Solicitors Regulation Authority

SRA financial protection policy statement

We are currently consulting on the implementation of this policy for October 2012. Read more

19 April 2011

The statement below was approved by the SRA Board on 13 April 2011.

Introduction and purpose

1 This statement sets out the SRA's policy for client financial protection for the period to 2014. It covers

- changes that will be made to the PII requirements for the 2011/12 indemnity year,
- changes that will be made to the PII requirements for the 2012/13 and 2013/14 indemnity years subject to further discussion and consultation on a number of detailed issues,
- changes to be considered to the SRA's Compensation Fund arrangements, and
- work that will be undertaken by the SRA in other areas of its responsibilities which have a direct bearing in the arrangements for client financial protection.

2 These decisions have been reached following the independent review of client financial protection undertaken for the SRA by Charles River Associates (CRA) in 2010 and the extensive consultation undertaken by the SRA on its own client financial protection reform proposals published in December 2010.

3 The primary purpose of these arrangements is client protection. However, they affect a wide range of stakeholders, including authorised bodies, individual solicitors and insurers—and it is important that the SRA provides clarity about the development of these arrangements over the next three years in order to allow all stakeholders to plan and make robust business decisions.

4 In reaching these decisions, the SRA has had regard to the statutory requirements set out in the Legal Services Act 2007 (LSA). These are as set out below.

S.28 of the LSA provides,

> (1) In discharging its regulatory functions (whether in connection with a reserved legal activity or otherwise) an approved regulator must comply with the requirements of this section.
> (2) The approved regulator must, so far as is reasonably practicable, act in a way
> (a) which is compatible with the regulatory objectives, and
> (b) which the approved regulator considers most appropriate for the purpose of meeting those objectives.
>
> (3) The approved regulator must have regard to
> (a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and

(b) any other principle appearing to it to represent the best regulatory practice.

The regulatory objectives are set out in s.1 LSA,

> (1) In this Act a reference to "the regulatory objectives" is a reference to the objectives of
>
> (a) protecting and promoting the public interest
>
> (b) supporting the constitutional principle of the rule of law
>
> (c) improving access to justice
>
> (d) protecting and promoting the interests of consumers
>
> (e) promoting competition in the provision of services within subsection (2)
>
> (f) encouraging an independent, strong, diverse and effective legal profession
>
> (g) increasing public understanding of the citizen's legal rights and duties, and
>
> (h) promoting and maintaining adherence to the professional principles.
>
> (2) The services within this subsection are services such as are provided by authorised persons (including services which do not involve the carrying on of activities which are reserved legal activities).
>
> (3) The "professional principles" are
>
> (a) that authorised persons should act with independence and integrity
>
> (b) that authorised persons should maintain proper standards of work
>
> (c) that authorised persons should act in the best interests of their clients
>
> (d) that persons who exercise before any court a right of audience, or conduct litigation in relation to proceedings in any court, by virtue of being authorised persons should comply with their duty to the court to act with independence in the interests of justice, and
>
> (e) that the affairs of clients should be kept confidential
>
> (4) In this section "authorised persons" means authorised persons in relation to activities which are reserved legal activities.

We have also to have regard to our statutory duties under the equalities legislation and an equality impact assessment (EIA) is published alongside this statement.

5 The SRA's client financial protection arrangements have two elements:

- a compulsory requirement on authorised bodies to have Professional Indemnity Insurance (PII) which meets minimum terms set by the SRA to ensure that client claims in respect of negligence and, in certain circumstances, dishonesty can be met. These arrangements also protect clients in the same circumstances where the body against which a claim lies has not obtained the required PII;
- coverage for all authorised bodies by a Compensation Fund (contributions to which are collected from recognised bodies and practising solicitors) which has the discretion to compensate clients who can demonstrate hardship from a body's failure to account for client money or from fraud.

6 This paper addresses both of these elements in turn and sets out the decisions we have reached on each as against the statutory requirements on the SRA set out above. It is important, throughout, to note that both sets of arrangements provide redress when something has gone wrong. Alongside the reforms set out in this statement the

SRA is implementing major reforms to the way it regulates which we believe will further address and reduce the causes of claims arising in the first place – an outcome immeasurably better for clients than receiving recompense at some later date.

Professional Indemnity Insurance

Available mechanisms

7 There are only three mechanisms through which the SRA can ensure that a scheme of compulsory indemnity insurance is in place in the public interest and in the interests of consumers. These are:

- open market insurance obtained through a master policy, covering all authorised bodies, the cost of which is met through a levy on all authorised bodies (referred to as master policy),
- a mutual indemnity fund, again, with the cost met through a levy on all authorised bodies (referred to as indemnity fund), or
- an open-market scheme where individual authorised bodies procure their own PII from the insurance companies in the open-market (referred to as open-market).

