Annex D - Financial stability and the compensation fund

In its March 2018 consultation, the SRA is proposing the following in relation to the compensation fund:

- narrowing eligibility so that the very wealthy and organisations that cannot establish hardship cannot claim
- reducing the maximum payment from £2m to £500k
- more robust claims assessment so that the fund is not available to those whose own actions could have prevented a loss because '[w]e do not believe that the Fund is intended to underwrite dubious investment schemes'.

Any rule changes proposed by the SRA following its consultation will of course come to the LSB as rule change applications. However, this work also raises the broader question of how the legal services regulators look at the financial stability of the firms they regulate, and what use they can make of any related work undertaken by other regulators such as the Financial Conduct Authority (FCA).

The SRA has in the past done some specific work on firms in financial difficulty (eg research published in February 2014). This work in now integrated into its overall approach to risk. The SRA has a Regulatory Risk Framework that outlines how it operates and oversees risk-based regulation. It considers risk at an individual, firm, thematic and market level, and publishes a Regulatory Risk Index which allows it to prioritise incoming information to build a picture of overall risk exposure. The Index has four categories of risk: firm viability risks (arising from the viability of the firm and the way it is structured), firm operational risks (arising from a firm's internal processes, people and systems), firm impact risks (arising from firm action or inaction that results in a negative effect on clients, consumer, the public interest or the market) and market risks (arising from the operation of the legal services market as a whole). The SRA looks at matters such as firms in financial difficulty, group contagion, and firm structural instability under the 'firm viability risk' heading. The SRA looks at matters such as acting outside regulatory permissions, bogus firms, criminal association, disorderly closure, failure to comply with regulatory requirements, misleading a party and misuse of money or assets under the 'impact risks' heading.

An example of the work the FCA undertakes on financial stability is its role as a national competent authority under the Recovery and Resolution Directive (RRD) 2014. The RRD was one of the EU initiatives to reduce future threats to financial stability in the wake of the 2008 financial crisis. All firms affected (in the FAC's case, certain types of investment firm) must submit a recovery plan to their competent authority[1].

[1] The resolution authority (in the UK, this is the Bank of England) draws up a resolution plan for each firm based on information provided by the firm. If a firm is failing or likely to fail and there is no reasonable prospect of alternative private sector recovery measures, the resolution authority must decide whether to use its tools and powers. Resolution tools at its disposal include:

- selling or merging the business with another firm

A firm is deemed to face financial distress if it is in breach of, or is about to breach, certain requirements (referred to as 'triggers'). In this situation, the competent authority may intervene. It has a choice of course of action. These include:

- replacing the firm's management
- requiring the firm to draw up an action plan to mitigate the problems
- implementing part, or all, of the firm's recovery plan, and
- moving the firm into the resolution phase.

- setting up a temporary bridge bank
- transferring the assets to a separate vehicle, and
- writing down and converting the liabilities (bail-in)