SIF as a percentage of fees would remain higher than the cost of the Master Policy or open market even if the shortfall contributions in 1998/99 and 1999/2000 were excluded from the calculation.

overall cost of insurance from the open market is substantially lower than that through the other two models. This indicates that there is no justification for moving away from the open market on the basis of this assessment factor. Furthermore, the calculations provide information on the expected additional cost of alternative schemes were they to be used.

4.1.2. Cost effective - variation in value of premiums

One concern that has been raised by solicitors and their representatives during the course of interviews is that the value of premiums under the open market is volatile. One particular issue about this is whether this suggests that the scheme is sustainable.

In addition, some interviewees have also stated that the variation in prices potentially causes unintended consequences through making planning and budgeting difficult for the profession. It is argued that both the Master Policy and SIF set out the basis of the calculation of premiums such that firms could identify the level of premium that they would be expected to pay. By contrast, solicitors note that they do not know how individual insurance companies arrive at the particular level of premium that they quote. Although the Master Policy and SIF did change the basis of their premiums over time, the resulting pricing policies were transparent.

Where PII is delivered through a model in which lawyers can only go to one particular source of insurance (i.e. the Master Policy of SIF), setting out the basis of the calculation on a transparent basis is straightforward. However, where there are competing insurers, the revelation of the basis of calculation would entail insurers publishing their (different) underwriting models. To do so would be exceptionally unusual in insurance markets since for any insurer their underwriting model is one of their key comparative advantages in which they invest considerable intellectual capital. Publishing such models would substantially reduce the incentive to ensure these models are robust and therefore be expected to reduce the extent to which price signals can be used to incentivise risk management (as discussed in section 4.2). It is also important to note that the prices that result from these calculations in the open market are transparent since premiums are clearly stated and easily compared with those from other insurers. The transparency of the calculation is not necessary to ensure transparency of the premium and no concerns were highlighted during interviews regarding the transparency of the premium itself.

Comparison of variation between schemes

In this section we assess whether the premiums charged to the profession have greater volatility to them under the open market compared to alternative models.

Ideally we would want to examine the variation in premiums as a percentage of gross fees (i.e. the data in Figure 16). An examination of the standard deviation by this measure shows that SIF has greater variation than the open market (0.26% compared to 0.19%).[52] It is notable that this is in direct contrast to the view put forward by some solicitors that the open market is more volatile than SIF.

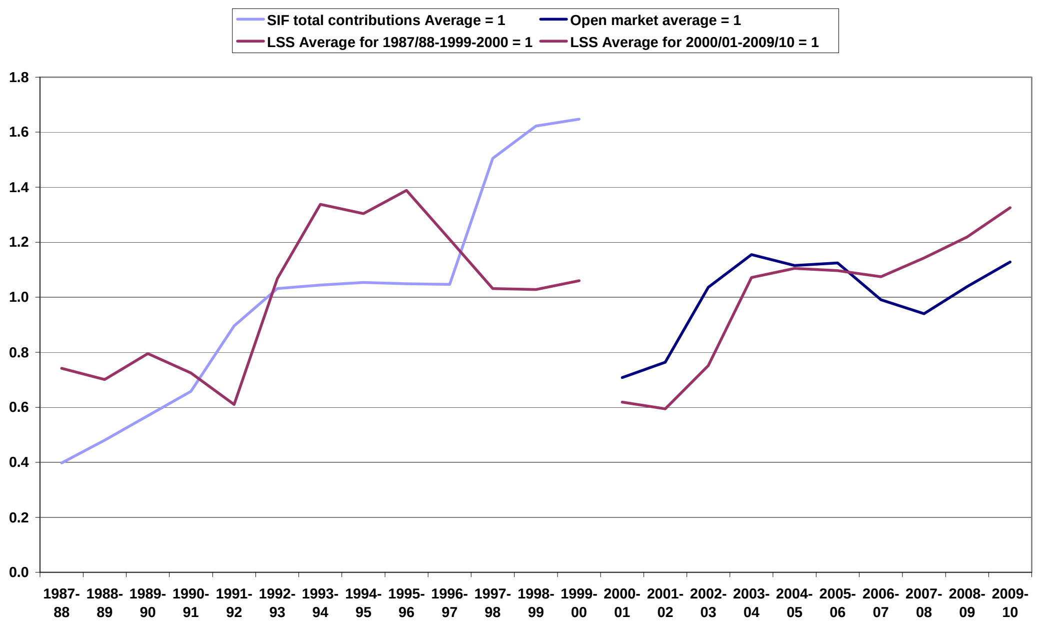
52 Data is not available to be able to conduct the comparison at the level of the individual firm.

It is not possible to compare the variation in premiums as a percentage of gross fees for the Master Policy as there is insufficient data available on gross fees. We therefore rely on data that has been provided by the Law Society of Scotland (LSS) where a Master Policy is in place. LSS has provided the data on the value of premiums to CRA for the purpose of the analysis but the actual data on the value of premiums is considered confidential and therefore not shown.

It should be noted that since we are comparing models over different periods and in different countries, this test would be a relatively weak test in terms of demonstrating that either SIF or the Master Policy would be preferred to the open market. Nonetheless, since LSS has had a Master Policy in place throughout the whole period it is possible to compare the LSS Master Policy to both SIF and to the open market, as well as to compare all three models over time.

The data has been normalised such that the average premium for the period and model has been set at 1 with the shape of the graph then showing the variation in premiums over time.

Figure 17: Variation in premiums



Source: CRA analysis based on data from SRA, SIF Annual reports and LSS.

In general, Figure 17 shows that:

- For 1987/88-1999/2000, the LSS Master Policy had less variation compared to SIF; and
- For 2000/01-2009/10, the open market had less variation compared to the LSS Master Policy.

The lower dispersion in the open market emerges clearly from different statistical measures that are reported in Table 7. In both measures we find the same result that the open market had less variation compared to the Master Policy, and that the Master Policy had less variation compared to SIF.[53]

Table 7: Comparison of measures of variation

	SIF (1987/88-1999/2000)	LSS (1987/88-2000/01)	LSS (2000/01-2009/10)	Open market (2000/01-2009/10)
Standard deviation[54]	0.41	0.26	0.25	0.16
Maximum/ minimum index	4.1	2.3	2.2	1.6

Source: CRA analysis based on data from SRA, SIF Annual reports and LSS.

Overall, therefore there is no evidence that, at the overall level, the open market leads to a greater degree of variation in the value of premiums compared to other models.

Shortfall contributions under SIF

One of the potential advantages of industry self insurance is that, as a single pool for the profession as a whole, it is possible for the self insurance pool to set insurance prices across the insurance cycle. That is, it would be possible for the pool to set prices such that in years of low claims, surplus premiums were collected, in order that in years of bad claims premiums would not be as high as otherwise, thereby smoothing the payment of premiums.

By contrast, models in which insurers take the underlying risk (both the open market and the Master Policy) can not smooth the payments over time. Where insurers make mistakes and under-price, their shareholders bear the cost of this and entry of new competitors limits the extent to which insurers are able to seek to recover these losses in later years. Where insurers make mistakes and over-price, their shareholders will gain but new entry prevents this from being sustained.

As noted above, in practice, SIF did not set prices that had less variation than alternative models. In addition to this, and as noted in section 3.1.2, during the course of SIF, under-

53 This conclusion also holds regarding SIF even if the shortfall contributions in 1998/99 and 1999/2000 were excluded from the calculation.

54 This value is the standard deviation of the normalised value of premiums. The normalisation allows a direct comparison of the values in the standard deviation.

pricing of premiums was identified leading the fund to suffer a shortfall in the late 1990s.[55]

The shortfall contributions were made by the profession and this highlights one of the risks to the profession under the model of having industry self-insurance. That is, there is a risk that the single self-insurance pool would under-price the true risk again and the profession would be required to make large unexpected payments. To place the information in context, the overall cost of the shortfall contributions of £180 million represents 94% of the value of contributions in SIF in 1996/97 before the under-pricing was identified.

Therefore, even though there is a theoretical advantage of industry-self insurance smoothing premiums over the cycle, in practice the evidence does not support this as one of the advantages of SIF. Furthermore, there remains the risk that a future self-insurance pool would make a similar under-pricing mistake leading to sudden increases in payments to recover from this. This is consistent with the decision made in other similar professional such as surveyors who have opted to replace a self insurance scheme (RICS Insurance Services) with a qualifying insurance arrangement.

We therefore conclude that there is no evidence that, at the level of overall premiums, alternative models are less volatile than the open market indicating that there is no justification to move towards these alternatives on the basis of this measure.

4.2. Incentives for risk management

In this section we consider how the different models compare in terms of the incentives for lawyers to undertake risk management. Schemes that encourage solicitors to manage risk through processes that reduce the likelihood of mistakes, and therefore of claims, are preferable to those that do not have such incentives. The fact that there is a very high value of claims arising currently indicates the importance of encouraging risk management in order to limit the extent to which claims occur in the first place. There are three different issues which we consider:

- The provision of direct risk management activities;
- Prices as an incentive for risk management; and
- Potential withdrawal of cover as an incentive for risk management.

55 The cost of the shortfall contributions has been taken into account in the analysis above when examining the cost of SIF for the years 1998/99 and 1999/2000 both in terms of the values of premiums shown in Figure 15 and the variation in premiums in Figure 17 and Table 5. The conclusions regarding both cost and variation would have remained the same even if the shortfall contributions are excluded from all of the calculations relating to SIF. However, it is important to note that the profession faced additional costs compared to those highlighted in Figure 15 since shortfall contributions continued to apply after the move to the open market as set out in Figure 13 in section 3.1.2.

4.2.1. Direct risk management activities

Risk management activities have occurred under both SIF and the open market (information is not available for the Master Policy).

During the years in which SIF was used it operated a "claims prevention strategy" through which it sought to raise awareness among the profession as to the cause of claims and how they might be avoided. For example, in 1994 SIF developed a general claims prevention education programme and staged a series of seminars around the country. In addition, SIF was also able to specifically target a number of firms who had poor claims records who were asked to provide information on their office processes.

In the open market, various insurers and brokers, along with other firms that specialise in advising on risk management, also undertake similar activities to those of SIF. This includes offering seminars, specific advice to individual firms and generic advice that is provided to the whole market such as "Insurance matters", the guide on PII from TLS in association with Aon. In addition, TLS has developed LEXCEL which is their practice management standard which assesses whether firms meet various management and client care standards which include areas of risk management.

Both SIF and the open market therefore deliver risk management activities. SIF may have had an informational advantage in targeting some of this activity towards high risk firms (since it had information on the whole market). However, the open market includes different suppliers of these risk management services competing and innovating to help advise firms on this. It is not possible to draw a strong conclusion on whether one model is preferable to another model on this issue.

4.2.2. Prices

The price of insurance is one of the key ways to incentivise firms to undertake risk management activities. It is therefore useful to compare the methods that are used for setting prices in some of the other models that have been in place:

- England and Wales Master Policy - As noted in section 3.1, by the end of the Master Policy, premiums were set on the basis of number of partners (with sole practitioners paying slightly more than others per partner), gross fees per partner, partner/staff ratio, the location of offices and type of work;

- England and Wales SIF – In early years, gross fee income per principal represented the basic method for setting prices, with an adjustment to reflect the partner/staff ratio, the number of claims and some areas of work being categorised as low risk leading to a discount on the premium. Additional elements were introduced over time including variations according to the level of deductibles. It was not until after the shortfall contributions had become necessary that SIF introduced a pricing approach which was aimed at "raising contribution more in line with that of the commercial market";[56]

- England and Wales open market - Insurers will set prices according to a wide range of different criteria as evidenced by the detail required for many insurance company proposal forms. In addition to information gathered under the Master Policy or SIF, specific information is often required for conveyancing (number of transactions, typical capital value, whether there is a high proportion of introductions from one source, number of buy to let transactions, work for specific lenders) and personal injury work (type of injury, average claim, highest claim);

- LSS – As noted in section A.1.2 in the Appendix, premiums are set by the lead underwriter based on number of principals and using various rating factors (fee income introduced as a rating factor in 2004/2005), discounts (such as for an increased excess) and loadings (maximum level of premium loading increased from 250% to 275% for firms with a loss ratio in excess of 300% and four or more claims over 5 year reference period); and

- CLC – As noted in section A.2.1 in the Appendix, premiums are mainly based on turnover with adjustments for claims and excess. There have been some complaints that the basis of setting premiums is not sufficiently transparent.

In general it appears to be the case that Master Policies and SIF set premiums on the basis of fewer rating factors compared to the open market in England and Wales.[57] Whilst the methodology for setting premiums changed over time for SIF and the various Master Policies, under the open market there is constant innovation in the approach used as insurers compete to set prices to different firms using a variety of different rating factors.

Cross-subsidies

One of the consequences of the pricing approach taken by SIF was that cross-subsidies arose between different types of firms. In particular, as seen in Table 8 below, one and two partner firms were consistently subsidised by larger firms.

Table 8: Proportion of contributions and (proportion of claims)

	Number of partners		
	1	**2**	**Over 10**

56 The quote is from the SIF Annual Report 1998. The information in the paragraph is also taken from the SIF Annual Report 1991.

57 Some caution needs to be applied when comparing the models in England and Wales over time since underwriting has generally become more sophisticated enabling greater differentiation between different types of firms. Similarly it is important to be cautious about the setting of premiums in Master Policies for schemes which are considerably smaller such as those in Scotland and the CLC (where it may be appropriate to use a smaller number of rating factors).

1987-1991	9% (14%)	11% (14%)	36% (31%)
1987-1995	9% (17%)	11% (20%)	37% (23%)
1995-2000	12% (19%)	15% (19%)	32% (27%)

Source: CRA calculations based on SIF Annual Report 1991, 1995, 2000. Note that the 2000 Annual Report presents information graphically and therefore the figures have been estimated through visual inspection.

Over the whole period, one and two partner firms paid around 24% of contributions but represented 37% the value of claims, whereas firms with 11 partners or more paid 35% of contributions and represented 25% of the value of claims.[58] In addition to the cross subsidies that were observed towards small firms, firms with low values of gross fee income (less than £0.5 million) were also consistently subsidised by firms with high values of gross fee income.

It is economically inefficient for cross-subsidies of this kind to remain in place. This is because cross subsidies reduce the extent to which price signals incentivise good risk management. (This is not to suggest that all small firms are high risk firms but that, as a group, small firms were not facing premiums that reflected their true risk.) While a model of industry self insurance or a Master Policy can sustain these inefficient cross-subsidies, competitive markets drive them out.

One of the reasons that some small firms favour a return to something like SIF is because they believe that they faced lower prices under SIF than in the open market. However, it is clear from Table 8 that as a group, one and two partner firms only faced relatively small premiums because they were cross-subsidised. Under the open market, small firms would have seen their relative premiums increase to reflect their overall share of claims.[59] From a risk management perspective this is appropriate and improves economic efficiency.

It is possible that a Master Policy or self insured pool for England and Wales could retain the complexity of pricing of the current open market in terms of the range of different ratings factors used and the information that would be required.[60] Indeed some interviewees have argued that these models have the benefit of having information on the whole market and would therefore be better able to price risk. On this point we note that during the transition from SIF to the open market, SIF data was provided to the market (and prices were observed to fall). In addition, TLS entered into a joint venture with St Paul (now Travelers) to offer PII which involved St Paul obtaining the SIF staff, including contributing to the operation of Fund with respect to staff, claims handling and

58 This is based on a simple average of the 1987-1995 and 1995-2000 periods.

59 They would also have been expected to gain from the general lowering of prices that arose in the open market as demonstrated in section 4.1.

60 For example, this could be done through tendering the underwriting component of the self insured pool and allowing the lead underwriter of a Master Policy to set prices as they thought appropriate. This does not imply that these models would be *better* at setting prices than the open market. Therefore the Master Policy and industry self insurance do not dominate the open market for this particular factor.

management.[61] Given the preferential position that St Paul was in, if there had been benefits from having greater information on the whole market we would have expected St Paul to have this advantage and therefore to be in a position to take a very substantial market share. In practice, however, while it has been one of the leading players in the market, it has not dominated the market.

In contrast to the argument regarding the benefits of having information on the whole market, we note that there are a large number of qualifying insurers in the market suggesting that they do not believe it is necessary to have information on the whole market in order to compete in the market.[62] Furthermore, it is important to take into account the positive impact of competition on innovation in pricing and risk modelling (as well as the removal of an inefficient cross-subsidy that was seen in practice).

Information

One of the implications of insurers seeking to innovate in their pricing models is that insurers will require additional information related to these issues. During the course of interviews, a number of firms have indicated that a greater amount of information is required by insurers compared to the Master Policy or SIF and it is generally acknowledged that proposal forms have increased in length to gather additional information.

Some small firms see the additional information that is required as a burden since they need to spend considerable time completing forms, checking information and gathering new information (especially where insurers request information that small firms do not have automatically available). Some firms therefore view the smaller amount of information that was required by the Master Policy and SIF as a benefit of those models.

However, insurers gather information in order to feed that information into their underwriting models such that they can set prices in an economically efficient manner and there is no incentive for insurers to collect superfluous information. We understand from interviews that the increase in information has particularly focused on conveyancing transactions as insurers seek to differentiate between high risk and low risk firms and set prices accordingly. In addition, insurers often request information on whether the firm is accredited by LEXCEL and seek information related to the risk management processes in place with this information acting as a signal of good risk management.

Hence this additional information helps insurers to identify good firms who undertake low risk activities and have good risk management processes in place to receive low premiums while firms operating in higher risk areas of work with poor risk management face higher prices. This therefore highlights the issue that if less information is gathered, and if fewer rating factors are used in pricing then weaker underwriting would be expected, and more cross-subsidies would result with good firms subsidising the cost of poor firms.

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61 SIF Annual Report 2001

4.2.3. Offering cover

The final element regarding the incentives for risk management is whether or not the insurance market is willing to offer any cover at all. Under a purely open market situation firms that are very high risk (due to the way they operate rather than the underlying activity being risky) and can be identified by the market as such, may not simply be offered very high premiums, but may fail to get cover altogether. The inability to obtain cover in the case of lax risk management standards enables the open market to set an additional incentive which is lacking in either the Master Policy or industry self insurance since the latter two arrangements guarantee cover for all firms.

We understand that this was a significant issue for SIF. Since SIF was required to offer cover to all solicitors, it was unable to refuse cover to firms that were considered to be exceptionally high risk, who could not be viably insured and whose continued presence simply led to additional costs being faced by the rest of the profession.[63]

We note that this element of the risk management incentive has a direct trade off against the assessment criteria relating to regulators setting the boundary of the profession:

- If insurers are able to refuse cover, this sets incentives for solicitors to ensure their risk management is good enough for them to obtain cover, but takes the decision relating to the regulatory boundary away from the regulator; or

- If the model in place guarantees cover, this reduces the incentives for solicitors to ensure their risk management is good enough for them to obtain cover, but leaves the decision relating to the regulatory boundary with the regulator.

The trade-off, in particular related to whether there is a need to have something like the ARP playing a role of insurer of last resort, therefore relates to the cost of the reduced incentives for risk management compared to the value of having the regulator set the boundary. This is considered further in section 4.3 below on targeted regulation.

Overall, however, it seems clear that the open market sets more effective incentives for risk management through setting prices to reflect risk and ensuring that there are no cross-subsidies in place. Premiums under SIF included cross subsidies which reduced the incentives for risk management and a return to a similar model (or the Master Policy) retains the risk that such cross-subsidies would arise once again. While firms that used to be subsidised may prefer models in which they receive a subsidy this is not economically efficient and would distort competition between lawyers. On the basis of this assessment factor we therefore conclude that there is no justification to move away from the open market.

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62 Potentially this contrasts with smaller markets where insurers may be unwilling to compete for a proportion of the risk.

63 However, had SIF or the Master Policy refused cover, this would have raised other problems since firms would not have been able to approach alternative insurers.

4.3. Targeted

The next principle we consider is whether the scheme is targeted appropriately i.e. whether it involves only intervening where it is necessary to intervene.

4.3.1. Trade-off between risk management and regulator setting the boundary

The trade-off between incentives for risk management and the regulator setting the boundary explored in the section above also links to the issue of the desirability of having targeted regulation.

At present, the open market sets risk management incentives through the price mechanism for those firms served. At present, even with the ARP at its largest size ever, the open market serves more than 97% of firms and a greater proportion of the number of solicitors. Given that the open market serves the overwhelming majority of firms, addressing the 3% of firms the market is *not* willing to serve through an intervention that adversely affects the 97% of firms it *is* willing to serve does not meet the requirement that the intervention be targeted. Therefore, the reintroduction of a Master Policy or industry self insurance would not seem to satisfy the need for targeted intervention.

It is possible that a Master Policy or industry self insurance pool could be arranged only for those firms that are most at risk of not being served by the open market. Firms entering the ARP over time have nearly always been firms with fewer than five partners. Hence a Master Policy or industry self insurance pool could be targeted on firms with fewer than five partners. However:

- more than 97% of firms with fewer than five partners are still covered by the market rather than falling into the ARP; and
- even for sole practitioners alone, more than 95% of firms are served by the open market today.

Again this does not represent strong evidence of targeted intervention on the grounds of the regulator setting the boundary.[64]

As noted in section 4.2.1, one of the reasons small firms give for preferring SIF to the open market is the relatively lower prices that they received in SIF. As already explained, this resulted from a cross-subsidy from larger firms which is economically inefficient and weakens incentives for good risk management. It is worth noting that if a Master Policy or industry self insurance was focused on small firms, this could not include any cross-subsidy from larger firms as was previously the case under SIF thereby removing the perceived advantage of these models in the view of some small firms.

We also note that the regulator setting the boundary can be achieved, as in the current approach, through a combination of using the open market as well as the presence of an

64 It is also possible that it could have unintended consequences through introducing distortions on the boundary. For example, some firms may add additional partners in order to have the freedom to use the open market, other firms may face problems if they suddenly grow or shrink in size.

insurer of last resort for the profession. This retains the role of the open market for the vast majority of firms with the associated benefits set out in section 4.2 for retaining risk management incentives which are better than those set through a Master Policy or industry self insurance.[65]

Hence the requirement for targeting gives a clear preference for the combination of the open market and the insurer of last resort over either the Master Policy or industry self insurance. It does not, however, assess whether the open market with an insurer of last resort is better than just having the open market. This relates to the regulator setting the boundary which we consider in section 4.5 and the role of the ARP more generally which we consider in Chapter 5.

4.3.2. Provision of insurance services

Insurance companies conduct a number of different activities when offering PII to solicitors including:

- Risk management services (discussed already in section 4.2.1);
- Actuarial or underwriting skills in setting prices;
- Administrative and claims processing skills; and
- Provision of capital.

When seeking targeted intervention it is useful to consider whether the method of intervention leads activities to be done by those firms that have a comparative advantage in conducting them.

In general we might expect the insurance industry to have an advantage in these activities rather than the legal profession. However, we note that in respect of risk management and claims processing skills it is common for these skills to be outsourced (even by insurance companies themselves). Hence a Master Policy or industry self insurance could simply buy in these skills, indeed the operation of the ARP at present involves buying in administrative and claims processing skills from Capita.

In respect of underwriting skills, the open market has these skills provided by insurance companies. The Master Policy benefits from these skills provided by competing insurance companies in terms of reaching the overall value of premiums, although the Master Policy would end up with a single underwriting model when sharing the overall premiums between different firms. SIF could buy in these skills but would also end up with a single underwriting model.

In terms of the provision of capital itself:

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65 It is possible that the Master Policy or self insurance could replicate the open market in which case the alternatives are no better than the open market, but in practice SIF was observed to retain significant cross-subsidies which reduces the incentive for risk management.

- Both the open market and the Master Policy have capital provided by insurance companies; and

- Industry self insurance involves capital being provided by the profession (although in practice there might be re-insurance particularly for losses beyond a certain limit).

It is reasonable to assume that insurers have a comparative advantage in the provision of underwriting capacity since this is one of the key components of their business. By contrast, it is reasonable to assume that the legal profession does not have a comparative advantage in the provision of underwriting capacity since, if they did, we would expect them to operate insurance companies.[66] We do not observe such activity and no interviewee argued that the legal profession had a comparative advantage over the insurance sector in this regard.

One advantage that industry self insurance might have over the open market or Master Policy is the ability to spread risk over time by building up a fund. As noted in section 3.1.2, in practice SIF suffered from under-pricing.

Overall, outsourcing of certain skills and re-insurance retains the ability to ensure activities are done by firms that have an advantage in doing them. However, it does not demonstrate advantages for the Master Policy or industry self insurance models compared to the open market.

4.4. Competition between lawyers

In this section we consider the impact of insurance arrangements on competition between lawyers. We examine the effect with respect to:

- static competition which considers how lawyers compete now; and

- dynamic competition which considers how lawyers may compete in the future where we particularly focus on the role of alternative business structures.

4.4.1. Static competition

When considering static competition, the issue for consideration is whether there is some aspect of the delivery of insurance through different models that prevents lawyers from competing effectively amongst themselves.

The concern that arises is that both the Master Policy and a model of industry self insurance would lead lawyers to have no choice but to obtain their compulsory insurance from these particular sources. Even if the characteristics of the firm meant that they would be better off seeking alternative insurance provision, they would be prevented from

66 Alternatively, given historic restrictions on their activities, we would expect to see insurance companies investing surplus funds directly in insurance companies. No interviewee indicated that they anticipated insurers and lawyers combining under the freedoms allowed with ABSs. Similarly, no insurance company indicated that they intended to enter the legal market such that they could benefit from any such comparative advantage of lawyers offering insurance capacity.

doing this. In turn this could distort competition between lawyers because such firms would not be able to obtain the benefits of lower costs and would therefore be disadvantaged compared to the situation where they did have alternative choices for their insurance.

At this stage it is important to note that for small firms PII costs have been highlighted as being one of the top three costs for the firm (after labour and property costs).[67] This indicates that concerns about the distortion of competition may not be trivial.

Furthermore, in both the Master Policy and SIF, there is no guarantee that cross-subsidies will not arise and, as noted in section 4.2.2, in practice the experience of SIF was that one and two partner firms were subsidised by larger firms.

Lessons can also be learned from other sectors. For example, it is notable that the OFT investigated the Scottish Master Policy between 2003 and 2005 precisely because of this concern that the Master Policy may distort competition between solicitors. While the OFT found that there was insufficient evidence to show that the Master Policy distorts competition, it is clear from wider discussions that the relatively small size of the Scottish legal profession and the large proportion of small solicitors were important elements in the OFT's decision. In this regard it is worth noting that the Scottish legal profession is less than one-tenth the size of the profession in England and Wales and similarly the total value of PII premiums in Scotland is less than one-tenth those in England and Wales. In addition, solicitors in Scotland are believed to represent a more homogeneous set of firms since the largest firm in Scotland has fewer than 50 partners whereas England and Wales has greater diversity in terms of the size of firms. The comparison with the CLC scheme is even more striking since England and Wales has premiums of around 100 times the value of that for the CLC.

These issues indicate that there is potential for the Master Policy and industry self insurance to distort effective competition in the legal market. Such a concern could prompt an OFT investigation in the absence of evidence of the need for that form of intervention.

4.4.2. Competition between lawyers – alternative business structures

The Legal Services Act will enable additional flexibility regarding the types of firms that can conduct certain legal activities in particular through allowing "alternative business structures" (ABSs) to enter the market. It is therefore important to assess whether the model through which insurance is delivered could adversely impact entry of ABSs through increasing the barriers to entry to the market.

As noted in section 3.3.1, the markets in which Master Policies are in place currently (Scotland, and licensed conveyancers) are characterised by firms that are relatively homogenous such as in terms of the types of work that is carried out or the spread of the size of different firms. Indeed it seems to be the case that Master Policies are appropriate to such circumstances where they may be less appropriate to situations where there is

67 TLS in association with Aon, Insurance Matters, Issue 2, April 2010.

greater homogeneity. A similar argument would appear to hold with respect to the industry self insurance model i.e. that pools of insurance are typically related to groups of firms that are similar.

Within a single pool of insurance, more heterogeneity is likely to raise more concerns about cross subsidies from one group of firms to another. By contrast firms can be confident that a competitive market will drive out these cross subsidies. In addition, different competitors may be better at serving different market niches. Indeed we observe in the market that some firms focus on providing insurance to particular types of firms e.g. sole practitioners, small firms, large firms etc.

ABSs bring about the potential for a greater variety of types of firms to enter the market than are currently observed thereby increasing the level of heterogeneity in the market. If Master Policies and industry self insurance are best suited to homogeneous groups of firms, the entry of ABSs makes the case for these alternative insurance models in England and Wales weaker compared to the situation where no ABSs are allowed.

During the course of discussions, especially with those responsible for schemes in other countries and other professions, it was clear that there are concerns regarding the interaction between the entry of ABSs and the terms and conditions which are set in different schemes.

Insurers are used to providing cover for a variety of different businesses generally and therefore have the flexibility to offer policies that would meet the needs of a variety of regulatory requirements as well as the business needs of different ABSs. Discussions with insurers indicate that before they design new policies for this purpose, they are waiting to see both how regulatory co-ordination deals with the issue of different schemes having different requirements, and also how firms might seen to exploit the new freedoms under ABS. In contrast to the open market, a Master Policy or SIF may lack the flexibility to deal with substantial variation of different business models.

One issue of concern relates to the scope of the cover in terms of whether all activities conducted by an ABS would be covered through the MTC or whether only legal advice would be required in the MTC. This is an issue that is more difficult when insurance is delivered through the Master Policy or industry self-insurance because these models would only offer the MTC and firms would therefore need a second policy to obtain cover for other activities which may involve additional costs.

Conceptually this is no different to the situation today where firms require top up cover going beyond the MTC. In practice, in the open market:

- Small firms who require additional cover beyond the £2/3 million minimum would typically be able to obtain one policy for up to around £10 million; and

- Large firms who have much more complicated needs would have a range of different policies in place for different “layers” of insurance, one of which would be their compulsory policy.

However, with both the Master Policy and industry self insurance, because they only offer the minimum cover, even relatively small firms who want additional cover would be required to seek this from a separate source of insurance. Indeed, where Master Policies are in place today, this is the approach that is taken. The flexibility of the open market would therefore be of particular benefit to small firms who would be able to obtain higher levels of cover through one policy which would not be a choice available to them under the alternative models.

We note that approximately 10% of sole practitioners and 50-60% of 2-4 partner firms currently take out top up cover and would therefore be placed at a disadvantage from moving away from the open market. For larger firms, although they are more likely to take out top-up cover, this constraint is likely to be of less concern given they are likely to have a range of policies in place already.

Hence it is clear that it is somewhat easier to obtain more flexible cover through the open market than through the situation with a Master Policy or industry self insurance. At the extreme, it is possible that small firms that want to take advantage of the flexibilities of ABSs would not do so because of the cost of obtaining a second insurance policy to cover them for the activities beyond those covered in the MTC. We consider this issue further in section 6.2 where we examine the issue of the activities covered through the MTC.

Other issues that were raised during the course of discussions related to the situation whereby the current MTC for solicitors were generally seen as representing a higher and wider level of cover compared to other schemes. This led some interviewees to indicate that this may causes problems in terms of different types of entities competing on a level playing field. We note that this issue is specific to the details of the terms and conditions rather than to the question of the model of delivery of these terms and conditions and therefore consider this issue in Chapter 6.

4.5. Equality and diversity

Assessing the different models against the requirement to ensure that there is a strong, independent and diverse profession has two major components. First related to the premiums that different types of firms would pay under different models, and second related to whether firms would obtain cover under different models of insurance delivery.

First, in respect of pricing, it is possible that different models for delivering insurance have differential effects in respect of the pricing charged to different groups of lawyers. Data is not available at the level of individual firms under the Master Policy, SIF or open market that enables an assessment to be made on the prices charged. Hence it is not possible to conclude that one model or another has better or worse effects on equality and diversity measures with respect to the premiums paid.

