Matrix to accompany draft Handbook for LSB

April 2011

Draft SRA Indemnity Insurance Rules [2011] and Qualifying Insurer's Agreement (QIA)*

Overview of Indemnity Insurance Rules and QIA

CSIIR1	**Nature and effect of the existing provisions (if applicable)**	The current Solicitors' Indemnity Insurance Rules prescribe the compulsory professional indemnity insurance arrangements for firms regulated by the SRA. The regulated profession engaged in private practice is required to secure professional indemnity insurance complying with certain Minimum Terms and Conditions (MTC) of cover from any of the qualifying insurers. The current rules (Solicitors' Indemnity Insurance Rules 2010) will remain in force in respect of claims made during the indemnity year ending on 30 September 2011. The new rules (SRA Indemnity Insurance Rules [2011]) will come into force on 1 October 2011 and will cover claims made in the indemnity year ending 30 September 2012. The rules require firms carrying on a practice in England and Wales to take out and maintain professional indemnity insurance with "qualifying insurers". The purpose of the cover is to provide clients with a basic level of protection in the event that a firm is negligent or dishonest which results in the claimant suffering a loss. The QIA is the agreement that authorised insurers must sign to be able to offer qualifying insurance. The QIA includes the agreement, the ARP policy, the Indemnity Insurance Rules and the MTC. Under the terms of the QIA the insurers agree to: • issue policies that comply with the MTC; • participate in the ARP; • report suspected dishonesty to the SRA; • arbitration arrangements for disputes between insurers.

CSIIR2	**Are the provisions to be applied to ABS? If so, why?**	Yes. The Legal Services Act 2007 requires a Licensing Authority's licensing rules to have appropriate arrangements as to professional indemnity cover. The draft rules aim to ensure that clients of an ABS receive the same level of protection as clients of a traditional firm of solicitors; and that the level of protection is proportionate to the risk.
CSIIR3	**Nature and effect of the proposed changes**	The draft rules are based on the existing (i.e. 2010) rules, but have been changed in a number of respects as follows: • the rules have been extended to apply to ABSs; • ABSs are required to effect policies of qualifying insurance in the same way as other persons and entities; • the period a firm can be in the Assigned Risks Pool (ARP) has been reduced from 12 months to 6 months; • minor consequential changes needed to reflect the future treatment of sole practitioners as recognised bodies; • changes to the rules and MTC (many stylistic) to accommodate the Handbook Glossary. The draft QIA has been changed as follows: • to clarify of insurers' obligations to provide information to the SRA; • to remove the provision for the recalculation of ARP participation in the event of insurer insolvency.
CSIIR4	**How do these proposals impact upon the regulatory objectives and the principles of better regulation?**	The Legal Services Act 2007 requires a Licensing Authority's licensing rules to have appropriate arrangements as to indemnity cover. By ensuring clients of an ABS receive the same level of protection as those of a traditional firm, extension of the current rules to ABS will: • protect and promote the public interest; and • protect and promote the interests of consumers. The SRA's current arrangements for professional indemnity and compensation have been the subject of an independent review carried out by Charles River Associates (CRA).

		The changes to be introduced this year are the first stage in a three year plan aimed at relieving the stresses that have built up over the last few years which have led to an unwillingness on the part of insurers to provide profession indemnity insurance to solicitors, or to insurers restricting their participation to a limited volume of business or to only certain types or sizes of firms. There is a significant risk that if these issues are not addressed the market will not be willing to provide cover to certain segments of the profession. This will impact the firms in those segments and the clients of those firms that wish to make a claim. The proposed changes are essential not only to improve the competitiveness of the open-market arrangements but also to ensure that they are sustainable. We believe that the changes proposed meet the principles of better regulation and, in particular, are proportionate to the risks to clients.

*** The QIA does not form part of the Handbook but parts of it do form part of the SRA's "regulatory arrangements" and as such changes require LSB approval.**

Specific proposals – Indemnity Insurance Rules and QIA

	Proposal	**Relevant provisions**	**Purpose and desired outcome of the specific provisions**	**Could the provisions conflict with those of another regulator? If so, how will such conflicts be addressed?**	**Are these provisions dependant upon a S:69 Order?**
CSIIR5	Extension of the existing Solicitors' Indemnity Insurance Rules to accommodate ABS.	Changes made throughout the rules, as necessary. In particular, the SRA's legal jurisdiction in relation to an ABS is delineated in the rules through the concept of the ABS's "regulated activities".	Purpose - to accommodate ABS within the SRA Indemnity Insurance Rules. Desired outcome - to ensure that clients of an ABS receive the same level of protection as clients of a traditional firm of solicitors; and that the level of protection is proportionate to the risk.	Generally there will be no conflict with the arrangements of other regulators. The SRA's legal jurisdiction in relation to an ABS is delineated in the rules through the concept of the ABS's "regulated activities".	No

				An ABS which is a multi-disciplinary practice (MDP) may have professionals who are subject to the rules of more than one regulator. Any potential difficulties which may arise in this context are being resolved through discussion with other regulators and the adoption of Framework Memorandum of Understanding. We are also exploring the scope for closer future alignment of indemnity requirements between regulators.	
CSIIR6	Definition of "Eligible Firm"	Rule 3.1	Purpose - the definition has been amended to limit the period a firm is eligible to be in the ARP from 12 months to six months. There are transitional provisions such that firms already in the ARP on 30 September 2011 may be eligible to remain at ARP for the balance of the period that they were eligible to be in the ARP when they entered the ARP i.e. 24 months for firms entering in the 2009/10 indemnity period or 12 months in respect of the 2010/11 indemnity period. This is part of the planned phasing out of the ARP as a provider of policies of qualifying insurance. The definition has been updated to reflect the fact that the current exception	No.	No

			which gives certain firms an additional month's cover in the Assigned Risks Pool ("ARP") (because the 2003/04 indemnity period was a 13 month period) will not apply to firms seeking ARP cover from 1 October 2011. Desired outcomes: • to improve the efficiency and effectiveness of the market in solicitors' professional indemnity insurance, to which the ARP is the main obstacle, by removing the ARP. Reducing the period a firm is eligible to be in the ARP is a step in that direction. • foster competition in the market for solicitors' professional indemnity insurance to the benefit of firms and their clients. The presence of the ARP acts as a potential barrier for insurers wishing to enter the market.		
CSIIR7	Identity of each firm's qualifying insurer can be made a matter of public record.	Rule 17.6 and clause 16.3 of the QIA	Purpose - in the interests of transparency it is intended that the identity of each firms' Qualifying Insurer will be part of the public information held by the SRA which will be available on request. This will apply to policies incepting on or after 1 October 2011.	No	No

			Desired outcome - to give consumers more information to make informed choices and to cut down the number and cost of enquiries that the SRA receive for disclosure of insurer details under Rule 17.		
CSIIR8	Clarification of insurers obligations to provide information to SRA	Clauses 6.2 and 6.3.2 of the QIA	Purpose - to clarify insurers' obligations to disclose information about firms to the SRA as the regulatory body. The insurers' reporting obligations are set out in clause 6 of the QIA. Currently where a firm wilfully refuses to pay any sum due to an insurer in respect of any policy the insurer may notify the SRA and the ARP manager. The word "may" has been changed to "shall" in the 2011 QIA. Insurers will also be required to confirm the expiry date of a policy which can end on any 30 September. Desired outcome - to improve the information held by the SRA and to help improve the efficiency and effectiveness of the SRA as a risk-based regulator. Notification to the ARP manager of non-payment is relevant as it helps the ARP manager assess whether an applicant firm is an "eligible firm".	No	No

CSIIR9	Removal of the provision for the recalculation of ARP participation in the event of insurer insolvency	Paragraph 9.3 of Schedule 1 to the QIA	Purpose - to remove a long standing source of irritation to insurers which represents an open ended unquantifiable risk. The issue became very live in April 2010 when there was the real prospect that one of the qualifying insurers might be the subject of an "insolvency event". The impact of making such a change is that in the event that an insurer becomes insolvent, any valid claim against an ARP firm after the insolvency event may not be settled in full. This will leave the firm exposed and the client potentially unable to make a full recovery. In certain cases the firm or client may be able to benefit from the Financial Services Compensation Scheme to help make good the deficit. Firms that have their qualifying insurance with a qualifying insurer that becomes insolvent are required to effect replacement cover within four weeks of the insolvency event. Desired outcome - to improve competition in the market for solicitors' professional indemnity insurance, by breaking the link between insurers, which is imposed by the current requirement for	No	No

			insurers to step in and make good the gap left in the ARP when an insurer becomes insolvent.		
CSIIR10	Removal of references to the Legal Complaints Service	Clause 1.2.6 of the QIA Clauses 1.8, 7.11 and 8.1 of Schedule 2 to the QIA Rule 17 Clauses 1.8 and 8.1.1 of Appendix 1 to the Rules	Purpose - various changes have been made to reflect the fact that the Legal Complaints Service no longer exists and that its replacement body (the Office for Legal Complaints) is not part of the Law Society or SRA. Desired outcome - that the QIA and the SRA Indemnity Insurance Rules accurately reflect the up to date position regarding legal services complaints handling. To remove redundant and potentially confusing references and thereby improve the clarity and internal coherence of the rules, for the benefit of all users.	No	No

Annex 1

Details of respondents to December 2010 consultation on Future Client Financial Protection Arrangements, and of other stakeholder engagement

We received 308 responses submitted by, or on behalf, of a range of organisations as follows:

Breakdown of Respondents

• Solicitors in private practice	262
• In-house (non private practice) solicitors	2
• Representative groups	11
• Local law societies	10
• Other legal professionals	1
• Other regulators	2
• Qualifying Insurers	6
• Brokers	6
• Members of the public	1
• Building Societies	2
• Unknown/other	5

@forths Solicitors
ABI
Ablitts Solicitors and Notaries
Absolute Legal
Alan Ashley & Co
Alan E Short
Alexander & Co Solicitors
Alison Fielden & Co Solicitors
Alistair Keeble Solicitors
Altermans Solicitors
Amanda Shaw Solicitors
Ames Kent Solicitors
Andrew Kingston & Co
Anthony F Cox, Solicitor
Anthony Holden Crofts & Co
Astburys Solicitors
Aviva Insurance Ltd
Baines Wilson LLP
Barbican Syndicate 1955
Beachcroft LLP
Beaty & Co
Beechmast Consultancy Limited
Bell Park Kerridge
Bell Wright & Co
Beor Wilson Lloyd
BIBA
Bignalls Solicitors
Black Graf LLP
Black Solicitors Network

Blatchfords Solicitors
Boyce Hatton Solicitors
Brignalls Balderston Warren
Brindles Solicitors
British Nigeria Law Forum
Broome Palmer Solicitors
Browning Grassam
Building Societies Association
Burgoyne & Co
Burkill Govier
Butcher Burns LLP
C E P Colombotti
Cahill De Fonseka Solicitors
Capita Insurance Services
Cardiff & District Law Society
Catlin Insurance Co Ltd
Chambers Rutland & Caruford
Charles Fraser & Co
Charles Lucas & Marshall Solicitors
Charles, Crookes & Jones
Chattertons Solicitors
Chenery Maher
City of Westminster & Holborn Law Society
CLLS
CML
Colemans Solicitors LLP
Coley and Tilley
Colin Palmer & Co
Collier Littler Solicitors
Collins, Dryland & Thorowgood LLP
Copleys Solicitors
Cullimore Dutton Solicitors
David Conway & Co
David Grindall
David Ward
Davis Bays t/a John Bays & Co
Denison Till
Devine Law
Devon & Somerset Law Society
Drysdales Solicitors
Duchenne Solicitors
Ellis & Co Solicitors
Elvin & Co Solicitors
Evans Harvey Solicitors
Eversheds LLP
F W Meggitt & Co
Farnfield & Nicholls Solicitors
Fisher Ridley Solicitors

FOIL
Footner & Ewing
Freeth Cartwright LLP
French and Co
fwdlaw Limited
Gales Solicitors
Garner Canning Limited
Gavin Nichols
Geoffrey Searle Planning Solicitors
Gerald Elvidge
Gillian Mather
Gordon Bishop
Gotolee Solicitors
Graeme John with A F Brooks & Co
Graff & Redfern
Graham Tooze
Grant Argent & Co
Greenways Solicitors
Grindleys LLP
Grower Freeman
Guthrie Jones & Jones
Hansell Wilkes & Co
Hardman & Whittles Solicitors
Healys LLP
Heather Thomas Consulting
Helen Bradley
Henry Highes & Hughes
Henry Y Smith & Co
Herbert Smith LLP
Horsey Lightly Solicitors
Houseman Benner Solicitors
Hudgell & Partners
Humphreys Solicitors
Hunters Solicitors
Ian Savill Solicitor
ILEX
Irwin Mitchell
J G Richards Solicitors
Jackson Quinn Solicitors
Jacobs and Reeves
James Morgan Solicitors
Janis Purdy
Jeremy Case Solicitor
Jeremy Gibbs & Co
Jeremy Jones Solicitor
John Britten
John Welch & Stammers Solicitors
Juliet Hardwick solicitors

Keith Barlow
Kent Law Society
King-Davies and Partners
Kingsley David
Kiteleys Solicitors
Kitsons LLP
Lancasters
Leeds Building Society
Legal Ombudsman
Legal Risk LLP Solicitors
Legal Services Consumer Panel
Leicestershire Law Society
Lincolnshire Law Society
Linklaters LLP
Lyons Solicitors
Macnamara Moore Shore
Manchester Law Society
Mark Harvey
Markland & Co Solicitors
Marsh Ltd FINPRO Division
Martin Beard
Martin Ross, Solicitor
MGW Law (Morris Goddard and Ward)
mhlaw
Michelmores LLP
Miller Gardner
ML Law
Monitor Insurance Services Ltd
Murray Roach
Nationwide Building Society
Newbold & Co Solicitors
Newstead and Walker
Nicholas Huber & Co
Nicholls & Sainsbury
Nick Hayes
Nick Hutchinson & Co
North Staffordshire Law Society
Nutter & Richards Solicitors
Oates Hanson Solicitors
Osman Ward & Sons
P A Todd and Company
P E P Honke Solicitors
P R Vince Solicitors
Page Nelson Solicitors
Pamela Clemo & Co
Parabis Law
Parry Carver
Passmores Solicitors

Patersons Solicitors
Patrick Bullen Smith
PCB Lawlers LLP
Peachey & Co LLP
Pearson Caulfield
Pellmans Solicitors
Pengillys
Peter Bloxham
Peter J Fowler Solicitors
Peter Lawrence
Philip Brown & Co
Philip Crowe
Pooleys Solicitors
Pure Law LLP
QBE
Reynolds Parry Jones Solicitors
Richard Kanani & Co
Richards and Cleaver Solicitors
Richardson & Davies
Robert Eaton
Robert Howard
Robertsons Solicitors
Rodney Smith
S W Law
Sarah Mumford
Saunders & Co
Scaiff LLP
Scott Burden
Scott Richards Solicitors
Seldons
Sharp and Partners
Sharples & Co
Sherwood Dunham Solicitors
Shirley Fretwell Solicitor
Simkins Solicitors
Simon Stowe Solicitors
Sinclairs Solicitors
Sleigh, Son & Booth Solicitors
Smart Law Solicitors LLP
Smith Sutcliffe Solicitors
Solicitor Sole Practitioners Group
Sproull Solicitors LLP
Starbuck and Mack
Steeles Law
Sterratt & Co Solicitors
Stork & Coles Solicitors
Strube & Co
Surbiton Law

Susan Chapman
Sydney G Thomas & Co
Tallents Solicitors
Tarbox Robinson & Partners
Terrie Pridie
The Law Department
The Law Society
Thurstan Hoskin Solicitors
Tim Driver
Timothy Prior
TLT LLP
TQ Solicitors
Trafford Council
Underhill Langley & Wright
Unma Duraisingam Solicitors
Unsworth Rose
Van Eaton Solicitors
Veronique Marot & Co
Vingoe Lloyd Solicitors
Waddington & Son
Walkers Solicitors
Ward Benger
Warner & Richardson
Warwickshire Law Society
Whatley Weston & Fox
Whetham & Green
Whitemans Solicitors
Wholley Goodings LLP
Wholley Goodings LLP
William Robins
Williams & Company
Windsor Partners LLP
Wright & Co
Wright Hassall LLP
Wylie Kay
Zurich Insurance plc

Plus 51 other respondents who asked for their name / capacity to be kept confidential.

Webinar 28/01/11 - 316 delegates

External Reference Group meetings held 17/09/10, 21/10/10, 17/02/11

BME Practitioners Meeting 08/12/10

ABI Solicitor's PII Conference 20/01/11

CML Legal Issues Conference 08/02/11

Annex 2: FUTURE CLIENT FINANCIAL PROTECTION ARRANGEMENTS – REPORT ON CONSULTATION RESPONSES AND SRA CONCLUSIONS

APRIL 2011

INTRODUCTION

1.1 As part of the review of client financial protection arrangements, a consultation paper was issued on 6th December 2010 with a closing date of 28 February 2011. This paper summarises the key points emerging from the responses and sets out the SRA's conclusions. This document should be read in conjunction with the SRA's Financial Protection Policy Statement, which sets out the decisions reached by the SRA Board on changes to be made to these arrangements between October 2011 and October 2013, and the Equality Impact Assessment on the planned changes.

