Solicitors Regulation Authority

# Consultation: Professional Indemnity Insurance

## Proportionate regulation: changes to minimum compulsory professional indemnity cover

May 2014

## Summary of our proposals

- **Reduce the level of mandatory PI cover to £500,000**
- **Introduce an aggregate limit on claims**
- **Require compulsory cover for claims by individuals, small and medium-sized enterprises, trusts and charities**[1]
- **Reduce run off cover to a minimum of three years**
- **Require firms to assess the level of cover appropriate to their firm beyond the minimum**

1. These proposals are designed to ensure that regulation is proportionate and targeted. They should assist small law firms in providing the right level of protection to their clients without incurring additional expense that drives up their costs and thus prices to consumers. The proposals will assist consumers in as much they ensure that firms have the right level of cover for the work undertaken and provide greater choice to empowered and informed consumers in achieving the level of cover that they wish to have. Overall these measures are designed to reduce costs for legal services providers and consumers. It is important to bear in mind that they relate to compulsory cover. There is nothing to prevent firms choosing to obtain higher or broader levels of cover or indeed for clients, particularly commercial clients, to agree their requirements with the law firm of their choice.

## Background

2. We have been reviewing the compensation arrangements and how they fit within our overall regulatory approach. Changes have been made to the Assigned Risk Pool (ARP) and other elements of client protection in recent years. We will continue to review the minimum terms of insurance cover and other aspects of client protection as we seek to ensure that our regulatory approach is proportionate. We have launched a consultation on changes to the Compensation Fund alongside this consultation. Each of these consultations decisions stands on its own merits.

3. Professional indemnity insurance (PII) is widely recognised as an important protector of consumer and public interests. While the cover directly protects solicitors and law firms (regulated by the SRA) from the cost of claims against them, there are clear benefits to consumers. It provides consumers with greater certainty that any loss incurred (within the scope of the insurance) will be paid without reliance upon the solicitor, or the firm, neither of which may have assets to pay damages.

[1] The European Recommendation 2003/361/EC of 6 May 2003 categorises a micro enterprise with having a turnover of not more than €2 million. We consider that it is appropriate to convert the reference to £2m sterling for ease and certainty.

4. However, as with any regulatory intervention of this nature, PII is not free of cost for solicitors, firms, or consequently, consumers. Thus, the requirement for PII has both costs and benefits for consumers. The setting of the minimum terms and levels of that insurance has to be balanced to achieve the optimum benefit for consumers and the public. If the protection is very weak (or not in place at all) then consumers should benefit from lower costs but some consumers would face detriment including irrecoverable losses. Conversely, if the cover is very high then few, if any, consumers will face losses, but all consumers will pay higher prices and some consumers will be excluded from the legal market entirely because of the cost of legal services.

5. Competitive forces also provide some driver towards appropriate consumer protection. Solicitors hold themselves out within the legal market against unregulated competitors as meeting professional standards and this can include having appropriate PII cover. We know that this has some force in the legal market because many firms choose to take cover beyond the minimum required level either to protect themselves against claims, to provide confidence to their own clients or to set themselves apart within the market. Add to this the fact that, in any market for credence goods or services (i.e. those goods or services that the consumer cannot judge the quality of even after receiving them), consumer and public confidence in the market is likely to be increased by targeted regulation, and the challenge to balance the costs and benefits of any particular level or extent of cover of PII becomes clear. Regulation does not usually seek to offer absolute protection to all consumers – the cost would be prohibitive of preventing any harm and it would in any event be an impossible task. Our current client protection regime goes some way to offering redress to all consumers but it is arguable that the cost is too high – a cost that is paid by those consumers that access services and those that cannot afford the cost of doing so in different ways. The challenge for us as a regulator is to take account of the current context and strike the right balance.

6. In designing the level and extent of compulsory PII cover as set out in this consultation paper, we have had due regard to the regulatory objectives set out in the Legal Services Act 2007 and to the better regulation principles.[2] We will conduct an impact analysis as part of reaching any final decision post consultation.

