Solicitors Regulation Authority

Consultation on the introduction of a minimum financial strength rating requirement for Participating Insurers

1. Introduction

Purpose of this consultation

1.1 The purpose of this consultation is to seek views on the proposed introduction of a minimum financial strength rating requirement in the 'B's as part of the criteria for an insurer to become a Participating Insurer for the purposes of our compulsory client financial protection arrangements. The proposal is our response to problems that have been created for consumers and firms as a consequence of unrated insurers getting into financial difficulties.

Background rationale

1.2 The requirement that law firms hold qualifying insurance helps to protect their clients in the event of financial loss caused by negligence, dishonesty and insolvency of the law firm. While our main concern is that qualifying insurance is there to protect clients, it is law firms that choose the provider of the qualifying insurance. We are concerned that a number of the unrated insurers that have entrered the market have not provided sufficiently robust insurance coverage for the purpose of protecting clients. The evidence below shows that a number of these insurers have exited the insurance market suddenly which has been disruptive and detrimental for both clients and law firms. Further, in most cases this unplanned exit was directly linked to their poor underwriting of risk within the solicitors professional indemnity insurance (PII) market. However, it should also be noted that a number of other unrated insurers here operated effectively.

1.3 In the past five years, 15 insurers have exited the market for solicitors' professional indemnity insurance out of a total pool of 37. Of these, 11 were rated and four unrated. There is no material difference between the rate of attrition of rated as against unrated insurers (39% as against 37.5%). What is notable is that the exit by unrated insurers is far more likely to be "unplanned" and related to financial difficulties compared to exit by rated insurers. In the past five years, there have been two regulatory interventions and two insolvencies amongst Participating Insurers. All related to unrated insurers.

1.4 In the 2009/10 indemnity period, Quinn (an unrated EEA insurer based in Ireland) was insuring 2900 firms (approximately 30% of all firms) when in April 2010 it went into administration under Irish insurance law. At that point it was unclear how consumers would be protected but eventually the Irish Insurance Compensation Fund provided a degree of protection to consumers.

1.5 Lemma was a Gibraltar based unrated EEA insurer that provided cover to 590 firms prior to the 2011/12 indemnity period. In the 2011/12 indemnity period it

insured only one firm. On the last day of that period Lemma was the subject of an insolvency event. This has affected those firms previously insured with Lemma who had made claims or notified circumstance to Lemma. The liquidator also obtained a Disclaimer which effectively prevents any further claims under policies issued by Lemma. This affects the clients of those firms that were being provided with run-off cover. Gibraltar does not have any compensation arrangements so consumers would have to rely on the UK's Financial Services Compensation Scheme (FSCS).

1.6 Balva is an unrated EEA insurer based in Latvia. In the 2011/12 indemnity period it entered the market for solicitors qualifying insurance fronted by the unrated Icelandic insurer European Risks Insurance Company (ERIC) as Balva did not have the necessary passport at that time. In the 2012/13 indemnity period Balva insured approximately 1500 firms. In March 2013 the Latvia regulator placed a restriction on Balva preventing it writing any new policies or renewing any existing policies in the UK. Balva is now in the process of being wound up.

1.7 Berliner is based in Germany and is an unrated EEA insurer. An intermediary in the UK made arrangements to cancel Balva policies mid-term to be replaced by policies of qualifying insurance provided by Berliner. As a consequence of action taken by the German regulator Berliner decided not to be involved in the market for solicitors PII. This has caused law firms considerable confusion and uncertainty as to who they were insured by and whether Berliner policies issued for 2013/14 were valid.

1.8 Certain common themes have been evident in relation to the difficulties experienced with Quinn, Lemma, Balva and Berliner each of which was unrated. Whilst the following list of events did not apply in every instance, across the board contributing factors may have included one or more of the following:

- No financial strength rating
- No prior experience in writing solicitors PII either in England and Wales or elsewhere.
- Little evidence of engagement with the Home State regulator regarding entry into the solicitor's field
- Passported into the UK to write business based on Home State regulation.
- Limited financial resources to deal with any adverse outcomes.
- Outsourcing of the underwriting and administration of the business, and in some cases through a complex chain of authority.
- Reliance on reinsurance to meet its obligations.
- The underwriting of solicitors business in England and Wales threatening the insurer's survival.
- Apparent lack of engagement with Home State regulator on ambitious plans to grow the business by entering the solicitors market.
- An absence of reliable data on which to base either a decision to enter the market or properly price the business or drive risk selection.
- The need to be particularly price competitive given their unrated nature to achieve market share especially when they first enter the market.
- A question as to whether there was a proper alignment of interests between the insurer and the outsourcing agent.
- Achieved significant market share based upon ambitious growth targets.

