



18 August 2021

## **APPLICATION FOR INTERIM CHANGES TO THE CILEX COMPENSATION FUND**

### **Background to the proposal**

1. CILEx Regulation is the independent regulator for Chartered Legal Executives, other grades of CILEX membership, CILEX Practitioners and CILEX Authorised Entities. We take a risk based and outcomes focused approach to regulation, by working constructively with our regulated community to ensure that they deliver the best outcomes for clients. We have set clear principles within our Code of Conduct and inform the public of the standards they can expect. We believe this provides a balanced approach.
2. CILEX was designated as a regulator of individuals and law firms in 2014 and was subsequently granted the rights to make compensation arrangements and rules to establish the fund and require CILEX Authorised Entities to contribute to the fund via a section 69 Order. The fund is primarily designed to protect consumers of CILEX firms who have suffered loss in relation to dishonest misappropriation or failure to account.
3. As part of our work as a regulator of law firms, we operate a compensation scheme on behalf of CILEX, which provides discretionary grants to consumers of legal services from our CILEX Authorised Entities<sup>1</sup>, where the consumer is in hardship, and this has been caused by a dishonest misappropriation or a dishonest failure to account. We also cover situations where there is a civil claim which is not purely a negligence claim and is not covered by professional indemnity insurance.

### **Introduction to the proposal**

4. Our current compensation arrangements are set out in the CILEx Regulation Compensation Arrangements Rules. They provide for a maximum discretionary grant to an individual of £500,000. The total of the claims per Authorised Entity is limited to £2m.

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<sup>1</sup> For the avoidance of doubt, CILEX-ACCA probate firms (currently under consideration at the LSB) will not rely on the compensation arrangements subject of this application. They have a Fidelity Guarantee as part of the PII arrangements.

5. Originally the CILEX compensation fund was partly insurance backed and partly covered by a £1m loan facility from CILEX. This was amended in 2017 to a fully insurance-backed scheme, releasing the £1m back for CILEX use and which covered successful claims to a total aggregate of £6m for the period of insurance.
6. In late May 2021, we were advised that our insurer would not be renewing the policy which underwrites the CILEX compensation arrangements. The policy expired on 4 July 2021 and CILEx Regulation was able to obtain a short, 60-day extension to the policy to allow us to create an alternative approach to cover the next 12 months. There is a possible further extension to the policy currently being negotiated.
7. Without insurance to underwrite successful claims against the fund, clients who are subject to dishonest actions of CILEx Regulation authorised entities will be left in the position of not being able to claim for loss. Therefore, we have considered alternative options to replace the compensation arrangements. Given the short time frame between the notice that the insurance would not be renewed and the expiry of the policy covering the compensation arrangements, CILEx Regulation has approached the issue in two stages:
  - To provide interim arrangements to ensure there is cover for the next 12 months; and
  - To undertake a review of the full range of possible options in the next 12 months, which will enable CILEx Regulation to provide appropriate compensation arrangements to clients of the firms we regulate for the long term.
8. This application relates to the introduction of interim arrangements that we have been able to agree within the short timeframe available to us. To assist with the proposal, we have engaged the services of an actuary as well as working with our brokers to continue to search for replacement insurance to cover the compensation arrangements.
9. This application sets out the proposals for compensation arrangements to cover the next 12 months. Our intention is to work over this period to create a long-term, sustainable position, which will protect the interests of consumers of CILEX Authorised Entities and at the same time ensure that future arrangements are not primarily supported by insurance, which may be subject to changes owing to changes in attitude to risk by these commercial organisations.
10. In summary, the current approach, the actuary's view and CILEx Regulation's interim proposal are set out below:

<b>Figure 1: Review of current, recommended, and proposed changes</b>			
	<b>Current arrangements</b>	<b>Actuary recommendation</b>	<b>CILEx Regulation proposal for change</b>
<b>Individual limit</b>	£500,000	£250,000 (probate and conveyancing claims) £10,000 (all other areas of practice)	£500,000
<b>Firm aggregate</b>	£2m	£250,000	£500,000
<b>Total fund</b>	£6m	£250,000	£500,000

11. As mentioned above, the proposed approach is an interim position to enable CILEx Regulation to consider longer-term alternative options e.g. Third Party Managed Accounts, Fidelity Guarantee Insurance etc.