Second, in respect of whether cover is available for *all* firms, we note that the arguments are identical to those set out in section 4.6.1 below regarding the assessment factor that the regulator set the regulatory boundary:

- Where there is only the open market with no insurer of last resort there is a risk that some firms will fail to obtain cover from the open market. It is possible that the firms that fail to obtain such cover may be disproportionately representative of one particular group of lawyers compared to another in which case there is the potential for this to have a detrimental impact from an equality and diversity perspective; and

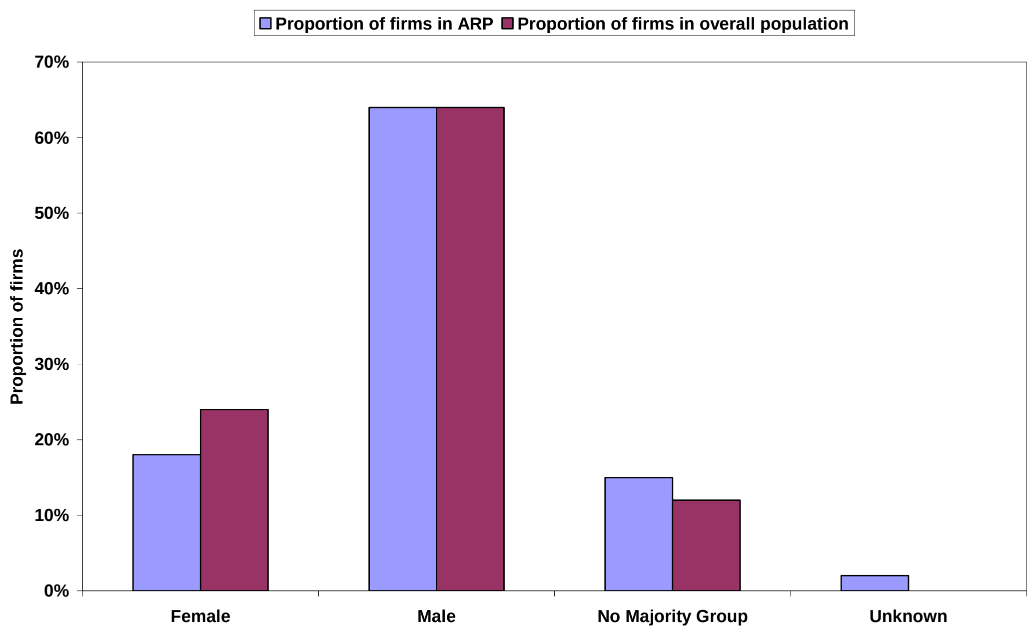
- With all other models (open market with insurer of last resort, Master Policy, industry self insurance), all firms would be able to obtain cover. Therefore the insurance model would not cause one particular group of lawyers to exit the market and would therefore not have a detrimental impact from an equality and diversity perspective.

It is useful to consider whether the theoretical concern about equality and diversity is born out in practice. This can be done through examining the firms that are currently in the ARP since these would be the firms that we assume would fail to obtain cover under a model of the open market with no insurer of last resort.

Equality and diversity data is only available on the firms in the ARP in respect of age, gender and ethnicity. No interviewee raised concerns in respect of any of the other criteria for which data is not available.

Figure 18 below indicates that there is no evidence of one gender being particularly represented in the ARP compared to the other. No interviewee raised any concern regarding gender issues.

Figure 18: Proportion of firms in the ARP and overall population by gender



Source: SRA

Note: Data as of 2 February 2010

A similar comparison on the basis of age gives some suggestion that lawyers under the age of 50 are disproportionately represented in the ARP compared to lawyers over the age of 50. When undertaking a previous assessment of the ARP we note that the SRA concluded that, “firms led by younger solicitors may be perceived as having less experience and may well be earning less than those run by older solicitors and therefore assessed as higher risk”. It therefore appears likely that the apparent age issue is likely to link to the number of years PQE. As noted in section 2.4.5, insurers believe that the number of years PQE after which individuals can set up their own firm is currently set at too low a level – it is possible that the result in respect of age therefore reflects regulatory failure related to PQE. No concerns were raised during interviews regarding age.

Interviews with BME firms have also indicated that they face considerable difficulties in obtaining cover. It should be noted that similar concerns have been raised by small firms more generally during the interview process and therefore it is not possible, on the basis of interviews, to draw strong conclusions from this.

However, we do find that BME firms are disproportionately represented in the ARP since BME firms represented around 28% of firms in the ARP during 2006/07-2008/09 (this increased to 41% in 2009/10) compared to 11% in the profession as a whole.[68] This indicates that there could be a detrimental equality impact in respect of moving to a model of having the open market without an insurer of last resort.

We examine this issue in detail, along with other equality and diversity factors, with respect to the role of the ARP which is examined in detail in Chapter 5. It should be noted that we focus on the impact on equality and diversity factors relating to any recommended changes rather than examining equality and diversity factors per se. We note that BME firms are disproportionately small firms and therefore issues that affect small firms would also be expected to have an impact on BME firms.

In addition, we also note that there may be an interaction between specific elements of the MTC and their impact on equality and diversity. Where we consider the different elements of the MTC in Chapter 6 and propose recommendations for changing any of these elements, we therefore set out any equality and diversity issues. Since there may be correlation between small firms and other equality and diversity criteria (such as BME firms) we highlight the potential impacts in connection with this.

4.6. Regulatory supervision

There are two components to the assessment factor that the scheme support but not replace regulatory supervision which we consider in turn:

- setting the boundary of regulation; and
- ensuring that there are incentives for the model for the delivery of insurance to reveal appropriate information about firms to the regulator.

68 Based on SRA data from 2 February 2010.

4.6.1. Setting the boundary

If regulators are to set the boundary regarding which firms can operate in the legal profession, it is important that firms are able to obtain insurance in order for them to do this. Applying this assessment factor to the models:

- The open market alone can lead to insurers being unwilling to offer insurance to all firms. At present around 3% of firms would be at risk of being in the situation where the insurance sector refused to offer insurance but where the regulator is wiling to allow these firms to operate; whereas

- The models in which there is: an open market and an insurer of last resort; a Master Policy; and industry self insurance all allow the regulator to set the boundary of who can operate in the profession and who can not.

Although the implication of this assessment factor is clear, it is important to note that interview evidence has highlighted that the inability of SIF to exclude some firms from obtaining insurance was considered by SIF to be detrimental. This is because high risk firms with large claims against them remained in the profession (as discussed in 4.2.3 above).

Furthermore, if regulators are to set the boundary this needs to be done effectively. As discussed in section 2.4.4, interviewees have raised a number of concerns in this regard and we note that the SRA is in the process of revising its regulatory approach in order to improve its effectiveness in this regard.

4.6.2. Revelation of information

At present there is a large value of claims that are arising and interview evidence has indicated that a significant minority of these claims come from a relatively small group of individuals and firms. One issue therefore is whether these firms are being closed down sufficiently quickly.

In the past the insurers have probably had more information on the performance of the profession in certain respects (especially claims) compared to the SRA. As noted in section 2.4.4, to date the SRA has not gathered the necessary data to enable them to do this effectively although we note that the SRA is currently altering its processes and investing in IT systems which should improve the level of information that they have and therefore increase their effectiveness.

At present, qualifying insurers are required to report suspected dishonesty to the SRA. However, there are concerns that insurers do not have the incentive to do this because of the operation of certain terms and conditions. In particular, the fact that insurers are on risk for firms that go into run-off (and indeed may not receive a premium for this) means that insurers have the incentive to not report firms to the SRA, wait until the end of the indemnity year and then refuse cover to the firm. At the end of the indemnity year, these firms would either receive insurance from an alternative insurer (who may then face a similar incentive not to tell the SRA about any suspected dishonesty a year later) or would fall into the ARP the cost of which then applies across the whole market. It is important to note that this incentive arises in part because of the role of run-off and we consider this specific issue in section 6.10.

Nonetheless there is a clear distinction between the incentives according to different models of insurance:

- qualifying insurers can refuse cover to a particular firm at the end of the year and therefore have weaker incentives to report a firm if they face being on risk for the run-off cover if the firm is closed down during the indemnity year. Under a model that also includes an ARP and where payment for the ARP is from the qualifying insurers (as present), individual insurers face a proportion of the costs associated to run-off and therefore do have some incentive to report firms to minimise the ARP related costs (albeit that these incentives remain relatively weak);

- insurers within a Master Policy have reasonably strong incentives to report a firm. If the insurer wishes to participate in the Master Policy to any degree in the following year it will continue to face the claims risk from a specific firm and therefore has an incentive to report the firm in order to reduce the overall risk. In practice it is common for the lead underwriter, who commonly deals with claims, to remain in place for multiple years suggesting that this insure would retain an incentive to report firms. However, it is possible that if the individual insurer dealing with the claims of a particular firm intends to exit the market at the end of the indemnity year, the insurer may not have the incentive to report the firm; and

- the industry self-insurance model has the incentive to report the firm since the self-insurance pool will face the risks of that firm in the future.

Given the different incentives it is useful to review whether, in practice, there has been a distinction in the number of firms that are reported to the SRA under each model. Data is not available for the Master Policy.

Discussions with interviewees have indicated that SIF had a process through which firms thought to be dishonest would be identified and information would be passed on to TLS (then acting both as regulator and representative body).

Data for SIF does not appear to be easily available although in the 1997/98 indemnity year, SIF notes that there had been a change in the rules such that it could liaise with TLS's Office for the Supervision of Solicitors (OSS). It states that 169 firms were reported to the OSS during that year. It is noteworthy that this occurred after the need for shortfall contributions was identified and during a time at which the future of SIF was under discussion.

In discussions with insurers there have been mixed views regarding reporting of suspected dishonesty. Many insurers interpret this as something that requires a high burden of evidence and therefore state that they report few firms to the SRA. Other insurers state that the SRA already has the same information as the insurers and it appears that they do not report firms as they believe the SRA is already aware of the issues. In general it was apparent from interviews that there was little reporting of firms to the SRA.

This conclusion is also supported from discussions with the SRA. The SRA could not provide us with data on the number of firms that are reported by insurers but indicated that there were very few intelligence reports that came from the insurers.

However, it is important to note that the SRA has also acknowledged that in the past the reporting mechanisms between the insurers and the SRA have not been in place to easily facilitate information flow as there have not been the appropriate gateways through which information could be passed by the insurers to the SRA. Having identified this weakness, the SRA is in the process of improving its reporting mechanisms and seeking the engagement of the qualifying insures, the ABI, as well as other organisations such as the CML to improve the sharing of information. Data is not yet available to assess the success of this new approach.

We recommend that the SRA monitor:

- the number of firms that are reported by insurers (whichever model is in place);
- the number of firms subsequently required to alter their working practises; and
- the number of firms subsequently closed down.

It may also be useful for the SRA to set out more clearly the types of cases that it would expect to be reported by insurers. (We note that this also interacts with suggestions made regarding run-off as set out in section 6.10.)

Overall, the misalignment of incentives remains in place for insurers compared to a model of industry self insurance or the Master Policy. However, the differences in practise regarding the number of firms reported to the SRA is not a function of the incentives alone, but also related to the historic lack of reporting mechanisms being in place, the responsibility for which would seem to sit with the SRA rather than with the insurers.

In section 6.5 we consider the interaction between the incentive to report firms and the non-payment of premiums. In section 6.10 we consider the interaction with run-off.

4.7. Fair, transparent and accessible

As well as ensuring that clients are compensated appropriately, it is important to consider whether clients are compensated in a manner that is fair, transparent and accessible. There are two elements considered: the time take to pay claims; and the issue of whether there are disputes on the borderline between PII and the Compensation Fund.

4.7.1. Time to provide compensation

The time taken to provide compensation to clients will vary according to the circumstances of particular cases. Nonetheless it is apparent that at present all models of delivering compensation to clients take a considerable length of time with this typically stretching into years rather than weeks. Information from our survey of insurers have indicated that the qualifying insurers take an average of between around 1 and 3 years to deal with claims. We understand that the average time for SIF to resolve claims was around 2 years and 2 months.[69] Although the data is weak we can not conclude from this that SIF was faster at dealing with claims than the open market.

We can also consider a comparison on the proportion of claims that have been paid out after a period of time. One insurer has also provided CRA with indicative evidence of the proportion of claims that have currently been paid (i.e. in 2010) compared to indemnity years in the past.

One issue that we need to take into account relates to the fact that, while claims are still outstanding, there is no absolute certainty as to the value of those claims that will actually be paid. Hence, the reserve value associated to these claims may change over time as additional information becomes available and as claims that are notified become claims on which a payment is more or less likely. Given this reason, and since insurers have indicated that it can take an average of 1-3 years to deal with claims, we consider it appropriate to use a period of time that is greater than 3 years and have chosen a period of 6 years.[70] Table 9 below therefore sets out the proportion of claims made within a particular indemnity year which are paid within 6 years of that indemnity year.

Table 9: Claims paid within 6 years of indemnity year

	Proportion of claims paid after 6 years (by value)
Master Policy (1978/79-1984/85)	68%
SIF (1987/88-1990/91)	66%
Qualifying insurer (2010)	96%

Source: SIF Annual Reports 1988, 1995, CRA/ABI survey.

Given some of the caveats around the data, this should not be used as conclusive evidence of the precise proportion of claims paid. However, it can be used to indicate

69 Based on evidence from interviews.

70 The accuracy of the calculation does therefore depend on the accuracy of the reserving policy and whether this differs between the models. We examine the estimate of the total value of claims 6 years after the indemnity year compared to the latest estimate for which data is available for years in which there is an estimate at least 10 years later (only one of the years concerned was closed indicating that the final estimation could still have been inaccurate). For the Master Policy this could lead the proportion of claims paid by 6 years later to be as high as 89%. For SIF a similar adjustment could raise the proportion of claims paid by 6 years later to 70%. It should be noted that we are not aware that there was a difference in the reserving policy between the Master Policy and SIF as opposed to the accuracy of the reserving policy being found to be different in practice. These adjustments do not alter the conclusion in the main text that there is no evidence of the Master Policy or SIF paying out claims faster than qualifying insurers.

that qualifying insurers are not less efficient than alternative models at paying out compensation.[71]

4.7.2. Disputes with Compensation Fund

In addition to the issue of the time taken to provide compensation, it is also important to consider whether there are any disputes between the delivery of PII and the Compensation Fund. The Compensation Fund covers own fraud whereas the PII terms and conditions require that any innocent partner is covered for the fraud of a dishonest partner. One potential implication of this is that models of insurance where insurers take the underwriting risk may seek to suggest that fraud is prevalent among all partners in order to avoid the claim. By contrast, under industry self insurance, the profession pays for this claim either through the Compensation Fund or through the PII and therefore disputes would be less likely since they would represent moving claims from one pot paid by the profession to another pot also paid by the profession.

Evidence has not been available from the Compensation Fund for the number of cases in which such boundary disputes arise.

Interview evidence has not revealed any concerns of this nature save for concerns by lenders that they do not receive compensation from the Compensation Fund. We consider this further in Chapter 7. However, since Chapter 2 set out that regulatory protection should be provided for individuals but not corporates, this concern should not drive the choice of model.

4.8. Unintended consequences

Finally, we note that there is a possibility for unintended consequences to arise. In particular, this links to the discussion in section 2.4.3 related to the role of the economic cycle and whether there is an “market-wide-insurance-cycle” as distinct from a “solicitors-PII-insurance-cycle”. As set out earlier, there is weak evidence fro this.

However, if there is a market wide insurance cycle then it is possible that an event in an unrelated insurance market could lead to the withdrawal of capacity available for underwriting the solicitors PII market. This could lead some firms to be unable to obtain cover:

- Under the open market without an ARP this would lead some firms to be forced to exit;

71 It should be noted that the comparison may also be affected by the approach to run-off cover. In particular, if run-off claims are accounted for in the indemnity year in which the firm enters run-off (rather than the years in which claims are actually made) then the calculations will be affected by whether the model deals with all of the firms in run off. For example, if under the current model, many run-off firms are dealt with through the ARP, this may mean that the open market calculation does not include some of the claims with the longest time for claims to be dealt with (because the claims themselves could be made up to 6 years later rather than because of the time taken to deal with the claims once they have been made). It has not been possible to assess whether run-off claims are accounted for in the same way for both the Master Policy and SIF.

- Under the open market with an ARP funded directly by the profession (see section 5.10) this could lead to a an increase in the size of the ARP, but firms would continue to operate;
- Under the open market with an ARP funded by the insurers, at the extreme this could lead insurers to pull out of the market altogether because they can not escape the ARP risk (i.e. they suffer particularly badly from the adverse selection problem described in section 2.4.4. A similar argument applies to the Master Policy; and
- Under a model of industry self insurance, cover would be retained. In as far as the model sought re-insurance cover for extreme levels of claims, however, it would be expected that this would be withdrawn under these conditions.[72]

It should be stressed that interviewees do not consider that it is market wide insurance cycle effects that are causing firms to enter the ARP currently, but rather that this is linked specifically to issues within the solicitor PII market.

4.9. Conclusion of comparison of models

Model assessment

We have examined this range of models against the assessment criteria described above. In keeping with the approach that regulatory intervention is only required if there is evidence of a market failure in the delivery of insurance, the burden of proof sits with the alternative models to be demonstrably better than the open market, for intervention away from the open market to be appropriate.[73]

There is strong evidence that the open market model should be retained.

Cost effective (level of premiums): The average cost of insurance under the open market (including the ARP) under the present model has been around 1.4% of gross fees in comparison to 2.2% under the Master Policy and 3% under SIF. Over the period 2000/01-2008/09, this implies that the open market has saved the profession around £1.1 billion compared to the Master Policy and £2.1 billion compared to SIF.

Cost effective (variation in premiums): Although there may be a theoretical advantage from a model of self insurance being able to smooth premiums over the cycle, in practice SIF was not able to achieve this. Overall premiums charged under SIF were more volatile than those under the open market. Further, SIF made mistakes of under-pricing and the profession had to suddenly pay for this mistake. Under industry self insurance, the profession would face a risk of similar pricing mistakes. The risk of this was one of the reasons that a similar model in RICS was replaced by the open market. There is also no

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72 Note that this is not the reason that SIF's stop-loss cover was withdrawn during the 1990s which instead related to the specifics of the solicitors PII market.

73 This is distinct from a market failure with respect to the asymmetry of information in client understanding of solicitors that leads to a need to have some form of insurance in place.

evidence that the Master Policy in Scotland has been less volatile than the open market in England and Wales.

Risk management: Prices under the open market have been set with reference to a wider range of rating factors than under SIF or the Master Policy. While this does involve the profession providing additional information, it ensures that prices are appropriately matched to risk. Indeed, under SIF, one and two partner firms paid around 22% of contributions but represented 34% the value of claims, whereas firms with 11 partners or more paid 35% of contributions and represented 27% of the value of claims. Such cross-subsidies are economically inefficient and distort competition in the legal market. Cross subsidies are driven out by a competitive insurance market (also leading low risk small firms to gain in comparison to high risk small firms). In addition, the open market can sharpen incentives for risk management by refusing cover for firms.

Targeted: The open market currently provides insurance to around 97% of all firms and 95% of sole practitioners. The reintroduction of a Master Policy or industry self insurance because of a concern about the firms that are not covered does not satisfy the requirement that intervention be targeted. Even a Master Policy or industry self insurance focused on sole practitioners alone would fail this test.

Competition (static): Competition between lawyers may be distorted under the Master Policy or industry self insurance because this limits their choice of insurance to one source. Master Policies appear to be most appropriately used where there are relatively low values of premiums for relatively few, reasonably-homogeneous, firms - not the characteristics seen in England and Wales. England and Wales has premiums of more than 10 times that of Scotland and around 100 times that of the CLC with similar ratios with respect to the number of people in the respective professions. Similarly, England and Wales has greater diversity in terms of firm size compared to Scotland and greater diversity of work compared to licensed conveyancers.

Competition (dynamic): The open market retains the necessary flexibility to deal with new entry by Alternative Business Structures (ABSs) whereas the Master Policy or industry self insurance may lack this flexibility. This could have particularly detrimental consequence for small firms that wish to exploit the use of ABSs but would face additional costs of obtaining multiple insurance policies where they can currently extend a single policy to obtain additional cover.

Equality and diversity: There is a greater proportion of BME firms in the ARP (28%) than in the profession as a whole (11%). This implies that where there is only the open market with no insurer of last resort there is a risk of some BME firms failing to obtain cover and therefore a detrimental equality impact could arise. All other models (open market with insurer of last resort, Master Policy, industry self insurance) would retain the ability of all BME firms to obtain insurance. No other equality concerns have been identified with respect to model choice.

Regulatory supervision (setting the boundary): As with the equality and diversity concern, if regulators are to set the regulatory boundary this means that the open market with no insurer of last resort would not meet this principle. As noted, there are concerns of regulatory failure with respect to where this boundary is currently set.

Regulatory supervision (revelation of information): Due to being on risk for run-off (for which currently insurers may not be paid), insurers have an incentive to not report firms to the SRA where they suspect dishonesty. The incentive to report is greater for the Master Policy (unless insurers plan to exit the market entirely) and for industry self insurance (where they continue to face the risk each year). Currently there is little evidence that insurers do report dishonest firms although the SRA has acknowledged that it has not had the necessary infrastructure in place to facilitate this.

Fair, transparent and accessible: We have only weak evidence available on the time taken to deal with claims by the different models. It does not suggest that alternative models deal with claims faster than the open market.

Unintended consequences: If there is a "market-wide-insurance-cycle" distinct from a "solicitors-PII-insurance-cycle", it is possible that an event in an unrelated insurance market could lead to the withdrawal of capacity for solicitors PII market leading some firms to be unable to obtain cover. There is weak evidence on this arising generally (events specific to solicitors PII are the cause of the current increase in the size of the ARP).

Overall as summarised in Figure 1, the open market model dominates the Master Policy or industry self insurance. However, there are some criteria where there are concerns regarding the open market specifically related to regulatory supervision regarding setting of the boundary, revelation of information to regulators, and equality issues. Each of these have important interactions with the ARP and particular terms and conditions (see subsequent chapters).

4.9.1. Recommendations

Given all of the evidence summarised above **we recommend that the open market model be retained** in preference to the Master Policy or industry self insurance. Chapter 5 considers the role of the ARP.

4.9.2. Impact

Since we do not recommend a movement away from the current position of using the open market, there is no economic impact from our recommendation. Similarly there is no impact from an equality and diversity perspective.

Figure 19: Comparison of models against assessment criteria

	Open market	Open market and ARP	Master policy	Industry self insurance
Examples	Ireland (2009/10), FSA, ACCA	SRA (2000 to date), Ireland (excluding 2009/10), RICS, ICAEW	SRA (1987-2000), Scotland, CLC	SRA (1976-1987), RICS (pre 1996)
Cost effective (level of premiums)	+ + + (1.4% gross fees as per current market)	+ + + (1.4% gross fees)	+ + + (2.2% gross fees)	+ + + (3.0% gross fees)
Cost effective (variation in premiums)	+ + + (based on current market)	+ + + (low volatility)	+ + (based on comparison with Scotland)	+ (high volatility)
Risk Management	+ + + (Premiums are risk reflective and cover can be withdrawn)	+ + (Premiums are risk reflective but cover can not be withdrawn)	+ (premiums set on few criteria, cover can not be withdrawn)	+ (evidence of cross-subsidies, cover can not be withdrawn)
Competition between lawyers - static	+ + + (lawyers free to compete)	+ + + (lawyers free to compete)	+ + (competion may be distorted as heterogeneous profession)	+ + (competion may be distorted as heterogeneous profession)
Competition between lawyers - dynamic	+ + + (lawyers free to innovate)	+ + + (lawyers free to innovate)	+ + (possible restriction of ABSs)	+ + (possible restriction of ABSs)
Targeted	+ + + (allows competitive insurance market)	+ + + (allows competitive insurance market)	+ (disproportionate when 97% of firms are currently served)	+ disproportionate when 97% of firms are currently served)
Equality and diversity need to be maintained	+ + (some firms excluded)	+ + + (all firms allowed in the market)	+ + + (all firms allowed in the market)	+ + + (all firms allowed in the market)
Regulatory supervision - setting boundary	+ + (insurers may set boundary)	+ + + (regulators set boundary)	+ + + (regulators set boundary)	+ + + (regulators set boundary)
Regulatory supervision - aligning incentives on revelation of information	+ (possible misalignment)	+ (possible misalignment)	+ + (alignment of incentives except for firms that plan to exit)	+ + (alignment of incentives)
Efficient in providing compensation -weak evidence	+ + + (based on current model)	+ + + (faster at dealing with claims)	+ + (slower at dealing with claims)	+ + (slower at dealing with claims)
Unintended consequences - weak evidence	+ + (possible withdrawal of cover from external events)	+ + (possible withdrawal of cover from external events)	+ + (possible withdrawal of cover from external events)	+ + + (cover maintained despite external events)

Source: CRA analysis

5. ASSIGNED RISKS POOL

When the financial compensation regime switched from SIF to the open market in 2000, the Assigned Risks Pool (ARP) was introduced. The main purpose of the ARP was to ensure that the open market regime replicated SIF as much as possible. The specific purposes of the ARP have been set out as:

> *"to provide financial protection to clients of those firms that practice without having an appropriate policy of Qualifying Insurance; and*
>
> *to leave decisions regarding whether a firm or any solicitor should continue in practice with the SRA rather than the insurance market."*[74]

We note that the first purpose represents one aspect of the primary objective of the financial protection arrangements more generally as set out in section 2.5 and the second purpose represents one aspect of principle 7 namely that the regulator should set the regulatory boundary. Under an open market option, for this principle to be fulfilled this would necessitate the presence of some form of ARP acting as an insurer of last resort for the profession. However, it is clear that the ARP is performing a wider set of roles than simply acting as an insurer of last resort to enable firms to continue in practice.

We have also found it useful to separate out various different elements that sit underneath these two aims since in practice it is clear that the ARP is undertaking the following roles:

- Acting as the insurer of last resort in order to rehabilitate firms in difficulty and allow them to continue in practice – this is in line with the second purpose above and is considered in section 5.2;
- Providing temporary insurance cover for firms which were not able to obtain insurance by the end of the renewal period but are able to obtain insurance shortly afterwards – this is in line with the second purpose above and is considered in section 5.3;
- Client protection from non-applied firms and ineligible firms who do not have insurance in place – this is in line with the first purpose and is considered in section 5.4; and
- Acting as the insurer of last resort for firms that should have been shut down earlier, but where insurers do not reveal information about these firms to the regulator – this is in line with the first purpose, but arises as an unintended consequence of the misalignment of incentives set out in section 4.6.2. It is considered in section 5.5.
- Facilitating the orderly run-down of firms that need to be closed down – this is in line with the first purpose above and is considered in section 5.6;

74 SRA, "Review of the Compensation Fund – Report of the Financial Protection Committee's Compensation Fund Review Working Party", April 2009, p8.

- Acting as the insurer of last resort for firms that do not obtain insurance from alternative sources and where firms are ultimately closed down and go into run-off – this is in line with the first purpose and is considered in section. 5.6.

In each section, we endeavour to set out the implications of each of these different roles (although it is not always possible to provide quantitative evidence on every aspect). In addition to the different roles of the ARP, having an ARP also imposes a management cost which is set out in section 5.8. We provide a summary of the roles of the ARP in section 5.9.

Section 5.10 then considers different options regarding the funding of the various functions. It is also worth noting that while these roles are currently performed within the ARP rather than through the Compensation Fund, there is no particular reason why the roles need to be done through separate structures. However, for convenience we set out these issues separately.

Before examining these different roles, we start the chapter by providing an overview of the ARP.

5.1. Overview of the ARP

In this section we provide an overview of some of the key facts relating to the ARP which helps to provide the context for the subsequent sections.

5.1.1. Firm categorisation

There are a variety of different categories of firms covered within the ARP and data that is quoted does not necessarily cover all of the categories. Firms in the ARP can be categorised into five groups:

- Applied firms: firms that applied for ARP cover before 1st October in any given indemnity year;

- Default firms: firms that applied for ARP cover on or after 1st October in any given indemnity year;

- New firms: newly established firms that apply for ARP cover at some stage during the indemnity year. (As from the 2010/11 indemnity year, these firms are not eligible to obtain cover through the ARP - it is worth noting that the decision to prevent new firms to enter the ARP has already given insurers a role in setting the regulatory boundary with respect to these types of firms);

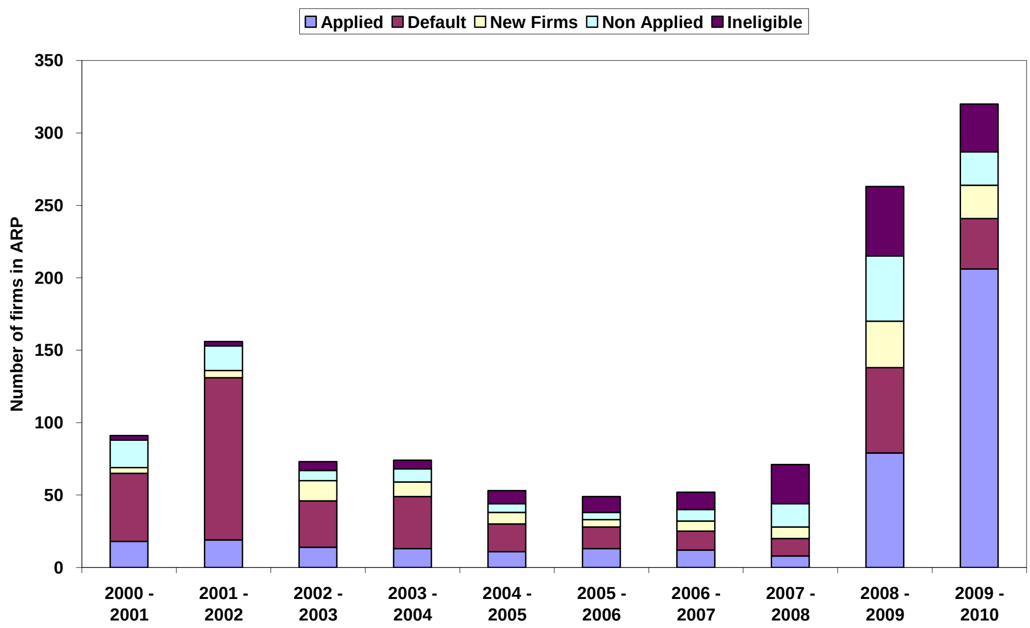
- Non-applied firms: firms that do not have qualifying insurance in place and therefore claims are met by the ARP; and

- Ineligible firms: firms that have stayed in the ARP for the maximum period allowed but do not exit the ARP (although they are assumed to be in the process of being closed down) and therefore claims continue to be met by the ARP.

It should be noted that the figures that are most commonly cited as representing the number of firms in the ARP typically exclude the non-applied and ineligible firms. Where possible we provide information on all five categories. Where this is not possible we state the categories that are covered within the data.

Figure 20 below sets out the number of firms in the ARP over time by these categories.

Figure 20: Number of firms in the ARP by category



Source: CRA calculations based on data from the ARP

Figure 20 shows clearly that the number of firms in the ARP has grown dramatically in the last two years. Between 2002/03 and 2007/08, the number of firms in the ARP varied at a level of around 50–70 firms, representing less than 1% of firms. However, in 2008/09, there were 263 firms in the ARP and the number has increased further to 320 in 2009/10 representing around 3% of firms.

It is also worth understanding the spike in the number of firms in default in 2001/02. This year represented the first year in which insurance was renewed in the open market. Based on discussions with the SRA, it is understood that a small number of law firms with low premiums did not receive a renewal notice from their insurer. These firms then discovered that they were not insured, entered the ARP as a firm in default but were able to obtain cover in the open market quite quickly. They spent little time in the ARP and are understood to not have imposed many claims on the ARP. The spike in 2001/02 should therefore be understood in the context of this issue.

