Potential options for SRA PII requirements

A report for the Solicitors Regulation Authority

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Disclaimer

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Executive Summary

Economics, Policy and Competition (EPC) has been commissioned by the Solicitors Regulation Authority (SRA) to examine potential changes to their professional indemnity insurance (PII) requirements. This report is designed to explore the possible impacts of a wide variety of different options for change in order to help the SRA to identify proposals to take forward for consultation.

Recent evidence from The Law Society (TLS) has indicated that, on average, solicitor firms pay PII premiums of around 5% of turnover, although sole practitioners pay an average of 7%.[1] The Competition and Markets Authority (CMA) has highlighted that regulatory costs may hinder entry and exit of small firms to the legal services market and recommended that regulators work to reduce the cost of PII.[2]

PII requirements

The SRA requires firms to have PII in place as a major form of client protection since many clients, particularly consumers, are in a weak position to judge the quality of advice that they receive.[3] The presence of PII helps to protect clients when they receive low quality legal services to ensure that they can receive redress for any failings. The SRA specifies the Minimum Terms and Conditions (MTC) that PII must meet but firms must also ensure their level of PII is appropriate to their business. Alongside PII, the Compensation Fund (CF) also provides protection for some clients.

Methodology

The report draws on a small number of discussions with insurers, brokers and lenders as well as a short online survey of insurers. A significant input into the report has been claims data for 2004-2014 from insurers representing 74% of the market. Overall the data covers claims worth £1.95 billion and defence costs of a further £0.55 billion.

PII principles

The SRA has reaffirmed the use of principles used in previous work on client protection for the present analysis:

- 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.

[1] Professional Indemnity Insurance Research for The Law Society, mustard, April 2016.
[2] Legal services market study, Competition and Markets Authority, December 2016.
[3] References to consumers should be interpreted as including small businesses covered by the Compensation Fund. References to firms should be interpreted as referring to law firms.

- 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 - ABSs).
- Principle 4: The scheme should encourage an independent, strong, diverse and effective legal profession.
- Principles 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.

The principles, along with standard approaches to impact assessments, have been used to consider the expected effects of different changes to the MTC.

Transition

Since PII works on a "claims made" basis, transitional arrangements may need to be in place to retain a reasonable level of protection given the expectations of clients, at the time at which work was conducted. Such arrangements also imply that some of the anticipated impacts from any change will take time to arise.

Possible options

Reducing the single claims limit

There is no evidence of different claims behaviour based on the legal form of firms hence the current approach of different limits by legal form contravenes Principle 3. Some firms will maintain existing limits even if the minimum limit falls to £1 million or £0.5 million. A small premium reduction will result for firms who reduce their limits including those in sectors where high claims have not been seen (Principle 2). For small firms where the proportionate cost of PII is higher, this may reduce barriers to entry (Principle 3) and encourage diversity (Principle 4). It could place clients at risk with at most 19% of the value of claims affected and 8% of the value of claims at risk from a £1 million limit, although retaining a higher limit for conveyancing would reduce this. Reducing the limit would also affect top up cover where "non-standard" MTC provisions (associated to misrepresentation, dishonesty, run-off and unlimited aggregation) may be removed at a lower level of cover than is currently the case (potentially against Principle 6).

Introducing an aggregation cap

An aggregation cap increases the cost for firms and the threat of insolvency when they face aggregate claims (Principle 8), but reduces the incentive for insurers to send price signals to manage such risks (against Principle 8). Overall, limited behavioural change is expected from firms and therefore any reductions in premiums would be mainly due to the risks moving to firms, the CF and

non-consumer clients. The policy could also bring differential outcomes around the ends of indemnity years, the timing of which clients will probably not know (against Principle 6).

Flexibility in client coverage

Allowing flexibility in the client coverage of the MTC introduces definitional issues around the boundary of which clients are protected, and some small businesses, charities and trusts would move across the boundary over time (against Principle 6). Some clients close to the boundary may not obtain appropriate redress (against Principles 1 and 6). Greater clarity would arise from a definition based on financial institutions although the argument for this is linked to high conveyancing claims and therefore it would be more targeted for the definition to link directly to conveyancing (Principle 5).

Flexibility in client coverage would result in non-standard MTC components being removed from non-consumer clients. Depending on the precise rules, firms may need processes to identify consumer and non-consumer clients although it may make insurance arrangements easier for large firms and multi-disciplinary practices (in line with Principle 3). There is a risk that some lenders would reduce the size of their conveyancing panels (against Principle 6).

Exclusions for conveyancing

Allowing exclusions for conveyancing would bring greater clarity regarding which firms provide conveyancing services and which do not (Principle 8). This will produce more accurate pricing with some non-conveyancing firms seeing slightly lower premiums over time. Some firms that conduct a small amount of conveyancing may cease to do so potentially increasing quality (Principle 4).

Small costs would be incurred in gathering and publicising data over time regarding the firms with conveyancing cover although clear records of this bring other regulatory benefits (Principle 7). Depending on whether the non-standard MTC components remain for conveyancing, consumers could be unprotected (against Principle 1) and lenders may limit conveyancing panels (against Principle 6).

Alter requirements regarding the excess

The excess has a valuable function to ensure firms have skin in the game. The current rules, in which insurers must pay the excess to clients if firms do not, may cause more small value claims than otherwise and lead some firms to not pay the excess.

If insurers are no longer responsible for the excess, some firms would obtain higher excesses in return for lower premiums. Among these firms would be some who could not afford to pay the higher excess in the event of a claim. Should the SRA limit this through a maximum excess, greater regulatory cost may be incurred and large firms could be constrained (against Principle 6). Without a restriction on the excess, clients would be unprotected and, unlike insurers, they are unable to prevent firms from arranging a high excess and in a weak position to seek redress from firms. They could be protected through the CF but this would lack the price signals for good risk management (against Principle 8).

Allow greater flexibility for defence costs

If an excess for defence costs is allowed, firms will face the consequences of defending a claim (in line with Principle 8). Firms with claims they defend will face higher costs but others will pay lower premiums. This should reduce the number of claims that are unnecessarily defended and may speed up compensation for clients (in line with Principle 1).

Limited detrimental impacts are anticipated from removing other restrictions around defence costs since insurers generally retain an incentive to ensure the defence is appropriate to the nature of the claim. Removing restrictions would be in line with Principles 2 and 5.

Reform of run-off

Insurers must provide run-off cover for six years after firm closure. The data shows that up to 30% of claims arise in years 4-6 hence a reduction in the length of run-off would place a substantial proportion of claims at risk (against Principle 1). It would reduce run-off premiums in reflection of this risk moving on to clients or the CF (against Principle 8).

An aggregation cap in run-off would have little impact on firm behaviour hence the main impact would be to reduce run-off premiums but shift risks onto clients (against Principles 1 and 8).

Insurers are required to provide run-off cover even when premiums are not paid which is not consistent with normal market practice and results in up to 50% of run-off premiums being unpaid (against Principle 6). If this was changed, premiums would fall for those firms who pay them as they would no longer cross-subsidise those who do not pay (in line with Principle 8). However, firms without resources, along with those willing to flout regulation at a time when they are leaving the sector, would not buy run-off leaving clients unprotected (against Principle 1). Non-consumer clients unprotected by the CF may take action to reduce their use of small firms more likely to enter run-off (against Principle 6).

Changes to successor practice definitions

Failure to have clarity on the definition of successor practices causes uncertainty (against Principle 6) although, given the small number of cases, change here would need to be done carefully to ensure the cost of clarity is proportionate. Limiting successor practice definitions to smaller parts of firms (e.g. live files only) would encourage takeover activity (in line with Principle 3) but increase the risk of asset stripping (against Principle 6) although the main concern with the latter is the failure to pay run-off premiums. Handling claims is easier when there is a successor practice to contact hence more run-off policies could lengthen the claims process (against Principle 1). Other aspects of client protection would be unchanged if run-off policies maintain similar protection to ongoing policies.

Exclude cyber-crime

If cyber-crime is excluded from PII cover, the overall impact on consumer risks depends on the proportion of firms who would take out specialist cyber policies if not compelled to do so. Those with cyber policies would face good incentives for appropriate risk management (Principle 8).

However, the protection for clients from cyber policies may not be as great as within PII policies (against Principle 1) unless they too are subjected to MTC requirements. Further, the underlying cause is irrelevant to clients who suffer detriment.

Misrepresentation

If firms are responsible for reckless misrepresentation then they would face the cost of claims (in line with Principle 8) including potentially increasing insolvency risks and improving the average quality of law firms (Principle 4). Consumer protection could be retained through the CF but non-CF-eligible clients would be unprotected and some may take steps to avoid this risk by changing the firms they deal with (against Principle 6). Insurers would have less incentive to seek out misrepresentation in advance (against Principle 8) and more incentive to argue misrepresentation in future, potentially increasing costs for the CF even further.

Alternatively, allowing insurers to seek reimbursement from firms for *all* cases of reckless misrepresentation would maintain client protection, cause misrepresenting firms to face the consequence of this, and also maintain insurer incentives to identify misrepresentation in advance since they would not be reimbursed if the firm became insolvent.

Extend exclusions for dishonesty

If exclusions for dishonesty are allowed, this reduces the incentive to turn a blind eye to the action of other principals (Principle 8) and implies that firms would face greater consequences of internal failings (Principle 8) potentially increasing the quality of firms (Principle 4). Firms could seek alternative insurance to fill this gap, although, it is unclear whether such insurance would be available at a reasonable price for small firms.

Consumer protection could be retained through the CF but non-CF-eligible clients would be unprotected and may take steps to avoid this risk by changing the firms they deal with (against Principle 6). Insurers also have a role to play which the CF can not, which is to provide price mechanisms through PII to encourage the use of processes and systems that are likely to reduce fraud particularly with reference to the client account and this role would be lost (against Principle 8). They would also be expected to argue that more cases involve dishonesty.

As with misrepresentation, if insurers were allowed to seek reimbursement from firms for all cases of dishonesty this would sharpen beneficial incentives on firms and maintain client protection.

Regulatory action and information sharing

The SRA should review the conveyancing sector since it produces 40% of the value of claims. Addressing the underlying conveyancing problems rather than the insurance market would be a targeted approach (Principle 5) and is likely to have a more significant impact on the cost of insurance than many other issues the SRA is considering. Conveyancing transactions are also linked to concerns about misrepresentation, dishonesty and cyber-crime hence action on conveyancing will also help reduce concerns about these aspects of PII.

In the past, the SRA has considered poor behaviour by firms in relation to certain aspects of PII to represent simply commercial disputes between firms and insurers. Insurers have little incentive to provide information if the SRA does nothing with it, but more information could be provided on: failure to pay the excess; failure to pay run-off premiums; misrepresentation; and dishonesty. While some of these cases may reflect genuine commercial disputes, they may also be linked to wider regulatory failings in the firm indicating financial instability or poor systems and controls

Greater engagement with insurers on such issues and higher regulatory penalties for both firms and individuals would help with targeting wider supervision (Principle 7) and improving the quality of law firms (Principle 4). Such actions could be taken irrespective of changes to the MTC and could limit some of the detrimental consequences within the current PII conditions.

1 Introduction

Economics, Policy and Competition (EPC) has been commissioned by the Solicitors Regulation Authority (SRA) to examine potential changes to their professional indemnity insurance (PII) requirements. This report is designed to explore the possible impacts of a wide variety of different options for change in order to help the SRA to identify proposals to take forward for consultation.

Recent evidence from The Law Society (TLS) has indicated that, on average, solicitor firms pay PII premiums of around 5% of turnover, although sole practitioners pay an average of 7%.[4] The Competition and Markets Authority (CMA) has highlighted that regulatory costs, including requirements surrounding PII, may hinder entry and exit of small firms to the legal services market and recommended that regulators work to reduce the cost of PII.[5] In addition, high regulatory costs are ultimately passed through to clients in the form of higher prices for legal services. Hence, the SRA wishes to examine whether changes can be made to various aspects of the PII requirements in order to reduce the costs of PII while ensuring that client protection remains appropriate.

1.1 PII requirements

The SRA requires firms to have PII in place as a major form of client protection. Many clients, particularly consumers, use legal services rarely, are unlikely to have full information about the legal services market and are in a weak position to judge the quality of advice that they receive. The presence of PII helps to protect clients when they receive low quality legal services to ensure that they can receive redress for any failings. Some clients such as corporate clients are repeat users of legal services, are sophisticated purchasers of these services and are able to ensure that appropriate redress mechanisms are in place to protect themselves. Regulated PII protects these clients as well as consumers, although other protection mechanisms such as the Compensation Fund (CF) do not.[6]

PII also protects solicitors since with PII they do not face the loss of paying out for a claim which could, if large, have detrimental effects on their business. While solicitors make the decisions regarding the purchase of PII, their clients are affected by these decisions and solicitors may not always make decisions which are in their clients' interests. From a regulatory perspective, the Minimum Terms and Conditions (MTC) of PII needs to be primarily determined with respect to the level of protection required by clients who are unable to protect themselves rather than either clients who can protect themselves or solicitors.[7]

The specific requirements of the MTC must also be set in the context of the SRA's wider rules including the Code of Conduct which states, "you assess and purchase the level of professional indemnity insurance cover that is appropriate for your current and past practice, taking into account potential levels of claim by your clients and others and any alternative arrangements you or your

[4] Professional Indemnity Insurance Research for The Law Society, mustard, April 2016.
[5] Legal services market study, Competition and Markets Authority, December 2016.
[6] References to consumers in the rest of the document should be interpreted as including small businesses covered by the CF – this is discussed further in section 0. References to firms should be interpreted as referring to law firms.
[7] Client coverage is considered in section 0, but it is also worth noting that the ability of clients to assess PII may vary depending on the particular characteristic of PII under consideration. The specific requirements are set out in the SRA Indemnity Insurance Rules 2013 – Appendix 1.

client may make."[8] Hence it must be noted that the MTC are *minimum* requirements, many firms should purchase insurance that goes beyond the requirements of the MTC and insurers are free to offer products that provide cover beyond the MTC. In addition, to specifying the MTC, the SRA can therefore also supervise and enforce rules to make sure that firms are sufficiently proactive in choosing higher or wider cover where this is appropriate.[9]

Further, PII is not the only form of regulatory based client protection since the CF is also available for certain clients and some protection may be better delivered through the CF than PII. For example, it is not possible to insure your own dishonesty and therefore dishonesty of sole practitioners is covered through the CF. In other cases, excluding cover from PII may bring benefits from enabling the PII market to work more effectively, while securing consumer protection through the CF. Beyond regulatory protections, clients could choose to hold their own insurance although the fact that many clients, particularly consumers, will be unaware of such insurance or any need for it, again highlights why regulatory requirements for PII are in place.

1.2 PII principles

Previous work was conducted for the SRA in 2010 looking at different models for delivering PII comparing the open market with alternative approaches such as using a single fund or a master policy.[10] During that work, principles were developed for the assessment of the system of financial compensation and the SRA has reaffirmed these principles for the present analysis:

- 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 - ABSs).
- Principle 4: The scheme should encourage an independent, strong, diverse and effective legal profession.
- Principles 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.

[8] SRA Code of Conduct Outcome 7.13.

[9] This could be done through the SRA providing guidance regarding where additional cover would be expected and/or through SRA monitoring of individual firm information and level of insurance cover. It is unclear how the SRA will judge whether it is reasonable for a firm to have a particularly aggressive risk appetite and the SRA may wish to give consideration to this.

[10] Review of SRA client financial protection arrangements, CRA, September 2010. The author of the current report was one of the authors of the previous CRA report.

- 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.

Since these principles were designed to cover both the delivery model and also the detailed requirements of financial protection arrangements, not all of the principles will be relevant to any specific option. Nevertheless, the principles, along with standard approaches to impact assessments, have been used to consider the expected effects of various different possible changes to the MTC.

1.3 Methodology

As part of the analysis, the report draws on a small number of discussions that have been held with insurers, brokers and lenders in order to help to understand the expected impacts from different proposals.

In addition, the SRA conducted a short, online survey of insurers on some proposals. Responses were received from 8 insurers, with a further 3 insurers responding only on a single question about client coverage (section 0).

Finally, claims data was received from insurers details of which are set out below.

Claims data

In 2016, insurers were asked by the SRA to provide claims data in order that the SRA could obtain a better understanding of the nature of PII claims. Data was submitted by insurers to a third party and anonymised data was made available to EPC. Claims from all types of clients including consumers, lenders and other corporate clients are included.

Data has been collected for the indemnity years 2004-2014. Data was not submitted by all insurers who have provided PII over this period, but over the whole period claims data was provided by insurers with an average of 74% market share.[11]

Non-responding insurers may have a different claims experience to those insurers that did respond to the survey. In particular, some insurers who did not respond were particularly focused on small. Hence the overall data will therefore understate the proportion of claims that typically arise with small firms and overstate the proportion of claims that are more common with larger firms. Nonetheless given the high share represented by the data, this is a very good basis for analysis.

Data was provided in nominal terms and has been uprated by the Retail Price Index (RPI) such that it represents claims values as at June 2016. The data includes open claims (those that have not yet been settled) as well as closed claims.[12] Recent claims are more likely to be open than older claims

[11] The market share is based on the shares of qualifying insurance which was used historically to apportion the costs of the Assigned Risks Pool. Some top up policies for large firms may not be written on an MTC basis and may not have been included in these totals. Hence the total value of PII premiums will be higher than the value of premiums for policies on an MTC basis.

[12] A small number of negative claims have been removed for the purpose of analysis.

simply because it takes time to process claims. This will understate the total value of claims over the period. Overall, therefore, it is important to recognise that the data represents only a portion of the true value of claims over the period. For this reason, most data is presented as a proportion of claims as well as in value terms. Overall the data covers claims worth £1.95 billion (which would include claimant costs) and defence costs of a further £0.55 billion.