## Where should the minimum compulsory cover for any one and aggregate claims be set?

7. The Handbook currently requires firms to obtain a compulsory professional indemnity insurance cover of £2m (£3 million for incorporated firms). This level of

[2] Five principles were identified by the Better Regulation Task Force in 1997 as the basic tests of whether any regulation is fit for purpose. *Proportionality* (Regulators should intervene only when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.) *Accountability* (Regulators should be able to justify decisions and be subject to public scrutiny.) *Consistency* (Government rules and standards must be joined up and implemented fairly.) *Transparency* (Regulators should be open, and keep regulations simple and user-friendly.) *Targeting* (Regulation should be focused on the problem and minimise side effects.)

cover is a minimum requirement and is not dependent on the type of clients the firm has; the legal work it does; risk posed or a firm's claims history. Many firms add layers of cover above this level as they assess their exposure and potential risks.

8. However for many firms, for example sole practitioners with low turnover or say £100k - £250k per annum, coupled with low levels of transactions being undertaken, this level of compulsory cover may be above what is really needed.

9. In 2010 Charles River Associates (CRA), commissioned by the SRA, in their report "Review of SRA client financial protection arrangements"[3] estimated that the average value of claims is between £40,000 and £60,000, with exception of conveyancing claims averaging between £60,000 and £180,000[4]. In addition, analysis of data from the Solicitors Indemnity Fund (SIF) for 1988-1999 shows that majority of claims (98%) were below £500,000, with only 2%[5] of claims being above that figure. CRA in its report considered links between number of PC holders and number of claims. The number of claims rose by about 10% between sole practitioners and 2-partner firms, falling by about 5% for 3-4 partner firms while increasing again for firms with more than 5 partners.

10. Given that many firms buy additional protection for themselves above the minimum terms and levels where necessary, we should ask what level of minimum cover should be required by the regulator. The Law Society, in its practice note on PII cover, says *"the total amount of PII you need will depend on your firm's size and exposure to risks. You should seek advice from your broker and/or insurer to ensure that you have a sufficient level of cover for your firm."*

11. We do not consider, as some recent commentators have suggested[6], that PII cover should be optional so we are proposing that all firms should have minimum compulsory cover, albeit at a lower level than previously required. Our proposal is therefore a middle ground between the most cost reductive option and the current very high level of protection. We will continue to keep the level of cover under review as we consider other aspects of the minimum terms to ensure that we have the right balance. This may lead to further reductions for the very smallest firms in the future.

**Proposal 1** - **We propose that the compulsory cover will be reduced to £500,000 for any one claim, for all firms and that no distinction will be made between different types of firms.**

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[3] Charles River Associates, September 2010, http://www.sra.org.uk/sra/how-we-work/reports/cra-financial-protection-arrangements.page

[4] Calculations based on Solicitors Indemnity Fund (SIF) data, as the last consolidated data set available for solicitors market. Data not restated to present day values.

[5] Data not restated to present day values

[6] http://www.lawgazette.co.uk/analysis/comment-and-opinion/is-it-time-to-scrap-mandatory-pii/5040701.article

12. The existing compulsory limit contains no cap on insurers' ultimate exposure during the period of insurance. This means that any number of claims may need to be paid, creating an unpredictable sideways exposure for insurers. This is often said to be a cost driver – one that is ultimately paid by consumers. The only measure insurers can rely upon is the aggregation clause in the Minimum Terms and Conditions (MTC) used to define Any One Claim. The application of the "aggregation" language depends on the specific facts of each claim and can provide uncertainty as to ultimate liability. This may have deterred some insurers from entering the market.

13. We believe that the introduction of a cap on insurers' total exposure would have a beneficial impact when compared to that currently, particularly if combined with a reduction in the limit for any one claim to £500,000 as above. We are interested in views on the appropriate level of a cap. Possibilities include a requirement of three cases at the maximum of £500,000 each, making the aggregate cap, for all claims, of £1,500,000 could be appropriate. We are mindful however that losses can occur to multiple clients because of a practitioner's disorganisation or incompetence. A cap of £5m may be more appropriate There may also be a need to make the definition of "any one claim" to be reviewed to apply a more predictable cap at say £5m than an unpredictable one based on argument about the meaning of, for example, "one series of related acts or omissions".[7] It may be that the balance is to apply a clear cap at £5m or some other figure but reduce or remove the ability for insurers to add claims together as "one claim" ("aggregation") to take advantage of the maximum payable for one claim. Given that there is currently no financially defined cap, we invite comments on the level at which one should now be set at either of these two levels or a different value.

