LEGAL SERVICES BOARD

Financial protection arrangements

Response to Consumer Panel advice

October 2013

Contents

Executive Summary

1. On 1 October 2012, the Legal Services Board (the LSB) asked the Consumer Panel (the Panel) for advice on the extent to which regulators' financial protection arrangements, including compensation, are adequate and the appropriate level of risk that consumers should be expected to bear. The Panel published its advice on financial protection arrangements in June 2013[1] together with a discussion document of the wider issue of how risk and responsibility should be divided between consumers and providers.[2]

2. The Legal Services Act 2007[3] (the LSA) requires the LSB to consider the Panel's advice. This response therefore sets out the LSB's consideration of the Panel's advice on financial protection arrangements. Where we do not agree with the Panel's view, this document satisfies the requirements of section 10(2) of the LSA requiring the LSB to give the Panel a notice stating the reasons why it does not agree with representations made to it.

3. We welcome both the advice and the wider discussion document on risk. We also welcome the SRA's comprehensive review of its compensation fund arrangements. The fact that these types of issue can now be properly debated is an indication that regulation in the legal services market(s) is maturing.

The LSB's rationale in asking for advice

4. The LSB considers it important to establish (both generally and in relation to financial protection) a broad framework in which it is clear that the level of risk to consumers justifies regulatory intervention. This is because every regulatory requirement has a cost to businesses that is eventually borne by consumers. It is therefore important that regulators understand the risks that consumers face in different segments of the legal services market(s); disproportionate and/or untargeted regulatory requirements introduce unnecessary costs and can lead to inappropriate cross subsidies between market segments. However, it may be that some element of cross subsidy (for example for compensation arrangements) is appropriate if it contributes, say, to wider confidence in the legal services market(s). Similarly, costs may not be increased (for example by irrelevant minimum requirements for professional indemnity insurance (PII)) if insurers are able adequately to assess risk.

[1] http://www.legalservicesconsumerpanel.org.uk/ourwork/Financial%20Protection/FPAs%202013%2006%2010%20final.pdf
[2] http://www.legalservicesconsumerpanel.org.uk/ourwork/Financial%20Protection/2013%2006%2010%20riskandresponsibility.pdf
[3] section 11(2)

The LSB's response to the Panel's recommendations

Panel recommendation 1: financial protections should remain mandatory

LSB response

5. We agree that regulators should be able to require firms to have professional indemnity insurance (PII) and contribute to compensation arrangements.

6. The LSA's definition[4] of "regulatory arrangements" includes "indemnification arrangements" and "compensation arrangements" which are defined[5] as:

    - *"compensation arrangements", in relation to a body, means arrangements to provide for grants or other payments for the purposes of relieving or mitigating losses or hardship suffered by persons in consequence of: (a) negligence or fraud or other dishonesty on the part of any persons whom the body has authorised to carry on activities which* constitute *a reserved legal activity, or of employees of theirs, in connection with their activities as such authorised persons, and (b) failure, on the part of regulated persons, to account for money received by them in connection with their activities as such regulated persons;*

      and

    - *"indemnification arrangements", in relation to a body, means arrangements for the purpose of ensuring the indemnification of those who are or were regulated persons against losses arising from claims in relation to any description of civil liability incurred by them, or by employees or* former *employees of theirs, in connection with their activities as such regulated persons.*

7. There is no compulsion under the LSA to have such arrangements in place now, although the wording is slightly different for ABS and non-ABS. We take the view that the ABS wording requiring "appropriate" arrangements to be in place indicates that there may be circumstances when the arrangements are not required, irrespective of the ownership model of the firm. However, taking the range of risks into account, we consider that it is very likely that PII will always be required (because it covers most instances of negligence) whereas the need for compensation arrangements for fraud may only be triggered when, say, client money is held.

[4] s21(1) and s83(5)
[5] s21(2)

8. We consider that for PII, regulators' requirements should be based on achieving outcomes that provide proportionate levels of consumer protection. They should be risk-based, linked to the activities a firm carries out rather than blanket requirements across the board. We can therefore see merit in regulators exploring whether there could be common requirements for minimum PII terms and conditions for the same activities, in particular for conveyancing, not least to avoid any danger of deliberate or inadvertent miscommunication to consumers, which leads them to make purchases on the basis of a mistaken understanding of the protection available.

9. However, we do not consider that setting minimum terms and conditions for PII is necessarily appropriate for all firms. Levels of PII must be adequate for the services provided and the consumers to whom they are provided. So while minimum terms and conditions may well be an appropriate requirement for law firms that provide services to individuals and small businesses, they may not be needed for large corporate law firms because their clients should be able to carry out their own checks on the adequacy of the firm's PII cover. The requirement for runoff cover needs to be considered in context of a barrier to exit (and transfer between regulators). The LSB has commissioned research which includes consideration of runoff cover; it will be published around the turn of the year.