Decision to retain open-market approach and risks to its continued viability

8 For the reasons that have been set out in the CRA Report, the SRA's December consultation and the SRA's response to the consultation, our decision is that the open-market system best meets the regulatory objectives. All systems are capable of providing the required level of client protection. However, the open-market system provides PII

- at a lower overall cost to authorised bodies (with consequential benefits to the consumers of legal services),
- in a way which supports good risk identification and management in individual authorised bodies, and
- in such a way that the cost of PII to each individual authorised body is related to the level of insurance risk they present.

The alternative approaches (master policy and indemnity fund) do not have these characteristics.

9 In order for the SRA to mandate the open-market approach it is necessary for us to be confident that there will be a robust and competitive market willing to provide PII to solicitors on the minimum terms deemed necessary by the SRA to ensure the appropriate level of client protection. If such a market does not exist, it would be necessary to switch to one of the two alternative approaches; notwithstanding the fact that such schemes do not have the benefits identified at paragraph 8 above, and the fact that there have been significant difficulties with the operation of such schemes in the past.

10 From the SRA's and CRA's analysis, from the responses the SRA has received to its consultation and from direct engagement with stakeholders, the SRA has decided that the current arrangements specified by the SRA are causing significant problems in the operation of the open-market approach. The current arrangements are leading to unwillingness on the part of insurers to provide PII, or to restrict their participation to a limited volume of business or only to certain types of firm. For many authorised bodies there is effectively a choice between only two or three insurers. The indications are that, without change in the arrangements, this situation will not improve and will, in fact deteriorate further; probably to the point where there is no alternative but to revert to a master policy or indemnity fund system due to a lack of open-market provision. Given this, the SRA has decided that changes to the arrangements are essential not only to improve the competitiveness of the open-market arrangement but also to ensure its continuation.

11 There are a number of factors that are causing problems. These are problems which impact directly on the insurers, although the results of these problems (because they impact on the availability and cost of insurance) manifest themselves in problems for authorised bodies and would ultimately, if unresolved, manifest themselves in problems for clients wishing to make a claim. This consequential impact, through firms onto consumers who require the protection afforded by PII is of the greatest concern to the SRA.

12 The most significant problems in the current arrangements are:

- the cost to insurers of the ARP (arising from cost associated with ARP policies of qualifying insurance, the provision of run-off cover for firms that closed whilst in the ARP and claims in respect of firms without qualifying insurance),
- the unpredictability of the cost of the ARP,
- the unlimited liability qualifying insurers assume for the ARP, including costs that should have been met by any other qualifying insurer in the circumstance of that insurer becoming insolvent, and
- the scope of the minimum terms upon which all qualifying insurance must be provided, including
    - the fact that the scope of cover cannot be varied, i.e. in terms of the type of business and clients covered, even if this might be desirable in individual cases for both insurer and insured. As insurers can only provide insurance on the basis of the full minimum terms and conditions (MTC) this means that some authorised bodies will not be able to obtain cover at all, and means insurers will have to meet claims for work of the type that an authorised body might have declared that it was not undertaking;
    - insurers are effectively underwriting losses arising from dishonesty within an authorised body, even if that dishonesty was undertaken by the insured owners/managers, as long as there is at least one innocent insured owner/manager. Claims arising from dishonesty related to property transactions have become a major element of claims being met by insurers; and
    - insurers are not permitted to cancel or revoke policies on the basis of fraud or misrepresentation in the information provided in proposal forms or for non-payment of premiums.

13 The current arrangements provide comprehensive protection to clients (and any revised arrangements must maintain this) and have the benefit of simplicity, in that all authorised bodies have the same minimum level of PII cover. In addition, they place the liability for certain types of loss on insurers rather than, as might be the case, the Compensation Fund. Despite the apparent benefit to recognised bodies as a result of some types of claim being paid by insurers rather than by the Compensation Fund, it is important to note that, ultimately, all claims have eventually to be borne by authorised bodies (either directly through the Compensation Fund or indirectly through the level of PII premiums being paid to insurers). As set out in the SRA's consultation paper, it is economically less efficient for claims that might be met by the Compensation Fund to be met indirectly by insurers as PII premiums attract brokers' fees and insurance premium tax; whereas payments to the Compensation Fund do not.