1.2 A summary by number of the answers to the various questions posed is at Table 1.

1.3 The number of responses received to this consultation paper was very considerable with 308 responses in total. It should be noted that one market participant wrote to its clients to encourage members of the profession to disagree with some of the proposals made (particularly the proposal to move away from a single renewal date). We believe that this has generated a number of responses on one issue in terms very similar to that advocated.

OVERALL APPROACH

Q1: OBJECTIVE AND PRINCIPLES

2.1 The objectives and principles were supported by 100 respondents compared to 18 who were against them. Other respondents gave more ambiguous responses or provided general comments.

2.2 A number of those who objected to the principles or who expressed partial disagreement with them, objected to principle 3 (encouraging competition). The main area of concern was that this principle was interpreted as benefiting alternative business structures at the expense of traditional law firms.

2.3 Many respondents also believed that intervention by the SRA was not necessary and expressed concern regarding the amount of regulation surrounding insurance arrangements; some suggested that it was wrong for the SRA to intervene in respect of market forces in the insurance market.

Q2: COMMENTS ON FUTURE DEVELOPMENT OF FINANCIAL PROTECTION ARRANGEMENTS

2.4 There is a divergence in opinions among respondents regarding the future development of financial protection arrangements. Some see the value of additional flexibility being brought into insurance arrangements as a way to benefit the profession and as a way to increase the availability of cover and choice of insurer. They argued that the current inflexible arrangements were preventing some firms from being able to obtain cover.

2.5 Others see the value of maintaining a single approach for the sake of simplicity. They argue that greater variety will reduce certainty as to the details of insurance cover in different firms and some believed that flexibility would involve removing all regulatory requirements. They also see a danger in fragmenting the insurance requirements which some believe will lead to a reduction in availability of cover.

Q3: COMMENTS ON THE WIDER REGULATORY ISSUES

2.6 The great majority of respondents strongly supported the SRA taking a more rigorous and tough approach with the regulatory issues highlighted. A small number of firms raised concerns that this approach did not match with a movement towards outcomes focused regulation which they perceived to be a reduction in regulation.

2.7 In general, many respondents agreed that there were firms in the profession that posed an unreasonably high level of risk and which should be closed down. They noted that good, high quality, firms in the profession bear the cost of low quality or dishonest firms and that more rapid action was needed to close firms. Many argued that the fact that firms could not achieve open market insurance cover was indicative that they should be closed down. Many respondents argued that the ARP was a significant problem for the profession

and that firms in the ARP with bad claims records and an unsatisfactory risk profile should be closed.

Conveyancing

2.8 Conveyancing was the topic most commonly commented on. Respondents believed that the SRA needs to take a tougher line on firms that conduct conveyancing. They supported the plan to investigate this area in more detail. Representatives of the BME sector indicated that more rigorous regulation of this sector would be to the advantage of BME firms by avoiding lenders taking actions based on factors such as size and turnover which they feel disproportionately affect BME firms.

2.9 Many respondents believed that large conveyancing firms were the cause of high claims and that reductions in pricing over time were linked to reductions in quality. However, it should be noted that the evidence of the ARP is that it is overwhelmingly small firms in the one to three partner range that are those unable to obtain open-market insurance and therefore generate claims against the ARP.

PQE

2.10 Mixed responses were received on the length of time needed before individuals could set up new practices. Many agreed with the suggestion from insurers to move this to five years (or even longer) and expressed concern that the SRA had not previously taken action on this. They argued that allowing individuals to set up firms with only three years' experience creates risks for the sector. Others argued that raising the boundary beyond three years would simply be a barrier to new firms being set up, seeing this as a blunt instrument. They questioned the link between length of experience and risk.

Financial viability

2.11 Respondents who commented on financial viability were generally in favour of taking this into account. Many noted that if firms could not afford run-off cover then the cost of this was faced by the rest of the profession. Some did highlight the difficulties for firms seeking to close who are unable to because of the cost of run-off cover.

QLTT

2.12 Respondents who commented on this generally agreed that the QLTT was not sufficiently robust arguing it was not a proper test of competency. Some believed the new QLTS was better.

BME Firms and the ARP

2.13 Respondents who commented on BME issues were in favour of ensuring that such firms did not face discrimination. Many who responded believed that difficulties faced by some BME firms were linked to the problems of the QLTT.

2.14 There were few individual respondents who were from the BME sector. Among those who did respond, some in the sector expressed concern that the current arrangements were unfair towards BME firms. Some therefore favoured a return to SIF since SIF guaranteed insurance for all firms. Representative groups in this sector expressed the concern that if the ARP was closed or the timescale available in the ARP shortened this would be particularly detrimental to BME firms.

Q4: TWO-STAGE APPROACH

2.15 The two-stage approach was supported by 48 respondents compared to 45 who were against it. Many of those who objected to the two-stage approach objected because they objected to the actual proposals rather than the two-stage approach itself. Nonetheless there were mixed responses with some respondents arguing that more time should be allowed for the first set of changes to be implemented while others believed that the second stage changes should be brought in earlier than planned. Some respondents argued that it would be better to bring in all changes in one stage whereas others saw benefits in staggering changes, including over more than two stages. In general there was a preference to ensure that the proposals were the right proposals rather than concerns regarding the timing of those proposals being implemented.

2.16 Insurers were generally against the two stage approach arguing that changes needed to be made to the ARP at the earliest opportunity rather than delaying this, in order to maintain the viability of the open-market approach. There was also concern expressed that proposals which were delayed may not actually occur in practice with insurers seeking greater commitment to future change. Some also indicated that unintended consequences could arise in any transitional periods. Some insurers highlighted that confusion could be introduced by removing the single renewal date in advance of other changes being made.

2.17 Others insurers and some brokers argued that the lack of consensus on how the ARP should be dealt with meant that a two-stage approach was inevitable.

OUR RESPONSE

2.18 We are pleased that respondents to the consultation paper have supported our objectives and principles in our approach to the review of financial protection arrangements. Over time we will seek to remove any unnecessary intervention in insurance markets while ensuring that regulatory minimums are clearly set out.

2.19 As set out, the review of financial protection arrangements also highlighted various weaknesses in the regulatory regime specifically with respect to the conveyancing process, the conditions in place when setting up a new firm and the financial viability of a small number of firms. The SRA will continue to make progress in taking a more rigorous approach in these issues.

2.20 The SRA will continue to work with representatives of the BME sector and insurers on the issue of disproportionate outcomes.

MAINTENANCE OF CURRENT ARRANGEMENTS

Q5: USE OF THE OPEN MARKET

3.1 Although it represents the maintenance of current arrangements, one of the key considerations during the course of the client financial protection review was whether the overall model used for the delivery of insurance was appropriate.

3.2 There was overwhelming support for the continued use of the open market. Among those who responded to this question, 128 were in favour of the open market with 10 against; a number of respondents gave ambiguous comments. Among those who were against the open market, the Solicitors Indemnity Fund (SIF) was favoured due to its mutual nature and the fact that it was obliged to insure all solicitors.

3.3 One area of concern raised regarding the open market was a view that insurance companies make arbitrary decisions regarding the firms that they will insure and that few insurers are willing to offer insurance to small firms.

3.4 Some, however, rejected the current open market approach as not being sufficiently “open” and suggested that the SRA should move towards much more minimal requirements.

Q6: QIA

3.5 The maintenance of the QIA was supported by 122 respondents compared to 11 who were against its use. Of those against the QIA who gave reasons for their opposition, two were against it as they considered it to be an unnecessary intervention. Those who gave reasons for favouring it argued that it assists with the SRA’s ability to ensure that certain criteria are met and that insurers report information to the SRA, others noted the benefits of having standardised contract terms to prevent clients needing to examine the detail of the provisions.

3.6 Insurers were split with respect to the QIA. Some argued it should be maintained due to the current mechanism for funding the ARP and also because it ensures standardisation in the terms of insurance contracts. Others argued it was unnecessary given that insurers are already strictly regulated by the FSA.

3.7 One key area of concern related to the insolvency clause related to the funding of the ARP. Currently if a Qualifying Insurer (QI) becomes insolvent, the other QIs would increase their share of the ARP funding cost. This provides firms in the ARP with greater protection than firms outside the ARP. It also means that individual insurers face risks associated to the insolvency of their competitors. Insurers highlighted this as unreasonable and that a similar clause does not exist in ARPs run by other professions.

Q7: REQUIRING ADDITIONAL CRITERIA ON INSURERS TO BE QUALIFYING INSURERS

3.8 103 respondents agreed that there should be no additional requirements placed on insurers while 27 disagreed. Many of those who disagreed argued that credit ratings should be required with respondents commonly making reference to Quinn having lacked such a credit rating. These respondents argued that the simplicity of this does not detract from its value. Others who agreed that there should be no additional criteria stated that financial regulators were in a better position to check the quality of insurers than is the SRA.

3.9 Insurers had mixed views with some arguing that insurers already faced high levels of regulation and others that credit ratings should be added since QIs face the risk of insolvency of their competitors.

OUR RESPONSE

3.10 As outlined in the consultation paper and as supported by the great majority of respondents we intend to retain the current open market model for PII. At present we will retain the QIA and will not impose additional requirements on insurers before they can be qualifying insurers. As set out below we will, however, make some changes to the terms of the ARP funding related to insolvent insurers which will have the effect of placing firms in the ARP in a similar position to those outside the ARP if their insurer becomes insolvent rather than providing additional benefit to ARP firms which is currently the case.

PROPOSAL 1: REMOVE THE RESTRICTION OF THE SINGLE RENEWAL DATE WITH EFFECT FROM 1 OCTOBER 2011

4.1 The proposal to remove the restriction of the single renewal date was, after Proposal 2 to permit the exclusion of claims by financial institutions from the MTC, the issue which provoked the second highest number of comments. Among the profession 51 respondents agreed that the single renewal date should be removed, while 147 disagreed. Of those that disagreed with the proposal there were a large number of firms that made reference to or directly quoted the advice of the market participant mentioned in the introduction. The Law Society is in favour of abolishing the single renewal date.

4.2 Brokers were split regarding their view on the single renewal date with some making similar arguments to those of the profession outlined below. Insurers all agreed with the proposed removal of the single renewal date.

4.3 Overall, 69 respondents were in favour of removing the single renewal date with 150 against.

4.4 Among those who were in favour of removing the restriction of a single renewal date, firms made the following arguments:

- Introducing variable renewal dates would be beneficial for good firms as it will allow more time for insurers to underwrite each case and by encouraging better management, this will reduce premiums for well run firms. More time to assess firms would mean that badly run firms would be identified more quickly, would face higher prices and would find it more difficult to obtain cover. This would be to the advantage of the majority of the profession;

- Variable renewal dates would give more flexibility for firms to arrange insurance at a time that was most convenient for the firm;

- The single renewal date puts insurers and the profession under time pressure every September such that insurers do not have time to consider properly the risk profile of practices and firms do not have time to assess the choices which they have which some describe as placing the profession under unnecessary pressure;

- The single renewal date creates volatility and a lack of predictability in pricing and firms believed that it created a “sellers market” where premiums could be kept higher than otherwise would occur because insurers know that all firms have no choice but to renew by a fixed date;

- They stated that the argument that firms were more likely to remember a single renewal date was poor arguing instead that forgetting about the renewal date indicated poor practice management;

- Other professions do not have single renewal dates and operate without difficulty; and

- The single renewal date exacerbates problems related to the ARP problem by reducing choice in the run up to the renewal date hence moving to a variable renewal date would reduce the number of firms entering the ARP.

4.5 Among the respondents who disagreed with the proposal, they made the following arguments:

- The current situation provides simplicity and transparency and enables the SRA to identify firms who have not obtained PII;

- A single renewal date provides competitive pressure on insurers and therefore keeps premiums low whereas removing it would lessen competition between insurers causing an increase in premiums;

- A variable renewal date could leave some firms unable to obtain insurance because insurers might have a lack of capacity in some parts of the year whereas the current approach is described by some as “fair” because all firms renew at the same time;

- They were sceptical that firms who fall into the ARP temporarily do so because of the single renewal date arguing that it was simply that they were disorganised and therefore they would continue to miss their renewal date if there were variable renewal dates;

- They argued that there would be an additional layer of regulation and record keeping to keep track of individual firm’s renewal dates;

- Variable renewal dates would lead to insurers requiring more information and taking more time to underwrite on an individual firm basis; and

- Some argued that firms would choose to have renewal dates linked to their end of year which would be burdensome at what is already a busy time of year.

4.6 A number of those who disagreed with the proposal instead favoured a move towards two renewal dates per year (others suggested four or twelve). Many firms that objected to the proposal nonetheless expressed concerns regarding the short period of time that they had to consider renewal terms from insurers.

4.7 A number of respondents cautioned that it would take some time before the benefits of moving away from the single renewal date were seen. Some brokers highlighted that the benefits of collective bargaining which they believed they brought for their clients would continue irrespective of the single renewal date.

4.8 Insurers also highlighted that the proposal would enable short term renewals of 30 or 60 days to consider notification of claims that arise in the run-up to renewal whereas the current arrangements may mean insurers are unwilling to offer insurance for 12 months. Insurers were also keen to ensure that the removal of the single renewal date would facilitate policies which were both shorter than and also longer than 12 months.

OUR RESPONSE

4.9 The single renewal date is an unnecessary restriction which causes difficulties for insurers and the profession alike during September. As noted earlier, one market participant wrote to its clients to encourage members of the profession to disagree with some of the proposals made (particularly the proposal to move away from a single renewal date) and we believe that this has generated many of the responses against the proposal to remove the single renewal date. We note that TLS is in favour of removing the restriction.

4.10 We have decided to continue with the proposal to remove the requirement that all firms renew insurance at the same time. Removing the restriction does not mean that all firms will be required to renew insurance at a different time of year but rather than firms will have a choice when to renew.

4.11 Those firms that believe that an October renewal is in their interests can continue to renew in October; those brokers that believe this can continue to persuade their clients to renew at the same time as other clients. Those firms that would value the flexibility to move their renewal date to another part of the year would also be able to do so. Over time, the preferences of the profession along with any pricing benefits from spreading renewal over the year compared to any pricing benefits from renewing multiple firms at one time will determine the outcome.

4.12 Although we will continue with the proposal, we will not implement this change from October 2011. This is because of the package of other changes which we are proposing to introduce and we consider that it will be easier to implement the whole package by delaying the removal of the single renewal date until other parts of the package can also be implemented. We therefore intend to remove the single renewal date from October 2013.

PROPOSAL 2: REMOVE CLAIMS BY FINANCIAL INSTITUTIONS FROM THE COMPULSORY MTC WITH EFFECT FROM 1 OCTOBER 2011

5.1 The proposal to remove claims by financial institutions from the compulsory MTC by way of permitted exclusion was the proposal which raised the greatest number of responses with many respondents choosing to respond to this issue alone.

EXCLUDING FINANCIAL INSTITUTIONS FROM COMPULSORY MTC

5.2 Among solicitors and their representatives, 224 respondents opposed the proposed financial institution exclusion, while only 16 agreed with it. Representatives of the BME sector were against the proposal. Insurers were in favour of allowing the exclusion while brokers and financial institutions were against. In total, 236 respondents opposed the proposal and 25 supported it.

5.3 There were three main arguments which were commonly made by solicitors who disagreed with the proposal.

5.4 First, many firms argued that the proposal dealt with the symptoms of the problem and not the cause. They stated that the root cause of the difficulties lay in poor regulation of firms conducting conveyancing and that it would be better to improve regulation of firms and the conveyancing process rather than to address this issue through insurance provisions. Many firms also highlighted that TLS's Conveyancing Quality Scheme (CQS) was likely to be used by lenders to reduce the size of their panels and therefore that the market would already begin to address concerns about conveyancing through this channel. They argued this meant excluding financial institutions from insurance cover would not be necessary as a mechanism to deal with conveyancing claims.

5.5 Second, they argued that the proposal would lead to an increase in the cost of insurance for those who took out "additional cover". Firms argued that premiums are already based on the type of work carried out by individual firms and therefore insurers are capable of determining the extent of conveyancing conducted and pricing accordingly. Few respondents made reference to the inability of insurers to avoid cover where information is misrepresented which in practice means that insurers can not always identify the amount of conveyancing conducted and price accordingly.

5.6 Third, solicitors expressed considerable concern that firms would not all be able to obtain cover for financial institutions. A number of firms stated that similar cover had been withdrawn from the Irish market in the second year in which it had been possible to exclude cover for conveyancing activities. Linked to this was the observation that the proposal would place the decision regarding whether firms could conduct work for financial institutions with insurers rather than with the SRA (although insurers could simply refuse the firm altogether).

5.7 Additional arguments that were made against the proposal included:

- Preferences for only allowing firms with specific qualifications to conduct conveyancing to do so rather than blanket exclusions being permitted for financial institutions through insurance contracts;

- Preferences for any such exclusion to be limited to firms in the ARP alone;

- Concerns regarding the “claims made” nature of PII in which firms may have obtained cover in the year in which advice was given, but may no longer be able to obtain cover in subsequent years leaving them exposed to claims from financial institutions;

- It would be difficult for members of the public to know whether a firm has cover for financial institutions or not. Therefore when looking to instruct a solicitor individuals might not be aware that separate lender representation could be required which could create confusion;

- Conveyancing transactions are linked to other types of law and failure to obtain cover for financial institutions could affect firms ability to conduct matrimonial or probate work in which selling the family home may be required, personal injury cases where settlement money may need to be forwarded to banks as security for loans, use of powers of attorney etc;

- It could make takeovers and successions less likely if there are differences in the cover between the acquired firm and the acquiring firm;

- Views that if firms were unable to obtain cover for financial institutions then they should not be in the market at all;

- Preferences for changing other terms related to misrepresentation such that insurers would not be required to cover claims where firms may deliberately misled insurers regarding conveyancing;

- The observation that given financial institutions will insist on firms having cover then their incentive to assess the quality of the conveyancing will be unchanged from today and therefore that the exclusion does not achieve a great deal; and

- The observation that not all fee earners will know the scope of PI and therefore that they could conduct work without cover.