**Proposal 2 – We propose an introduction of a cap on insurers' ultimate exposure through a new aggregation limit.**

14. We considered reducing the aggregation limit to a total exposure of £1,000,000 but concluded that this was too big a step to make at this stage, particularly since several consumers could suffer substantial losses individually under £500,000 but cumulatively adding up to a multi-million pound sum. Moving from cover limited by reference to debatable methods of aggregating claims will mean uncertainty as to whether all consumers will have their claims met because of exhaustion of the limits from earlier settlements. Consumers may need to seek alternative redress, such as proceedings against negligent practitioners directly. We would be particularly interested in evidence of the risk, or lack of risk, to consumers by providing for a cap.

15. Setting the aggregate limit at a level of say £1,500,000 will alleviate some of these instances; a higher limit of £5,000,000 will alleviate more. However we do acknowledge that there is a risk to consumers at any level. There is of course an implied risk even under the unlimited sideways cover because of the viability of insurance firms, and complexities arising from how claims are currently aggregated. Any change to the aggregation limit could be a significant reduction in cover, but our assessment of claim levels and frequency mean that we consider that this is a proportionate move that will support the right balance between consumer protection and lower costs of regulation. We will expect and if

[7] See the current definition of "one claim" in clause 2.5 of the Minimum Terms and Conditions.

necessary require firms that deal with cases or transactions carrying higher risk (such as clinical negligence, catastrophic personal injury or probate) to obtain levels of cover appropriate to provide reasonable protection for consumers.

16. We have considered if these two proposals are likely to disproportionately impact upon vulnerable consumers, BME consumers or any other group. We do not have quantative evidence with which to make this analysis. Our preliminary assessment is that the poorest third of the population are less likely to be involved in expensive transactions such as house purchase or probate and thus less likely to be affected by limits on cover, although there may be some risk arising from the aggregation cap where there is multiple failure by a firm. This combined with the analysis of claims as set out above means that we do not at this stage have serious concerns about the impact of these changes being negative for the more vulnerable consumers, and we would welcome evidence in consultation responses.

17. In our view it is appropriate to consider the impact of the requirement to have PII at the level of cover set out rather than simply to look at the change in level proposed. So our key question is the extent to which the level set out above can be justified with reference to our regulatory objectives and the better regulation principles. In our provisional view and allied with a competitive market and strong adherence to the professional principles, it will strike the right balance between consumer protection, access to justice and public confidence in lawyers and the legal market.

18. Indeed, given that we consider these changes will reduce the cost of PII (at least to some degree) we see potential, if marginal, benefits for poorer consumers through increased access to the legal market at lower cost. These are tentative assessments and we would welcome views, evidence and analysis that will allow us to conduct an impact assessment when considering the results of this consultation.

## Who should firms be required to protect via professional indemnity insurance?

19. Currently every client can, in effect, assert a claim on the firm's professional indemnity insurance. However entities regulated by the SRA serve a wide range of clients, from individual consumers to financial institutions and government agencies. These consumers are not all empowered to the same extent in their choice of service provider. Nor do they possess the same amount of knowledge and confidence to engage with a firm to put things right if they are unhappy with an aspect of the service received. Large commercial service users are better able to protect their interests and make a commercial decision on the use of legal services and the risks involved.

20. It is generally accepted[8] that most individual clients of legal services providers are likely to have significantly less information than the providers. In most cases the customer will face an informational disadvantage compared to the lawyer which means that they may be unable to assess the quality of services which they receive.