14 As we have identified (at para. 10 above) the SRA's clear view is that, collectively, the issues set out at paragraph 12 are constraining the proper operation of the open-market system for PII. If unchanged, the open-market system will become unviable through further withdrawals by insurers from the market, a lack of new entrants and the artificial constraint by existing insurers willing to remain in the market of the volume of business and the types of firm they are prepared to underwrite. Much of this is driven by a business need to limit exposure to the costs of the ARP.

15 This move to unviability will be accelerated by the implementation by the FSA at the beginning of 2013 by the pan-

European Solvency II requirements. The Solvency II requirements may well make the continuation of the ARP in its current form unviable for qualifying insurers. The fact that insurers' liabilities for the ARP are open-ended, unquantifiable, are not in their direct control and are unpredictable may well restrict the management model they will be able to adopt against the Solvency II requirements, with the result that they would have to make far higher capital provisions for the ARP. In our view this may well lead current insurers to exit the solicitor PII market in order to transfer capacity to less capital-hungry markets and, for the same reason, discourage new entrants.

Changes necessary to maintain viable open-market arrangements and improve availability and competition within them

16 Given the above, the SRA has considered the changes to the current arrangements that are available to put the open-market system on to a sustainable basis for the medium-to-long term in the interests of clients and in the context of the regulatory objectives to which the SRA must have regard. The SRA has considered the range of factors that might, either in isolation or together, be varied such as to achieve both the necessary level of client protection and a long-term viable open-market PII system. This consideration has included:

- the continuation of the ARP in its current or some modified form,
- the funding mechanism for the ARP, should it continue;
- the scope and variability of client and activity coverage,
- the scope of coverage for claims arising from fraud or dishonesty, and
- the inability of insurers to cancel or revoke policies for misrepresentation or non-payment of premiums.

17 In the light of this analysis, considering all of the review material (including CRA's report and the responses received to the consultation) and the discussions we have undertaken with stakeholders, the SRA has decided that the priority issue to be addressed is the ARP. This is the single issue that is causing the greatest level of distortion in the operation of the open-market PII arrangements and which must be addressed before the Solvency II provisions are implemented in early 2013. The majority of responses to our consultation argued in favour of closing the ARP, including insurers and the Law Society.

18 In taking this view, and before setting out the details of how the SRA intends to take this issue forward, it is important to address two issues that were raised by some respondents to the consultation.

19 It has been argued that, without an ARP, it is insurers who decide whether a firm should be allowed to practise rather than the SRA and that this is inappropriate. The SRA does not agree with this view. Any regulated business must meet a wide range of regulatory requirements and normal economic business requirements if it is to continue to operate. The SRA's remit in this area is to set out the requirements of practice to ensure that clients are financially protected. It is the firm's responsibility to ensure that it can meet those requirements as well as meeting the normal requirements of business. Should a firm not be able to obtain PII then, in the SRA's view, it is not a regulatory responsibility to create and manage alternative PII arrangements to enable a firm to stay in business. By analogy, for a firm to operate it needs to obtain banking and finance facilities. Should no bank be willing to take a firm on, it is not the regulator's role to step in and provide finance. The SRA is satisfied that it is consistent with its role and with the regulatory objectives to require PII at the level necessary to ensure client protection without operating an "insurer of last resort" mechanism provided that clients are properly protected.

20 As shown by the EIA to be published as part of our response to consultation, it is clear that BME firms are over-represented in the ARP. The SRA Board has had regard to this issue in reaching its decisions. It is important to note that the ARP does not provide long-term PII for firms that are unable to obtain open-market cover, but provides insurance for one year in order

- to ensure clients are protected from the disorderly closure of a firm in a matter of days (following the point at which it is clear to the firm that insurance cannot be obtained), and
- to give time for the firm to plan and accomplish orderly closure or to obtain cover on the open market.

21 The statistics show that majority BME owned and controlled firms are disproportionately represented in the ARP when compared to majority white owned and controlled firms. What is not clear from the statistics, or from the other information available, are the reasons for these disproportionate outcomes. Despite this having been an issue of considerable attention for the SRA, firms and representative bodies over the past two years, no instance of direct discrimination on the part of an insurer has been identified to the SRA.

22 The generally accepted view is that the operation of the underwriting criteria used by insurers is resulting in indirect discrimination against BME firms. At one level, it is relatively easy to see how this might be the case. We know that BME firms are, for example, proportionately over-represented in the population of small firms, concentrated in major conurbations and are more likely to undertake certain categories of business. If underwriting criteria categorise such factors as being of relatively higher risk (than, in these cases, large firms, firms practising outside of major conurbations and those undertaking other areas of business) then PII will be relatively more costly to such firms or, on occasion, unavailable.