It also important to note that the absolute number of firms in the ARP is substantially greater than the number of firms that are in ARPs in other countries. Indeed, in Ireland only 14 firms entered the ARP between 1996 and 2008 and in 2009, there were 9 firms in the ARP. There are far more solicitors in England and Wales than in Ireland and once this is taken into account this suggests that the ARP has around 3 times the proportion of solicitors in the ARP compared to the proportion in Ireland.[75] Concerns about a sudden growth in the ARP in Ireland led to it being suspended for the 2009/10 indemnity year although it is expected to be in place again for the 2010/11 year.

It is also useful to compare the performance of the ARP to other professions:

- In the RICS scheme (which has a similar number of firms to solicitors in England and Wales) there have been relatively few firms in the ARP. In 2001/2002 there were around 16 firms in the ARP although this then fell reaching a low of 2 in 2008/09. This has subsequently increased again to around 14 at present; and

- In the ICAEW scheme (which has a similar number of firms although far fewer practising certificates compared to England and Wales), the number of firms in the scheme at any point has never exceeded around 15 firms.

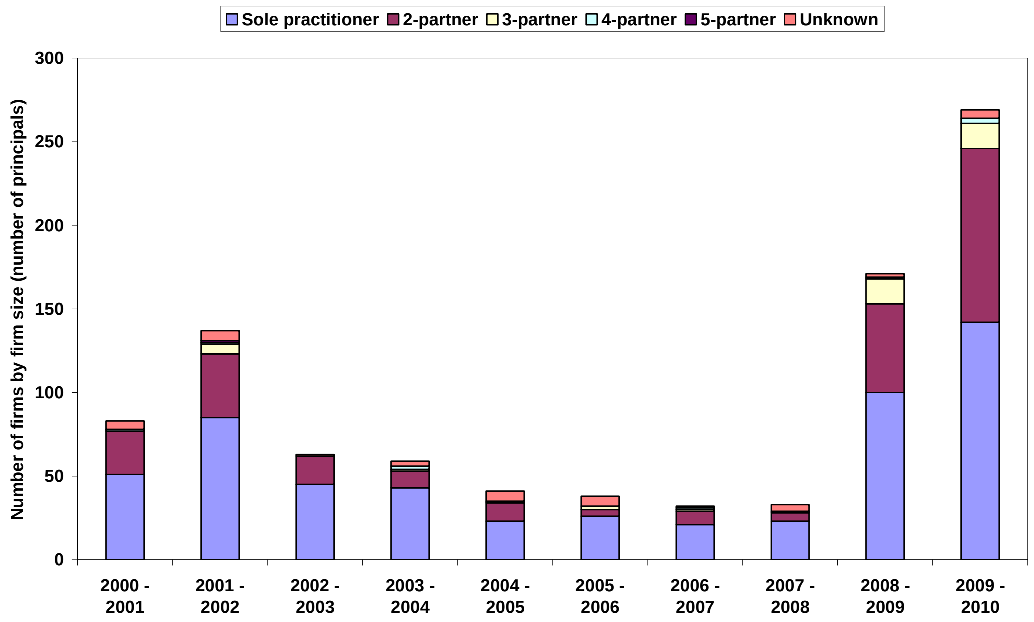
Although the recent years are clearly of most concern with respect to the size of the ARP, the consistent level of even 50-70 firms between 2002/03 and 2007/08 is still more than 3 times the number of firms that are in the ARPs in other schemes (with broadly the same number of firms as compared to ICAEW and RICS).

5.1.2. Types of firms in the ARP – firm size

It is also useful to understand the breakdown of the types of firm that are in the ARP. It should be noted that due to data limitations Figure 21 below provides the breakdown by firm size only for those firms that are categorised as applied, default and new firms i.e. it excludes the non-applied and ineligible categories.

75 This is based on the number of practising certificates in each country.

Figure 21: Number of firms in the ARP by firm size



Source: CRA calculations based on data from the ARP

It is very clear from Figure 21 that the firms that are in the ARP are all small firms. No firm within the ARP has been identified that has more than 5 partners (indeed, only one firm with 5 partners has ever been identified). Overall, sole practitioners and 2 partner firms have represented around 90% of the number of firms in the ARP.

5.1.3. Types of firms in the ARP – equality and diversity

As noted in section 4.5, concerns regarding equality and diversity issues have been raised in respect of BME firms. The particular issue that is raised by BME firms is that there is a disproportionate number of BME firms in the ARP compared to the profession as a whole which, it is argued, indicates that insurers are discriminating in respect of the firms that they are willing to offer cover to. There is clear evidence that BME firms are disproportionately represented in the ARP:

- Approximately 41% of firms currently in the ARP are BME firms (this is an increase from an average of 28% for the years 2006/07-2008/09); whereas
- Only 11% of firms in the whole profession are BME firms.[76]

One of the implications of this is that any changes that are made to the ARP would disproportionately affect BME firms compared to other firms. However, it is also the case that there are other characteristics that are shared between BME firms and those in the ARP. For example:

76 Percentage data is based on SRA data as of February 2010.

- As indicated in section 5.1.2, 90% of firms in the ARP are sole practitioners and 2 partner firms and it is also the case that BME firms are disproportionately small firms.

- Discussions with insurers have indicated that lawyers with qualifications from overseas tend to have higher probability of having claims against them and therefore insurers consider foreign qualifications as an indicator of risk probability in underwriting process. "REL, RFL, QLTT majority firm" only account for 3% of the whole profession while 26% of the ARP firms.[77] BME firms are firms that are mostly like to be categorised as "REL, RFL, QLTT majority firm".

- Around 5% of firms holding the LEXCEL qualification are BME firms whereas BME firms represent 11% of profession as a whole.

Nonetheless, the fact that BME firms are disproportionately represented in then ARP indicates that changes to the ARP would be expected to particularly affect BME firms and therefore we will have particular regard to this in considering the impact of any recommendations.

5.1.4. Types of firms in the ARP – risk measures

The LEXCEL qualification, which is the TLS practice management standard, is also a useful indicator on which to examine firms in the ARP and we note that insurers typically request information on whether or not firms hold the LEXCEL qualification. Here we note that:

- there is currently only one firm in the ARP that has a LEXCEL qualification; compared to around 10% of firms in the wider profession that have this;[78]

- on the basis of the mix of firms in the ARP (which are mainly small firms who are less likely to hold the LEXCEL qualification) we would expect to observe 8-12 firms in the ARP with the LEXCEL qualification rather than the one firm that is observed.

Assuming LEXCEL qualification is a good indicator of the risk management quality of law firms, this data shows that the quality of ARP firms on general is lower than the firms outside of ARP.

5.1.5. Value of claims in the ARP

The value of claims in the ARP mirrors the number of firms in the ARP in terms of being at a relatively modest level for the period 2002/03-2007/08 followed by a dramatic jump in 2008/09 as shown in Figure 22 below. It should be noted that the data for 2009/10 was been provided during the course of the 2009/10 year and may not capture all claims for

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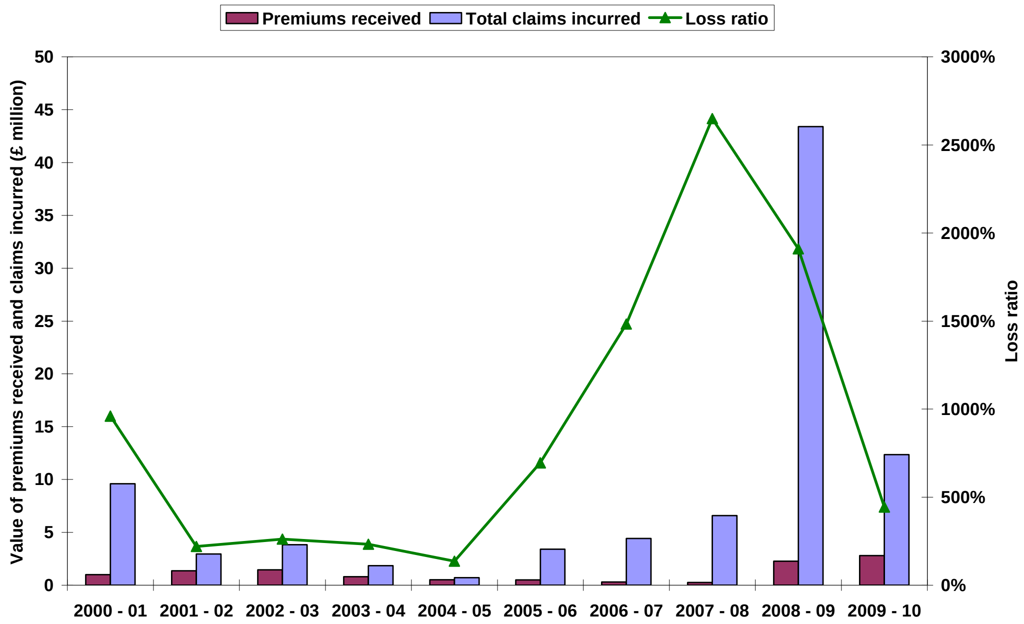
77 REL stands for Registered European Lawyers, RFL for Registered Foreign Lawyers, and QLTT for Qualified Lawyers Transfer Test. They are the routes through which lawyers who achieved their qualification overseas can practise in the UK. Where more than 50% of the PC holders at a firm are QLTT, REL and RFL, the firm is classed as a "REL, RFL, QLTT majority firm".

78 Data provided by SRA.

the year. Similarly, there is uncertainty regarding the actual value of these claims since it takes some time for this to be revealed. Hence the data for 2009/10 should be interpreted cautiously.

Figure 22: Premiums received, total claims incurred and loss ratio over time



Source: CRA calculations based on data from the ARP

The cost of the ARP is disproportionate relative to the number of firms in it. In the indemnity year 2008/09, the 263 firms in the ARP represented around 2.4% of the whole profession. However, firms in the ARP generated £43 million worth of claims in 2008/09 accounting for 19% of the total premiums of PII of £226 million in that year.[79]

The conclusion is reinforced by examining the loss ratio as shown in Figure 22. The loss ratio is the ratio of total claims (including both claims paid and outstanding) to total premiums received from those in the ARP. A loss ratio of 100% indicates that the value of claims is equal to the value of premiums.[80] The value of total claims incurred peaked at 2008-09 but the loss ratio of the year actually declined as there was an improvement in the proportion of premiums due that were received. It further declined in 2009-10 although this is likely to be partly due to the fact that claims have not yet fully materialised.

Over the last ten indemnity years, the loss ratio has averaged around 800%. Loss ratios of this kind would be inconceivable in the commercial market. It is also worth noting that

79 While the value of premiums for 2009/10 does not necessarily equate to the value of claims (as insurers could all have made a loss in 2009/10), the magnitude of the relative difference means the comparison is a valid one.

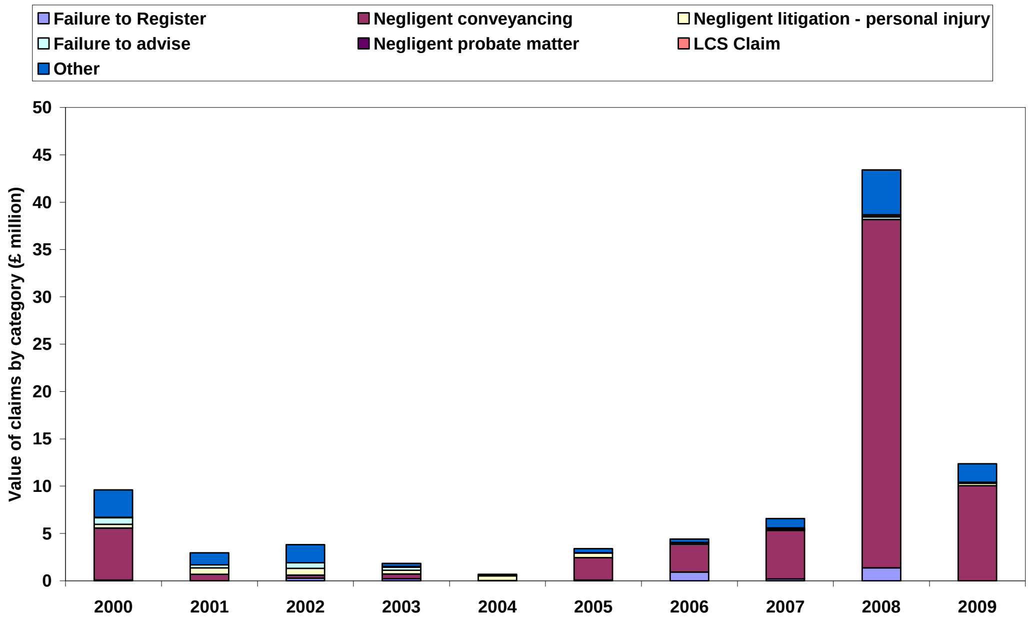
80 Administration costs would also arise indicating that an underwriting loss would be expected occur with a loss ratio at this level (subject to any positive returns through investment income).

this places the solicitors ARP in a different position to that of the ICAEW scheme where premiums from firms in the ARP have usually been greater than claims costs.

5.1.6. Claims by type of work

It is also important to consider the type of work that is leading to the claims in the ARP. The evidence of the data in Figure 23 below shows very clearly that conveyancing related claims (negligent conveyancing and failure to register) represent the overwhelming majority of the value of claims. Again this supports the contention set out in section 2.4.4 that there is a need to review the conveyancing process more generally.

Figure 23: Claims by category over time



Source: CRA calculations based on data from the ARP

The proportion of claims cost generated in conveyancing has been more than 85% since 2005. Not all claims before 2005 were categorised by type of claim (reflected in part by the relatively high proportion of “other” claims in early years) and therefore it is reasonable to focus on the period since 2005. It is notable that the high proportion of conveyancing claims arose before the recent property market crash, although the value of claims has clearly been affected by the property cycle.

It is also important to consider who the claimants are for claims made in the ARP. The ARP does not categorise claimants as lenders or individuals, but it is possible to undertake an indicative assessment of this on the basis of the names of claimants.

We have examined the claims over time and have categorised cases as lenders where the name of the claimant includes the name of a lender. This has been done to obtain an estimate of the proportion of claims that are lender claims and it has been identified that over the entire period, lender claims have been more than 50% of the total value of claims. This figure increases to over 66% for the period of 2005 onwards.

5.2. Insurer of last resort for the rehabilitation of firms in difficulty

Principle 7 of our assessment criteria sets out the desirability of the regulatory setting the boundary of who can practice and who can not. This has also been identified as an explicit purpose for having the ARP.

It is important at the start of this section to recognise that this role would be unnecessary if the boundary set by the regulator was within the boundary set by insurers i.e. if the regulator of solicitors was more restrictive than the insurers of solicitors. In this case, all law firms permitted by the regulator to operate would be considered as acceptable firms by insurers and hence would be able to get insurance cover from the commercial market. This picks up on the issues identified in section 2.4.4 that at present insurers are concerned that some firms are able to continue in practice which should be shut down. As noted in section 2.4.4 this may be causing insurers to face a particularly challenging adverse selection problem implying that more “good” firms may fall into the ARP because the regulator does not shut down “bad” firms.

It is possible that wider insurance market events could lead to a reduction in capacity in the solicitors PII market causing good firms to be unable to obtain insurance. It should be recalled from section 2.4.3 that the evidence for this impact of the wider insurance market was considered to be weak.

Nonetheless, it is at least possible in theory that firms may experience short-term difficulties in getting insurance from the commercial market. This might include the following examples:

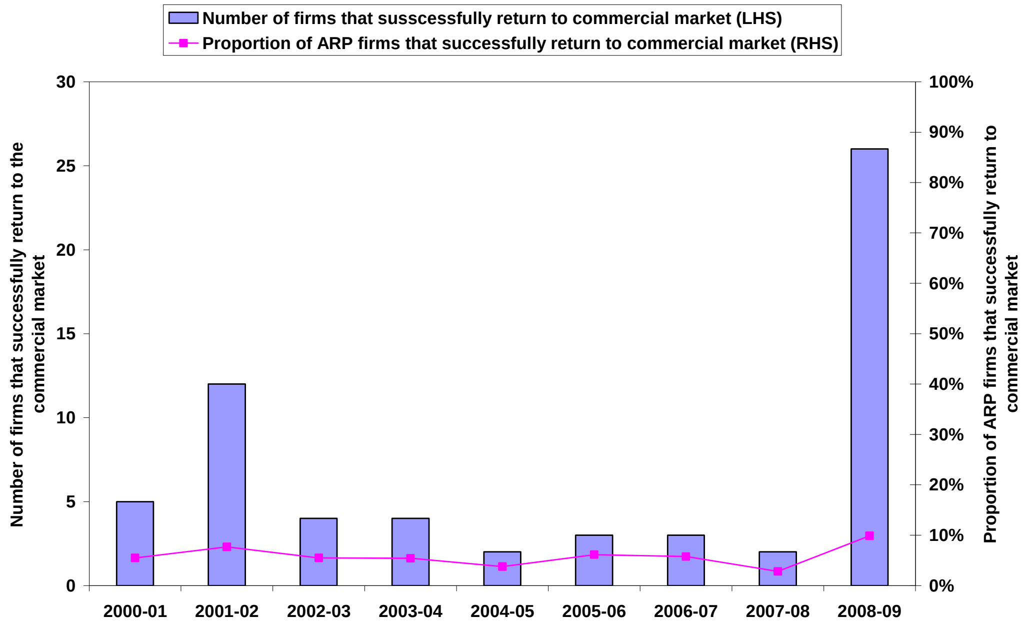
- Firms that receive a notification of a potential claim just before the renewal of its insurance policy might not be able to renew the policy or find another insurance provider before the existing policy expires even if the claim turned out to be frivolous after investigation and they are later able to obtain insurance from the open market; or

- Firms that did not achieve satisfactory results in risk management and generated disappointing claims records may rightly be rejected in the application of insurance in the commercial market. However, the regulator or the profession may wish to provide these firms with an opportunity to improve their risk management processes such that they can later be accepted by the open market again.

5.2.1. Firms exiting the ARP

Against this particular objective, the key question is whether or not firms do in fact emerge from the ARP and return to the open market. If the ARP is successful on this objective, the proportion of successful firms would be expected to be at a relatively high level.

Figure 24: Number of firms that have successfully returned to the commercial market



Source: SRA data and CRA calculation. Note: firms that have successfully returned to the commercial market are defined as those that are still practising 12 months after leaving the ARP and that have not subsequently ceased or been intervened in by the SRA.

Figure 24 demonstrates that throughout the period, only a small number of firms have successfully exited the ARP. As noted in section 5.1.1, the figures for 2001/02 should be interpreted cautiously, but in total only 61 firms have ever successfully exited the ARP. The proportion of firms that have successfully exited has fluctuated in the range 3-10% over the period.

It should be noted that our definition of "successful exit" is based on the number of firms that are still practising 12 months after leaving the ARP and have not subsequently ceased or faced an intervention by the SRA. This therefore excludes those firms that temporarily exit the ARP only to cease a little while later.

Historically, more than half of the firms that successfully returned to the open market for 12 months subsequently ceased practising or faced an intervention. Hence the data for the 2008/09 indemnity year must be interpreted with caution since it represents an upper bound on the number of firms that are considered to represent a successful exit i.e. some of the 26 firms may cease or be intervened in over the course of the next few years.[81]

One issue for consideration is whether a constraint on insurance capacity in 2008/09 meant that more "good" firms fell into the ARP. Although there is an increase in the number of firms that have successfully exited from 2008/09 compared to firms in previous

81 There are concerns that current market conditions are causing more "good" firms to fall into the ARP. Therefore it is not appropriate to assume that the proportion of firms that subsequently cease or are intervened in will be at the average of around half of the firms that survive in the commercial market for 12 months. However, it is clear that 26 is an upper bound on successful exit.

years, it should noted that the proportion of firms exiting in 2008/09 has remained small. Taking the upper bound estimate of the number of firms would still only represent 10% of the firms in the ARP successfully recovering.

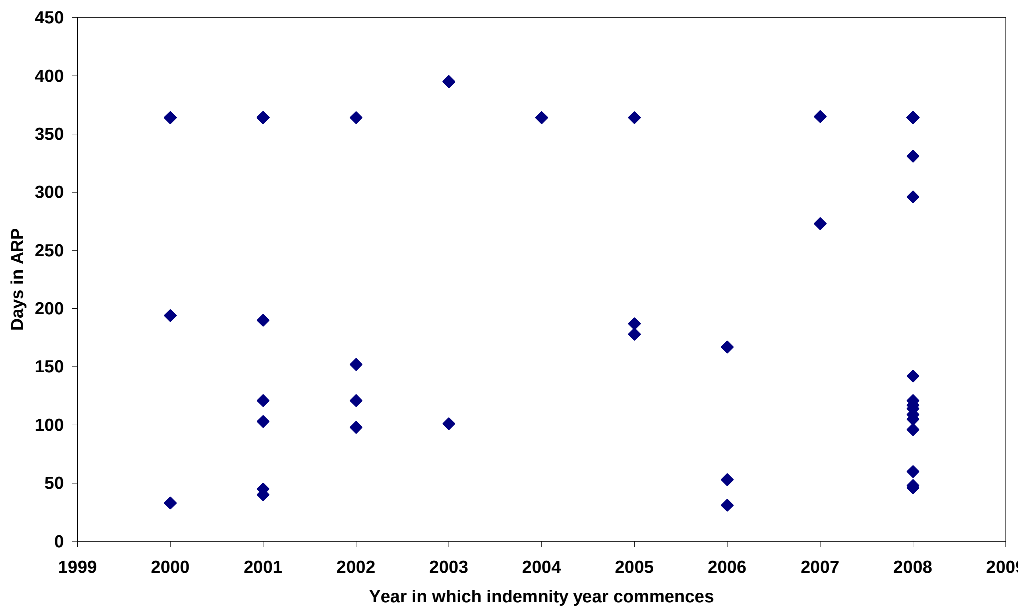
A greater proportion of firms in the ARP in 2007/08 and 2008/09 have remained in the ARP for a second year compared to in the past (37% compared to an average of around 15% for 2002/03-2006/07). However, the proportion of firms in the ARP which ceased or were intervened is 47% for 2008/09 which is similar to 2006/07 although a little lower than the average of around 57% for 2002/03-2005/06.

In general, however, the data does not support the position that a greater proportion of firms in the ARP in recent years were "good" firms.

5.2.2. Time in the ARP

An important issue in respect of the characteristics of the ARP is the length of time that firms should be allowed to stay in the ARP in order to facilitate rehabilitation. In order to answer the question, we examine the length of time spent in the ARP by those firms that have successfully returned to the commercial market which is presented in Figure 25 below.

Figure 25: Length of time in the ARP for firms that successfully exited over time



Source: CRA analysis based on data from SRA

Figure 25 above shows the number of days of each of the firms that successfully exited over time. As can be seen, there is considerable variation in the time spent in the ARP with many firms exiting within 6 months and a number of others exiting after a full 12 months.

The issue on the appropriate length of time for rehabilitation is further complicated by the arrangement of single renewal date, which greatly affects how easy it is for firms in the

ARP to find alternative sources of insurance. Given this complication, it would not be appropriate to reduce the time spent in the ARP to less than 12 months until the single renewal date has been removed (as we recommend in section 6.4) and there has been sufficient time for a number of firms to transition away from this date.

5.2.3. Costs incurred by firms due to work undertaken while in the ARP

It is also important to understand the costs associated to the rehabilitation role of the ARP. In particular, the total costs of the ARP can be broken down into at least two parts:

- the cost of claims generated by firms in the ARP where the work that caused the claim ("the cause of action") happened while they were in the ARP; and
- the cost of claims by firms in the ARP where the cause of action happened before they entered in the ARP.

Only the former example, where the cause of action arose while firms were in the ARP, represents the costs associated to the ARP playing a rehabilitation role. The cost of the other claims would arise even if all firms were closed down as soon as they entered the ARP.

Information on the cause of action has not always been captured accurately in the ARP and therefore we are only able to conduct analysis of this issue for the indemnity year 2008/09.

Table 10: Cause of action

	Value	Proportion
Cause of action while in ARP	£3.7 million	9%
Other claims	£39.4 million	91%

Source: CRA analysis of data from ARP. Note that the £3.7 million excludes £0.3 million claims arising from non-applied firms where the cause of action occurred in the same year in which claims are revealed to the ARP.

It is clear from Table 10, that the proportion of claims that relate to the time that the firm is in the ARP is only around 9% of the claims with the great majority of claims occurring before firms enter the ARP.

Nonetheless, this does demonstrate that £3.7 million of claims could be saved if firms in the ARP were unable to continue in practice. Given there were 26 firms in 2008/09 that successfully returned to the commercial market, this implies an average cost of slightly more than £140,000 per firm for the benefit of maintaining the rehabilitation role of the ARP. For the reasons discussed above, it is likely that some of these 26 firms will cease to practice or get intervened by the SRA in the future, hence this cost number should be seen as a lower bound of the cost of rehabilitation per firm.

It is important to note that this does not mean that the 26 firms themselves actually caused £3.7 million of claims. However, unless it is possible to distinguish on day 1 of entering the ARP those firms that will ultimately successfully leave the ARP from those firms that will ultimately be closed down, the ability to continue in practice would need to apply to all firms and the cost of allowing firms to continue in practice is £3.7 million.[82]

5.2.4. Potential options

Having the ARP for the purpose of rehabilitation flows directly from two principles:

- Principle 4 that the scheme encourage an independent, strong, diverse and effective legal profession – as noted in section 4.5, BME firms are a disproportionately represented in the ARP; and
- Principle 7 that the scheme should support, but not replace, regulatory supervision – in particular that the regulator should set the regulatory boundary.

However, it is also clear that there are costs associated with having an ARP for the purpose of rehabilitation. Given the nature of these principles, it is a regulatory, rather than economic, judgement as to whether the rehabilitation role should be retained. That is, it is for the regulator (and the profession) to assess the value that is placed on these principles compared to the cost that they impose.

Since the ARP is currently in place, and does currently allow a rehabilitation role, we set out below the implications were this to be removed.

Removal of rehabilitation role

Removing the rehabilitation role from the ARP would imply that firms that fall into the ARP would be shut down and would not be able to continue in practice. The implication of removing the rehabilitation role of the ARP would be:

- The SRA would no longer set the regulatory boundary;
- Over the entire course of the ARP, a maximum of 61 firms would not have been rehabilitated. For 2008/09 the equivalent figure is 26 firms; and
- Claims costs of around £3.7 million would have been saved in 2008/09 since no firm would be able to continue providing advice to clients in the ARP. This equates to around £140,000 per firm rehabilitated.

There could also be implications for equality and diversity from the removal of the rehabilitation role. As noted in section 4.5, the only issue related to equality and diversity where there was evidence of differentials within the ARP related to BME firms.

From an equality and diversity perspective, the relevant issue here is not the proportion of BME firms in the ARP generally, but the implication for equality and diversity of the firms

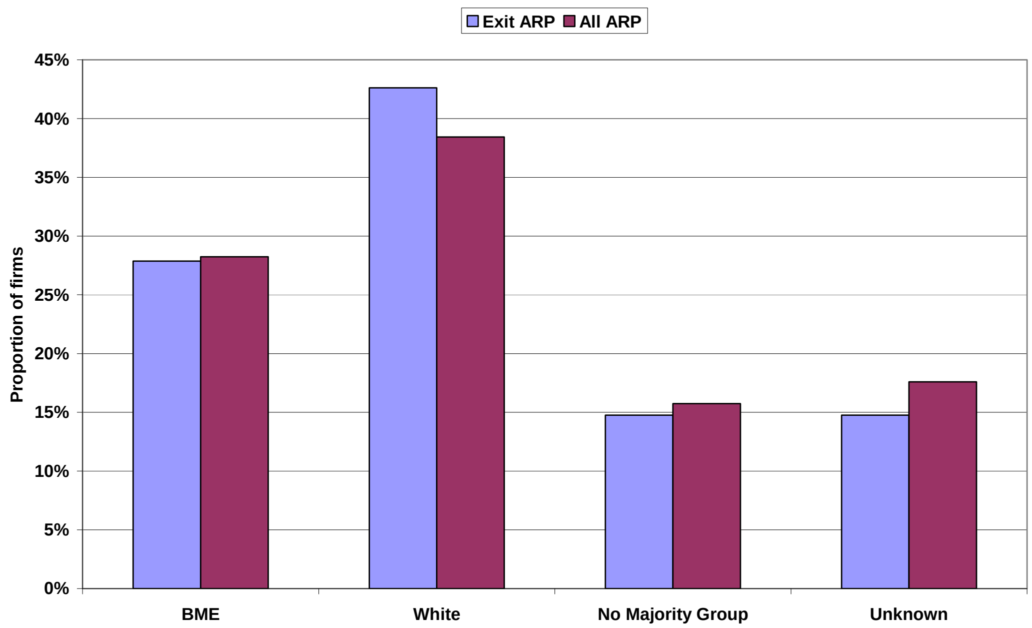
82 We note that if this could be identified on day 1 we might expect to see “bad” firms to be prohibited from undertaking new business since day 1. However, the faster that “bad” firms can be identified, the lower the cost of the claims would be expected to arise for claims where the cause of action arose in the ARP.

that would no longer be rehabilitated (since the great majority of firms in the ARP will close anyway).

It is important to note that information is not available on the breakdown of all ARP firms by ethnicity going back to the start of the ARP. For this reason it is not possible to conduct an analysis of the likelihood that firms of different ethnicity exit the ARP. However, the SRA has been able to provide data on ethnicity for all of the firms that have successfully exited the ARP. From this data we can identify that, of the 61 firms that exited the ARP, 17 of these were BME firms.

Data is available on the ethnicity of all ARP firms for the period 2006/07- 2008/09 years and therefore it is possible to compare the ethnicity of firms which exit the ARP successfully compared to those that enter the ARP.

Figure 26: Proportion of firms in the ARP and successfully exiting from the ARP



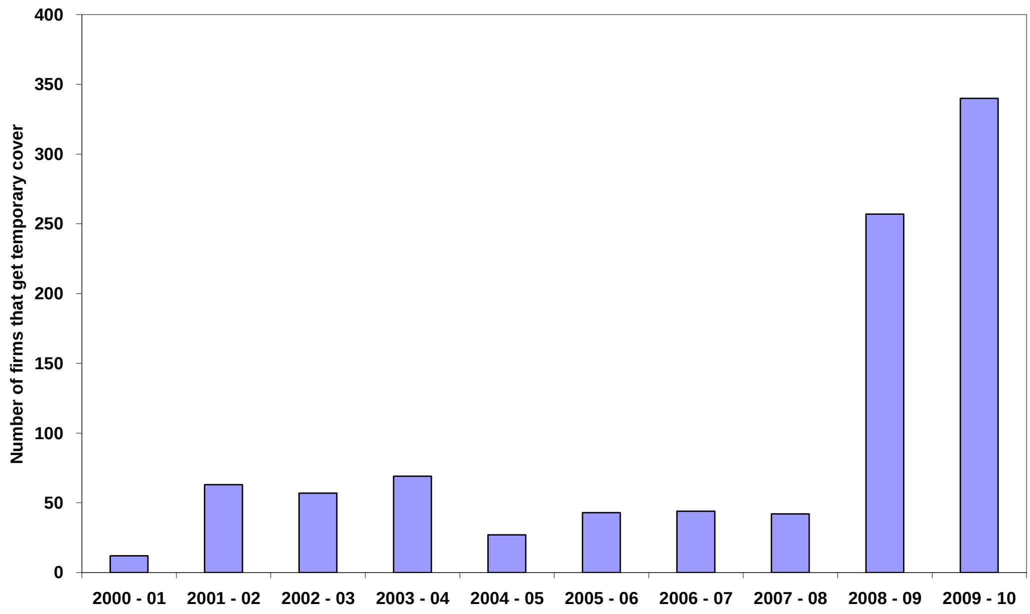
Source: SRA data and CRA calculation.

