Consultation response

SRA: Changes to minimum compulsory PII cover

Overview

1. **The Panel's core challenge is to find the right balance between access to justice and consumer protection. Our position is that both too much as well as too little regulation can harm consumers and we seek to find the right amount to enable consumers to truly benefit from open and fair markets. Unnecessary restrictions hold back innovation and increase the price of legal services, but we also know that regulation gives consumers the confidence to engage effectively in markets. Each issue requires individual careful judgement.**
2. **The consultation documents contains insufficient evidence that reducing PII cover would lead to equivalent gains for consumers in terms of lower prices, greater choice, and wider access. There are other changes the SRA could make which might make a bigger difference to premiums, for example around client accounts which are a high risk area.**
3. **We oppose the proposal to lower the level of compulsory cover to £500,000 for any one claim. There are weaknesses in the current evidence base, concerns that the proposals would not reduce prices for consumers, and research suggests consumers would not shop around and make sure their lawyer had a higher level of PII cover if needed.**
4. **We see risks to consumers in allowing an aggregation limit on insurance claims because where very large aggregated losses arise there is a possibility that individual claims may not be met. Losses could arise from systematic fraudulent or negligent activity in a firm.**
5. **Reducing run-off would mean solicitors offer less protection to consumers than that required by other regulators, and would make the SRA limit different to the Legal Ombudsman limits for accepting cases. Greater divergence is not likely to be in the consumer interest. Additionally, more work needs to be done to establish exactly when it is that claims start to tail off before setting an arbitrary period to end run-off cover.**
6. **We are content with proposals 3 and 5. However, we would like to see greater engagement with the consumer interest when thinking about potential impacts, as well as more concrete plans on how to monitor effects on consumers in practice, if and when any changes are implemented.**

The proposals

7. The SRA is consulting on proposals to reduce the level of professional indemnity insurance (PII) which law firms must hold. The proposed changes are intended to reduce costs for firms, with a subsequent impact on the prices consumers pay for legal advice. The proposals should also mean that law firms purchase the level of cover which is right for them rather than having to buy a high blanket level of cover no matter how high or low risk the work they do is. This consultation is one in a suite of proposals relating to financial protection arrangements which the SRA is currently consulting on.

8. There are five main proposals:

- Reducing the level of mandatory professional indemnity insurance cover to £500,000
- Introducing a cap or limit on the amount insurers have to pay out when claims are aggregated
- Limiting compulsory PII cover to individuals, small businesses and charities, and trustees of a trust with a net asset value of less than £2 million
- Reducing the minimum amount of run-off cover from six years to three
- Requiring firms to assess and put in place an appropriate level of cover beyond the minimum where needed

The Panel's response

9. What we want to achieve as a result of this consultation exercise, is:

- The right balance between access to justice and consumer protection
- Comprehensive coverage of risks
- Better and more transparent data used to judge risks and evaluate the operation of the system
- Consumers are aware of any instances where they are not covered
- SRA policy takes account of consumer behaviour

10. The Panel's core challenge is to find the right balance between access to justice and consumer protection. We recognise that both too much as well as too little regulation can harm consumers and seek to find the right amount to enable consumers to truly benefit from open and fair markets. We recognise unnecessary restrictions hold back innovation and increase the price of legal services, but we also know that regulation gives consumers the confidence to engage effectively in markets. Each issue requires individual careful judgement.

11. Last year, the Panel published a think-piece on the appropriate level of risk consumers should be expected to bear.[1] It touches on some fundamental and difficult questions that regulators must grapple with: how much freedom of choice consumers should have, what steps it is fair to ask consumers to take to protect themselves, what obligations providers should have towards consumers and what regulatory protections should overlay all this. Our response to this consultation draws on this document and on consumer research we commissioned around financial protection arrangements.[2]

12. In order for the Panel to support the proposals, we would need to see evidence that they would have the net benefits for consumers which the consultation claims, e.g. lower prices, redistributive effects and increased competition in the insurer market. However, the consultation document is light on data and relies too much on arguments which can be challenged. At present we are not convinced that loosening regulations in the area of financial protection would lead to equivalent gains for consumers.

13. Finally, we believe there are other changes the SRA could make which will make a much bigger difference to PII premiums. One thing we pointed out in our report on *Financial Protection Arrangements*, for example, is that reducing the frequency of solicitors holding client money could help to reduce PII premiums since client accounts are seen as a particularly high risk area. Escrow accounts could be something to explore for instance.

Proposal 1: Reduction in compulsory cover

14. The Panel is opposed to the proposal to lower the level of compulsory cover to £500,000 for any one claim. We see logic in some of the arguments put forward by the SRA but for us to support a decision of this magnitude, with the transfer of risk from firms to consumers which it would involve, we would need to be convinced there would be at least commensurate benefit for consumers. Currently there are weaknesses in the evidence base, concerns that the proposals would not reduce prices for consumers, and research suggesting consumers are unlikely to shop around and make sure their lawyer had a higher level of PII cover if needed.