### **Current arrangements**

12. Our current approach to ensuring compensation arrangements are available to consumers of CILEX Authorised Entities is to purchase an insurance policy which covers payments of discretionary grants to those individuals who have suffered hardship primarily as a result of dishonest misappropriation or dishonest failure to account.
13. The maximum discretionary grant available to an individual under the current rules is £500,000. The aggregate maximum payment per firm is £2m (i.e. 4 maximum discretionary grant payments), with an overall aggregate in the insurance policy of £6m (i.e. covering 3 firms) See column 2 of Figure 1 at page 2.
14. The rules state that where the fund is exhausted that no grants can be paid.
15. To date there have been no claims made on the fund and therefore no discretionary grants have been paid from the fund.

### **Actions taken following notification of non-renewal of the insurance policy:**

16. As soon as we received the notification from the insurer regarding non-renewal of the policy, we took a number of actions:
  - We instructed our broker to seek alternative cover from the insurance market;
  - We gave early notice to the LSB of the potential issue emerging;
  - We engaged the services of an actuary; and
  - We spoke to other regulators who either may be affected by our insurers decision or who have experienced claims on their compensation fund to understand the short to medium term risks of the situation.

### *Alternative insurance cover*

17. Since we received notification that the insurance policy would not be renewed, our broker has sought alternative cover from a wide range of other insurers, including those who underwrite similar schemes in the legal services market. We approached other regulators who we believed had insurance backed schemes to aid our broker in their search.
18. At the time of writing, no insurer has been willing to cover the risk. Therefore, CILEx Regulation has created an interim solution to ensure that there are client protections in place whilst we consider longer-term options.

### *Other regulators*

19. We reached out to other regulators, who might be similarly affected in the future by the withdrawal from the market, to ascertain whether a larger number of firms would make the risk more attractive to insurers.
20. We also contacted other legal sector regulators to investigate whether there was any scope for joining with a larger established fund but legally this was not an option.

21. We requested data from those regulators with a history of claims on their funds and, whilst all regulators we spoke to were willing to share data, the timeframe has meant that for the short-term position we have been limited to the use of publicly available data relating to the SRA compensation fund. We expect that more data will be available when we seek to request a long-term change to the compensation arrangements at CILEx Regulation next year.

#### *Services of an Actuary*

22. Whilst our broker continues to attempt to secure alternative cover, CILEx Regulation engaged the services of an actuary to determine what the minimum sustainable level of cover would be to continue to protect the consumer whilst being affordable to CILEX and CILEx Regulation. His summary opinion is attached to the application at **Appendix 2**. The information on which his opinion is based is outlined below:

#### *Assessing the likelihood of a claim on the fund in the next 12 months*

23. With only 23 Authorised Entities, including two recently authorised, we are able to have a good understanding of any risks that they might pose. We provided the actuary with comprehensive information in relation to both active and closed firms at CILEx Regulation, including PII claims history and premiums, client base and client account information.
24. We also advised him that since being granted the power to regulate firms, we have not had to exercise our intervention powers nor consider any requests from grants under the compensation arrangements. All annual returns and accountants' reports are up to date. Only one firm has had to close and that was carried out in an orderly manner.
25. We have reviewed any complaints received about our Authorised Entities (including those whose clients fall outside the scope of the Compensation Arrangements) and concluded that there are no complaints received that would indicate any likely claim under the compensation arrangements. Given that the scope of the compensation arrangements is limited to dishonest misappropriation or failure to account for active firms<sup>2</sup> and we know from the experience of other regulators and legal professionals involved in intervention work, that one usually will have significant notice of potential claims, because they are the consequence of other actions and/or misconduct by the firm or individual. The actuary assessed the risk of a claim arising in the next 12 months as remote.
26. We have received no notice of any actions by our Authorised Entities that would lead us to believe that a claim may be forthcoming.

#### **Proposed arrangements**

##### *Interim arrangements to cover the next 12 months*

27. Based on the information outlined above, the actuary recommended minimum sustainable cover for the next 12 months. The recommendations are set out in Figure 1, column 3 at page 2.

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<sup>2</sup> Civil liability under the fund would only arise in the event of a closed firm not obtaining run off cover and a claim arising that is beyond pure negligence

28. Having considered the impact upon the consumer, should we adopt the minimum sustainable arrangements for the next 12 months, and after discussions with CILEX, we have been able to increase the interim compensation arrangements, from the actuary's recommendation for the next 12 months to that set out in Figure 1 column 4 at page 2.
29. The interim requirements will need to be underwritten to £500,000 for the next 12 months. We have agreed with CILEX that together we will underwrite a fund of £500,000 which would cover the payment of any discretionary grant made following a claim on the scheme.
30. The fund will be underwritten between CILEX (the owners of the fund) and CILEx Regulation (who manage and administer the fund on behalf of CILEX).
31. CILEx Regulation will ringfence £250,000 from our reserves to cover claims in the first instance and CILEX will act as surety for the remaining £250,000 to underwrite the scheme for the next 12 months, until a longer-term solution is agreed (see confidential Appendix 6). An agreement has been drawn up to formalise the arrangements .
32. The CILEX Group reserves currently hold just under £7m, of which £700,000 is the CILEX Regulation share of the contingency reserve. Further information on the reserves can be found in the [CILEX Annual Report](#). These arrangements are therefore sustainable for the next 12 months.
33. The final CILEx Regulation reserves policy is being finalised as part of the practising fee application for 2022 and will be submitted with that application together with the CILEX Group Reserves Policy.