As indicated in Figure 26, there is little difference in the proportion of all firms in the ARP compared to those firms that successfully exit the ARP. One of the implications of this is that changing the rehabilitation role of the ARP does not introduce a further equality concern. However, it is clear that BME firms are disproportionately represented in the ARP more generally since they represent around 28% of firms that enter the ARP, 28% of firms that successfully exit the ARP and only 11% of firms in the profession.

5.3. Temporary insurance cover

An additional function that the ARP currently provides is to offer short-term insurance cover. A number of firms are unable to obtain insurance by the end of the renewal period, but do manage to obtain insurance within 60 days of the renewal date (to be reduced to 30 days effective from 1st October 2010). Figure 27 shows the number of firms that obtained this "short-term" cover. These firms are not captured in the figures presented in earlier charts.

Figure 27: Number of firms that obtained temporary cover in the ARP



Source: Capita

It is clear from Figure 27, that, relative to the size of the profession as a whole, only a small proportion of firms have gained from the temporary insurance cover. However, the number of firms that obtain temporary cover is broadly similar to the number of firms that end up staying in the ARP for longer periods of time indicating that, in terms of the various roles of the ARP, this issue is not trivial.

A similar pattern to those in other charts is again seen with relatively few firms obtaining temporary cover before the 2008/09 indemnity year (before which the peak was 69 in 2003-04). However, the number increased sharply in the last two indemnity years reaching 257 in 2008/09 and 340 in 2009/10.

Firms that use the ARP for temporary cover receive discounts on their ARP premium.[83] The discounts do not apply if claims or circumstances that give rise to claims are notified to the ARP during the indemnity period concerned.

We have not been able to gather any data relating to the cost of claims for firms that exit the ARP within 60 days although we note that it seems likely that if firms do receive a claim, they may choose to continue in the ARP since otherwise they would end up paying multiple premiums for the same indemnity year (as they would not be entitled to receive

83 In particular, firms that exit the ARP within 60 days would receive a 60% discount on the premiums and those that exit within 30 days would receive an 80% discount. SRA, Solicitors' Indemnity Insurance Rules 2010, Appendix 2.

the discount that other firms receiving temporary cover receive). This will depend on the level of premiums they are offered in the open market.

Offering temporary cover will, by definition, lead to adverse selection problems for the ARP since firms that do not have claims will be able to obtain cover elsewhere, whereas firms that do face claims will be expected to remain with the ARP since the claim would be indicative of being a more risky firm.

It is worth noting that having an ARP to provide a role of offering short term temporary cover is highly unusual in insurance markets. It is not usually deemed necessary to intervene in a market by providing an ARP because of a timing issue in relation to obtaining insurance.

Since firms obtaining this cover do manage to obtain cover from the open market within 60 days, it seems clear that this issue is driven by a purely temporary inability to obtain cover. Indeed, it is apparent from the interviews and other evidence that this issue is closely connected to the presence of a single renewal date which is placing considerable pressure on solicitors. Firms may not be able to obtain insurance before the end of the renewal period because of resourcing constraints faced by insurers. That is, the restriction to impose a single renewal date is distorting the insurance market and is the cause of the requirement for the ARP to play a role of providing temporary cover.

In section 6.4 we recommend removing the restriction of the single renewal date. We therefore expect the number of firms requiring temporary cover to reduce substantially as the market moves away from the single renewal date. Hence there would be no need for the ARP to play a role of offering temporary cover.

If the ARP continues to play a rehabilitation role, it would remain appropriate for incentives to encourage firms to seek insurance from the open market at the earliest opportunity. In practical terms, therefore, the ARP may end up providing short-term cover for some firms.

If the ARP no longer plays a rehabilitation role, there would be no need for this temporary cover role since the temporary cover is a function of the single renewal date.[84]

5.3.1. Recommendation

Since temporary cover is only in place to overcome unintended consequences due to the single renewal date, we recommend that the provision of temporary cover is removed if the ARP no longer plays a rehabilitation role.

However, since we anticipate that it would take a number of years for firms to gradually move away from the 1st October renewal date, it may be necessary to retain the role of temporary cover for the next few years while firms begin to use the flexibility to obtain cover at other times of year. Assuming that the recommendation to remove the restriction

84 Firms do not need to be given additional time to seek alternative cover before facing closure since the previous insurer would *already* have given notice of their intention not to renew cover in advance of the end of the policy year.

of a single renewal date is implemented, we recommend that the temporary cover element could be removed around 3 years after the single renewal date restriction is lifted.

5.3.2. Impact

There is no additional impact from this recommendation in comparison to the recommendation in section 6.4 to remove the single renewal date.

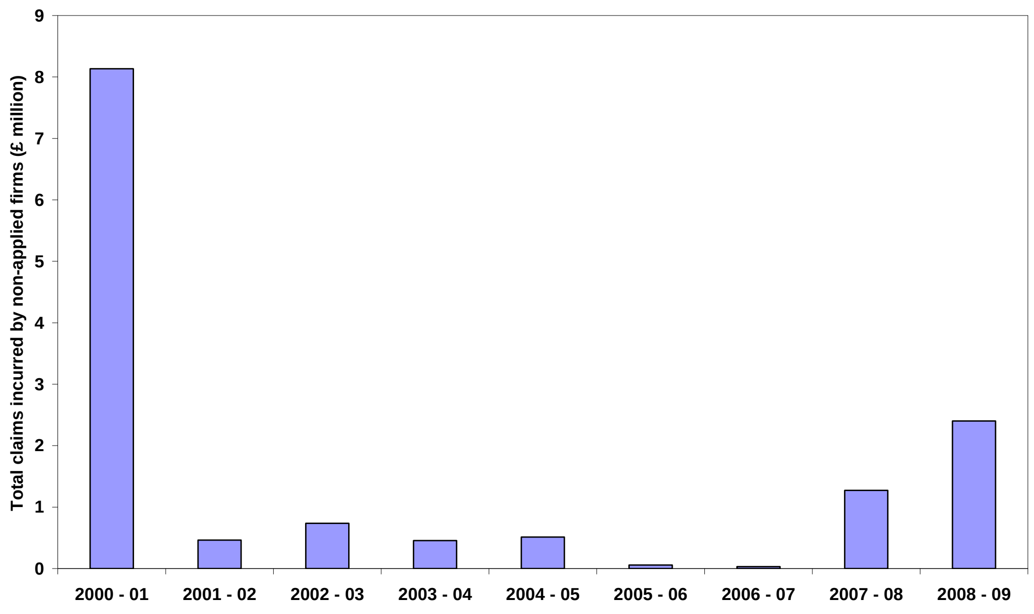
5.4. Client protection from non-applied firms

Given the objectives of ensuring that clients receive a minimum level of protection, it is necessary to have an arrangement in place to protect clients from firms that do not obtain insurance (i.e. firms that do not comply with regulatory requirements). Currently these claims are met by the ARP in respect of “non-applied” firms. This aspect of the ARP’s role can be seen as equivalent to that of the Motor Insurance Bureau which exists to compensate the victims of negligent uninsured and untraced motorists.

The presence of non-applied firms indicates that there are firms that are not compliant with the SRA requirements to have insurance. From the data available it has not been possible to identify whether these non-applied firms are typically continuing in practice (and either forgot to purchase insurance or deliberately chose to practice without insurance) or have closed without taking out the appropriate run-off cover.

Figure 28 below shows total claims incurred by non-applied firms and other firms in the ARP.

Figure 28: Total claims incurred by non-applied firms



Source: CRA calculation based on data for the ARP

The total value of claims incurred by non-applied firms has fluctuated considerably over time. We understand from the SRA that the claims in 2000/01 relate mainly to one particular matter.

However, since 2001/02, the value of claims associated to these firms has been less than £1 million per year. It has increased sharply in the last two years with claims reaching £2.4 million in 2008-09. Of this £2.4 million, £0.3 million related to work conducted in the 2008/09 year.

As non-applied firms do not comply with regulation but nonetheless generate claims, it is to the benefit of both clients and the profession that these face prompt enhanced regulatory action. Indeed there is some form of failure of regulation that allows these firms to be non-compliant with the rules. At the very least this suggests that the SRA needs to make better use of its information related to the insurance that firms have in place and to get in rapid contact with firms that do not have insurance or a successor practice. It also indicates a need to check whether firms have run-off cover in place when they cease practice.

A tightening of the regulatory rules such that firms could not continue to practice without appropriate insurance appears the most appropriate solution.

Ideally the cost of these claims would be met by the non-applied firms themselves, but little, if any, of the payments due from these firms is collected in reality. The profession as a whole suffers collective reputational damage from non-applied firms and benefits collectively from disciplinary action taken against them. As a result, it is reasonable for the profession to face the cost imposed by these firms. It is less clear whether the protection of clients should be arranged through an ARP or through the Compensation Fund.

5.4.1. Recommendation

We do not recommend any change to the function of providing protection to clients of non-applied firms. Since we recommend no change, there is no impact from this.

5.5. Insurer of last resort due to misalignment of incentives

As noted in section 4.6.2, one of the possible concerns regarding using the open market is that insurers do not have the incentive to report poorly performing firms to the regulator because if they do so and the firm is shut down, the insurer will face the risk of run-off. (This misalignment of incentives is exacerbated by the current position in which insurers may not actually receive a premium for providing this cover – we consider this issue in section 6.5.)

The consequence of this is that firms continue to operate, insurers refuse cover at the end of the indemnity year and the firm falls into the ARP. The claims that could have been prevented altogether are those claims that arise from a cause of action that occurred in the indemnity year immediately preceding the year in which the firm entered the ARP. This is because, had insurers reported these firms to the SRA, the SRA might have been able to take steps leading to remedial action or the firm being closed down during the course of the year in which the firm was still insured by the open market. Instead, if the insurer does not reveal information to the SRA, the SRA only identifies the firm as a high risk firm once it enters the ARP. By this time a whole year of work may have been completed including work that subsequently gives rise to claims which are made during the time in which the firm is in the ARP.

In order to obtain an estimate of the possible cost of this issue, we need to use data on the timing of the cause of action. As noted in section 5.2, due to data difficulties, we can only rely on data from the 2008/09 indemnity year.

Table 11: Misalignment of incentives

	Value	Proportion
Cause of action in 2007/08 claimed in indemnity year 2008/09	£3.7 million	9%
Total of all claims in 2008/09	**£43.4 million**	100%

Source: CRA analysis of data from ARP. Note that the £3.7 million excludes £0.9 million claims arising from non-applied firms where the cause of action occurred in the same year in which claims are revealed to the ARP.

As set out in Table 11, £3.7 million of claims result from work where the cause of action happened the year before the firms entered the ARP (i.e. during the 2007/08 indemnity year). (It is purely coincidental that this is approximately the same figure as that set out in section 5.2.) It should be noted that this figure:

- Is a lower bound estimate of the value of claims resulting from causes of action in the 2007/08 indemnity year because the ARP only has robust data on causes of action from the 2008/09 indemnity year. Indeed, some £19 million of the £43.4 million claims is not associated to a particular year with respect to the cause of action; but

- Not all causes of action arising in 2007/08 would have been prevented even if insurers did not face a misalignment of incentives. This is because it would have taken some time to identify firms as those that may need to be reported to the SRA. In addition, it would have taken some time for the regulatory assessment to have arisen and firms to be closed down where this is appropriate.

The first reason suggests that £3.7 million is an underestimate of the value of claims that could be prevented, but the second reason suggests that it is an overestimate. In the absence of better information we use this estimate as an indication of the likely magnitude of the problem.

The value of claims arising in this way will be reduced if insurers are only required to provide run-off cover when the premium for run-off is actually paid (as we recommend in section 6.5) since this would increase the incentive to report firms to the SRA. However, this is likely to be insufficient to overcome the misalignment of incentives. Given that £3.7 million is not an insignificant amount of money this indicates that it is important to ensure that insurers have appropriate incentives to inform the SRA in a timely fashion about any firms of concern.

5.5.1. Options

We recommend that incentive alignment be improved between insurers and the SRA. Given the interaction with run-off cover, we set out possible options for this in section 6.10. The impact of these options is also considered in that section.

There are a number of possibilities regarding changing the function of the ARP more generally and issues to do with incentive alignment may be affected by this. For this reason we consider all of these options together in section 5.12**.**

5.6. Orderly run-down

Instead of providing the option to rehabilitate firms in the ARP, all firms in the ARP could be closed down.

If there was no arrangement to provide firms with continued cover, they would all have to be closed down the moment they are unable to renew or obtain insurance. At present the difficulty that would be caused by this is exacerbated by the single renewal date and the current value of claims arising which would imply hundreds of firms would need to be shut down on the same day.

Although moving away from single renewal date will help to mitigate the problem over time, it remains impractical for the regulator to be able to close down all these firms immediately after their insurance policy ceases. Since many firms would have been planning to continue practising before they find out they are unable to obtain insurance, it is unlikely that these firms could exit the market immediately without causing considerable disruption to their clients.

It is possible that SRA intervention that allows orderly run down may give these firms the opportunity to continue to conduct negligent work leading to additional claims. In as far as this happens, this would suggest a failure of the intervention process. The cost of this would be contained within the £3.7 million set out in section 5.2 above.[85]

However, it would also be expected that the sudden shut down of firms could itself generate additional claims because firms stop working on cases and therefore fail to complete tasks that were underway leading to negligence on these cases. Since the SRA does not currently close down firms in an abrupt manner, claims do not currently arise from this route. It is possible that a movement towards closing all firms immediately could in fact generate some claims but the expected level of claims is unobservable currently. In general, it seems reasonable that the ARP continue to perform a role in protecting clients while the SRA closes firms down in an orderly fashion. (We note that performing this role may interact with other roles of the ARP considered below.)

85 This does suggest closing the rehabilitation role may not save all £3.7 million, but we would expect the difference to be minimal if the SRA closes firms promptly.

5.7. Insurer of last resort for firms that enter run-off

The final element of the role played by the ARP is that it acts as the insurer of last resort for firms that ultimately end up being closed down and entering run-off. This is not to say that the ARP insures all firms that enter run-off, but rather that firms which enter the ARP and subsequently go into run-off are covered through the ARP. Other firms that enter run-off are covered by the commercial market.

Effectively all of the remaining costs that are identified within the ARP which have not already been categorised in the other sections represent those costs that arise as a result of this final role played by the ARP. This represents £33.6 million. It is striking that it is this function that represents the great majority of claims.

These claims represent claims that would have arisen even if firms in the ARP were not allowed to continue in work, if there were no firms that operated without insurance and if there was no misalignment of incentives between insurers and the SRA's regulatory oversight.

It is clear that clients need to be protected from these costs. It is less clear how these costs should be paid and whether they should be paid within an ARP or whether insurers should be required to fund the costs of this. We consider the options for funding this, and the other component of costs, in section 5.12.

We also note that this interacts with the role of orderly run-down. In particular, it is unclear that the ARP can act as the insurer of during orderly run down but not form firms that enter run-off more generally. That is, it raises the question of what firms would be deemed to be "orderly run-down" firms but not "ARP run-off firms". Similarly, if the ARP acts for firms generally that enter run-off it would be acting as insurer during orderly run-down.

5.8. Cost of operating the ARP

In addition to the claims that arise for firms within the ARP, costs also arise because of the need to manage these claims over time. The cost of running the ARP itself is not negligible. Over the last ten years, the total cost has been around £7.2 million. It should be noted that since the management of claims takes some time, and given the large increase in the number of firms in the ARP and associated claims in the last two years, the cost per indemnity year would be expected to be higher than average for recent years (with many of these costs still to be incurred as claims continue to be dealt with).

5.9. Summary of the roles of the ARP

As highlighted throughout this section the ARP is currently meeting a number of different roles. Table 12 provides a summary of this for 2008/09. Due to data limitations, this is the only year for which all of the analysis can be done.

Table 12: Summary of ARP costs for 2008/09

	Value	Proportion
Rehabilitation role – see section 5.2	£3.7 million	9%
Temporary insurance cover – see section 5.3	-	-
Non-applied firms – see section 5.4	£2.4 million	6%
Insurer of last resort due to misalignment of incentives – see section 5.5	£3.7 million	9%
Orderly run-down – see section 5.6 and Insurer of last resort for firms that enter run-off - see section 5.7	£33.6 million	77%
Total of all claims in 2008/09	**£43.4 million**	100%
Costs for running ARP		

Source: CRA analysis of data from ARP.

It is useful to note at this stage that while we have separated these different roles, this is not to say that some roles could be excluded while having no implication for the other roles of the ARP. For example:

- The concept of orderly run-down within the ARP may not make sense if firms in run-off are themselves not within the ARP (for example because insurers are required to take on the risk of run-off); and
- Measures to address the costs associated to the misalignment of incentives to reveal information to the regulator are affected by the method of funding the remaining costs where firms end up in run-off (whether this is within the ARP or the open market).

Given the interaction between some of these roles, we set out issues below relating to funding the ARP.

5.10. Funding the ARP – firms in the ARP

As the preceding section shows, there are different roles that the ARP is seeking to meet some of which feed directly into the objectives of the overall compensation arrangements. In this section, we consider how the costs of the different components of the ARP should be met.

Before examining this, it is worth highlighting once again that the key reason for the high level of costs within the ARP relates to the value of conveyancing claims and the concerns related to regulatory failure. Swift regulatory action in closing down high risk firms would contribute greatly to a reduction in the cost of the ARP and therefore to the funding required for the ARP.

5.10.1. Payment by firms in the ARP

The first issue to recognise is that it is highly desirable that the firms that are in the ARP actually contribute to the costs of the ARP. This meets the needs of principle 8 that risk management be encouraged and there be a recognition of ensuring some element of "polluter pays".

It is important to note that the requirement to have payment by firms in the ARP interacts with whether or not firms continue in practice within the ARP i.e. whether the rehabilitation role continues or whether orderly run-down implies some (very brief) period in which firms continue in practice before entering run-off. Similarly, the requirement to have payment by firms who are covered for run-off within the ARP depends on whether run-off cover is provided by the ARP.

Premiums charged for firms continuing in practice

Firms that are in the ARP pay premiums that are set out according to the rating schedule in the Solicitors' Indemnity Insurance Rules. This uses a sliding scale of payments in which for the first £0.5 million of gross fees, firms pay either:

- 27.5% of gross fees for the sole practitioners and partnerships; or
- 30% for limited companies and limited liability partnerships.[86]

For fees above £0.5 million, the proportion of fees falls as the value of different fee bands increases such that if firms have fees of more than £20 million, firms would pay 5.5% or 6% of the value of fees above £20 million. In reality, most firms in the ARP have gross fees of less than £0.5 million and fall into the category where the premiums are either 27.5% or 30% of their gross fees.

In addition to the premiums, firms that apply in default i.e. after 1st October must pay an additional 20% penalty (firms that are non-applied must pay a similar penalty). There is also a minimum premium of £1,500 irrespective of the level of gross fees or the period of time spent in the ARP. Firms can pay their premiums by instalments through a loan facility provided by Premium Credit.

During the course of discussions, a number of market participants have raised concerns about the level of premiums including that:

- the current level of premiums is set at a prohibitively high level - there are concerns that the level of premium itself has the effect of pushing firms towards failure to pay since they are not able to afford the premium;
- the rate is flat across firms irrespective of their risk profile; and

86 SRA, Solicitors' Indemnity Insurance Rules 2010, Appendix 2.

- the rate is flat over time irrespective of improvements to the risk management process made by firms and irrespective of the value of claims arising while the firm is in the ARP.

Initially, when the ARP was set up, the level of premiums was set in the way that discouraged firms from entering the ARP unless they had no alternatives. As such the premiums were designed to replicate the cost of a firm operating in a high risk line of business and with a large number of claims. Although the current approach means that premiums are transparent and easy to calculate (hence minimising administration costs), they do not appear to appropriately reflect risk.

In general the concerns raised reflect the need for the use of a better underwriting process for firms in the ARP. In this regard it is interesting to note how ARP premiums are set in other schemes where we find that:

- RICS sets ARP premiums through a group of underwriters; and
- ICAEW sets ARP premiums through a group of the largest underwriters although they would typically use a rule of thumb of doubling the previous year's premiums.

One potential improvement to the scheme would therefore be to bring in better underwriting skills such that the ARP charges firms according to their individual risk profile with firms being underwritten on an individual firm basis. Since the ARP is likely to lack the appropriate skills for this it would make sense to outsource this requirement to an independent underwriter who could conduct the work for the ARP. It may be desirable to allow flexibility in the premium such that where claims are notified against firms but turn out to be frivolous, ongoing premiums can be adjusted downwards as appropriate. This approach would have the merit of linking the premiums paid to the specific conditions of individual firms. We note that in as far as BME firms may be concerned that they unfairly end up in the ARP, individual underwriting should help to alleviate some of their concerns.

There would, of course, be a cost associated with buying in this underwriting capability, however this seems unlikely to be prohibitive.

Premiums charged for firms in run-off

Firms that enter run-off within the ARP are currently charged 100% of the annual ARP premium (plus the 20% penalty for being in default if applicable).

Based on discussions with insurers and data provided by some insurers, we note that in the open market it would be typical for run-off premiums to be approximately 2.5-3 times the level of annual premiums.

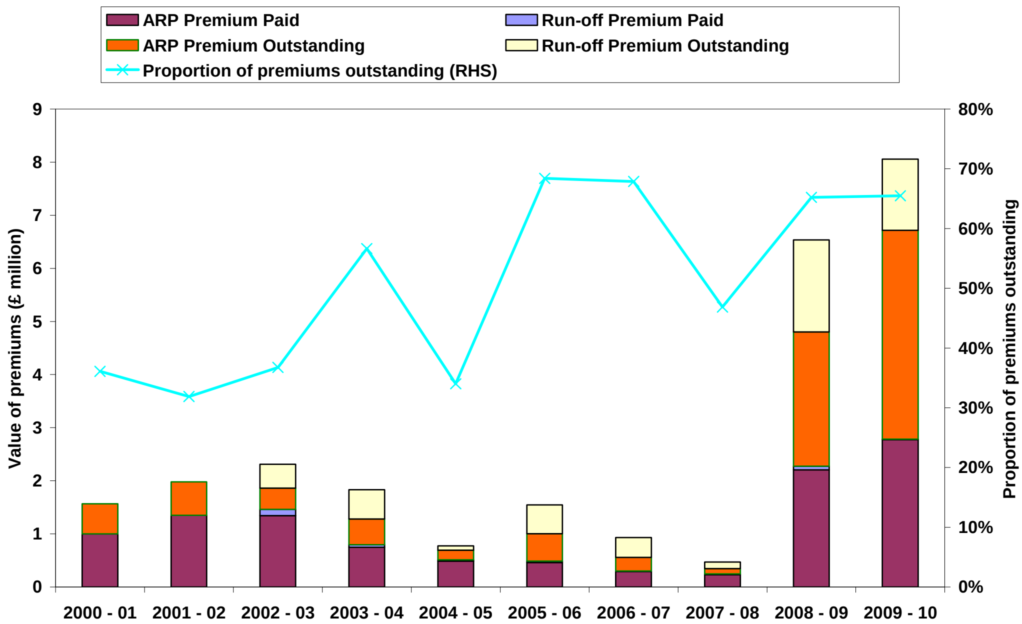
The ratio between the run-off premium and the ongoing premium appears to be too low within the ARP in comparison to the commercial market. Indeed, a small number of interviewees have suggested that some individual firms that plan to close may deliberately begin to shrink the size of their business, and then enter the ARP in order to gain from relatively cheap run-off rates. No data is available on this issue.

The introduction of individual underwriting for the ongoing premium would be expected to also address the premiums charged for run-off.

Failure to pay premiums

Historically, firms that fail to pay premiums to the ARP have still been able to obtain cover from the ARP and continue in practice. As we note further in section 6.5, this distorts normal market practice and provides poor incentives to firms with respect to risk management. In particular this means that firms that fail to pay premiums can effectively receive free insurance the cost of which is passed on to compliant firms. As set out in Figure 29 below, failure to pay premiums within the ARP is a significant problem.

Figure 29: Premiums paid and outstanding of ARP firms over time



Source: Capita data and CRA calculation

Even in 2001/02, the indemnity year in which the greatest proportions of premiums due have been collected, premiums outstanding still accounted for 32% of total premiums. In recent years, premiums outstanding have been 65% of total premiums showing the magnitude of the problem.

We note that the SRA has changed its enforcement strategy with respect to ARP firms including that the SRA take steps to ensure that the firms in the ARP pay their premium or are managed out of the ARP.

5.10.2. Recommendation

If the ARP continues to play a role in rehabilitating firms, we recommend that if firms do not pay their premiums they should not receive insurance cover. Since this would place them in breach of SRA regulations we recommend that such firms be shut down. This is in line with our analysis in section 6.5, and consistent with our conclusion that other firms that fail to pay premiums should be intervened in by the SRA.

5.10.3. Impact

Closing down firms that do not pay their premium would be expected to lead to an increase in the number of firms that are closed down. In turn this should reduce the number of claims that arise while firms are in the ARP. Just under 50% of the ARP premium (as opposed to the run-off premium) is outstanding suggesting that, if these firms are closed down there could be a reasonably substantial reduction in the claims arising in the ARP, although data is not available for us to estimate this.

This does not necessarily imply that the problem of non-payment will be completely eradicated in the future:

- There has been a particularly poor record with respect to the payment of premiums for the purpose of run-off. Over the entire period, only £0.3 million of run-off premiums have been paid compared to £5.2 million of run-off premiums that is outstanding. We note that the threat to intervene in a firm is unlikely to alter the behaviour of firms that are already in run-off and no longer practising;

- While the rule could lead to an increase in the number of firms being intervened in, this does not necessarily mean that these firms will subsequently be able to pay their premium; and

- Some firms that can not afford the ARP premiums may choose to operate without insurance rather than be in the ARP. That is, it may lead to an increase in claims resulting from non-applied firms As explained in section 5.4, this indicates the importance that regulatory action has to be enhanced as well (through vigorous monitoring of the requirement that a firm has valid insurance to be in practice).

Nonetheless, the consequence is that some firms will be shut down if they fail to pay their premiums should lead to an increase in the proportion of premiums that are paid. We do not have information on who the firms are that fail to pay their premiums and are therefore unable to assess equality issues.

More generally, the fact that large numbers of firms do not pay their premiums raises questions about the financial viability of firms. Again this calls into question whether there is regulatory failure in respect of the firms that are in the profession but are unable to find the resources to fund PII premiums. This is a particular concern regarding run-off and it would appear appropriate for the SRA to take steps towards ensuring that firms would have sufficient resources to enter run-off if this was necessary.

5.11. Funding the ARP - additional funding of the shortfall

It is important to note that even if all of the firms in the ARP paid the premiums that were due, this would be insufficient to meet the level of claims that arise in the ARP. As such it is important to ensure that there is a funding mechanism in place to deal with the shortfall in the ARP.

It is clear that the contentious nature of the funding of the ARP is highly correlated to the overall size of the claims in the ARP that need funding. At present, the high value of claims in the ARP that have arisen recently have given rise to considerable complaints regarding the method of funding. By contrast, when claims are relatively modest there are few concerns about the channel through which the ARP is paid.

In general it is also clear that there is a need for regulatory action to be taken to reduce the level of negligence in the profession. This would be expected to reduce the value of claims and therefore reduce the concerns regarding the cost of the ARP.

Three options to fund the value not paid by firms in the ARP are considered. The analysis of these options is set out below.

Payment according to the market share of qualifying insurers

Under the current arrangements, qualifying insurers are liable for any funding gap identified by the ARP which they pay in proportion to their market share of the value of premiums related to the compulsory level of cover. When setting premiums, insurers must therefore assess their expectations of:

- The total value of claims in the ARP; and
- Their expected market share.

We note that both of these issues impose uncertainty on insurers who have to set the price of their premiums in advance of knowing the cost of the ARP. It is likely that the uncertainty associated to these costs is exacerbated by the single renewal date because:

- changing market conditions can not be rapidly factored into the price, but rather firms need to wait until the next renewal period to adjust for the level of claims; and
- insurers only find out their share of total market premiums after they have set their premiums for almost their entire book of business; and
- individual insurers only know the number of firms in the ARP after all other insurers have also made their own independent commercial decisions regarding which firms they are willing to cover.

One of the consequences of this is that the current arrangement distorts the incentive of insurers in terms of competing for market share. Since the cost of the ARP is proportionate to market share, expanding their business leads to an insurer taking on a greater proportion of the uncertain ARP costs. As a result, insurers are incentivised to restrict their market share to avoid this cost.

Indeed, evidence from interviews has highlighted that some insurers are actively seeking to reduce their market share because of their concerns about the cost of the ARP. This is particularly evident in a hard market and underwriting capacity is badly needed. An unintended consequence of the current arrangement is that the insurance cycle within the solicitor PII market is magnified by this distorted incentive. Furthermore, we note that it is somewhat unusual within commercial insurance markets for insurers to face a proportion of the risks of firms that they are unwilling to offer cover to.

However, although there are concerns about the uncertainty that is imposed in the current situation, a movement away from a single renewal date (see section 6.4) would reduce the uncertainty associated to the risks that insurers would face. In addition, insurers, who have data on the profession and whose business model is predicated on their ability to assess uncertainty, should be in a reasonable position to make the best estimate of the likely cost of the ARP.

Although the cost of funding the gap falls directly to insurers, insurers will factor this into the cost of premiums that they set and seek to pass this on to the profession which implies that:

- As they would estimate a fixed value of ARP contributions they can seek to recover this fixed amount as they see fit. It is not necessarily the case that they will recover these costs in a way that incentivises good risk management; and
- Firms that have bargaining power, particularly large firms, can negotiate with insurers and therefore pay a lower amount of the ARP cost.

Insurers may make mistakes in their estimations of the ARP cost and hence set premiums that do not correctly reflect the risks they end up facing:

- They may underestimate the cost of the ARP in which case the profession gains from the ARP costs being subsidised by the shareholders of insurance companies; or
- They may overestimate the cost of the ARP in which case the profession will face premiums that over-compensate insurers for the contribution to the ARP.

If firms underestimate the cost one year we would expect them to use this information to revise their expectations of costs the following year. (This is not to imply that they can recover their losses the following year since the threat of new entry should prevent this.) By contrast if they overestimate the costs of the ARP one year we would expect them to use the information to revise their expectations of costs the following year. Over the long term the presumption should be that insurers' expectations of the ARP broadly reflect the true cost of the ARP although for any given year they may diverge substantially from this.

One of the other unintended consequences of this arrangement is that there may be attempts to get "get around" the cost of the compulsory cover through the way that they arrange their various insurance policies. It is clear that such attempts are currently arising.

It is common in commercial insurance arrangements for large firms to arrange their insurance in a series of different layers which cover costs of claims for different amounts. We would therefore expect firms to have the compulsory layer for the risks of £0-3 million and then the various additional layers that they require would be expected to sit on top of this layer.

However, what is actually happening is that firms are arranging very high levels of excess for their compulsory cover such as by having an excess of £100 million and then their compulsory cover would pay out if a claim worth over £100-£103 million came in. Since claims over that size are rare, this makes the cost of the compulsory cover quite low. But firms are not simply taking a very large excess and paying the first £100 million of claims.

Instead they have other insurance policies that will pay out for various different amounts up to the £100 million excess. The effect of this is not to give rise to any concerns about client financial protection since these firms do have insurance and typically have considerable financial resources at their disposal anyway.

While the example has been given for large values, information from discussions has indicated that a similar approach is being taken by small firms. Indeed, while there may be a small number of cases where it is efficient for large firms to arrange their insurance in this way, it is clear that in the case of insurance for small firms, the arrangements are in place primarily to reduce the premium associated to the compulsory cover in order to avoid the insurer's ARP contribution associated to this. This is a clear example of an unintended consequence that once the cost of the ARP is significant, insurers have the incentive to seek to avoid premiums that would count towards their ARP cost.

Levies as a percentage of premiums

An alternative to the current arrangement would be to set an explicit levy for the payment of the ARP as a percentage of premiums. This levy would be set by the SRA and applied on the compulsory cover of all insurance policies in a similar way to Insurance Premium Tax. Insurers would be responsible for the collection of this levy and would collect it at the same time as their insurance premiums. Crucially, the profession would be on risk for any mis-match between the levy and the value of claims in the ARP.

