

Client financial protection review – report on consultation responses and SRA conclusions

April 2012

1. Introduction

- 1.1. As part of the review of client financial protection arrangements, a second consultation paper was issued on 25 October 2011 with a closing date of 17 January 2012. This paper summarises the key points emerging from the responses and sets out the SRA's conclusions.
- 1.2. 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.
- 1.3. The number of responses received to this consultation paper was 38. It should be noted that it appears that the representative of one market participant wrote to its clients to encourage members of the profession to disagree with one of the proposals made (a notice period of intention not to renew cover) and to support another proposal (to introduce a requirement for credit ratings). We believe this has generated a number of responses on these issues in the same terms as that advocated. A summary of overall results is shown in **Annex 1**.
- 1.4. In accordance with the SRA financial protection policy statement dated 19 April 2011 and the subsequent SRA financial protection review consultation, it has been proposed from 1 October 2013:
 - a) the Assigned Risks Pool (**ARP**) will cease to be a provider of insurance (save for in respect of run-off cover for those firms that closed whilst in the ARP);
 - b) the Qualifying Insurer last on risk (that is, for the immediately preceding indemnity period) will be required to provide extended policy coverage to the firm for a further period of 90 days, such period to allow the firm to either obtain a policy of qualifying insurance or to cease practise in an orderly fashion;
 - c) firms that are unable to obtain a policy of qualifying insurance before the end of the 90 day period must cease to practise;
 - d) the Qualifying Insurer last on risk must provide run-off cover to the firm for six years (the six-year period commencing at the end of the original policy period); and
 - e) the existing "side-arrangement", whereby coverage is provided to uninsured firms that have not applied or are not eligible to enter the ARP, will be

withdrawn with effect from 1 October 2012, and instead claims arising from the operation of such firms will be met by the Compensation Fund.

2. Overall Approach

Purpose and scope of the consultation

2.1. The April 2011 Policy Statement set out the steps leading to the changes to the indemnity insurance and compensation arrangements. The main proposed changes are:

- a) the closing of the ARP as a provider of policies of qualifying insurance from 30 September 2013 (with the exception of the continued provision of run-off cover incepted before that date);
- b) the introduction from October 2012, of a requirement that all policies of qualifying insurance make provision for the extension by 90 days at the end of insurance period if the insured firm has not taken out a new policy of qualifying insurance;
- c) changes to the Authorisation Rules to control the work that may be undertaken by firms during that 90-day period;
- d) provision for the funding of the ARP in 2012/13 to be provided by both the regulated community and the qualifying insurers; and
- e) provision to remove the role of the ARP in 2012/13 for making payments in respect of uninsured firms and move this responsibility to the Compensation Fund.

2.2. The objectives and proposals were broadly supported by over 80% of respondents. Other respondents gave diverse comments ranging from suggesting that these proposals do not go far enough to wanting to keep the ARP.

Our response

2.3. We are pleased that respondents broadly supported our decisions set out in the April 2011 Policy Statement. Detailed comments, often highlighted in this section of response, are reiterated in respondents' answers to specific questions referred to below.

3. Qualifying Insurer's Agreement (QIA) 2012 including the SRA Indemnity Insurance Rules (SIIR) 2012

Changes proposed to QIA and SIIR

Extended indemnity period and cessation period

3.1. Generally respondents support the proposal of an Extended Indemnity Period and Cessation Period, however many have reservations about implementation details and workability of these arrangements.

Our response

- 3.2. We welcome all the issues raised relating to implementation and workability of these arrangements. We analysed them carefully to ensure all aspects were considered when developing the mechanics of this policy.
- 3.3. On consideration of all the responses we will introduce the Extended Indemnity Period and Cessation Period in policies of qualifying insurance from 1 October 2012.
- 3.4. We agree with some respondents' suggestions that the cover should be back dated. If a firm in the Extended Indemnity Period or Cessation Period obtains cover from a Qualifying Insurer, that insurer will be obliged to back date the cover to the end of the original policy (prior to the start of the Extended Indemnity Period).
- 3.5. We recognise that limiting cover to liabilities arising from existing instructions during the Cessation Period could lead to disputes as to what amounts to "new instructions" and could adversely affect client financial protection. We have taken this into account and now propose that there will be no carve out of cover for liabilities incurred in respect of "new instructions" during the Cessation Period as previously contemplated. The relevant Qualifying Insurer will be required to provide cover for such liabilities although the reimbursement provisions will be amended to allow the Qualifying Insurer to seek reimbursement of any amounts paid to meet such liabilities from the firm and its Principals.

Notice of intention not to renew cover

- 3.6. Most respondents do not support this proposal, believing it cannot work in practice. There are concerns that insurers will send the notice to all firms while other arguments include the need for the profession to take responsibility themselves in submitting proposal in a timely way.