23 Where such indirect discrimination arises as a result of the operation of underwriting criteria, it is for each insurer to demonstrate that it has had regard to the impact of the criteria in the context of its duties under the law and is able to justify them notwithstanding any indirect discriminatory effect that might result from their operation. The ABI is working with qualifying insurers on this issue and they are liaising with their own regulator, the FSA, and the EHRC in doing so. They are also engaged with the SRA and the Law Society as they progress this work. The SRA will continue to provide whatever assistance it can to the ABI and insurers on this issue and encourage them to complete it and publish the outcome promptly and to take any action required as a result.

24 The SRA's view is that the maintenance of the ARP in its current form is not the correct response to the current disproportionality in the ARP as, notwithstanding the other factors which we accept as requiring its fundamental reform, its maintenance does not represent the best policy outcome for BME firms.

25 Alongside the conclusion of the work being undertaken by insurers and the ABI on the risk factors used in underwriting, the great majority of BME firms are likely to be best served by a more open and competitive market for PII so that they can obtain open-market cover at appropriate premiums (ARP premiums are relatively higher than open-market premiums). Statistically, BME firms are disproportionately in the small firm category (one to three partners). It is this category of firms for which choice of insurer is most constrained. At present there are only three insurers providing policies for this type of firm, and it is in this category where a future constriction of the market (if it remains unreformed by the SRA) is likely to be felt soonest. Given this, the reforms we are planning to the ARP and other aspects of the PII arrangements are most likely to benefit small firms by the introduction of increased capacity and competition in this market sector.

New open-market arrangements

26 The SRA is setting out on a programme of reform which will address the issues arising from the ARP between October 2011 and October 2013. This will involve the ending of the ARP at October 2013 and its replacement with a mechanism to enable firms unable to obtain open-market cover to close in an orderly fashion and to ensure clients are protected. Our view is that the implementation of these arrangements will create conditions that increase the likelihood of existing insurers remaining in this market, the number of new insurers entering the market and the level of competition for business between them.

27 Managing the transition from the current arrangements to the new ones will require us to maintain the single renewal date and the indemnity year (1 October to 30 September) approach that we have now. However, we intend to remove the annual renewal date once the new arrangements are in place in 2013.

28 Our plans for the new scheme will operate from October 2013 but be foreshadowed in the Solicitors Indemnity Insurance Rules (SIIR) and Qualifying Insurers Agreement (QIA) which will come into force in October 2012. These plans draw heavily on proposals made by the Law Society in the course of the consultation period and we are grateful to the Law Society for its work and assistance on this issue. These arrangements, which we refer to as the Extended Policy Period (EPP), will mean that when insurers and authorised bodies enter into annual PII contracts in October 2012 they will do so on terms that will enable the new arrangements to operate in October 2013.

29 In September 2013, any authorised body that is unable to obtain new PII for the period from 1 October 2013 will not have the option of entering the ARP as the ARP will at that point cease to be a provider of policies of qualifying insurance. Instead, the authorised body will have the option of triggering a policy extension with its existing insurer for a period of 90 days (with an additional premium payable based, pro rata, on the previous year's premium).

30 During the first 30 days of this period the authorised body will be able to continue to take new instructions and, if it is able to obtain open-market insurance, back date the cover to 1 October. In the second 60 days, the firm will not be permitted to take new instructions and will be expected to focus on achieving an orderly close down within that period.

31 Throughout this period, the previous year's insurer will provide cover for work undertaken under the policy extension. If the authorised body is unable to obtain alternative PII cover within this 90 day period and closes, run-off cover will be provided by this same insurer for the six year period commencing on the date (in this instance 30 September) on which the original policy expired. The authorised body will be charged a premium for this run-off cover as is already the case.

32 These arrangements will achieve the policy objective of ending the ARP as a provider of policies of qualifying insurance, continue to protect clients (from sudden and disorderly closure, possibly with no PII cover in place) and provide authorised bodies with a period of 90 days following the end of an insurance policy to either obtain insurance or close in an orderly fashion.

33 In many respects these arrangements will not be wholly new for insurers to manage as under the current arrangements they are obliged to provide run-off cover to any firm they insure and which closes during that period of insurance. However, insurers will now need to take account of the fact that should an insured authorised body be unable to obtain insurance with a new insurer at the end of the period of insurance, the insurer will have to provide run-off cover as there will be no possibility of the authorised firm entering the ARP even for a very limited period, and therefore triggering run-off with the ARP instead. Although therefore this situation will not be wholly new to insurers, it will inevitably lead them to review their risk assessment and underwriting criteria.