5.8 In addition, financial institutions have informed the SRA that should such a proposal be implemented, they would have insufficient time to change their IT systems in order to capture information about whether or not solicitors had cover in place for financial institutions. Some of these firms expressed the

view that if the change was implemented quickly they would be forced to move towards a very small panel of firms and, having done that, would be unlikely to reverse this decision once IT capabilities could be brought into place.

5.9 Among those who favoured the ability to exclude cover for financial institutions, respondents typically highlighted that the exclusion would be fair as financial institutions are able to look after themselves. Some respondents stated that this would lower the cost of insurance for firms that did not work for financial institutions.

5.10 Financial institutions and their representatives who responded were all against the proposal. Some indicated that the proposal would lead to greater costs for consumers as it would increase the extent to which financial institutions appoint their own solicitor with these costs paid by the consumer. The increased cost of assessing whether or not firms had the appropriate cover was stated as likely to lead to smaller panels. They also highlighted concern about the timing of proposals expressing doubt that a database of firms with cover for financial institutions would be available in advance of October 2011. They also indicated that while financial institutions could assess whether cover was in place at the time that advice was given, they would not be in a position to assess whether cover in later years or run-off cover included cover for financial institutions at the time of any claim – brokers made similar observations on this issue. Some respondents indicated that variation in the MTC should be allowed for different types of work rather than for different types of client.

5.11 Insurers were generally in favour of the proposal arguing that additional flexibility of cover would be beneficial and financial institutions do not need regulatory protection. They noted that the benefits would be seen in better management of the next financial downturn rather than in the immediate aftermath of the recent downturn. Some insurers noted that if they were unwilling to offer financial institution cover to a firm, they thought it unlikely they would be willing to offer the more reduced cover.

5.12 Insurers indicated their willingness to offer cover for financial institutions. Some insurers indicated that the cover could have different terms associated to it compared to the rest of the MTC. Many highlighted the need to address the underlying regulatory issues to do with conveyancing.

DEFINITION OF FINANCIAL INSTITUTIONS

5.13 The proposed definition of financial institutions was supported by 40 respondents compared to 72 who were against it. There were a number of respondents who gave comments regarding the question but where the comments were more ambiguous and respondents had mixed feelings about the definition.

5.14 Of those against the definition, the main argument made was that it was too wide in scope. Most respondents against the definition argued that if an

exclusion was to be permitted it should be limited to work conducted in the course of conveyancing rather than any work conducted for financial institutions. In this regard they noted that some of the work which would be caught by the current definition included: undertakings with regard to inheritance tax, company and commercial matters, grant of easement, and transfers of equity. One implication of this is that the current scope of the exclusion is such that many more firms would need to ensure they had financial institution cover than if the exclusion was limited to conveyancing. The benefits of any exclusion are somewhat smaller if most firms could not use it in practice.

PERMITTED EXCLUSION FROM THE MTC

5.15 The proposed implementation of the financial institution exclusion by way of a permitted exclusion was supported by 47 respondents compared to 67 who were against it.

5.16 The main reason why respondents are against this proposal was because they actually oppose the financial institution exclusion proposal. Other Respondents in favour of the proposal stated that even though they do not support the FI exclusion, if it is to be implemented then it should be by way of a permitted exclusion.

OUR RESPONSE

5.17 The primary reason for proposing the ability to allow cover for financial institutions to be excluded which was that financial institutions are capable to looking after their own interests rather than needing regulatory protection. In addition, there was a very high level of claims by financial institutions in connection with conveyancing.

5.18 The exclusion was intended to make insurance policies more flexible for the profession. We note that the implication of rejecting the proposal is that some firms may be unable to obtain any insurance cover from the open market where they could have been able to obtain narrower insurance cover with the permitted exclusion; other firms may pay higher prices for their insurance than they otherwise would.

5.19 However, given the very strong feelings expressed by the profession, the concern by financial institutions regarding the time necessary to implement a change of this nature and the potential impact in terms of a sudden and extensive reduction in the size of lenders' panels (with a potential consequential impact on consumers), we have decided not to implement this change in October 2011.

5.20 As set out in the consultation paper and in the separate Financial Protection Policy Statement that is published alongside this Response, the SRA intends to conduct further research and analysis into the regulation of the conveyancing process. This will include consideration of which parts of the process are most susceptible to negligence and fraud, whether there should

be explicit authorisation to conduct conveyancing, whether the conveyancing process itself should be altered; or whether alternative approaches could be used to provide protection to clients.

5.21 We intend to complete this research in time to consider whether changes should be implemented at a later date after the transition to new ARP arrangements as set out in our Policy Statement.

PROPOSAL 3 AND OTHER ISSUES RELATED TO THE ARP

6.1 Proposal 3 was to increase controls over the ARP included amending the ARP such that, with effect from 1 October 2011, firms can only be covered for six months as well as requiring that such firms must develop a plan to obtain open market insurance or close. In addition to this proposal, the consultation paper also raised the possibility of changing the role of the ARP as a provider of policies of qualifying insurance either by ending this role altogether or by placing conditions on the work that can be undertaken while in the ARP such as by the SRA requiring the firm to not accept new instructions or to not hold client money.

6.2 The consultation paper raised a number of questions regarding the ARP and a large number of comments were received regarding the ARP.

REDUCTION OF THE ARP PERIOD TO 6 MONTHS

6.3 Among the profession, 71 were in favour of reducing the time in the ARP (52 in favour of 6 months, 8 in favour of 3 months and 11 in favour of the ARP being closed altogether) while 41 were against reducing the time in the ARP. Once all respondents are included, 84 were in favour of reducing the time in the ARP and 49 against. Representatives of BME firms (who are disproportionately present in the ARP) were against this proposal arguing that there was insufficient evidence to support this step and viewing six months as insufficient time for firms to prepare to exit the ARP.

6.4 Insurers were in favour of reducing the period of time firms can spend in the ARP as being a step to reduce ARP liabilities, but argued more strongly for the complete closure of the ARP or, if its were to kept as a mechanism, the liability for funding the ARP shortfall transferred directly to the profession. Insurers argued that the ARP is distorting the market, reducing competition and increasing premiums for the whole profession.

6.5 Among those who were against the reduction, many respondents stated that the change from two years to 12 months had only just been made and that time needed to be spent assessing the impact of this previous change before making further reductions in the time in the ARP. Others in favour of the reduction to six months considered that this was a sufficient period for any good firm to sort its difficulties out or for other firms to be closed in an orderly manner.

DETAILED PLANNING BY ARP FIRMS

6.6 Among the profession, 45 respondents were in favour of requiring ARP firms to undertake detailed planning of how they would exit the ARP while 11 were against this. Among those who were against it, respondents indicated that this could lead to “tick-box” regulation of these firms, that the planning would distract firms from getting on with serving their clients, or that it was an academic issue given that most firms in the ARP close anyway. Some objected on the grounds that not all firms in the ARP should be required to do

this as not all firms in the ARP were high risk firms, rather were in the ARP due to mis-conceived rejections by insurers.

CLOSURE OF THE ARP

6.7 The consultation paper raised a question as to whether the ARP should cease to offer policies of qualifying insurance in the future. Among the profession, 45 respondents were in favour of closing the ARP compared to 36 who disagreed with this option. Once all respondents are taken into account the figures are 55 for and 43 against. The insurers were strongly in favour of closing the ARP because of its distorting effect on the operation of the market and the fact that it results in increased premiums. Those who were in favour of closing the ARP made the following main comments:

- The ARP leads well run firms to subsidise the claims of poorly run firms and the cost of the ARP is very significant for the rest of the profession;
- Firms that cannot obtain insurance in the open market should not be in practice;
- Firms in the ARP rarely exit the ARP to continue practising, the ARP does not rehabilitate firms and therefore should be closed;
- Closing the ARP would force firms to close which, since they would be high risk firms, would be to the benefit of the rest of the profession; and
- Keeping the ARP makes entry by insurers less attractive, is a barrier to new entry and reduces competition which in turn makes it more difficult for firms to obtain open market insurance.

6.8 Those who were against closing the ARP made the following comments:

- Without an ARP firms may be forced to close suddenly which would not be to the benefit of clients (although many respondents highlighted that having some form of policy extension similar to that suggested by TLS would assist in this);
- Closing the ARP would place the insurers in the position to determine whether firms could continue to practice;
- Some form of fallback mechanism was needed for firms who cannot obtain insurance because of unfair actions by insurers;
- Closing the ARP would force firms to close which was seen as unreasonable; and
- BME representatives highlighted the disproportionate number of BME firms in the ARP as a reason against closure.

MEETING CLAIMS AGAINST UNINSURED FIRMS

6.9 Among the profession, 82 firms were in favour of retaining the role of the ARP to meet claims against uninsured firms while 35 disagreed. Of those who disagreed, 17 thought that the ARP should be scrapped altogether. Others who disagreed stated that the client should not expect full protection as this would not be the case in other professions and then clients would take more care about their choice of solicitor. Some preferred the idea that the previous insurer should pick up the risk from these firms.

PROVISION OF RUN-OFF COVER THROUGH THE ARP

6.10 Among the profession, 80 firms were in favour of retaining run-off cover through the ARP while 37 were against.

6.11 Those in favour of retaining run-off cover often gave arguments in favour of run-off cover itself being required rather than run-off cover being delivered through the ARP. Some of those in favour of retaining run-off cover through the ARP suggested it should be delivered through the Compensation Fund. Others thought that the cover should be continued to be delivered through the ARP but with the principals of the firm facing the liability for claims. Many respondents favoured tighter requirements on the financial viability of firms to prevent costs of run-off falling onto the ARP.

6.12 Among the few who gave reasons for objecting, many objected to run-off cover itself arguing that the cost of this was a considerable burden for firms especially small firms and preferring to find an alternative way of providing run-off cover for all firms such as through either higher annual premiums or through a separately provided fund. Some respondents thought firms should be obliged to plan for the cost of run-off so that they could afford it themselves. Others supported TLS' suggestion of requiring the last insurer to provide run-off cover.

FUNDING THE ARP

6.13 The consultation paper sought views on whether to change the method of funding the ARP should it remain in place. The two options suggested were:

- A direct levy on the profession, possibly collected and managed through a SIF mechanism (option one); or

- A levy as a percentage of the insurance premium (option two).

6.14 Overall, among the profession, 61 favoured changing the way that the ARP was funded while 14 disagreed that there should be a change (two of these disagreed because they thought that the ARP should be scrapped). Many of those in favour of changing the funding mechanism indicated that it was unreasonable for insurers to fund the cost of the ARP where these firms, by definition, were firms that insurers were unwilling to insure. Many respondents recognised that the funding of the ARP was stopping insurers from entering

the market which they described as being bad for the profession as a whole; hence they were in favour of altering the funding mechanism. Firms suggested that this was particularly detrimental to small firms.

6.15 Although firms were generally in favour of moving away from the current funding mechanism, there was a more mixed response regarding the method that should be used in the future. Among those who expressed an opinion, 14 favoured option 1 compared to six who favoured option 2 and 4 who stated that either would be acceptable. A further 18 expressed a preference for the proposal by TLS that the ARP should be replaced by the previous insurer taking responsibility for firms.

6.16 Other options suggested included merging the ARP with the Compensation Fund with the levies paid according to current Compensation Fund levies; extracting all monies from those in the ARP; requesting highly profitable members of the profession to pay; or basing it on the turnover of firms.

6.17 Insurers were all in favour of a direct levy on the profession if the ARP were to continue in its current form. Some believe that if Option 1 were implemented, the profession would have an incentive for greater self-regulation. They argued that a direct levy on the profession would be easier to be administer and would provide highly transparent costs which could accelerate self-regulation. If Option 2: was implemented, they generally believe it would be subject to the same market pressures as the current insurer-funded shortfall.

6.18 In terms of the current funding arrangements, as well as the general concern that funding via the profession introduced disincentives to compete for market shares, many insurers drew attention to two other issues:

- The fact that Qualifying Insurer's ARP liabilities are scaled up in the event of insolvency of other Qualifying Insurers. Insurers objected to this because it meant that their liabilities depended on whether or not their competitors became insolvent. They also highlighted that it meant that firms in the ARP therefore had more protection than did firms insured through the open market; and

- Concerns regarding the manipulation of market share information for apportioning the ARP cost between Qualifying Insurers. Insurers were concerned that some insurers and firms had sought to "get around" the rules which was to the disadvantage of those insurers that had not done this.

TLS PROPOSALS

6.19 Following the SRA's review of client financial protection arrangements and the publication of the consultation paper, TLS made proposals for an alternative approach related to the ARP. TLS proposed:

- The closure of the ARP to new entry other than the role of providing cover for uninsured firms;

- An Extended Renewal Period lasting a minimum of 3 months in which firms can either obtain insurance elsewhere or plan for orderly merger, succession or shut-down;

- A notice period of six months of an insurers' intention to note renew a policy (which can include the 3 month Extended Renewal Period);

- The premium for the 3 month Extended Renewal Period to be charged at the same pro-rata amount as for the existing policy in place;

- The ability to place firms into the Extended Renewal Period in the case of fraud, mis-representation or material non-disclosure; and

- A requirement that insurers take on the 6 year run-off risk for firms they were previously insuring.

6.20 A number of respondents made reference to TLS proposals in their responses to various questions in the consultation paper.

OUR RESPONSE

6.21 A number of potential changes have been suggested by TLS and other stakeholders regarding the approach to be taken in relation to the ARP. In the light of comments received through the consultation process and continued discussions with key stakeholders, we have decided to revise our approach to the ARP. Not all of these issues were included in the consultation paper and we have therefore decided that we will set out our long term plans for the ARP, including transition arrangements, in a separate document (see the SRA's separate Financial Protection Policy Statement) with further consultation on the detail of the arrangements as necessary.

Medium term

6.22 Our approach, which will take effect from 1 October 2013, is as follows:

- The Assigned Risks Pool (ARP) will close to new entrants;

- Following the expiry of a policy of Qualifying Insurance:

    - A firm has a grace period of up to 30 days to obtain cover and backdate it to have effect as from the expiry of the previous policy – the "Qualifying Period Extension";

    - On the expiry of the 30 days, if the firm has not obtained Qualifying Insurance:

    - it must cease accepting any new instructions and run-off all existing instructions in an orderly manner by no later than 3

months following the expiry of its last policy of Qualifying Insurance;

- the SRA shall have powers (and will be expected) to supervise the orderly wind-down, take steps to restrict the firm from accepting any new instructions and, if necessary, transfer of business to another firm within the 3 months period;

- the last Qualifying Insurer of record retains the risk for claims arising from the work of the firm during its 3 months winding down period; and

- as is currently the case, the last Qualifying Insurer of record retains the risk for a 6 year run-off period after the expiry of the last policy of Qualifying Insurance. This run-off policy will also provide cover (to the same date) for any claim arising from work performed by the firm in the 3 month period after policy expiration.

6.23 In respect of closing the ARP to new entrants, we note that more than half of the profession who gave clear comments on this issue were in favour of closing the ARP and many in the profession expressed frustration that firms were being sustained in business when they should be closed down.

6.24 One of the main concerns expressed regarding the closure of the ARP was that this could lead to firms suddenly having to close down because they were temporarily unable to obtain insurance from qualifying insurance. The proposal to have a Qualifying Period Extension helps to deal with this concern as it introduces additional time for firms to seek appropriate cover if they have been unable to do so in advance of renewal. It should be noted that this does not prevent insurers and firms from freely choosing to extend policies for short periods of time. Rather, the Qualifying Period Extension is aimed at ensuring that firms have an extra 30 days to obtain insurance should their existing insurer determine that it is unwilling to continue offering insurance to them.

6.25 We will also ensure that information channels are put in place between insurers and the SRA to ensure in order to ensure that there is clarity as to whether a firm is operating under the Qualifying Period Extension during which time we anticipate increased regulatory attention. Firms which enter the Intervention Period will face considerable regulatory attention with a view to firms being closed down in an orderly fashion.

6.26 The final element of the long term proposal is that insurers will be required to automatically take on run-off cover for any firms that they insure if those firms cannot obtain alternative insurance and enter the Qualifying Period Extension and the Intervention Period. This is an extension of the requirement that insurers take on run-off cover for firms that close down during the policy year as is currently the case.

6.27 The intention of this proposal is that it would prevent the re-emergence of the current situation where firms end up with qualifying insurance provided by the ARP and then enter run-off also through the ARP. This would also improve the incentives for insurers to report information to the SRA regarding any poor behaviour of firms because the current insurer would inevitably bear the run-off risk of the firm and therefore has an incentive to limit the cost of this through rapid reporting of any failures by the firm.

6.28 Some respondents to the consultation paper suggest that this proposal may lead to an increase in premiums for some firms compared to the absence of this requirement.

Short term – changes from October 2011

6.29 As well as the changes which we set out for the longer term, while the ARP continues to operate we will make the following changes:

- the maximum time a firm may obtain Qualifying Insurance from the ARP will be reduced to six months from 1 October 2011;

- ARP firms will be required to plan for either obtaining open-market insurance or closing in an orderly manner;

- changes will be made to remove the scaling up of a Qualifying Insurer's ARP liabilities in the event of insolvency of one of them (bringing the ARP funding in line with what would happen if insolvency arose in the open market);

- the criteria for apportioning the ARP cost between Qualifying Insurers will, if deemed necessary following the current review of declared premiums for the 2010/11 indemnity year, be revised in order to enhance clarity and transparency.