The total cost of the ARP since the move to the open market compared to the total value of premiums over the same period would suggest a levy of around 4%.

The levy would be set as a percentage of premiums which are decided by the commercial market following their commercial underwriting processes. A significant advantage of this would be that the levy would reflect the risks of the individual firms. Riskier firms that pay higher premiums would pay a higher levy. This is consistent with principle 8.

Another merit of this alternative arrangement is that the distortion of incentives regarding seeking to increase market share would be removed. Insurers would be freed from the uncertainty of the ARP cost and would have proper incentives restored to compete for market share.

Under this model, firms would continue to face an incentive to seek to get around the cost of the compulsory layer. However, insurers would have less incentive to do this as they would not face the shortfall risk of funding the ARP. In addition, since larger firms are currently able to negotiate with insurers, we expect that large firms currently bear less burden of the ARP than smaller firms. It is possible therefore that some large firms could face additional costs associated to the ARP from this approach.

The method through which the ARP levy is calculated may also have an effect on the profession:

- It could be calculated at the end of a year in the light of the costs that have been faced. While this would broadly align with incentives for risk management it would mean that the individual firms that close down because of poor risk management would not contribute in advance. We note that the FSA is considering moving away from funding the FSCS on this basis because of the concern that the good firms that survive end up paying for the bad firms;

- It could be calculated at the beginning of the year on the basis of the best estimate for the year ahead. This would retain incentives for risk management and ensure that individual high risk firms made an appropriate contribution. However, it would also mean that since the cost of ARP increases significantly during the hard insurance market, the value of the levy would need to increase at the same time. This would also be expected to coincide with an increase in the firm's premium for their own individual risk which would therefore be expected to exacerbate the cyclical nature of premiums; or

- It could be calculated so as to gather the appropriate level of premiums across the economic cycle by having a flat percentage levy over time or aiming for a consistent value of contributions to be gathered each year. This would lead to a surplus in good years which would be drawn down in bad years.[87] This would maintain incentives for risk management but avoid some of the cyclical effects of the second option.

It has also been suggested during interviews that a further benefit of the ARP being levied more directly from the profession would be that lawyers and the TLS would place greater attention on the ARP and would in turn place pressure on the SRA to ensure regulatory effectiveness in reducing the overall level of claims. At present some of this concern may be lacking as some of the profession view the ARP costs as falling on the insurers rather than the profession.[88]

We note that this would also impose a cost on insurers although it is not clear why it would be any greater than the current costs associated to paying the ARP contribution. Indeed, it could be somewhat smaller since they would know the level of the payment to be made and would not need to make additional payments over time as they may be required to do under the current arrangements. A similar proposal for funding the ARP in Ireland has been suspended because it was not seen as desirable by insurers.

Levies with some risk reflective elements

In a similar way to a levy on premiums, it would be possible to set levies for the profession with a risk reflective element to it. Since some functions of the ARP (such as the cover for non-applied firms) exist for the benefit of the profession as a whole it would be appropriate to have some contribution applied to all individuals.

However, other elements are clearly linked more closely to some types of firms rather than another. In particular, it is much more likely that small firms will end up in then ARP and more likely that small firms will enter run-off. This suggests that a risk reflective funding mechanism would apply more charges to small firms than to large firms.

87 It is important to note that given the cyclicality in the underlying premiums it would be necessary to take this into account when setting the overall levy percentage.

88 To the extent that insurers under-priced the costs of the ARP, the view that the industry has been subsidised by the insurers is accurate.

Similarly, conveyancing imposes more claims on the ARP than any other area and therefore setting contributions according to the firms that conduct conveyancing would seem appropriate. We note that the SRA does not currently regulate on the basis of activities and therefore it is unclear whether it would be possible to apply levies on this basis in an accurate manner.

Levies as a fixed contribution

Another alternative is to levy an ARP contribution on the basis of a fixed contribution per firm. This could be collected either by insurers or directly by the profession along with other fees that are applied. The total cost of the ARP over time suggests a levy of around £75 per lawyer.

Again this arrangement would restore the incentive of insurers to compete for market share which would bring benefits. However, since the levy would be a fixed amount, it would be flat across firms and would not reflect the risk of individual law firms. Larger firms would not be able to avoid this payment although it is notable that they are not the ones that impose major risks to the ARP.

As with some of the alternative options, the profession would bear the cost of ARP and may see the cost vary in line with the economic/insurance cycle, although it is also possible that the levy could be calculated to be smoothed across the economic cycle.

Summary of funding options

It is clear from the discussion above that there are advantages and disadvantages of each model. We provide a summary of the issues in Table 13 below. We note that some of these options are similar to those set out for the Compensation Fund. Subject to which activities are required to be done by the ARP (as opposed to the open market), this may suggest that the functions of the ARP and Compensation Fund should be combined.

Table 13: Assessment of alternative funding models of the ARP

	Current model	Levy as percentage of premium	Levy with risk reflective elements	Levy as fixed premium
Incentives for law firms to manage risk	Partially aligned with risk management as small firms are likely to contribute more	Aligned with risk management as payments directly linked to premiums	Aligned with risk management as payments directly linked to premiums	Not linked to risk of firm
Avoidance strategies	Avoidance strategies arising currently	Some avoidance strategies may arise	No avoidance possible	No avoidance possible
Administrative costs	Potential for multiple unpredictable payments from insurers	Predictable payments from insurers	Predictable payments from lawyers	Predictable payments from lawyers

Incentives for insurers to compete for PII business	Reduced incentives	Incentives to compete	Incentives to compete	Incentives to compete

Source: CRA

These funding options could be refined further. For example, since the only firms that are in the ARP are firms with 5 partners or fewer any levy applied could be targeted only at these firms. This would have the merit of ensuring that the ARP contribution was paid by those who were most likely to impose costs through the ARP and would align with risk management incentives. However, one of the reasons for providing client financial protection is the detrimental impact on the reputation of the whole profession from clients being unprotected. From this perspective, the ARP plays a role in protecting the reputation of the whole profession which suggests that it would be appropriate for ARP funding to apply across the profession. In part this tension would be picked up through a levy with risk reflective elements.

Of the options set out, it appears as though a levy as a percentage of premiums or a levy with risk reflective elements would be most closely aligned to the principles set out in section 2.5. During the course of interviews it should be noted that in:

- Lawyers had mixed views on the appropriate method of funding although some saw the involvement of insurers in the current model as likely to imply that the full costs would not be faced by the profession; and

- Insurers favoured a move away from the current model.

5.12. Options for ARP

There are a number of different options that could be considered individually for the functions that are currently done within the ARP:

- The rehabilitation role could be kept (as today) or removed – the impact of this was set out in section 5.2.4;

- We recommend the end of the provision of temporary cover following a transitional period after the single renewal date – the impact of this is set out in section 5.3.2; and

- The insurer of non-applied firms as considered in section 5.4 needs to be undertaken somewhere and therefore we recommend that this function remains. It could be moved to the Compensation Fund although this appears to be a secondary issue.

- The issue related to misalignment of incentives could be addressed on its own – the impact of this is set out in section 6.10 where we consider issues to do with run-off more generally.

With all of the options above, there is a question as to the appropriate funding mechanism for the shortfall that would arise within the ARP due mainly to the role of the ARP acting as the insurer of last resort for firms that enter run-off. In general it appears as though a levy as a percentage of premiums or a levy with risk reflective elements would be most closely aligned to the principles set out in section 2.5.

Alternatively, the last insurer on risk could be required to cover the run-off period. We note that this interacts with the method of addressing the misalignment of incentives regarding revelation of information to the SRA. In particular, if insurers had to fund firms that went into run-off, it would not be necessary to follow the alternative suggestions put forward for dealing with the misalignment of incentives alone.

This also interacts with the assumption regarding the rehabilitation role:

- If there was no rehabilitation role this would mean that firms that failed to obtain cover would be closed down and required to take out run-off from their previous insurer; or

- If the rehabilitation role continued this would suggest that firms would fall into the ARP for the rehabilitation role, fail to be rehabilitated (over a period of up to one year) and then the run-off risk would return to the insurer,[89]

The major difference between these two options is that the latter would involve additional claims arising, and would involve uncertainty for insurers as to whether they were on risk for particular firms that fell into the ARP. This uncertainty may only be resolved a year later. For convenience the assessment below therefore considers the former option.

5.12.1. Impact

This main argument put forward for this option is that insurers are able to avoid the costs associated to risky firms by refusing to renew cover. As such the ARP faces an adverse selection problem in which it is left with all of the high risk firms where insurers are unwilling to take on the risk. The impact of this is that the costs of this are shared across the ARP rather than being faced by individual insurers.

The expected impacts would be:

- Improved incentives to report firms to the SRA: Since insurers could not escape facing the costs of claims, this should lead them to report firms to the SRA promptly in order that bad firms are closed down and the total value of claims reduced.[90]

- Reduction in the remaining cost of the ARP: Under the current funding arrangements the cost of the ARP is causing some insurers to fail to seek new business, a smaller ARP would prevent this perverse incentive. However, we note that this is a function of the funding mechanism for the ARP generally;

However, it is also likely that a number of unintended consequences would arise including:

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89 If the risk did not return to the insurer, this would be no different from today.

90 It is possible that insurers would continue to not report firms in the hope that another insurer would take the firm on for the standard indemnity cover before the firm went into run-off.

- An increase in the number of non-applied firms: Given that a large proportion of firms in both the open market and the ARP currently do not pay their premium for run-off, it would be expected that this would continue. Based on (limited) data from insurers, it appears as though around 50% of run-off premiums are not paid. The figure within the ARP is even higher at 96%. Since insurers should not have to offer cover in the event that firms fail to pay premiums, these firms would simply end up in the ARP as non-applied firms rather than in the ARP as firms in run-off that had not paid a premium. We note that this concern raises issues regarding regulatory failure with respect to ensuring that firms are financially viable and can afford to enter run-off without falling back on the protection of the ARP.

- It may be difficult to enforce in practice. When a law firm leaves its current insurers after its insurance expires, the insurer does not know whether the firm has obtained insurance from another insurer, entered the ARP, or become a non-applied firm. This would add great uncertainty to underwriting process. Information would need to be promptly provided to insurers as to the status of law firms that they were previously insuring.

- Withdrawal of insurers from offering insurance to firms most likely to enter run-off: Given that insurers would be less able to avoid the cost of run-off we would expect insurers to seek alternative methods of avoiding these costs. This would be most likely to include becoming more selective in offering insurance in order to avoid possible run-off cover. It is expected that these firms would be similar to those that currently enter the ARP but with a greater number of firms likely to be affected. We would expect this to have detrimental effects for small firms (and therefore BME firms).

6. DETAILED TERMS AND CONDITIONS

In this chapter we consider the terms and conditions that would lie beneath the potential models and the extent to which they are necessary to address the market failures discussed earlier in the report. In each case we look at the application of the terms and conditions across the different potential models (although in practice some may only be applicable to particular models). In this chapter we consider the following issues:

- Client coverage - in section 6.1
- Activities covered - in section 6.2
- Qualifying insurers – in section 6.3;
- Single renewal date – in section 6.4;
- Failure to pay premiums – in section 6.5;
- Level of cover – in section 6.6;
- Misrepresentation - in section 6.7;
- Fraud - in section 6.8;
- Payment of excess - in section 6.9; and
- Run-off cover – in section 6.10

Where we advocate a move away from the current requirements we also set out the anticipated market impact from the proposed changes.

6.1. Client coverage

As noted in section 2.6.2, there is evidence of a market failure with respect to individual clients but not with respect to corporations. Therefore it is appropriate to limit the regulatory requirement for PII to cover for individual clients rather than corporate clients. We note that this approach is similar to that taken in other compensation schemes such as within the Financial Services Compensation Scheme.

This raises an issue of where the borderline should be set for individual clients. A useful starting point is the definition of clients who are able to complain to the Office for Legal Complaints (OLC).[91] At present, under the Legal Services Act, the OLC can accept complaints from individuals. The OLC has proposed the following should be included along side individuals:

91 Office for Legal Complaints, Scheme rules consultation response.

- a micro-enterprise as defined in European Recommendation 2003/361/EC of 6 May 2003 (broadly, an enterprise with fewer than 10 staff and a turnover or balance sheet value not exceeding €2 million);
- a charity with an annual income less than £1 million;
- a club, association or society with an annual income less than £1 million;
- a trustee of a trust with a net asset value less than £1 million; or
- a personal representative or the residuary beneficiaries of an estate where a person with a complaint died before referring it to the Legal Ombudsman.

The OLS notes that these groups of people are eligible to use other Ombudsman schemes including the Property Ombudsman and Financial Ombudsman Service (FOS).

We note that some interviewees have suggested that the exclusion could be limited to lenders. It is not clear that this follows from the market failure analysis which indicates that regulatory intervention is not required for corporates generally rather than for financial institutions specifically. Therefore it is unclear why financial institutions should be treated in a differential manner to other corporations. It is possible that excluding financial institutions could lead to a straightforward boundary being drawn between individuals and "others", but this would require evidence suggesting that drawing the boundary in a different location would cause particular difficulties.

6.1.1. Recommendation

We recommend that the MTC require that cover be in place for individual clients but not for other clients. The SRA will need to consider the appropriate definition of an "individual" for this purpose although we note that there appears to be considerable merit in having a common definition of eligible clients in the insurance cover as that used by the OLS. This will help individual clients to understand whether or not they are covered.

6.1.2. Transition

In order to allow corporate clients to react to changes in the minimum terms and conditions and put in place conditions under which they are willing to work with particular solicitors, some period of transition would be required implying that changes should apply after a period of sufficient consultation.

We note that in Ireland changes to remove undertakings to lenders in the course of commercial conveyancing transactions were done relatively quickly. Indeed, there was a gap of only a few months regarding the exclusion of commercial conveyancing claims from their minimum terms and conditions.

Since PII operates on a claims made basis it would be inappropriate to remove cover for work that has already been conducted and was done at a time when corporate clients understood that they would have protection through insurance provision. The transition away from arrangements in which *all* clients are covered towards MTC in which only individual clients are covered would therefore need to retain retroactive cover for work done before the date on which the change in minimum terms is made. Failure to do this may generate a sudden influx of claims in advance of any change in conditions (along the lines of those seen in the last few months of SIF).

6.1.3. Potential impact

Removing from the MTC the requirement that insurers cover all clients is likely to change the market in a number of ways.

Conveyancing

At present given that conveyancing claims represent around 50% of all claims, and that lender claims represent around 50% of conveyancing claims, it seems likely that one of the most significant impacts of this change would be that insurers would seek to remove from their policies cover for financial institutions in respect of undertakings related to conveyancing transactions. This is similar to the actions undertaken in Ireland when cover for commercial undertakings to financial institutions was removed from their minimum terms and conditions.

In this way, individual law firms would be able to make their own commercial decisions to assess whether or not paying for additional cover for undertakings to lenders would be worthwhile. We would expect the impact of this to be:

- Lower premiums for firms that conduct no conveyancing: Law firms who conduct no conveyancing would not take out cover and would be able to clearly signal to their insurance company that they will not be providing conveyancing services.[92] These firms would then be able to gain from lower premiums. Approximately 64% of firms state that they conduct residential conveyancing indicating that around 36% of firms could gain from this.[93] It is likely that this could be of particular benefit to small firms (and therefore BME firms) that do not conduct conveyancing as these firms are currently least able to signal to insurers that they do not conduct conveyancing. This would also be expected to benefit those BME firms that focus on immigration work but are unable to signal to insurers that they do not conduct conveyancing work.[94]

- Greater open market coverage of firms that conduct no conveyancing: The ability to signal that a firm does not undertake conveyancing activities would also be expected to reduce the number of firms falling into the ARP. This is because this reduces the

92 At present lawyers can change their business models while insurers remain on risk. Hence firms that state that they conduct a small proportion of conveyancing business could rapidly increase this and insurers would be obliged to cover this risk. The effect of this uncertainty is that insurers set prices to many firms on the basis that the firms could undertake more conveyancing than they have revealed on their proposal form.

93 Based on data from The Law Society online database, http://www.lawsociety.org.uk/choosingandusing/findasolicitor.law.

94 BME firms within the ARP are more likely than other firms within the ARP to deal with immigration work and interviewees have generally indicated that immigration work tends to be low risk in terms of claims since individuals who receive negligent advice may no longer be in the country to seek recompense.

adverse selection problem set out in section 2.4.4 in which insurers reduce cover from groups of firms because they are unable to identify the risky firm from within this. Since the cost of conveyancing claims is high, providing conveyancing services will be an additional risk factor (although not the only risk factor) that may determine the willingness of some insurers to offer insurance to a particular firm. The expansion of market coverage would therefore reduce the number of firms in the ARP which would bring benefits to small and BME firms.

- Voluntary purchase of lender cover by firms that conduct conveyancing: A significant proportion of firms that conduct conveyancing would seek to obtain additional cover for undertakings to lenders in the course of conveyancing transactions. In Ireland it is estimated that around 30-40% of the profession voluntarily purchased this additional cover. Given the information from Ireland and the proportion of firms that state that they conduct residential conveyancing, this suggests 30-60% of firms may seek to voluntarily purchase this additional lender cover. Since this cover is currently provided in insurance policies to firms we would not expect premiums to increase for the firms that seek this lender cover compared to the premiums they currently pay.[95]

- A reduction in the number of firms that “dabble” in conveyancing: Since the cost of lender cover will become explicit, we would expect firms that only do a small amount of conveyancing would not find it worthwhile to arrange this cover. This would reduce regulatory concerns (also expressed by insurers) that firms conduct work when they are not up to date with the latest requirements. In as far as such dabblers are responsible for a disproportionate value of claims this would reduce the overall value of claims. Insurers have not been able to provide us with data to substantiate this point. (More generally, however, we note that concerns about dabblers may reflect regulatory failure and improving this issue would be the more direct approach to dealing with any concerns about dabblers.)

- Reduction in claims paid through the ARP: As noted in section 5.1.6, around 85% of claims in then ARP are related to conveyancing and of these around 50% are lender claims. We would therefore expect that removing lender claims from the MTC (and therefore from the cover offered through the ARP) would have the effect of reducing the value of claims in the ARP quite considerably. We do note that this depends on whether lenders attempt to pursue claims against ARP insured firms through individual mortgage holders (or whether, as seems likely they change the firms that they are willing to accept undertakings from as explained below).

Discussions with lenders have indicated that lenders will be unwilling to accept undertakings from conveyancers who did not have the additional lender coverage. Hence from the lender perspective there are likely to be additional implications

95 This does not conflict with the preceding bullet point as insurers will have lower uncertainty regarding whether a firm conducts conveyancing i.e. they will face less risk of adverse selection concerns. This should lead to lower prices overall i.e. we would expect firms that conduct no conveyancing to be better off without making firms that conduct a lot of conveyancing to be made worse off.

- Reduction in the number of firms on lender panels: Lenders may seek to reduce their panel of solicitors to firms that they have checked have the additional lender coverage and who will be able to retain insurance coverage over time. One way to limit the cost would be by having a centralised database of the firms that do have lender insurance – it seems likely that would need to be maintained by the SRA. We note that lenders are already seeking to reduce the size of their panels and therefore this accelerates a pre-existing trend.

- Reduction in the number of small firms on lender panels: Given the costs of checking the PII details of different solicitors this could disadvantage small firms who want to conduct conveyancing. Even with a centralised database, the number of small firms that lenders are willing to use is likely to reduce. Depending on the extent to which lender panels were reduced, this could have access to justice issues. However, as noted above, this accelerates what is already an existing trend.

It is also possible that unintended consequences could arise including:

- Causing firms to switch to being regulated by the CLC where the Master Policy would cover undertakings to lenders; and

- Encouraging corporate clients to pursue claims through individual investors. For example, in conveyancing cases, the financial institution might attempt to pursue the claim through the individual clients who would be protected by the PII. We note that this does not appear to have been the approach taken in Ireland and insurers would have the incentive to seek to prevent this from happening.

Other commercial arrangements

Other impacts that might arise include:

- Some corporate clients may choose to use solicitors that do not have PII and self-insure themselves against the risk. They may face detriment, although given the market failures set out in section 2.4, regulatory protection is not required to prevent this.

- Solicitors focusing on working for corporate clients will need to purchase their own insurance and determine terms and conditions that best serve their needs. This should encourage competition and innovation. However, since many solicitors who work for such clients already purchase top-up insurance (as discussed in previous chapters), the impact of this is unlikely to be dramatic.

- Difficulties may arise if firms face uncertainty as to whether they will undertake work for commercial clients from one year to the next. We are not aware of evidence on the extent to which a firms' business mix varies from year to year in a way that would suggest this will be a significant problem.

Some of the issues that would need to be addressed include:

- Difficulties may arise because of a change in the level of protection which may require the SRA to ensure that commercial clients are made aware of the change in regulation. This may be of particular concern for clients that are close to the boundary of the definition of individuals.

- Difficulties may also arise if firms conduct work for commercial clients work but are later unable to obtain PII that retains this cover. We would expect that this would cause commercial clients to take this into consideration when choosing their legal adviser.

6.2. Activities covered

At present the MTC require that PII cover all activities of solicitors.[96] This includes all of the different types of services that they provide (from conveyancing, to wills and probates to complex litigation cases. The arguments in favour of the current rules are as follows:

- It provides flexibility to the solicitor who can change the balance of activities they are doing through the years without constantly changing their insurance cover; and

- The price of insurance adjusts to reflect the business of different types of solicitors so it does not distort the incentive of different solicitors. Solicitors who conduct more conveyancing will pay a higher premium than solicitors who primarily focus on criminal work.

However, there are a range of arguments against the current rule:

- It means that insurers have to take into account the fact that the solicitor may change the business they are doing through the year and hence that the risk they are covering could also change significantly. This will be built into pricing of the insurance and be to the relative disadvantage of firms who have a similar mix of business from year to year; and

- It prevents insurers focusing on particular parts of the markets with respect to the work conducted. We have found insurers that are targeting a particular size of solicitor and some insurers specialised in providing top up cover instead of primary cover. However, we have not found examples where insurers specialise in covering firms specialising in particular types of legal services such as criminal work or personal injury work.

6.2.1. Recommendation

At present, once firms have met regulatory requirements to enter the legal services market, they have the ability to conduct any type of work within the regulatory boundary. For this reason, we would not recommend changing the requirement that PII cover all

96 Cover is for all civil liability arising from Private Legal Practice, with only limited permitted exclusions relating to matters unconnected with the work of private practice such as employment, partnership disputes, or trading debts. The insured includes the firm (and any prior practice) together with any current or former principal, employee or consultant. Cover extends to the practice as a whole including any body corporate. Cover extends to all activities permitted to a solicitor in England and Wales. SRA, The SRA's compulsory professional indemnity insurance scheme, October 2009, p3.

activities for individual clients. One of the main concerns regarding individual clients is their lack of understanding regarding financial protection. It would therefore add to the potential for confusion if individual were covered for some activities but not covered for others if the solicitor remains able to conduct those other activities.

6.2.2. Future developments

It is worth noting that the regulatory approach itself could change over time. For example, the SRA could move towards "activity based" regulation or make increasing use of the ability to place conditions on licensing arrangements. Such an approach could lead firms to be regulated to conduct particular types of legal services (e.g. conveyancing, probate, personal injury etc) or to operate in particular ways (e.g. not being allowed to hold client money).

If regulation does in this direction the MTC could adapt to reflect these developments. We would expect this to lead to additional flexibility in the MTC, enabling more firms to find insurance cover for a more limited range of activities.

Before moving towards an activity based approach and adapting the MTC it is important to recall that there is currently concern regarding regulatory failure in respect of setting the boundary of regulation both in respect of those firms that are allowed into the profession as well as the time taken to force firms out of the profession.

This suggests that it may be appropriate for the SRA to overcome the current regulatory failure regarding setting the boundary *before* introducing flexibility in the MTC. To do otherwise would run the risk of introducing the potential for additional regulatory failure across a multitude of boundaries.

At present the nature of the regulatory failure also suggests that the variation in the activities that firms are permitted to undertake should first be applied in a "constraining", rather than "flexible" way. That is, where firms are identified as potentially of concern, it would be appropriate to rapidly take steps to constrain the activities they can undertake through imposing conditions on their licence. Over the medium term, once regulatory failure has been reduced, such flexibility could be used to adapt entry conditions to different parts of the market.

6.3. Qualifying insurers

Under the current arrangements all insurers authorised to conduct business in the UK (either by the Financial Services Authority or the equivalent regulatory authority in member states) can become a qualifying insurer if they sign a Qualifying Insurer's Agreement (QIA). Under this, insurers agree to:

- Issue policies that comply with the MTC;
- Participate in the ARP in proportion to their share of the market for mandatory insurance by reference to premium income;
- Report suspected dishonesty to the SRA; and

- Agree to arbitration arrangements for disputes between insurers.

Individual qualifying insurers are not required to offer terms to all firms. They must offer cover on the MTC as a stand alone product but are free to provide a single quotation covering both the minimum level of indemnity cover and any top-up insurance that a firm may want. There are two alternative options that could be followed regarding the qualifying insurers.

The first alternative to the current approach would be to remove the need for a qualifying insurers agreement altogether, thereby allowing all authorised insurers to serve the market. This is the approach taken by the FSA and ACCA regulated accountants.

Given the need for a set of MTC (to avoid firms choosing an insurer based on the lowest level of cover offering the cheapest option) as discussed in section 2.6, it may be necessary to monitor the fact that firms have insurance that meets the MTC. The monitoring of this could arise through the SRA checking each set of policy documents when renewing practising certificates, but this would involve checking thousands of documents.[97] However, with a relatively large number of different terms and conditions required to be in place, a process of using a QIA prior to insurers selling cover to the profession involves checking a few dozen insurers. This latter approach therefore represents an efficient monitoring mechanism.

In addition, qualifying insurers agree to participate in the ARP in proportion to their share of the overall market. Given this funding mechanism, it is necessary for there to be an agreement in place to ensure that the insurers will indeed participate in the ARP since they absence of such an agreement would prevent the enforcement of such participation. We therefore do not recommend the removal of the QIA altogether.[98]

The second alternative to the current approach would be to set *additional* threshold requirements on insurers before they could be considered eligible to sign a QIA. For example, RICS requires insurers to have a credit rating of at least B+ from AM Best or BBB from Standard and Poors. The arguments for adding additional threshold requirements include that:

- Insurers entering the solicitors PII market could be unsophisticated or even naïve, and may not have good underwriting processes with this represented through having a poor, or no, credit rating. As a result they may set unrealistically low prices to rapidly expand their market share thereby undercutting those firms that set prices at a level supported by statistical data. Indeed, some interviewees have suggested that this described some of the entry observed over the last three years.

- Insurers with poor underwriting may also end up offering insurance to firms with poor risk management processes resulting in law firms being sustained in the profession

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97 Even checking a sample of these policies would still involve considerable effort.

98 We consider the issue of funding the ARP in Chapter 5, but here we note that if the ARP was not funded through the qualifying insurers this would reduce the necessity of a QIA.

that would otherwise have been forced into the ARP and attract additional regulatory attention. We note that this argument is predicated on insurers setting the boundary of regulation and that this would not apply if regulatory standards were higher such that the regulator sets the boundary in a more restrictive manner than insurers.

- Insurers that do not have sound practices may be forced to exit the market because of losses incurred. This may cause serious disturbances in the market. This has become evident from the experience of Quinn, which did not manage to get a credit rating and against whom an administration order has been made (although we understand this was not caused by losses in the solicitor PII market itself). Quinn has now exited the market resulting in their previous customers (around 3000 mainly small firms) needing to find a new insurer. In addition, if a firm enters insolvency, the remaining insurers would face a sudden increase in the proportion of the ARP costs that they need to face for the remainder of that indemnity year.

- The administrative costs to the SRA of imposing a credit rating requirement would be low.

However, there are also significant arguments against such a change in policy:

- Insurers are only allowed to conduct business if they are approved by the FSA or equivalent regulators in other countries. These are the designated regulators of financial services. It is not clear that the SRA, a regulator of the legal profession, has the capacity to add an extra layer of regulatory requirement and achieve a better result than the approved regulators of financial services. Instead, if the SRA has concerns about a particular insurer it would seem more appropriate to raise these concerns with the FSA.[99] This may be of particular importance for insurers with large market shares by value or by number of firms.

- SRA could simply use credit ratings as a proxy of the soundness of insurers.[100] However, it is debatable that credit ratings serve this test perfectly since insurers with very good ratings such as AIG experienced difficulties in the recent credit crisis, other insurers with good ratings have subsequently gone bankrupt, while many insurers without good ratings have fared well. We also note that there is a potential risk for the SRA in applying credit ratings if insurers which were deemed “safe” subsequently enter into insolvency.

- If unsophisticated new entrants set unrealistically low prices to expand their market share rapidly, the profession would gain in the short run. If the price was not sustainable the insurer would suffer a loss and adjust prices or be forced to exit the market. Entry and exit of this kind often happens in markets, including insurance markets, and is not commonly an argument for intervention.

99 This may include encouraging the FSA to provide feedback via European supervisory arrangements to ensure that firms regulated by other European member states meet necessary standards.

100 Financial regulators already have this information and are therefore able to feed it into their wider regulatory approach with respect to insurers.

- Brokers can help to advise on the financial strength of firms and whether they are suitable insurers for a particular client. Brokers may well be in a better position than the SRA to do this since comparing insurers is one of a broker's core activities. Indeed some brokers would refuse to deal with insurers that they considered low-quality. In the event of insurer exit, brokers can also help to mitigate the extent of the disturbance by finding alternative insurers for their clients.

- Requiring a credit rating above a particular level imposes an extra cost on insurers and acts as an extra entry barrier. This could therefore deter new entrants from entering the market. This would be a particular concern during periods of hard market (which interviewees consider represents the current condition of the market). We also note that a market in which there are many other insurers competing to cover the risks limits the disturbance caused by an insurer that exits.

- It is possible that insurers without good underwriting processes might issue insurance policies to law firms that are not viable or even fraudulent. However, it goes beyond insurers' scope of responsibilities to *require* that they assume the regulatory role of screening out firms that should not be in practice. Furthermore, the vast majority of firms insured *are* viable and these firms might find it more difficult, and more expensive, to get insurance from other insurers should their existing insurer be banned from the market.

- A sudden increase in the cost of the ARP to existing insurers that comes from the insolvency of an insurer could impose an unexpected amount of cost that is not negligible (especially if the firm that enters insolvency has a large market share). The risk of facing this cost could distort competition by discouraging the participation of other insurers. However:

  - The problem is created only if the new entrant sustains in the profession solicitors that would otherwise leave. To some extent this only changes the timing of the exit of these firms (although it could lead to higher overall claims against them). However, this problem is significantly mitigated if the boundary of the profession is set by high quality regulatory supervision rather than by insurers; and

  - This problem could be avoided by changing the way the ARP cost is funded. This was discussed in section 5.

6.3.1. Recommendation

Given the arguments above, we believe it is unnecessary for the SRA to impose an extra layer of regulatory requirement on insurers and it would serve the profession best by maintaining a system that ensures compliance with the MTC but not add an additional barrier to entry related to the qualifying insurers themselves.

Since we do not recommend a change to the MTC there is no impact from this.

6.4. Single renewal date

The current terms and conditions impose a single renewal date for PII which is also linked to the issuance of the practising certificate. In this section we consider the merits of retaining or removing this restriction. (We consider the interaction with the timing of renewal of the practising certificate separately in section 6.4.3 since this relates to a regulatory and process issue rather than the functioning of the insurance market.)

The current position, whereby all solicitor PII is renewed on 1st October each year, has arisen from history. The Master Policy and SIF had a single renewal date and when the model was changed to use the open market, this was maintained.[101] The scheme is also unusual amongst other open market models in having this requirement since a single date is not required for accountants, surveyors, or financial advisers. A single date is in place for the Law Society of Ireland scheme where the change from two dates (1st November and 1st January) to one date (1st December) was done on the grounds of administrative simplicity.