Our response

- 3.7. We have reconsidered this proposal and have concluded that it is an unnecessary interference in the market which could actually result in unacceptable distortions.

Solicitors' profession contribution to the ARP in respect of 2012 indemnity year liabilities

- 3.8. The April 2011 Policy Statement proposed a change to the mechanism through which any shortfall in 2012/13 ARP premiums will be met. To date this is met by the qualifying insurers. We proposed that to maintain a viable and competitive open-market system of insurance, the liability for the ARP's 2012/13 indemnity period (excess of premium collected) will be shared between the solicitors' profession and the qualifying insurers which participate in the 2012 indemnity period in a layered approach. We proposed that the first £10m of the shortfall should be 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.
- 3.9. Respondents' opinions were polarised on this question. Some respondents had significant concerns about the layered approach to liability on the basis that considering the current numbers of firms in the ARP, there will be a greater proportion of liability falling on the profession, which under this proposal is liable for the first £10 million and proposed an alternative approach.

Our response

- 3.10. We have considered very carefully all the views and concluded that there is less risk of destabilising the market and increasing the number of firms in the ARP in 2012/13 by staying with the layered structure. Additionally while the current position of firms in the ARP is relatively benign, this may change at any time, posing a significant challenge to the ARP and its funding.
- 3.11. On 4 May 2011 the Law Society Council, representing the profession, agreed to the layered approach to funding the ARP and the profession's commitment to support the transition to the situation of no ARP. We do not consider arguments presented in the alternative proposals as significant enough to waiver on this commitment.
- 3.12. The profession's responsibility for the first layer of the scheme provides additional stability to the insurance market through the removal of the need for Qualifying Insurers to earmark this sum as a emergency fund for the ARP, therefore reducing average premiums charged to firms obtaining open market insurance. The Profession as a whole contributes to the ARP in a more controlled manner, as the assumptions of the amount required are prudent but realistic. On the contrary, this exercise while done by Qualifying Insurers edges on the risk averse side, increasing the amount and therefore average premiums.
- 3.13. We will introduce a layered approach to the profession's contribution to the ARP in respect of the 2012/13 indemnity year, with the £10m layers proposed by the April 2011 Policy Statement.
- 3.14. The general costs of administering and managing the ARP will be borne by the Qualifying Insurers. Costs related to specific claims will form part of the layering.

ARP policy cut-off and run-off cover

- 3.15. There is a support for the ARP policy cut off and run-off proposals and for the use of the Compensation Fund for non-applied firms, however some respondents have argued against the proposals.
- 3.16. Most respondents generally show support for the closure of the ARP as an insurer of last resort and the continuation of its run-off cover for firms that cease to practise whilst in the ARP before September 2013. A small group of respondents was opposed to this proposal.

Our response

- 3.17. We have carefully considered all arguments relating to keeping the ARP as the provider of the cover for uninsured firms and the implications of moving this cover to the Compensation Fund. As set out in the April 2011 Policy Statement we believe it is more appropriate that clients are provided with financial protection by an expansion of the scope of the Compensation Fund.
- 3.18. We will continue with our policy proposals that the Compensation Fund will replace the existing ARP side arrangements from 1 October 2012 to 30 September 2013 and from 30 September 2013 onwards provide compensation in respect of claims against firms that were not insured under a policy of qualifying insurance.

Compensation Fund for non-applied firms and scope of cover

3.19. Responses to this varied with some respondents expressing concerns about costs of the contribution to the Fund, as well as the potential for loss of customer protection. Respondents were concerned about details of this approach and any unintended consequences that may emerge.

Our response

3.20. We will continue with the policy set out in the SRA April 2011 Policy Statement that the Compensation Fund will:

- a) in the period 1 October 2012 to 30 September 2013, replace the existing side-arrangement; and
- b) from 1 October 2013 onwards, provide compensation in respect of claims against firms who were not insured under a policy of qualifying insurance, including in respect of any liability arising from ongoing practise after the Cessation Period, but before the firm ceases to practise.

3.21. We believe that the existence of non-applied firms is a regulatory failure and it should be the responsibility of the SRA to ensure that the number of these firms and claims arising is minimised and eliminated.

3.22. Secondly the Qualifying Insurers have no association with the non-applied firms as they do not insure or regulate them. We believe it is therefore not appropriate to place the burden of financing claims arising from those firms on the insurance market. This has to date create a distortion in the market as insurers hesitate to enter and be responsible for activities outside their risk assessment.

3.23. In addition the maintenance of the side arrangements would require the maintenance of much of the structure of the current ARP. For a much smaller group of clients this would be disproportionate and add an unnecessary layer of regulatory burden.