6.30 The proposal to shorten the time in the ARP from 12 months to six months was supported by the majority of respondents who commented on this issue and we will implement this from 1 October 2011. This will further reduce the costs of claims against firms in the ARP, create a greater focus for ARP firms either to close in an orderly fashion or take the steps necessary to address the issues which prevented them from obtaining insurance and be consistent with the transition to the new arrangements applying from October 2013. In addition, it will be important to ensure that, when October 2013 is reached no firms remain in the ARP. This is more likely to be the case if entry into the ARP is permitted for 12 months rather than six as it is relatively common for ARP firms to seek waivers of the ARP rules to extend their period within the ARP. In addition, reducing the number of firms in the ARP at any point in time will enable the SRA to concentrate available resources to address the regulatory issue that arise with many ARP firms.

6.31 The reduction in the period for which a firm is entitled to continue to operate in the ARP is also likely to benefit consumers. About 50% of firms in the ARP

are categorised by the SRA as being high risk with the remaining firms categorised as medium/low risk. Reducing the period for which ARP firms can automatically continue to provide services to the public is a clear mechanism to address this particular risk.

6.32 Making this change does not reduce the client protection provided by the ARP as it will still enable firms up to one month temporary cover with subsequently obtained open-market insurance being backdated (something done by some 190 firms following the October 2010 renewal) and ensure that firms are not forced into rapid and disorderly closure.

6.33 Our EIA addresses the issue of the impact on BME firms of a reduction in the period of time a firm may spend in the ARP (as well as the decision to replace the ARP in 2013). BME Firms are disproportionately over-represented in the ARP compared to white firms. This issue has been considered carefully as set out in the EIA. However, the SRA's view is that this decision is proportionate and justified both as a measure to be implemented in October 2011 and as being consistent with the transition to the new arrangements for October 2013. It is important to note that small firms, a category in which BME firms are also over- represented, have a very limited choice of insurer within the current market. This step (together with the others we have set out) is critically important not only to maintaining a viable open-market system but also to encouraging new entrants and increasing competition for firms' insurance business – including that of small firms. The majority of BME firms do not rely on the ARP for insurance but the open-market and, therefore, improvements in the availability and cost of open-market insurance, particularly to small firms, will benefit BME firms generally.

6.34 In addition, we note the comments from the profession regarding the firms that fall into the ARP for a short period of time and the implications this may have for the quality of these firms' practice management standards. From October 2011, we therefore anticipate investigating all firms that enter the ARP for a short period as well as the more intensive approach that we will take for firms that remain in the ARP beyond the period of temporary cover.

PROPOSAL 4: CLARIFYING OBLIGATIONS ON INSURERS TO PROVIDE INFORMATION TO THE SRA

7.1 The majority of respondents from the profession agreed that insurers should be required to provide information to the SRA regarding misrepresentation or failure to pay premiums. A small number of respondents, however, raised cautions that the interpretation of whether information had in fact been misrepresented means that firms should have the opportunity to respond to this position.

7.2 Insurers, however, had more mixed views regarding the proposal. A number of insurers argued that the change would have little impact since the SRA already monitors the activities of almost all the reported firms. In respect of information related to paying premiums, some insurers thought this would have little effect since most insurers insist on cash before cover because they are unable to avoid cover for non-payment of premiums (although they can not do this for run-off). With respect to fraud and mis-representation, insurers stated that clear guidance would be need as to when suspicions should be transmitted to the SRA and warned that insurers did not always have proposal forms where insurance has been written through brokers using binding authorities.

7.3 Most insurers expressed frustration that where insurers have passed on information to the SRA there was insufficient regulatory action in response as well as concern that the SRA does not share information with insurers. More generally, insurers indicated that they should not take on the role of the regulator.

OUR RESPONSE

7.4 We will be making one small change to the QIA for 2011/12 to clarify reporting requirements. In addition we will continue to work with insurers to improve information flows.

POSSIBLE FUTURE CHANGES

FURTHER EXTENSION OF PERMITTED EXCLUSION TO LIMIT COVER ONLY TO INDIVIDUALS

8.1 Among the profession, 118 respondents were against the proposal to enable a permitted exclusion for all clients other than individuals and only 13 were in favour. Those who agreed with the proposal argued that commercial clients did not need regulatory protection.

8.2 Among those who disagreed, some thought that permitted exclusions should be based on the work type rather than the client type (with this linked to regulatory permissions in many cases). Others that the exclusion should be limited to large corporates rather than going as far as suggested by the Ombudsman definition of individuals.

8.3 Those who objected did so for similar reasons to those given regarding the exclusion of financial institutions. In particular, many respondents were concerned that they would be unable to obtain insurance cover for clients where permitted exclusions were possible. Some saw the proposal as unnecessarily complicated. It was also noted by many respondents that most solicitors act for firms outside the scope of the "individual" definition and would therefore require full client coverage, many firms also noted that it was common to act for small business owners on a range of issues some of which could fall inside the definition of work for individual clients and some of which would fall outside. They also challenged the assumption that non-individual clients would always be in a better position to assess the quality of the solicitor than individual clients would be (although some used the same argument to suggest that since individual clients can assess quality other clients can as well).

OUR RESPONSE

8.4 We will be considering this issue further but do not intend to make any changes in this area before we have completed the ARP transition programme in 2013/14.

CANCELLATION OF POLICIES FOR NON-PAYMENT OF PREMIUMS

8.5 The proposed permit of cancellation of policies for non-payment of premiums was supported by 86 respondents compared to 27 who were against it.

8.6 Those in favour of the proposal argued that law firms should not have undue protection against insurers and that the proposal was simply standard commercial practice. Many expressed concern that the current arrangements meant that those firms that pay premiums subsidise those that do not. Many also stated that firms that did not pay premiums should be shut down immediately (although some noted the need to give firms time to pay in case this was an administrative error) and respondents believed that this would be to the advantage of the profession as a whole. Others, while agreeing with

the proposal, thought it would not make much difference as they believed that insurers already required upfront payment.

8.7 Some of the respondents who oppose the proposal think that it is a good idea in theory, but impractical. Furthermore they believe this could damage the clients' interests and the reputation of the profession and could increase the number of firms that would be placed into the ARP. In general, however, these firms believed that failure to pay premiums should lead to SRA investigations of the firms.

8.8 We will consider this issue further in the context of the arrangements we are putting in place for the replacement of the ARP.

CANCELLATION OF POLICIES FOR FRAUD OR MISREPRESENTATION IN PROPOSALS

8.9 The proposal to permit cancellation of policies for fraud or misrepresentation was supported by 68 respondents compared to 22 who were against it.

8.10 One of the issues raised by some respondents is that there should be a different treatment for fraud, for which they agree with the policy cancellation, and misrepresentation, for which they think the cancellation, should not be allowed. Some other respondents state that only innocent misrepresentation should not lead to policy cancellation. In general there was more concern regarding making changes related to misrepresentation than making changes with respect to fraud. A number of respondents were concerned that the present arrangements mean that good firms pay for deliberate misrepresentation and fraud by bad firms. Respondents were also in favour of regulatory investigation of these firms.

8.11 As for the respondents against the proposal, they think that this measure, by removing protection, could have an adverse impact on clients, and could be abused by insurers who would seek to repudiate more claims. It is in their opinion that insurers should counterclaim against the insured. Some others think that this should primarily be a matter of professional misconduct requiring action by the regulator.

8.12 We will consider this issue further in the context of the arrangements we are putting in place for the replacement of the ARP.

COMPENSATION FUND

Q32: Single Compensation Fund

8.13 The proposed single Compensation Fund for covering all regulated organisations was supported by 71 respondents compared to 40 who were against it.

8.14 The main reason that respondents are against the single compensation fund report is that since the Compensation Fund has been fuelled by the contributions of traditional law firms, ABSs should not be allowed to benefit

from these contributions, but should rather pay into their own separate Compensation Fund. These respondents state that by creating a single compensation fund, the SRA would allow ABSs to free ride on the efforts and contributions of solicitors firms.

Q33: Interaction between the scope of cover through the MTC and the Single Compensation Fund

8.15 The respondents to this question seem to be mainly concerned by the fact that the Compensation Fund will be used to protect financial institutions, even though such organisations will not be protected by MTC (assuming that the financial institution exclusion was permitted). They argue that if financial institutions were protected by the single Compensation Fund the burden of financing such losses will merely move away from insurers and the ARP to the Compensation Fund. It is their opinion that a single Compensation Fund will exacerbate the concerns of the financial institutions in dealing with smaller firms and will consequently lead those firms to be excluded from the conveyancing market. This will have the effect of reducing consumer choice and driving more firms out of business.

8.16 Another concern relates to the different nature of the two funds: the cover provided by the MTC should be for civil claims, whereas the cover provided by the compensation fund should be for dishonesty.

8.17 Alternatively it was suggested that insurers should have an aggregate cap on claims by financial institutions, rather than having a single Compensation Fund with an aggregate limit on its liability and, therefore, a cap on the number of claims that can be made on it.

Q34: Views on the basis for assessing contributions to the Compensation Fund

8.18 77 respondents expressed views on the basis for assessing the contributions to the Compensation Fund.

8.19 Many respondents state that the contributions to the Compensation Fund should be based on risk reflective criteria. Others are concerned that the proposed contribution methodology might be too difficult and complex to be achieved without adding more bureaucracy and consequently more administrative costs. Some other respondents are concerned that this measure will imply that conveyancing firms will pay more.

8.20 Some respondents proposed alternative approaches to the contribution methodology. The proposal that is support by the greatest number of respondents is the approach adopted for TLS payments, i.e. that contributions should be set as a percentage of turnover. Other suggestions are to link the contributions to the size and type of business; gross premium income in previous years; the number of claims; to make contributions on a basis similar to that used to calculate the fee for the SRA; and to link contributions to the number of partners within the practice.

Q35: Single fund

8.21 It should be noted that this question is only relevant if the purpose of the ARP was not changed and that it continued to provide policies of Qualifying Insurance. Given this change, there were 44 respondents who believe that the ARP and the Compensation Fund should be combined into a single fund while 41 respondents opposed the proposal of a single fund.

8.22 Some objected to the proposal because the ARP and the Compensation Fund have different purposes and therefore should not be combined. Others fear that the value of a single fund may be insufficient to meet claims.

OUR RESPONSE

8.23 As set out in the separate Policy Statement we will be giving further consideration to a number of issues concerning the Compensation Fund during 2011/12.

EQUALITY IMPACT

9.1 Only 20 respondents commented on the initial equality impact assessment and among them there is a divergence in opinions regarding the impact of the proposed changes. All of the comments on equality issues were considered in the drafting of the final EIA which is published alongside this response.

9.2 Respondents who believe the changes would have a negative impact are mainly concerned that the financial institution exclusion will affect disproportionately the small firms. They believe that the PII premiums are unlikely to reduce in the early years following 2011. On the contrary, for firms with a financial institutions exposure, the overall premiums are likely to increase, as they will need to buy additional cover.

9.3 Another concern relates to the two-stage approach as it may make it more difficult for small firms, BME, female and sole practitioners to obtain insurance due to the period of uncertainty regarding the SRA's approach to the ARP.

9.4 Among the 5 respondents who see the impact of the proposed changes as positive, 3 respondents believe the changes would make the market more innovative and by removing barriers to entry, more competitive. Therefore the enhanced competition would improve equality by lowering prices and by making insurance more accessible.

9.5 Regarding the single renewal date removal, a respondent believes that if a sufficient spread of variable renewal dates is achieved, then there may be a positive impact on small firms and indirectly on BME firms. However, if there is not a sufficient spread of variable renewal dates then it is possible that firms will continue to be disadvantaged.

9.6 Concerns raised in relation to equality issues flowing from decisions on the ARP have been referred to in the relevant sections earlier in this paper and are addressed at length in the EIA published alongside this paper.

9.7 Nine respondents said that there is more work to be done on the equality impact, in particular concerning entry requirements to allow solicitors to practice. A respondent believes that a full equality impact assessment, as opposed to an initial assessment, and an extensive consultation with the groups likely to be affected by the current proposals are necessary.

Table 1

SUMMARY OF OVERALL RESULTS

The table below sets out a summary of the main responses by whether respondents agreed or disagreed with the main proposals.

	Yes	No
Question 1: Agree with Objectives and Principles	100	18
Question 4: Agree with Two-stage approach	48	45
Question 5: Maintain open market	128	10
Question 6: Maintain QIA	122	11
Question 7: No additional criteria for QI	103	27
Question 8: Maintain ARP for claims against uninsured firms	93	41
Question 9: Maintain ARP for run-off cover	89	44
Question 10: Maintain current approach to setting premiums	76	48
Question 11: Remove single renewal date	69	150
Question 12: Agree with FI exclusion	25	236
Question 13: Agree with definition of FI	40	72
Question 14: FI as permitted exclusion from the MTC	47	67
Question 16: Agree with ARP to 6 months	84	49
Question 17: Require detailed plan from firms in the ARP	54	14
Question 18: Agree with reporting	56	19
Question 19: Cover restricted to individuals	20	131
Question 22: Remove ARP as provider of QI	55	43
Question 26: Change ARP funding	79	17
Question 30: Permit cancellation for non-payment of premiums	86	27
Question 31: Permit cancellation for fraud or misrepresentation	68	22
Question 32: Single compensation fund (law firms and ABS)	71	40
Question 35: Single fund (ARP and CF)	44	41

Annex 3

SRA

FINANCIAL PROTECTION POLICY STATEMENT

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;

(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 Equalities 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).
- 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 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;

- 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 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

- 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); and

- 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 theses 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 50% 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; and

- 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.

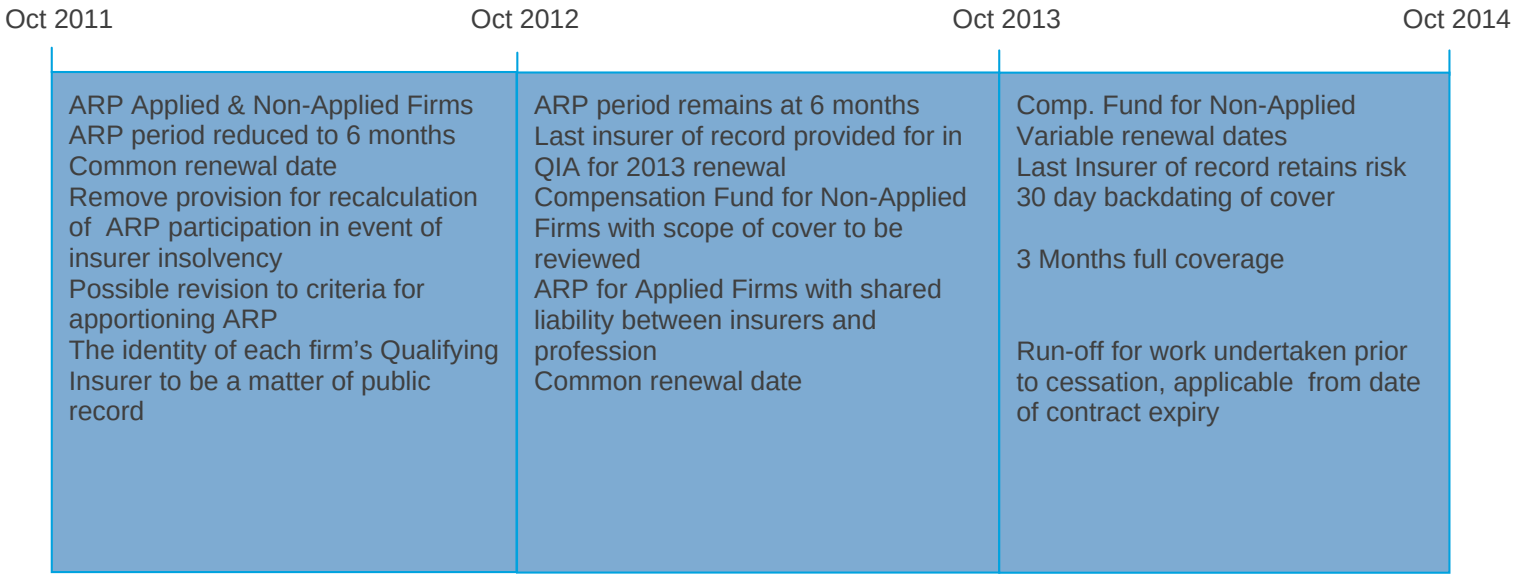
78 In addition there will be further consultation on any changes to the Compensation Fund arrangements and regulatory changes flowing from the review of conveyancing and holding client money. Each of these consultations will be accompanied by draft Equality Impact Assessments and decisions made with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

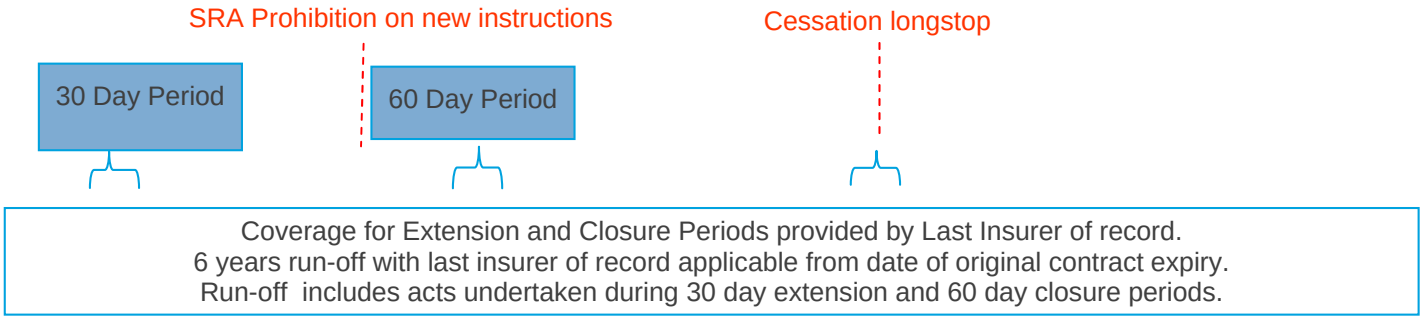
80 Finally, we will continue to review the effectiveness of these arrangements in providing real protection to clients. As a public interest regulator, the interests of the public and the consumers of legal services are paramount. The success of the SRA's client financial protection arrangements has, 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

Professional Indemnity Insurance Transition Plan



Insurer of record mechanism for firms that fail to obtain qualifying insurance at 2013 renewal



Annex 4

Future client financial protection arrangements - equality impact assessment

Business unit: Standards
Publication date:

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Appendix 1	Progress report on the action plan published with the 2009/10 ARP review equality impact assessment (as at March 2011)
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Appendix 5	Risk assessment scores of ARP firms broken down by ethnicity at the beginning of the practising year 2010/11
Appendix 6	Current status of ARP firms by risk status and ethnicity

Introduction

1. The SRA consulted on the arrangements originally proposed for client financial protection in December 2010, following the completion of a "root and branch" review conducted for the SRA by Charles River Associates (CRA). An initial equality impact assessment of the proposals put forward by the SRA was published with the consultation paper.