34 In the proposals published by the Law Society as a part of its consultation response it advocated that insurers provide authorised firms with information—up to 90 days before the end of a policy of insurance—on whether they were prepared to renew the insurance and if so, on what terms. The SRA agrees that, in moving to this system, it would assist its operation if insured firms were clear as early as possible about whether their existing insurer was willing to renew their policy. Having considered the proposal and discussed with insurers we believe that this issue requires further discussion. Therefore we intend to discuss and consult further on this issue before reaching a final decision on the detailed requirements that will be implemented via the SIIR and QIA for 2012/13.

35 With the implementation of these plans, there would remain just one other role for the ARP that is unaffected. This is the role played by the ARP in meeting claims made against "non-applied" firms, i.e. authorised bodies that have failed to obtain the required PII or, indeed, non-authorised bodies purporting to be authorised bodies. At present, the

qualifying insurers meet the costs of such claims through the ARP and the extent of that cover is the same as the MTC applying to properly insured and authorised bodies. In 2008/09 the cost of meeting these claims came to £2.4m.

36 It is our intention to change these arrangements for the following reasons:

- We consider that the scope of cover for these claims is too wide. For example, for sophisticated users of legal services, even the most cursory checks with a "firm" would be sufficient to establish that the "firm" was both authorised by the SRA and insured. However, we accept that for ordinary members of the public it is not necessarily the case that they would understand the need for, and be able to make, such checks.
- It is not apparent that paying these claims should properly be considered to be insurance payments rather than compensation for some wider regulatory failure (e.g. to ensure that an authorised body had obtained the required PII), or dishonesty (i.e. a decision by a solicitor to hold themselves out to be an authorised body or as having PII when they did not).
- When we remove the remaining functions of the ARP it would be disproportionate to maintain and resource the infrastructure necessary to manage an ARP (including assessing qualifying insurers' market share for the purpose of apportioning ARP costs) to meet such a low level of claims.

37 For these reasons we will review the scope of this cover and consult on transferring the responsibility for meeting such claims to the Compensation Fund prior to the 2012/13 indemnity year.

38 We have referred (at para. 28 above) to the need for the arrangements that will apply in October 2013, to be foreshadowed by specific provisions in the SIIR and QIA for 2012/13. In reaching the views the SRA has about the long-term arrangements that should apply from that point we have considered the immediate changes to the arrangements that should apply in 2011/12 in the context of our consultation on our specific proposals for that year set out in our consultation paper and the responses made to it. We have also looked backwards from October 2013 to consider how a smooth transition to the new arrangements can best be achieved. As a result we have decided on a transition plan covering the periods 2011/12, 2012/13 and 2013/14. This plan is consistent with both

- the firm decisions the SRA has made (having regard to the outcome of consultation) for 2011/12 which we consider both to be justified in their own right and consistent with the transition to the 2013 arrangements, and
- a managed transition that will enable the smooth implementation of the 2013 arrangements whilst maintaining a viable open-market insurance scheme throughout this period.

39 Attached at Annex A is a diagram that summarises the transition period. Set out below are details of the system that will operate at various points in the transition and the areas on which we will be undertaking further analysis and consultation as the transition progresses.

Transition—2011/12 indemnity year

40 In the light of the consultation, the responses received and our consideration and analysis of those responses the SRA has decided to make the following changes to the indemnity insurance arrangements for 2011/12. The analysis underpinning these decisions and the rationale for them are set out more fully in the separate consultation response document. The SRA is satisfied that these changes, justified on their own merits, are also consistent with the transition to the 2013 arrangements. The changes are:

- a reduction in the permitted period in the ARP from 12 months to six months. This decision is necessary to control and reduce the cost of the ARP, increase our ability to close firms that we regard as high

regulatory risk (we rate fifty per cent of ARP firms as high regulatory risk) and provide a transition path towards 2013. In addition it is important to provide real clarity to all stakeholders that the market problems arising from the ARP are recognised and are being addressed. This change will not affect the key purpose of the ARP, i.e. client protection;

- the introduction of requirements on firms in the ARP to plan and implement arrangements to address the issues that have led to a failure to obtain open-market cover, and to obtain such cover, or to close in an orderly manner;
- removing the liability on qualifying insurers to meet the ARP liabilities of any other qualifying insurer becoming insolvent;
- changes to the qualifying insurers agreement to clarify the reporting responsibilities of qualifying insurers to the SRA, and
- ensuring the SRA has the ability to make public the insurer providing minimum terms cover to any firm.

41 The basis on which the SRA has reached these decisions is set out fully in its response to the December consultation. In addition, they are consistent with the changes planned for 2012/13 and 2013/14.