Arguments for a single renewal date

There are some arguments put forward for a single renewal date:

- It is argued that a single renewal date leads insurance firms to compete vigorously for new business at the time of renewal because they face the possibility of very large swings in market share in a very short period of time;
- For the same reason, it is argued that new entry can be facilitated at a single renewal date as entrants can rapidly gain large market shares; and
- During the course of interviews a number of brokers indicated that brokers are able to arrange insurance facilities for their clients on very good terms because of the large volume of business that the broker is able to bring to insurers at a single renewal date.

Most market participants argue that this dynamic of vigorous competition at a particular date is only to the benefit of solicitors during soft insurance markets. Indeed, it is understood that until the last few years, solicitors could often do well through arranging insurance very close to the 1st October renewal date as insurance companies reduced premiums to ensure that they obtained the volume of business that they were seeking. Further, Marsh has noted that,

> *"within any 10 year period soft markets have significantly outweighed hard market cycles and so numerically this suggest that firms will be better served, on balance, by a single renewal date."*[102]

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101 The 2003/04 indemnity year lasted 13 months from 1/9/03 to 30/9/04 with the single renewal date moving from 1st September to 1st October.

102 Marsh, Compulsory insurance – variable renewal dates.

It has also been noted that a single renewal date helps solicitors to remember to renew their PII because there is considerable publicity surrounding the date as well as lots of activity from brokers and insurers seeking to attract clients.

Evidence against restrictions of a single renewal date

The primary argument against a single renewal date is that there is no evidence of a market failure in the solicitors PII market that is solved by a single renewal date. That is, none of the market failures identified in Chapter 2 are solved through the use of a single renewal date. This alone indicates that there is no reason to restrict the market in this way.

Additional arguments against the restriction of a single renewal date include:

- Evidence from other PII markets that a single renewal date is not necessary for the functioning of these markets (including in relation to oversight of the profession). Based on interviews with representatives of other schemes, insurers and with the administrator of the ARP, the administrative issues imposed by different renewal dates is not significant;

- No evidence that new entry of insurers would be prevented from the removal of a single renewal date. While a single renewal date gives the potential for a new entrant to gain substantial market share very rapidly, variable dates could enable new insurers to "test the water" and gradually build up market share over the course of the year adjusting prices as they see fit. No concerns have been expressed about entry in other schemes that do not have a single renewal date;

- Difficulties caused because the volume of business that needs to be renewed at a single point leads to resourcing constraints for insurers and brokers (especially, but not only, smaller insurers and brokers) who are unable to deal with large volumes of business in a very short period of time.[103] While insurers and brokers do find resources from elsewhere in their organisations or seek temporary staff, interviews have suggested that at least some firms face constraints in this way. This often causes insurers to prioritise firms that are existing customers over new customers and to prioritise firms with large value premiums (usually large firms) over those with small value premiums (usually small firms);

- As noted in section 5.3, around 50-100 firms obtain temporary cover from the ARP each year as a direct result of the single renewal date. In 2008/09 this increased sharply to 257 and reached 340 in 2009/10. These firms face considerable business uncertainty because they are unable to obtain cover from the open market during the renewal season. Since they are able to do so shortly afterwards, this indicates that

103 Lane, Clark and Peacock, Professional Indemnity Insurance renewal dates, Letter to The Law Society, July 2009.

this arises primarily as a result of the single renewal date rather than any other factors;[104]

- Evidence highlighted by TLS found that in 2009 some qualifying insurers left proposals unanswered for some time giving firms little time to decide whether to accept the quote which was often associated with substantially increased prices.[105] Around 20% of respondents to their survey stated that they had difficulty in renewing and around 50% of those stated that this was due to having little time to renew their quote.[106] Interviews with small solicitor firms during September 2010 have highlighted some similar concerns this year. Sole practitioners have indicated that they may be given only 10 days to confirm whether they will accept a quote that they are offered. From the insurers' perspective this partly reflects their own uncertainty regarding which quotes will be accepted given insurers may face constraints in the value of business they can write, especially at a time when they may be concerned about the proportion of the ARP for which they will be on risk;

- Interviewees have also suggests that a single renewal date raises difficulties for new law firms who may find it difficult to obtain cover outside the renewal season; and

- Concerns that the single renewal date leads to one-off, sudden, changes in pricing and risk appetite by insurers rather than changes arising gradually over time. The latter would lead solicitors, brokers and insurers to have more information about the development of the market enabling prices to adjust more rapidly (both upward and downward) to changing market conditions.

On the issue of whether a single renewal date works to the benefit of solicitors in more-frequent soft markets than it does in less-frequent hard markets, we are not aware of evidence demonstrating that the good value pricing in soft markets has been due to the single renewal date rather than the softness of the market itself. It is therefore not possible to assess this simply by looking at the number of years where the market is soft or hard.

It is useful also to comment on the argument made by brokers that negotiations with insurers can lead to beneficial terms for solicitors if the broker has a large volume of business to bring to the insurer. Here we note that if such benefits can be achieved, brokers can continue to offer terms to clients at a particular time of year to achieve these benefits. We also note that in other insurance markets the ability to bring a large volume of clients does not typically relate to a single point in time but usually operates across the year suggesting that large brokers would still be able to negotiate on behalf of their clients even if the timing of renewal was spread across the year.

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104 It has also been confirmed from discussions with the ARP that these firms overwhelmingly obtain short term cover after the single renewal date.

105 The Law Society Gazette, 5 November 2009.

106 The Law Society, Professional indemnity insurance survey 2009-10 renewal, April 2010.

In respect of the argument that a single renewal date helps solicitors to remember to renew their insurance, we note that existing insurers would be expected to send out information about renewal terms and brokers would also remind their clients about this timing. Lane, Clark and Peacock also note that a different renewal date could "easily be built into the risk management processes throughout the year".[107] We also note that it is not deemed necessary in other insurance markets to restrict the timing of renewal for the entire market on the grounds of the forgetfulness of some of the insured. For solicitors, failure to remember the timing of PI renewal could be an indication of wider risk management failures within a firm that would necessitate wider regulatory examination.

In summary, there is no market failure which has been identified that leads to a need to restrict the solicitor PII market through a single renewal date. If the single renewal date was not already in place there would be no reason to restrict the market in this way and such a restriction is not deemed necessary in other markets. Added to this, there are also a number of problems that have been identified from the single renewal date such as resourcing constraints and short renewal periods (and the uncertainty of ARP costs). These have been particularly apparent during a hard market but some issues, including the regular requirement of 50-100 firms to obtain temporary cover from the ARP are also apparent in soft markets.

We also note that both lawyers and insurers are in favour of removing the restriction:

- In November 2009, the TLS Council stated that it would be in favour of abolishing the single renewal date. They noted that this was consistent with the position of the majority of members who expressed a review.[108] Indeed, during the course of our interviews no solicitor argued in favour of a single renewal date in preference to having flexibility in the date on which insurance could be renewed (although a small number were indifferent). For some firms this was in order to match the insurance to their financial year, but for others this was simply to avoid what they saw as the "chaos" of the current situation; and

- Similarly, the ABI has stated that the single renewal date should be scrapped.[109] During the course of interviews, only one insurer argued in favour of the single renewal date.

6.4.1. Recommendation

Given the lack of market failure for which a single renewal date is an appropriate solution and since the single renewal date is causing additional problems to arise in the market, we recommend that the restriction of a single renewal date is removed.

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107 Lane, Clark and Peacock, Professional Indemnity Insurance renewal dates, Letter to The Law Society, July 2009.

108 The Law Society, PII single renewal date: Law Society position, 5 November 2009

109 ABI, Protection and Sustainability: ABI proposals on solicitors professional indemnity insurance, May 2010.

6.4.2. Transition

Given that the market currently has a single renewal date, a movement away from firms renewing their policies on 1st October may take some time. This does not mean that it will be necessary to artificially move the market away from this position. It seems likely that after a restriction is lifted, some law firms and some insurers will prefer to seek to agree insurance policies at a different time of year. This could involve insurers offering policies for periods which are for longer than 12 months in order to transition customers away from a 1st October renewal date.[110]

It is likely that it would take a number of years before there is a considerable movement away from the current situation and a peak in renewals may well remain at the 1st October for many years to come. However, removing the restriction leaves the renewal period to be determined by those who demand and supply insurance rather than through a regulatory construct.

The only potential transitional arrangement links to ensuring that the SRA can maintain effective oversight – we consider this below.

6.4.3. Potential impact

PII market impacts

Moving away from a single renewal date would be expected to bring the following benefits specifically related to the PII market:

- Reduction in the number of firms that fall into the ARP for temporary cover: The 340 firms that required temporary cover from the ARP faced considerable business uncertainty from their inability to obtain cover during the single renewal date. Given the way that insurers prioritise which firms to provide quotes to first, this is likely to bring particular benefits to small firms, and in so far as BME firms are disproportionately small firms, would also bring indirect equality benefits;

- Increased availability of cover from the open market:

    - Resource constraints may also lead some firms that fall into the ARP to stay within the ARP beyond 30/60 days because they receive a claim within this 30/60 day period and are then unable to exit the ARP until this is dealt with. Absent the resource constraints these firms could have received cover in the open market with the claim then dealt with by insurers rather than the ARP. This would bring benefits to small firms (and therefore BME firms);

    - Similarly, it may be easier for firms to exit the ARP after less than 12 months because more insurance companies will be used to offering terms throughout the year. We note that fewer than 50% of firms who successfully return to the

110 Insurers have been willing to offer terms and conditions lasting for up to two years in the past and therefore there is no reason to believe that they would not to do this in the future.

open market from the ARP are able to exit the ARP before the end of the indemnity year. Given that the firms in the ARP are small firms, this would bring benefits to small firms (and therefore BME firms); and

  - Increased ability for new firms to obtain insurance throughout the year.

- Reduced cost of insurance: Around 10% of solicitors indicate that they have difficulty in renewing their insurance due to having little time to renew their quote. Interviewees have raised concerns that the single renewal date leads them to receive quotes that they have to accept or reject within 10 days. In a hard market this prevents some solicitors from comparing quotes between insurers because they do not want to risk rejecting the quote that they do have. Variable renewal dates would be expected to reduce the extent to which firms have a short period of time to consider their quotes and therefore may increase price competition.

In addition, because variable renewal dates would enable changing market conditions to be taken into account as they arise rather than through sudden changes at a single date, this may also reduce the concerns that insurers have regarding uncertainty related to their contributions to the ARP (if ARP contributions remain funded via qualifying insurers).

Although the single renewal date is an unnecessary restriction in the PI market, it should be noted that it is not the primary cause of difficulties of the current arrangements highlighted in Chapter 1 and therefore we would not expect a removal of this restriction alone to solve these difficulties. Indeed, the ABI has also noted that this “is certainly not a panacea to the problems that this market is experiencing”.[111]

Changing terms and conditions

Moving away from a single renewal date would mean that future changes to the minimum terms and conditions would no longer apply to all firms from a single date. Instead, changes would need to apply to policies renewed after a particular date with new requirements gradually being met by the whole market over the course of a year. It is likely that this will lead to faster implementation of any necessary changes for at least some of the market since there will be no need to wait until the single renewal period each year.[112]

Interaction with ARP operations

Discussions with the ARP have indicated that the removal of the single renewal date would not cause problems for the organisation of the ARP. Changes would need to be made if the ARP continues to be funded via qualifying insurers but may not be required otherwise. We also note that both ICAEW and RICS operate an ARP without a single renewal date.

111 Protection and Sustainability: ABI proposals on solicitors professional indemnity insurance, May 2010.

112 This point is also noted by Lane, Clark and Peacock, Professional Indemnity Insurance renewal dates, Letter to The Law Society, July 2009.

Interaction with regulatory oversight and practising certificates

At present, when practising certificates are renewed, firms are required to send in details of their insurance policy. One concern therefore is that variable renewal dates could introduce a potential gap as firms that fail to renew their insurance are not identified until the moment of the renewal of practising certificates some months later. We note that although there may be costs associated to altering the method of obtaining practising certificates, other professions maintain regulatory oversight without requiring restrictions related to PII.[113]

It could be possible to alter the timing of the renewal of practising certificates such that these match with variable dates for insurance policies. Despite the temporary resourcing implications from this approach, it appears as though the SRA operations team are not in favour of this because of difficulties arising when individuals change firms and the frequency with which this arises.

The alternative, which appears to be favoured from an operational perspective, would be to maintain the single renewal date for practising certificates but to require greater information flow regarding insurance policies to ensure that there are no gaps.

At present, when solicitors inform the SRA about their insurance policies, a number of firms will provide inaccurate information relating to their policy such as mistakenly giving the name of a broker rather than their insurer, or giving inaccurate policy numbers. Rather than relying on the profession to do this (badly) it would seem more sensible to continue to require information from insurers regarding the firms that they insure as is currently the case.

With a variable renewal date, this could involve insurers sending monthly information to the SRA on the list of firms to whom they have issued new policies. This information could be as simple as the insurer providing a list of the firm's SRA registration number, the roll number of solicitors at that firm and the policy expiry date. The SRA would then be in a position to check on a monthly basis whether there were firms or solicitors who appeared to have failed to renew their insurance with immediate checks being made.

At least in the early years of a new approach, it would also appear important for insurers to inform the SRA as to:

- firms that did not renew their insurance with a particular insurer; and
- firms that had purchased run off cover.

This would provide additional sources of information to prompt a check of different firms and to limit the number of firms that practise without insurance.

The SRA is in the process of altering the process through which practising certificates are renewed with the intention that an online process be available by the 2011 renewal. It will

113 Source: Lane, Clark and Peacock, Professional Indemnity Insurance renewal dates, Letter to The Law Society, July 2009; and interviews held with representatives of other professions.

be important for the SRA to ensure it will have in place a robust monitoring process for checking compliance with insurance requirements before the single renewal date is removed.

6.5. Failure to pay premiums

Under the current PII arrangements, insurers are liable for paying claims for firms they insure even when the insured has not paid the premium for the cover they received. This is because the MTC prohibit insurers from avoiding or repudiating insurance on any grounds including failure to pay premiums. The arguments in favour of this include:

- It ensures that solicitors that obtain insurance at the renewal date are covered for the whole year before the next renewal process. This prevents clients of firms that do not pay for the insurance being exposed to financial risks if insurers were allowed to repudiate the insurance cover when the premiums were not paid; and

- It provides incentives for insurers to only offer cover for solicitors that are solvent and able to pay their premium.

We also note that the problems associated to this with respect to a particular indemnity years may be over-stated. In practice, some insurers require firms to pay premiums in full at the start of the policy in order to avoid offering cover in the absence of payment. Some such payments are provided through premium finance arrangements, under which the insurer would receive full premiums upfront and the finance house facilitates instalment payments with the law firm and assumes the credit risk. Such arrangements could largely mitigate any problems for the insurer.

However, there are also significant arguments against the requirement that insurers cover solicitors who do not pay their premium:

- Just as lawyers would not continue to work for free for clients who do not pay them, it is not normal business practice to require insurers to honour an insurance contract even though they do not receive payment for the cover they provide;

- Whilst innocent clients of firms that fail to pay premiums should be protected rather than suffer a loss from lawyers who lose their insurance cover, client protection can be achieved through other methods. As noted in Chapter 5, the ARP currently covers the risks of firms that have not obtained insurance; and

- The existing arrangement may not encourage risk management of law firms. If lawyers receive cover without paying premiums, the incentive to undertake proper risk management would be distorted as firms can continue in practice.[114]

The issue of failure to pay premiums is entangled with other issues including those related to run-off cover and the ARP. In particular, while insurers can take steps to mitigate the problems of failure to pay premiums for a particular indemnity year through

114 Although we note that insurers can seek recovery from firms in the event of a claim.

requiring upfront payments, they can not do this for run-off cover. Based on (limited) data from insurers, it appears as though around 50% of run-off premiums are not paid.

Current arrangements on run-off cover may incentivise insurers not to report to the SRA those firms that have not paid the premiums. This is because, if the firm is shut down, the insurer would then be on risk for the run-off cover despite no premiums being received for this cover. We discuss the issue of run-off more generally in section 6.10 where we set out ways to address the misalignment of incentives.

Non-payment of premiums is a much more severe problem in the ARP where premiums outstanding are substantial and where this imposes a significant cost to insurers. We have already examined this in Chapter 5.

During the course of interviews, insurers have indicated that they believe providing cover in the absence of the payment of premiums is unreasonable. Discussions with lawyers and their representatives have revealed a similar view. Many lawyers are incredulous that other firms would receive cover despite failing to pay for it. No interviewee supported the retention of the current position.

6.5.1. Recommendation

We recommend a change to the MTC such that insurers would not need to continue providing cover in the absence of payment. This would apply for both particular indemnity years and for run-off. We suggest that insurers would no longer need to be on risk once they have reported failure to pay premiums to the SRA.

6.5.2. Transition

The change to the MTC to allow insurers to deny cover in the event that the firm does not pay its premium does not look to have significant transition issues. We would anticipate that there would need to be notice from insurers to firms of failure to pay before insurers come off risk for the firm.

A reporting process would also need to be established so that insurers inform the SRA of non-paying firms as soon as they are identified. We have already noted in section 4.6.2 that the SRA has been working with insurers to develop a better approach to reporting more generally.

Since insurers would no longer be on risk once they have informed the regulator about this, they would have the incentive to do report quickly. This would identify non-viable firms more quickly which would be beneficial to clients, the profession and insurers.

6.5.3. Potential impacts

Since clients of non-paying firms would still receive financial protection, we do not anticipate substantial impacts for them. However, the proposed changes may affect the profession, insurers and finance houses:

- Improved incentives: the distortion of incentives for insurers to report defaulting firms to the SRA would be reduced since insurer would no longer be on risk once they report the firm to the SRA. This is in contrast to the current situation that insurers would receive no payment but the burden of run-off cover if firms are subsequently shut down. The distortion of incentives resulting from run-off cover is discussed in section 6.10. We also note that this interacts with the ARP as discussed in section 5.12

- Reduction of non-compliant law firms: As defaulting firms would be more likely to be identified and reported to the SRA by insurers, they face greater probability of SRA intervention. This would result in firms exiting more quickly and lower claims arising overall.

- Increased level of risk management: law firms would have greater incentive to manage risks and ensure the business is sound so as not fall into financial difficulty. This brings benefits to clients generally and benefits the reputation of the industry.

- Potential new entry by insurers: One insurer has publicly stated that the non-payment of premiums is one of the two reasons that they exited the solicitors PII market (the other linked to cover in the event of mis-representation). It is reasonable to conclude that insurers may re-consider their participation in the market in the light of this change;[115]

- Cost of defaulting firms shifted from insurers or finance houses to the ARP or Compensation Fund: If firms do not pay premiums and insurers report the firm to the SRA this firm would fall into being the ARP, presumably as a “non-applied” firm (and we assume it would be closed). This could shift some costs from the insurance sector to the ARP or Compensation Fund. Given that the value of bad debt in relation to run-off cover in the open market may be around 50% of run-off premiums at present, this issue is unlikely to be trivial. This also interacts with issues regarding the ARP as discussed in section 5.12.

6.6. Level of cover

Currently, the MTC require that the minimum sum insured for any one claim must be:

- £2 million for sole practitioners and partnerships; and

- £3 million for limited companies and limited liability partnerships.[116]

115 Post online, Hiscox withdraws from “flawed” solicitors’ indemnity market, 23 June 2010.

116 These figures are exclusive of defence costs which are covered in addition without financial limit. The insurance must not limit liability to any monetary amount whether by way of an aggregate limit or otherwise except as contemplated by clauses on minimum level of cover and proportionate limit on defence costs. Source: SRA, “Review of the Compensation Fund – Report of the Financial Protection Committee’s Compensation Fund Review Working Party, Annex B: Minimum Terms and Conditions of Professional Indemnity Insurance for Solicitors Registered in England and Wales 2008”, April 2009, p70.

The requirement for a minimum level of cover is aimed at ensuring that that law firms have adequate insurance cover for their client. Interviews with stakeholders in the market have acknowledged that it is such a requirement is necessary for client protection.

However, although not widespread, a small number of interviewees have raised issues regarding the current approach to the level of cover. There are two issues to consider:

- Whether the level of cover should be the same irrespective of business activities – some interviewees object that the level of cover is the same across all firms despite the fact that different firms will undertake different activities which may pose different risks; and
- Whether the level is set at an appropriate level – some interviewees have indicated that this may be set at a level that is higher than necessary (although it is also possible that it is not set at a sufficiently high level).

Business activities

In general we would expect that the appropriate minimum level of cover would vary according to different types of business which pose different risks. However, as noted in section 6.2, the SRA currently regulates entry into the whole of the legal profession and not to specific activities within the legal profession. As set out in section 6.2, differentiation in the level of cover for different activities would add to the potential for confusion for individual clients. We therefore do not recommend that the level of cover varies according to different activities undertaken.

However, it is worth noting that if, over time, the method of regulation changes towards activity based regulation, such that firms are regulated to conduct particular types of legal services (e.g. conveyancing) we would expect the MTC to adapt to reflect this.

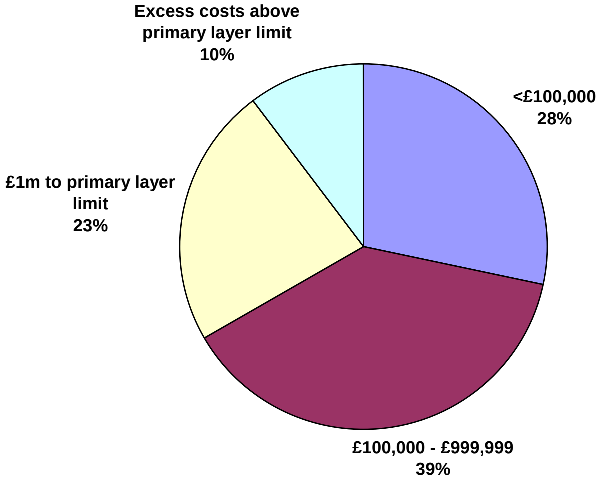
There is likely to be a relatively modest impact from the requirement that the level of cover is the same across all firms because the different activities undertaken by individual firms are already factored into the underwriting process by insurers. For the same minimum level of cover, law firms conducting high-risk business such as conveyancing have to pay far more than firms conducting low-risk business such as criminal work. We would also expect that firms conducting high-risk business would be more likely to purchase top-up cover while the minimum level of cover ensures that individuals are protected.

Overall level of cover

It is legitimate to question whether the minimum level of cover is set at an appropriate level. As indicated above, premiums will already take into account the necessity of the overall level of cover for different firms conducting different business indicating that if the level is high relative to the risks of certain businesses the additional costs that they are likely to pay for this would be expected to be modest.

Based on evidence from interviews the great majority of claims that occur are for relatively modest values. However, it is also important to assess the breakdown on the basis of the overall value of claims. This is set out in Figure 30 below.

Figure 30: Proportion of total claims incurred by claims value in 2005/06 – 2007/08



Source: ABI data and CRA calculation. Note: Total claims incurred is measured as value of claims paid and reserved as at 30 September 2009

Figure 30 above shows that, on average for 2005/06-2007/08, the value of claims where the individual claim value between £1 million and the level required through the MTC accounted for 23% of total claims incurred. This indicates that reducing the minimum level of cover to £1 million would result in 23% of the value of claims being at risk of not being paid to clients. Whether or not clients were compensated would depend on the commercial decisions by law firms which may, or may not, choose to top up their insurance cover. If the firm did not choose to top up the insurance cover, the financial protection of its clients would be adversely affected compared with the status quo.

Given the significant proportion of claims affected, this does not provide evidence that the minimum level of cover should be reduced to £1 million.

There is some indication from Figure 30 that up to 10% of the value of claims may be at risk of not being paid because the values of the individual claims currently sit above the minimum level of cover required through the MTC. In order to assess whether this is a concern we have sought information from the Legal Complaints Service (LCS) regarding whether or not individual consumers have complained about a lack of compensation from lawyers because the compensation due was above the level of PII cover held. The LCS was not aware of any case in which this had occurred. Currently this therefore does not provide compelling evidence that the minimum level of cover should be increased.

However, we do note that there appears to be no formalised approach to increasing the level of cover to take account of inflation and changes to the value of typical claims. This is also the case with other comparative schemes in other countries and other professions. The exception to this is the FSA where an increase in the level of cover has a prescribed increase through a European Directive which applies the impact of inflation every 5 years.

We understand that historically the level of cover was set to reflect the compensation that might be due in a complex personal injury case. It does seem appropriate to link the minimum level of cover to “typical high value” cases of claims that would be typical for individuals – this could include cases of conveyancing, probate and personal injury.

6.6.1. Recommendation

Since regulation does not apply on an activity basis, it would be inappropriate to vary the minimum level of cover according to business activity (although we would expect this to be considered should activity based regulation occur in the future).

There is no evidence that the current level of cover is unreasonable – either that it is too high, or that it is too low. However, we do recommend that the SRA set out the basis for determining the level of cover required in order that future changes can be taken in a transparent way linked to typical high value claims.

Since we do not recommend any changes to the current MTC, there is no impact from the recommendation.

6.7. Mis-representation

Under the current MTC, insurers are prohibited from avoiding or repudiating the insurance on any grounds whatsoever including, without limitation, non-disclosure or misrepresentation, whether fraudulent or not.[117] Insurers do have recourse to the firm in these circumstances.

This provision, which is unusual in insurance markets, was included in the MTC following historical arrangements from the Master Policy and SIF. The arguments in favour of this provision include that:

- This ensures clients are protected properly. If insurers are permitted to avoid or repudiate the insurance for non-disclosure or misrepresentation, firms may suddenly lose the cover, which they believed they had in place. While this may be seen as acceptable in respect of the lawyer (who has misrepresented information), this would leave the client lacking in protection (unless the ARP or Compensation Fund took over the liability).
- The provision also protects lawyers from being treated unfairly by insurers. Individual law firms, especially those at the smaller end of the profession, are in a weak position when negotiating with insurers – both in terms of the design of cover in advance oft being taken up, but also in reference to any disagreements regarding whether there has, or has not, been misrepresentation.

117 SRA, “Review of the Compensation Fund – Report of the Financial Protection Committee’s Compensation Fund Review Working Party, Annex B: Minimum Terms and Conditions of Professional Indemnity Insurance for Solicitors Registered in England and Wales 2008”, April 2009, p71.

However, there are concerns about the provision from insurers. The main arguments put forward are

- Forcing insurance to cover non-disclosure and misrepresentation of information even when it is fraudulent distorts the normal underwriting process. This is because insurers can not assume that information they rely on is correct. As a result, insurers are less able to distinguish between good and bad firms and suffer from concerns about adverse selection (as set out in section 2.4.4). They therefore have to price this risk in to premiums, although it is very difficult to evaluate the risk precisely. The price is then distorted compared to the price that lawyers would otherwise pay. At the extreme, insurers may simply reject applications in order to avoid the problem.

- The provision does not encourage good risk management of law firms since they continue to be insured even when they did not disclose information or misrepresented information on proposal form. For example, firms can hide the fact that they conduct certain high-risk activities and pay lower premiums than they should. In addition they may not pay sufficient attention to risk management generally as the claims arising from the work would be covered by the insurance anyway. Further, risk management incentives are also weakened because the role of the price mechanism in incentivising this is also distorted.

In most insurance markets, insurers can avoid cover for misrepresentation and it is clear that the incentives for lawyers are wrong if they receive cover despite misrepresenting information. Usually, the ability of insurers to avoid cover sets the appropriate incentive for the insured to reveal information truthfully since the insured would suffer the loss from misrepresentation. However, in this case, there is a high likelihood that the individual client would suffer a loss and the client is not in a position to assess the protection. Hence it is clear that the client requires protection and therefore relevant to consider how this can best be provided.

Here we note that if protection is provided via the Compensation Fund (or ARP if the firm is treated as a non-applied firm), then the information is provided to the Compensation Fund after the event, at a time when the Compensation Fund can not influence behaviour. By contrast, if protection is provided by insurers, then they have an opportunity to assess information ex ante and to challenge the lawyer for more information. This can lead insurers to decline cover where they are suspicious of misrepresentation which itself provides an incentive to not misrepresent information. In addition, the fact that insurers can seek redress from a firm that misrepresents information also provides an incentive to provide accurate information. We also note that insurers can report such cases to the regulatory and would recommend that they do so such that the SRA can investigate the firm further.

During the course of our research we have not been able to identify evidence on the magnitude of the problem. We note that insurers are the group arguing against the provision and are also the group in a position to provide evidence on it. Providing this evidence to the SRA would assist with their ongoing consideration of this issue.

6.7.1. Recommendation

In the absence of evidence on the magnitude of this problem, we recommend that no change is made.

Since we do not recommend change no issues regarding transition or impact assessment are relevant.

6.8. Fraud

The MTC requires that, other than for an individual's own fraud, the insurance must cover fraud for other principals in the firm. That is, the exclusion of fraud or dishonesty only refers to the acts of a sole principal or *all* the principals in a firm since cover must extend to any innocent principal.

The rationale for the provision is that insurance can not by its nature cover the applicant's own fraud since to do so would be to insurer an individual against their own dishonesty giving rise to highly distorted incentives and the most extreme form of adverse selection problems. Indeed, this is they key justification for the presence of the Compensation Fund as set out in section 2.6.

In respect of the MTC covering innocent partners, the arguments put forward against this provision are:

- Insurers argue that it is not possible to insurer against fraud generally and that this is an unusual provision in insurance markets;
- The provision does not encourage lawyers to be vigilant in preventing frauds. Since innocent partners are covered by the insurance even when their colleague or colleagues commit fraud, they are not incentivised to pay proper attention on the risk management of the firm. If they were incentivised this would help with early detection of fraud to the benefits of insurers, the profession and clients.
- There may be no clear distinction between partners who are innocent and those who know the fraud was committed but simply turned a blind eye. In practice this may give rise to disputes between whether the claim is related to fraud, which would be dealt with by the Compensation Fund, or negligence, which would be covered by the insurance.

In respect of it being unusual to insure fraud we note that many of the alternative schemes considered include cover against fraud for innocent partners, including, Scotland, CLC, RICS, ICAEW.

In addition, if covering fraud caused serious concerns for insurers, we would expect that top-up cover would exclude fraud. In practice, top up cover up to £10 million is usually written on identical terms to the MTC. Insurers argue that firms that take out top up cover are different to those where they are most concerned about fraud. However, as noted in section 2.6.1, as much as 40% of 2-partner firms may take out top up cover. This is particularly notable since these are the firms that insurers have stated are most at risk of imposing costs associated to fraud (since sole practitioner fraud would be covered through the Compensation Fund). The fact that fraud is included in the top-up cover indicates that the magnitude of distortion on incentives of proper risk management can not be causing serious concerns for insurers.

In respect of disputes between fraud and negligence, interviews have indicate that under the SIF regime there were only a handful of such cases under the regime of SIF (although we recognise that since the profession faces the risk under both SIF and the Compensation Fund, we may have expected a relatively modest amount here.

Evidence from the SRA regarding the Compensation Fund has highlighted only 2 cases in which there have been disputes with insurers. It should be noted that one of these cases had 641 applications with payments of £0.5 million and the other had 1,046 applications with payments of £12.6 million indicating that the value of money involved is not trivial.

Some insurers have also indicated that fraud, because it is "lumpy", can increase the minimum scale of firms that enter the market. This is because this reduces the likelihood that one bad fraud case knocks out all of the insurer's profits. We note that the cover for fraud is in place at present and the evidence provided in section 1.3.3 does not support concern about the number of players in the market or the level of entry that occurs being damaged because of concerns about fraud.

We also note that, as with misrepresentation, insurers are in a better position to assess fraud ex ante since they have statistical information as to its frequency and effect. Insurers are able to set prices to reflect this information and may be able to screen out some applicants whose proposal forms are suggestive of fraud. However, this does retain the risk that insurers face adverse selection problems and withdraw cover from a group of (probably small) firms.