2. The consultation proposed four key changes for 2011/12 and sought views on a number of longer term changes. The proposals for implementation in October 2011 were:

    - Removal of the restriction of a single renewal date;
    - Claims by financial institutions to be a permitted exclusion in the minimum terms and conditions and an exclusion in the ARP policy;
    - Tightening controls on the Assigned Risks Pool (ARP) - reducing cover to 6 months and requiring firms to plan their exit from the ARP; and
    - Clarification of insurers obligations to provide information to the SRA.

3. The consultation period closed on 28 February 2011 and the SRA has since formulated a plan for client financial protection which will be implemented over a period of 3 years. The changes for implementation in October 2011 involve two of the four original proposals and there are three new proposals that have

arisen from the consultation responses and/or discussions with our stakeholders.

4. The changes that are proposed for implementation in 2011 are listed below:

   - Identity of each firm's qualifying insurer to be a matter of public record (new)
   - Clarification of insurers' obligations to provide information to SRA (part of the original proposal)
   - Removal of the provision for the recalculation of ARP participation in the event of insurer insolvency (new)
   - Consideration to be given to revising the criteria for apportioning the ARP (new) and
   - ARP eligibility period reduced to 6 months and ARP firms required to plan their exit from the ARP (both part of the original proposal).

5. Full details of the proposals are set out in the paper that will be taken to the SRA Board on 13 April 2011 for a final decision.

6. The original proposal to remove the single renewal date in October 2011 has been postponed until October 2013. The SRA is no longer proposing to permit the exclusion of claims by financial institutions from the minimum terms and conditions but this may be re-visited following the review that the SRA is planning in relation to the regulation of conveyancing later in the year.

7. This equality impact assessment is focused specifically on the changes that are proposed for introduction in October 2011, although we will consider these changes in the light of wider decisions that we have made on the future of client financial protection.

8. In line with our new public sector equality duty which came into force from 5 April 2011, we have considered the equality impact across all equality areas, now referred to as "protected characteristics" by the Equality Act 2010. These include age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex, and sexual orientation. However, we have focused on race equality as our previous ARP equality impact assessment and the evidence and stakeholder feedback we have gathered since, suggests that race equality is where the main impact will be felt.

Background

9. During the 2009/10 practising year the SRA conducted a review of the Assigned Risks Pool (the ARP review) which led to a number of changes being introduced in October 2010 for the practising year 2010/11. The main proposal put forward for consultation during the ARP review was the closure of the ARP as a provider of qualifying insurance for firms unable to secure insurance on the open market. In the alternative, we proposed closing the ARP to new firms

and/or reducing the time that a firm could spend in the ARP from 2 years to 1 year. The SRA Board decided to keep the ARP open as a provider of policies of qualifying insurance but restrict its scope by adopting both of the alternative proposals.

10. The main finding of the equality impact assessment of the ARP review was that the SRA would not be justified in closing the ARP at that time because of the potential for adverse impact on Black and minority ethnic (BME) firms and the consequent adverse impact on access to justice, if fewer small BME firms were unable to obtain insurance and were forced to close. The impact assessment referred to some research which suggested that small firms, including small BME firms are likely to be located out of city centres and may be more likely to have a local and more diverse client base. Accordingly, any impact on access to legal services from small BME firms may also have an equality angle to it.

11. There were a number of reasons why the SRA Board decided not to close the ARP at that time. The following extract from the minutes of the SRA Board's meeting on 16 March 2010, summarises the position:

> 'The Financial Protection Committee had concluded that closure of the ARP was not viable, not only because almost every group consulted (including the profession and the insurers) was opposed to it, but also because the analysis showed the potentially detrimental consequences of that option (including disproportionate impact on BME firms and the real possibility of insurers of smaller firms leaving the market rather than bear the brunt of the new system)'.

12. Whilst the equality impact assessment concluded that there was also potential for adverse impact arising from the two alternatives, there were measures we could take to minimise the effect of these proposals. The measures included more support and guidance for new firms and smaller firms in securing market insurance, more effective regulation of high risk ARP firms, and the availability of objective criteria for firms applying to stay in the ARP for longer than 12 months. These measures were included in the action plan that was attached to the equality impact assessment and a progress report has been prepared and is attached as **Appendix 1**.

13. The Board was satisfied that this approach was a proportionate response to the particular problems posed by the ARP at that time and as such was justifiable. The SRA Board is again being asked to make decisions about the future of the ARP, although for this year we have the benefit of a comprehensive review of the client financial protection arrangements following the work undertaken by CRA and the findings of a fresh consultation exercise. In our analysis of whether the SRA would be justified in its decision to close the ARP as a provider of qualifying insurance with effect from October 2013 and in relation to the reduction in the eligibility period from 12 to 6 months from October 2011, we

will set out an explanation as to how the circumstances this year are different from last year.

14. During the ARP review and since, there has been mounting concern about the current framework for professional indemnity insurance, centred on the growing numbers of firms in the ARP, the increasing cost of claims arising from ARP firms which is borne by the insurers and the open-ended liability which insurers bear. Many stakeholders believe these factors are threatening the viability of the open-market approach.

15. There were also other developments in the professional indemnity insurance market for solicitors which led many commentators to anticipate a very high number of firms in the ARP for 2010/11. This was caused by the withdrawal from the market of one of the main insurers specialising in insurance for small firms, prompting fears that the market would not be able to absorb the small firm population.

16. Although there are more firms in the ARP this year (261 at 2 February 2011) than there were last year (241 at 2 February 2010), the increase is less than many had feared. However, the high number of ARP firms and costs are still of great concern. The total cost of the ARP for each of the years 2008/09 and 2009/10 will be in the region of £45m compared to the total premium income for insurers of the compulsory layer of insurance of about £250m. Despite the changes introduced for 2010/11 the insurers remain very concerned about the ARP and identify its continuation as a barrier to entry for new insurers, a factor that is likely to lead current insurers to withdraw and something that leads current insurers to artificially constrain market share.

17. As a result, in May 2010, the SRA Board decided to commission a "root and branch" review of the entire area of financial protection for clients, with "nothing ruled in and nothing ruled out" - the client financial protection review.

The client financial protection review

18. In preparing their report, CRA talked to a range of stakeholders and have had the benefit of input from a roundtable discussion with an external reference group, established to consider client protection. The external reference group included representatives of all the key stakeholders - full details are provided in the report itself.

19. Given the potential for adverse impact on BME solicitors identified during the ARP review in 2009/10, we arranged for CRA to meet with a number of BME practising solicitors and sole practitioners, many of whom have been working closely with the SRA and the Law Society to address ongoing concerns about the indemnity insurance market. The groups represented at the meeting were the Black Solicitors Network, the Society of Asian Lawyers, the Solicitor Sole Practitioner Group, and individuals from the BME community.

20. An agreed set of principles for client protection arrangements was drawn up at the outset, against which all key elements of the scheme would be measured. Principles 1 and 4 specifically refer to the need for fairness, and for the need to encourage an independent, strong, diverse and effective legal profession.

21. CRA started out by looking at the model for professional indemnity insurance. CRA recommended that the SRA retain the open market model as opposed to returning to either a single policy underwritten by insurers, or a single fund underwritten by the profession, such as the Solicitors Indemnity Fund. CRA identified strong evidence in favour of retaining the open market model and found no evidence that the choice of model could have a differential impact on equality groups in relation to the cost of insurance to the profession. The evidence overall indicated that the open market model has proved less costly for the profession than either of the previous models used. The open market model received overwhelming support in the consultation responses with 123 in favour and 8 against.

22. The analysis set out in CRA's report is useful in understanding the role that the ARP plays within the open market model as it is largely the ARP where the equality issues arise. The CRA noted that the open market model could operate either with or without an "insurer of last resort" i.e. a safety net for firms which are not able to get insurance in the open market. This function is fulfilled by the ARP at the present time, although time-limited to 12 months under the current arrangements.

23. In considering the equality impact of the proposals we will refer back to the relevant findings of the CRA report on the advantages and disadvantages of operating the open market model without an insurer of last resort.

Equality impact of the 2011 proposals

The proposal to make the identity of each firm's qualifying insurer a matter of public record

24. This proposal was not included in the consultation proposals but has arisen as we have been working on this review and has particularly been advocated by clients, such as lending institutions. We have discussed this with the insurers who in general terms do not see this as a problem. We do not see this as controversial and will be recommending to the Board that this be introduced in October 2011. Since the Qualifying Insurer's Agreement and the Solicitors' Indemnity Insurance Rules were first introduced in 2000, the identity of a firm's Qualifying Insurer has been treated as confidential information and can be released only to people entitled to it e.g. someone who is asserting a claim against the firm in question. A recent development is the Provision of Services Regulations 2009 which implements Directive 2006/123 on services in the internal market and imposes an obligation on firms to make available to clients information about their indemnity insurance. Firms in the ARP must give their clients the contact details for the ARP manager.

25. To support the aims and objectives of the directive and in the interests of transparency it is proposed that the identity of each firms' Qualifying Insurer will be part of the public information held by the SRA which will be available on request. This will apply to policies commencing on or after 1 October 2011 and will apply to firms who are insured on the open market as well as firms insured by the ARP.

26. This will give consumers more information to make informed choices and will cut down the number of enquiries that the SRA receive for disclosure of insurer details under Rule 17 of the Solicitors' Indemnity Insurance Rules. Our view is that this is a welcome improvement for consumers and we see no potential for adverse equality impact of this proposal.

Equality impact of the proposal to clarify insurers' obligations to provide information to the SRA

27. We are proposing that insurers are required to provide information to the SRA regarding firms that fail to pay their insurance premiums and firms that have mis-represented information. At the moment insurers "may" provide such information. This change is designed to provide better and more timely information to the SRA as part of our move to outcomes-focused regulation which will support our risk based approach.

28. We saw no potential for adverse impact of this proposal when we considered it at the consultation stage and we have not identified any evidence to alter our conclusion during the further work we have done to conclude this equality impact assessment.

Removal of the provision for the recalculation of ARP participation in the event of insurer insolvency

29. We are proposing to remove the provision for the recalculation of each insurer's percentage participation in the ARP in the event of a qualified insurer becoming insolvent. Under the current arrangements if one of the insurers becomes insolvent, the others have to take on their ARP liabilities in equal share.

30. There are implications for consumers arising from this change because under the arrangements proposed, claims against an ARP firm will no longer be absorbed by the other insurers. This will leave the firm exposed and the client potentially unable to make a full recovery.

31. The rules relating to firms insured on the open market require them to arrange replacement cover within four weeks of the insolvency of their insurer. If a claim arises before that replacement cover is put into place, the firm or client may be able to benefit from the Financial Services Compensation Scheme to help

make good the deficit. This is a scheme run by the Financial Services Authority but does not guarantee full recovery of claims made.

32. The proposal will place ARP firms and their clients in a similar position to firms insured in the open market and will remove one of the disincentives for insurers to enter and remain in the market for solicitors' professional indemnity insurance.

33. This proposal was not part of the consultation paper but has arisen from discussions with insurers during the review. Although we have not consulted on this proposal we are satisfied that it is appropriate to pursue this change.

34. We have identified that there will be an adverse impact on consumers, in particular on clients of ARP firms as a result of this change. However, clients of the vast majority of firms which are not in the ARP are in the same position and there is no justification for keeping this additional protection for ARP firm's clients. As mentioned above, there is some evidence to suggest that small firms and small BME firms in particular have a diverse client base and as such any impact on clients of these firms may have an equality impact. We do not have sufficient data to identify precisely which equality groups would be affected, but the research to date has focused largely on access to justice for BME groups.

35. If there were to be an adverse equality impact on consumers of legal services as a result of this proposal we nevertheless consider this change as a proportionate means of achieving a legitimate aim. The present arrangements were introduced when the ARP was very much smaller and in the current climate, with such high numbers in the ARP and the high cost to the insurers, we cannot justify providing this additional level of protection to ARP firm clients. Although a benefit will be lost to one group of consumers, the outcome will be that all consumers are treated the same which is ultimately fairer.

Consideration to be given to revising the criteria for apportioning the ARP

36. We are currently reviewing the 2010/11 renewal exercise to investigate whether some of the insurers have restructured their pricing policies to enable them to declare lower premium income. An insurer is required to contribute to the ARP in accordance with their proportion of the market share. It was apparent in the October 2010 renewal that some insurers and firms were structuring insurance policies in such a way that the premiums paid in respect of the compulsory layer were lowered; with the effect of reducing the insurers' proportion of ARP liability. A review is currently being undertaken into this.

37. We may need to introduce revised criteria to address this depending on the finding of the review. The impact of any changes is likely to be felt by the insurers rather than the profession or consumers.

Equality impact of the proposal to reduce the ARP eligibility period from 12 to 6 months and that ARP firms will be required to plan their exit from the ARP

38. The main change for October 2011 is the proposal to reduce the ARP eligibility period from 12 to 6 months. However, this proposal needs to be considered in the context of the SRA's decision that in the longer term the ARP should not act as an insurer of last resort although this will not come into effect until 1 October 2013. From this date, firms which cannot obtain insurance on the open market will have to close without spending a limited period in the ARP first. Arrangements are proposed to provide an additional period of time for firms to find open-market cover and to protect clients by making sure that firms are covered during the period while they find cover or close in an orderly manner.

39. The changes to the ARP will be phased in over 3 years:

- October 2011 – reduction from 12 to 6 months with cover provided for firms by the ARP
- October 2012 - 6 months' cover provided for firms by an ARP (the funding arrangements for which will change from those currently in place)
- October 2013 – arrangements brought into effect for firms unable, initially, to secure market insurance, providing them with an additional 3 months cover from their previous insurer to find new open-market cover or close in an orderly manner.

40. The proposal to require ARP firms plan their exit from the ARP may have an adverse impact on equality because BME firms are disproportionately represented in the ARP, but we are confident that this is justified. ARP cover has always been time limited and should not be seen by firms as a medium or long term solution. The requirement is not intended to be formal or onerous so we believe it is a proportionate requirement to impose.

41. We have taken into account the following sources of evidence in coming to our conclusions about the equality impact of main proposal to reduce ARP cover to 6 months and close this function of the ARP in the longer term.

Findings from the CRA report

42. CRA concluded that to operate an open market system without an insurer of last resort at this time, would adversely impact on BME firms, which were overrepresented in the ARP. In the executive summary published on the SRA website CRA concluded:

> '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.'

43. In relation to the ARP's current role as a provider of qualifying insurance (albeit limited to 12 months), CRA commented:

> '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.'

44. The report goes on to consider the arguments for and against retaining the ARP, looking in particular at the cost attributable to the ARP of providing qualifying insurance. CRA calculated that nine per cent (£3.7 million) of the value of claims for 2008/09 arose from work undertaken while firms were in the ARP. The remaining 91 per cent (£39.4 million) arose from work undertaken prior to the firm joining the ARP and as such would have arisen whether the firm was allowed to continue to practise in the ARP or not.

45. Dividing the £3.7 million cost by the 26 firms which emerged successfully from the ARP over the relevant period, leads to a notional cost of £140,000 per firm. The SRA warns in the consultation paper that the figure could more realistically be £280,000 as experience has shown that some firms emerging from the ARP are unable to survive much beyond 12 months.

46. It must be noted that the £3.7 million represents claims made in respect of work that all firms in the ARP conducted during their period of ARP cover – the statistics quoted represent a notional cost per rehabilitated firm of having the "safety net" available to the profession as a whole.

47. In summary, CRA found that closure of the ARP as a provider of qualifying insurance will have a disproportionate adverse impact on BME firms. It is for the SRA, in consultation with stakeholders, to balance the cost and wider implications of retaining the ARP against the adverse impact identified and to determine the point of principle referred to above.