#### *Longer term review of compensation arrangements*

34. The discussions that we have had with other regulators over the last month have indicated that the provision of compensation arrangements (alongside access to the Professional Indemnity Insurance market) is an issue that is exercising other regulators as well. As a sector there would appear to be an appetite for a roundtable discussion on the provision of consumer protections at their current level. We would welcome this.
35. In the meantime, our review, which will take place over the next 12 months, will encompass the following areas:
  - How compensation arrangements are provided by other professional sectors (outside of legal), including the limits and mechanisms that they use.
  - How we can use existing products that are in place to offer a different approach to managing risk for the consumer – potentially mandating the use of Third Party Managed Accounts (TPMAs) to remove client money from the control of a firm.
  - Whether the insurance market would extend the use of Fidelity Guarantee Insurance to the wider legal sector.
  - Whether the need for a consumer protection at the current levels can be alleviated by a new approach to all the risks that are required to be protected for the benefit of the consumer.

36. We have commenced initial discussions with a TPMA about what a mandated scheme might look like, and the costs involved to a user. These discussions will continue over the next few months with other providers to explore whether this is a feasible option that provides firms with choice.
37. We will use the contacts we have gained from working with the ACCA and the broker that they have close links to, to explore Fidelity Guarantee Insurance in greater detail.
38. Similarly, we will look to engage with the insurance market on what a future sustainable model might look like across PII and how the use of newer technologies may reduce the risk of claims across all areas of consumer protection including compensation arrangements.
39. Events have indicated to us the importance of producing a model that works in its own right, but we also note that there is an opportunity to look afresh at how risk in this sector is managed on a cost effective and sustainable way. We believe that with the greater focus on extending consumer protections more widely across the legal sector, including the unregulated sector, then this may present an opportunity to look afresh at what is required.

#### **Changes to the regulatory arrangements**

40. We are proposing to amend the CILEx Regulation Compensation Arrangement Rules as follows:
  - a. At **rule 3(2)**, we have reversed the order from which discretionary grants will be paid to reflect that in the short-term no insurance contract will be in place.
  - b. Clarification throughout the rules that grants are discretionary.
  - c. At **rule 6(1)** to confirm that discretionary grants will be made from the Fund.
  - d. At **rule 6(1)(a)** to confirm that claims can only be made by Eligible Persons
  - e. At **rule 6(3)(a)** to remove the possibility of an insurance policy covering interim payments, which may instead be made from the Fund.
  - f. To **remove 6(4)(d) from the rules**
  - g. To **amend rule 9** in relation to the maximum discretionary grants available from the Fund to reflect the revised arrangements set out at paragraph 13 of this consultation document.
41. We have **retained the rule at 6(2)** that 'A Discretionary Grant may not be made in excess of funds available under these compensation arrangements...' this ensures that the compensation fund is sustainable for the next 12 month period.
42. The proposed revisions to the CILEx Regulation Compensation Arrangements Rules are attached to this consultation at **Appendix 1**. Although there will be no insurance policy in the immediate term, some references to a policy have been retained within the rules in case of future access to a policy.
43. A letter from the Actuary confirming his recommendation is attached at **Appendix 2**.
44. The full report from the Actuary has been provided confidentially to the LSB under separate cover.

## **Costs/affordability**

45. As an interim measure we have replaced the insurance policy which backs our compensation arrangements with a £500,000 fund, which is underwritten on a 50:50 basis with CILEX from reserves. Claims will first be paid from CILEx Regulation reserves, with CILEX acting as surety for the remaining £250,000.
46. The current reserves held by CILEX are just under £7m, of which £700,000 is ringfenced to CILEx Regulation as part of the contingency reserves. Therefore, there are sufficient funds available to cover the scheme for the next 12 months.
47. In addition, each CILEX Authorised Entity makes an annual contribution to the fund, this is based on turnover and area of practice. Total annual contributions to the fund are currently in the region of £20-25,000. Over time these contributions (which formerly contributed to the premium to the insurance company) will build a fund from which discretionary grants may be paid.
48. In the unlikely event that claims leading to a discretionary grant, made in the 12-month interim period, exceed £500,000, the rules provide those discretionary grants cannot be made in excess of the funds available. Therefore, any subsequent claims could not lead to a grant or, if claims are made concurrently, the grants could be paid in proportion to the funds available. This is not a change to the current rules.
49. CILEx Regulation therefore considers that, even though the proposed fund for the next 12-month period is higher than that recommended by the actuary, that this will be affordable.