Conveyancing

Conveyancing claims represent around 40% of the value of claims in the data set. Since house price inflation has exceeded RPI over the period, using RPI may understate the current value of any of the conveyancing claims that are linked to the value of property. Nonetheless, given that conveyancing represents a high proportion of claims, there are various parts of the report which make particular reference to these claims. Some conveyancing claims are categorised as residential or commercial conveyancing. This does not necessarily imply that all residential conveyancing claims are consumer claims since lenders are able to make claims in respect of residential conveyancing. The report also recommends that the SRA conduct a separate review of conveyancing since there have been persistent concerns about PII claims in this area (see section 2.4).

1.4 Transition

PII works on a "claims made" basis where insurance is provided by the insurer in place at the time the claim is made, rather than the insurer in place at the time that the work was done. For this reason, transitional arrangements may need to be in place to ensure that historic work retains a level of protection that is reasonable given the expectations of clients at the time at which work was conducted. While consumer clients are unlikely to have detailed expectations of PII protection, some sophisticated clients may do so. In particular, mortgage lenders may have expectations of particular protections through PII coverage which is important since conveyancing claims tend to arise more slowly after advice is given compared to some other types of claim. Hence cut-off dates or other transitional arrangements may be needed such that work conducted before the change remains covered in the future on the existing MTC basis. A further implication of this is that some of the anticipated impacts from any change will take time to arise where insurers remain required to cover historic work.

2 Potential options for consideration

This chapter examines a range of different possible options for changing the PII requirements and considers the likely impacts that such changes would have.

2.1 Single claims limit

Currently, relevant recognised bodies and relevant licensed bodies must have single claims cover of at least £3 million while other firms must have cover of at least £2 million. This section explores reducing the (minimum) single claims limit to £1 million, or £0.5 million for all firms.

2.1.1 Calibrating the minimum single claims limit

Setting the minimum single claims limit requires a trade-off between the benefits from higher limits offering greater protection and the costs of paying for higher insurance coverage. As explained in Chapter 0, high PII premiums feed through to higher prices for legal services and may also form a barrier to entry, particularly for small firms, which reduces competition in legal services. As such, setting a very high minimum single claims limit may contravene Principle 2 (minimum necessary to meet objectives), Principle 3 (encouraging competition and allowing new entry) and Principle 4 (encouraging a diverse legal profession).

Table 1 below sets out the number and value of claims paid over the period 2004-2014.

Table 1: Positive claims payments 2004-2014

Value of claim (2016 values)	Number of claims in range	Value of claims in range	Proportion of claims by value
£0-0.5 million	26,679	£1,045 million	53%
£0.5-1 million	370	£255 million	13%
£1-2 million	165	£229 million	12%
£2-3 million	57	£140 million	7%
£3 million +	47	£286 million	15%
Total	**27,318**	**£1,955 million**	**100%**

Source: EPC calculations based on insurer claims data provided to the SRA.

It is clear from Table 1 that the vast majority (98%) of the number of claims are for claims less than £0.5 million although this represents a smaller proportion of the value of claims (53%).

The data collected does not include the level of cover in place so it is not possible to assess whether claims are made under policies which rely on the MTC limits or whether top-up policies have been used which have higher limits. Claims paid over £3 million (15% of total claims) must have been for firms that have taken out top-up cover, those for £2-3 million may have been made by relevant recognised bodies and relevant licensed bodies with the higher required minimum level of cover, or by other firms who have top-up cover. Claims for less than £2 million could have been made by a firm with the minimum cover, or by firms with top-up cover.

Under-insurance

Firms are obliged to make sure that they have an appropriate level of insurance reflecting the risks of their own business. Evidence from insurers and brokers have indicated that nearly all firms with

more than 10 partners or turnover over around £5 million have top-up cover.[13] Evidence from TLS indicates that around 70% of firms with 5-10 partners would take out top-up cover; 20% of firms with 2-4 partners and only around 5% of sole practitioners.[14] It is to be expected that smaller firms would be less likely to hold top-up cover since they are less likely to advise on larger, more complex matters that give rise to larger claims.

If under-insurance was a problem then we would expect to see large numbers of claims for precisely £2 million or £3 million as insurers pay out on the MTC levels. In fact, examining the data on a nominal basis reveals that there are only a small number of claims for precisely £2 million (14) or £3 million (5) in which under-insurance could theoretically have been a problem.[15] Further, this number of claims is an upper bound since £2/3 million may simply have been the appropriate claim value anyway and/or top up cover may have been in place in those cases.[16]

Combined, this evidence does not suggest that there is a substantial problem of under-insurance which requires higher minimum limits to be set.

Over-insurance

Alternatively it could be the case that the existing limits are too high and that firms are obliged to pay for more insurance than is necessary. Indeed, claims of up to £1 million represent 99% of the number of claims (67% by value) yet the current limits are set at two or three times this level. In addition, there are a number of work categories where there have been no large value claims in the data set which are set out in Table 2 below.

Table 2: Maximum claims

Maximum claim observed less than £0.5 million	Maximum claim observed £0.5-1 million
Adjudication, Arbitration, Architecture, Charity, Construction, Criminal, Environmental, Immigration, Libel, Marine, Mediation, Mental Health, PPI, Residential Care, Town and Country, Trade Mark	Debt, Welfare

Source: EPC calculations based on insurer claims data provided to the SRA.

While this does not imply that these categories *could not* have a maximum claim beyond £0.5 or £1 million, such claims have not been observed in the data provided to the SRA. Firms that specialise in these areas are currently obliged to obtain insurance for levels above any likely claims.[17]

[13] The Law Society's survey estimates 93% of these firms have top-up cover but the survey excludes the largest firms.
[14] Professional Indemnity Insurance Research for The Law Society, mustard, April 2016.
[15] Data has also been checked to see whether claims close to £2/3 million with excesses could have been constrained by the MTC and no further relevant claims have been identified.
[16] The annotation £2/3 million should be understood as "£2 million or £3 million depending on legal form".
[17] This is not to suggest that setting insurance requirements across the industry by reference to the highest ever claim is a *proportionate* approach, but rather to indicate that the current level is *disproportionate* to the claims in many work categories.

2.1.2 £1 million minimum single claim

This section considers the impact of changing the minimum single claim limit to £1 million. Data is also provided to assess the impact of changing the limit to £0.5 million.

Different limits by legal form

The original reason for having different minimum limits for different types of firm is believed to have been that some solicitors faced personal liability in the event of a claim, whereas in other cases the liability was limited to the firm. A lower minimum insurance limit was used where individual solicitors faced personal liability since their personal assets could be used to fund any claims.

Survey evidence from insurers was unanimous that there is no discernible difference in the level of claims by legal form. In the absence of evidence regarding differential outcomes for consumers from law firms with different legal forms, imposing higher limits for one type of firm contravenes Principle 3 (encourage competition between different legal services providers and allow new entry and innovation in new business models).

Firm behaviour

The impact of reducing the minimum single claims cover to £1 million will vary according to the behaviour of different kinds of firm:

- Some firms already choose to obtain insurance for claims above the regulated minimum of £2/3 million. These firms would be expected to continue to do this and their behaviour and their insurance conditions would remain unchanged.[18]
- Since firms are required to take out a level of insurance that is appropriate to their business, it is also to be expected that many firms will continue to hold insurance at existing levels even if the regulated minimum is reduced as will many risk-averse firms. Since insurers already offer cover at this level it is expected that they will continue to do so.
- Other firms, presumably including those operating in the sectors highlighted in Table 2 above, would choose to reduce their insurance cover to £1 million.

Premiums

Firms that reduce their insurance cover from £2 million to £1 million will not see premiums halved. Since insurers know that the majority of claims relate to levels below £1 million, most of the premium paid currently will relate to risks associated to the first £1 million of cover. However, for these policies, insurers would no longer need to reserve for, or reinsure, the (in some cases very unlikely) events that give rise to single claims of £1 million-£2/3 million. Some costs will be saved because of the shift of risks from insurers to firms and therefore some reduction in premium is expected.

Information from a broker suggests that premiums for an additional £1 million of cover for solicitors PII costs around £600-1000 for a small firm. This is consistent with a 5-10% price reduction

[18] It is possible that the minimum limits could have an anchoring effect whereby firms assess any higher limit with reference to the minimum limit. This could reduce the extent to which firms seek additional cover.

suggested in the insurer survey when applied to sole practitioners who currently pay around £8,800 in PII premiums.[19]

Most firms that choose to maintain insurance cover at £2/3 million will pay a similar premium to today unless this choice of higher coverage than the minimum reveals a riskier firm than insurers previously believed. If firms are revealed to be risky, some firms may see premiums increase but this would be risk reflective and send appropriate incentives for risk management (Principle 8).

Competition between law firms

Although the price impact is expected to be reasonably modest for firms that choose the lower cover of £1 million, the benefit of lower premiums will be focused on smaller firms who are precisely the firms that currently pay proportionately higher premiums compared to turnover. As such this will have beneficial effects in terms of reducing barriers to entry in legal services (Principle 3) and encouraging diversity (Principle 4).

Some firms that choose to reduce their cover but then face a claim over £1 million will, however, suffer the consequences of this in line with Principle 8 (polluter pays). If they have insufficient internal resources to pay the additional claim value, this could lead to insolvencies although will affect only a small number of firms (fewer than the 222 cases with claims of £1-3million). If facing an uninsured claim of over £1 million indicates a low quality firm, this will lead to a marginal improvement in the quality of law firms in line with Principle 4 (effective profession).

Client protection

If firms choose to reduce their cover down to £1 million when they ought to maintain it at £2/3 million this could also place clients at risk should the firm have insufficient internal resources to cover any large claim, potentially contradicting Principle 1 (proper compensation). This is already the case for claims that are above the existing regulatory minimum of £2/3 million.

Table 3 below provides details of the *maximum* impact on clients that could arise because of the difference between the new limit and £3 million. This is equivalent to assuming that:

- *all* claims of £2-3 million are for relevant recognised bodies and relevant licensed bodies without top-up cover; and
- *all* of the relevant firms would choose to reduce their cover down to £1 million; and
- *all* of the relevant firms would have no internal resources to pay for claims.

Each of these assumptions is very conservative and hence the calculation for the impact on clients is considered to be an upper bound on the actual impact. Table 3 below sets out the maximum impact – since cover would remain in place for the first £1 million, the actual value of claims at risk from not being paid would be £147 million.

[19] Professional Indemnity Insurance Research for The Law Society, mustard, April 2016, p26. It should be noted that the reduction in price for reducing cover by £1 million would be lower than the increase in price for increasing cover for £1 million due to the asymmetric pattern of risks that is clear from Table 1.

Table 3: Change in limit

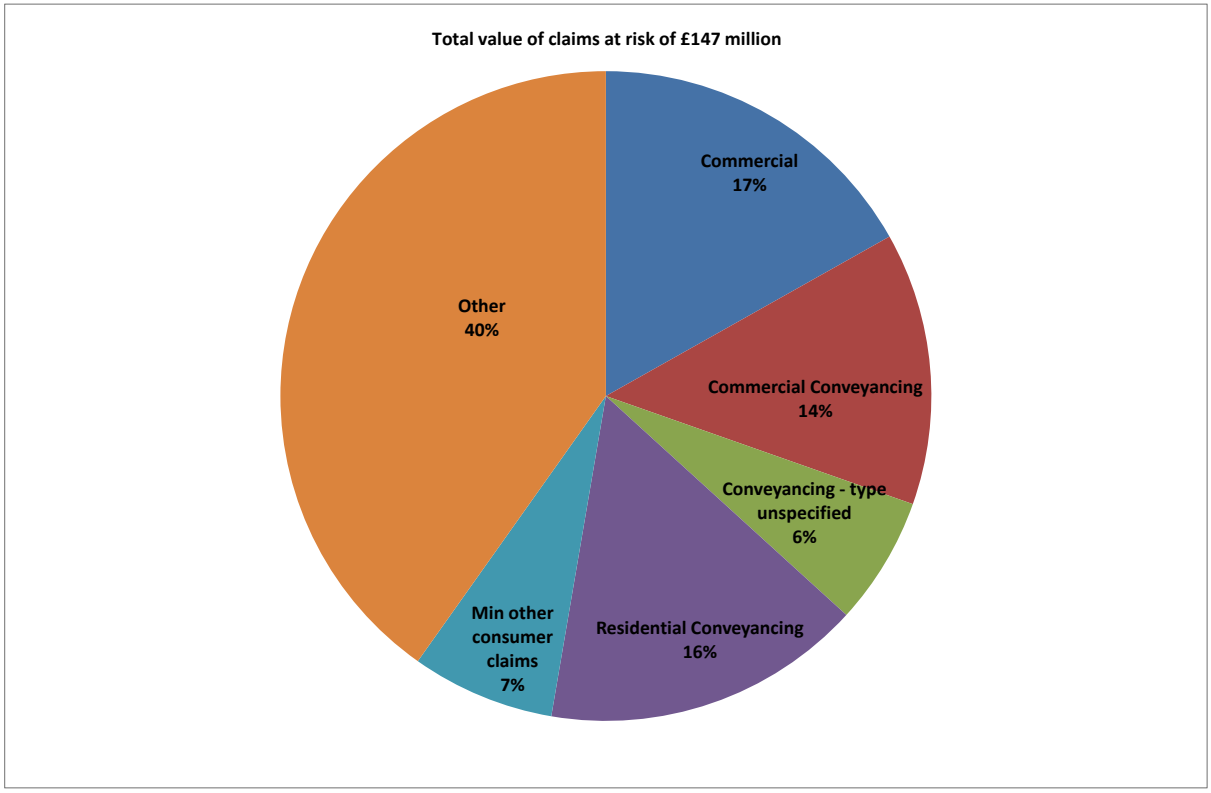
Change in limit	Number of claims impacted	Total value of claims impacted	Claims value at risk
£0.5 million	592	£624 million (32% of total claims)	£328 million (17% of total claims)
£1 million	222	£369 million (19% of total claims)	£147 million (8% of total claims)

Source: EPC calculations based on insurer claims data provided to the SRA.

At most, based on highly conservative assumptions, around 8% of total claims could be at risk from a £1 million minimum single claims limit. In reality, not all firms would reduce their single claims limit to £1 million and many firms would have internal resources from which claims could be paid.

It is also useful to consider how these claims break down by work category which is shown in Figure 2 below for the £1 million minimum claims limit (the equivalent picture for a £0.5 million claims limit is very similar).[20]

Figure 1 Split of claims value at risk from £1 million minimum claims limit



Source: EPC calculations based on insurer claims data provided to the SRA. Note: Other consumer claims includes injury, medical negligence, trusts and executry, and wills and probate.

[20] Proportions for the £0.5 million limit are: commercial 16%; commercial conveyancing 14%; conveyancing – type unspecified 8%; residential conveyancing 15%; Minimum other consumer claims 7%; and other 40%.

It is not possible to identify the client type in all cases and therefore an estimate of minimum consumer claims has been based on the following categories: injury, medical negligence, trusts and executory, and wills and probate along with residential conveyancing (shown separately in Figure 2).[21] Based on this categorisation, consumer claims at risk represent at least £34 million (2% of overall claims) for a £1 million limit or £74 million (4% of overall claims) for a £0.5 million limit. If all claims other than commercial or commercial conveyancing are considered as potentially consumer claims then the figure would rise to £102 million (5% of overall claims) for a £1 million limit and £231 million (12% of overall claims) for a £0.5 million limit.

Conveyancing

As expected, conveyancing represents a large proportion (36%) of the claims value at risk with £53 million of the claims at risk related to conveyancing with a £1 million single claims limit. One possibility would be to require firms providing conveyancing advice to maintain higher insurance limits (e.g. £2 million) reflecting the greater risks arising from this area of work. If this was the case then the total conveyancing claims value at risk would fall to a maximum of £11 million.[22] Other combinations are shown in Table 4 below.

Table 4: Claims at risk

Single limit	Conveyancing limit	Conveyancing claims at risk	Other claims at risk	Total claims at risk
£0.5 million	£0.5 million	£120 million (6% of total claims) 229 claims	£208 million (11% of total claims) 363 claims	£328 million (17% of total claims) 592 claims
£0.5 million	£1 million	£53 million (3% of total claims) 79 claims	£208 million (11% of total claims) 363 claims	£260 million (13% of total claims) 442 claims
£1 million	£1 million	£53 million (3% of total claims) 79 claims	£94 million (5% of total claims) 143 claims	£147 million (8% of total claims) 222 claims
£1 million	£2 million	£11 million (1% of total claims) 21 claims	£94 million (5% of total claims) 143 claims	£105 million (5% of total claims) 164 claims

Source: EPC calculations based on insurer claims data provided to the SRA.

In this regard it is also worth noting that the Council for Licensed Conveyancers (CLC) sets a requirement of £2 million for firms which it regulates (although there are other differences between the requirements of the CLC and SRA). Setting a similar limit across regulators (assuming that the firms impose similar risks) is beneficial for competition between firms regulated by different regulators since it prevents distortions from arising through differential regulation and is in line with

[21] Lenders make claims in relation to residential conveyancing as well as individual consumers, hence including all residential conveyancing in the consumer claims may overstate this calculation. However, as explained in section 2.3, if insurance cover for some clients is changed, this could cause lenders to oblige consumers to make some types of claims on their behalf.

[22] Different impacts would arise depending on whether firms providing conveyancing advice required a minimum of £2 million for any claim or only for conveyancing claims.

Principle 3 (competition between legal services providers). Further considerations regarding conveyancing are set out in section 2.4.

Top up cover

Participating insurers are free to alter the terms and conditions for policies which go beyond the MTC in terms of the level of claims. Hence it is possible that top up policies which extend the cover from £1 million back to the current levels of £2/3 million would have different terms.