Equality breakdown of the ARP firms

48. The potential adverse impact that we identified in our initial equality impact assessment arises from the disproportionate number of BME firms in the ARP, which has been a feature of the ARP for a number of years. At **Appendix 3**, we have provided an equality breakdown (by ethnicity, age and gender) of ARP firms for the current practising year and the previous practising year, setting out for each year the percentage that each group represents in the overall firm population for comparative purposes.

49. The number of firms in the ARP can change from day to day, however, after the first 2 or 3 months, the ARP numbers stabilise and we have therefore taken a snap shot of the ARP as at 2 February for both 2010 and 2011 for consistency. The initial equality impact assessment referred to BME firms representing 41 per cent of the total ARP firms in 2009/10; this was the figure for an earlier date. For this full equality impact assessment we will be using the figures as at 2 February 2010 which was 42 per cent for BME firms.

50. 102 of the 243 firms (42 per cent) in the ARP on 2 February 2010 were BME and BME firms made up only 11 per cent in the overall solicitors' firm population and 15 per cent of the overall population of 1 and 2 partner firms. The latter comparison would be a more accurate measure of the disproportionality as over 90% of firms in the ARP are 1 and 2 partner firms.

51. The disproportionality for BME firms has continued into this practising year albeit at a lesser rate. 100 of the 261 firms (38 per cent) in the ARP on 2 February 2011 were BME and BME firms made up only 12 per cent in the overall solicitors' firm population and 15 per cent of the overall population of 1 and 2 partner firms.

52. Female firms are underrepresented in the ARP over both years compared to the overall firm population and male firms are over represented although not to the same extent as for BME firms. In February 2011, 20% of the ARP firms were female as compared to 26% in the overall firm population and 67% of firms were male as compared to 62% in the overall population.

53. For the age categories, whilst there was overrepresentation in the ARP for firms in the age categories from 31 to 50 in 2010, this was very much reduced for 2011 with this category representing 18% of the ARP firms as compared to 17% of the overall firm population.

54. In summary, this evidence suggests that closure of the ARP as a provider of qualifying insurance will have a disproportionate adverse impact on BME firms.

Stakeholder response

55. There was a large response to this consultation and a full report summarising those responses will be published and provided to the SRA Board.

56. A majority of respondents to the consultation favoured the removal of the ARP as the insurer of last resort. Among responses received from the profession, 43 respondents were in favour of ending this role for the ARP compared to 33 who disagreed.

57. Those who were in favour of ending this role for the ARP made the following main comments:

- The ARP leads well run firms to subsidise the claims of poorly run firms and the cost of the ARP is very significant for the rest of the profession;
- Firms that cannot obtain insurance in the open market should not be in practice;
- Firms in the ARP rarely exit the ARP to continue practising, the ARP does not rehabilitate firms and therefore should be closed;
- Closing the ARP would force firms to close which, since they would be high risk firms, would be to the benefit of the rest of the profession; and
- Keeping the ARP makes entry by insurers less attractive which in turn makes it more difficult for firms to obtain open market insurance

58. Those who were against closing the ARP made the following comments:

- Without an ARP firms may be forced to close suddenly which would not be to the benefit of clients (although many respondents highlighted that having some form of policy extension similar to that suggested by the Law Society (and which we are now planning to introduce) would assist in this);
- Closing the ARP would place the insurers in the position to determine whether firms could continue to practice;
- Some form of fallback mechanism was needed for firms who cannot obtain insurance because of unfair actions by insurers; and
- Closing the ARP would force firms to close which was seen as unreasonable.

59. A majority of respondents to the consultation favoured reducing the time that a firm could spend in the ARP. Among the profession, 71 were in favour of reducing the time in the ARP (52 in favour of 6 months, 8 in favour of 3 months and 11 in favour of the ARP being closed altogether) while 40 were against reducing the time in the ARP. Once all respondents are included, 84 were in favour of reducing the time in the ARP and 48 against.

60. Of those who were against the reduction, many respondents stated that the change from two years to 12 months had only just been made and that time needed to be spent assessing the impact of this previous change before making further reductions in the time in the ARP. Others in favour of the reduction to 6 months considered that this was a sufficient period for any good firm to sort its difficulties out or for other firms to be closed in an orderly manner.

61. A number of respondents stated that reducing the time in the ARP was unlikely to materially affect the claims in the ARP as by the time firms entered the ARP they were already facing large numbers of claims and were on their way to closure. These respondents argued that greater action by the regulator was needed to do this.

62. In relation to the suggestion that firms in the ARP should be required to undertake detailed planning of how they would exit the ARP, among the profession, 42 respondents were in favour of requiring ARP firms to while 10

were against this. Among those who were against it, respondents indicated that this could lead to “tick-box” regulation of these firms, that the planning would distract firms from getting on with serving their clients, or that it was an academic issue given that most firms in the ARP close anyway. Some objected on the grounds that not all firms in the ARP should be required to do this as not all firms in the ARP were high risk firms, rather were in the ARP due to mis-conceived rejections by insurers.

63. In addition to the consultation responses, we have taken on board the feedback we received from those who were involved in a number of other engagement events that we held over this period:

- We held an event with the Black Solicitors Network in Birmingham on 6 December 2010 to talk about the SRA's move to outcomes-focused regulation and discuss the client financial protection review;
- Over 300 people joined our webinar on 28 January 2011;
- We arranged a further workshop for BME groups in London on 7 February which we had to cancel as there were insufficient numbers able to attend. We were assured by those invited that this was not due to lack of interest in the issues but the practicalities of taking time out during the working day to attend the workshop and the fact that the other two events just before and after the planned workshop provided alternative opportunities for engagement;
- The stakeholder reference group, set up during the client financial protection review, met again to discuss the proposals on 17 February 2011 with all the main stakeholder interests represented as before.

64. The engagement events indicated the strength of feeling on both sides about the ARP. BME stakeholders expressed concern about their experiences in the professional indemnity insurance market and the impact on them if the ARP was removed or limited as a 'safety net'. The insurers were very concerned about the numbers of high risk firms still practising in the ARP and the cost.

65. We asked respondents specifically to comment on the equality impact of the proposals and there were diverging views from the 20 responses to this question. Respondents who believed the proposed changes would have a negative impact on equality were mainly concerned that the financial institution exclusion will affect small firms, and therefore BME and female firms disproportionately. Another concern expressed was that it would be more difficult for small firms, BME and female firms and sole practitioners to obtain insurance as a result of uncertainty regarding the SRA’s longer term approach to the ARP.

66. Among the 5 respondents who saw the impact of the proposed changes as positive, 3 believed the changes would make the market more innovative and by removing barriers to entry, more competitive. Therefore the enhanced competition would improve equality by lowering prices and by making insurance more accessible.

67. In summary, there was a majority of support from the profession and our wider group of stakeholders for closing the ARP as a provider of qualifying insurance and for reducing the time spent in the ARP. Although very much in the minority, there were strongly held views in support of the ARP from BME groups arising from their concern that there was racial discrimination in the professional indemnity insurance market.

Our experience of regulating the current ARP firms

68. As a result of the ARP enforcement strategy that we introduced in July 2010, we have been proactively engaging with ARP firms and taking regulatory action where necessary. We have been closely monitoring the impact of this strategy and a progress report has been provided for the SRA's Compliance Committee on 12 April 2011.

69. The evidence provided in the report and its conclusions have been summarised and the relevant statistical data has been appended to this equality impact assessment for completeness.

70. All ARP firms have been risk assessed and **Appendix 5** sets out the risk categories allocated at the outset of practising year 2010/11 broken down by the firm's ethnicity. The tables show that there is an equal split between the two risk categories with 48% of the 261 firms in the high category and 51% in the Medium/low category. There was one firm that we did not have the information for at the time of producing the data. The BME firms were evenly split between the two categories and there was a slightly higher proportion of the white firms in the Medium/low category, 53 per cent, with 46 per cent of white firms in the High risk category.

71. The current status of the firms in each risk category, broken down by the firm's ethnicity is set out in **Appendix 6**. The tables show that 120 of the 124 firms in the high risk category have been referred for action, either to the Practice Standards Unit or to the Forensic Investigation Unit of the SRA. The 'action' that might be taken could involve any of the regulatory outcomes available to the SRA, including intervention. Two of the remaining four firms are closed or closing and two are being monitored. There is little difference in the status of BME firms as compared to white firms - 83 per cent of BME firms and 82 per cent of white firms are with the Practice Standard Unit for action and 18 per cent of BME firms and 11 per cent of white firms are with the Forensic Investigation Unit for action.

72. 131 of the 134 Medium/low category firms are with the Practice Standards Unit or the Forensic Investigation Unit for action. Of the remaining three firms, one is being monitored and two are closed or being closed. There is little difference in the status of BME firms as compared to white firms - 100% of BME firms and 96% of white firms are with the Practice Standards Unit for action.

73. In summary, the SRA's risk assessment process has identified just over half of the ARP firms as Medium/low risk, although this does not mean these firms are

risk free - once the SRA has been able to more closely assess the firms in question further problems may come to light which may necessitate further regulatory and/or disciplinary action.

74. The outcomes for all 210 firms which were in the ARP at the end of the 2009/10 ARP year (September 2010), broken down by the firm's ethnicity, are set out in **Appendix 4**. The table shows that 97 firms (46 per cent of the total) went into the ARP for the current practising year. 64 firms (31 per cent) closed and 47 (22 per cent) have been able to secure insurance on the open market.

75. Looking at the equality breakdown, the table shows that the outcomes for BME firms were better overall than for white firms, with 27 per cent of BME firms securing market insurance as compared to only 15 percent of white firms. 29 per cent of BME firms closed as compared to 40 per cent of white firms. However, a slightly higher percentage of BME firms went back into the ARP this year, 44 per cent as compare to 43 per cent of white firms.

76. In summary, 22 per cent of ARP firms were 'rehabilitated' back into the market at the end of last year, which represents 47 firms as compared to 26 the previous year. We are unable to work out the notional cost per firm as CRA did for the 26 firms which exited the ARP last year - the claims data will not be available until the practising year is concluded but it is likely to be a much smaller figure. The outcomes were better overall for BME firms than white firms.

77. The figures at paragraph 72 suggest that there is no significant differentiation between BME and white firms in the ARP; there is an equal proportion of high risk and medium/low risk firms in each group. If BME firms were receiving less favourable treatment from insurers on factors not purely related to justifiable and objective underwriting criteria, than white firms, we might expect to see a greater proportion of medium/low risk BME firms in the ARP than white firms. However, as set out at paragraph 76, of the firms that exited the ARP at the end of 2009/10 (22%), a greater proportion of BME than white firms did so, this might indicate that these BME firms were of lower risk when they went into the ARP or that they had been more successful at addressing their underlying risks. Given the range of differing indicators and the relatively small populations on which they are based, it is difficult to draw hard conclusions from these particular statistics within the ARP.

78. Non payment of ARP policy premiums is an issue that has caused concern among insurers and the profession as a whole. The SRA has declared its intention to take a firmer approach to non payment of premiums by ARP firms this year through the ARP enforcement strategy. Proposals for more effective debt recovery action by Capita, the ARP Manager, are being developed and the SRA is developing a policy to pursue proportionate and appropriate regulatory or disciplinary action against those in default. We are considering the equality impact of this work and will be reporting on that separately.

79. Our monitoring work in relation to this indicates that 38 firms which represent 15 per cent of the 261 firms in the ARP are not up to date with their premium payments. The SRA is seeking improved recovery rates of ARP premiums this year but past experience indicates that premium revenue does not in any event cover the cost of claims made for ARP firms. This is referred to as the loss ratio - if the total number of premiums received equalled the total number of claims paid the loss ratio would be 100%. CRA quotes in its report that the loss ratio over the past 10 years has averaged 800 per cent which it states 'would be inconceivable in the commercial market'. The data provided in the CRA report does indicate a decline in the loss ratio over 2008/9 and 2009/10, indicating an improved rate of collection of ARP premiums but potentially also because some of the claims that may be attributable to those practising years have not yet been made.

80. In summary, the issue of premium default is an important one, but may not be one of the central factors relevant for determining the future of the ARP as even full collection of premiums due are unlikely to cover the costs of claims made by ARP firms.

Concerns about discrimination in the professional indemnity insurance market

81. The evidence of differential outcomes for BME firms in the professional indemnity insurance market and an account of our actions to tackle the issues are set out in the attached report at **Appendix 2.**

82. One source of evidence for the differential outcomes was a survey of firms commissioned by the Law Society for the 2009 renewal period. In summary, the survey found that in comparison to the wider population, BME firms were less likely to get offers from insurers, were likely to get the offers a little later and were more likely to be offered insurance at an increased premium. The Law Society has repeated its survey of firms' experience of the renewal round for this year and their report is awaited.

83. There were some reasons suggested for this in the report, namely that some of the underwriting criteria which might impede a firm's ability to get insurance involved features which were disproportionately found in BME firms, namely: being located in Greater London, being identified as a high street practice, the type of work being undertaken (in particular immigration and residential conveyancing but also crime, and family), lower turnover, size of firm, and the number of solicitors in the firm which transferred in to the profession from another jurisdiction.

84. The SRA will continue to facilitate and support the work being done to address these concerns and although there is no proven instance of *unlawful* discrimination, there is evidence that some of the underwriting criteria being used by the industry (as described above) are indirectly causing disproportionate adverse impact on BME firms.

85. To determine whether this indirect impact is lawful or unlawful, the industry will have to demonstrate that their approach is justified, which in legal terms is whether it is a proportionate means of achieving a legitimate aim.

86. The Association of British Insurers (ABI) is confident that they can demonstrate that their members are justified in their underwriting practice. The ABI has committed to working with its members to voluntarily provide aggregated industry data in relation to the underwriting criteria. The commercially sensitive nature of each firm's underwriting policy means that they are only prepared to provide aggregated data – the ABI's report is expected in August 2011.

87. In summary, there is evidence that BME firms have experienced adverse outcomes in the professional indemnity insurance market and removing or restricting the ARP will mean that BME firms are likely to be disproportionately affected. We are seeking to address this in the longer term, but for the purpose of this equality impact assessment we have to balance the potential adverse impact on equality of the proposal to remove the ARP as a provider of insurance (staged as outlined above over 3 years) as against the benefits for consumers and the profession (including the majority of BME firms that do obtain open-market insurance) that the proposal will bring.

Assessment of the evidence - is there an adverse impact?

88. Having assessed all the evidence we have concluded that there will be an adverse impact on BME firms if the ARP is closed as a provider of qualifying insurance. The impact will be felt mainly when the proposal is fully implemented in October 2013. However, the impact will also be felt from October 2011, albeit to a lesser extent, when firms will only be able to practise with ARP insurance for 6 months rather than 12. We recognise that in practical terms, firms will have to be much more focused, and move much more quickly to address any underlying issues in their practice if they are likely to have a chance of securing market insurance within 6 months.

89. As there will be adverse impact we have considered whether there are any ways in which the impact can be mitigated and also whether we can justify proceeding with the proposals.

Mitigating the adverse impact

90. There are ways in which the adverse impact can be mitigated.

91. First, by delaying final closure of the ARP as a provider of insurance for two years, although we have already acknowledged that this will still involve adverse impact from October 2011.

92. Second, from the increased engagement we are having with firms as part of our overall ARP enforcement strategy. The enforcement strategy is helping us to more efficiently and effectively manage high risk and 'failing' firms out of the

ARP, whilst at the same time constructively engaging with firms which are low risk and have the potential to rehabilitate themselves back into the open market. Requiring the ARP firms to plan for their exit from the ARP will facilitate this process.

93. Third, by continuing our work with the ABI and insurers as they take forward their own work to ensure that their underwriting arrangements are appropriate given the equalities requirements on them.

94. Fourth, through the work that we will be undertaking to help firms implement our outcomes-focused regulation which will help firms focus much more clearly on the identification and management of their own risks.

Justifying the adverse impact

95. We need to weigh up the potential benefits to be gained from the proposal against the adverse impact identified. We have to satisfy ourselves that the proposal has a legitimate aim and is a proportionate response.

96. As part of the client financial protection review, CRA identified key principles which the SRA has agreed for the arrangements that we were seeking to introduce:

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.

97. These principles reflect the overall aims of the client financial protection arrangements which are focused both on outcomes for consumers and the profession. Some of the underlying assumptions for the arrangements are reflected within the principles namely that they should be cost effective and involve the minimum of intervention by the SRA.

98. There may be some tension between some of the principles when considering the proposals that deal with the ARP. For example, the adverse impact on BME firms we have identified may compromise principle 4 (in particular promoting a diverse legal profession), but may at the same time further principle 2. However, a balance across all principles is required and in assessing whether the adverse impact is justified we have considered the need to achieve the right balance by answering the question as to whether the proposals are proportionate. We have set out below the various issues that we have considered in coming to our decision.

The increasing cost of the ARP

99. The high cost of claims from ARP firms, the fact that it involves an open-ended liability for insurers, its unpredictability and the increased difficulties the ARP will cause with the implementation of Solvency II are issues that the insurers have indicated cause problems. The result of these problems is a lack of competitiveness in the market (for example small firms, which make up the majority of firms, generally have a choice of only two or three insurers prepared to operate in this sector of the market). The significant problems caused to insurers by the ARP are already manifest in the operation of the market. The CRA report provides evidence of the cost of claims from firms in the ARP arising from the ARP's role as a provider of qualifying insurance and also the much larger cost of run-off cover which flows from the fact that the ARP has been the last provider of qualifying insurance. There can be no doubt that the costs are significant (the loss ratio for ARP policies has averaged 800 percent over the past 10 years) and the market problems it causes are real and acting to the detriment of all firms and threatens the continuation of the open-market approach.