1.9 From the consumers' perspective although solicitors PII is primarily for their benefit, they have no control over the choice of insurer. If a firm's insurer fails then this can mean that clients with claims are left to seek redress from the firm.

The effect on clients is that they are subject to distress and inconvenience and are either left to pursue claims with overseas compensation arrangements or else to claim against the FSCS. The FSCS provides a degree of protection to clients of some firms but we have had examples of situations where large claims have not been covered by any insurance or compensation arrangements as a consequence of the failure of an unrated insurer.

1.10 The current arrangements leave the market vulnerable to further large scale entry by unrated insurers followed by rapid and unplanned exit with no guarantee that clients will be protected in these circumstances.

1.11 Increasing reliance on the FSCS is also a cause of concern for UK financial regulators who are urging us to address the risks associated with unrated insurers. Using this information provided by the financial regulator, it is for the SRA (on behalf of consumers) to ensure that law firms insurers are more likely to be stable (and thus in existence to pay out on claims) given the long run nature of these claims.

What happens if a Participating Insurer is the subject of an insolvency event?

1.12 The effect of an "insolvency event" is that we can give notice to the Participating Insurer which terminates its right to issue policies of qualifying insurance. The existing policies remain in place so any claim made prior to the inception of any replacement policy will fall to be dealt with as part of the insolvency or via the FSCS. Such a claim does not fall to be dealt with by our Compensation Fund (unless it would have been a Compensation Fund claim regardless of the insolvency event). Insured firms must put in place qualifying insurance with another Participating Insurer as soon as reasonably practicable and in any event within four weeks of the insolvency event.

1.13 Our primary concern is the impact an insurer insolvency can have for consumers of legal services. Clients have the uncertainty as to whether, and to what extent, a claim will be covered by the FSCS. If it is not so covered, then there is the adverse affect on clients if the firm is unable or unwilling to make good any shortfall. A summary of the protection provided by the FSCS in respect of EEA insurers can be found on the SRA website. To be entitled to make a claim against the FSCS, a firm insured by any insurer would need to be relatively small, with an annual turnover of less than £1 million. However, even then a firm could be excluded if, despite having an annual turnover below £1 million, it is either a Limited Liability Partnership with net assets in excess of £3.26 million and more than 50 employees; or it is a partnership/unincorporated association with net assets in excess of £1.4 million.

1.14 One of the weaknesses of the FSCS from the perspective of the SRA’s objectives is that the eligibility test is applied to the firm not the client. The result is that a lender client of a small firm may be protected by the FSCS whereas an individual client of a medium sized firm will not. Individual clients can not be expected to understand and consider these distinctions when seeking legal advice.

1.15 An insolvency event will also impact firms and their principals who are insured with the insolvent insurer. Firms will have the aggravation, difficulty, and expense of having to find replacement insurance and the possibility of exposure to shortfalls on existing and future claims. The position can be particularly acute for the principals of firms that are outside the scope of the FSCS.

2. Current arrangements

2.1 All law firms regulated by us that are engaged in private practice from offices in England and Wales are required to have qualifying insurance in order to practise. Qualifying insurance can only be provided by a Participating Insurer (prior to October 2013 called a Qualifying Insurer).

2.2 In order to become a Participating Insurer, an insurer must:

(a) be an "authorised insurer" as defined in the Solicitors Act 1974, that is authorised to offer the relevant insurance contracts under the Financial Services and Markets Act 2000 (FSMA) (whether from the Prudential Regulation Authority (PRA) or the equivalent regulator in another EEA Member State under the "passporting"[1] arrangements); and

(b) have signed a Participating Insurer's Agreement (PIA) (prior to 1 October 2013 it was called a Qualifying Insurer's Agreement (QIA)), under which the insurer agrees to offer policies which meet the minimum terms and conditions (MTC) set out in Appendix 1 to the SRA Indemnity insurance Rules.