Currently most top up cover which simply extends cover to £5 million is understood to be written on the same terms and conditions as the MTC since the administrative cost of designing different policy terms for relatively small extensions in cover are not through to be worth incurring.[23] However, for larger levels of cover this is not the case and terms which are "non-standard" in other parts of insurance (such as those related to dishonesty, misrepresentation, payment of the excess and the level of cover in run-off) may be altered in top up policies. Similarly, exclusions for cyber risks could be brought in for larger claims.

Competition between insurers, may maintain wide product coverage in soft insurance markets. However, in the event of hard markets or where increases in a particular type of risk seen, it is possible that cover may be eroded for firms which seek top up policies. Hence it may be the case that those firms that seek to maintain cover at £2/3 million are not able to obtain policies which exactly replicate the existing level of cover for the claims valued at £1-3 million.[24] Other sections consider the non-standard MTC components.

Changing limits over time

The SRA does not currently have a process to set the minimum level of cover over time to take into account changes in claims values. The SRA may wish to give consideration to such a regular review process based either on inflation, or for example on some measure of typical high value claims for individuals. The SRA would, of course, retain flexibility to adjust the minimum single claims limit at any stage should it determine this is appropriate, but signalling a regular process for this helps firms and insurers to plan for changes in advance.

Summary

There is no evidence of different claims behaviour based on the legal form of firms hence the current approach of different limits by legal form contravenes Principle 3. Some firms will maintain existing limits even if the minimum limit falls to £1 million or £0.5 million. A small premium

[23] This may change if other proposals relating to client coverage (section 0) or coverage for conveyancing (section 2.4) are pursued because it would make the cost of having different policy terms more worthwhile as it would have greater applicability.

[24] The impact of this will also vary depending on whether differential levels of minimum cover are in place, and if so, how these interact with the MTC. For example, if conveyancing requires minimum cover of £2 million, the MTC could apply to all of the £2 million or only the first £1 million if the latter applies to non-conveyancing firms. Put another way, requiring MTC cover up to £2 million unless a firm does no conveyancing will have different implications from requiring MTC cover up to £1 million for all firms and a single limit minimum of £2 million for firms conducting conveyancing. This is considered further in section 2.4.

reduction will result for firms who reduce their limits including those in sectors where high claims have not been seen (Principle 2). For small firms where the proportionate cost of PII is higher, this may reduce barriers to entry (Principle 3) and encourage diversity (Principle 4). It could place clients at risk with at most 19% of the value of claims affected and 8% of the value of claims at risk from a £1 million limit, although retaining a higher limit for conveyancing would reduce this. Reducing the limit would also affect top up cover where non-standard MTC provisions may be removed at a lower level of cover than is currently the case (potentially against Principle 6).

2.2 Introducing an aggregation cap

Currently there is no aggregation cap permitted under the MTC. This section considers permitting an aggregation cap for a single indemnity period. An aggregation cap would be set in addition to the minimum single claims limit and could be set at any level but this section provides data on a limit of £3 million; this could also possibly be combined with an automatic increase in the limit to £6 million on payment of the relevant premium (which would be set in advance).[25] Table 5 below shows the number of cases where the aggregate value of claims in a year exceed £3 million or £6 million.

Table 5: Aggregation cap

Claims exceeding specified cap	Minimum aggregation cap	
	£3 million	**£6 million**
Number of cases	70	19
Number of claims	932	154
Value of claims	£420 million (22% of total claims)	£204 million (10% of total claims)
Value of claims excluding single claims above specified limit	£309 million (16% of total claims)	£137 million (7% of total claims)
Value of claims at risk excluding single claims above specified limit	£183 million (9% of total claims)	£53 million (3% of total claims)

Source: EPC calculations based on insurer claims data provided to the SRA.

Overall there are 70 cases where the total claims value for a firm in a single indemnity year is greater than £3 million. These represent 932 separate positive claims with total claims of £420 million. Of these, some cases simply reflect a single large claim valued at more than £3 million rather than firms that have multiple smaller claims that sum to more than £3 million.[26] The fact that such large single claims have been paid indicates that top up cover must have been in place. It is also possible that many of the firms with high aggregate claims are also firms that choose to take out high single claims cover in line with the riskiness of their business. Since information on the level of cover in place for the firm is not available it is not possible to assess the extent to which this is the case.

Insurers consider that aggregation risk is highest for firms that are active in areas where similar processes are repeated for multiple clients and where a mistake in one part of the process can

[25] Failing to retain a minimum single claims limit could lead some firms to choose an unduly low single claims limit as described in section 2.1.

[26] Single claims over £3 million have only been excluded if that is the only claim for a firm in a particular year. By contrast, if a firm has two claims in a year, one or both of which is more than £3 million, the claims have not been excluded.

therefore affect many clients before it is identified. Areas typically highlighted by insurers include: conveyancing; personal injury; and probate. In total these areas represent 30% of the aggregate claims over £3 million but only 17% of the aggregate claims over £6 million.

Firm behaviour

If an aggregation cap was in place, firms that conduct work using repeat processes might face sharper incentives to have robust processes in place to prevent similar mistakes being made for multiple clients. It has also been suggested that it could lead firms to consider the risks that they face from individual retainers e.g. conveyancing work on lender panels. At the same time however, these firms are likely to face worse price signals from insurers regarding risk management processes against Principle 8 (see below). Overall it is not clear that behaviour would change significantly for these firms since they already have an incentive to remedy defective processes once they are discovered so as to prevent further single claims and the associated impact on excesses and future premiums.

If claims exceed the aggregate level (even if some firms choose a higher aggregation cap than the regulatory minimum), firms would need to make payments from internal resources and this would also increase the risk of insolvency both of which are in line with Principle 8 (polluter pays). To the extent that such firms were low quality firms this could also raise the quality of the profession in line with Principle 4 (effective profession). However, it is likely that firms with unexpectedly high aggregate claims would struggle to obtain insurance in subsequent years and therefore firm closure might be expected even if the firm is not made insolvent from the claims.

Premiums

Using an aggregation cap would limit the risk for insurers of facing multiple claims with a very high total value for any given firm. This would reduce the extent to which insurers needed to reserve for, or reinsure, this risk and therefore some costs would be expected to be saved leading to a reduction in premiums, particularly for firms specialising in the areas highlighted above where the aggregation risk is highest. Insurers considered that aggregation risk is not of greatest concern for very small firms since they do not usually run process driven operations and therefore small firms would not expect to see any change in premiums.

However, discussions with insurers have indicated that minimum aggregation caps are likely to have a limited impact on premiums unless the aggregate limit is set close to the current single limit. Responses to the insurer survey suggested a price reduction of up to 5% with an aggregate cap of £5 million which is in line with the 3% value of claims affected by a £6 million limit in Table 5 while most thought there would be a negligible impact if the cap was set as high as £10 million. Modest changes are consistent with a view that there would be limited changes to incentives for firms if an aggregate limit was brought in and therefore any reduction in premiums would reflect the movement of risk away from insurers rather than a change in behaviour by firms.

Client protection

Unless an aggregation cap alters the behaviour of firms, the impact of a cap will simply be to shift the costs of claims from insurers to firms and their clients. Shifting the costs to firms is consistent with Principle 8 (polluter pays) but, given the value of aggregate claims, in some cases firm resources would run out and therefore some clients will be unprotected which is against Principle 1 (proper compensation).

Further, aggregation caps will lead to different outcomes for clients according to the timing at which any claims are made - clients who claim quickly and whose claims are settled quickly may be paid out in full while those who claim later would find that both the insurance cover and internal resources have been exhausted. Even well-informed clients can not be expected to be able to judge the claims of other clients (although if they did, they may claim early and exhaust both the aggregate cap and internal resources leaving more consumer clients at risk). In addition, odd incentives may be created around the end of indemnity years and moving into run-off periods. For example, some clients could be better off by delaying their claim until a run-off period begins and a new aggregation cap applies (if it did).

Since clients could be unprotected, the SRA would need to consider access to the CF for consumers. The CF does not need to incur the costs of reinsurance or reserving capital as insurers do but this would lead to occasional very large sums needing to be paid out by the CF and therefore volatility in CF contributions. The CF costs would be split across the whole profession and therefore involve less alignment with risk than premiums charged by insurers against Principle 8 (polluter pays) although the overall costs to the CF would be lower than claims paid by PII due to costs being paid from internal firm resources. It would also lead to differences in cover compared to today since the CF has more limited client eligibility criteria compared to PII. These issues would also reduce the cost of the CF compared to PII, but would reduce client protection to non-CF eligible clients in line with the reduced cost.

Insurer behaviour

Imposing an aggregate limit may reduce the extent to which insurers send positive risk management signals through insurance to firms that are at risk from large aggregate claims which could worsen risk management within firms against Principle 8 (polluter pays).

Currently, with only a single claims limit in place, insurers have an incentive to have similar claims treated as a single claim so as to limit their exposure. This behaviour would be slightly reduced by an aggregate limit although insurers would still want to save the value of claims equal to the difference between the single limit and the aggregate limit.

Having an automatic increase in an aggregate the limit is not general practice in the UK but it could reduce the value of claims that fall outside insurance compared to just having a lower aggregate limit. An aggregate limit more generally may attract US based insurers to the market since they are more familiar with writing PII policies on an aggregate basis. In addition, limiting the downside risk to insurers could also attract insurers, particularly to those parts of the profession where aggregation risk is of most concern. Such entry would be expected to increase competition in insurance markets to the benefits of all firms. Since there are already around 30 insurers providing solicitors PII, it may

have limited effect on the market as a whole but the main of beneficiaries would be those segments of the market bringing the most aggregation risk.

Summary

An aggregation cap increases the cost for firms and the threat of insolvency when they face aggregate claims (Principle 8), but reduces the incentive for insurers to send price signals to manage such risks (against Principle 8). Overall, limited behavioural change is expected from firms and therefore any reductions in premiums would be mainly due to the risks moving to firms, the CF and non-consumer clients. The policy could also bring differential outcomes around the ends of indemnity years, the timing of which clients will probably not know (against Principle 6).

2.3 Flexibility in client coverage

Currently, the SRA requires that work for *all* types of client must be covered by the MTC. This section considers allowing flexibility for firms and insurers by limiting compulsory requirements to consumers rather than applying them for all clients.[27]

Client coverage

Individual consumers and small businesses who rarely engage with legal services are in need of regulatory protection as highlighted in Chapter 0. However, large corporates are more sophisticated, often have in-house legal resources and ought to be in a position to understand the relevance of assuring for themselves that their legal services provider has appropriate insurance. Allowing flexibility by removing sophisticated clients from the minimum PII requirements may be in line with Principle 2 (minimum necessary) since the role of regulators is to protect those who are unable to protect themselves rather than to protect those who can protect themselves.

Limiting the minimum requirements to unsophisticated clients requires a definition of which clients need regulatory protection. This can be informed by the SRA's existing definitions regarding eligibility for the CF which is restricted to:

- Individuals;
- businesses, companies or associations with a turnover of less than £2 million;
- charities with an annual income of less than £2 million unless it can be shown that the beneficiaries will suffer hardship; and
- trustees of a trust with an asset value of less than £2 million unless it can be shown that the beneficiaries will suffer hardship.[28]

For convenience, clients falling into these categories will be referred to as consumer clients in the rest of the report. Such consumer clients would be required to be covered through the MTC but other arrangements could be made to protect non-consumer clients.

[27] This has a parallel issues to the two options set out in section 2.4.2 regarding the difference between including and excluding clients within the MTC. Here it is assumed that there is no need for the equivalent to Option 1 in section 2.4.2 since the justification for the change is that there is no need to protect certain clients.
[28] SRA Compensation Fund Rules 2011. Changes to eligibility were made in 2015.

One issue that is raised by this, however, is that it creates uncertainty for clients which are close to the definitional boundary thereby breaching Principle 6 (unintended consequences). Very large corporate clients will never fall within the definition and individual clients will always fall within the definition. However, some small businesses or charities will be close to the boundary and may move across the boundary over time including at different times during the course of receiving legal services or between the point at which work is conducted and a claim is made.

It may be reasonable for the CF to use such definitions because the CF acts as a fund of last resort, it retains discretion in whether payments are made, and such payments would only be made after PII or other compensation has been exhausted.[29] However, the impact of uncertainty around whether clients are covered is more concerning when it relates to insurance, which represents the main source of compensation for most clients, since this will generate far more cases of uncertainty. Further, some non-consumer clients, especially those close to the boundary, may not in fact be sufficiently sophisticated to obtain appropriate redress mechanisms potentially against Principle 1 (proper compensation) and Principle 6 (unintended consequences).[30]

An alternative approach that has also been suggested in respect of client coverage would be to limit the MTC requirements to non-financial institutions (insurers and firms could choose to have this exclusion even where they have an option for a wider exclusion). This helps avoid the concerns surrounding uncertainty since it is clear whether a client is a financial institution i.e. Principle 6 (unintended consequences) is not breached on definitional grounds. However this may not meet Principle 2 (minimum necessary) since one group of sophisticated clients is treated differently to other sophisticated clients. The reasoning put forward for having a separate requirement for financial institutions is inherently linked to the large value of conveyancing claims. However, if conveyancing claims are the root cause then it is in line with Principle 5 (targeted) to focus directly on conveyancing (see section 2.4) rather than something correlated to conveyancing (financial institutions).

Insurer behaviour

It is unusual for PII policies to be written in such a way that the coverage of the insurance varies according to the underlying client. One exception to this is in Ireland where the equivalent PII requirements allow insurers to exclude cover for certain undertakings given to financial institutions in commercial conveyancing transactions i.e. there is both a client restriction and a work type restriction.

Most insurers responding to the survey indicated that they would be willing to provide cover for work for commercial clients and lenders although not all would be willing to cover lender work.

[29] Indeed, the eligibility criteria of the CF demonstrate that the overall package of client protection measures already encompasses the principle that only those clients that need regulatory protection should receive it.

[30] There is also a question as to whether PII cover, as distinct from the CF, is the type of regulatory protection that *should* vary according to client types. In other sectors such as financial services, there are a range of requirements such as capital requirements (applying by firm), sales regulation (some of which vary by client), insurance requirements (which usually apply by firm) and compensation funds (limited to particular clients). Hence sophisticated clients gain from some types of regulatory protection even if they do not gain from all types. The SRA may wish to consider the interaction between this and the reserved activities.

Insurers have been clear that if non-consumer clients or financial institutions do not need to be covered by the MTC then they would develop new terms and conditions associated with PII coverage for such clients. In particular they would no longer use the non-standard conditions related to: dishonesty; misrepresentation; payment of the excess; unlimited aggregate cover and aspects of run-off cover. They may also choose to exclude particular high risk areas such as cyber-crime. Such approaches would make the non-consumer PII protection more akin to PII cover seen in unregulated sectors. Once separate terms are standard for certain non-consumer clients, they may also then be applied for top-up cover for consumer clients as the additional cost to insurers of doing so is small.

The greater flexibility with respect to non-consumer clients may also lead to more innovative or targeted insurance products being developed, particularly for larger firms who are less likely to work with non-consumer clients.

Firm behaviour

The Code of Conduct requires PII cover to be in place that "is appropriate for your current and past practice, taking into account potential levels of claim by your clients and others and any alternative arrangements you or your client may make."[31] Operating without any PII for non-consumer clients would not meet the requirements of the Code of Conduct unless firms can demonstrate that alternative arrangements are in place for *all* of these other clients. This is unlikely to be practical hence firms will be required to seek PII cover for non-consumer clients (although that they may choose to make alternative arrangements for particular clients).

For firms who advise only non-consumer clients, no constraints would be imposed through the MTC, with firms and insurers free to determine the appropriate insurance arrangements. These firms would also need to ensure that their processes for taking on new work identified, and refused, consumer clients and this may be problematic in some cases due to definitional boundaries for small firms.[32] This may also lead firms conducting occasional consumer work to no longer do so, potentially improving the quality of legal services if such firms are not experienced in it (Principle 4).

For some of the largest firms, this may make insurance arrangements more straightforward such as where large firms have various tiers of insurance policies with different conditions in different tiers arising due to the constraints of the MTC. This may also enable international firms to have more consistent insurance policies across countries although this will also depend on the local requirements in other countries. Similarly Multi-Disciplinary Practices would have greater freedom to arrange insurance policies across different activities. Overall, this would be expected to lead to better value insurance premiums for such firms and encourage new business models (Principle 3).

Firms that advise only consumer clients would be in a straightforward position with PII cover in place on the MTC basis although they may need to check the position of small businesses, charities and

[31] SRA Code of Conduct Outcome 7.13.

[32] Alternatively all firms could still be required to have the consumer cover on an MTC basis whether they provide services to consumers or not.

trusts.[33] Clarity that these firms only advise consumer clients may mean that these firms can demonstrate that they do not conduct certain higher risk activities such as commercial transactions or conveyancing (where it is assumed that cover for lenders will be required) which may bring lower premiums. It is assumed that if firms advise consumer clients but do not have PII cover in place for that, the costs of any associated claims would fall to the CF (due to operating without insurance) rather than the insurer (due to misrepresentation) but this would need to be made clear.

Firms that advise both types of clients could see differential terms and conditions in their PII policies depending on the client. Those that advise non-consumer clients would have lower protection and bear greater risks themselves. This would encourage better management of non-standard risks (see other sections in the report) in line with Principle 8 (risk management).

Client behaviour and client protection

Consumer clients that the SRA has determined need protection would remain protected in this scenario and therefore no direct change in behaviour or client protection would be expected for consumers. Those close to the boundary, however, would face uncertainty breaching Principle 6 (unintended consequences).