10. In terms of compensation for fraud, it is important to note that the LSA definition refers to "compensation *arrangements*". This does not necessarily mean that, if arrangements are needed at all, this must be a compensation fund. Alternatives to a fund may be more appropriate or efficient than having a large amount of money sitting in a fund at any one time. It is also important to take into account that the cost of establishing a sufficiently large fund may be a significant barrier to entry, for both new approved regulators and for businesses. The ability to use money in the fund for activities unrelated to fraud may also reduce the incentives on regulators to reduce the costs of those other activities.

Next steps

11. No specific action is required by the LSB other than publication later this year of its research into entry and exit barriers.

Panel recommendation 2: consumers should not be asked to source their own insurance

LSB response

12. We agree that consumers should not be required to source all their insurance.

13. However, we also agree with the Panel that consumers must bear some risk. Where there are gaps in the protection provided by compulsory PII requirements, we see merit in the development of "top up" products by insurers. We would

welcome a debate on whether it is appropriate in some cases (such as conveyancing) to place a cap on the level of compensation available so that purchasers of very expense properties are not subsidised by those buying less expensive ones. Again, if there was a need for "top up" products we anticipate that insurers would respond to that need. However, we recognise that more reliable data than currently exists is needed about the operation and cost effectiveness of the current system in order to evaluate possible alternatives.

Next steps

14. No specific action required by the LSB.

Panel recommendation 3: Approved Regulators should be required to collect more comprehensive data on financial protections, especially in relation to compensation funds. Data should be published in an accessible and timely manner.

LSB response

15. The LSB agrees that regulators should have comprehensive data on claims for, and grants of, compensation. Without this information, they will not have a comprehensive analysis of potential risks to consumers. Data in summarised form should be published in order to aid consumer understanding of the nature of compensation arrangements. We regard this type of management information as an indicator of the overall competence and capacity of the regulator as well as an important factor in developing its risk assessment framework. However, we do not agree that it would be a proportionate use of our statutory powers at this stage to require regulators formally to collect the data.

16. Regulators should also have in place rigorous audit controls for their compensation arrangements. In addition, we consider that the cost of administering compensation arrangements needs to be in the public domain; it can then be weighed against the value of grants made in order to inform decisions about alternative arrangements. Publicly available information should also include whether (and how much) compensation arrangements are used for other activities such as funding intervention costs, paying for shared services and other administrative/staffing costs or the payment of Ombudsman awards.

17. In terms of PII, we consider that regulators and insurers must have appropriate information sharing agreements in place (see recommendation 6). But, as with compensation arrangements, we do not agree that we should require regulators to collect this information; we regard this type of management information as an indicator of the overall competence and capacity of the regulator as well as an important factor in developing its risk assessment framework.

Next steps

18. We consider the appropriateness of regulators' management information as part of our work on regulatory standards. That work also includes the extent to which regulators have developed risk-based approaches to regulation, an element of which is understanding what leads to payment of PII and compensation claims. An understanding of – and transparency about – the costs incurred in administering compensation schemes is also essential for an effective regulator.

Panel recommendation 4: a set of key performance indicators should be developed for compensation funds, and assessment should then be made against these

LSB response

19. The LSB considers that regulators should develop their own key performance indicators for the operation of their compensation arrangements. These should be reported regularly to their senior management and Board and be published. Regulators may want to discuss with each other the best way to ensure that consumers can compare performance of different arrangements between regulators, although this may not be a relevant consideration for many consumers. However, we will explore with regulators whether it would be appropriate for standardised data to be collected.

20. We also agree with the suggestion[6] that regulators should set out broad objectives for financial protection arrangements in order to assess their effectiveness.

Next steps

21. We consider the appropriateness of regulators' management information as part of our work on regulatory standards. That work also includes the extent to which regulators have developed risk-based approaches to regulation, an element of which is understanding what leads to payment of claims for compensation. We will consider as part of all future rule change applications concerning financial protection arrangements the appropriateness of the regulator's broad objectives for compensation schemes and the regulator's understanding of, and transparency about, the costs allocated to them. We will also explore with regulators whether it would be appropriate for standardised data to be collected.

[6] At paragraph 5.46 of the Panel's paper

Panel recommendation 5: the discretionary nature of compensation funds should be examined in greater detail, and research should be carried out with consumers who have gone through the process of making a claim

LSB response

22. The Panel has clarified – and we agree - that it is not practical for payments made under compensation arrangements to be anything other than discretionary. We also agree that much greater transparency is needed about how that discretion is exercised and the criteria used by decision makers in deciding whether to make compensation awards. The revised Regulators' Code[7] which will come into force in Spring 2014 requires regulators to ensure that their approach to their regulatory activities is transparent. This includes publishing a "set of clear service standards, setting out what those they regulate should expect from them". We consider that this principle should be extended to instances where consumers come into direct contact with regulators, such as when they make a claim for compensation. In particular, we consider it important that comprehensive information is provided about how the process works in practice, the likely time taken to assess a claim and what the level of compensation the consumer may get. A full explanation should also be provided at the end of the process about why an award has or has not been made and the value of it. It is also important that there is a way for consumers whose applications are refused or paid at lower value than their claim to request a review of the decision. It is likely that consumers' experience of making claims would be useful to inform regulators about how best to design their processes around consumers' needs.