42 Of the other two significant changes proposed for October 2011 in the consultation paper, the SRA will not be proceeding with these at this stage. We plan, however, to remove the compulsory single renewal date from October 2013, once this transition programme has been implemented.

43 With regard to the permitted exclusion from the MTC for work done for financial institutions we have set out in section 4 of this paper a wider range of work that the SRA will be undertaking including our review of the regulation of conveyancing and the holding of client money. We plan to complete this wider review work, which will address the reasons why property transactions give rise to such a high proportion of claims arising from negligence and dishonesty and the regulatory steps that might be taken to address this, before returning to the scope of insurance coverage. There remain strong arguments for permitting greater flexibility for authorised bodies and insurers in the insurance arrangements and we will continue to examine this matter, although given the focus on the reform of the ARP we would not expect to be in a position to implement any such changes before 2014.

Transition—2012/13 indemnity year

44 The detail of the SIIR and QIA for the 2012/13 indemnity year will be the subject of a consultation process that will commence in mid 2011. The 2012/13 year is the earliest point at which we can put in place the arrangements necessary to replace the ARP with the EPP provisions at the end of the year. The QIA and SIIR will need to make provision for:

- any requirements on an insurer to provide firms that they insure with a decision on whether they will renew the existing insurance, and the terms on which this will be offered, at a set point before the current insurance ends. In their proposals, the Law Society suggested a three-month period but insurers have indicated that they believe this to be impractically long. The SRA will need to undertake further discussions with stakeholders on this issue.
- the period for which an insurer is obliged to extend a 2012/13 insurance policy if an insured authorised body is unable to obtain PII for October 2013, the terms applying to that extension, the premium payable and the scope of the work to be covered.

45 As the new EPP provisions will not come into being until October 2013, we have had to consider the arrangements that should apply for the ARP in 2012/13. Our view is that entry into the ARP should be available to firms in October 2012—even though there was a strong view in the consultation responses in favoured of ending the ARP. In consultation responses, some have made the case for further restrictions to be placed on ARP, for example in terms

of the scope of work that they might be permitted to undertake or restrictions on their ability to hold client money. As part of the consultation on the detail of the arrangements to apply in 2012/13 we will consider these issues further.

46 Given our assessment of the health of the open-market insurance arrangements, there are risks associated with maintaining the ARP as a provider of policies of qualifying insurance in 2012/13. However, the timetable necessary to implement these changes and to enable all stakeholders, including solicitors and insurers, an appropriate period of time to plan for their implementation means that the timetable is unavoidable.

47 For insurers, the nature of the risks they will be assuming and pricing under the EPP arrangements will be different than for the current arrangements. Therefore, there needs to be a full year's lead in to them (i.e. when insuring a firm in October 2012, the insurer will be doing so on the basis that the EPP arrangements will apply at the end of that year).

48 For solicitors, there will need to be a greater focus on risk management and control and the management of the solicitor/insurer relationship as a failure to obtain open-market PII will result in a movement into the EPP mechanism rather than an ARP.

49 As has been set out above, the need to maintain the ARP as a provider of policies of qualifying insurance is inevitable given the transition timetable but this presents risks to the continuation of a competitive insurance market. These risks are heightened by the planned implementation in January 2013 of the Solvency II requirements.

50 Given this, we plan to mitigate these risks in two ways.

51 First, we would intend to remove one of the elements of client protection currently provided by the ARP and provide for its coverage by the Compensation Fund which, in any event, is the more appropriate source of cover. This is the mechanism under which the ARP pays for claims made against uninsured firms on the same basis as if they were insured under the MTC. In making this change, on which we will consult, we will wish to examine the scope of the coverage provided by this mechanism. At present claims are paid in respect of authorised firms that have not taken out insurance and non-authorised firms purporting to be firms of solicitors. Given this, it is not apparent that all claims should automatically be paid as against the MTC provisions and it is possible that a discretionary system, as applying in the Compensation Fund might be more appropriate.

52 In addition, were this change to be implemented, the replacement of the ARP with the EPP arrangements, would, from 2013/14 remove the need to construct and manage a mechanism to assess each qualifying insurer's market share in order to apportion ARP funding. This would remove a current incentive on insurers to constrain or manage their market share which, we believe restricts and distorts competition to the disadvantage of authorised bodies and their clients.