Non-consumer clients would lose the protections that they currently have under the non-standard parts of the MTC. Many of these clients will be unaware of such a change and will incur no additional costs in checking this.[34] It is possible that some sophisticated clients who conduct a lot of repeat business will require firms to obtain additional insurance such as fiduciary insurance or cyber insurance to cover risks that were no longer protected through PII.

Some lender clients may make bigger changes. Different responses by lenders, compared to other clients, are plausible first because conveyancing represents 40% of claims, but second because the vast majority of conveyancing transactions involve dual representation where the conveyancer acts for both the purchaser of the property and also the mortgage lender, but the conveyancer is typically chosen by the purchaser.[35] The lender will therefore want to be assured that the choice made by the purchaser is one that meets the lenders requirements as well.

If lenders lose the protection of the non-standard terms, they may take a range of steps to protect themselves against the additional risks. This could include costs associated to checking whether non-consumer PII was in place, and whether firms had additional cover such as for fiduciary or cyber-crimes. Many lenders participate in Lender Exchange which is a centralised source of information on

[33] Alternatively, these firms could be required to have PII cover for non-consumers in place even if there are no subsequent conditions placed on the PII for these clients.

[34] The SRA would need to be confident that other parts of regulation which are designed to prevent detriment from arising in the first place is sufficient to remove regulatory protection of non-standard parts of PII from non-consumer clients who are unaware of these risks.

[35] In the context of a house purchase, lenders who wish to sell a mortgage have an incentive to have large panels of conveyancers with consumers choosing among these (potentially because of a recommendation by an estate agent). If lenders faced greater risks from reduced insurance coverage they may restrict these panels and if all lenders act in a similar manner, competition for the mortgage may be unaffected. For remortgages, lenders are likely to have smaller panels already.

conveyancers hence for these firms there would be no set up cost for doing this, but there would be additional issues in need of checking which brings costs.

However, some risks such as dishonesty and misrepresentation would remain uninsured. This may cause lenders to restrict their conveyancing panels to firms where there are lower risks such as by not using small firms or using only firms with assets above a certain level which would reduce the number of firms acting for lenders. It could also lead to greater use of separate representation (see section 2.4.2).

Under this proposal, lenders may also change the terms and conditions of their mortgage arrangements such that they can make claims against the solicitor via the consumer. In this way, consumers would make the claim (and therefore be covered under the MTC), but the money would then be due from the consumer to the mortgage provider. A change along these lines may result in few other impacts. This may not be feasible for claims linked to the dubious behaviour of consumers such as when part of the purchase money has not been passed through the solicitor or where there is a variation in the purchase price compared to that in the mortgage offer, but it may be relevant for issues such as loss of client funds, failure to register title and property boundary issues.

Summary

Allowing flexibility in the client coverage of the MTC introduces definitional issues around the boundary of which clients are protected, and some small businesses, charities and trusts would move across the boundary over time (against Principle 6). Some clients close to the boundary may not obtain appropriate redress (against Principles 1 and 6). Greater clarity would arise from a definition based on financial institutions although the argument for this is linked to high conveyancing claims and therefore it would be more targeted for the definition to link directly to conveyancing (Principle 5).

Flexibility in client coverage would result in non-standard MTC components being removed from non-consumer clients. Depending on the precise rules, firms may need processes to identify consumer and non-consumer clients although it may make insurance arrangements easier for large firms and multi-disciplinary practices (in line with Principle 3). There is a risk that some lenders would reduce the size of their conveyancing panels preventing access to those firms that bring more risk around the non-standard MTC components (against Principle 6). They may also change terms and conditions within mortgage products to obtain better protection via consumers for some risks.

2.4 Exclusions for conveyancing

Currently the SRA requires that all types of work for all clients are covered through the MTC. This section considers allowing conveyancing to be excluded from the MTC.

2.4.1 Current approach

Conveyancing claims

Conveyancing claims represent £0.77 billion or nearly 40% of the £1.96 billion total claims reported to the SRA although this proportion may be an underestimate as noted in section 1.3.

Conveyancing claims reflect a range of different issues including failure to register title, conducting inadequate searches, boundary issues and many others. Some claims include failing to comply with the Council of Mortgage Lenders (CML) Handbook which sets out agreed standards between lenders and conveyancers. It has been estimated that around 20% of conveyancing claims are due to one of four particular areas, namely failure to report: back to back transactions where there is an intermediate owner who buys and immediately sells on; when the seller has owned the property for less than six months; where part of the property is not passing through the solicitor; and where there is a variation in the property price between the transaction price and the value in mortgage documents.[36]

Regulatory failure

Concern about conveyancing claims is not new and has been observed over the course of multiple housing market cycles and in previous reviews about PII. Persistent concern about this area suggests that there are underlying problems in the quality of conveyancing services and that there has been regulatory failure with respect to addressing these, rather than that there is a problem with the insurance market.

It is therefore recommended that the SRA undertake a broader regulatory review of conveyancing. Better regulation and raising the standard of conveyancing would be expected to reduce the cost of PII. Given the scale of conveyancing claims, addressing the *underlying* problems in conveyancing is likely to have a more significant impact on the cost of insurance than many other issues the SRA is considering. It is also noteworthy that conveyancing transactions also commonly underlie the opportunities for dishonesty, misrepresentation and cyber-crime. Tackling the underlying problems in conveyancing would help to reduce concerns about those aspects of the MTC as well.

Such a review could involve analysing conveyancing claims in order to understand what gives rise to conveyancing claims, where the weak points in the process occur, which types of firms are involved and how the value of claims varies for different characteristics. It would be useful for any review to include co-ordination with other bodies with sources of information on the functioning of, and problems in, the conveyancing market including the Land Registry, Council for Licensed Conveyancers (CLC) and mortgage providers.

A wider review of conveyancing could also examine whether alternative forms of reducing or mitigating claims would be appropriate such as using a single third party account for all conveyancing transactions. It is, however, only possible to assess these in the context of a review of *conveyancing* rather than a review of *insurance*. Again, the fact that some £0.77 billion of conveyancing claims were recorded in the data set indicates that it would be reasonable to use regulatory resources to consider these issues.

2.4.2 Excluding conveyancing

Two alternative approaches could be followed with respect to excluding conveyancing from the minimum PII cover:

[36] Claims Trends, Conveyancing Analysis and Risk Improvement, Marsh, July 2016.

- Option 1: Allow conveyancing to be excluded from the MTC – firms could choose whether to *exclude* conveyancing from their PII cover. If they did not exclude it then conveyancing claims would be covered on the MTC basis.[37]
- Option 2: Exclude conveyancing from the MTC – firms could then choose whether to *include* conveyancing in their PII cover. If included, conveyancing could be covered on any terms i.e. terms related to issues such as misrepresentation could differ from those terms in the MTC.

Option 2 would imply that clients, including consumers, would not receive protection from the non-standard elements of the MTC. Variations in these options by type of client could also be possible such that conveyancing for consumers received MTC protection but non-consumer clients did not.

It would also be possible for one insurer to offer a PII policy excluding conveyancing and another insurer to offer a PII policy covering only conveyancing. It is not anticipated that this would be particularly common due to the fixed costs of offering PII – the fact that similar information would need to be collected for both policies should give an insurer offering a single policy including conveyancing an advantage over the insurer that offered only conveyancing.

It should also be noted that, as with other issues, conveyancing conducted before a particular cut-off point would need to be covered by all insurers in order to retain the level of protection that sophisticated clients such as lenders would have expected at the time that advice was given.

Definition of conveyancing

As with other definitional issues, this scenario would require a clear definition of conveyancing to be agreed by the SRA, TLS and insurers in order to prevent disputes surrounding whether activities do, or do not, fall into the definition. The definition of conveyancing that is used for determining reserved activities could be used for this. However, it would need to be established whether that definition captures the work that generates the PII claims that are categorised as conveyancing claims. Depending on the precise rules in place, some firms or insurers may also choose to differentiate within conveyancing between residential and commercial conveyancing by excluding one or other of these.

Regulatory cost

In order to ensure that firms have conveyancing cover when they conduct conveyancing services, the SRA will need to collect information from insurers regarding the firms that do, and do not, hold conveyancing cover. Insurers have suggested that this could be a relatively simple amendment to the information that they already provide to the SRA on PII and therefore the cost of gathering this additional information is likely to be very small. A database of firms with conveyancing cover could be made available to the public as well as lenders. This may also need to capture information on whether firms conduct conveyancing services over time due to the claims made nature of PII.

The SRA could also collect other information regarding firms that provide conveyancing services such as by seeking information from the Land Registry. There may be a cost involved for the SRA and Land

[37] Alternatively, the SRA could simply require that conveyancing cover be provided on an MTC basis.

Registry to facilitate such a flow of information. Unlike with data from insurers, where a process is already in place, systematic information from the Land Registry would probably require a new process to be developed although the actual data required is quite small and the cost of this is again expected to be small. Further, the truthful revelation of which firms are involved in conveyancing activities may have benefits to the SRA beyond simply confirmation of PII cover. There may also be other information available from the Land Registry which could aid the SRA's regulatory functions in line with Principle 7 (supporting regulatory supervision). The SRA would be expected to act rapidly should any firm be identified that provides conveyancing services without being insured.[38]

Insurer behaviour

Under Option 1, most insurers would be willing to provide policies including conveyancing just as they currently do, with premiums reflecting the risk of offering conveyancing services. Some insurers have suggested that they may not offer lender cover and this may extend to not offering conveyancing either if it is optional. Such insurers indicated that they currently had limited conveyancing exposure already.

If insurers are able to replace non-standard terms and conditions under Option 2, they are expected to do so. Hence conveyancing claims would be written without client protection against issues such as misrepresentation. Some clients, such as consumer clients, could be required to be explicitly protected on the usual MTC terms (e.g. by limiting what can be excluded from the MTC under Option 2 to conveyancing claims by non-consumers).

Excluding conveyancing from the MTC may, however, run a risk of changed insurer behaviour at recessionary times in conflict with Principle 6 (unintended consequences). Conveyancing claims in the past have been cyclical and there is a risk that in future recessions the cost of including conveyancing would increase substantially, or that insurers would withdraw from offering such cover. An additional concern around this is whether firms would then be able to secure insurance for historic conveyancing work even where the firm ceases ongoing conveyancing. Dealing with the underlying problems in conveyancing before the next recession would clearly go a long way towards reducing the extent of this potential problem.

Firm behaviour and premiums

This scenario would reveal an accurate, risk-reflective, price of insurance for conveyancing, allowing solicitors to determine whether it is a worthwhile line of business in line with Principle 8 (risk management). Firms would be able to identify the additional premiums for conveyancing cover although the difference in premiums may be modest to start with because insurers would still have to provide cover for historic conveyancing. Over time, however, larger reductions in premiums would be available for those firms that do not conduct conveyancing or cease to do so.

[38] It is assumed that responsibility for any claims associated to any conveyancing transaction that did in fact occur would not fall to insurers under the current misrepresentation clause, but rather would fall to the CF as other claims do when firms operate without insurance. Since lenders are not covered by the CF they would have an incentive to check that conveyancing cover is in place.

This scenario would be expected to reduce the number of firms that undertake only a small number of conveyancing transactions each year since the additional premiums for conveyancing cover would not be worthwhile for them. It is estimated that around 8% of firms that conduct conveyancing have less than 5% of their turnover from conveyancing hence these firms might cease conveyancing services if they considered it was no longer worthwhile.[39] Both insurers and lenders have highlighted in discussions that firms that "dabble" in conveyancing, are disproportionately likely to generate claims and therefore a reduction in the number of such firms would raise the standard of conveyancing in line with Principle 4 (effective profession).

Concern has also been raised about examples where conveyancing transactions represent a small part of a wider case and where firms without conveyancing insurance might therefore be unable to provide legal services on the whole case. However, firms are in the best position to know whether the value of conveyancing services is sufficient to justify paying the additional premium regardless of whether such services are provided on a standalone basis, or because the services affect wider work.[40]

In addition, misrepresentation regarding whether firms conduct *any* conveyancing would decline because firms without conveyancing cover would be identified rapidly. This would also bring benefits to the average quality of legal services in line with Principle 4 (effective profession) since regulatory action could be taken against these firms. It would also imply that some firms that already do not conduct conveyancing would face a slightly lower premium because insurers would be able to rely on the accuracy of this statement which is currently not always the case.

Client behaviour and client protection

For consumer clients, the level of protection will be unchanged under Option 1. However, unless additional restrictions are put in place, and if internal firm resources are insufficient, Option 2 would leave consumers unprotected from the non-standard aspects of the MTC including: misrepresentation; non-payment of the excess; dishonesty; unlimited aggregation and aspects of run off. This would be against Principle 1 (proper compensation).[41]

Lenders would face an additional cost in checking whether solicitors had conveyancing cover. Under Option 1 this would only be a small cost since a simple check of the database would suffice to assure lenders that insurance was in place and that they were protected.

Under Option 2, lenders would face greater risks because they would no longer be protected through the non-standard aspects of the MTC. In general, risks from these aspects are greater from small firms that do not have internal resources to cover any claims and where processes may not be sufficiently robust. Lenders may therefore no longer include on panels those small firms which they consider to impose higher risks of these kinds. This is consistent with some (but not all) lenders

[39] Source: SRA data.
[40] Some firms may seek to enter arrangements in which they refer conveyancing work to other firms if they are unable to conduct conveyancing services themselves.
[41] Alternatively consumer protection could be maintained if they could access the CF but discussion in other sections considers whether this is preferable for each of the non-standard elements of the MTC.

already no longer permitting new sole practitioners to join panels because lenders can no longer claim from the CF in the case of dishonesty of sole practitioners.

It is possible that Option 2 could prompt a greater use of separate representation where lenders appoint a very small panel of firms to act as their conveyancer rather than using dual representation as is currently used in the overwhelming majority of cases. Although lenders would still not receive protection through insurance for the non-standard risks, they would have much greater control of the standards in place at those firms. This option may also alter preferences as between CLC regulated firms and SRA regulated firms since lenders would have greater protection against dishonesty when working with CLC regulated firms so lenders may choose dual representation for CLC regulated firms, but separate representation for SRA regulated firms in conflict with Principle 6 (unintended consequences). It would also lead to higher costs being passed onto consumers during the mortgage process.

Summary

The SRA should review the conveyancing sector since the large value of claims suggests that focussing on the underlying conveyancing problems rather than the insurance market would be a targeted approach (Principle 5).

Allowing exclusions for conveyancing would bring greater clarity regarding which firms provide conveyancing services and which do not (Principle 8). This will produce more accurate pricing with some non-conveyancing firms seeing slightly lower premiums over time. Some firms that conduct a small amount of conveyancing may cease to do so potentially increasing quality (Principle 4).

Small costs would be incurred in gathering and publicising data over time regarding the firms with conveyancing cover although clear records of this bring other regulatory benefits (Principle 7).

Under Option 1, making a database available would be expected to limit unintended consequences and does not appear likely to constrain any future actions taken through a subsequent conveyancing review. Option 2 brings greater risks that lenders take action to limit their panels because they would no longer be protected under the non-standard aspects of the MTC (against Principle 6) and could also leave consumers unprotected from these aspects (against Principle 1).

2.5 Alter requirements regarding the excess

Currently, firms and insurers may agree any level of excess, but if the firm does not pay the excess then the insurer is liable to pay the value of the excess to the client. This section examines removing this obligation on insurers and potentially introducing a maximum level of excess.

At present the excess does not apply to defence costs – this issue is considered in section 2.6.2.

2.5.1 Current approach to using and regulating the excess

The use of an excess is typical in insurance markets and the excess has different functions:

- it helps overcome the problem of moral hazard in which the presence of insurance means that the insured does not manage risks because they do not face the consequences of those

risks (although clearly premiums would increase in the light of claims) i.e. the insured retains some "skin-in-the-game";
- it reduces the number of low value claims for insurers where the cost of administering the claim is disproportionate to the actual value of the claim – this should reduce the average cost of claims; and
- it focuses insurance on the lower-probability, higher-value claims the consequences of which the insured is less able to cope with – this should increase the average value of insurance.

In most insurance policies, the insured is free to choose the level of excess – a higher level of excess is associated to a lower premium and vice versa. In the event of a claim the insured then faces the consequence of their choice of excess. However, with PII there is a risk that some firms choose an unduly high excess, and pay a low premium, but without the intent or means to pay that excess in the event of a claim, and therefore cause their clients to suffer the consequence. This mismatch in incentives is what prompts the need for some form of intervention surrounding the excess.

In the past, insurers have expressed concern around being liable for the excess since this is not usual practice in insurance markets. They have also argued that this leads them to choose to use a zero or very low excess with certain firms in order to reduce: the risk that firms do not pay the excess; any subsequent costs of chasing the payment of the excess; and any costs of making the excess payment themselves. To the extent that the excess is set at zero or too low a level this will reduce the beneficial functions of the excess listed above in breach of Principle 6 (unintended consequences).

Prevalence of zero excess policies

Despite the concerns raised by insurers, of those that responded to the SRA's survey, most indicated that less than 5% of policies had a zero excess although one respondent stated that there was a much higher incidence of these policies. Zero excess policies are typically limited to the smallest firms with only 1-2 partners or with a turnover of less than £250,000 and therefore insurers which focus on smaller firms might be expected to have a higher proportion of firms with a zero excess than other firms.

It is important to note that since some insurers who were active in the small firm space did not respond to the SRA's survey and have not provided data to the SRA, the prevalence of zero excess policies is likely to be understated in the data available for this work. Further, even though zero excess policies do not appear common, it may nonetheless be the case that excesses are lower than they would be in the absence of the current MTC requirement related to the excess.

Claims closed without payment

There is some evidence to suggest that the beneficial functions of the excess may not be operating successfully. For example, Table 6 below shows that of 129,000 closed claims that were notified, 96,000 involved no claim payment and no defence payment.

