

Review of SRA client financial protection arrangements

27 October 2010

The full report is available to [download \(PDF 189 pages, 1.2MB\)](https://media.sra.org.uk/globalassets/documents/sra/cra-report-on-sra-financial-protection-arrangements.pdf) [<https://media.sra.org.uk/globalassets/documents/sra/cra-report-on-sra-financial-protection-arrangements.pdf>].

One of the key objectives of the SRA is "to protect consumers by ensuring effective professional indemnity and compensation fund arrangements". The Legal Services Act 2007 also requires approved regulators to have appropriate compensation and indemnification arrangements.

In July 2010, the SRA commissioned Charles River Associates (CRA) to undertake a "root and branch" review of the current financial protection arrangements.

The review considers the scope of protection offered to the consumers (including sophisticated consumers such as financial institutions) of legal services, the means by which that protection is delivered, and the impact of those arrangements on consumers, individual firms, the legal services sector as a whole, and the SRA itself. Given the impending changes to the legal services sector, the review also considers alternative business structures (ABSs) as part of the population of firms for any proposed financial protection arrangements.

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, eight insurers, seven brokers, and three 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 per cent 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 [\[#n1\]](#) 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).
- Principle 4: The scheme should encourage an independent, strong, diverse and effective legal profession.
- Principle 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 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 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](#)}
[\[#n2\]](#)

- **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
- **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 [\[#n3\]](#) 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 [\[#n4\]](#)

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 per cent of gross fees in comparison to 2.2 per cent under the Master Policy and 3 per cent 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 per cent of contributions but represented 34 per cent the value of claims, whereas firms with 11 partners or more paid 35 per cent of contributions and represented 27 per cent 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 per cent of all firms and 95 per cent 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 per cent) than in the profession as a whole (11 per cent). 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)	++ (competition may be distorted as heterogeneous profession)	++ (competition 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 "+++" (three plus signs) implies the best option for the criteria, "++" signs implies the second best option, and "+" 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](#)} [\[#n5\]](#) 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 per cent 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.

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 per cent 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 per cent 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 per cent 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 per cent 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 per cent 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 assess 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 misrepresentation 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 per cent of two-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.

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	<p>Require cover for individual clients but not for other clients as market failure is not evident for them</p> <p>Retroactive cover would need to be in place for work done for commercial clients before the date of the change in MTC)</p>	<p>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</p>
Single renewal date	<p>Remove restriction of single renewal date.No evidence of market failure for which a single renewal date is an appropriate intervention</p> <p>Evidence of problems particularly for small firms because of resourcing constraints arising from single renewal date</p>	<p>Reduction in need for temporary cover; increased cover in the open market especially for small and BME firm; reduction in cost of insurance.</p> <p>Additional requirements for SRA regarding monitoring</p>
Non-payment of premiums	<p>Remove insurance cover when premiums are not paid (for indemnity year, run-off and in ARP)</p> <p>This is in line with good business practice and prevents payers subsidising non-payers</p>	<p>Enhances risk management; restores incentives for insurers to report firms to the SRA thereby reducing overall claims; no obvious equality and diversity impacts</p>
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 Temporary insurance cover	Remove this role so that all firms in the ARP are shut down If rehabilitation role removed, then also remove the provision of temporary cover after 3 years subject to the removal of single renewal date	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 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

Notes

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.
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).

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