15. The SRA estimates are largely based on data from the Solicitors' Indemnity Fund (SIF) which is at best 15 years out of date and at worst over 25 years old. The majority of claims relate to conveyancing; since property values have increased significantly since then it is difficult to justify relying on these historic figures to work out what the minimum cover amount should be today. Insurers should be able to provide data on the median and average value of claims, in particular those claims which arise in the highest risk areas of law as assessed by the value and frequency of claims. Insurers could also say the extent to which minimum cover amounts drive the price of premiums relative to other factors such as the legal activity and claims history, for example.

16. We note that other respondents to the consultation also have raised doubts about whether the proposed changes will lead to the hoped for lower prices, ultimately resulting in greater choice and wider access for consumers. The Council for Mortgage Lenders has raised concerns that the proposals could lead to higher levels of separate representation, which will actually cause additional costs for consumers due to replication of work. Insurance brokers have warned that the proposals are unlikely to lead to a reduction in premiums. Tackling the frequency and high cost level of conveyancing claims, they suggest, would be a better way to reduce premiums.

17. Lenders may well insist that conveyancers buy top up cover, or lawyers will do so in order to protect themselves – either way,

the total cover amount may not change very much in reality. Furthermore, if the SRA is correct that only a tiny minority of claims currently exceed £500,000, this suggests the vast majority of exposure to insurers currently falls within this bracket and premiums will continue to reflect this.

18. In order to lead to cheaper prices for consumers the decrease in PII premiums would need to be combined with strong competition between law firms. However, a recent study by the Legal Services Board concludes there is limited evidence of competitive pressures driving firms to adapt to service areas of unmet consumer need, and thus facilitating greater access to justice. [3]

19. In short, should the savings to consumers not materialise as a result of the proposed changes, consumers would lose current protections but without gaining anything. Risk would be transferred to consumers at marginal or no benefit – this would not be a fair or desirable outcome.

20. The SRA state the proposals should provide greater choice for those consumers who are empowered and informed to achieve the level of cover they desire. However, we think this is unlikely to happen in practice. Financial protections in legal services are a very particular area, where consumers suffer strongly from behavioural biases. Our research on *Risk and the Role of Regulation*[4] showed consumers across the spectrum expect that when they use a lawyer they will be protected if something goes wrong. They do not think about checking to see if protection is in place, they simply assume it will be. Furthermore, there are a number of risks which consumers do not consider at all, such as fraudulent activity by a lawyer, meaning they are not able to make empowered choices in this context.

21. When faced with the option of paying lower premiums and having greater choice in the level of protection provided, the consumers questioned in the research were happy to pay for the protections provided and did not want to see these taken away. They rejected the idea of having to buy their own insurance, and were uncomfortable with the idea of having to check whether their lawyer had adequate indemnity insurance or not. The research concluded that few consumers would feel able to make informed decisions or shop around for the most appropriate level of protection. Both respondents deemed as 'risk averse' and those identified as 'risk accepting' saw legal services as a special case, dealing with life changing events, and wanted to see protections maintained.[5]

22. Our qualitative research provides a robust indication of how consumers approach financial protection in legal services. We are not aware of further research having been undertaken to test the current proposals, and so are perplexed by the argument that empowered consumers desire more choice in the context of their lawyer's professional indemnity insurance.

23. If, on the other hand, the SRA was to go ahead with the proposed changes, it would be very important to impose an information duty on lawyers. This would mean lawyers would have to make it very clear to consumers when their insurance cover was

not high enough to cover the consumer's assets, and should be done before work was started (where possible) to allow the consumer to switch to a lawyer with a higher level of cover if they wanted to. Where information was not provided, or not provided in a clear and noticeable way, any shortfall where a problem did materialise should fall on the compensation fund (where the sum exceeds the maximum that can be awarded by the Legal Ombudsman).

Proposal 2: Introduction of a cap on insurers' ultimate exposure by introducing an aggregation limit

24. Coupled with the initial proposal, the SRA suggest a cap on insurers' sideways exposure by setting an aggregation limit. The current limit for any one claim is £2 million, but there is no limit to how many claims an insurer may have to pay over the period of insurance. Insurers complain they are unable to predict how much they could ultimately have to pay out.