4. Authorisation Rules

Comments on the changes proposed to the SRA Authorisation Rules

- 4.1. This question did not raise as high level of response as some previous sections. Less than 20% of respondents commented on proposed changes. The responses range from no support, feeling that this is just more complexity, to stating that the rule changes are fit for purpose.
- 4.2. In general there is support for the proposed changes as they are needed to fully implement the proposals outlined.

Our response

4.3. We are pleased that this change is generally supported. We believe the change is essential in order for us to be able to take prompt and effective regulatory action against firms that do not take proper steps to close down in the Cessation Period and those that continue to practice beyond the end of Cessation Period.

5. Compensation Fund Rules

Comments on the changes proposed to the SRA Compensation Fund Rules

- 5.1. Less than 20% of respondents commented on these proposals. Many express a variety of doubts and concerns including: that this proposal may not apply in all cases, that the Fund might not be sufficient in every scenario before it, as to the cost of this proposal, and as to other unintended consequences.

Our response

- 5.2. The Legal Services Act extends the permitted scope of our compensation arrangements including the Compensation Fund. In order for the Compensation Fund to be properly utilised for this purpose it must be able to make grants of compensation in circumstances substantially the same as the circumstances which are presently covered by the Minimum Terms and Conditions (**MTCs**) and the ARP Policy.
- 5.3. The Law Society has powers to make rules in respect of compensation arrangements under section 36 and 36A of the Solicitors Act (**SA**). These powers are broad and allow the Law Society to make rules for grants of compensation that would cover "any act or omission". However, the powers under the SA do not extend to licensed bodies, the regulation of which is governed by the Legal Services Act (**LSA**). It was for this reason that an Order was made under section 69 of the LSA (**the Order**). The Order had the effect of extending the Law Society's compensation powers to apply to licensed bodies on the same broad terms as exist under the SA.
- 5.4. We are seeking the permanent section 69 Order to grant us the above powers. We will be amending the Compensation Fund Rules to allow grants to be made, covering these additional circumstances.

6. Proposed changes not included in the April 2011 policy statement

Credit ratings of qualifying insurers

- 6.1. This question provoked one of the greatest responses. The majority of respondents are in favour of introducing a credit rating notification requirement for qualifying insurers. It is generally felt that whilst it is not for the SRA to regulate qualifying insurers, they need to provide better information to the profession, including financial strength information, and the identity of the rating agency. Other suggestions include requiring a report of any downgrading in ratings; prominent disclosure of the rating; and details of the protection available and of those insurers not offered protection by EEA compensation criteria.
- 6.2. Some respondents go further and think that the SRA should require (and set) a minimum credit rating. However there is also an opposition to this proposal highlighting the danger of confusion and unnecessary bureaucratic burden, which would detract more competitors into the market.

Our response

- 6.3. We are encouraged by the overwhelming support for the introduction of a requirement on each insurer to disclose its credit and/or financial strength rating or the absence of such a rating.
- 6.4. We will request, from the 2012/13 indemnity period, that all qualifying insurers disclose their rating/or lack of it, and the name of the rating agency to allow the SRA to publish this information on our website. We will also require qualifying insurers to make this information part of any quotation.
- 6.5. We will keep these arrangements under review and reconsider our position in due course, together with all the responses we received during this consultation.

7. Further issues

Acceptance periods

- 7.1. We had a good response to this question with almost 60% of respondents commenting. The majority of respondents are in favour of an acceptance period for a quote, but most of these think that the proposed five days timescale is too short and suggest a longer period of between 10 and 21 days.
- 7.2. Many respondents also raise concern that extending the deadline may encourage late issuing of terms by insurers and more firms moving to the Extended Indemnity Period.

Our response

- 7.3. Whilst there is a support for the introduction of an acceptance period for quotes, we do not intend making any changes in this respect. We believe that as a legal services regulator it is not our role to set a time limit and it is more balanced, to ensure that there is a vibrant and competitive market for professional indemnity insurance (**PII**) which is not unnecessarily burdened by disproportionate regulation.

Cancellation of policies

- 7.4. Responses show a split as to cancellation of policies for non-payment of premium, but the majority do not support cancellation for misrepresentation which is seen as a much more complex issue. Some responses do support cancellation unless premiums have been fully paid (or are subject to a loan agreement). Misrepresentation is an issue which is currently under review by the Law Commission but many think this should not be a ground for cancellation (which puts a justified claimant at risk). Some think the SRA should take a tougher action over non-payment of premiums.

Our response

- 7.5. We value all the comments and suggestions put forward in this discussion. These responses will help inform our thinking when we reconsider this matter in due course. However we do not intend making any changes in this area for 2012/13.

8. Impact analysis

- 8.1. The consultation paper was accompanied by the April 2011 equality impact assessment (EIA) which had been revised and updated to take account of the

dramatic changes in the size and composition of the ARP and the SRA's decision to replace the ARP with the system of extended policy periods. Respondents were invited to comment.

