



The Law Society

Solicitors' professional indemnity insurance and the Assigned Risks Pool

The Law Society's alternative approach

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supporting
solicitors

Contents

Introduction	3
Alternative approach	3
Extended Renewal Period (ERP)	4
Notice Period	4
ERP premium	5
Circumstances of fraud or fraudulent misrepresentation/non-disclosure on the proposal form.....	6
Transitional arrangements.....	6
Benefits of the alternative approach	7
Glossary	9

Introduction

1. The Law Society of England and Wales (TLS) has responded to the Solicitors Regulatory Authority (SRA)'s consultation on Future Client Financial Protection Arrangements which proposed potentially widespread changes to solicitors' professional indemnity insurance (PII) and the assigned risks pool (ARP). Our full response is available at: <http://www.lawsociety.org.uk/influencinglaw/policyinresponse/view=article.law?DOCUMENTID=434733>.
2. This short paper sets out an alternative approach to the SRA's proposals on the ARP.

Alternative approach

3. TLS has developed an alternative approach to one aspect of the SRA's proposals contained in their consultation on client financial protection arrangements. This approach may be thought to better balance the interests of all stakeholders while, as a minimum, maintaining existing levels of client protection consistent with regulation in the public interest. We believe that this approach benefits from the fact that it can be implemented in October 2011 with appropriate transitional arrangements which could well avoid the possible unintended consequences of the SRA's two-stage approach, which increases the uncertainty surrounding the ARP. Uncertainty in the market will rebound to the disadvantage of solicitors.
4. The alternative approach makes PII more attractive to insurers in order to provide certainty and market stability in a manner that is consistent with the regulatory objectives in the LSA and in a way that will benefit the profession by creating conditions for a more competitive market. The centrepiece of the alternative approach addresses one of the main complaints of insurers; the fact that insurers are currently responsible for the pooled liability of firms in the ARP that they have never chosen to insure and, in some cases, refused to insure. In recent years, the cost and poor regulation of the ARP has been a factor in insurers' decisions to exit the market or reduce market share and also operates as a deterrent to new insurers looking to enter the solicitors' PII market.
5. TLS recognises that if the SRA decides to adopt this alternative approach, close consideration will have to be given to the details and the drafting, particularly, surrounding the transitional arrangements. We have outlined a broad concept that we consider to be sufficiently flexible to allow for changes in the detail.

Extended Renewal Period (ERP)

6. TLS considers that the ARP should cease its role as an insurer of firms who are unable to obtain insurance and thereafter gradually shut down and run-off those firms in the ARP. The transitional arrangements are outlined below. As an alternative safety net, firms must be given an extended renewal period (ERP) by their current insurer in which to either obtain insurance elsewhere or plan for orderly merger, succession or shut-down. The ERP is a minimum period of three months from the expiry of the existing insurance contract. The current ARP will have to be run-off and maintained (in some form) to continue in its role of providing cover for uninsured firms (i.e. 'the Motor Insurer's Bureau role'), but would otherwise be closed to new entry. As an essential precondition of this reform, we regard a need for better regulation and regulatory control by the SRA to minimise the number of firms practising without insurance and failing to pay premiums. We are not persuaded that identifying the firms without insurance at the end of a renewal period is technically difficult.

Notice Period

7. An insurer must be required to give reasonable notice of its decision not to renew insurance for a firm. TLS considers that another precondition of reform should be the availability of a minimum period for firms to consider quotations and maximum processing times for insurers when responding to insurance proposals. Insurers would, in the usual course of events, be required to provide six months notice from the later of either the date of an unequivocal notice of an insurers' intention not to renew a policy (this does not mean an information request on an incomplete proposal form) or, in the case of economic declinature, refusal or expiry of a final quotation from the existing insurer (the 'notice period'). This six month notice period can, but does not have to, be provided concurrently with the ERP. This would mean that an insured firm would have six months notice that their existing insurer was not prepared to renew cover and a transparent process to obtain responses and quote from alternative providers. This is consistent with the SRA's proposal to reduce the ARP from twelve to six months as it provides the same opportunity for rehabilitation. Consistent with the public interest regulatory objective, TLS considers that there needs to be a minimum three month period from the expiry of their existing policy to ensure orderly closure in the event that alternative insurance or succession is not an option.
8. For example, if the notice period is triggered three months before the end of the policy then the insurer's obligation to provide six month notice can include the three months of cover provided under the ERP. Where the notice period is triggered less than three months before the end of the policy, the ERP will need to be extended to ensure that six months notice is provided from the commencement of the notice period. Where the notice period is triggered in advance of three months prior to the end of a policy, the ERP will be the minimum three months because the six month notice requirement will have been satisfied by the early commencement of the notice period. This approach guarantees that firms will, in general, have six

months in which to obtain quotes from other insurers and consider their options. TLS notes that, as a qualifying insurer (QI), the ARP would have to provide firms currently in the ARP with a similar extended renewal period and that this is reflected in the transitional arrangements.