53 The second significant change we plan for the 2012/13 ARP is the mechanism through which any shortfall (of premiums paid as against claims made) is met. At present this is met by the qualifying insurers. As we have set out above, we believe that we will not maintain a viable and competitive open-market system of insurance if this continues, particularly once the requirements of Solvency II are introduced at the beginning of 2013. For these reasons we plan that in 2012/13 the shortfall will be jointly funded by insurers and the profession. The detail of these arrangements will be covered in the forthcoming consultation. However, subject to that, our current view is that this will be done such that the first £10m of the shortfall is met by the profession, the next £10m by insurers (each in proportion to their market share) and that this layering should continue up to £50m. Any amount above that would be met by the qualifying insurers.

54 This arrangement will provide insurers, in 2012/13, with, in real terms, a capped liability for the ARP as at no point in its history, even in the years of heaviest claims (2008/09 and 2009/10) has the level of the shortfall exceeded £50m. The most significant variable in the total cost of ARP claims is the economic cycle and we entered the current cycle

(in terms of the value of claims) in 2008/09. By 2012/13 we would expect claim levels to have reduced significantly. This should enable qualifying insurers to better manage the issues arising for them from the ARP, including the implementation of Solvency II during this year; which will be the last ARP year.

55 Our intention is to use SIF to provide the profession's funding into the ARP. The current resources available to SIF mean that the first £10m of ARP liability could be met without any further contributions from regulated solicitors and bodies. Should claims the shortfall for the 2012/13 ARP exceed £20m, existing SIF resources will be able to meet some further level of claims, but the SRA may need to levy additional contributions.

56 During 2011 and into 2012 we will undertake detailed financial modelling work—in conjunction with qualifying insurers, the Law Society and SIF, in order to assess and prepare for the funding of the 2012/13 ARP as set out above.

57 On the basis of the above arrangements, we would expect to see the majority of current qualifying insurers continue in this market in 2012/13 and new entrants enter given that the issue of uncapped ARP liability would have been substantially addressed.

Transition—2013/14 indemnity year

58 In this year firms will either have to obtain PII from a qualifying insurer, close immediately or trigger the EPP provisions with their existing insurer. There will be no ARP (although qualifying insurers will continue to pay money into the ARP to meet claims that were notified or made in previous years in which they were qualifying insurers).

59 The nature of the EPP will,as we have set out above, be the subject of further detailed consultation. However, at present our intention is that it will run for 90 days split into two periods. A firm will need to pay a pro rate premium to their existing insurer for this period of cover.

60 In the 0–30 day period firms will be able to continue to take on new clients and undertake all work whilst they continue to seek PII in the open-market. Should this be obtained, the firm will be able to backdate their new insurance to the date the previous insurance ended. In these circumstances the EPP premium paid by the firm would be refundable as the previous insurer would never have been on risk.

61 In the 31–90 day period, the firm would not be permitted to take on new work, but would be permitted, and insured to continue work for existing clients whilst winding down the practice. The firm would need to cease work and close (or have merged or been taken over by another firm) by day 91.

62 Run-off cover would then be required to be provided by the existing insurer for which a run-off premium would be payable. Our current view is that this run-off should extend for six years from the date of the end of the policy (not taking account of any EPP).

63 Alongside these arrangements, the SRA will be examining its approach to the supervision and regulation of firms in an EPP. For firms that are unable to obtain new insurance, our initial approach, through supervision, will be to work with the firm to facilitate orderly closure and the transfer of cases, to ensure clients are properly informed and to ensure the transfer of their matters to other firms. We would expect professional regulated individuals and firms to co-operate and, in accordance with their regulatory obligations, act in the best interests of their clients. However, we also need to ensure that we have the necessary powers available to ensure that EPP firms comply with the requirements and do not practice, uninsured, after day 90. We will be reviewing, and amending if necessary, our regulatory arrangements to ensure that this can be done.

Compensation Fund

64 In addressing the reform of client financial protection our primary focus has been on the PII arrangements as these have been in the most urgent need of review. Our work on the Compensation Fund arrangements has primarily been undertaken within the context of the introduction of OFR and the application to the LSB to become a licensing authority for ABS.

65 As a result of this, the only major change to the Compensation Fund arrangements that will be implemented in October 2011 is the extension of the Fund to cover ABS. However, the LSB has indicated that this approach will only be approved through to December 2012 without further review.

66 Given this, the consideration of the responses to consultation on this issue, and the intention, as set out at para. 37 above, to move claims in respect of unapplied firms to the Compensation Fund, our further work on the Fund in 2011 will look at

- the continuation, post-December 2012, of a single Compensation Fund covering all SRA authorised bodies, and the alternatives to such an approach;
- the basis on which claims made against unapplied firms should be dealt with by the Compensation Fund and the scope of such payments in comparison to that currently provided through the ARP and that provided by the current provisions of the Fund, and
- the basis on which future, October 2012 onwards, contributions to the Fund should be assessed, including whether they should be more risk reflective.