Finally, we note that concerns with respect to fraud that have been expressed in interviews have focused on the conveyancing process. As noted in section 2.4.5, there is evidence of market and regulatory failures in respect of the conveyancing process and in respect of setting the boundary of the profession. In as far as the regulator tightens regulation in both areas we would expect fraud to fall and the adverse selection problem to reduce.

6.8.1. Recommendation

On the basis of the current evidence we recommend that no change is made to the current provisions.

Since we do not recommend any change are made, there is no impact from this recommendation.

6.9. Payment of excess

Under the MTC, there is no fixed level of self insured retention or excess. However, if the firm is not able to pay the excess, the insurer will have to pay this although the insurer can then seek to recoup the payment from the firm. The arguments that are put forward against the current rules are that:

- The rules distort the function of the excess. In particular, the excess plays an important role in correcting the problem of moral hazard. If firms themselves face costs when a claim is made they are more likely to take action to reduce the number of claims, whereas if they do not have to pay the excess they have reduced incentives for risk management.

- Insurers may have to pay excess even when the law firm is able to afford it. They could seek to recoup the payment from the firm but the cost of doing so could be even more than the money that could be recouped.

There are two components to the consideration of the excess provision – whether to have any regulation on the excess, and if so, how this should be regulated. We note that with the exception of Ireland, all of the other comparative schemes have some form of regulation of the excess although there is considerable variety in how this is implemented as set out in section 3.3.2. The arguments are as follows:

- In the absence of any regulation of the excess, the client may go unprotected. This is because without intervention, firms could choose a very high level of excess when they have neither the intention nor the means to pay this, but so that they are able to receive a low premium. If the insurer faces no consequence from this, the insurer has no incentive to make sure that the excess is appropriate. Furthermore, if the claim was subsequently to be paid from the Compensation Fund or ARP, these entities have no ability to influence the excess in the first place which does not improve incentives. Hence it is clear that some form of intervention is required in order to overcome this problem

- As noted in section 3.3.2, other scheme have a variety of different approaches to this – in itself this may indicate that there are a range of valid alternatives that can meet the same need. In fact, the approach taken by the SRA is the most flexible of these options since the SRA leaves the choice of the level of excess to a commercial decision between insurers and lawyers. Insurers are in the best position to assess the risk of each individual firm as they collect information and evaluate the risk in the underwriting process. Leaving excess level to market forces instead of regulation enables the market to factor in the appropriate level of risk for individual firms in the level of excess.

It is common for small firms to have no excess because insurers are unwilling to face the cost of paying the excess. However, this does not mean that law firms face no consequence of this since firms with no excess would pay higher premiums. In addition, firms retain an incentive to conduct risk management in order to avoid high premiums resulting from claims.

We note that some concerns have been raised regarding the general level of financial viability of some firms which may be a further consideration in insurers setting the excess at zero since the insurer does not believe that they will be able to recoup the payments.

It is clearly appropriate for insurers to have the ability to seek redress from firms that do not pay the excess. We also anticipate that insurers would inform the SRA if firms had failed to pay this in order that the SRA can take regulatory action which may include intervention. (This is more likely to happen if incentives are improved in relation to run-off as discussed in section 6.10)

Finally, we note that insurers, who are most concerned about the provision, have not provided evidence of the magnitude of problems regarding the non-payment of excess. Providing this evidence to the SRA would assist with their ongoing consideration of this issue.

6.9.1. Recommendation

We recommend that no change is made to the current provisions.

As such, there is no impact from this recommendation.

6.10. Run-off cover

The current MTC require that firms that close without a successor practice must take out run-off cover lasting for 6 years. As indicated in section 2.4.1, individual clients suffer from asymmetric information in respect of their choice of lawyer and are unable to judge the quality of their lawyer in advance. In addition, individual clients are likely to be unable to judge the quality of the advice after it has been given and therefore some claims will only come to light some considerable time after the advice has been given. For example, in the case of conveyancing, this is often at the point at which the house is sold, or the owner faces financial difficulties prompting the lender to investigate the conveyancing process.

Length of run-off

The fact that quality is only observed over a period of time, and given that PII is on a claims made basis, it is important that insurance be in place even after a firm has closed. The evidence in 2.4.1 indicated that around 40% of claims relate to work that was done more than 3 years before the indemnity year in which the claim was made. This supports the provision of run-off of at least 3 years.

Information from comparative schemes have indicated that 6 year run-off is common although Ireland only requires this for 2 years. RICS requires that firms have it for 2 years but make best endeavours to seek run-off for 6 years.

Interviews have indicated that all stakeholders including lawyers, insurers and regulators believe that run-off cover is necessary to provide adequate financial protection to clients. No interviewee raised concerns regarding the 6 year period.

In addition, as explained in section 3.1.2, SIF is being used as the vehicle for providing “post six year run off” (i.e. claims which arise more than six years after a firm has entered run-off) with arrangements in place until the end of September 2017. We understand that the cost of arranging this cover was minimal and, since it protects the profession as well as clients, the profession may wish to give consideration to renewing the cover in due course.

Payment for run-off

The main area of contention in respect of run-off that has been highlighted in interviews is in respect of firms that fail to pay for run-off but where the insurer is still on risk for this. As noted in section 6.5 we recommend that insurers should not be on risk, including for run-off risk, where firms have not paid their premiums.

We note that the premium for run-off cover is typically set at around 2.5-3 times the annual premium that the firm pays and this is specified in the policy conditions related to the particular indemnity year. Insurers are free to set the level of premiums for run-off as they desire and there is no regulatory restriction in respect of this. This is appropriate since it allows insurers to set prices that they believe are risk reflective and there is no evidence to suggest that intervention is needed in this regard.

Misaligned incentives for run-off

However, even in a situation where run-off cover is provided only where premiums are paid, insurers may still face misaligned incentives regarding providing this cover to individual firms. The MTC require that insurers must provide run-off cover at pre-specified terms when a firm goes into run-off during the course of an indemnity year. The implication of this is that where claims from a firm are high, insurers have the incentive to not report this to the regulator, wait until the end of the indemnity year and refuse to renew cover. The firm would then end up being in the ARP with claims higher than they could have been because of failure to report the firm to the SRA. As noted in section 5.5, the cost of this could be around £3.7 million.

The issues here clearly interact with those discussed in section 5.12 regarding the role of the ARP more generally. However, even if the ARP retains all of its existing functions (or stops providing the rehabilitation role), it is appropriate to seek to improve the current misalignment of incentives.

Under the QIA, insurers agree to report dishonest firms to the SRA. As noted in section 4.6.2, the gateways through which this information is reported may not have been sufficiently clear in the past, but the SRA has taken steps to improve this.

In order to address the issue of the misalignment of incentives, it would seem appropriate for the SRA to seek to identify whether there are firms in the ARP that should have been reported to the SRA before the firm entered the ARP.

6.10.1. Recommendation

We recommend that no changes are made to the length of run-off. There are no impacts from this recommendation.

We recommend that insurers should only be on risk for run-off cover where they are paid for this. This has already been taken into account in section 6.5 so we do not repeat the impacts here.

6.10.2. Options

We recommend that the SRA give consideration to a process in which they scrutinise each firms that enters the ARP and require information from the insurer that previously insured the firm. If there is evidence that the insurer should have known that the firm was problematic and hence should have reported the firm to the SRA but failed to do so, then there are a variety of possible options:

- the insurer could be fined for failure to comply with the requirements in the QIA;
- the insurer could be liable for the claims that arose between the time at which the insurer could reasonably have been expected to report the firm to the SRA and when the firm entered the ARP; or
- the insurer could be liable for the whole run-off cover for that firm (with or without the specified premium being paid to them – presumably from the ARP or Compensation Fund).

We note that, of these, the second option appears the most closely aligned to the intention of seeking to reduce claims arising because of a failure to report firms to the SRA. This would still leave the insurer in the position of avoiding cover for work that was done in the past which would end up being covered through the ARP, but we note that once the work has been done, the claims will arise somewhere and changing incentives to report firms does not alter this particular issue.

It is important to note that if the insurer did report the firm to the SRA and it then either the SRA did not believe regulatory changes were required or took some considerable length of time for the firm to be shut down, then we would not expect the insurer to be on risk for work conducted after the firm was reported. Instead this would need to be covered through the ARP (as implicitly it is now).

6.10.3. Impact

If it is the case, as insurers maintain, that they already report dishonest firms to the SRA, then we would expect there to be no impact from any of these options.

However, given the evidence on the limited number of firms that are reported to the SRA, we would in fact expect an impact to arise. In particular we would expect to observe:

- An increase in the number of firms that are reported to the SRA. In general this would be a very positive development since it would provide the SRA with additional information regarding firms that may need to be shut down. As such we would also expect high risk firms to be shut down more quickly bringing benefits to the whole profession.
- An over-reporting of potentially dishonest firms. The more stringent the financial implications for insurers, the more likely they are to over-report firms to the SRA where there is any concern at all regarding the firm. For example, this could lead to every claim being reported to the SRA. In order to avoid this it would seem

appropriate for the ABI, TLS and SRA to set out clear criteria for which reporting of firms would be appropriate.

- Depending on which of the options is taken forward, insurers may react by seeking to withdraw from those sectors of the profession where firms are most at risk of regulatory intervention and where run-off cover is most commonly required. It is expected that these firms would be similar to those that currently enter the ARP but with a greater number of firms likely to be affected. We would expect this to have detrimental effects for small firms (and therefore BME firms).

The latter point indicates the importance of ensuring that the method chosen to realign incentives between insurers and the SRA should not be "over-zealous" since this could lead to unintended consequences of insurers withdrawing from particular sectors.

We note that the anticipated impact of these options needs to be considered in connection with the suggestions made in section 5.12 regarding the funding of the ARP more generally.

7. COMPENSATION FUND

The Compensation Fund is a discretionary scheme established under the Solicitors Act 1974, from which a grant may be made to an applicant who has suffered a loss due to a solicitor's dishonesty or to an applicant who has suffered hardship due to a solicitor's failure to account for monies held.

In this chapter, we consider the role of the Compensation Fund (the Fund), issues regarding Alternative Business Structure (ABS), and how contributions to the Fund should be made. We also consider the possibility of combining the functions of the ARP with those of the Fund.

It should be noted that during the course of discussions for the purpose of the project, very few stakeholders raised any issues regarding the Fund. The exception to this were a small number of concerns highlighted by lenders. It is therefore important to note that any suggestions made in this chapter would therefore need to be subject to further consideration by the SRA in due course.

7.1. Requirement for a Compensation Fund

As noted in section 2.6 a safety net is needed for risks that the insurance market is unable to cover. As noted in section 6.8, insurance policies never provide cover in the context of an individual's own fraud. Since this risk can not be covered by the insurance market (however that insurance is delivered), clients would be at risk of not being protected.

This is the key justification for the Fund since the Fund covers this gap by providing cover in the event of an individual solicitor's dishonesty. By doing so, the Fund protects the reputation of the whole industry from the damage imposed by unscrupulous firms.

7.2. Scope of the Compensation Fund

At present the Fund may provide grants of up to £2 million to replace money which has either been stolen by a solicitor, or to alleviate hardship or loss suffered by applicants where the solicitor has failed to account for client money in their possession.[118]

An applicant needs to pass a hardship test in which he needs to satisfy the SRA that,

> *"he has suffered or is likely to suffer loss and hardship in consequence of a failure to account for money which has come into the hands of a defaulting practitioner or the employee or manager of a defaulting practitioner, which may include the failure by a defaulting practitioner to complete work for which he was paid."*[119]

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118 Grants can include an applicant's new solicitor's costs of carrying out work which the original solicitor failed to do, and the legal costs of making the application to the Compensation Fund.

119 Compensation Fund Rules 2009, article 3.2.b.

Individuals dealing with solicitors in a personal capacity are assumed to pass the hardship test while institutional applicants in a business capacity must provide evidence to satisfy the SRA on hardship test.

Application has to be made to the SRA within 12 months after the loss or likelihood of loss, or failure to account, as the case may be, first came or reasonably should have com, to the knowledge of the applicant. The time limit can be extended subject to the SRA decision. We are not aware of any concerns related to the time limit being insufficient.

In line with the information set out in section 2.4, individual clients are most in need of protection while institutional clients are better able to assess the quality of their lawyer. It is therefore unclear whether the current scope of the Fund, which allows some institutional clients to seek redress is appropriate. Instead it would seem appropriate to limit the scope of the Fund to the same individuals that need to be protected through PII and as such as we would suggest that a similar approach is taken to that related to the definition of individuals as set out in section 6.1.

Grants may also be made to a solicitor who has suffered loss because of liability to clients as a result of default of his partner or employee.

The position of other solicitors is complex since the fact that they can obtain compensation may encourage individual solicitors to inform the SRA regarding the dishonesty of fellow principals. Indeed, this is one of the reasons put forward in Ireland of why their compensation fund should cover other solicitors. Since the Fund is paid directly from the profession it seems reasonable for the profession to decide whether or not this cover is retained within the Fund.

7.2.1. Option

We suggest that further consideration is given to whether corporations should be excluded from the scope of the Compensation Fund. The market failure analysis in section 2.4 is clear that individual clients are most in need of regulatory protection institutional clients do not need this protection. We would therefore expect to start from the position that institutional clients should not be covered within the scope of the Compensation Fund.

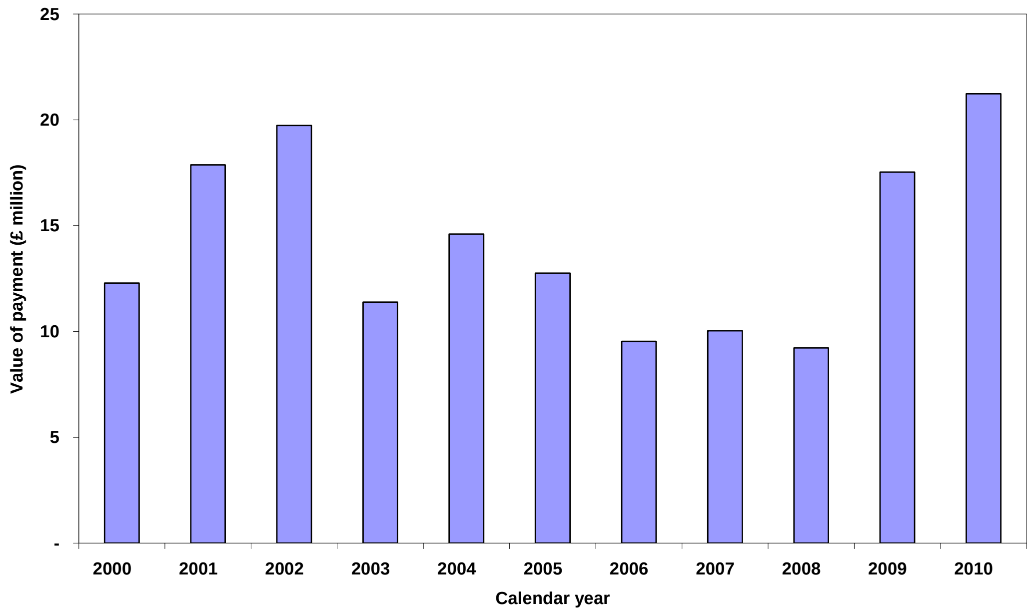
However, insufficient evidence has been available to be able to assess whether additional implications that are specific to fraud would cause problems and it has therefore not been possible to understand the detailed impact of a potential change in this regard. In particular it has not been possible to assess whether unintended consequences or distortions as a result of changes might arise such as through institutions (particularly lenders) making claims via individual clients.

It seems likely that firms that give rise to claims will be small firms and those conducting conveyancing and probate work (since these are the areas of business where large sums of money may be involved). However, data has also not been available to assess the firms that give rise to claims on the Compensation Fund and the impacts that such changes would have on them

7.3. Payments made by the Compensation Fund

The majority of claims on the Compensation Fund are related to circumstances where the SRA had intervened into a firm. The value of payments has fluctuated between around £10-20 million each year. There is some indication that the value of payments may be linked to the economic cycle (and/or property cycle). There has been a substantial increase in the payments made in the last few years as this increased from £9.23 million in 2008 to £21.2 million for 2010 to date.[120]

Figure 31: Value of payments by the Compensation Fund over time



Source: Data provided by the SRA.

Again it is worth noting that in as far as the value of payments from the Fund represent payments related to fraud in connection with conveyancing activities, this gives further support for the need to investigate the conveyancing process.

7.4. Compensation Fund and ABS

The SRA has requested that we specifically consider the impact of ABSs on the Fund. In particular, we understand from the SRA that there are two potential options regarding the interaction of ABSs and the Fund namely that there could be:

- A single compensation fund which includes all firms regulated by the SRA; or
- A separate (or possibly multiple) compensation funds for different types of ABSs.

120 As of 4th October 2010.

The argument put forward for having a separate fund for ABSs compared to other firms regulated by the SRA is based on the argument that ABSs will conduct different activities compared to other law firms and will impose different levels of risk. It is therefore argued that a single fund would lead to cross-subsidise arising. This would imply that low-risk firms (assumed to be traditional law firms) would subsidise high-risk firms (assumed to be ABSs). A scheme with separate compensation funds would separate firms into different groups and remove cross-subsidisation between groups.

We disagree that separate compensation funds should be applied for (different types of) ABSs. This is for the following reasons:

- Differentiation on the basis of legal structure is not an appropriate basis on which to have separate Funds since there is no reason to suppose that firms undertaking the same work but with different legal structures would impose different risks;

- The separation of groups on this basis may discriminate against ABSs and in particular could cause problems for those ABSs that are first movers because a new compensation fund would need to be built up from scratch. Seeking funding from new entrants alone would be likely to significantly inhibit the amount of entry and to distort competition between ABSs and other firms in the legal services market;

However, this is not to suggest that the underlying concern regarding cross-subsidies is without merit. On the contrary, it seems entirely appropriate to seek to limit the extent to which cross-subsidies arise through the Fund. We consider this further in section 7.5 below where we examine the basis of contributions to the Fund.

7.5. Contributions to the Compensation Fund

The basis of contributions to the Compensation Fund have varied over time and the current level of contribution is set as £10 per solicitor and a fixed contribution from firms that hold client money of £120.[121]

It is useful to set out the principles that help to determine the appropriate basis of making contributions to the Fund. In the light of the principles set out in section 2.5 this indicates that contributions that reflect risk and reflect the objectives of the Fund:

- The Fund protects the reputation of the whole profession and therefore we would expect all members of the profession to contribute towards this;

- Grants that are made relate to money that has been stolen or due to failure to account for such money – we would therefore expect contributions to differ according to whether firms hold client money;

121 SRA website, http://www.sra.org.uk/fees-2010-faqs.page

- Different activities may give rise to different levels of dishonesty – we would therefore expect contributions to differ according to the activities undertaken by firms. We note that at present the SRA does not regulate on the basis of activities and therefore it does not seem as though this element could be used at present; and

- Different types of firms (in particular by size of firm) may give rise to different levels of dishonesty – we would therefore expect contributions to differ according to different types of firm.

There are a number of options that could be considered in respect of the method of contributions:

- Individuals and firms each make a flat contribution (which we assume to be linked to whether or not firms hold client money) – This is the approach taken today. This meets that requirement that all members contribute in reflection of the protection of the reputation of the profession. It also targets the contribution on firms that hold client money which is also risk reflective. This approach also has the merit of being straightforward and therefore the burden of calculating the contributions is modest. However, it is not risk reflective in terms of the types of activities or types of firms and therefore involves cross-subsidies arising from those firms that undertake low risk activities to those firms that undertake high risk activities.

- Addition of a small number of rating factors – This option would add a small number of additional factors to the contributions used to day. For example, this could include consideration of including factors that weights the contribution towards firms operating in such a way that reflects where claims arise.[122] Compared to the first option this has the merit of being more risk reflective. With a small number of additional weighting factors it would not add too much additional complexity. We note that the merit of this would depend on what the additional weighting factors were. At present it appears as though SRA regulation does not lend itself to including activities but information on firm size (which links to risk) could easily be included.

- Risk rating applied to all firms on an individual basis - This option suggests that the levy would be based on the risk ratings of firms, which, for example, could be linked to their claims records over the preceding years. The major advantage of this option is that it would be highly risk reflective with firms that impose the greatest risks on then Fund paying more than firms that are low risk. However, the major shortcoming of this option is that the administration of it would be much more burdensome. Indeed, at the extreme this could be seen as replicating the entire insurance industry.

122 Some care would need to be applied in this regard since levies on the basis of last year's claims end up being paid by firms that survive rather than firms that are closed down. Instead, it may be appropriate to apply levies over the cycle on the basis of risk over the cycle so as to ensure a greater level of "polluter pays".

- Levies on insurance premiums - A variation on the risk rating approach which would reduce the administrative burden on the SRA would be to impose a levy on the insurance premium charged to firms – this would be similar to suggestions made in section 5.11 regarding the funding of the ARP. This would retain much of the risk reflection although it is unclear whether the risk to PII policies is exactly correlated to the risk to the Fund. In particular, this is likely to lead to sole practitioners paying an insufficient amount of contributions to the Fund (since their fraud risk is excluded from PII and therefore not taken into account in the PII premium).

As is clear from the discussion above, there are advantages and disadvantages of each approach.

We also note that some of the approaches may be more feasible depending on the development of SRA regulation more generally especially with respect to activity based regulation. In this regard, the use of separate compensation funds may have some merit in the future if these separate funds are linked to the activities that firms are conducting (rather than the legal structure of the funds conducting them). This would be similar to the way that the FSA currently arranges the Financial Services Compensation Scheme where there are “silos”, i.e. sub-sectors based on business activities. It would also need to be considered whether activity based regulation would justify separate silos or simply different values of contributions.

7.6. ARP and Compensation Fund

We note that at present financial protection arise through the combination of the Compensation Fund and the ARP. However, it is not obvious why two separate arrangements are required. The merit of having one combined fund compared to two separate arrangements mainly depends on the functions that need to be covered and the method of funding those functions. For example:

- It is well understood that insurance policies can not cover own fraud and therefore for this risk to be covered there needs to be a Compensation Fund for compensation purposes i.e. any combined arrangement could not be done through the current ARP;

- If the functions that are carried out by both arrangements are similar then there could be merit in combining them. For example, the ARP function of providing compensation for non-applied firms does not involve insurance rating (since such firms by definition do not get insurance), but simply imposes a cost on the ARP. This is similar to the way that the Compensation Fund operates in respect of simply facing a cost that needs to be paid out; and

- If the appropriate funding methods are similar this would suggest merit in using one fund, whereas if the appropriate funding method is very different this could suggest separate arrangements (or a more complex arrangement to cover multiple functions).

At this stage of the review of client financial protection arrangements, it would seem most appropriate for agreement to be reached on the functions that should be played by the

ARP (as distinct from the open market) and the Compensation Fund. Once that decision has been made it is important to assess the appropriate method of funding the relevant functions. Only once both previous elements have been considered is it feasible to consider whether it would be appropriate to combine the ARP functions and Compensation Fund functions into one structure sense.

APPENDIX A REVIEW OF DIFFERENT SCHEMES

In this Appendix we set out the detailed information on the different schemes which apply in:

- different countries (Ireland and Scotland) in section A.1; and
- in different professions (licensed conveyancer, surveyors, financial advisers, accountants) in section A.2.

A.1 Schemes in different countries

A.1.1 Ireland

The Law Society of Ireland (LSI) has required solicitors to hold PII since 1996 and also operates a compensation fund. In 2005, LSI set up a PII Task Force to conduct a fundamental review of the PII regime. The task force had four principal considerations in respect of PII which were to:

- protect the public;
- protect the profession;
- place the Law Society in a strong and tenable position in relation to PII; and
- have a healthy competitive market.

The task force reported in 2007 and concluded that there was no need for radical replacement of the existing system of freedom of choice among qualifying insurers, finding no need to move to a Master Policy.[123] The report did lead to a number of changes many of which made the scheme in Ireland more similar to that in England and Wales including:

- PII to be held by firms rather than individuals;
- Any level of excess can be agreed with the insurer;
- A movement to a single renewal date –firms previously renewed on 1 November or 1 January and through a single year in which policies lasted for 13 month or 11 month policies the market moved to 1 December from 2008. It is understood that this was done for the purpose of administrative streamlining;
- Run-off cover was increased to six years rather than two years and would be automatically provided by the last insurer (including in the absence of the payment of premium) or through the insurance of any successor practice;

123 The taskforce report itself is not publicly available and considered confidential to LSI.

- Insurers could not repudiate a policy on any grounds including fraudulent misrepresentation; and
- Changes were made to the ARP cover to increase it to €2.5 million on an each and every claims basis as with policies outside the ARP.[124]

However, in 2009 significant difficulties placed the PII arrangements under pressure,

> *"The recession has caused great stress in the PII market both in Ireland and internationally. The problem has been particularly acute in Ireland due to the avalanche of negligence claims for the failure of solicitors to comply with undertakings given in commercial conveyancing transactions." and*
>
> *"The Law Society convened a special Council meeting to deal with this issue on 27 August 2009. The Society's task force proposed, and the Council agreed, that a number of changes be made to the Society's regulations, which set out the minimum terms and conditions of PII insurance. These changes make some reductions in the protection of clients and of solicitors, but increase the likelihood that a competitive market will exist for PII renewals this year."* [125]

In the light of these difficulties, in September and November 2009 changes were made to the minimum terms and conditions for the indemnity period commencing 1 December 2009. We understand that many of these changes were considered necessary in order to maintain the willingness of insurers to participate in the market:

- A reduction in the level of cover from €2.5 million to €1.5 million;
- Undertakings in the course of a commercial property transaction (including buy-to-let) provided after 1 December 2009 would no longer be required to be covered i.e. where the solicitor acts for the borrower but gives undertakings to the lender. Cases where the solicitor acts directly for the lender (and does not act for the borrower) were unaffected by this;
- Reversal of changes made in 2008 regarding fraud or dishonesty which would no longer be covered. Similarly where there is fraudulent misrepresentation or non-disclosure in placing the insurance claims could be declined by insurers in respect of financial institutions (which is no similar to pre-2008). Although they cannot be avoided by the insurer for other clients, the firm must indemnify the insurer for all claims; and
- Run-off cover was reduced from six years to two years (as per pre-2008) and could be cancelled by the insurer in the case of non-payment of premium.

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124 Law Society of Ireland Gazette, Report of Law Society Council meeting held on 13 July 2007, August/September 2007; Law Society of Ireland Gazette, Notice to all practising solicitors: new professional indemnity insurance regulations, August/September 2007; Law Society of Ireland Gazette, Professional indemnity insurance: implications of taking over an existing practice, August/September 2009.

125 Law Society of Ireland, Annual report and accounts 2008-2009

In respect of the ARP, between 1996 and 2008, only 14 firms had ever entered it, and in 2009 there were only 9 firms in the ARP, but market conditions in 2009 led to considerable concern about the ARP growing. The funding of the ARP was previously done through contributions from insurers in proportion to their market shares. In September 2009 it was proposed that an ARP contribution representing 2% of the premium payable for the minimum level of cover be applied, although in November 2009, the ARP was suspended for the indemnity period 2009-2010.[126] Based on evidence from interviews with a range of market participants, the suspension of the ARP was considered to be a key element in enabling the largest provider of insurance operating in the market to obtain reinsurance without which it would not have been able to write any business.

We understand that LSI intends the ARP to be in place again for 2010-2011. However, the levy will not be introduced as had been planned because it was unpopular with both the profession and the insurers who thought it would complicate their administration systems. The funding of the ARP will therefore continue based on contributions from insurers in proportion to their market shares.

Despite all of the concerns about the market, it is notable that XL entered the market in 2009 and was able to take a very substantial market share although this was partly in the light of difficulties with other major insurers.

Table 14: Summary for Law Society of Ireland

PII cover	Arrangements in Ireland
Type of PII cover	Qualifying insurers
Number of professionals	Approximately 8,300 practising certificates
Value of premiums	€42 million (£35 million)
Premium basis	Insurer determined
Renewal	Single renewal date on 1 December (previously there had been two renewal dates on 1 November and 1 January)
Level of cover	€1.5 million (reduced from €2.5 million from 1 December 2009) for each and every claim
Excess	Any level of excess can be arranged
Significant exclusions	Undertakings in the course of a commercial property transaction provided after 1 December 2009 not covered and banned after 1 December 2010. Claims by financial institutions can be denied for material non-disclosure when placing insurance
Fraud	Fraud and dishonesty not covered
Run off	Two years (reduced from six years from 1 December 2009 although had

126 Law Society of Ireland Gazette, Professional indemnity insurance: Another slice of the PII, November 2009.

	been two years pre 2008)
Assigned Risks Pool	Suspended for 2009-2010 renewal period. Funded via qualifying insurers in proportion to their market shares in the indemnity year.
Additional arrangements	
Compensation Fund	Provides cover against solicitor's own fraud when not covered through PII

Source: Law Society of Ireland, Annual report and accounts 2008-2009; Law Society of Ireland Gazette, Professional indemnity insurance: Another slice of the PII, November 2009; LSI.

Despite the reduction in the level of cover which arose for the renewal on 1st December 2009, LSI reports that the average premium paid by firms for PII almost doubled. They note that this was driven by a high number of claims.[127]

While there was a risk that the suspension of the ARP would be very detrimental, it is believed that only around 30 firms closed because they were unable to obtain PII. It is understood that many of these were part-time sole practitioners many of whom were approaching retirement with minimal fee income who insurers considered had insufficient financial standing. It is believed that other firms may have merged and some sole practitioners may have become consultants at alternative firms in order to continue conducting a small amount of legal advice.

LSI also reports that extra cover for solicitors' undertakings to financial institutions in commercial conveyancing transactions was not provided for firms with poor risk management but it was estimated that 30-40% of firms obtained this cover. It has been estimated that this typically added around 10-15% to the premium firms would otherwise have received.

The LSI has now changed regulation such that from 1st December 2010, lawyers will no longer be able to give commercial undertakings which will lead to separate representation for borrowers and lenders in the context of commercial conveyancing. (Insurance cover for firms acting directly for lenders is unaffected.) The LSI has indicated that commercial conveyancing rather than residential conveyancing had been identified as the area of greatest concern and where many claims had resulted. It is understood that lenders have attempted to require firms to guarantee that they will continue to have cover for previous commercial conveyancing undertaken before 1st December 2010 although LSI has advised that such guarantees can not be made.

Compensation fund

Ireland also has a compensation fund which pays out in the event of fraud. It is noted that all of the cases paid for through the compensation fund have been for sole practitioners or two partner firms. In the latter case it is considered desirable to provide cover through the compensation fund since the second partner is often the whistleblower which encourages incentives for them to reveal fraud when they discover it. (Fraud was only covered in the minimum terms and conditions of the PII during 2008 and 2009 and therefore an innocent

127 Law Society of Ireland Newsletter, Current Market Trends, 26 July 2010.

partner would be exposed to claims resulting from the actions of the fraudulent partner without the compensation fund being in place.)

Annual contributions to the fund increased to €660 per solicitor for 2009 from €400 in 2008.[128] This increase came after a large number of years in which the contribution was fixed at €400 but where increasing costs over time were being absorbed by the fund's reserves and therefore it was necessary to increase the contribution to reflect the increased costs over time.

A.1.2 Scotland

The Law Society of Scotland (LSS) provides client financial protection through the combination of requiring solicitors to hold PII which is provided through a Master Policy that has been in place since 1978 and the "Guarantee Fund" which is a compensation fund of last resort.

Research conducted by the University of Manchester indicated that solicitors viewed the purpose of the Master Policy was the provision of PII for solicitors with the protection of clients a secondary purpose,

> *"The purpose of the Master Policy, the simple answer is to allow solicitors to sleep at night. It provides professional indemnity insurance cover for firms. Lawyers have to insure against risks that arise from potential negligence. This statement about the Master Policy's aim has been consistent from the Law Society. The purpose of the Master Policy is to provide consumer protection, but that is secondary, that is a by-product. Its primary purpose is to protect the profession."* [129]

Currently Marsh acts as the broker for LSS and RSA is the lead underwriter. A variety of other insurers also involved each of whom take a proportion of all of the premiums and all of the claims. As is common with a Master Policy arrangement, the premiums and underwriters are reviewed each year.

