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Response to Legal Services Board consultation on ABS

This is the ABI's response to the Legal Services Board consultation on *Alternative Business Structures: Approach to Licensing*, published in November 2009. The views expressed in this response are not necessarily those of every insurer in the market, and individual insurers are not bound by the opinions expressed herein.

About the ABI

The ABI (Association of British Insurers) represents the collective interests of the UK's insurance industry. The Association speaks out on issues of common interest; helps to inform and participate in debates on public policy issues; and also acts as an advocate for high standards of customer service in the insurance industry. The Association has around 400 companies in membership. Between them, they provide around 90% of domestic insurance services sold in the UK. ABI member companies account for almost 15 per cent of investments in the London stock market.

Conclusions

The case for instituting a more modern and sophisticated approach to indemnity arrangements for ABS is clear. The system of indemnity for solicitors has significant flaws, and to replicate a flawed system for ABS would risk building in systemic weaknesses at the beginning of the process. The history of the solicitors' PII market tells us that those weaknesses re-occur.

This is an opportunity for the LSB to bring in some key changes that can ensure maximum consumer protection at the same time as complementing good regulatory practices and ensuring a sustainable and competitive insurance market.

We believe the indemnity arrangements for ABS need flexibility to reflect the diversity of the new business structures, and be adaptable in the light of early experiences.

We believe that policy limits should be set after more in-depth study, but do not necessarily need to be the same across all varieties of work, or across all regulators. This will provide the ability for insurers to be innovative and to make the market efficient.

We believe run-off arrangements must be more realistic and provide the right incentives to tackle fraud and dishonesty. Further careful consideration needs to be given to this.

We believe that claims for fraud and dishonesty should be paid through a compensation fund which protects the public, rewards the honest, and gives wider support to regulators, as well as makes insurance easier to price.

1 Background

1.1 The current insurance market for solicitors is undergoing its most stressful period since the open market was formed ten years ago. A combination of the economic crisis, regulatory weaknesses, and the minimum terms imposed on the market has led to a worsening claims environment for insurers, and very difficult times for many smaller solicitors' practices. This is illustrated in the rapid rise in firms falling into the Assigned Risks Pool, a tenfold increase in just two years.

1.2 Some of the biggest problems have stemmed from the most difficult parts of the minimum terms and the qualifying insurers' agreement:

- Fraud and dishonesty must be covered by insurers, despite the fact that these are almost impossible to underwrite
- The run-off provisions create a perverse incentive to keep bad practices in business
- There is no way to avoid a policy, even if the customer fails to pay premiums or the excess due under the policy
- The customer can misrepresent their business and history to the insurer, but the insurer cannot avoid the policy.

1.3 The need for changes to the system is clear and overwhelming. It cannot carry on in this way. In working for reform, the ABI has focused on a number of clear principles for change.

- Consumer protection must be paramount and not threatened by any changes – but it must be recognised that consumer protection is about preventing fraud and dishonesty as much as compensating when it happens.
- Change must give the right balance of incentives to solicitors, insurers, and regulators to fight fraud and malpractice.
- The best way to provide rapid compensation in a cost-efficient way is through an open market in insurance.

1.4 These principles are as true for ABS as they are for the general solicitors' professional indemnity market. We believe that the case for not simply replicating the existing policy is clear, and that new arrangements are needed to prevent a repeat of the crises of the late 1990s and 2000s.

2 Insurers and ABS

2.1 Insurers are enthusiastic about the potential for ABS, and they see an excellent opportunity to build a strong and stable market, if the regulatory framework is right. It will clearly be a complex market, encompassing a range of disciplines, and this will present many challenges for underwriters particularly. Understanding the work of each ABS in the many different forms that they will take will be the initial challenge.

2.2 This diversity will therefore need to be reflected in the indemnity arrangements. One of the weaknesses of the existing solicitors' minimum terms and conditions is the fact that it does not make allowances for the existing diversity of the profession. A massive City law firm buys much the same policy as a sole practitioner in a rural setting. Arrangements for ABS will therefore need to be flexible and adaptable to changing circumstances.

2.3 Furthermore, the indemnity arrangements ought to build in the right incentives for all concerned to support good regulation. Insurers are not regulators and do not wish to be. They can support regulation through risk assessment and management, and information sharing where appropriate. However, a system which sustains the dishonest cannot work to anyone's benefit, especially the customer. That is why it is so important to break apart the terms of the policy as they apply to fraud and run-off.

2.4 The most negative aspect of the solicitors' policy is that which states that an insurer will pick up six years of mandatory run-off for a firm which closes during the period of insurance. This removes the incentive that insurers have to report and take action on firms suspected of fraud. We believe that this risk is unacceptable. It gives a fear of catastrophic losses to insurers, it keeps bad practices running, which in turn creates more damage to the customer. We set out below how this must change.

2.5 ABI is currently finalising its detailed proposals for change. These will be published shortly. In the meantime, our approach to indemnity arrangements for ABS is set out below, as per the questions asked in the consultation paper.

3 Answer to Specific Questions

3.1 **a. How should an appropriate level of PII be set for ABS that are carrying out a variety of different activities, not all of which are currently regulated by the ARs?**

A flexible approach needs to be adopted. While it is true that some apparently low-risk activities can result in significant losses, a uniform approach could lead to a lack of insurance innovation and potential cost issues.

We certainly do not want to risk under-insurance. However, a common sense approach would be best. Given what we know about the history of PII claims for solicitors, we would recommend that limits are set after further study, and set appropriate limits, differentiated by activity.