100. This cost and the market problems have to be balanced against the value to consumers and the profession of maintaining this function. The 'value' is summarised below:

- Allowing the regulator to set the boundary to determine which firms practise and which do not rather than relinquishing this to the qualifying insurers. However, it is also up to the regulator to ensure that firms which should not be practising (because they pose too high a risk to consumers) are closed down promptly, therefore preventing or limiting claims made,

rather than being allowed to remain in practise for the full period of ARP eligibility.

- Promoting a diverse profession by offering a safety net (albeit time limited) for firms, which offers a particular benefit for small firms and BME firms.
- By offering a time limited benefit for the consumers of small firms and BME firms which are often likely to be from areas where the population is diverse and thereby improving access to justice.

101. Our assessment is that the value of the ARP, in the terms set out above, is outweighed by the costs of the ARP and the distorting effect it has on the operation of the market to the detriment of firms generally and, therefore to consumers. Although the costs are borne directly by the insurers, there is little doubt that these costs are largely recouped through increased premiums on the profession as a whole.

102. The SRA does not agree with the view that operating without a safety net involves relinquishing regulatory control to the insurers. 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.

103. Reducing the period of time spent in the ARP will reduce the cost of claims in the ARP, simply because the firms are practising for a shorter period of time under ARP cover. In addition, it is an important step both to transition to the arrangements planned for October 2013. Given the magnitude of ARP costs in 2008/09 and 2009/10 and the impact of these arrangements on insurers and the operation of the market it is necessary to take steps to both address cost and maintain a viable and competitive open-market system (which requires the confidence of insurers) through the transition period.

Viability of the market based model

104. The ARP is having a significant distorting effect on the market for solicitors' professional indemnity insurance and is threatening the very existence of the current arrangements. Many insurers have indicated that a continuation of the current arrangements will lead them to leave the market. Last year it was anticipated that there would be a significant reduction in the capacity of the

small firms market in particular. Whilst only a very small number of insurers have continued to cover this area of the market most firms were able to obtain cover. However, this will not necessarily continue to be the case and the information from insurers, our own analysis and the advice of industry experts indicates that the market will not be maintained unless the problem of the ARP is addressed. It is clear that the consequences of the market failing to provide the insurance required will have an adverse impact on consumers and the profession alike.

105. Having considered the matter very carefully, we accept that the case for removing the role of the ARP as a provider of qualifying insurance is compelling. Although we chose not to close this function of the ARP following our review in 2009/2010, we have since had the benefit of a full and thorough review of the client financial protection arrangements and the benefit of further engagement and consultation with the profession, insurers and other key stakeholders.

106. Trusting that insurers will remain in the market and bear the cost of the ARP this year, with the promise of a full review of the arrangements, may have been a reasonable step last year. This year, our view is that without making some clear albeit difficult decisions about the ARP, we would not be able to count on the insurers to stay in the market for another year. Our clear view is that without addressing the current ARP this year, the open-market system of insurance will become unviable to the detriment of clients and the profession.

107. Our view is the number of firms failing to obtain insurance and therefore entering the ARP is a result of both the number of firms that present a risk (against the current minimum insurance terms) that no insurer is prepared to underwrite, and a lack of capacity and competitiveness in the market – particularly for small firms. Our view is that the long term solution to this problem for firms failing to obtain insurance for the latter reason is not to maintain the ARP (which is itself the major cause of the problem) but to ensure that firms have a wide range of choice of insurer and that the market is very competitive. This can best be achieved by closing the ARP so as to retain current insurers' participation, encourage the entry of new insurers and remove a reason for insurers to constrain market share rather than compete hard to increase it. Therefore, the creation of this more competitive market is the major mitigating factor of the disproportionate impact of reducing and then closing the ARP on BME firms and presents a better outcome for such firms.

108. We accept that there has been very little time to assess the impact of the changes made to the ARP last year. However, we are clear that we need to make some changes this year to ease the problems caused by the existence of the ARP and its costs. We considered that the other changes proposed in the consultation paper would have eased the pressure in the market and might have meant we did not have to reduce the ARP cover this year. However, there was overwhelming opposition to removing the single renewal date this year and

to our proposal to exclude financial institutions from the minimum terms and conditions.

109. Accordingly, we satisfied that our proposal to plan the transition to our new arrangements over a period of 3 years is an appropriate compromise. We are of the view that it would be proportionate to reduce eligibility to stay in the ARP from 12 to 6 months this year and maintain the position for 2012/13. The new arrangements for firms which cannot obtain open market insurance will come into effect for the 2013/14 practising year and the precise transition arrangements will be the subject of further consultation.

Tackling concerns about discrimination in the professional indemnity insurance market

110. We acknowledge the concerns that have been expressed about discrimination in the professional indemnity insurance market and were at the forefront in setting up the work that has been ongoing to tackle these concerns. We made our position very clear to the insurers and in the face of strong opposition, included what have been referred to as the 'equality riders' in the agreement that we have with them. These clauses emphasise the requirement for insurers to comply with the equality legislation and put insurers under an obligation to provide information and documentation to the SRA on request if there were complaints or concerns expressed about discrimination. We have not had occasion to make any requests for information to any of the qualified insurers nor have we been asked to get involved in any individual complaint of discrimination made about any of the qualified insurers. However, we are aware that there were a number of concerns expressed to the Law Society through their helpline and other routes about further problems experienced by BME solicitors in obtaining insurance this practising year. The outcome of the Law Society's survey is awaited and will give us a better understanding of the current position.

111. We will continue to work with the ABI and BME stakeholders regarding the allegations of discrimination by insurers against BME firms and have been seeking to involve the FSA in addressing what is essentially an issue for the insurance industry. Nevertheless, it remains a high priority for us to continue working in this area to bring about improvements in the experiences for BME firms in the market.

112. However we have decided that this should not prevent us for taking steps to introduce long term arrangements for client financial protection which we feel are in the best interests of the profession and consumers alike. We believe our approach to be proportionate as the transition will come about over three years and there are remedies available for solicitors firms which feel that they have been discriminated against by an insurer and a regulatory body (the FSA) which is responsible for making sure that financial services are delivered in an appropriate manner. Nevertheless, we will continue to support the work going forward to tackle the disproportionate outcomes felt by BME firms and will work

with the Law Society to support firms which believe they have been discriminated against and will not hesitate to use the equality riders to address concerns identified against individual insurers.

Looking to the future of outcomes focused regulation

113. We acknowledge that the future feels uncertain for small firms, with alternative business structures due to enter the legal services market from October 2011 and the changes in the SRA's approach to regulation.

114. We recognise also that we have an instrumental part to play in minimising the claims arising from ARP firms through a more rigorous and timely approach to monitoring, risk assessing and taking appropriate action in relation to high risk firms. We have implemented an enforcement strategy for ARP firms since July 2010, which combines close contact and support for firms who are able and willing to tackle their problems and get back to the open market with a firmer approach to firms where regulatory and or disciplinary action is appropriate.

115. In the longer term we accept that we have been less rigorous that we perhaps should have been in our decisions as to which firms should be able to practice in the first place. Our new approach to authorisation and outcomes focused regulation will require firms to plan their businesses better - developing business plans, being more risk aware and thinking through the approach and policies that best suit their firm. We anticipate that in the longer term, this will help firms represent themselves better to insurers and give the insurers improved confidence in the SRA. We hope that this will mean in the longer term that there is less of a gap in the boundary between the firms the SRA is allowing to practise and the firms which the insurers are prepared to support. It is the firms which fall outside the more tightly drawn barrier imposed by the insurers which are potential candidates for the ARP.

Promoting good relations

116. Our statutory duty includes the need for us to have due regard to promoting good relations between equality groups. We have previously identified the risk that adverse publicity about ARP firms could threaten relations between BME firms and non BME firms given that there is a disproportionate number of BME firms in the ARP.

117. There is more that we can do to ensure that we make information available to the profession about the ARP and the work that we do to pursue our published ARP enforcement strategy. We will look again at making our work in this area more transparent, starting with publishing on our website the information due to be reported to Compliance Committee about the impact of our ARP enforcement strategy.

Conclusions

118. We did not identify any adverse equality impact arising from the proposal to make the identity of each firm's qualifying insurer a matter of public record or the proposal to clarify insurers' obligations to provide information to SRA.

119. There is a potential for adverse equality impact for consumers arising from the proposal to remove the provision for the recalculation of ARP participation in the event of insurer insolvency. However, we felt that the ultimate outcome of removing what in reality was a fairly arbitrary benefit from one group of consumers would be to place all consumers in the same position and as such, given the current pressure on insurers as a result of the high cost of the ARP, the change was proportionate.

120. We will assess the equality impact of any measures that we consider necessary if we do decide to revise the criteria for apportioning the ARP although any changes to this is likely to impact on insurers rather than consumers or the profession.

121. The proposal to require ARP firms plan their exit from the ARP may have an adverse impact on equality because ARP firms are disproportionately represented in the ARP, but we are confident that this is justified. ARP cover has always been time limited and should not be seen by firms as a medium or long term solution. The requirement is not intended to be formal or onerous so we believe it is a proportionate requirement to impose.

122. We have identified that closure of the ARP as a provider of qualifying insurance from October 2013 and the proposed reduction of ARP cover from 12 to 6 months from October 2011 will have a disproportionate impact on BME firms. We have not had any evidence to suggest that there are any other significant impacts on equality for other groups who share one of the protected characteristics, despite the benefit of a broad response to our consultation and close engagement with our key stakeholders.

123. There is little data available on whether there would be any impact on access to justice and, if so, what impact that might be. The issue has been raised by some stakeholders and we recognise that there is information to suggest that BME solicitors/firms are concentrated in areas with large BME populations. Therefore, if the impact of the ARP changes resulted in may BME firms closing, there could potentially be an impact on access to justice for these groups. However, it is important to note in this context that, whilst BME firms are disproportionately represented in the ARP relative to white firms, the great majority of BME firms obtain open-market insurance and do not enter the ARP. Nevertheless, we will look to monitor the impact of our proposals, including on consumers and their access to legal services.

124. In the SRA's view, based on a careful analysis of the evidence, that the continuation of the ARP in its current form is having a significant negative

impact on the operation of the insurance arrangements for firms, is causing unnecessarily high insurance costs for the wider profession, restricting competition in the market and, if unchanged, will lead to the current system of open-market insurance becoming unviable.

125. Maintenance of the current arrangements is not an option and our proposals are a proportionate means of achieving a system which will best deliver client protection in accordance with the principles which we set at the outset.

126. We will nevertheless continue to closely monitor the ARP and ARP firms and consider the equality impact of our work on an ongoing basis. The further consultation that will take place as we flesh our plan for years 2 and 3 will be assessed for its impact on equality. We will also continue to work with stakeholders to improve the outcomes for BME firms in the professional indemnity insurance market.

- **Appendix 1 - Progress report on the action plan published with the 2009/10 ARP review equality impact assessment (as at March 2011)**

Objective	Action required	Progress
Keep the ARP under review	Work with Capita to improve the data recorded for ARP firms for the next insurance year to improve our ability to capture and monitor the data	• At the start of the ARP year we received regular updates from Capita's database showing the firms who are covered by the ARP, those who applied for cover but did not take it up (NTUs) and those who received a copy of the proposal form but did not return it. We made use of this information (frequently updated at the start of the year) at the beginning of the year to establish the list of firms covered by the ARP. • We also used this data for other purposes (for example checking the insurance status of the NTU firms). • We now receive regular updates of extracts from the Capita database (almost weekly) to ensure that we have an up to date list, and make any necessary adjustments to our definitive list that arise from this. • We have also now arranged to receive daily reports from Capita providing us with the most up to date premiums information available for ARP firms.

	Ensure that better and more detailed records are kept for ARP firms as to why they were unable to obtain insurance on the open market	• For firms entering the ARP in 2009/10 we kept records from visits to ARP firms (by our Practice Standards Unit) and our Risk and Designation Centre (RADC) issued questionnaires to all ARP firms - in both we asked firms what reasons they were given and what the perceived were the reasons for being refused market insurance. This data has been reviewed and has been available for our monitoring work on the ARP. • For firms entering the ARP in 2010/11 we included a similar question to the ARP proposal form which is completed by all firms applying to enter the ARP
	Compile and review the 'rehabilitation data' for the 09/10 ARP firms	• The outcomes for firms in the ARP as from July 2010 has been collated and is updated and monitored regularly to reflect the latest position. The outcomes are taken from July 2010 as this was when the SRA's ARP enforcement strategy was implemented.
	Ensure that data is captured for all firms entering the ARP at the commencement of the insurance year, including those that subsequently withdraw during the 'grace period'	See above
	Review and consider further, through engagement with the profession, the age and gender equality impacts of the proposed changes to the ARP	We have continued to monitor the ARP firms by age and gender firm classification as well as ethnicity. No further significant issues have been raised in relation to gender and age from our engagement with stakeholders.

	If possible in light of the new Diversity Census data, review the equality impact for equality in relation to disability, sexual origin, religion or belief	As we are primarily monitoring the equality classification of firms, the data for other equality groups is inadequate to produce meaningful firm classification at this stage.
	Monitor and review data for the ARP firms in the next insurance year and publish a report in relation to the impact on equality of the changes that are made	We have been monitoring and reviewing the ARP firms over the 2010/11 insurance year as part of our ARP enforcement strategy and as part of the equality impact assessment of the financial protection review proposals.
Work with stakeholders to better understand the alleged race discrimination in the professional indemnity insurance market and improve equality practices and outcomes in the sector	Follow up the SRA's initial request for equality data with those qualifying insurers who have not yet responded	Rather than approach individual qualifying insurers, we are working with the ABI to improve equality guidance and practice for insurers across this market
	Set up a forum for the SRA, qualified insurers and representatives of BME firms to discuss the issues of concern	We have set up a group of stakeholders to review the allegations of discrimination in the PII market and met in July and October 2010 and February 2011 to discuss progress. This work is ongoing.
	Advise the FSA of the evidence identified within this full EIA and work with the FSA to identify the issues and develop an action plan to address any concerns	We have approached the FSA to encourage their involvement in dealing with these concerns as the industry regulator and the ABI have indicated their intention to work with the FSA to produce the industry guidance on equality obligations.
	Work as appropriate with the EHRC in relation to equality in the professional indemnity insurance sector	The EHRC hosted one of the stakeholder meetings (in October 2010) and have been involved in helping to coordinate the commitments made by the ABI following that meeting.

	Work with the Law Society to draft and implement an action plan arising from the research data (not yet published)	The Law Society led on work taken to support the profession eg through the renewals helpline available in 2010 and we attended regulator meeting with the Law Society and BME stakeholders to monitor the situation.
Ensure that ARP firms are more effectively regulated	Review the effectiveness of the improvements introduced for the 09/10 insurance year	This work was overtaken by the introduction of the ARP enforcement strategy referred to above and this strategy was subject to an equality impact assessment as its implementation has been monitored closely.
	Start the risk assessment process earlier and take appropriate risk based action earlier	
Ensure that support is available for all solicitors seeking to set up new firms	Work with the Law Society to ensure that there is adequate provision of advice for solicitors seeking to set up new forms, through review and extension where necessary of the seminars provided by the Law Society	Seminars and information have been made available to the profession by the Law Society
	Work more closely with the Sole Practitioner's group to support the guidance that they give to solicitors proposing to set up new firms	The SRA has regular engagement with the SPG, including discussions about professional indemnity insurance arrangements
	Continue to offer guidance to Solicitors through the SRA' Professional Ethics helpline and review whether there is any further help that can be offered through the SRA's Practice Standards Unit	Ongoing with the Ethnics Helpline and a key element of the enforcement strategy is constructive engagement with ARP firms
	Promote the guidance and seminars (in relation to setting up a new firm) that are available to BME solicitors in particular	This has been led by the Law Society

Implement published criteria for firms seeking to stay in the ARP for than 12 months	Agree and publish objective criteria	The Financial Protection Committee approved the criteria on 31 March 2011 and they will be published on the SRA's website in the near future. We would not expect there to be any applications for an extension of this renewal year until much later in the year.
	Review and report on the number of firms granted more than 12 months in the ARP	We have not had any applications for extension as yet and would not anticipate receiving such applications at this stage in the year. We have approved 5 extensions for firms to extend the 24 month period to which they were entitled before we introduced the eligibility period to 12 months.
Continue to engage with stakeholders in relation to the professional indemnity insurance scheme and the ARP	With the qualified insurers through the existing arrangements.	Regular Liaison Committee meetings take place between the qualified insurers and the SRA
	With the BME stakeholders through the BME forum or otherwise as requested.	The Law Society holds regular meeting with the BME forum and the SRA
	With the Sole Practitioners Group through regular meetings.	The SRA has regular engagement with the SPG, including discussions about professional indemnity insurance arrangements
	With the Law Society as appropriate.	There are regular discussions between the SRA and the Law Society.
Improve how the SRA promotes equality in this area	Consider adding equality requirements to the Qualifying Insurers Agreement	'Equality clauses' introduced to the Qualifying Insurers Agreement for the 2010/11 period

Appendix 2 - Allegations of discrimination in the solicitors' professional indemnity insurance market

Progress report March 2011

Introduction

1. This paper reports on progress made by the SRA in understanding and tackling the concerns raised by BME solicitors in recent years.