Table 6: Claims outcome

Claims outcome	No of claims
Closed claims	128,931
-of which zero claim, zero defence	*96,185*
Open and other claims	12,965
Total	**141,896**

Source: EPC calculations based on insurer claims data provided to the SRA. Note: Other claims include a large proportion of claims which appear to be ARP related

This could suggest that firms are notifying too many circumstances when these are not really likely to represent legitimate claims, potentially because excesses are set at too low a level. This is corroborated by some insurers who have suggested that solicitors tend to make more notifications than other professions.

In practice, however, the main cause of the large number of notifications is the wording in insurance policies requiring firms to notify circumstances that could give rise to a claim and individual insurers have control over this wording should they wish to alter it. Further, in roundtable discussions, insurers were consistent in preferring that solicitors err on the side of caution in notifying potential claims despite the large number of zero claims that this leads to. As well as reducing the risk of subsequent surprises, some insurers believe that the notifications also generate useful data on firms and claims.

Cost of claims without payment

Once a claim has been made, insurers have an incentive to deal with it in a cost-efficient manner. Information from a small number of insurers has indicated that it could take from 9 months up to 24 months to administer and close claims that pay out nothing in either claims costs or defence costs.

Although this may be a significant elapsed time, the actual time spent opening, monitoring and closing the claims file is considered to be quite modest with indications that it might take only 2-3 hours of administrative time on simple cases. This suggests that such administration costs represent only around 0.2% of the total value of claims paid.[42]

As well as administration costs (which will be passed on to firms through premiums), dealing with small claims also brings uncertainty for firms who need to declare open claims on application forms when searching for subsequent insurance – this could reduce the likelihood of switching insurer as firms may be reluctant to switch while they have an open claim.

Overall, however, it does not appear as though there are significantly detrimental consequences from the current arrangements regarding notification of claims which lead to no payment and their associated costs.

Small value claims

[42] This is based on: a salary of £25,000 per year; 220 working days per year; 7 hours per day; 96,185 claims; and 2.5 hours per claim. The resulting figure of £3.9 million has been compared to claims paid of £1.954 billion.

As well as the large number of claims without payment, it is also striking how many claims are made for small values. As shown in Table 7, nearly half of the claims with positive payments are for payments under £10,000 although in total this represents only £37 million of claims.

Table 7: Small positive claims

Value of claim (2016 values)	No of claims in range	Value of claims in range
£0-500	2,082	£0.6 million
£500-1,000	1,981	£1.4 million
£1,000-5,000	5,663	£14 million
£5,000-10,000	2,842	£21 million
£10,000+	14,750	£1,928 million
Total	**27,318**	**£1,964 million**

Source: EPC calculations based on insurer claims data provided to the SRA.

The large number of low value (but positive) claims again indicates that the value of the excess may not be appropriately calibrated. Since some administrative costs of dealing with positive value claims will be fixed, these will be disproportionately high for low value claims compared to higher value claims.[43]

Non-payment of excess

If it were the case that all firms did in fact pay the excess in the event of a claim, then the fact that insurers are liable for it would not matter. Insurers were split on the proportion of settled claims in which excesses were not paid with some stating 0-5% and others 6-10%. This proportion will clearly be affected by the policies which have a zero excess since claims on such policies would not have any non-payment of excess. Insurers have indicated that there is a mixture of types of firms that do not pay the excess:

- Some firms are in financial difficulty or in run-off and, since there are limited assets available, there is no point in insurers pursuing the firm; but
- Some firms do have the financial resources to pay and simply refuse to pay the excess – insurers will usually seek recourse through the courts unless the cost of pursuing the claim, combined with the likelihood of receiving the funds, means this is not worthwhile. In some of these cases, firms may have had resources to be able to pay, but close down or individual solicitors wilfully abandon the firm and their debts.

Firms are only liable to pay the excess after the claim has been agreed (typically within 30 days of the claim being paid by the insurer). Insurers do not believe that more firms could be forced to pay the excess by bringing the payment of the excess earlier in the claims process since to do so could affect all claims (including those with zero payment) and would be disproportionate to the non-payment problem.

[43] An unduly low excess may also limit the opportunities to use alternative mechanisms for dealing with low value claims such as permitting firms to settle claims if the value is below the excess, without this breaching notification responsibilities or causing a withdrawal of insurance if the claim value subsequently increases.

2.5.2 Removing the requirement on insurers and introducing a maximum excess

Firm behaviour and premiums

If insurers did not have to pay the excess, then many small firms would be able to choose a higher excess in return for a lower premium. This would reduce the large number of small value claims that are paid. Some of these firms, however, would choose an unduly high excess and, if firms had insufficient internal resources this would bring risks to customers in breach of Principle 1 (proper compensation) and Principle 6 (unintended consequences) and may lead to increased insolvency in line with Principle 8 (polluter pays). In order to limit this, the SRA would propose introducing a maximum excess.

Insurers would no longer seek to prevent unduly high excesses and would not be able to offer lower prices for higher excesses (taking into account that they have to pay the excess) where they considered this reasonable which is against Principle 8 (risk management). Replacing mainly market-driven excesses with maximum excesses determined by the SRA therefore reduces flexibility for firms and insurers alike and partly substitutes the view of the SRA in place of insurers and firms on the premium/risk trade-off which is against Principle 2 (minimum necessary). It would restrict the behaviour of well-run firms who choose high excesses because they have robust risk management processes and sufficient internal resources to cover the excess and is against Principle 6 (unintended consequences). It would be particularly detrimental for large firms who often arrange a complex set of insurance policies including large excesses on the MTC compliant policies with other policies in place to cover some part of these excesses. The more flexible any maximum excess policy, the less constraining it might be, but the more boundaries could be introduced around which unintended consequences might result against Principle 6.

Nonetheless, the current arrangements could be improved if there was greater confidence that excesses would be paid. While most policies do not have a zero excess, it remains possible that many firms face lower excesses than might otherwise be offered and similarly the reduction in premium for increased excesses is smaller than it would otherwise be. Both of these effects lead to some firms paying higher premiums than they otherwise would (although they bear less risk for this) compared to a situation in which insurers are more confident that firms will actually pay the excess.

Risks to clients

Where firms have insufficient internal resources to pay the excess in the event of a claim this would place the client at risk. Although the excess is paid in the vast majority of cases, this is in the context of some firms having zero excesses and others having lower excesses than they might prefer, hence with higher excesses, the proportion of claims with non-payment could increase.

Clients are unable to prevent firms from arranging a high excess (in contrast to insurers), and therefore would be reliant on any maximum excess imposed by the SRA being appropriate to specific firms.[44] Consumer clients are also in a poor position to pursue firms for any unpaid excess (again in contrast to insurers who will be more familiar with the process of pursuing these firms)

[44] Many clients, particularly consumers, have little understanding of the terms and conditions of PII cover and it is very unlikely that consumers would engage with details surrounding the excess.

even where the excess is constrained by the SRA's maximum. Hence they may face more cases of unpaid excesses than insurers do currently.

While client protection could be achieved through access to the CF, the CF can not influence the decisions of firms whereas insurers can send price and other signals that help with risk management in line with Principle 8. The cost of the CF falls on all firms rather than only those firms that insurers consider risky. Further, pursuing claims through the CF will also add to the length of time that clients have to wait before they are fully compensated. By contrast, the current arrangements related to the excess ensure that clients are protected, would generate fewer cases than under the proposed change and involve speedier resolution for clients.

Regulatory behaviour

Setting a simple maximum excess would incur limited regulatory costs. However, if the SRA sought to minimise distortions from a simple excess by allowing the maximum to vary according to different characteristics of firms, this would necessitate a more complex set of arrangements with higher regulatory costs. Any such complexities may also affect the extent of client protection.

The critical issue, however, is one of increasing the likelihood that firms *will* pay the excess and so reducing the likelihood that insurers have to pay the excess. In the past, the SRA has considered non-payment of the excess to be a commercial issue between the firm and the insurer, hence insurers have provided little information to the SRA and the SRA has taken little action in response.

As with run-off cover, this could be improved if the SRA takes robust action against both firms and principals that fail to pay the excess. If the SRA took such action, this would increase information flow from insurers (in line with Principle 7), should reduce the number of cases of failure to pay where firms have resources to pay but choose not to and would also increase the quality of firms (Principle 4) particularly if non-payment reflects wider problems at the firm. It is less likely to change the situation where the excess relates to claims made against run-off cover.

Summary

The excess has a valuable function to ensure firms have skin in the game. The current rules may be causing more small value claims than otherwise and lead to a proportion of claims (less than 10%) in which the excess is not paid.

If insurers are no longer responsible for the excess, some firms would obtain higher excesses in return for lower premiums. Among these firms would be some who could not afford to pay the higher excess in the event of a claim. Should the SRA limit this through a maximum excess, greater regulatory cost may be incurred and large firms could be constrained (against Principle 6). Without a restriction on the excess, clients would be unprotected and, unlike insurers, they are unable to prevent firms from arranging a high excess and in a weak position to seek redress from firms. They could be protected through the CF but this would lack the price signals for good risk management (against Principle 8).

Currently the SRA takes little action against non-payment, viewing this as a commercial dispute. The SRA could take greater action to ensure firms and principals do in fact pay the excess and greater engagement in this may also help with wider supervision (Principle 7) and improving the quality of law firms (Principle 4).

2.6 Allow greater flexibility for defence costs

Under the MTC, no excess can be applied to defence costs and defence costs must be covered in addition to the minimum single claims limit.[45] This section considers allowing an excess to apply to defence costs and also removing the requirement that defence cost must be covered in addition to the minimum single claims limit. The prohibition on deducting defence costs from awards to clients would be maintained hence this element of client protection would remain unchanged.

2.6.1 Current approach to defence costs

Value of defence costs

In total, as shown in Table 8, around £0.55 billion of defence costs were incurred alongside the £1.96 billion in indemnity claims representing around 22% of the total of the two costs. Some caution must be applied to this split of costs because some insurers will deal with the defence of the claim in-house while others will outsource the defence to third parties.[46]

Table 8: Defence costs

Value range	No of claims in range – defence costs only	Value in range – defence costs	No of claims in range – claims plus defence	Value in range – claims plus defence	Of which defence costs
£0	120,453	-	105,096	-	
£0-0.5 million	21,343	£429 million	35,999	£1,349 million	£351 million
£0.5-1 million	66	£45 million	463	£320 million	£58 million
£1-2 million	21	£29 million	208	£291 million	£52 million
£2-3 million	9	£22 million	66	£163 million	£22 million
£3 million +	4	£29 million	64	£396 million	£70 million
Total	**141,896**	**£554 million**	**141,896**	**£2,518 million**	**£554 million**

Source: EPC calculations based on insurer claims data provided to the SRA.

As is clear from Table 8 above, the great majority of cases by both number and value arise when defence costs are in the range £0-0.5 million. Of the total defence costs, £116 million (21% of defence costs) relates to defence costs where there was no positive claim indicating that claims were successfully defended (not shown in Table 8). A further £68 million relates to open cases which have not yet paid a positive claim.

[45] Liability for defence costs in relation to a claim which exceeds the sum insured can be limited to the proportion that the sum insured bears to the total amount paid in the claim. See paragraph 2.3 of the SRA Indemnity Insurance Rules 2013 – Appendix 1.

[46] In addition there may be limited distinction between claims handling costs and defence costs when claims are dealt with internally.

When considering different sectors, those with low maximum claims (shown previously in Table 2) also tend to have low defence costs. The sectors with low maximum claims in Table 2 remain in the same categories even when considering the total of claims plus defence costs. The only exception to this is debt where the maximum value observed for the sum of claim plus defence cost is £1.1 million.

Current incentives to incur defence costs

Discussions with a small number of insurers have suggested that defence costs for solicitors PII tend to be proportionately higher than those in other professions which is due to the relative complexity of claims. Some insurers have also suggested that the wide terms within the MTC also give rise to higher defence costs because time is spent on claims that might otherwise have been declined. Discussions have also suggested that defence costs represent a smaller proportion of claims compared to when insurance was provided through the Solicitors Indemnity Fund (SIF).

In general, insurers have appropriate incentives with respect to defence costs since the insurer will usually have considerable ability to control these costs and there is no reason for insurers to waste costs. Where insurers both make the decision and incur the defence costs, they face good incentives to manage these costs appropriately.

However, insurers need to rely on the cooperation of solicitors in processing and defending claims. In some cases a solicitor may wish to continue to defend a claim where their insurer does not. In these circumstances the fact that defence costs are covered in addition to the minimum limit may mean that solicitors do not take into account the cost of the defence because it will be covered by the insurer.

2.6.2 Allow excess for defence costs

Currently, the beneficial functions of the excess highlighted in section 2.5 do not arise in respect of defence costs. Firms therefore lack sufficient "skin-in-the-game" when influencing whether or not a claim will be defended. Insurers have suggested that this leads firms to seek to defend claims when it is clear that they should not be defended, because the firm faces limited downside from this.

Impact on firm behaviour and premiums

With an excess for defence costs, firms would have to pay for the initial defence costs up to the value of the excess. The excess on defence costs becomes due as soon as defence costs are incurred. Hence firms face an immediate impact of choosing to defend the claim in line with Principle 8 (polluter pays). (This differs from the excess on the claim which becomes due only once the claim has settled.)

Since firms would face the immediate consequences of seeking to defend the claim, this is likely to lead firms to be more realistic about whether a claim is in fact defensible and to reduce the number of claims that are defended.

At the same time, if firms have to pay the initial defence costs it is also possible that firms will want to influence the defence strategy to a greater extent than they do today. Some brokers and insurers

have suggested that if insurers run the defence this leads to a more dispassionate approach since they are able to take a more objective view of the various circumstances that gave rise to the claim. Greater involvement of firms may therefore complicate the defence which could itself generate additional costs.

However, allowing an excess to be applied to defence costs does not mean that such an excess must be applied. If insurers believe that the presence of the excess would lead to detrimental involvement of firms in the defence, then insurers are free to continue offering policies without defence excesses to prevent this. In reality, it is clear that insurers believe the beneficial properties of a defence excess across most firms outweigh concerns about complicating the defence by some firms.

Premiums would therefore fall both because the number of claims defended would fall and also because the value of the defence excess would switch from being paid by insurers to being directly incurred by firms. The latter effect would mean that firms with claims that they defend would face higher overall costs but firms that do not make claims would face lower premiums. This supports Principle 8 (polluter pays).

An illustration of the potential magnitude of this effect can be estimated if it is assumed that all firms would have a defence excess of £5,000 (a common level for the usual excess for small firms). If firms had paid up to £5,000 of defence costs then insurers would have saved approximately £79 million or 4% of claims values over the 2004-2014 period. Most insurers who responded to the survey believed the reduction in premium would be up to 5% although one respondent thought allowing a defence excess could lead to a 10% reduction in premiums. In the main this cost will instead be faced by firms with claims, although the overall cost to firms would be lower to the extent that firms chose not to defend claims.

Insurer behaviour

The presence of a defence excess may alter the incentives of insurers to categorise certain costs as defence costs since insurers would not pay the excess on these, potentially giving rise to unintended consequences in conflict with Principle 6. A clear definition would therefore be required regarding what is, or is not, part of defence costs. Since similar excesses are used in PII in other areas this should be straightforward.

Client protection

If there is a reduction in the number of claims defended, this will improve client protection in these cases since clients will receive their compensation faster than otherwise. Since the claims process may cause distress and uncertainty to clients, faster compensation is of benefit to them. This supports Principle 1 (prompt compensation). Since defence costs can not reduce the payments to clients, other aspects of client protection would be unchanged.

Summary

If an excess for defence costs is allowed, firms will face the consequences of defending a claim (in line with Principle 8). Firms with claims they defend will face higher costs but others will pay lower

premiums. This should reduce the number of claims that are unnecessarily defended and may speed up compensation for clients (in line with Principle 1).

2.6.3 Allow flexibility for defence costs

The SRA could also allow for greater flexibility on defence costs more generally, for example by allowing insurers to specify a maximum limit on defence costs.

If, for example, insurers chose a cap of £1 million for defence costs, in theory this may change incentives to incur the £80 million of defence costs (4% of total claims) above this level (column 3 of Table 8 above).

Alternatively, insurers could choose to include defence costs within the overall cover (e.g. £1 million) so long as this did not reduce the payments to clients. This approach would be less certain for both insurers and firms since there could come a point where it is not clear whether the combination of the claim and the defence costs would exceed the limit as the value of the claim itself would not yet be agreed. If such an approach was followed, then this could change incentives to incur £144 million of defence costs (column 6 of Table 8 above and 7% of total claims). It seems common for defence costs to be specified in addition to claims limits in PII policies more generally.

A cap does not change incentives for firms until the defence costs approach that cap, but at that stage firms would have clear incentives to seek resolution of the claim to prevent defence costs exceeding the cap and the firm becoming liable for them again. Should firms become liable for the defence at this stage it seems inevitable that the firms would expect to take greater control of the defence because they would have to pay all of the defence costs subsequently incurred.

In practice, however, insurers have the incentive to continue to pay to defend claims while they believe that these costs will reduce the likely value of the claim by more than the cost of the defence. Unless it is the case that firms currently play a disproportionate role in deciding to continue to incur high value defence costs, then it seems unlikely in practice that imposing a maximum cap on defence costs would make a substantial difference to outcomes. Further, insurers may in fact be reluctant to cede control of the defence back to firms when the insurers themselves are affected if the case is lost.

For high value claims exceeding the insured limits, insurers may be less concerned about the defence as they will be required to pay out for the insured limit anyway. Insurers can already reduce the value of defence costs that they pay in proportion to the overall claim although more flexibility on defence costs would bring greater restraint on fighting claims because firms would once again have skin-in-the-game regarding incurring defence costs. Firms would then need to balance incurring defence costs with the potential reduction in the overall claim value.