Wider areas of work

Conveyancing review

67 Throughout this review and the consultation we have been told by stakeholders that a focus on insurance and compensation to ensure that clients are protected is merely addressing the symptoms of the problem rather than the cause. We believe, for the reasons set out in this paper and elsewhere, that work on the financial protection arrangements was, and is, essential. However, we agree that further work is needed to prevent the causes of claims arising in the first place.

68 Even in a system with high professional and ethical standards, high levels of competence, excellent risk and business management and effective regulation, negligent actions will occur and clients will need to be protected financially through insurance. Insurers provide insurance on the basis that such claims will arise. However, many insurers that have responded to consultation have argued that much of their risk management and underwriting resource is now focused not on negligence but on dishonesty – either from within authorised bodies or through authorised bodies' risk management and controls systems being so weak as to allow them to become subject to the activities of dishonest third parties.

69 Overwhelmingly this has occurred in property work.

70 Given this we will be undertaking a fundamental review during the course of 2011 into our regulation of conveyancing and property transactions and the holding of client money. This review will seek to examine not only the activities of authorised bodies in property transactions but how they interact with other major stakeholders, including client purchasers, client lenders, surveyors and estate agents and insurers. It will be within the context of this understanding of how the system is operating (and might operate differently in the future) that we will examine our approach to regulating this key area of business.

71 As a part of this work we will be examining the arrangements for the holding of client money and the provision of undertakings by solicitors within the process. In respect of the former, we intend to examine the extent to which the

passing of client money through the solicitor remains necessary given the dramatic changes that have occurred in the banking system over the past ten years.

72 Within the SRA we will be examining whether our regulatory requirements and powers are appropriate to manage and reduce risk and whether our authorisation, supervision and enforcement approaches are as effective as they might be.

73 In this last respect we are already implementing significant changes to our approach to authorisation and supervision as a part of our implementation of OFR. Notwithstanding the planned review, we will be applying a far more rigorous authorisation test and process which, in our view, will prevent some of the types of dishonest behaviour seen in recent years. As a part of this programme we will be implementing a new conveyancing supervision and enforcement strategy in 2011, the details of which are being published alongside this policy statement.

74 Our work in this are will need to be highly collaborative, drawing on the information and experience available in the profession (through the Law Society), clients (such as lenders) and the insurers. We will wish to take account of wider developments in this area such as the establishment of the Society CQS and the lenders' developing approach to the risk management of their conveyancing panels.

75 We expect to publish full details of this review and commence discussions with stakeholders in May 2011.

Further engagement and analysis of impacts

76 Within this policy statement we have set out a programme of work in respect of PII and related issues that will be implemented over a three and a half year period. We have taken this approach because of a need to ensure a managed transition from the existing arrangements to the new and to provide clarity for all stakeholders on which they can plan and make business decisions.

77 Throughout this transition, and particularly at key stages in it, there will be further engagement with all stakeholders to develop the detail of new arrangements and to identify, discuss and, if necessary, address, the impacts that will arise. There will be further consultations on the arrangements for each of the indemnity years; 2012/13 and 2013/14.

78 In addition there will be further consultation on any changes to the Compensation Fund arrangements and regulatory changes flowing from the review of conveyancing and holding client money. Each of these consultations will be accompanied by draft Equality Impact Assessments and decisions made with due regard to the impact on equality as evidenced by the final EIAs.

79 Our engagement will extend more widely than the detail of the transition to the new PII arrangements. In particular we will continue to engage with insurers, the ABI and the groups representing BME lawyers, as the ABI and insurers work to demonstrate that underwriting criteria are justified as against the requirements of the equalities legislation. Our view is that clients, solicitors and authorised bodies are best served by a highly competitive open-market insurance system. This should particularly benefit small firms whose choice of insurer is currently relatively limited. However, it is important that insurers are able to demonstrate that the market is fair and open to all and that underwriting decisions are founded on objective and justifiable criteria.

80 Finally, we will continue to review the effectiveness of these arrangements in providing real protection to clients. As a public interest regulator, the interests of the public and the consumers of legal services are paramount. The success of the SRA's client financial protection arrangements has, ultimately, to be considered in terms of their impact on these groups. This extends past the immediate issue of whether their financial interests are protected but also to the secondary impact the arrangements have on the cost and accessibility of legal services.

Annex A

Download Annex A: Professional Indemnity Insurance Transition Plan (PDF 1 page, 54K)