3.2 **b. Should there be minimum PII levels, which are not the same for all LAs for different types of activity?**

Minimum levels are usually set in compulsory classes of insurance to avoid the obvious problems. As for the answer to question (a) above, flexibility is sensible. Further study should highlight where losses historically arise, and where the risks merit higher limits.

3.3 **c. Are Master policy arrangements appropriate for ABS?**

It is unlikely that Master Policy arrangements would provide the freedom of choice and efficiency that an open market solution provides. Insurers are more adaptable to changing circumstances, when permitted to be so, and strong competition provides value to the market.

3.4 **d. What would be appropriate arrangements for run-off and successor practices to enable sufficient protection for consumers after practice closure?**

Run-off arrangements are important. They can present a barrier to entry and exit from the market for insurers, which in turn creates inefficiency. We have set out

above why we believe that the current run-off arrangements for solicitors are not appropriate.

Clearly, the majority of legal practices are honest and do not present the kind of risk we have illustrated. For them, run-off is a normal part of closure. Whether six years of run-off is needed could be determined by a study of previous claims and by looking at other professions' run-off arrangements. Consumers have a right to expect high levels of protection, but there is no need to 'gold plate' the requirements for ABS.

We are currently looking at different run-off options, which might include different systems for different types of practice, or treating those businesses that close in a disorderly fashion differently from those that close without problems.

3.5 **e. What should the requirements be for compensation funds in ABS?**

We believe that compensation funds play a key role. We would support the existence of compensation funds for ABS in very specific, well defined areas. We see the main role as paying fraud claims.

It is a matter of great concern that fraud and dishonesty must be covered by insurers. There are three compelling reasons to end this situation:

- It is impossible to underwrite for fraud
- There is a disincentive for insurers to investigate fraud and thus prevent it happening again
- It would provide an incentive for the profession to regulate itself better

Fraud cannot be a part of normal underwriting considerations because, by its very nature, it is extremely difficult to assess the chances of it being committed. Underwriting relies on the principle of 'utmost good faith', whereby the customer answers questions about themselves and their business honestly, and the underwriter uses his judgement to set a premium which reflects the risks to the business. Clearly, a person who has committed or intends to commit fraud or some other form of dishonesty will not disclose this to the underwriter.

This is highly serious and prejudicial to the operation of the market as it means that the risks across the market are not being correctly priced. Insurers may have to 'guess' the extent of fraud in order to price it into premiums. This may mean that some firms are paying too much for premiums and others too little. Insurance costs ought to reflect the risk of foreseeable events, not criminal acts.

A further negative impact is that insurers have little choice but to apply their knowledge of the types of firms who do commit fraud to other, similar firms. This can lead to accusations of discrimination, which are not justified, but are understandable based on the fact that fraud is not a normal underwriting consideration.

Under normal circumstances, a suspicion of fraud or dishonesty by the insured customer would trigger an investigation and possible civil or criminal action. Across other classes of insurance this is usual. In the solicitors' market, insurers could leave themselves open to the compulsory six years of run-off cover if the firm closes due to a conviction for fraud. It is evident that one count of fraud means that others are possible. No insurer would knowingly allow this scenario to come about. The result is that all too often insurers have no choice but to try to rid themselves of the bad risk through underwriting.

This is damaging for both insurers and the profession, as it means that the fraudulent individual can remain active, doing more damage to consumers and their profession.
Too many solicitors or conveyancing clerks find it easy to commit fraud and move around the profession once discovered. Some later appear as unadmitted fee earners. The disincentive for insurers to investigate, as well as a lack of regulatory checks and risk assessment, help to facilitate fraud. Were systems to be changed, we could see a shift towards full investigation and prosecution of those most culpable.

Where the costs of fraud are left wholly with insurers, there is no incentive for the profession itself to bear down on fraud. Solicitors' firms do pay the costs indirectly through the pricing of the policy, although as stated above, that pricing cannot be entirely accurate. If the costs of fraud were highlighted and made clear, we would see greater desire of the profession to reduce the costs through dealing with poor solicitors.

We envisage claims for fraud being paid from a Compensation Fund, funded through a levy on ABS firms. This has a number of distinct advantages:

i. It provides consumer protection through ensuring compensation is available and also helps to prevent fraud.
ii. It makes the costs of fraud clear rather than hidden, incentivising the reduction of fraud and emphasising the advantages for the profession in its reduction.
iii. It provides an incentive for insurers to investigate and report fraud or suspected fraud, and therefore help to reduce its impact and extent, preventing further fraud.
iv. It makes premiums more accurate, benefitting well-run firms who identify and manage the risks to their business well.

3.6 **f. How could a compensation fund work in an ABS environment, in particular when the services offered by the ABS may be much wider than legal advice and where an AR may not currently have a compensation fund?**

Setting out clearly the scope of a compensation fund would make it clear to all those taking up the ABS option when and why the fund would be used. We would not wish the fund to be a barrier to entry for those wishing to be an ABS, and it could be viewed as an extra cost to the firm.

The key point is that where fraud is included in the indemnity arrangements, the participants will ultimately bear the cost of fraud through higher premiums. And this cost cannot be easily controlled where the problems of mandatory run-off, as set out above, exist.

The choice is therefore clear, either the participants pay for fraud cover through insurance premiums, or they pay through a transparent compensation fund where success in reducing fraud can be demonstrated.

It would not be overly bureaucratic to set up compensation funds when they do not currently exist, and running costs would be linked to caseload. Regulators could share many of the functions necessary to run compensation funds, while not harming the integrity of their own fund.