Given that there appears to be limited detrimental impacts from allowing a maximum limit on defence costs, there could be an argument that allowing this change would be in line with Principle 2 (minimum necessary to meet objectives) and Principle 5 (the scheme is targeted, intervening only when there are clear problems).

Summary

Limited detrimental impacts are anticipated from removing other restrictions around defence costs since insurers generally retain an incentive to ensure the defence is appropriate to the nature of the claim. Removing restrictions would be in line with Principles 2 and 5.

2.7 Reform of run-off

Insurers are required to provide run-off cover after a firm has closed.[47] This reflects the nature of claims made PII policies, the fact that poor quality in some aspects of legal services may take time to be discovered and therefore that firms may have closed down by the time that clients make claims.

Run-off requirements affect only those firms that close. In 2015-16, 725 firms (7% of all firms) closed of which 341 (47%) ceased practising with the remainder mainly merging or changing status.[48]

Alongside the run-off requirements, SIF currently provides cover for claims made more than six years after a firm has entered run-off although this cover will cease after 30 September 2020.[49]

There are various different aspects to run-off cover which are considered in this section.

2.7.1 Length of run-off cover

Currently, insurers must provide run-off cover for six years. This section considers whether this length of time could be reduced to three years.

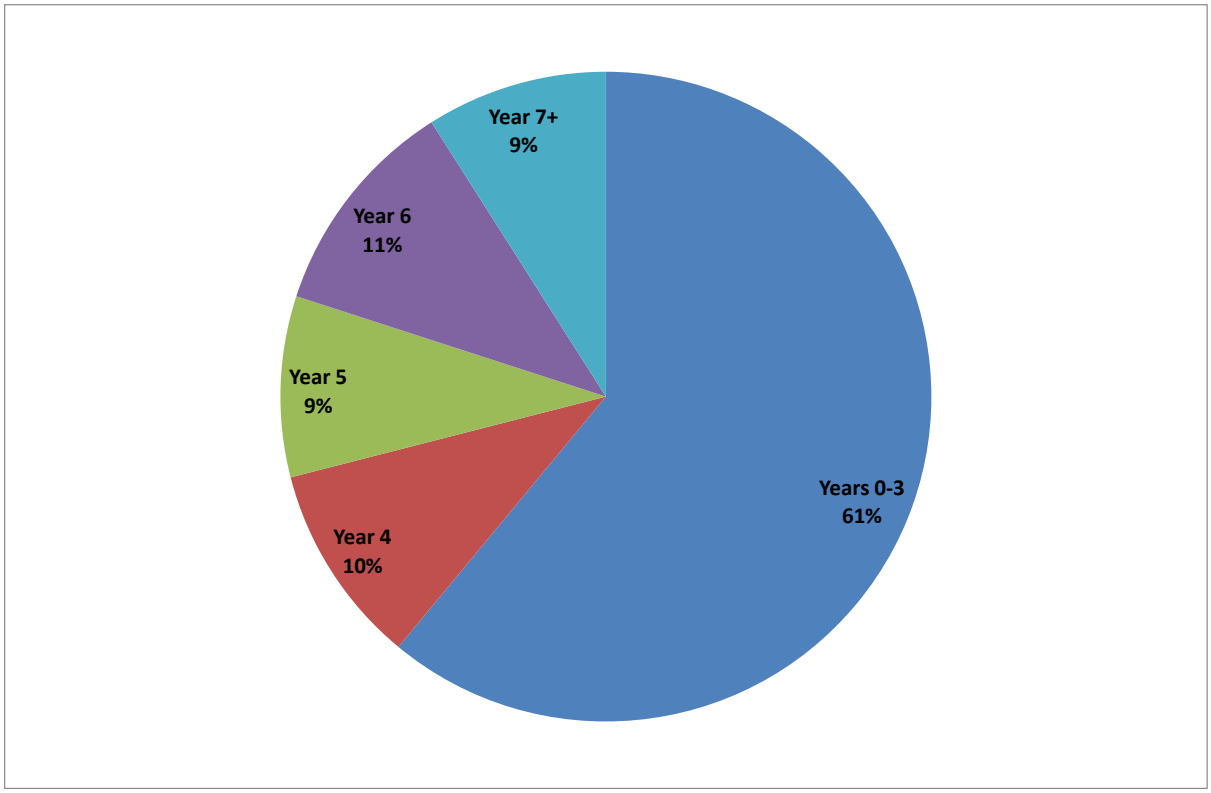
Current approach

The claims data provided by insurers did not enable separate identification of run-off claims or the length of delays between advice and claims. Data is available from SIF which covers the period 1987-2016. SIF was the single insurer for solicitor PII claims from 1987-2000 at which point it was replaced by the current approach of using qualifying insurers although, as noted above, it continues to provide post six year run-off cover. It should be noted that the SIF data would not include claims made against insurers from 2000 onwards and it may therefore understate the proportion of claims made in years 1-6 of run-off and overstate the proportion of claims made in year 7 onwards. Similarly, the SIF data includes all claims from the period when it was the single insurer and not only run-off claims. Since there would typically be a delay between advice being given and a firm entering into run-off, a claim that is made 6 years after the advice is given does not imply that the claim would be made 6 years into a run-off policy. The minimum 6 year protection therefore applies only to those clients who receive legal services just before firm closure while most clients would receive protection for more than 6 years after the advice is given.[50]

[47] It should be noted that it is unclear whether there is an explicit requirement on solicitors and firms to ensure run-off cover is in place, or only on insurers to provide run-off cover for six years.
[48] SRA statistics: http://www.sra.org.uk/sra/how-we-work/reports/data/firm_closure_breakdown.page.
[49] After 2020, clients will therefore face differential levels of protection for claims against older work according to whether, and when, their firm has subsequently closed. In addition, individual solicitors who left the profession before 2000, when SIF insured the whole profession, and who had unlimited liability, could also face claims from historic advice although the number of claims from more than 20 years ago (in 2020 and beyond) is likely to be very small.
[50] It is possible that if firms start to make a large number of mistakes this would lead to closure in which case the time between advice and closure could be short.

Figure 2 below shows the proportion of claims by length of delay.

Figure 2 Split of claims by timing of claim



Source: SIF analysis of all claims against SIF (1987-2016). As cited in Reflecting on Solicitors Professional Indemnity Insurance (PII): market trends and analysis of historic claims data.

Data is not available to EPC on the breakdown of the 9% of claims made more than 6 years later so it is not possible to provide information on whether there would be merit in extending run-off cover to 7 years or more (e.g. if nearly all of the remaining 9% of claims arose in year 7 rather than subsequent years). As noted earlier, these claims are currently covered through SIF but this cover will cease in 2020. The SRA may be able to obtain further data to help inform this issue.

When examining claims by work type, SIF data suggests that personal injury claims arise quite quickly, but that conveyancing claims arise more slowly than the typical claim, which may reflect problems coming to light only once property is resold or due to external events such as recessions. Some evidence on run-off claims is also available from the Assigned Risks Pool (ARP) where it is estimated that around 75% of claims in the ARP relate to lender claims in conveyancing transactions.

Reducing the length of run-off

It is clear from Figure 2 above that a substantial proportion of claims continue to be made in each of years 4, 5 and 6. Hence reducing the length of run-off cover to three years could place up to 30% of run-off claims at risk of not being paid through PII (unless firms proactively chose to extend cover for a longer period of time).

Insurers would save costs associated to the run-off claims made in years 4-6 and this would reduce the price of run-off premiums in line with the reduced costs. If this led to a significant change in price, in theory this might result in a greater proportion of run-off premiums being paid and reduce the extent to which purchasing run-off, which typically costs around 250-300% of the annual premium, acts as a barrier to closure (see section 0). It has also been argued that the high price of run-off represents a barrier to switching regulator. The SRA has already consulted on waiving the run-off requirements for firms that wish to switch to another regulator and therefore this issue is not considered further here.

The main consequence of reducing the length of run-off cover, however, would be that clients would be unprotected in relation to these claims. Since the firm is closed, it is reasonable to assume that firms would have no assets three years later. Hence it would be very difficult for clients to seek recourse directly from the firm itself.[51] The main effect of this policy would therefore be to shift consumer claims from PII to clients and the CF (assuming that consumers could claim from it), against Principle 1 (proper compensation). The beneficial effect of price signals would also be reduced if claims fell to the CF rather than PII against Principle 8 (polluter pays). Non-consumer clients would be unprotected and if they understand the increased risk they would face, this may cause some of them to no longer appoint sole practitioners or other small firms where the risk of firm closure is greatest (simply because there may not be surviving principals to continue the firm). It would be very difficult for such firms to avoid this effect by committing in advance to maintaining six year run-off cover since such a commitment may not be seen as credible.

Summary

SIF data shows that up to 30% of claims arise in years 4-6 hence a reduction in the length of run-off would place a substantial proportion of claims at risk (against Principle 1). It would reduce run-off premiums in reflection of this risk moving on to clients or the CF (against Principle 8).

2.7.2 Aggregation cap on run-off

This section considers whether to introduce an aggregation cap on run-off claims. Most of the comments raised in respect of aggregation caps in section 0 apply here as well. Evidence has not been specifically provided from insurers regarding aggregated run-off costs.

If an aggregation cap was in place for run-off claims (either on an annual basis or in aggregate across the six years of run-off), this would provide certainty for insurers on their maximum exposure from such policies. This in turn would lead to lower prices, reflecting both lower total claims paid out and the reduced uncertainty surrounding the impact of high aggregate claims. This would be expected to reduce premiums in line with the reduced claims paid by insurers.

If the impact on claims was substantial and the premium reduction large, this could in theory have an impact on the proportion of run-off premiums that are paid by any firms that are currently constrained by lack of funds (see section 0 for further details). At the same time, it would leave a large value of claims unprotected from PII.

[51] Some owners of firms may have unlimited liability but these individuals may not have sufficient assets to pay for claims and would also need to be tracked down for clients to make claims against them.

For consumers, it would be expected that access to the CF would provide them with protection but non-consumer clients would not receive this. If there were external prompts for claims (such as a recession or house price reduction), well informed non-consumer clients would know that the aggregation cap acted as a rationing device and that the faster they brought claims the more likely they would be to have them paid. In the event of such external prompts, this might cause them to observe the firms entering run-off, and rapidly check advice so as to make claims before others did wherever possible. Hence the value of claims against the CF might be greater than the proportion expected when simply based on the proportion of consumer compared to non-consumer claims.[52]

Although not available at the time of writing, it may be possible for the SRA to obtain further data from SIF or insurers on the likely impact of different aggregation caps on run-off cover. However, the combination of impacts is clear: the lower any aggregation cap, the more such a cap will be binding on claims, the lower the premiums that will result. At the same time, the greater the value of claims that would be unprotected through PII, the greater the claims against the CF against Principle 8 (polluter pays) and the greater the risk that non-consumer clients take action to avoid using small firms with a high risk of entering run-off. Since firms are already in run-off by this stage, and assuming owners have limited liability, it unlikely that their behaviour would alter due to the shifting responsibility for risks i.e. there is unlikely to be an impact on the overall value of claims.

Summary

An aggregation cap in run-off would have little impact on firm behaviour hence the main impact would be to reduce run-off premiums but shift risks onto clients (against Principles 1 and 8).

2.7.3 Insurance only with payment of premiums

Currently, insurers *must* provide run-off cover for six years when a firm enters run-off (unless there is a successor practice – see section 2.8). One of the consequences of this is that insurers must provide run-off cover even if firms do not pay the premium for it. This section considers a change such that run-off cover is only provided to firms that do in fact pay premiums.

Insurance when premiums are not paid

Requiring insurance to be provided even when premiums are not paid is clearly not consistent with normal market practice. The requirement is in place in order to protect clients who would otherwise be unprotected if firms failed to obtain run-off cover. However, the clear result of the requirement is that a large proportion of firms simply fail to pay premiums against both Principle 8 (polluter pays) and Principle 6 (unintended consequences).

Information on the extent to which firms do not pay run-off premiums varies with responses to the insurer survey equally split across 21-30%, 31-40% and over 50%. It is likely that the different responses reflect insurers covering different parts of the solicitor market. The report by CRA from 2010 estimated that around 50% of run-off cover may involve non-payment of premiums.[53] Insurers have indicated that they typically chase firms that fail to pay premiums although this will depend on

[52] In addition, lenders may seek to make claims via consumer clients as explained in section 2.4.
[53] Review of SRA client financial protection arrangements, CRA, September 2010.

the value of the premiums and the likelihood that they will be paid since some firms close due to financial difficulty and therefore have no assets. Insurers have also highlighted that it appears as though there is little downside for firms from failing to pay the premium when they receive insurance anyway.

Failure to pay run-off premiums by some firms will inevitably increase the price of run-off for other firms, and possibly lead to a slight increase in annual premiums for many firms.[54]

In addition, it is possible that insurers may not even know that they are on risk for run-off cover, again breaching Principle 6 (unintended consequences). In the absence of a premium for run-off, insurers may assume that firms are continuing in business and have obtained insurance from an alternative provider when in fact the firm is in run-off. Insurers were split on how difficult it was to maintain records of firms in run-off but the issue could be mitigated by better firm closure processes and better coordination between the SRA and insurers regarding the firms that have closed.

The fact that such a substantial proportion of run-off premiums are not paid also reveals that the underlying intent of the requirement (that firms obtain, and pay for, run-off cover) is not being delivered, or enforced. Historically the SRA has considered failure to pay run-off premiums as simply a commercial dispute between insurers and firms. This has resulted in limited information on non-payment being provided by insurers to the SRA, and limited action by the SRA in response to any information they did receive. This may represent regulatory failure against Principle 7 (supporting regulatory supervision).

Insurance only when premiums are paid

If run-off insurance is provided only when premiums are paid, in theory some firms that do not currently pay for run-off insurance may start to do so in order to ensure they are protected. The response of firms would vary depending on the current reason for non-payment:

- Some firms do not pay because they have insufficient financial resources to be able to do so; and
- Some firms have the resources to pay, but do not pay because: they do not know they need run-off cover; they believe they do not need to pay run-off premiums (as insurers are obliged to provide run-off); or they think that they can get away with not paying (as there is little downside).

The first group would be unaffected because the firm has no resources and so cannot pay whether this results in them being insured or uninsured.

Among the second category of firm, those that did not realise they needed to pay run-off premiums might start to do so in order to be insured. In addition some unlimited liability firms may start to pay

[54] Some firms, such as small firms, are more likely to enter run-off than others although any firm could enter run-off. Insurers who cover firms that are not likely to enter run-off would face minimal costs of non-payment whereas insurers who cover firms that are more likely to enter run-off would face higher costs of non-payment and therefore firms more likely to enter run-off, including those that do in fact enter run-off would face higher premiums due to non-payment by others.

premiums to protect individual solicitors from future claims.[55] However, once limited liability firms close, it is likely that any remaining company assets will be dispersed to shareholders leaving no assets from which to pay claims. Since individual solicitors would not be personally liable for the claims, they may continue to think they can get away with not paying run-off premiums and being uninsured.[56]

If insurers did not have to provide insurance in the absence of the premium being paid, then this would reduce the price of run-off cover down from 250-300% of the annual premium since those who pay the premium would no longer need to subsidise those who do not. In addition, insurers would be willing to offer more flexible payment arrangements including payment by instalment. Arguably, this could help firms with limited resources although since the firm would be closed there would be no additional revenue becoming available for the firm to pay these smoothed premiums.[57] Furthermore, once a firm has closed, there is little to stop the firm from cancelling the policy, no longer paying premiums by instalments and simply flouting the regulatory requirement for run-off at a point at which they are outside the SRA's remit breaching Principle 6 (unintended consequences). Insurers would not have any incentive to chase firms failing to pay premiums (either at the start of run-off or subsequent instalments) since they would no longer be providing insurance once premiums fail to be paid.

It is therefore very likely that if insurance is no longer in place in the absence of the payment of run-off premiums, many firms would continue to fail to pay run-off premiums, and clients would lose the protection they have from PII. Instead risks would simply shift from PII (lowering PII premiums for run-off) to clients or the CF (increasing the cost of CF contributions) which is against Principle 8 (polluter pays). Non-consumer clients would be unprotected and this may cause non-consumer clients to reduce the extent to which they use small firms more likely to enter run-off, against Principle 6 (unintended consequences).

Regulatory action

Whether the insurance arrangements change or not, there is a problem of firms failing to pay run-off premiums. There is a significant challenge to enforcing the payment of run-off premiums at a time when firms, by virtue of closure, are moving outside the remit of the SRA's regulatory boundary.

At the time of writing, the SRA is conducting work on the firm closure process and seeking to develop clearer guidance on this. Such a process could involve confirmation as to purchase of run-off cover and/or confirmation regarding the successor practice. This could reduce the number of firms who fail to pay premiums either because they do not know they need run-off cover or because they do not realise they need to actually pay for it.

[55] In general, insurers ought to be able to seek payment of premiums from individuals with unlimited liability but there may be circumstances where the cost of chasing the premium means it is not worthwhile for the insurer. At the same time the individuals, while currently willing to get away with not paying the premium, may be sufficiently risk averse to want run-off protection if they have to pay for it.

[56] This explains both the need for run-off cover to be in place, but also the difficulty of enforcing that firms actually pay for the run-off cover – whether failure to pay results in being insured or not.