## **Consultation**

50. CILEx Regulation published its consultation on the CILEx Regulation website and sent out regular reminders by social media and through the CILEX weekly email to members. We have also provided the consultation to the Legal Services Consumer Panel (LSCP) and the Competition and Markets Authority (CMA) for their opinion on our interim proposals. Full details of the consultation and the analysis can be found at Appendix 3 and 4. The LSCP response is attached at Appendix 5.
51. . In summary, we received 2 substantive responses to the consultation (1 from the LSCP and 1 from a CILEX member). We also received communication from the CMA indicating that they did not intend to provide a response to the consultation.
52. The CILEX member sought clarification in relation to future contributions to the fund in the absence of the insurance policy and we responded to that individual directly to address their concerns.
53. The LSCP raised a series of issues including concern over the lack of published data on which the revisions are based and the size of the interim fund which is set to cover only 1 maximum discretionary grant in the 12 month interim period. A full response to the LSCP response is attached at Appendix 4, however in short, CILEx Regulation has acknowledged the LSCP's concerns, noting that the data on which the proposals are based are confidential and sensitive, could identify the individual firms or belong to 3<sup>rd</sup> parties. We have also explained why we are unable to revert to the previous compensation arrangements in operation at CILEX (i.e. owing to the

lack of available insurance cover at any level in the market and the balance between ensuring continued consumer protection and the viability of the CILEX Group in relation to outlay of capital to underwrite the fund). The LSCP has also provided some helpful advice and guidance in relation to steps which should be taken in the next 12 months as we consider the longer-term proposals to provide ongoing consumer protection to clients of CILEX authorised entities, and we commit to ensuring that we take these actions during our review period.

### **Strategic objectives**

54. CILEx Regulation has [3 strategic objectives](#) (taken from our 2019-2021 strategy) which are focused on standards, consumer and diversity.
55. It is our view that the actions we have taken to create an interim solution for the next 12 months relate to our strategic priorities as follows:
- Protecting consumers: We have chosen to retain the maximum individual grant payable at £500,000. This is twice the actuary's recommended amount for probate and conveyancing transactions and many times higher than the £10,000 recommended for other areas of practice. In this way, we are limiting the possibility of consumer detriment as far as possible, whilst ensuring that CILEx Regulation and the fund remain viable throughout the period.
  - Strengthening diversity in the legal profession: CILEX and CILEx Regulation offer a route into the practise of the law, which is inclusive and enables those from diverse backgrounds to be successful in a legal career. Our interim solution supports this by ensuring that our firms are able to continue to provide legal services with a sustainable compensation scheme protecting their clients.

### **Regulatory objectives**

#### **56. Protecting and promoting the public interest and the interests of consumers**

- By ensuring that we have retained the current single maximum discretionary grant payment, we have acted to protect consumers from harm in the event of dishonest actions by one of our regulated firms. Whilst the aggregate limit has been reduced to the value of one maximum payment, we consider, based on the advice of our actuary, that this will provide continued protection, which is affordable to CILEx Regulation, without reducing the mitigation of loss to an individual. At the same time, CILEx Regulation is ensuring that consumers may continue to access legal services from our regulated firms.

#### **57. Promoting competition in the provision of services provided by Authorised Persons**

- By providing this interim cover, we are enabling the continuation of the delivery of legal services with appropriate consumer protection in place for the next 12 months. This will also allow for us to authorise more CILEX Authorised Entities in the future ensuring that there continues to be a variety of authorisation options available to individuals considering opening a new law firm.
- Under this approach, we are maintaining the number of entities operating in the sector, and we hope that more CILEX members will consider opening law firms in the future.

## **58. Encouraging an independent, strong, diverse and effective legal profession**

- By continuing to provide compensation arrangements to clients of CILEX Authorised Entities, we ensure that there continues to be available alternative routes to authorisation, and increasing the options available to those wishing to practice.