9. As a condition of the QIA, the insurer should notify the SRA at the commencement of the ERP. This will enable the SRA to commence monitoring the firm with the view to approving a detailed action plan in the event that it does not obtain insurance on the open market. Further regulatory action by the SRA may be required.
10. The details of this notice period require careful consideration and scenario testing to avoid any unintended consequences. TLS also recognises that there will have to be subsequent amendments to the Rules to include reporting obligations on insureds and insurers to notify the previous insurer in the event that alternative cover has been secured. TLS notes that it is ultimately for the SRA to determine who should retain the risk/benefit of the various scenarios. For example, it is open for the SRA to determine that if an Insurer is unable to provide a quotation due to delay on the part of the insured in submitting a completed proposal form, then it would be appropriate to deem that the insured has waived all or a proportion of the notice period to which it is entitled. However, we consider that a minimum ERP is required in the public interest by providing a safety net to allow for orderly closure. This is in contrast to the SRA's proposal for 2012 which will remove the safety net role of the ARP without providing an alternative mechanism for orderly closure.

ERP premium

11. Insurers will be able to charge an ERP premium that is pro-rata of the insured's existing annual policy premium but otherwise the insurer will be in the same position regarding liability to provide insurance¹ and run-off cover. In terms of non-payment of premiums, TLS considers that there are avenues available to insurers to adequately protect themselves and that no regulatory intervention is required. Thus, this approach maintains the current levels of public protection and the ability of insurers to collect premiums.
12. If the alternative approach is adopted then temporary cover will no longer be required to be provided by the ARP. If the firm obtains alternative insurance during the ERP, then the ERP policy with their existing insurer would be terminated by agreement at the point of inception of the new market policy and any pro-rata balance in ERP premium for the unexpired policy period would be returned to the insured.

¹ TLS proposes that the provisions relating to insolvent insurers and successor practice rules should remain unchanged.

Circumstances of fraud or fraudulent misrepresentation/non-disclosure on the proposal form

13. In general, TLS considers that non-payment of premiums, material non-disclosure, misrepresentation and fraud are serious regulatory and disciplinary issues that should be dealt with through better regulation by the SRA and risk management by firms. To ensure client protection, these events must remain covered by the MTC. However, in recognition of the fact that insurers will not be able to, in effect, transfer firms into the ARP, the alternative approach allows insurers to immediately place an insured in the ERP if fraud, misrepresentation or material non-disclosure (with an exception for honest mistakes) is discovered in relation to a proposal form. TLS notes that in order to ensure client protection and promote orderly closure, insurers will remain liable for the provision of the minimum three month ERP and run-off cover for these firms (n.b. this is another circumstance in which it would not be appropriate for the insured to benefit from a six month notice period). Insurers should retain the right to claim any outstanding premium notwithstanding the early end of the policy.
14. As an alternative to prematurely ending the policy, insurers should have the ability to adjust premiums to place them in the position that they would have been in but for the misrepresentation or material non-disclosure. In the event of a dispute, this premium adjustment should be determined by an independent arbitrator and the dispute resolution clause in the MTC should be amended accordingly.
15. These amendments only relate to circumstances arising from the proposal form. TLS does not propose any changes to the fraud provisions of the MTC or their interaction with the Compensation Fund.

Transitional arrangements

16. TLS recognises that this alternative approach will require changes to the QIA, MTC and Solicitors Indemnity Insurance Rules (Rules). Variation of these instruments is provided for under clause 5 of the QIA. Unless there are exceptional circumstances, at least two months notice must be provided; any changes will have to take effect as of 1 October 2011; and any changes must be made to all agreements with QIs and Run-Off Insurers.
17. In the event that the SRA does not consider that there is sufficiently 'exceptional' circumstances to warrant variation of the current regime to introduce the ERP prior to the 2011/12 Indemnity Period, TLS proposes the following arrangements for a transitional ARP. The transitional ARP will provide an ARP Policy to firms that must expire by 31 December 2011; firms in the ARP will be provided with a three month ERP that will end on 31 March 2012. This effectively closes off the ARP to new entry as firms will be ineligible to apply for the ARP after 31 December 2011 and provides these firms with a six month 'notice period'. Importantly, in order to remove pooled liability in the transitional ARP, clauses 5 and 6 of Schedule 1 of the QIA will be amended to provide that individual insurers will be liable for

firms that they previously insured (as at 30 September 2011) that were transferred to the ARP after 1 October 2011.