[8] Charles River Associates, September 2010

21. The extent to which clients suffer from asymmetric information varies by type of client – individual vs corporate. Linked to the potential risk is the ability of different clients to understand this risk and protect themselves. It is common to offer less protection for corporate clients who have the resources and capabilities to assess quality and are often repeat purchasers of services who can also make their own insurance arrangements. In contrast, individual consumers will usually require greater protection. For example the Law Society of Ireland has certain restriction on commercial conveyancing and in some cases involving financial institutions, while Financial Advisors can exclude specific lines of business (though this may present its own challenges), subject to additional capital being held and for ICAEW misrepresentation leads to avoidance of claims.

22. Whether or not compulsory cover requirements should be restricted to certain clients is not a new issue. The SRA consulted on a proposal to exclude financial institutions from the compulsory indemnity cover in 2011[9]. Most respondents to the 2011 consultation did not support this proposal, citing mainly conveyancing related issues and potential problems in obtaining insurance for the excluded activity, without the compulsory prescription from the SRA. However, in our response, we noted that while financial institutions were perhaps understandably against the proposal:

> "Among those who favoured the ability to exclude cover for financial institutions, respondents typically highlighted that the exclusion would be fair as financial institutions are able to look after themselves. Some respondents stated that this would lower the cost of insurance for firms that did not work for financial institutions. …
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> Insurers were generally in favour of the proposal arguing that additional flexibility of cover would be beneficial and financial institutions do not need regulatory protection. They noted that the benefits would be seen in better management of the next financial downturn rather than in the immediate aftermath of the recent downturn. Some insurers noted that if they were unwilling to offer financial institution cover to a firm, they thought it unlikely they would be willing to offer the more reduced cover.
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> Insurers indicated their willingness to offer cover for financial institutions. Some insurers indicated that the cover could have different terms associated to it compared to the rest of the MTC. Many highlighted the need to address the underlying regulatory issues to do with conveyancing."

23. We believe that limiting the compulsory cover to individuals, small enterprises and charities will allow for more flexibility and lower cost of insurance, especially for firms providing services only to this group. We also believe that corporate institutions are able to look after themselves as they do not suffer from significant information asymmetry when dealing with whether or not they want insurance cover and if so how to structure it. There is of course nothing to prevent any lawyer or firm to purchase the level and extent of cover that they consider is right for them and their clients.

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[9] Future client financial protection arrangements – report on consultation responses and SRA conclusions, April 2011: http://www.sra.org.uk/documents/SRA/consultations/financial-protection-consultation-analysis-responses.page

**Proposal 3 – We propose that the compulsory professional indemnity cover be limited to:**

- **individuals;**
- **small and medium-sized enterprises –businesses with a turnover not exceeding £2 million[10];**
- **a charity with annual income less than £2 million; and**
- **a trustee of a trust with a net asset value less than £2 million.**

24. This proposal mirrors (though is not dependent upon) a similar consultation issued in relation to the Compensation Fund and is consistent with the Legal Ombudsman.

25. The change proposed here will focus protection on the least sophisticated consumers. That is consistent with the better regulation principles and our regulatory objectives. It will promote competition by reducing costs and providing firms with a choice as to the level of cover provided to consumers outside of the minimum requirements. It will protect the consumer and public interest by upholding confidence in the legal profession and focusing mandatory protection on those consumers that require it the most. A full impact assessment will be completed as a part of any final decision making and we are particularly interested in any views, evidence or analysis that will support that impact assessment.

## Should the SRA set the requirement for run-off cover at three years?

26. Professional indemnity insurance for law firms we regulate is on the 'claims made' basis. Claims do not necessarily arise immediately after the service has been delivered but rather are revealed over time. It is therefore important that insurance is in place even after a firm has closed. However, the period required for cover must be unlimited if a guarantee of no consumer detriment is to be upheld.

27. When closing down, firms are required to obtain cover for 6 years, at the cost of 2 to 3 times their annual level of premium. This is a significant cost to firms and therefore to consumers. It does not provide cover beyond six years and we know that claims can and do continue for many years, especially in relation to wills and house purchase.[11] Claims are however concentrated in the initial years after closure.

[10] The European Recommendation 2003/361/EC of 6 May 2003 categorises a micro enterprise with having a turnover of not more than €2 million. We consider that it is appropriate to covert the reference to £ sterling.