- 8.2. Only two respondents commented. The first made a general comment that we should ensure we make provision for reasonable adjustments for disabled people as we implement these changes. The second considered that the updated EIA is justified in light of the equalities evidence.

Our response

- 8.3. We will continue to make provision for reasonable adjustments in line with our [Reasonable Adjustment Policy](#) as these changes are implemented. We will take reasonable steps in the way we work with disabled people so they are not disadvantaged in comparison to people who are not disabled.

Summary of overall responses

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

	Q1 Comments on the decisions, set out in the policy statement which form the basis of changes consulted on	Q2 Comments on changes proposed to the QIA and SIIR: a. Extended policy & cessation period b. Notice of intention not to renew cover c. Contribution to the ARP d. ARP policy cut off and run off cover e. Comp Fund for non applied firms	Q3 Comments on the Authorisation Rules	Q4 Comments on the Compensation Rules	Q5 Credit ratings of QI- require QI to confirm its rating (if any)	Q6 i. .acceptance periods ii. .cancellation of policies a. .non payment b. misrepresentation
LAWYER REPRESENTATIVE GROUPS						
1	Rule changes should be clear concise and unambiguous with reasonable adjustments for disabled people as the changes are implemented	-	-	-	-	-
2	Support	Support save that b is unworkable	-	-	Yes	i. Yes but 10 as a minimum ii. a. – b. No
3	Support	-	-	-	Yes plus SRA should introduce a minimum rating	i. Yes ii. a.Yes b.Yes

4	-	Support	-	-	Yes	i.Yes ii.a. Yes ii.b.No
5	-	Support save that for concerns about premium under a. and about c and e	-	Does not support move to Compensation Fund	-	i.Yes but 14 days
6	Support	Support	-	-	No	i. Yes but more than 5 ii.a. Yes ii.b.No
7	Support	Support	-	-	No	i. Yes but 14 ii.a. Yes ii.b.No
8	-	c.Do not support any contribution by the profession,.	Do not support - all messy	Do not support – all messy	Yes	i.No ii.a. Yes ii.b. Yes
9	-	a.Support b.Do not support c.50:50 share d.Support e.Do not support	Support	Do not support – retain side policy	Yes	i. Yes but 21 ii.a. No ii.b.No
10	Keep ARP as insure of last resort	b. is unworkable. e.Do not support	-	Do not support	Yes	i.No ii.a.No ii.b.No
11	Support	Support	-	-	No	i. Yes ii.a. Yes ii.b. Yes
12	-	b.is unworkable	-	-	-	i.No ii.a.No ii.b.No
OTHER REPRESENTATIVE GROUPS						
13	-	a.Support c. Support	-	-	-	i.- ii.a.No ii.b.No
14	Support	b. is unworkable	-	-	-	i.- ii.a. Yes ii.b. Yes

REGULATORS and OMBUDSMEN						
15	Proposals do not go far enough	e. concerns	-	-	-	-
INSURERS and BROKERS						
16	Support	Support save that b is unworkable	-	-	Yes plus SRA should introduce a minimum rating	i. No ii.a. No ii.b. No
17	Falls short of our expectations	a.Support b.Do not support c.Support d.Support e.Support	Support	-	Yes	i.Do not support ii.a.- ii.b. -
FIRMS						
18	Support the decisions already made	-	-	-	Yes	i. Yes but 10 or 14 ii . a. Yes ii. b. -
19	Support	-	-	-	-	i.Yes ii.a.Yes ii.b.Only for deliberate or fraudulent
20	-	-	-	-	Yes	-
21	-	Support save that b is unworkable	-	-	Yes	-
22	Support	No these changes will not work in practice	-	-	Yes plus SRA should - introduce a minimum rating	-
23	-	-	-	-	Yes	-
24	-	Support save that b is unworkable	-	-	Yes	-
25	-	-	-	-	Yes	-
26	-	-	-	-	Yes	-
27	-	-	-	-	Yes	-
28	-	-	Support	Support	Yes	-
29	Support	c.Do not support any contribution by the	Support	Support	-	i.- ii.a.Yes

		profession,. Does support SIF payment				ii.b. -
30	-	-	-	-	Yes	-
31	-	-	Many difficulties in practice	Do not support – not properly costed	yes	-
32	-	b.is unworkable	-	-	Yes	i.Yes ii.a.- ii.b.-
33	Support	-	Support	-	Yes	i.Yes ii.a.No ii.b.No
INDIVIDUALS						
34	-	-	-	-	Yes	-
35	Support	Support save that b is unworkable	-	-	Yes plus SRA should introduce a minimum rating	i. No ii.a. No ii.b. No
36	-	-	-	-	Yes	-
37	-	-	-	-	Yes	-
38	-	-	-	-	Yes	i. Yes but 21 ii.a.No ii.b.No