Benefits of the alternative approach

18. The alternative approach ensures that the pooled liability for the ARP is gradually reduced as existing insurers will provide PII cover for a reasonable period for a firm to obtain market insurance or consider other options.
19. TLS notes that the alternative approach is consistent with the SRA's characterisation of its role of setting the regulatory boundary by specifying the minimum PII requirements without managing insurance-of-last resort arrangements. It also aligns with the SRA's preference for removing unnecessary regulation and cross-subsidies because, instead of mandating insurer participation in the assigned risks pool, insurers will be responsible only for the risks that they write, effectively introducing the concept of 'polluter pays'. It also ensures that the current level of client protection is maintained and provides a safety net mechanism for orderly closure, consistent with the LSA's public interest objective.
20. This change will effectively 'close-off' the ARP to future risks and its current risks will diminish over time. It will make pooled ARP liability more certain for insurers and should eventually reduce premiums and encourage new market entrants by removing the ARP component currently included in all firms' premiums (estimated between 15%-20% for the 2010/11 renewal). TLS notes that the charge for the minimum ERP period — three months as a pro-rata proportion of the annual premium — would, in most cases, be less than the equivalent 27.5% of turnover that ARP currently charges. Additionally, a firm moving back to the market after one month in the ARP, is entitled to an 80% rebate (i.e. it costs 20% of the ARP Premium); under the ERP system, the charge is only equivalent to 8.5% (i.e. 1/12 of the annual premium. Given that insurers' obligation to provide run-off cover for insured firms is mandatory; the ERP will mean that the majority of run-off cover (and eventually all run-off cover) will be provided by individual insurers and not the ARP.
21. Under the alternative approach, insurers will only be liable for the risks of firms they have actually written; removing liability for pooled risks that they did not insure in the first place. This gives insurers an incentive to write risks in contrast to the current situation where ARP uncertainty exposes insurers to risks of others and provides a perverse incentive for insurers to limit market share. Removing the ARP's role of providing insurance means that insurers will no longer be able to transfer firms into the ARP but will remain liable for firms; therefore, it reduces the perverse incentive on insurers not to report firms to the SRA.
22. The alternative approach contains significant benefits for insurers by addressing one of their main complaints, the ARP. This should create a more predictable and stable PII market and encourage new entrants, creating competition and the incentive to write risks, reducing premiums for

the profession. As such, the alternative approach is consistent with the better regulation principles and regulatory objectives in the LSA. It will also remove the SRA's concern about the 'relative disadvantage' created by certain pricing methodologies (such as 'flipping' and infill policies) that are employed by some insurers to minimise their share of declared premium in order to limit their ARP exposure.

23. We have conducted an equality impact assessment (EIA) on our proposals. The EIA concludes that compared to the SRA's 2011 proposal, the alternative approach, will have a neutral equality impact on black and ethnic minority (BME) firms, sole practitioners, female practitioners and small firms. In terms of the SRA's 2012 proposal, the alternative approach may result in benefits for these firms by retaining some form of safety net.

Glossary

The **Law Society** of England and Wales (TLS) is the representative body of over 140,000 solicitors qualified in England and Wales. TLS negotiates on behalf of the profession and makes representations to regulators and government in both the domestic and European arena.

Solicitors Regulation Authority (SRA) is the independent regulatory body of the Law Society that regulates solicitors in England and Wales.

Professional indemnity insurance (PII) is insurance that covers civil liability claims arising from the work of a solicitor, which most commonly involve professional negligence. PII is a compulsory requirement to practise as a solicitor.

Qualifying Insurers - The Solicitors Regulation Authority does not regulate, vet or approve insurers. In order to be eligible to be a Qualifying Insurer an insurer must be an "authorised insurer" as defined by section 87(1A) of the Solicitors Act 1974. "Authorised insurers" are regulated by the Financial Services Authority.

Qualifying insurers have signed a **qualifying insurers' agreement** (QIA). The QIA is a contract that is entered into each year between each Qualifying Insurer and the SRA. It requires Qualifying Insurers to offer a minimum level of cover as set out in the **Minimum Terms and Conditions** (MTC). This minimum level of cover applies regardless of the actual wording of the policies issued. See: <http://www.sra.org.uk/solicitors/code-of-conduct/professional-indemnity/minimum-terms-conditions.page>

Run-off cover – as part of the minimum terms and conditions, insurers must provide a firm with six years 'run-off' cover on cessation of their practice. Run-off premium is typically between 2-3 times a firm's annual premium.

Fraud, material non-disclosure or misrepresentation – it is usual practice that failure to disclose material facts or fraud in the information provided as part of an insurance proposal voids the insurance policy. However, because the goal of compulsory PII is client protection, the MTC policy prevents insurers from avoiding or repudiating the policy on these grounds, although insurers retain recourse to the firm.

Assigned Risks Pool (ARP) provides cover for firms which cannot get cover from qualifying insurers or cannot reasonably afford the terms available to them. The cover is underwritten by the qualifying insurers in the same proportion as their share of the premium income from compulsory cover for the indemnity period in question. Currently, firms may apply to be insured through the ARP for a maximum of 12 months in any five-year period. If a firm is unable to obtain cover with a qualifying insurer in the open market by the end of the 12-month period, the firm will have to cease practice.