[11] At present cover beyond six years is provided by the Solicitors Indemnity Fund (SIF) out of 'spare capital' built up prior to the ending of SIF. That cover beyond 6 years is currently scheduled to end in 2020.

28. CRA analysed run-off data from the Assigned Risk Pool (ARP) and identified that a large proportion of claims (60%[12]) are made within the first three years after the firm's closure. In following years number of claims decline, however there is a clear 'tail off' which in many cases lasts into the foreseeable future.

29. There is variation in run-off cover requirements posed by other regulators in England as well as legal regulators in other countries. For example Law Society of Ireland requires 2 years run-off cover, the same as ICAEW. On the other hand the Council for Licensed Conveyancers and the Royal Institution of Chartered Surveyors require 6 years run-off cover. It should be remembered that the reduction of run off cover would not reduce the liability of the solicitor or firm and firms, again, can choose to purchase more cover if they wish to do so. Clients can ask what insurance cover the firm has.

**Proposal 4** – **We propose to set the requirement for compulsory run-off cover to 3 years. The amount of run-off available will be limited by the compulsory cover amount and re-instatement** (as described in Proposals 1 and 2).

30. This proposal would make business from law firms significantly more attractive to insurers, therefore encouraging new entrants and increasing competition in the market and potentially lowering prices for consumers. It will not prevent firms from offering higher levels of protection (even beyond the six year period) as part of a competitive offer to attract consumers where that may be appropriate such as with regard to long run matters in wills and conveyancing. We will undertake a full impact analysis as with other proposals and welcome evidence, analysis and views to support this.

## How will clients be protected if the cover and run-off are reduced?

31. As mentioned earlier, many law firms choose to obtain cover beyond that specified in the minimum terms. This is usually because of the particular nature of the firms work and clients and is of course based on their own risk assessment. The net effect of the above proposals is to increase the scope for law firms that we regulate to take responsibility at a lower level than they currently do. It is a natural step for our model of regulation to allow more firms to assess risks themselves in order to achieve the right level of consumer protection. That allows regulatory interventions to be focused at the required level to achieve basic or minimum protections. A strong and independent legal profession, upholding the public interest and adhering to strong ethical requirements will want to ensure that wherever the minimum terms are set they have appropriate levels of cover for their firm with its practice and consumer base.

32. Our final proposal is therefore to introduce a new requirement that each firm assess the level of PII cover that is appropriate for its work. In undertaking this

[12] This figure is heavily influenced by conveyancing claims, coming from firms that were unable to obtain an open market insurance and therefore entered ARP and relates to claims made in 2008/09 which may be particularly affected by the timing of the property crash.

assessment it will need to consider not only its current practice but also any practice that was in place previously. Where we find that the firm's has not properly carried out its own assessment or it is insufficient, we may require the firm by regulatory action to take appropriate steps such as to obtain further cover or otherwise reduce the risk to clients.

33. It is already the case that if a firm has previously undertaken large amounts of high value conveyancing and private client work valued at several million per transaction (that it covered with an additional layer of non-compulsory PII cover) stops work it remains liable at that higher level of potential claim even if it now moves into lower value work. That is not changed by these proposals but it is made more common.

34. On implementing these changes it is recognised that a group of consumers (specifically but not exclusively those with potential claims over £500,000 and those cases between 3 and 6 years old) could face a change in cover. Indeed, a client may have checked at the time work was done that the firm had suitable cover and would have been told of the minimum level (and indeed any additional layer). Whether any particular firm has consumers that fall into this category will depend upon their own past work and client pattern. It will be a matter for each firm to assess if they need cover for that past period that is different to the current level. And of course no change in cover affects the individual's or firm's responsibility in law.

35. We are not suggesting that the minimum terms must be replicated at a higher level if the potential for claims is higher. It will be a matter for each firm reasonably and properly their clients' needs and to assess how they want to be positioned within the legal market.