25. The case of *Godiva Mortgage Ltd v Travelers Insurance Company*, previously highlighted in our report on *Financial Protection Arrangements*, illustrates the possible risk that consumers could be left out of pocket due to the use of caps on claim aggregation. The case concerns a partner at a law firm who was involved in a number of allegedly fraudulent property transactions. When the losses came to light numerous claims were brought against the firm, including by the claimant, Godiva, a lender. The law firm has gone into liquidation and cannot meet the claims. The insurer asserts that all the activities from the partner's involvement in alleged fraudulent activity can be aggregated as one claim and therefore capped at £2 million. However, the total losses in the case could exceed £50 million in reality.

26. The risk to consumers is that where very large losses such as this arise there is a possibility that individual claims may not be met. Losses could arise from systematic fraudulent or negligent activity in a firm. Should the compensation fund become liable for such a high number of claims, it is likely the SRA would have to levy law firms and this could ultimately be passed on to consumers in the form of higher charges, or, in the worst of circumstances, the fund might be unable to cover all the losses.

27. The Law Society and the SRA have been given permission to intervene in the case by the High Court. The case was due to be heard in the first half of 2014 but is now listed for November 2014. The outcome is likely to provide clarification on how an insurer may (or may not) interpret the current definition of 'any one claim'.

Proposal 3: Limits to PII cover

28. We are content with the limits to professional indemnity cover suggested in proposal 3. As we said in our response to the SRA consultation on *The introduction of an eligibility criteria for the compensation fund*, the Consumer Panel itself has a remit to represent the interests of wide range of consumers but we prioritise those consumers who are less able to give voice to their own interests. Indeed our 2013 publication on *Financial Protection Arrangements* explicitly focused on individual consumers, small businesses and

small charities. This was because we recognised that large corporate buyers are better able to assess risks and suffer less from the information asymmetries present for smaller consumers in the legal services market. Larger buyers may also have the market power to demand changes to standard terms where these do not provide them with adequate protection.

Proposal 4: Changes to compulsory run-off cover

29. Proposal 4 suggests reducing the required amount of run-off cover from 6 years to 3 years. We note that reducing run-off would mean solicitors offer less protection to consumers than that required by the Bar Standards Board, the Council for Licensed Conveyancers and ILEX Professional Standards in this respect. The proposal is also likely to affect notaries, a high proportion of whom work in solicitors firms and are covered by solicitors' PII. In addition it will mean the SRA limit is different to the Legal Ombudsman limits for accepting cases, which are currently six years (or three years after discovery). It will give slightly longer cover than that required by ICAEW, however. Greater divergence in terms of the protections offered by different types of lawyer contributes to a confusing market for consumers, rather than truly giving them a choice between different levels of protection. While we do not argue for consistency for consistency's sake and recognise the need for regulators to innovate, the overall regulatory framework should be rational; the LSB has a role to deliver this and avoid a race to the bottom.

30. Data shows that about 60% of claims are made within three years, meaning 40% of claims are made more than three years after the alleged error or omission. Some of the claims made after three years will also be made after more than the six years currently mandated. The SRA correctly say that run-off cover would need to be unlimited to ensure no consumer detriment, and this is of course impractical. However, the Panel believe more work needs to be done to establish exactly when it is that claims start to significantly tail off.

31. The data referenced above, which has been used by the SRA, the Law Society and the Panel in our 2013 report is the only data currently available, and dates from 2008/2009. But as the SRA recognises, it is skewed by the number of conveyancing claims, which were made against firms which had entered the Assigned Risks Pool (ARP), and which may also have been affected by the timing of the property crash. Therefore further collection and analysis of data should better establish the period during which consumers are most at risk and may need to make a claim. Once this has been established it will be possible to define the best balance between the level of cover needed and the level of consumer protection required.

Proposal 5: firms to assess the need for cover beyond the minimum level

32. We support the proposal to require firms to assess the need for cover which goes beyond the minimum specified, and to purchase this cover where need is identified. It is important that firms undertake their own risk assessment and

ensure that they hold the level of cover they need in relation to the risks their business raises. This requirement should apply whatever level the minimum cover is set at.

Monitoring the impact of any changes

33. Finally, the SRA state they expect the net effect of the proposed changes to be positive for both providers and consumers. They plan to monitor trends through the Law Society survey in order to track the effects. However, this survey (we assume the reference is to the annual Law Society reports on PII and associated survey) does not incorporate consumer views, only those of providers. Therefore we are concerned that the SRA does not intend to monitor the impact these changes, if made, might have on consumers. We would like to see greater engagement with the consumer interest when thinking about the potential impact on consumers, as well as more concrete plans on how to monitor any effects on consumers in practice, if and when any changes are implemented.

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[1] Legal Services Consumer Panel, *Risk and responsibility*, June 2013.
[2] Vanilla Research, *Risk and the Role of Regulation*, January 2013.
3 Legal Services Board, *Changes in competition in different legal markets*, October 2013.
[4] Vanilla Research, *Risk and the Role of Regulation*, January 2013.
[5] Ibid.