2. The SRA's Equality and Diversity team have been working for some time with BME and other stakeholders to address these concerns and identify a way forward.

Background

3. BME solicitors have reported to the SRA and Law Society their concerns that insurers were discriminating against them on racial grounds - the allegations involved claims of both direct discrimination and indirect discrimination. Further details of the allegations are set out below.

4. The SRA convened a meeting on 13 July 2010 between the Association of British Insurers (ABI), representatives from BME solicitor equality groups and the Law Society. The ABI did not accept that their members were responsible for any racial discrimination but there was agreement between all parties at the meeting to work together to provide support to the profession through the 10/11 renewal. In particular, the ABI would publish information about the constraints of the market to forewarn the profession and the Law Society would run its PII renewal helpline for firms and feedback concerns raised to the ABI and the SRA.

5. The ABI agreed to investigate and provide a full response to each of the 'case studies' that the Law Society had provided to the ABI towards the end of June 2010. The case studies were an account of individual complaints received from solicitors who felt they had been discriminated against on racial grounds during the previous renewal period. A private response was made available to the SRA and the Law Society and the individual solicitors concerned. The ABI gave a response in each of the case studies as to the reasons why insurance was not provided which was not based on the ethnicity of the applicants.

6. The ABI responded to the discrimination allegations in general terms in their report 'Addressing concerns about the operation of the market for solicitors' professional indemnity insurance for Black and Minority Ethnic firms' which was published in August 2010.

7. The Equality and Human Rights Commission (EHRC) had been kept informed about these concerns and were provided with the case studies in the event that they felt it appropriate to take legal enforcement action.

8. The EHRC convened a meeting for all parties on 6 October 2010 at their offices, inviting the Financial Services Authority (FSA) in addition to the existing group of stakeholders. The EHRC were not inclined to use their legal powers to take enforcement action but were keen for the parties to agree a way forward to resolve the concerns raised.

9. The ABI made the following commitments after the meeting:

- to develop new guidance for insurers on the Equality Act, covering all six protected characteristics, outlining the main provisions of the Act, to develop a common understanding of the legislation and set out the general principles that insurers must consider and implement, with the aim of helping to achieve a fair and transparent approach across the industry. The race chapter was to be published by April 2011 and the other equality areas to follow (pending the outcome of litigation in Europe in relation to age and sex discrimination).
- to coordinate publication of aggregated industry data on some of the risk factors of greatest concern to the BME solicitors' community, including turnover/gross fees, claims history, type of legal services provided, size of firm, location of the firm, and experience. Publication is expected by August 2011 - details as to what data they will be able to publish is still to be confirmed.
- to review communications throughout the entire process to include: the design of the proposal form; the communication of an underwriting decision; guidance for consumers in how to select a suitable broker and the importance of completing a proposal form in full. This work was to proceed in the early part of 2011.

10. A meeting was convened by the ABI on 21 February 2011, in particular to discuss expectations in relation to transparency and communication in line with their third commitment. The outcome was that the ABI would draft guidance about communications for comment and at the SRA's request, would invite the FSA to the next meeting. There was considerable frustration from BME stakeholders about the pace of progress.

11. Since the meeting at the EHRC offices in October 2010, the SRA have been in communication with the FSA as the appropriate regulator for the qualified insurers. A meeting took place in November 2010, letters were exchanged between our respective Chief Executives, and the FSA have indicated they will be discussing the issues with relevant insurers and taking their findings and recommendations to the FSA's Executive Diversity Committee in March 2011. They indicated also that they would include a reminder to all insurers of the importance of meeting their legal obligations in the area of equality law in their May 2011 newsletter.

The evidence

12. The evidence of discrimination in the PII market for solicitors has come from the following sources:
    - reports of experiences brought by BME solicitors to the SRA, the Law Society and to equality groups representing the profession
    - the Moulton Hall report of solicitor experiences in the 09/10 renewal (we await a further report following the 10/11 renewal)
    - the ABI's own report referred to above 'Addressing concerns about the operation of the market for solicitors' professional indemnity insurance for Black and Minority Ethnic firms'.

13. The key findings from the Moulton Hall report are listed below and many of the findings were supported by the anecdotal reports from BME solicitors:

    - A higher proportion of BME firms (16%) were not offered cover from their previous insurer compared to the wider profession (6%)

    - BME firms were less likely to receive an offer compared to the wider profession (73% of BME firms compared to 84% in the wider profession)

    - 44% of BME firms were notified of decisions by the first insurer they approached by mid September, compared to 64% of the wider profession, explained in part by BME firms applying for cover later than the wider profession

    - The average percentage change in premiums for BME firms was an increase of 56%, compared to an average increase of 27% for the wider profession

    - 39% of BME firms, compared to 27% of the wider profession received an increase of 50% or more to their premium. However, BME firms receiving a 50% increase in premium were more likely to have made an insurance claim in 2008/09 than other BME firms, which was not true of the wider profession. In addition, the cost of insurance was no higher for BME firms, in fact 56% of BME firms were paying less than £10,000, compared to 42% of the wider profession.

14. It was clear from the Moulton Hall report and the other sources of evidence suggested that some of the underwriting criteria used by insurers involved features which were disproportionately found in BME firms:

    - **Being located in Greater London** - in the Moulton Hall survey this applied to 50% of BME firms, compared to 18% of the wider profession. The ABI confirmed that location was an important factor for insurers and some insurers were not keen to insure certain firms from specific localities at all, with East London having been identified as a key hot spot for mortgage fraud. This coincides with an area with a very large proportion of the population from BME communities.

- **Identified as a high street practice** - 68% of BME firms, compared to 53% of the wider profession.

- **Type of work being undertaken** - in particular immigration and residential conveyancing but also crime, and family. Firms undertaking work in immigration were more likely to be refused cover (28%), than firms not undertaking immigration work (10%).

- **Lower turnover** - the annual gross income was on average less (£280,000) for BME firms than the wider profession (£400,000). The ABI confirmed that firms' gross fee income is an important underwriting factor and where insurers take the view that profitability is marginal, premiums will invariably be higher or terms will not be offered.

- **Size of firm** - the ABI report indicated that the small firms market was much more difficult that the market for firms of 5 or more partners where competition had kept premiums lower.

- **The number of QLTS solicitors in the firm** - this was possibly linked to the reports from individual BME solicitors who reported that they were discriminated against on grounds that they had a 'foreign sounding name' and could amount to direct discrimination.

15. The 'case studies' compiled by the Law Society and referred to above reflected a selection of the complaints being made by BME solicitors, including:

- firms with no disciplinary record, no claims and no previous problems in securing insurance before were refused in 2010/11 or received vastly increased quotes - in the absence of an explanation felt that the ethnicity of the partners was a factor;
- several firms were asked for details of solicitors qualifying outside of England and Wales and found their quote increased substantially or they were refused quotes at all;
- many of the firms were quoted reasons such as low turnover, location, size of the practice, a constricting small firms market, 'foreign sounding names/ QLTS.

16. The Risk Centre has recently reviewed various other sources of data available to the SRA to help build our understanding of the reasons why ARP firms did not get open market insurance both for the 09/10 period and the 10/11 renewal period.

17. For the 2009/10 period, we have considered the information that we hold from the following two sources:

- information from the Practice Standards Unit (PSU) ARP monitoring visits in early 2010 where firms were asked about the reasons given for refusal of

market insurance. If no known reasons were given, firms were also asked about their perceived reasons for refusal of market insurance;

- Risk Assessment and Designation Centre (RADC) information from questionnaires sent out to some firms in the ARP in early 2010 (pre enforcement action). Where responses were received, we have used data from questions about the reasons firms were given about refusal of market cover, and their perceived reasons for refusal. Unlike the PSU data, this perceived reasons question was not limited to only those firms who were not provided with a known reason for refusal.

18. The following tables show the reasons given by 114 firms in the ARP - either through the PSU visit or through the RADC questionnaire or both. It does not include the 35 firms who did not give reasons. The data percentages relate to the number of reasons given, not to the number of firms who responded. Some firms provided multiple reasons

19.

Reasons given for refusal of insurance 09/10	Numbers	Percentages
Low turnover / fee income	15	16%
Lack of experience / new practice	12	13%
Firm does not fit risk criteria	11	12%
Previous or outstanding claims/claims history	10	11%
Type of work	8	9%
Regulatory history	7	7%
Sole practitioner	6	6%
Economic climate	6	6%
High premiums	5	5%
Late application / missed deadline	4	4%
Insurer failed to advise refusal in time	3	3%
Quotas allocated already achieved	2	2%
Offer withdrawn	2	2%
No clear business plan	1	1%
Needed immediate cover	1	1%
Complaints history	1	1%

Perceived reasons given for refusal of insurance 09/10	Numbers	Percentages
Low income / Turnover	12	18%
Type of work	11	17%
Size of firm / sole practitioner	10	15%
Targeted racial discrimination	8	12%
Market forces / Economic climate	7	11%
Previous claim history	4	6%
Practitioner status	3	5%
Lack of experience / new practice	3	5%
Regulatory history	3	5%
Business minded companies do not care about anyone's future	2	3%
Late application	2	3%

20. For 2010/11, we have considered the ARP proposal forms completed by firms who went on to take up ARP cover, although not all of these firms will now be in the ARP. The form asks firms to state the reason why they were refused market insurance, if known. Firms who did not know or did not provide a reason for not being offered market insurance have been excluded. Where it was clear from a firms response that the reason was perceived rather than known, we considered this separately. After these removals there were 221 reasons (both perceived and known) across 189 firms. The percentages relate to the number of reasons given, not to the number of firms who responded. Some firms provided multiple reasons

Reasons given for refusal of insurance 10/11	Numbers	Percentages
No decision received so applied to ARP	40	20%
Type of work	27	13%
Size of firm / Sole practitioner	25	12%
Low turnover / fee income	17	8%
Firm does not fit criteria	17	8%
Previous or outstanding claims/claims history	15	7%
Previously in the ARP	12	6%
High premiums/unable to finance premiums	12	6%
Needed immediate cover	10	5%
Regulatory history	8	4%
Lack of experience / new practice	7	3%
Economic climate	4	2%
Late application / missed deadline	4	2%
Insurer failed to advise refusal in time	3	1%
Quotas allocated already achieved	2	1%

Perceived reasons given for refusal of insurance 10/11	Numbers	Percentages
Low income	7	37%
Regulatory history	4	21%
Size of firm/ Sole practitioner	3	16%
Discrimination	2	11%
Previously in the ARP	2	11%

21. Some, but not all of the factors cited for both years are the ones identified from the ABI's report and the Moulton Hall survey such as turnover, type of work and size, market conditions.

Stakeholder views

22. BME solicitors equality group representatives feel very strongly that insurers are discriminating against them, in particular the Black Solicitors Network, the Society of Asian Lawyers and the British Nigerian Law Forum. There is a strong feeling of injustice and frustration with the insurance industry, the ABI, and the FSA for not

recognising the extent of the problem and not reacting strongly or quickly enough. There is equally a sense of frustration and disappointment in the EHRC and the Law Society and SRA for not having been able to force faster progress in tackling the issues.

23. The insurers and the ABI feel equally strongly that there is no discrimination in the PII market and have resisted even the possibility that there is potential indirect discrimination, strongly asserting that all underwriting criteria are justifiable and based on claims experience. In support of insurers, they cite the fact that there have been very few discrimination complaints made direct to insurers, and that they have provided a satisfactory response to the case studies which illustrated there is no discrimination.

Conclusions

24. The SRA will continue to facilitate and support the work being done to address the BME solicitors concerns, but progress remains slow. As guardians of the PII arrangements for the profession we remain concerned and have to take into account the evidence which demonstrates disproportionate outcomes for BME solicitors in the PII market.

25. Adverse impact on BME solicitors of some of the underwriting criteria, will only amount to unlawful indirect discrimination if use of these criteria cannot be justified. In legal terms, the justification test is whether the criteria is a proportionate response to a legitimate aim. There are difficulties in tackling this question:

- each insurer has its own underwriting criteria and policies so the aggregated industry data offered by the ABI will only provide a general indication of the position
- the underwriting criteria is commercially sensitive data which individual insurers are unwilling to share
- firms report that they are not always told of the reason for the insurer's proposal or they suspect they are not told of the real reason
- the role of the broker in managing communications between the firm and the insurer can distort the reasons that are being given
- many BME firms are reluctant to openly complain about their experiences.

26. Even though there is no proven instance of *unlawful* indirect discrimination, there is evidence of disproportionate impact, which equates to potential indirect discrimination. There is some evidence from the ABI about how the market works and why certain criteria are used by insurers in their report 'Addressing concerns about the operation of the market for solicitors' professional indemnity insurance for Black and Minority Ethnic firms' and the aggregated industry data is awaited. This will need to be evaluated further to determine whether the disproportionate impact can be justified as a proportionate response to a legitimate aim – the legal test for justifying indirect discrimination.

27. The next steps are to pursue the ABI's commitments to produce the industry guidance (due April 2011), the publication of aggregated industry data about underwriting criteria (due August 2011) and improve communications in the process (ongoing).

28. Unless there is a new catalyst for change - a clear case of discrimination which is strong enough to be tested at court, or new evidence of discriminatory practices - progress is likely to be reasonably slow. However, the work is important and is likely to bring benefits for consumers in the professional indemnity insurance market albeit in the longer term.

Appendix 3 - ARP firms in 2010 and 2011 as compared to the overall solicitor firm population

	ARP firms at 02/02/2010		Overall firm pop. 2010	ARP firms at 02/02/2011		Overall firm pop. 2011
	No.	**%**	**%**	**No.**	**%**	**%**
Ethnicity						
BME majority firm	102	42%	11%	100	38%	12%
White majority firm	51	21%	76%	103	39%	76%
No majority group	44	18%	8%	39	15%	8%
Unknown majority	46	19%	6%	19	7%	5%
Grand Total	**243**	**100%**	**100%**	**261**	**100%**	**100%**
Age Band						
22-30 majority firm	8	3%	1%	4	2%	1%
31-40 majority firm	50	21%	11%	41	16%	11%
41-50 majority firm	55	23%	17%	47	18%	17%
51-60 majority firm	32	13%	18%	47	18%	17%
61-65 majority firm	9	4%	5%	16	6%	5%
65+ majority firm	5	2%	3%	20	8%	3%
No majority group	81	33%	45%	86	33%	47%
Unknown majority	3	1%	0%	-	-	1%
Grand Total	**243**	**100%**	**100%**	**261**	**100%**	**100%**
Gender						
Female majority firm	45	19%	24%	53	20%	26%
Male majority firm	157	65%	64%	176	67%	62%
No majority group	39	16%	12%	32	12%	12%
Unknown majority	2	1%	0%	-	-	1%
Grand Total	**243**	**100%**	**100%**	**261**	**100%**	**100%**

NB Percentage figures have been rounded up in the usual way and may appear not always add up to 100%.

Appendix 4 – Outcome as at 15/03/2011 for firms in the ARP at the end of the 2009/10 ARP year (September 2010) - subject to change

	BME Majority		White Majority		No Majority		Unknown Majority		Grand Total	
	No.	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**	**No.**	**%**
ARP 2010/11	40	44%	20	43%	20	54%	17	47%	97	46%
Closed	25	28%	17	36%	6	16%	12	33%	60	29%
Possible Intervention	1	1%	2	4%	0	0%	1	3%	4	2%
Insured	24	27%	7	15%	11	30%	5	14%	47	22%
Other	0	0%	1	2%	0	0%	1	3%	2	1%
Grand Total	**90**	**100%**	**47**	**100%**	**37**	**100%**	**36**	**100%**	**210**	**100%**

Appendix 5 - Risk assessment scores of ARP firms broken down by ethnicity at the beginning of the practising year 2010/11

	BME majority firm		White majority firm		No majority group		Unknown majority		Grand Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
High	50	50%	47	46%	20	51%	7	37%	124	48%
Low/Medium	50	50%	55	53%	18	46%	11	58%	134	51%
Unknown	0	-	1	1%	1	3%	1	5%	3	1%
Grand Total	**100**	**100%**	**103**	**100%**	**39**	**100%**	**19**	**100%**	**261**	**100%**

Appendix 6 - Current status of ARP firms by risk status and ethnicity

	BME majority firm		White majority firm		No majority group		Unknown majority		Grand Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
High Risk Firms										
Closed – KPMG monitoring wind down	0	0%	0	0%	0	0%	1	14%	1	1%
With Forensic Investigations for action	9	18%	5	11%	2	10%	0	0%	16	13%
In liquidation	0	0%	1	2%	0	0%	0	0%	1	1%
With Practising Standards Unit for action	41	82%	39	83%	18	90%	6	86%	104	84%
With Practising Standards Unit for monitoring	0	0%	2	4%	0	0%	0	0%	2	2%
Grand Total	**50**	**100%**	**47**	**100%**	**20**	**100%**	**7**	**100%**	**124**	**100%**
Medium/Low Risk Firms										
Closed – KPMG monitoring wind down	0	0%	1	2%	0	0%	0	0%	1	1%
With Forensic Investigations for action	0	0%	0	0%	0	0%	1	9%	1	1%
In liquidation	0	0%	0	0%	1	6%	0	0%	1	1%
With Practising Standards Unit for action	50	100%	53	96%	17	94%	10	91%	130	97%
With Practising Standards Unit for monitoring	0	0%	1	2%	0	0%	0	0%	1	1%
Grand Total	**50**	**100%**	**55**	**100%**	**18**	**100%**	**11**	**100%**	**134**	**100%**