**Proposal 5 - we propose to change the Handbook to include an outcome that ensures that firms assess the need for and purchase cover beyond the minimum cover specified.**

**Current outcome** - Code of Conduct, Chapter 1 (client care) is:

- *clients* have the benefit of your *compulsory professional indemnity insurance* and you do not exclude or attempt to exclude liability below the minimum level of cover required by the *SRA Indemnity Insurance Rules*;

**Proposed additional outcome:**

- *You* assess and purchase the level of 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 the client may make.

36. We would particularly welcome any evidence or analysis about how firms could implement such an outcome, and how they assess and manage their own requirement for additional layers of insurance at present.

## Proposals

**Proposal 1** - We propose that the compulsory cover will be reduced to £500,000 for each claim, for all firms and that no distinction will be made between different types of firms.

**Proposal 2** - We propose an introduction of a cap on insurers' ultimate exposure through a new aggregation limit.

**Proposal 3** – We propose that the compulsory professional indemnity cover be limited to:

- individuals;
- small and medium-sized enterprises –a business with a turnover not exceeding £2 million[13];
- a charity with annual income less than £2 million; and
- a trustee of a trust with a net asset value less than £2 million.

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**Proposal 4** – We propose to set the requirement for compulsory run-off cover to 3 years. The amount of run-off available will be limited by the compulsory cover amount and re-instatement (as described in Proposals 1 and 2).

**Proposal 5** – we propose to change the Handbook to include an outcome that ensures that firms assess the need for and purchase cover beyond the minimum cover specified.

## Impact of our proposal

37. A purist principles/OFR approach to PII would be to require firms to have PII which provides protection to their clients and which is appropriate in the context of their business, clients and type and value of work undertaken. Then, firms *could* make proportionate decisions and be held to account by us for those decisions.

38. We expect that the impact will vary depending on the current and past type of work carried out by firms, size of firm and claims history. While some firms may see their cost or effort to obtain insurance increasing, others will see an opposite trend.

39. These proposals are intended to encourage insurers to enter the market and provide competition. In the long term we anticipate the overall cost of insurance to fall and therefore costs to consumers be reduced.

40. Considering all these variations we estimate that the net effect of these changes will be positive on the profession and consumers. We will monitor these trends annually through the Law Society survey.

[13] The European Recommendation 2003/361/EC of 6 May 2003 categorises a micro enterprise with having a turnover of not more than €2 million. We consider that it is appropriate to covert the reference to £ sterling.

## Consultation questions

1. Do you agree with reducing the compulsory cover to £500,000?
2. Do you agree with introducing a cap on insurers' liability?
3. Do you think any such cap should be £1,500,000, £5,000,000 or another figure?
4. Do you agree that the introduction of a cap should be balanced by reducing the opportunity for claims to be added together to treat them as "one claim"?
5. Do you agree with limiting the compulsory cover requirements to individuals, small enterprises, charities and trusts?
6. Do you agree with reducing the run-off cover to 3 years?
7. Do you agree with the proposed changes to Code of Conduct Outcome?
8. Do you have any views about our assessment of the impact of these changes?
9. Are there any impacts, available data or evidence that we should consider in finalising our impact assessment?
10. Are there any other aspects of the minimum terms and conditions for PII that you think we should review?

## How to respond to this consultation

**Online**

Use our online consultation questionnaire—https://forms.sra.org.uk/s3/consult-pii

— to compose and submit your response. (You can save a partial response online and complete it later.)

**Email**

Please send your response to consultation@sra.org.uk. You can download and attach a consultation questionnaire.

Please ensure that:

- you add the title "PII – Reducing MTC" in the subject field,
- you identify yourself and state on whose behalf you are responding (unless you are responding anonymously),
- you attach a completed About You form,
- you state clearly if you wish us to treat any part or aspect of your response as confidential.

If it is not possible to email your response, hard-copy responses may be sent to:

Solicitors Regulation Authority
Policy and Strategy Unit – Professional Indemnity Insurance
The Cube
199 Wharfside Street,
Birmingham,

B1 1RN

**Deadline**

Please send your response by 18 June 2014.

**Confidentiality**

A list of respondents and their responses may be published by the SRA after the closing date. Please express clearly if you do not wish your name and/or response to be published. Though we may not publish all individual responses, it is SRA policy to comply with all Freedom of Information requests.