2.3 These are the only two criteria for becoming a Participating Insurer. Other regulators, such as the Royal Institute of Chartered Surveyors (RICS), have different criteria for their listed insurers including the need to meet a certain level of financial strength rating. The simplest indicators of the financial strength of insurers are the rates given by independent rating agencies which provide a measure of the insurer's capacity to meet policyholder obligations under a variety of economic and underwriting conditions. RICS require their insurers to be rated by AM Best to at least category B+, or Standard & Poor's to at least category BBB, or have specific written approval from RICS to waive the requirement.

[1] An EEA insurer can apply to carry out business in the UK and may do so if it is within the scope of a relevant EU Single Market Directive. The exercise of this right is known as 'passporting' whereby the insurer notifies its home state regulator of its intention to passport, including which European Directive it is applying under. The home state regulator will then inform the Financial Conduct Authority (FCA) of the insurer's intentions. The passport may be for a branch passport if they wish to establish a physical presence, or a cross border services passport if the services are provided remotely (for example, through the internet).

Neither the FCA or Prudential Regulation Authority (PRA) as a host state regulators are responsible for matters of prudential regulation for the insurer (this is the responsibility of the home state regulator). However, the insurer is expected to meet the FCA's conduct of business requirements (for example, in relation to mis-selling).

An EEA insurer that has been set up in the UK as a subsidiary will be fully authorised by the PRA. Regulation will be divided with prudential regulation by the PRA and conduct regulation by the FCA.

3. Proposed change for 2014/15

Ways to address the risks posed by unrated insurers

3.1 We engaged Marsh Risk Consulting (Marsh) to assist us in identifying and assessing possible ways of tackling the risks posed by unrated insurers.

3.2 Various possible solutions were considered as set out below. The recommendation is to introduce a requirement for a 'long term insurer financial strength rating' from one of the recognised rating agencies with a minimum rating in the 'B's ("secure" group). Information about the rating of insurers is set out in **Appendix 1**. We believe this provides the best balance between providing additional protection for consumers and minimising any negative impacts on consumers and law firms.

Recommendation - Introduce a rating requirement, from one of the recognised agencies, with a rating in the 'B's

3.3 Minimum ratings in the 'B's are considered to reflect firms that are secure. For example, A.M. Best describe B+ and B++ rated insurers as "good" assigned to insurers with "a good ability to meet their ongoing insurance obligations" and remain within their overall "secure" group. B- and B are described as "fair" but fall into the "vulnerable" category.

3.4 There are three unrated Participating Insurers that have insured firms in the current indemnity year. Of these, two are either seeking or considering seeking a rating and can realistically target a rating around this level. They currently insure 2,426 of the 2,560 firms (95%) covered by unrated insurers (see **figure 3.1**). We understand that the smallest of the three (as measured by their participating in the solicitors PII market) would not seek a rating in response to the recommended policy. Overall, the risk of firms being unable to obtain insurance and reduced access to justice is expected to be minimal. (The impact assessment can be found in **section 4**).

Figure 3.1 - Participation of unrated insurers 2013/14

Unrated Insurers	Qualifying Premium Income 2013/14	£ Market Share 2013/14	Number of Policyholders 2013/14
Alpha Insurance	£16.5m	6.5%	1,380
Enterprise Insurance Company PLC	£4.4m	1.7%	134
Elite Insurance Company	£10.0m	3.9%	1,046
TOTAL	**£30.9m**	**12.1%**	**2,560**

3.5 Clients would see benefits from the additional protection that arises through the lower likelihood of insurers defaulting. They may also face higher fees due to firms passing on the increased cost of insurance, but this would also be expected to be modest given that the major unrated insurers would remain in the market.

3.6 This is our recommended policy, providing greater benefit to clients in terms of a reduced likelihood of disruption and the associated detriment from insurers that become insolvent compared to the status quo. The impact on access to justice

and the level of increased fees and the associated pass-through to clients is also expected to be minimal. Solicitors firms would also gain from the reduced disruption.

3.7 Solicitor firms will be able to consider rating agencies opinions on insurers' financial strength, business and ability to meet policyholders obligations.

Other rating possibilities.

3.8 Consideration was given to setting the minimum rating in the 'A's but rating agencies are highly unlikely to give an A rating as the first rating an insurer achieves, unless they were to inject an enormous amount of additional capital into their businesses. This requirement would prevent entry from new insurance firms and would be expected to rule out all of the currently unrated insurers who currently insure 2,560 smaller firms. We believe that this would be an unnecessary barrier to entry into the market for solicitors compulsory professional indemnity insurance for little additional benefit over the recommended policy.