[57] It is possible that individual solicitors would have additional sources of money from which to pay the premium over time

In some cases it is thought that principals wish to close a firm but realise that they can not afford run-off premiums. This appears to be a failure to have a plan for closure. TLS already provides guidance on its website highlighting that run-off cover is required on closure and highlighting that firms planning for closure will need to consider how PII cover will be paid for.[58] Potentially there is also a failure by the SRA to check that firms would be able to close in an orderly fashion including checking whether firms have access to funds to pay for run-off cover if required.[59]

More significantly, firms closing without paying run-off premiums may contain some individual solicitors that wish to continue to practice, although they may also involve individuals who are leaving the profession for a variety of reasons including retirement, ill health, death or some other reason. When solicitors do wish to continue, the SRA could prevent them from practising if they were recently at a firm that failed to pay run-off premiums. This would encourage much greater personal responsibility for paying premiums. Where relevant, the SRA could also consider the practicalities of compelling individuals on the roll to ensure that run-off premiums have been paid before leaving the roll and moving outside the SRA's regulatory boundary.

Alternative approaches to run-off

It is also worth considering whether the cost of enforcing payment of run-off premiums would be such that an alternative approach would be more effective. Possible alternatives include:

- Incorporating run-off cover within the annual policy such that no additional run-off premium is due;
- Provision of a hardship fund by the SRA for individuals that cannot afford to pay run-off premiums;
- SRA payment of premiums where they are not paid by firms; and
- Collective provision of run-off cover for the whole profession.

Insurers have indicated considerable reluctance around the first of these options which would be expected to increase annual premiums for firms that share characteristics of those that enter run-off including many small firms. This approach may also cause difficulties in a recessionary period when more firms enter run-off due to financial difficulty and the cost of this would be faced by all firms with similar characteristics to those about to enter run-off. Further, some insurers that participate in solicitors PII have chosen not to particulate in schemes where this has been brought in suggesting that there could be a withdrawal of insurers should this arise for solicitors.[60] Despite this it should be recognised that if 50% of firms currently fail to pay premiums, insurers are *already* effectively providing run-off cover within the annual insurance for these firms.

[58] Closing down your practice, The Law Society, March 2016, available at http://www.lawsociety.org.uk/support-services/advice/practice-notes/closing-down-your-practice/

[59] The SRA could consider whether it is reasonable to require firms to build up a pot of money over the first few years of existence which is designed to be used for the purchase of run-off cover should it be required. There would be a cost of doing this since firms would be limited in using this money for other purposes. The cost across the whole profession may be disproportionate to the benefit with respect to a small number of firms entering run-off.

[60] Risks vary across sectors so this does not imply that the approach is unreasonable for other sectors.

The second and third options are similar and both involve the profession at large subsidising those firms that do not pay run-off premiums, which runs counter to Principle 8 (polluter pays). They could be considered appropriate if the cost of the subsidy is lower than the cost of enforcing payment by those who currently do not pay. The fourth option also involves the profession at large paying for run-off causing all firms to pay for the cost of run-off for closing firms, although it could also be seen as firms or individuals paying for run-off across their career so they do not need to pay for it at the point of closure. The cost of this provision is likely to see spikes during recessionary periods when more firms close

In general when considering these options, the more "collective" the run-off provision, the better the coverage for clients, which is in line with Principle 1 (prompt and proper compensation) and may help to maintain the reputation of the profession. In addition, the more affordable the run-off premiums become for any given firm or individual solicitor because the cost is being shared across a wider set of firms or individuals.[61] At the same time, however, the less the run-off premiums reflect risk – both because risky closing firms are subsidised by less risky closing firms, but also because closing firms are subsidised by open firms – both of which are against Principle 8 (polluter pays).

Summary

Requiring insurance to be provided even when premiums are not paid is not consistent with normal market practice and results in up to 50% of run-off premiums being unpaid (against Principle 6). If this was changed, premiums would fall for those firms who pay them as they would no longer cross-subsidise those who do not pay (in line with Principle 8). However, firms without resources, along with those willing to flout regulation at a time when they are leaving the sector, would not buy run-off leaving clients unprotected (against Principle 1). Non-consumer clients unprotected by the CF may take action to reduce their use of small firms more likely to enter run-off (against Principle 6).

The SRA has historically viewed failure to pay as a commercial dispute and has taken no action. However, this suggests regulatory failure (against Principle 7) as requirements to have a plan for closure are not enforced. The SRA could also do more to encourage greater responsibility by preventing individuals continuing in practice if their firm has not paid premiums (in line with Principle 8).

Alternative approaches with more collective provision help client protection (Principle 1) but reduce the extent to which premiums reflect risk (against Principle 8).

2.8 Changes to successor practice definitions

When a firm closes, run-off cover must be purchased unless another firm is deemed to be a successor practice. In these circumstances, the firm can choose to purchase run-off cover or the successor practice can take on responsibility for the prior work of the firm. If run-off premiums are not paid then the successor practice is deemed to have taken on the responsibility.

[61] Such collective provision could be operated either through a single mutual fund such as SIF or using a group of insurers akin to a Master policy. Since collection mechanisms are already in place through funding the CF and paying regulatory fees, there would not be set up costs from paying for run-off this way.

If a firm closes without a successor practice, run-off cover must be in place. Allowing a firm to close without taking out run-off cover, because risks are covered through a successor practice, is therefore an additional flexibility to the approach to firm closure although it does come at the cost of disputes surrounding definitions on successor practices.

This section examines alternative approaches to the successor practice definition including differentiating between closed files and live files such that succession responsibilities could relate to live files only.

Definitions of successor practices

The SRA's rules defining successor practices are complex and there may be inconsistencies surrounding the approach as between firms that have different legal structures against Principle 6 (unintended consequences). The SRA's website suggests that firms contact them regarding successor practice definitions which also seems to acknowledge the complexity of this area.

Of those who responded to questions on successor practices in the insurer survey, insurers were equally split on whether the current definitions were clear and also on whether they inhibit merger activity. They also indicated that there are relatively few cases of disputes surrounding whether there is a successor practice with insurers seeing five or fewer cases each year. Insurers have argued that the SRA should state whether a firms has a successor practice so that there is clarity both for firms and for insurers as to who bears which risks.

As noted in section 0, the SRA is conducting work on the firm closure process and seeking to develop clearer guidance on this. Such a process could involve confirmation as to purchase of run-off cover and confirmation regarding any successor practice. It is possible that this guidance will reduce the number of times that there are disputes surrounding successor practices.

Under the proposal for succession to relate to live files only, however, disputes may continue to arise but focus on whether or not something is a live file. Irrespective of what the definition is, failure to have clarity around the successor practice definition is in conflict with Principle 6 (unintended consequences) since firms may become a successor practice without realising and similarly insurers may be unaware of who is a successor practice and therefore unable to set appropriate prices for the risks involved. Taking action to provide such clarity is therefore likely to be positive, although given that there are relatively few cases in dispute, care would need to be taken to ensure that the cost to do this is proportionate. It is unclear whether gaining clarity on a definition based on live files would be more or less costly than the current definitions.

Firm behaviour and premiums

The nature of the successor practice rules affects incentives to take over some, or all, of the business of a firm that is closing. The SRA believes that a small number of mergers may have been prevented by the current rules and also that some firms deliberately structure any takeover of parts of businesses so as to avoid successor practice responsibilities.

If the "takeover firm" has no responsibility for past claims then this will encourage firms to take over whole firms, parts of firms, or live files without being concerned for claims associated to past advice. The less responsibility the takeover firm has, the more takeover activity and the more PII would be provided through run-off rather than ongoing policies. Takeover activity may be of benefit to the legal services market as a whole if it encourages more efficiency in legal services in line with Principle 3 (encouraging competition). In addition, facilitating takeovers will help to ensure that current clients continue to receive legal services rather than risk interruption of these services if firms close in a disorderly fashion.[62] By contrast, the more takeover firms do have responsibility for past claims, the less takeover activity might be expected.

It is assumed that firms would retain the option to either trigger run-off or proactively take on responsibility for historic claims. For well-run businesses that are being purchased (and then one legal entity closed), the cost of run-off premiums would be taken into account in any purchase price in relation to ongoing business. The combined business would then be able to choose whether to pay a one-off premium for run-off or to pay higher ongoing premiums. The business would be in the best position to determine which was preferable.

However, this approach could cause individuals to deliberately remove assets from the firm, close the firm with insufficient assets to pay run-off premiums and then open a new firm thereby avoiding historic liabilities. There is therefore a risk of increasing the number of run-off policies where premiums are unpaid and reducing the extent to which cover is provided through ongoing PII policies (where premiums are paid).

Fundamentally, failure to pay the run-off premium is the main concern for insurers and this has been discussed in more detail in section 0. If more run-off policies are in place but without paying the associated premiums, then the cost of run-off premiums to firms who do pay, and possibly the cost of premiums to all firms, may increase reflecting this non-payment. By contrast, if the SRA is able to ensure greater enforcement of the payment of run-off premiums including through greater responsibility for individual solicitors, unintended consequences surrounding successor practice rules would be somewhat lessened.

Insurer behaviour and premiums

Clarity in the definition of a successor practice would reduce administrative costs for insurers that are incurred when such definitions are in dispute although since such disputes appear to happen relatively rarely these costs are expected to be relatively modest.

From a practical perspective, having a successor practice may bring benefits when dealing with claims since insurers can contact the firm and gain access to past files whereas in run-off when the firm has closed, this may not be possible. The cost of this will already be accounted for in run-off premiums, but more such policies would be in place if successor practices related only to live files.

Client protection

[62] It is possible that disorderly closure could lead to further claims.

Client protection is broadly unchanged by changes to the definition of successor practices since in either case clients will be protected through the PII cover in place – either the run-off cover or the successor practice's ongoing PII cover.

Currently, run-off PII and ongoing PII cover the same risks on the same terms, however, if other changes contemplated in this report are made, then client protection could be affected by changes to the definition of successor practices. For example, if an aggregate cap is in place for run-off cover, but not for ongoing cover, then having firm closures result in more run-off policies and fewer successor practices will exacerbate the effects described in section 2.7.2 above, namely the risk of exhausting aggregate run-off cover, more claims falling to the CF and more non-CF eligible clients being unprotected. It would also lead to more claims falling outside PII because they are made after the six year run-off period where currently they would be covered by ongoing policies of the successor practice.

Summary

Failure to have clarity on the definition of successor practices causes uncertainty (against Principle 6) although, given the small number of cases, change here would need to be done carefully to ensure the cost of clarity is proportionate. Limiting successor practice definitions to smaller parts of firms (e.g. live files only) would encourage takeover activity (in line with Principle 3) but increase the risk of asset stripping (against Principle 6), although the main concern with the latter is the failure to pay run-off premiums. Handling claims is easier when there is a successor practice to contact hence more run-off policies could lengthen the claims process (against Principle 1). Other aspects of client protection would be unchanged if run-off policies maintain similar protection to ongoing policies.

2.9 Exclude cyber-crime

Currently, some forms of cyber-crime against law firms and their clients are covered by the MTC. This section explores whether it would be appropriate to exclude cyber-crime from the MTC. At the same time, firms could be required to take out separate, specialist cyber-crime policies.

2.9.1 Cyber-crimes

Cyber-crime claims are relatively new in solicitors PII but some insurers have raised concerns that such claims can involve substantial sums of money and should not be covered by PII policies. Cyber-crime can vary considerably, covering issues such as gaining access to bank accounts and fraudulently transferring money, stealing data including personal information, stealing trade secrets or gathering inside information, and denial of service attacks which damage essential operation. Not all of these would be covered by PII policies depending on whether they resulted in client harm.

Insurers have highlighted payment related fraud as the most concerning issue. For example, firm email systems are hacked and then emails with account details are altered such that clients make a payment to a fraudulent account rather than their solicitor's account. This can be particularly costly where large value payments are being made such as in relation to conveyancing transactions. The SRA has stated that three-quarters of all cybercrimes reported to them involve emails being

modified and half of these are in connection with conveyancing proceeds.[63] While cyber-crime related to client account money is a significant issue, it is not the only type of cyber-crime that can lead to harm to clients and at present systematic information on the scale of cyber-crime in relation to solicitors PII is not available.

Issues surrounding such payment related fraud overlap with concerns that have been raised regarding the payment systems more generally. The Payment Systems Regulator (PSR) is currently pursuing a project on "authorised push payment" scams in which customers are tricked into authorising a particular payment.[64] Capabilities for "confirmation of payee" are being considered which customers receive information about the account to which they are about to send money which could reveal whether it is the correct account. Hence this element of cyber-crime may reduce in future if such payment fraud is reduced due to changes by payment systems.

Concern about cyber-crime is also clear from the Prudential Regulation Authority's (PRA's) recent consultation paper highlighting the need for insurers to be aware of the loss potential both from explicit cyber risk policies, and also from "silent" cyber risk implicitly covered in other policies, including PII.[65] The PRA has raised concerns that insurers have not considered their own strategies and risk appetites surrounding cyber risk and that insurers have themselves made insufficient investments in developing cyber expertise. As such, it is not a surprise that cyber risks are of increasing concern to PII insurers.

2.9.2 Excluding cyber crime

Firm behaviour and premiums

Excluding cyber-crime from PII cover would lead to a reduction in premiums for firms considered at risk from such crime. Insurers are split on the likely reduction in premiums with some suggesting it would be only 0-5% and others suggesting it could be as much as 10%. However, such a reduction in premiums would come at the expense of a reduction in cover.

Some firms will choose to purchase separate cyber policies even without a regulatory requirement. For example, some firms may want to protect themselves from cyber risks particularly with a view to forthcoming European regulation which will require certain data breaches to be notified even if these do not cause subsequent detriment to clients that might give rise to a PII claim. In comparison to a generic PII policy, specialist cyber policies would be more targeted around cyber-specific issues and provide clear incentives for risk management processes in line with Principle 8 (risk management). These policies may also provide more support in remedying any cyber weaknesses that are revealed through the claims process which may help risk management over the longer-term also in line with Principle 8.

[63] Cybersecurity issues central as experts agree firms should view them as a serious business risk, SRA news release, April 2017.

[64] Authorised push payments are where the customer instructs the bank to transfer money from their account to another account. These are distinct from unauthorised payments where the customer did not give consent to the payment and from pull payments where the receiver of the money sends the instruction to the bank (such as with direct debits).

[65] Cyber insurance underwriting risk, CP39/16, PRA, November 2016 and Cyber Underwriting Risk CEO letter, PRA, November 2016.

For firms that purchase cyber policies, the total cost of premiums for both the cyber policy and PII will depend on the coverage within the cyber policy. Cyber policies will cover some risks to firms that do not give rise to client claims (not currently covered by PII) but other terms and conditions in cyber policies will not be in line with the non-standard components of the MTC. Competition from specialist cyber insurers could also lead to lower premiums than otherwise.

Other firms will not purchase separate cyber policies unless compelled to do so either because they have a greater risk tolerance or because they are unable to demonstrate robust internal processes to insurers at what the firm considers to be a reasonable price. These firms would be better off due to the lower premiums despite the reduction in cover. However, among these firms will be some whose greater risk tolerance simply reflects a lack of concern for, or lack of knowledge of, the risks they and their clients face from cyber-crime. Firms that subsequently faced a cyber-crime claim would have to make payments out of internal resources increasing the risk of insolvency in line with Principle 8 (polluter pays).

Insurer behaviour

Currently, because cyber risk has emerged relatively recently, insurers may not yet have gathered much data to be able to understand all of the drivers of risk (as suggested by the PRA). They may also not yet have identified appropriate risk management strategies to help to reduce the likelihood of solicitors falling prey to cyber-crime attacks.

If insurers under-price this risk, this may cause PII to no longer be profitable. Since insurers believe that many cyber claims are of large value when they occur, a small number of claims might generate a loss for insurers. However, over time, insurers will send price signals to firms so those that invest in risk management will receive more favourable prices than those that do not. These beneficial incentives would be lost if cyber-crime cover was removed from PII policies altogether and consumer protection left to the CF.

If separate cyber policies are required, specialist insurers may enter to develop such products. Cyber policies generally are likely to have applicability to a wider set of firms than just legal services firms and therefore specialist cyber insurers would be able to gain from the expertise they gather from other sectors. This may bring more innovative, flexible and targeted cyber products to the market. PII insurers, many of whom would be expected to offer cyber policies as well, may well chose to offer cyber policies as an extension to the PII policy; indeed they would have an advantage in doing so since much of the information needed to write PII will also be applicable in writing cyber policies.

However, it is unclear whether small firms will be able to obtain insurance for cyber risks in a standalone policy since it is not clear whether selling such policies will be profitable for specialist insurers at a reasonable level of premiums.

Client protection

Excluding cyber-crime from PII cover would leave clients at risk in the event of suffering harm from such crimes which is against Principle 1 (proper compensation), unless similar cover is required through specialist cyber policies. The very fact that these crimes, especially in relation to

conveyancing transactions, can cause large sums of money to be defrauded from consumers means that the risk to an individual or family of the loss of such money is particularly damaging. Consumers are also likely to face associated distress due to failing to complete their house purchase. As such it is not reasonable to leave these consumers unprotected.

If separate policies are not required, the SRA could provide protection for consumers through access to the CF although non-consumer clients would be unprotected. Relying on the CF rather than insurers to cover this risk means that valuable incentives for risk management are lost against Principle 8 (risk management) because, unlike insurers, the CF is unable to assess whether firms are taking appropriate steps to mitigate cyber-crime.

If firms are compelled to seek separate cyber policies in addition to PII then client protection could be maintained at the current level, but only if there was an equivalent to the MTC.[66] Otherwise, firms could choose any excess on a cyber policy and choose not to obtain run off cover for cyber-crime without any regard for the consequences for clients.

In addition, PII is clearly aimed at protecting end clients and any consequential impacts on them whereas it is not clear whether cyber policies would cover such consequences for end clients. Similarly, PII insurer claims processes are set up to deal with the end clients and not just the insured firm whereas again this is not necessarily the case for insurers offering cyber policies hence there is a risk to client protection in conflict with Principle 1 (proper compensation).