The overall premium for the whole scheme is agreed between LSS and the insurers. Historically fairly simplistic approaches were taken to divide the premium across the profession but additional rating factors have been added over time although the scheme is still described as having "discounts" and "loadings" to reflect different types of risk or changes in the level of the excess. Currently the lead underwriter will calculate the premiums to be charged to individual firms.[130]

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128 Law Society of Ireland, Annual report and accounts 2008-2009 and 2007-2008

129 Stephen F, and A Melville, University of Manchester, Report to Scottish Legal Complaints Commission on the Master Policy and Guarantee Fund Research, June 2009.

130 Typically differences arise between the overall premium agreed and the sum of the individual premiums but these differences are thought to be small (less than £100,000) and it is expected that they will be smoothed from year to year.

The level of cover was increased from £1.5 million to £2 million per claim in 2007/2008. It is understood that this was not because claims were observed in excess of the level of cover but because the value of cover is eroded by inflation and it was deemed appropriate to increase cover over time to reflect this. Interestingly, the level of premiums did not increase substantially at the time that the level of cover was increased due to the timing in respect of the insurance market.

The Master Policy covers the whole profession hence firms that do not pay premiums would still be covered although failure to pay premiums would prevent practising certificates from being renewed and would be considered to be professional misconduct. Run-off cover is provided for indefinite duration through the Master Policy. Where there is no continuing or successor practice, the ceased practice is treated as going into run-off and there may be a charge to a firm for this depending on the claims experience of the ceased practice.[131]

The LSS does not receive any information from underwriters regarding the claims history of individual firms although it would be informed about any emerging trends regarding claims as a whole in order that LSS can highlight any concerns to the wider profession.

It is useful to note that solicitors that are members of a multi-national practice (e.g. one that primarily operates in England and Wales) does not need to take out insurance under the Master Policy if it has insurance which is equivalent to the terms of the Master Policy.[132]

The value of premiums has increased by around 7% in 2009/2010.[133] Discussions with a range of interviewees have indicated that in part this is likely to reflect an increase in the number of conveyancing related claims in the last few years. The property market in Scotland operates in a different way to that which is common in England and Wales. In particular, the majority of residential transactions arise through solicitors who are also estate agents. However, it is worth noting that the presence of a Master Policy does not appear to be preventing some of the issues related to conveyancing. For example we note that the Co-operative Bank (acting as lender) is seeking to remove sole practitioners from its panel in Scotland.[134]

Table 15: Summary of Law Society of Scotland

PII cover	Arrangements in Scotland
Type of PII cover	Master Policy

131 The Law Society of Scotland, Solicitors ceasing their practices, November 2007.

132 The Law Society of Scotland, Solicitors (Scotland) Professional Indemnity Insurance Rules 2005 [June 2005], taken from LSS website.

133 The Law Society of Scotland, Annual Report & Accounts 2009

134 The Law Society of Scotland, Society welcomes extension for further talks with CFS on sole practitioners, 5 October 2009.

Number of professionals	10,413 practising certificates in issue as at October 2009, approximately 1200 firms
Value of premiums	£15-20 million (LSS considers exact figure as confidential) Renewal for 2009/2010 described as having a 6.9% increase.
Premium basis	Set by lead underwriter based on number of principals and using various rating factors (fee income introduced as a rating factor in 2004/2005), discounts (such as for an increased excess) and loadings (maximum level of premium loading increased from 250% to 275% for firms with a loss ratio in excess of 300% and four or more claims over 5 year reference period).
Renewal	Renewed on 1st November
Level of cover	£2 million (claims attributable to the same act are regarded as one claim). This was increased from £1.25 m to £1.5 million in 2005/2006
Excess	£3,000 per partner with a 15 partner cap (i.e. £45,000)[135]
Significant exclusions	None
Fraud	Fraud and dishonesty are covered through the policy (other than all-principal fraud). Cover for firms that fail to pay premiums.
Run off	Provided through Master Policy for unlimited duration. (Contributions for run-off only made by those who had claims in the five years preceding exit.)
Assigned Risks Pool	Not required
Additional arrangements	
Compensation fund	Guarantee Fund – provides cover against solicitor's own fraud when not covered through PII; would also cover clients where PI cover insufficient

Source: The Law Society of Scotland, Master Policy for Professional Indemnity Insurance – 2008/2009 taken from LSS website; The Law Society of Scotland, Solicitors (Scotland) professional indemnity insurance rules 2005 in relation to the renewal of practising certificates taken from LSS website; The Law Society of Scotland The Master Policy for professional indemnity insurance, Master Policy Information, taken from LSS website; The Law Society of Scotland, Annual Report & Accounts from various years.

The Master Policy was the subject of an OFT investigation between 2003 and 2005. The OFT investigated whether the Master Policy prevents, restricts or distorts competition in the market for solicitors' services. The detail of their investigation has not been published, but the case summary concluded that,

135 The excess is doubled in respect of risk management categories including conflict of interest matters, non standard undertakings, certain time-bar matters, inadequate professional service awards and where a settled claims arise in a conveyancing transaction where the primes causes is attributable to charging the client a fee which was unreasonably low. The Law Society of Scotland, Master Policy for Professional Indemnity Insurance – 2008/2009 taken from LSS website.

> *"…notwithstanding the operation in other jurisdictions of more liberal arrangements for solicitors' indemnity insurance, there is insufficient evidence to show that Master Policy arrangements appreciably restrict competition between individual solicitors' firms either by denying them the freedom to seek insurance outside of the Master Policy or by encouraging solicitors to refuse to act for clients who wish to take action against a fellow solicitor.*
>
> *However, we remain concerned that the current arrangements for handling complaints against solicitors in Scotland appear not to have the confidence of the public."* [136]

Although the OFT found insufficient evidence of restrictions of competition, they are quoted as follows,

> *"The OFT stressed that their decision not to proceed does not necessarily mean that they are fully satisfied with the operation of the Master Policy, and in particular, there are still concerns about whether the Master Policy is supported by public confidence."* [137]

Interviews have indicated that the relatively small size of the Scottish legal profession, the large proportion of small solicitors (including a large geographical spread across islands) and the bargaining power that LSS could exercise on behalf of its members were important elements in the OFT's decision. In this regard it is worth noting that the Scottish legal profession is less than one-tenth the size of the profession in England and Wales and similarly the total value of PII premiums in Scotland is less than one-tenth those in England and Wales. In addition, solicitors in Scotland are believed to represent a more homogeneous set of firms since the largest firm in Scotland has fewer than 50 partners whereas England and Wales has greater diversity in terms of the size of firms.

It is also interesting to note that the OFT identified that claimants seemed to believe that delays in claims arose because solicitors were colluding in order that their own payments in respect of the Master Policy would remain low.[138]

The OFT found insufficient evidence of this in 2005, but the claimant view of this persisted in the research conducted in 2009 by the University of Manchester.

Licensed providers

The Scottish Parliament is considering allowing "licensed providers" to offer legal services in much the same way that England and Wales is considering ABS. At present legislation is still to be passed but interviews with a range of market participants have indicated that it is likely that those licensed providers who are regulated by the LSS would be included

136 Office of Fair Trading, Competition case closure summaries, April 2005.

137 Stephen F, and A Melville, University of Manchester, Report to Scottish Legal Complaints Commission on the Master Policy and Guarantee Fund Research, June 2009.

138 The concern regarding incentives arises because the profession as a whole is responsible for both pursuing compensation claims against other lawyers and for paying for resulting claims through the Master Policy.

within the Master Policy with respect to the provision of legal services, but would need to seek alternative insurance arrangements for the other services that they might offer. If a firm conducting legal services was regulated by another regulatory body then that body would be responsible for ensuring that the PII for legal services was equivalent to that in the Master Policy. At present it is unclear whether some aspects of the cover could be replicated through the open market such as the run off cover which is indefinite through the Master Policy but typically limited in policies used in the open market.

Guarantee Fund

The "Guarantee Fund" acts as a fund of last resort where claimants have exhausted all alternative means of recovering their loss. The aim of it is to make grants, "in order to compensate persons who in the opinion of the Council suffer pecuniary loss by reason of dishonesty on the part of" solicitors.[139] The fund itself has unlimited liability with no cap in respect on individual claims or in aggregate. Financial institutions can make a claim against the Guarantee Fund, but the LSS can reduce the payment due to contributory negligence.

Payments are at the discretion of the Council of the LSS. The fund made grants of £77,000 in 2007/2008 compared to £315,000 in 2006/2007. Members of LSS make contributions to pay for the Guarantee Fund. It is only funded by principals in private practice and directors of an LLP. The current contribution is £630 which increased somewhat last year due to the anticipation of increased claims in the future due to identified fraud.

A.2 Schemes in other professions

Finally we set out information on PII schemes in place for other professions in the UK.

A.2.1 Licensed conveyancers

The Council for Licensed Conveyancers (CLC) maintains a Master Policy through which all regulated firms receive PII. A Master Policy has been in place since the CLC started which reflected the use of the Master Policy by TLS at the time the CLC regulatory structure was being developed.[140]

The CLC scheme was reviewed in January 2009 by Marsh which indicated some concerns about the future size of the premium pool and the scheme's commercial viability although Marsh nonetheless recommended that the Master Policy continue.

139 Section 43 of the Solicitors (Scotland) Act 1980 as quoted in Stephen F, and A Melville, University of Manchester, Report to Scottish Legal Complaints Commission on the Master Policy and Guarantee Fund Research, June 2009.

140 Note that TLS switched to using SIF in 1987, but the CLC only commenced operations in 1988.

The Marsh report indicates that there is "overriding concern within the member firms about the lack of freedom of choice".[141] Despite this, Marsh states that a movement away from the Master Policy would be risky and may expose smaller licensed conveyancing firms to the risk of being declined cover. Small firms also indicated concern about the work involved in obtaining their own cover if there was no Master Policy. Marsh noted that allowing large firms to find insurance outside the Master Policy would reduce the premium pool without reducing the cost of insuring the rest of the profession. In this regard it is important to note that the CLC regulates approximately 200 firms and 1,100 individuals and is therefore the Master Policy covers a group of firm which is significantly smaller than the number of solicitors. In addition, since all firms conduct conveyancing, the group of firms insured in this manner would be expected to be more homogenous than when considering all solicitor firms.

The base rate for premiums is negotiated by the CLC's appointed broker and agreed by the CLC. Premiums for individual firms are set by the underwriters of the Master Policy based on the turnover of the firm along with claims history and the level of the excess.

Due to the small number of firms, there are only a small number of claims that arise under the CLC Master Policy.[142] For this reason, it is difficult to draw strong conclusions about any changes in the number or value of claims from year to year. However, one area of claims that has increased in the light of the decline in the property market is that of lender claims. As indicated in Chapter 2, this again suggests that a review of the conveyancing process more generally may be appropriate.

The small number of claims and modest value of claims overall may reflect the fact that the small number of very costly mortgage fraud cases have not arisen in the licensed conveyancer space. Alternatively this may reflect either:

- Specialisation of licensed conveyancers who focus on conveyancing alone in contrast to many solicitor firms who offer conveyancing services on a less frequent basis and therefore may not be up to date with the relevant processes; or

- Different regulatory approaches taken by the CLC compared to the SRA. We note that the CLC regulates a group of 200 firms offering conveyancing and probate services whereas the SRA regulates 11,000 firms offering a wider range of services.

Marsh notes that many members of the CLC were concerned about the level of costs involved in servicing claims (£5.92 million since 1993) compared to the value of claims (£9.63 million).

141 Marsh, Executive Summary of Report to the CLC on Professional Indemnity and Compensation Fund Arrangements, January 2009.

142 The CLC were unable to provide us with data on this issue, but as noted in the main text the small number of claims makes interpretation of year to year changes difficult.

Table 16: Summary for CLC

PII cover	Arrangements for CLC
Type of PII cover	Master Policy
Number of professionals	Approximately 200 firms
Value of premiums	£2.46 million (2008/09)
Premium basis	Set through Master Policy scheme with some complaints that the basis is not sufficiently transparent. Mainly based on turnover with adjustments for claims and excess.
Renewal	1 July
Level of cover	£2 million for each and every claim
Excess	The excess for residential conveyancing must be no more than £3,500 or the sum of: 5% fees for fees of £0- £200,000; 3% fees for fees of £200,001-£500,000; and 2% fees on fees between £501,000 and £1,000,000. Firms with fees over £1 million can make individual applications to increase the excess subject to demonstrating how they can ensure they will meet this obligation
Significant exclusions	Insurers can avoid for non-disclosure or mis-representation unless free of fraudulent intent (insured to prove) and for false or fraudulent claims
Fraud	Fraud is not covered
Run off	Run-off is required for six years
Assigned Risks Pool	None
Additional arrangements	
Compensation Fund	Covers run-off and is also insured

Source: Marsh, Executive Summary of Report to the CLC on Professional Indemnity and Compensation Fund Arrangements, January 2009; and CLC, Master Policy supplementary Self insured excess (domestic conveyancing), June 2009.

A compensation fund also exists which is a fund of last resort and covers fraud and negligence claims where clients have been unable to obtain redress via the licensed conveyancer and their insurer. Contributions to the compensation fund have typically been based on a percentage of turnover. The compensation fund itself is also insured and Marsh indicated that there was concern expressed by conveyancers regarding whether costs paid to the compensation fund were subsidising other parts of the CLC activities. We understand that the CLC is changing the mix of different fees (practice fees, licence fees, compensation fund contribution) in the light of these concerns.

Where firms do not have their own run-off cover, this is currently covered through the compensation fund although Marsh suggested that run-off cover should move from the compensation fund to PII. Firms can seek to obtain the run-off cover from any insurer although the underwriters of the Master Policy offer run-off and it is likely firms would consider these insurers first.

A.2.2 Surveyors

The Royal Institute of Chartered Surveyors (RICS) requires members to hold professional indemnity insurance which is provided by listed insurers of which there are currently around 40.[143] Firms are required to ensure that they have "adequate and professional indemnity insurance" cover.[144] The level of cover required depends on the firm's turnover and ranges from a minimum of £0.25 million to £1 million per claim. Further details regarding the RICS PII requirements are set out in Table 17 below and alongside PII is a client money protection scheme.

Unusually amongst the different regulators, RICS explicitly states why it requires firms to have professional indemnity insurance which is for the following reasons:

> *"to comply with RICS' public interest role;*
>
> *to comply with the RICS' obligations for self regulation under the terms of the Royal Charter and/or the relevant Bye-Laws and Rules;*
>
> *to provide access to compensation for members of the general public who have suffered loss as a result of the negligence of a Firm;*
>
> *to ensure that Firms and Members themselves are protected in the event of a professional indemnity claim."*[145]

PII used to be provided through RICS Insurance Services which was an industry wide scheme similar to SIF. This ceased in 1996 because of concerns about the potential that any catastrophic risk would have to be funded by the profession. Since this time the open market has been used to deliver PII with a variety of requirements in place for the PII cover. These requirements are generally reviewed every 3 years but are understood to have originally been modelled on those in place under TLS.

In addition, RICS explains why it has an ARP as follows,

> *"RICS recognises that circumstances may arise where a Firm may be unable to obtain professional indemnity insurance and therefore render(s) it unable to comply with the RICS Insurance Requirements. This may be as a result of a poor claims record, the type of business being carried out or other risk factors and may occur through no direct fault of the Firm."* [146]

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143 RICS, RICS listed Insurers UK firms' list, 1 July 2010.

144 RICS, Professional indemnity insurance policy sheet.

145 RICS, Assigned Risk Pool Guidance notes, 1 April 2010.

146 RICS, Assigned Risk Pool Guidance notes, 1 April 2010.

The number of firms in the ARP has always been quite small. In 2001/2002 there were around 16 firms in the ARP although this then fell reaching a low of 2 in 2008/09. This has subsequently increased again to around 14 at present.

Table 17: Summary for RICS

PII cover	**Arrangements for RICS**
Type of PII cover	Participating insurers who must be regulated in the European Union and entitled to conduct insurance business in the UK. Insurers must be rated at least B+ by AM Best or BBB by Standard and Poors or have specific approval from RICS to waive this requirement
Number of professionals	Approximately 10,000 firms with 90,000 corporate members
Value of premiums	Approximately £50 million
Premium basis	Insurer determined
Renewal	No fixed date
Level of cover	Cover of £0.25 million for turnover less than £100,000; £0.5 million for turnover of £100,000-200,000 and £1 million for turnover of more than £200,000. Cover is on an each and every claims basis.
Excess	Maximum excess of 2.5% of the sum insured or £10,000 whichever is greater
Significant exclusions	Mis-representation must be free of any fraudulent conduct or intent to deceive (which is for the insured to prove).
Fraud	Fraud and dishonesty is covered.
Run off	Members requires cover to be maintained for at least 6 years although claims can arise for up to 15 years
Assigned Risks Pool	ARP in place with listed insurers required to subscribe to it in proportion to overall share of market. Firms must demonstrate declinature or constructive declinature or the existing insurer and at least three other prescribed listed insurers. ARP can provide cover for a maximum of three years. Premiums for ARP firms determined by main insurers. Indemnity cover is limited to £1 million in ARP and on an aggregate basis not each and every claims basis. The policy cover ceases from the date the firm ceases to be regulated by RICS. (Note that this implies there would be no run-off cover for these firms unless they are able to obtain it from the open market.)
Other	Cover must be on a “fully retroactive” basis so all former work carried out is covered.
Additional arrangements	

Compensation Fund	Clients' Money Protection Scheme

Source: RICS, Professional indemnity insurance retirement; RICS, Professional indemnity insurance policy sheet; RICS, Insurers and brokers; RICS, Assigned Risk Pool rules of admission, 1 April 2010.RICS, Handling claims notices – a guide firm firms, February 2008; RICS

Due to economic conditions the number of insurers willing to offer PII to surveyors is believed to have decreased over the last two years, claims are understood to have increased four-fold between 2008 and 2009 and some firms have seen premiums increase by up to 100%.[147]

Clients' money protection scheme

Alongside requirements for PII, RICS also has a "Clients' Money Protection Scheme" which is in place as a means of last resort if money has been misappropriated. The current level of financial cover is £50,000 per claimant subject to an overall limit on payments in any year of £5 million. It only applies in cases where the firm concerned is unable to make full restitution.[148]

All firms holding client money are required to pay an annual fee to fund the Clients' Money Protection Scheme. The clients' money insurance levy fee is based on the number of principals in the firm and ranges from £30 for a firm with one principal, £60 for 2-4 principals and up to £2,250 for firms with more than 50 principals.

A.2.3 Financial advisers

The Financial Services Authority (FSA) requires that financial advisers hold PII and also make contributions to the Financial Service Compensation Scheme (FSCS). The value of the PII held by firms varies according to whether they are subject to various different rules. This includes considering whether they are:

- an insurance intermediary or mortgage intermediary; and
- subject to certain directives such as the Insurance Mediation directive (IMD), Capital Adequacy Directive (CAD) and the Market and Financial Instruments Directive (MiFID).

For firms subject to the IMD, the level of minimum cover is set through this European Directive.[149] The Directive applied from January 2005 and limits were originally set at €1 million for each claim and €1.5 million in aggregate. The IMD itself specifies that these levels should be increased every five years to take into account changes in the European Index of Consumer Prices, hence the level of cover increased to €1.12 million for a single claim and €1.68 million in aggregate. If a policy is denominated in a currency other than

147 Post Magazine, Tough Conditions, 25 March 2010; and Post Magazine, Reduce Exposure, 25 March 2010.

148 RICS, The RICS Clients' Money Protection Scheme.

149 EC, Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

euros, firms are required to ensure that they meet this level of cover at the start of the policy but not necessarily throughout the duration of the policy if this varies due to exchange rate fluctuations.

Exclusions to the policy can be made for specific business lines if the firm has not worked, and will not work, in these areas or for specific claims that have been previously notified to the firm's insurer and claimed for under another policy. In these cases additional capital resources are required to be held.

During 2002-2004, there were some difficulties with a number of IFA firms finding PII cover as the market capacity tightened in the light of a large number of claims for issues such as mis-selling. In response to increases in premiums averaging 50%, the FSA made temporary changes to their requirements in the light of this.[150] Many firms who were initially unable to find cover subsequently secured suitable cover, were given individual guidance through which their cover could be considered complaint or a waiver (a further 12% were being considered at the time the FSA published the statistics) and 26% cancelled their permissions to offer financial advice.[151]

It is interesting to note that there are a number of areas of the FSA requirements in which the policy conditions required can be varied (higher excess, exclusion of certain lines of business) if additional capital is held instead. More generally it is worth noting that a variety of other regulatory requirements sit alongside the requirements for PII cover such as regulation of insurance products and of the sales process. Firms face capital requirements and solvency requirements which would also be expected to help protect clients in the case of making a claim. In this way it is clear that there are a variety of methods through which client protection can arise with some of these factors being traded off against others.

Table 18: Summary for insurance intermediaries

PII cover	Arrangements for FSA
Type of PII cover	Any insurer regulated to offer PII in the European Economic Area or equivalent status in certain other countries
Number of professionals	Approximately 10,000 firms with 35,000 approved persons
Value of premiums	Estimated as around £40 million
Premium basis	Insurer determined
Renewal	No fixed date
Level of cover	€1,120,200 for single claim and €1,680,300 in aggregate. The aggregate limit is then increased based on the level of fee income up to £22.5 million for firms with income in excess of £30 million.

150 FSA, FSA acts on professional indemnity insurance concerns, FSA/PN/106/2002, October 2002

151 FSA Annual Review 2002/2003.

Excess	The excess can not be more than £5,000 unless the firms hold additional capital
Significant exclusions	Specific lines of business can be excluded subject to additional capital being held
Fraud	Not specified
Run off	Full retroactive cover is required for claims arising from work carried out by the firm in the past
Assigned Risks Pool	N/A
Additional arrangements	
Compensation Fund	Financial Services Compensation Scheme

Source: FSA Capital Resources and Professional Indemnity Insurance Requirements for Personal Investment Firms Instrument 2009, FSA 2009/62, November 2009; IMD. Note that details of the cover required relate mainly to those firms which are insurance intermediaries. The number of firms is based on the number of investment intermediary firms (many, but not necessarily all of which will be insurance intermediaries) as cited in FSA, Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules, PS10/6 Annex 1. The number of approved persons is based on figures for life and pensions intermediation in FSA, FSCS Funding Review, PS07/19, November 2007. Value of premiums based on estimates from interviews – interviewees indicated considerable caution should be applied to the figure due to the difficulty of defining which intermediaries would fall into this sector and how issues such as captives should be considered.

Financial Services Compensation Scheme

The FSCS applies across the financial services sector and the method by which it is funded has been changed over time and is currently under review. Prior to 2008 the FSCS operated in "silos" with caps implying that firms in designated sectors or classes paid a levy to compensate customers in their own sector in the event of a default by a firm from that sector, but funds from one sector could not be used to compensate customers in another sector.

In 2008, the funding model was altered as firms were organised into classes and sub-classes and instead of a cap the notion of a "threshold" was introduced for each sub-class.[152] If funds for a particular sub-class (e.g. life and pensions intermediation) were exhausted then funds from the wider class (e.g. life and pensions) could be drawn on. If funds in the class were exhausted, the scheme could then use funds from the General Retail Pool.

For 2009/10 a levy of £19 million was applied to the life and pensions intermediation sector which equates to approximately £530 per approved person.

The funding model for the FSCS has primarily worked on an ex post approach with annual levies on different firms depending on the types of defaults that had occurred. However, in the light of the credit crisis, the funding mechanism is under review because of concerns that the ex post approach does not align with the concept of "polluter pays".

A.2.4 Accountants regulated by ICAEW

Since the 1980s, the Institute of Chartered Accountants in England and Wales (ICAEW) has required its members who engage in public practice to take out PII.[153] The regulations are similar for equivalent bodies in Scotland and Ireland. Details of the PII are found in Table 19 below.[154]

Since it was already common practice for firms to hold PII before the requirement came in, firms obtained PII at different times of the year and there has never been a single renewal date in place. As part of their annual return each year, ICAEW requires firms to send confirmation of having PII cover. The ICAEW sends a reminder letter to firms before the date on which insurance is due for renewal and PII cover is subject to checks during monitoring visits.

The minimum level of cover required by ICAEW was increased recently to take into account inflation and, using "rounded" figures, increased from £1 million to £1.5 million per claim. Firms with gross fees below £0.6 million must have cover of 2.5 times their gross fees subject to a minimum which increased from £50,000 to £100,000. It is also interesting to note that insurers have competed to provide cover on an each claim basis rather than an aggregate basis (although they might have the latter for a particular type of work such as investment business where they may be concerned about the lack of a long stop e.g. with FSA pensions mis-selling issues).

Retroactive cover is in place and this was extended from five to six years from January 1999 although it was noted that most insurance policies already provided for a period of six years.[155] This was to link it to the six year statute of limitation period. It is noted that insurers frequently do not impose any retroactive limit.

Run-off cover is required for two years although firms must make best endeavours to extend this to six years. It is understood that most claims are likely to arise within two years of work being conducted since many accountancy services such as assisting with tax returns or completing audits are provided on an annual basis (unlike many legal services).

As well as requiring PII cover, the ICAEW has an ARP which it describes as follows,

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152 FSA, Financial Services Compensation Scheme – Funding Review, CP07/5.

153 Some accountants may also have to meet the FSA's PII requirements if they are FSA regulated. Compulsory PII rapidly followed the requirement for PII for those firms that the ICAEW authorised under the Financial Services Act 1986.

154 Much of the information in this section is drawn from ICAEW, Professional indemnity insurance regulations and guidance.

155 Retroactive cover is the cover for activities conducted in the past. Unless specified, most PII policies for the other professions will provide cover for activities conducted in the past irrespective of the length of time passed (although the claim itself may not be valid if clients delay for too long).

> *"The assigned risks pool is effectively an insurer of last resort and was set up to ensure that members are almost always able to comply with these regulations whatever their circumstances"*[156]

In addition, the fact that ICAEW is a member organisation may have driven the need for an ARP in order that no member of the profession was forced out of the profession due to lack of insurance. It is understood that the ARP is in place in order that it is the ICAEW rather than the insurance sector that draws the regulatory boundary.

In order to enter the ARP, firms must demonstrate declinature or constructive declinature (based on high premiums) from a number of insurers which is aimed at forcing the firms into taking action. The ARP/ICAEW would give them a list of the top 8 or 10 insurer to try and the firm would need to report back to the scheme broker.

Firms entering the ARP will broadly be charged around double the cost of their previous PII cover for the minimum terms. This is subject to a minimum of £1,000 and the doubling of the cost is supposed to act as a disincentive to entering the ARP. The premium for firms in the ARP is set by the insurers. Typically this is done by the main insurers and a rule of thumb is that the premiums will be double the amount firms were previously charged although the insurers have the flexibility to charge different amounts. In addition the firm must pay for an inspection which costs around £1,500 for a small firm. To put these figures in context, the cost of PII in the open market for a sole practitioner would typically be around £1,000.

The number of firms in the ARP at any point has never exceeded 15 despite covering around 12,000 firms in England and Wales, 2,000 firms in Scotland and 2,300 firms in Ireland (all of whom are eligible to enter the ARP). In general it has been small firms in the ARP often sole practitioners who have a claim that may suggest that they have been operating outside of their area of competence. Based on discussions with market participants, most firms in the ARP are able to return to the open market after they have dealt with the problems that led them to enter the ARP.

Finally, although any excess of claims over premiums must be paid by qualifying insurers in proportion to their value of premiums in a calendar year, the premiums in the ARP have usually been greater than the claims costs such that no significant insurer contribution has been necessary.

Table 19: Summary for ICAEW

PII cover	**Arrangements for ICAEW**
Type of PII cover	Participating insurers
Number of professionals	12,000 firms with approximately 18,000 practising certificates
Value of premiums	Approximately £30 million

156 ICAEW, Professional indemnity insurance regulations and guidance.

Premium basis	Insurer determined
Renewal	No fixed date
Level of cover	£1.5 million for any one claim and in total unless gross fee income is less than £600,000 in which case indemnity must be 2.5 times gross fee income subject to a minimum of £100,000
Excess	Excess up to a maximum of not more than £30,000 per principal
Significant exclusions	Misrepresentation leads to avoidance of claim unless free of intent to deceive
Fraud	Fraud and dishonesty must be covered.
Run off	A member requires cover for at least two years although the guidance recommends six years A firm must have cover for at least two years following the cessation of the practice and thereafter members must use their best endeavours to ensure cover is in place for a further four years Retroactive cover of six years from January 1999
Assigned Risks Pool	ARP in place with participating insurers required to subscribe to it in proportion to calendar year premiums. Firms must demonstrate declinature or constructive declinature. ARP can provide cover for up to two years (with discretion for exceptional extensions). Premium broadly double the firm's previous PII cost.
Additional arrangements	
Compensation Fund	No compensation fund exists other than for investment business through the FSCS

Source: ICAEW, Professional indemnity insurance regulations and guidance, discussions with ICAEW.

In contrast to the legal profession, the ICAEW does not have a separate compensation fund that pays out to clients who can not obtain redress from their accountant or the accountant's PII cover. It is understood that this reflects the relatively modest amount of client money typically held by accountants on behalf of their clients (which may be limited to money received through tax reclaims). It is also understood that cases of loss of client money are rare.

A.2.5 Accountants regulated by ACCA

The Association of Chartered Certified Accountants (ACCA) requires PII to be in place for practitioners. This is described as being in place to ensure that practitioners have the means to meet any claims for professional negligence or loss through fraud or dishonesty. Where they are in partnership, have fellow directors or employ staff this must include "fidelity guarantee insurance" (FGI) to cover against acts of fraud or dishonesty.

The ACCA has negotiated schemes for members through Lockton in the UK (which has a facility with RSA) and Willis Risk Services (Ireland) in Ireland although other brokers also offer access to PII from a range of insurers. No restrictions are placed on the pricing of this cover. Firms need to provide evidence to the ACCA of their insurance policies when renewing their practising certificates.

While six years of run-off cover is required to be in place, it is more common for firms to take out a series of one year policies over time than to take out a six year policy although this would also be available. Typically the price of the run-off cover would fall by around 10-20% each year so the first year of run-off would cost around 80-90% of the previous indemnity year.

Table 20: Summary for ACCA

PII cover	Arrangements for ACCA
Type of PII cover	Any reputable insurer
Number of professionals	Approximately 5,000-5,500 firms and 20,000 individuals
Value of premiums	Approximately £15 million
Premium basis	Insurer determined
Renewal	No fixed date
Level of cover	Greatest of a) 25 times the largest fee raised during the previous accounting year; b) if income less than £200,000 then 2.5 times total income or £50,000; or c) £300,000 plus total income of the firm (for income of £200,000-700,000) or £1 million. This applies for each and every claim.
Excess	Maximum excess is the lower of £20,000 per principal and 2% of the level of indemnity for each and every claim.
Significant exclusions	None
Fraud	Fraud and dishonesty must be covered
Run off	Six years fund off cover is required
Assigned Risks Pool	N/A
Additional arrangements	
Client Fund	None

Source: ACCA, Professional Indemnity Insurance requirements factsheet; interviews.

The ACCA does not have any separate requirement to contribute to any form of client fund. The ACCA notes that,

> *"Making a complaint against a member is not a substitute for seeking damages or other redress through the courts. Therefore, whilst ACCA members or firms may be ordered to pay compensation if a complaint against them is found proved, the maximum sum payable is £5,000. ACCA itself cannot provide compensation for*

any loss suffered, unless the claim falls within the scope of its Financial Services Compensation Scheme."[157]

157 ACCA, Complaints, taken from http://www.accaglobal.com/members/professional_standards/complaints/