3.9 If a rating requirement was introduced but without specifying a minimum level then only those insurers currently unrated who do not seek a rating would be excluded from the market. This would be less effective at preventing a repeat of the sort of situations which occurred with Quinn, Lemma and Balva. Given the long-term nature of solicitors PII which needs to be able to cover six years of run-off as well as the original year of insurance, this approach provides only marginal benefit to consumers. The Fitch data (see **Appendix 1**) indicated that all insurers rated CCC to C failed within ten years and therefore the benefits of such low ratings to client protection and to prevent disruption to solicitors firms are minimal. [2]

Letters of credit

3.10 A letter of credit is a document issued from a bank guaranteeing payment of an agreed sum to the holder on presentation of the agreed documents. Letters of credit are issued for a set face value and for a finite period of time, usually a year. They are often irrevocable without the consent of the beneficiary. Depending on the credit worthiness of the applicant the cost of a letter of credit may range between 2% and 7% of the face value.

3.11 Letters of credit could be requested from each participating insurer as a means of ensuring participants have funds to meet their obligations. They were discounted as a practical alternative to insurer financial strength ratings because:

- It would be difficult in advance to ascertain an adequate face value for the instrument. The relevant exposure base is claims, but without reliable information on the average value of expected claims per policyholder and estimates for the expected number of policyholders it would not be possible to set anything other than an arbitrary threshold for insurers.

- The obligation would be expensive for insurers and difficult to administer and could exceed the cost of a securing an insurer financial strength

[2] 2003 was chosen as the starting point in order to assess a 10-year view of insurer defaults. The result does not imply that all firms rated CCC to C should be expected to fail within 10 years, but serves to highlight the increased default risk of these firms compared to those in the Bs.

rating. As the exposure base is dependent on the number of claims / policyholders the face value would need to be regularly reviewed and amended.

- The beneficiary would logically be the SRA . In the event of a call for payment the SRA would be responsible for allocating and distributing the funds to policyholders. A difficult and potentially contentious exercise.

Financial guidelines

3.12 Participating insurers could be required to meet and maintain minimum financial guidelines. These would most logically be based on the level of unencumbered policyholder surplus (the difference between an insurer's assets and liabilities). For example Marsh's own minimum guidelines for property casualty insurers domiciled in the UK are USD 100m or for new start-ups liquid capital of not less than USD 200m. The guidelines would apply to the entity providing the insurance but the assets of the wider group may be considered subject to receipt of an appropriate parental guarantee.

3.13 Stand alone minimum guidelines were discounted as a practical alternative to insurer financial strength ratings because:

- The solicitors professional indemnity market is polarised with a relatively small number of insurers providing cover to the majority of policyholders. Consequently a set capital threshold is likely to be either excessive or inadequate for the levels of business underwritten in most cases.

- Determining minimum capital requirements for insurer market entry may set the SRA at odds with the Financial Regulator and leave us open to challenge for creating a barrier for new entrants.

- Insurer capital positions can be difficult to determine for third parties and additional resources would have to be deployed to monitor and review the positions on an on-going basis.

- A set capital threshold is an arbitrary measure as it is difficult to take account of the insurer's retrospective commitments or prospective changes in strategy. For example an entity may look adequately capitalised underwriting £1m annually in premium, but a different proposition were they to suddenly increase to £10m without increasing their capital.

An acceptance criterion for participating insurers

3.14 Due diligence could be undertaken on a more holistic basis to assess the expertise, commitment and financial stability of participating insurers. A checklist could be developed and review meetings undertaken with each insurer to ascertain whether they meet the required standard. Essentially this would be a scaled down and bespoke version of a formal rating. Key areas are likely to include: relevant experience and business plan; capital, earnings and reinsurance; historic performance; management and governance; and risk management.

3.15 An acceptance criterion for participating insurers was discounted as a practical alternative to insurer financial strength ratings because:

- Performing a qualitative assessment may leave the SRA open to challenge by either the subjects of the assessment or those expressing reliance on it i.e. the policyholders in the event of insurer default.

- Without the expertise or access of a formal rating agency it is questionable whether a bespoke assessment could be undertaken with the same level of rigour and credibility at an acceptable cost.