Further, from the perspective of client protection, there is no particular reason to treat cyber-crime differently to other risks that might lead to fraud or negligence giving rise to a claim by clients. Differentiating by underlying cause creates uncertainty for clients and from their perspective the underlying cause is irrelevant to the fact that they have faced detriment.

Regulatory behaviour

There are steps that can be taken to lessen the likelihood of cyber-crime emerging. For example, the SRA, TLS and insurers can share information regarding the nature of different types of threats and good practice to avoid them. The SRA has already started to publicise information surrounding cyber risks and has highlighted the importance of having unambiguous procedures in place when clients notify them of a change in banking details during a transaction. Similarly, simple steps from firms could include sending bank account details in the terms of business letter at the start of the process, and advising clients that firms will not alter their bank details during the course of a transaction.

Alternative approaches could be explored in a wider review of conveyancing including the impact of any confirmation of payee processes and/or a single client account for all conveyancing transactions which could be pre-installed into the payment options of banks thereby reducing the ability to alter the account to which money flows.

Summary

[66] An alternative approach of allowing cyber-crime to be excluded from the PII policy if a separate cyber policy is in place would also leave clients unprotected from the non-standard components of the MTC.

The overall impact on consumer risks depends on the proportion of firms who would take out specialist cyber policies if not compelled to do so. Those with cyber policies would face good incentives for appropriate risk management (Principle 8). However, the protection for clients from cyber policies may not be as great as within PII policies (against Principle 1) unless they too are subjected to MTC requirements. Further, the underlying cause is irrelevant to clients who suffer detriment.

2.10 Misrepresentation

Currently, insurers are not able to avoid insurance on any grounds including in relation to misrepresentation. Insurers are able to seek reimbursement of these claims from firms in certain circumstances. The Insurance Act 2015 includes a new duty for non-consumer insurance contracts requiring the insured to make a fair presentation of the risk.[67] If there is a deliberate or reckless misrepresentation (which is for the insurer to prove), the insurer may avoid the contract, refuse all claims and need not return the premium paid. This section considers allowing avoidance of cover for deliberate or reckless misrepresentation, bringing the MTC in line with the Insurance Act 2015.[68]

There is limited information available regarding the extent of misrepresentation that currently occurs. Of those who provided information in the insurer survey, most suggested that there were currently only a handful or a small, stable number of cases.[69] Common issues regarding misrepresentation were in relation to: past claims or circumstances; disciplinary actions; proportion of work done in different areas; value of fee income; and outside business interests.

Previous research has suggested that misrepresentation of whether firms provide conveyancing arises particularly for firms that conduct only a small amount of conveyancing. Hence an alternative approach to conveyancing (see section 2.4) may partly help to address misrepresentation as well.

Firm behaviour and premiums

Currently, firms who misrepresent their business pay a lower premium than they would otherwise pay but do not face the full consequences of their misrepresentation since insurers still have to pay out for any claims which is against Principle 8 (polluter pays).

If insurers can avoid cover then firms that continue to deliberately misrepresent information, would have to pay claims itself which in line with Principle 8 (polluter pays). This could lead the misrepresenting firm into insolvency which, assuming it was a low quality firm, would have a positive effect on the average quality of the profession in line with Principle 4 (encouraging an effective legal profession).

[67] See Insurance Act 2015 at http://www.legislation.gov.uk/ukpga/2015/4/pdfs/ukpga_20150004_en.pdf. See Paragraph 3(1), 8(6) and Schedule 1, Part 1 Paragraph 2.

[68] Similar arguments to those set out in this section also apply for other aspects of misrepresentation which have been changed in the Insurance Act, namely where misrepresentation is not deliberate or reckless but where the insurer would not have provided cover, would have applied different terms or would have charged a higher premium.

[69] Respondents were asked which of the following best represents their view on the current incidence of fraudulent or reckless non-disclosure in firms' proposal forms: a handful of cases; a small, stable number; a small, growing number; a small reducing number or a systematic problem.

Insurers avoiding cover would also increase the incentive to make a fair presentation of risks and if this means information becomes truthfully revealed, some firms will face higher, risk-reflective, prices and stronger incentives to improve risk management or to move away from providing higher risk activities which is also in line with Principle 8 (polluter pays).[70]

The majority of firms who are already providing accurate information will see a small reduction in premiums reflecting the removal of current cross subsidies towards firms that misrepresented information. Insurers have suggested a range of responses regarding the impact on overall premiums from 0-5% to 10% although the latter seems optimistic given that most insurers simultaneously indicate that misrepresentation currently applies in only a small number of claims. Although most firms would gain through lower insurance premiums, they may have to pay higher contributions to the CF if the latter paid out for consumers whose law firms misrepresented information and had insufficient resources to pay the claims. If the costs of dealing with claims is the same for the CF as for PII, on average the decrease in PII premiums would be greater than the increase in CF contributions because both misrepresenting firms and non-CF eligible clients would bear greater risk than today.

Client protection

The change would, however, introduce a risk for clients where a firm's internal resources are insufficient to meet the claims and so clients do not receive the full value of their claim. Clients are in a worse position to chase this reimbursement compared to insurers who will do so on a more frequent basis and from a position of greater information about the process. In addition, clients would be delayed in receiving redress if they have to wait until the claims process and misrepresentation determination has concluded, while insurers have to wait for this anyway. The SRA could maintain consumer protection through allowing access to the CF for claims related to misrepresentation.

Non-consumer clients would be unprotected and most of them would not be in a position to check for misrepresentation since they cannot assess whether firms accurately provide information to insurers. Hence even the sophisticated client who checks that PII is in place at an appropriate level of cover is at risk in this situation in conflict with Principle 6 (unintended consequences). It is possible that some such clients might change the firms that they are willing to deal with because of this.

Insurer behaviour

The fact that insurers remain on risk despite misrepresentation means that insurers will aim to discover any misrepresentation in advance of deciding whether or not to insure a firm. Any misrepresentation identified by insurers will likely lead them to not insure firms - which itself

[70] Firms currently minded to misrepresent information where they would otherwise not be able to get insurance cover (as opposed to paying a higher price) are unlikely to fairly represent the information – rather they would continue to misrepresent and run the subsequent risk of insolvency in the event of a claim.

encourages firms to provide accurate information where failure to do so can be discovered.[71] By contrast, if insurers can decline claims they will be less concerned about misrepresentation.[72]

Insurers can seek reimbursement from firms who misrepresent information but only if all directors of a company or all members of an LLP commit or condone the misrepresentation. Insurers may currently choose not to seek reimbursement if the firm has limited resources available or if proving all principals condoned the act is unlikely and insurers may not always be reimbursed the full claim value. With a change in rules, if insurers prove misrepresentation then they would avoid paying out *any* of the claim value. Hence it would be expected that insurers would seek to argue that a greater proportion of cases involve misrepresentation than they currently do, with the claims then flowing to the CF or non-consumer clients being unprotected.[73]

An alternative approach would be to remove the requirement that *all* directors or members of an LLP must have condoned the misrepresentation for insurers to be able to seek reimbursement. Insurers would still have to pay the claim to clients maintaining current client protection in line with Principle 1 (proper compensation). Misrepresenting firms would bear greater consequences of their actions in line with Principle 8 (polluter pays) and could lead to insolvency potentially increasing the quality of the profession in line with Principle 4 (encouraging an effective legal profession). The fact that insurers would not be reimbursed in the event of insolvency would mean they would maintain an incentive to identify misrepresentation in advance.

In addition, insurer evidence on misrepresentation could be used to trigger SRA enforcement and intervention also leading to the firm's exclusion from the market if this was deemed appropriate (although this could also be done under the current MTC).

Summary

If firms are responsible for reckless misrepresentation then they would face the cost of claims (in line with Principle 8) including potentially increasing insolvency risks and improving the average quality of law firms (Principle 4). Consumer protection could be retained through the CF but non-CF-eligible clients would be unprotected and some may take steps to avoid this risk by changing the firms they deal with (against Principle 6). Insurers would have less incentive to seek out misrepresentation in advance (against Principle 8) and more incentive to argue misrepresentation in future, potentially increasing costs for the CF even further.

Alternatively, allowing insurers to seek reimbursement from firms for *all* cases of reckless misrepresentation would maintain client protection, cause misrepresenting firms to face the

[71] Insurers generally consider that that misrepresentation is indicative of other problems at the firm and therefore would not offer insurance rather than charge higher premiums.

[72] Insurers will still be concerned about misrepresentation because if it is indicative of other problems this reveals the firm to be risky and insurers will also face costs associated with proving misrepresentation and declining claims.

[73] The Insurance Act 2015 places the onus on insurers to prove that the insured had deliberately misrepresented information and so it would be for the courts to determine the decisions. If the firm has closed or become insolvent, the firm may not defend the charge of misrepresentation which may also give rise to a greater risk of claims flowing to the CF even when there has not in fact been deliberate misrepresentation.

consequence of this, and also maintain insurer incentives to identify misrepresentation in advance since they would not be reimbursed if the firm became insolvent.

The SRA may be able to reduce misrepresentation by greater regulatory penalties under all of the alternatives including under the current rules. Misrepresentation is also linked to conveyancing again indicating the importance of a review in that area.

2.11 Extend exclusions for dishonesty

Currently the MTC requires that dishonesty must be covered wherever there is an innocent principal in the firm but dishonesty can be excluded where all principals have committed or condoned the dishonesty. If there is an innocent principal then claims would be covered by PII whereas if all principals are dishonest then claims would be paid by the CF. This section considers extending the exclusion for dishonesty such that dishonesty would not need to be covered by the MTC.

Information is available from the claims data which suggests that around £95 million or 5% of total claims may be associated to fraud and dishonesty. Of this, £52 million or 56% of fraud and dishonesty claims are linked to conveyancing transactions. This is likely to reflect the simple fact that conveyancing transactions involve large sums of money flowing into client accounts. Again it highlights the relative riskiness of conveyancing transactions, not only with respect to poor advice but in connection with fraud and dishonesty. Hence an alternative approach to conveyancing may help to partly address fraud and dishonesty as well (see section 2.4). Other areas associated to high values of fraud are: lettings and property (£11 million or 12% of fraud) and Trusts and Executry (£6 million or 6% of fraud).

Firm behaviour

Currently, if an individual principal is honest, they will be protected from fraud committed by other principals. However, there is a concern that individuals do not pay sufficient attention to the acts of others within the same firm because they know they will be protected through PII. Principals within a firm are in the best position to be able to take measures to prevent dishonesty or to observe it quickly within their own firm. Excluding the cover for innocent principals would sharpen the incentive for them to pay attention to potential risks from dishonesty and make them less likely to ignore any suspicions that they had regarding the actions of other principals. If other principals have a greater incentive to act in relation to suspicions then this would be expected to reduce the opportunity for fraud to be committed. This could reduce the incentive to be dishonest if individuals think that it increases the likelihood of being caught or changes the likely penalty when caught.

Firms with dishonest staff would be liable to pay for any claims related to dishonesty and this could lead to insolvency. Since remaining principals may have failed in regard to their regulatory duties surrounding systems and controls, this would be consistent with Principle 8 (polluter pays) and could improve the quality of law firms in line with Principle 4 (effective legal profession).

Instead, separate insurance products may become more widely available to protect firms from the dishonest acts of some. These would be tailored to the nature of the risks of particular firms and would likely encourage particular systems and controls that would minimise risks of dishonesty. In

addition, if fraud commonly relates to client accounts, firms would have increased incentives to control these accounts properly and may also seek alternative approaches to client money such as using third party accounts.

Price signals from these policies would encourage risk management behaviour (Principle 8) but would only be applicable to firms that sought the additional insurance whereas currently price signals can be sent to all firms through PII. It is also unclear whether standalone fiduciary policies would be available for small firms at costs which are not prohibitive due to adverse selection risks (i.e. small firms that take out fiduciary insurance may be those who have good reason to be particularly suspicious about one or more principals).

Insurer behaviour and premiums

Insurers would remain unlikely to cover firms where proposal forms or other sources of information indicated fraud or dishonesty since such information may be indicative of other failings at the firm.

Insurers would be expected to identify more cases of dishonesty since proving dishonesty of one principal would be sufficient to avoid the claim whereas currently insurers must show all principals are dishonest. This would also reduce the costs of proving dishonesty for insurers. Since the cost of fraud would be shifted onto dishonest firms as well as clients or the CF, premiums would fall with insurers suggesting a range of responses from 0-5% to 10% if dishonesty can be excluded – the former is consistent with the current proportion of claims linked to dishonesty, but as noted more claims may be linked to dishonesty under this options. The benefit of this would particularly accrue to firms with honest staff but who are currently unable to demonstrate this to insurers.

This would, however, also remove the incentive of PII insurers to give price signals to all firms to encourage the use of systems and controls that could limit the impact of dishonesty and fraud (against the aims of Principle 8).

Some insurers could choose to continue to include cover for fraud and dishonesty in their PII policies in order to gain market share by offering wider product terms than the MTC. However, since top up cover beyond £5 million typically excludes fraud and dishonesty insurers are unlikely to compete to provide this aspect of product terms within PII.

As with misrepresentation, an alternative approach would be to remove the requirement that *all* principals must have condoned the dishonesty for insurers to be able to seek reimbursement. Insurers would still have to pay the claim to clients, maintaining current client protection in line with Principle 1 (proper compensation). Dishonest firms would bear greater consequences of failures of systems and controls in line with Principle 8 (polluter pays) and this could lead to insolvency potentially increasing the quality of the profession in line with Principle 4 (encouraging an effective legal profession). Since insurers would not be reimbursed in the event of insolvency they would maintain an incentive to encourage processes that limit the opportunities for dishonesty.

Client protection

If dishonesty was excluded from the MTC then clients would be at risk if firms are unable to pay the claims from internal resources. If consumer claims were covered by the CF, this would clearly raise the cost of the CF although only to the degree that sums were not recoverable from the fraudulent firm. Since the CF has regulatory backing, the CF should be in as good a position as insurers to recover funds from the dishonest firm. Consumers, however, would be delayed in receiving redress due to waiting for both the claims process and the CF process to be completed.

At the same time, however, far more cases would be expected to come to the CF than are currently considered to result from dishonesty since insurers have every incentive to show dishonesty of one principal in order to avoid the claim.

Non-consumer clients would be unprotected in conflict with Principle 6 (unintended consequences). As with misrepresentation, many of these clients are in a weak position to be able to assess whether their firm is at risk of fraud or dishonesty.

Regulatory behaviour

Historically, little information on dishonesty has been provided to the SRA by insurers as they had little confidence of regulatory action in response although this has changed recently. Greater regulatory penalties could be imposed on individuals who conduct fraud both by seeking redress from them and also though banning them from the profession. More robust action by the SRA is also likely to encourage insurers to provide swift information regarding dishonesty in line with Principle 7 (supporting regulatory supervision). In addition, if stronger regulatory action was taken in respect of the firms at which dishonest principals work, then this would also improve incentives for good risk management and reduce the extent to which principals are willing to turn a blind eye to poor behaviour of other principals supporting Principle 8 (risk management). It should be recognised that the SRA could take more robust action in response to insurer information without changing the PII requirements. However, it is possible that institutional incentives for the SRA to take action might be greater if the SRA observed the higher costs through the CF.

Summary

Increasing the cost on individuals who are dishonest should reduce the incentive to commit dishonest acts. Making it clear that insurers and firms can seek redress from individuals who are dishonest can help with this. Similarly, stronger regulatory action should also aid this including banning individuals from the profession. Such actions can be taken irrespective of whether the MTC is changed with respect to dishonesty.

If exclusions for dishonesty are allowed, this reduces the incentive to turn a blind eye to the action of other principals (Principle 8) and implies that firms would face greater consequences of internal failings (Principle 8) potentially increasing the quality of firms (Principle 4). Firms could seek alternative insurance to fill this gap, although, it is unclear whether such insurance would be available at a reasonable price for small firms.

Consumer protection could be retained through the CF but non-CF-eligible clients would be unprotected and may take steps to avoid this risk by changing the firms they deal with (against

Principle 6). Insurers also have a role to play which the CF can not, which is to provide price mechanisms through PII to encourage the use of processes and systems that are likely to reduce fraud particularly with reference to the client account and this role would be lost (against Principle 8). They would also be expected to argue that more cases involve dishonesty.

As with misrepresentation, if insurers were allowed to seek reimbursement from firms for all cases of dishonesty this would sharpen beneficial incentives on firms and maintain client protection.

Finally, as with many other issues, it appears as though fraud is also particularly linked to conveyancing transactions, once again strengthening the need to review the overall approach to conveyancing.

2.12 Information sharing

The data that insurers have shared with the SRA has been extremely important in helping the SRA to understand the nature of PII claims across the whole market and in assessing the possible impacts of changes in this report. Regular liaison meetings between insurers and the SRA also provide an opportunity to share information about emerging risks across the whole market (such as cyber-crime). It is clear, however, that there would be value in sharing more information in relation to individual firms.

As noted in previous sections, in the past the SRA has considered poor behaviour by firms in relation to certain aspects of PII to represent simply commercial disputes between firms and insurers. As such, the SRA has taken little action in response to any information they have been sent and therefore insurers have sent the SRA little information. However, information from insurers about individual firms is likely to be of use for the SRA, particularly information on: failure to pay the excess; failure to pay run-off premiums; misrepresentation; and dishonesty. While some cases may reflect genuine commercial disputes between firms and insurers, these issues may also be linked to wider regulatory failings in the firm indicating financial instability or poor systems and controls.

Combined with other information that the SRA holds or has access to, poor practice by firms in connection with PII can feed into the SRA's wider supervisory approach and help them to target the use of their regulatory resources towards those firms most likely to cause harm (Principle 7). This does not imply that the SRA would necessarily take action in respect of each firm that insurers identify, but if the SRA is seen to act on the information in general this will give insurers greater confidence that it is worth communicating it.