Next steps

23. We will consider as part of all future rule change applications concerning financial protection arrangements the appropriateness of the regulator's information for consumers about how decisions on claims are made, the information provided with decisions about claims and the adequacy of review processes.

Panel recommendation 6: the LSB should encourage greater openness and joined-up working between Approved Regulators, the Legal Ombudsman and other actors in the financial protection field

24. The Panel's report sets out examples of what this could mean in practice. It says:

    - This could include the introduction of formal processes for information sharing between Approved Regulators themselves (such processes are already in place between regulators and insurers, as well as between regulators and the Legal Ombudsman)

[7] http://www.bis.gov.uk/brdo/regulators-code

- Existing information sharing channels should be used to better effect to improve intelligence gathering and any subsequent enforcement action.

This would help to stop problems before they reach the stage where financial protection measures are needed.

LSB response

25. We agree that regulators, insurers and the Legal Ombudsman should have processes in place to share information with each other and that these should be used to maximum effect by all parties. We consider that sharing information will help to identify activities, entities or individuals that pose an increased risk to consumers and the regulatory objectives and should therefore help regulators to identify where additional supervision (or enforcement action) may be needed.

Next steps

26. We consider the appropriateness of regulators' management information as part of our work on regulatory standards. That work also includes the extent to which regulators have developed risk-based approaches to regulation, an element of which is understanding what leads to complaints to the Ombudsman and the results of those complaints.

Panel recommendation 7: as part of the LSB's work on general legal advice we recommend attention is paid to the financial protections in place (if any) for those using unregulated providers. In particular, the Panel is concerned about the potential detriment to consumers when protections are not in place, or not adequately enforced

LSB response

27. Our work on general legal advice is not now being taken forward as a separate item of work. However, we have set out in our response[8] to the MoJ's review of legal services regulation proposals for:

- broadening consumers' right of access to redress for all legal services;
- developing the role of the Office for Legal Complaints to enable it to play this enhanced role; and

8 http://www.legalservicesboard.org.uk/what_we_do/responses_to_consultations/pdf/A_blueprint_for_reforming_legal_services_regulation_final_09092013.pdf

- breaking the link between redress and regulation to ensure that these additional consumer rights do not generate unnecessary further cost for firms.

28. Although this suggestion differs from the protections provided by PII and compensation arrangements for regulated providers, we consider that broadening consumers' right of access to redress for all legal services is a proportionate safeguard to the risks faced by consumers who use unregulated providers.

Next steps

29. No specific action required by the LSB.

Panel recommendation 8: we strongly recommend that the idea of centralised protection arrangements for all regulated legal advice providers is fully scoped, with attention paid also to the possibility of bringing unregulated providers (or those who currently have no financial protection arrangements) under the same umbrella

LSB response

30. As the Panel's report makes clear, it is not recommending that a single set of arrangements should be set up immediately without first understanding the potential impacts, both negative and positive. The recommendation is that such a scheme should be fully scoped in order to assess the costs and benefits, with consideration also being given to enabling voluntary membership by unregulated providers.

Compensation arrangements

31. We note that the Council for Licensed Conveyancers[9] (CLC) and the Council for Mortgage Lenders[10] support exploring the idea of a single compensation fund. It is for regulators to decide if they want to develop this proposal further. If they do, it may be appropriate to also consider different types of centralised compensation arrangements as alternatives to a fund. Data will also be needed about the costs and benefits of the current arrangements. Centralised compensation arrangements may have the advantage of removing the blanket compulsory nature of the current arrangements since membership of such a scheme could be based on the risk of fraudulent activity. This could remove the cross subsidies inherent in the current system, for example from firms that do not handle any (or handle only small) amounts of client money to those that handle large amounts.

[9] http://www.legalfutures.co.uk/blog/better-together
[10] http://www.cml.org.uk/cml/filegrab/cml-response-to-moj-call-for-evidence-legal-regulation-30-august-2013.pdf?ref=8791

32. We consider that in order to have merit, centralised arrangements must lead to lower costs, meet the transparency/KPI requirements discussed earlier and have explored whether risk-reflective contributions are desirable.

Indemnification arrangements

33. We are more circumspect about whether uniform PII requirements can work in a liberalising market, where insurers' decisions are based on risk (which is linked to what activity is being carried out). However, for firms wanting to change regulator, some sort of commonality of cover might help to overcome the barriers to exit created by the SRA's current successor practice rules and run off requirements.

Next steps

34. No specific action required by the LSB.

Other issues

35. Although not a specific recommendation, we strongly disagree with the Panel's suggestion to take a deposit from all newly opening firms that would be held against the cost of interventions and paid back to firms closing in an orderly manner to set off against the cost of runoff premiums. We consider that this would be an unnecessary – and potentially very significant - barrier to entry: there is no evidence that new entrant firms are more likely to lead to interventions than established ones, not least because they will, by definition, have moved through a more rigorous authorisation process than most existing players in the market. Firms that decide for themselves when to exit the market can also decide to put aside money to cover the runoff requirements. In addition, some regulators have the power to make rules requiring those they investigate to pay the cost of investigations and Schedule 14 to the LSA gives licensing authorities the power to recover the cost of interventions.