### **Better Regulation Principles**

#### ***Proportionate***

59. In designing the interim solution to replacing the insurance-backed compensation arrangements with a fund underwritten by CILEX and CILEx Regulation, we have been proportionate; in that we considered how we could continue to provide similar levels of protection to clients of our law firms whilst ensuring the risk was sustainable to the CILEX Group for the 12-month interim period. We consider that we have struck the right balance, having taken into account the views of the actuary, the protection afforded under the current scheme and assets available to the CILEX Group to underwrite the scheme. We have not made substantive changes to the compensation arrangements available beyond those relating to how the arrangements will be underwritten for the next 12-months.

#### ***Accountable***

60. We have set out the justification for taking the actions that we have in relation to the changes to the compensation arrangements and we have communicated on a regular basis with relevant stakeholders to ensure that the reasons for our proposals are fully understood.

#### ***Consistent***

61. By limiting the changes made to the current rules relating to the compensation arrangements we have sought to maintain consistency with the existing arrangements as far as it is practicable to do so.

#### ***Transparent***

62. We conducted a 4-week consultation, which was published on our website as well as being communicated to our regulated firms and to both the Legal Services Consumer Panel and the Competition and Markets Authority.

63. Once the changes to the compensation arrangements have been approved by the Legal Services Board, we will publish the scheme information on our website.

#### ***Targeted***

64. The proposed changes continue to ensure that consumers most in need of financial protection when facing detriment caused by dishonest providers of legal services regulated by CILEx Regulation will be able to make a claim for compensation. Whilst we have reduced the aggregate limits to £500,000 within the scheme rules, as CILEx Regulation has excellent insights into its regulated firms, the risk of multiple high claims submissions is considered to be remote and this is supported by the actuary's report.

## Impact assessments

### ***Regulatory Impact Assessment***

65. In terms of contributions payable by CILEX Authorised Entities, we are not proposing to increase the contribution to the fund for 2022 (this will be subject to an application to the Legal Services Board alongside the annual PCF application for 2022 later this year). Therefore, there is not considered to be detriment to the regulated community.
66. The fund will be underwritten from CILEX and CILEx Regulation reserves and we are not intending to make any changes to the PCF as a result of this ringfencing of reserves. Therefore, this will not cause an increase to the PCF for 2022 and therefore is not considered to be a detriment to the regulated community, nor will it impact on the cost of delivery of legal services which may be passed onto the consumer.

### ***Equality Impact Assessment***

67. In relation to the potential impact on consumers of legal services and the available fund from which discretionary grants may be made, the overall available fund has been reduced, although the maximum individual payment has not.
68. CILEx Regulation has been operating compensation arrangements since 2015 and there have been no claims made on the fund against which we would be able to assess any differential impact on protected groups. We have therefore considered as a proxy, the publicly available data from the SRA.
69. Their findings indicated (inter alia)<sup>3</sup>:
- Most payments from the Fund are relatively low.
  - Over the period 2010 to 2018, more than 75 per cent of claims paid were for less than £5,000.
  - Higher value claims tend to arise from a limited range of legal services, generally to stolen probate, mortgage monies and damages settlements.
  - Historically, average payments have remained relatively stable over time, except for payments relating to the loss of probate monies which show an upward trend.
  - Characteristically vulnerable applicants (older, lower social grading, BAME, disabled) are less likely to use the types of legal services that give rise to large claims on the Fund (conveyancing and probate).
  - The likelihood that small firms will be undertaking work that may involve very large sums of money that would not be covered by the £500,000 limit is low.
70. The average claims based on SRA publicly available data by area of practice is as follows:

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<sup>3</sup> Data taken from [Supporting evidence and analysis - Compensation Fund \(legalservicesboard.org.uk\)](https://legalservicesboard.org.uk/supporting-evidence-and-analysis-compensation-fund)

Practice Area	Claim reason	Average payment (£000s) (rounded)
<b>Probate</b>	Balance due to estate	40
<b>Conveyancing</b>	Unredeemed mortgage	230
	Fraud	260
	Other	20
<b>All Other/Unspecified</b>	Gross overcharging	200
	Fraud	125
	Client account	40
	Other causes eg: Expert/Counsel fees, Investment fraud Tax avoidance schemes, Damages	<20

71. Based on this analysis, we consider that the interim proposed changes will not have a negative impact on protected groups.

### Evaluation and monitoring

72. As has been made clear throughout this application, the proposals are interim arrangements to enable CILEx Regulation to undertake a review of compensation arrangements available to determine how we should proceed in the longer term.

73. We will however continue to closely monitor the operation of our Authorised Entities to ensure that the risk of a claim on the compensation fund is mitigated as far as possible.

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