Question 1	**Do you agree with our recommendation to introduce a long term insurer financial strength rating requirement into the Participating Insurer criteria with a minimum rating set in the 'B's ("secure" group)?**
Question 1.1	**If not, please explain why not?**
Question 1.2	**Do you have an alternative proposal?**

Recognised rating agencies

3.16 The recognised rating agencies for insurers in the United Kingdom and Europe are Standard & Poor's (S&P), A.M. Best, Fitch and Moody's. There are other rating agencies operating in the UK and elsewhere in the world, including a large number of "Nationally Recognised Agencies". These vary considerably in size and may lack experience in the insurance sector particularly in Europe and the US.

3.17 They may often lack coverage in the number of companies they cover, acceptability to institutions like banks, leasing companies and government agencies and some do not give their rationale in how they have arrived at a particular rating. A number of these rating agencies are relatively small organisations. Some would not attach a risk loading for low levels of turnover and capital. Consequently their ratings tend to be higher. Smaller rating agencies also lack the transparency and published criteria of the larger more established firms.

3.18 Small rating agencies may find it harder to:

- Access the management's time at the company being rated
- Obtain information which is not in the public domain like run off statistics for a particular class of business and as a whole, projected run off statistics going into the future, reinsurance protections available which have been used and available for the future, maximum exposure to one single event like a hurricane.
- Take account of swift changes to the underwriting strategy over time.

3.19 In some cases, however, smaller rating agencies in operation are staffed by people who were previously with the rating agencies like A. M. Best, Standard and Poor's etc. and can very often arrive at a well thought out rating, although, this is an exception to the rule.

3.20 If we decide to introduce a rating requirement, we intend to accept ratings issued by the recognised rating agencies and to have a facility for other rating agencies to apply to be added to the list of recognised agencies. This is the approach recommended by Marsh.

Question 2	**Do you agree that the acceptable rating agencies should be limited to Standard & Poor's (S&P), A.M. Best, Fitch and Moody's coupled with a facility for other agencies to apply to be added to the list of recognised agencies?**

The entity to be rated

3.21 In some cases the Participating Insurer authorised to transact cover for solicitors may be a subsidiary of a wider group. Marsh recommend that any rating requirement must be satisfied by the Participating Insurer itself and not rely on a rating of another entity within the group.

3.22 Similarly the fact that an unrated insurer may have reinsurance with rated insurers will not be sufficient to meet the amended Participating Insurer criteria.

Question 3	**Do you agree that the minimum rating requirement should apply to the insurer itself?**

Changes to the Participating Insurer's Agreement

3.23 The current Participating Insurer's Agreement can be viewed at http://www.sra.org.uk/documents/rules/participating-insurers-agreement-2013.pdf. The draft amendments to the Participating Insurer's Agreement to give effect to the change on 1 October 2014 are set out in **Appendix 2**.

4. Impact assessment

Introduction

4.1 The proposed change will impact stakeholders to varying degrees. The key stakeholders are consumers of legal services, firms and insurers. The impact on consumers is linked to the impact on firms, which in turn is linked to the impact in the insurance market.

4.2 Although it is the impact on consumers of legal services that is of most concern to us, the impact on consumers can only be assessed after considering the anticipated impact on the insurance market. Therefore, this section first examines the expected impact on the insurance market and then sets out the impact on law firms and consumers.

4.3 The impact assessment is based on the proposed introduction of a minimum rating requirement in the 'B's, which we recommend. The proposal is compared to the current situation where no minimum ratings requirement is in place.

Impact on the insurance market

Impact on currently unrated insurers

4.4 The immediate impact of having a rating requirement in the 'B's would be that unrated insurers who currently participate in the solicitors' PII market would need to obtain at least a B rating in order to continue operating in the market. Based on discussions between Marsh and these firms it is anticipated that:

- Two insurers that currently insure 2,426 out of the 2,560 firms insured by unrated firms would seek and obtain the required rating; and
- One insurer that currently insures 134 out of the 2,560 firms insured by unrated firms would not seek the required rating.[3]

4.5 Based on discussions with Marsh, we understand that a rating requirement in the 'B's would be relative easy to achieve as an initial rating for previously unrated insurers. This is in contrast to a rating in the 'A's which is understood to be highly unlikely as the first rating that a firm receives.

4.6 Under the proposal, it is expected that only 134 or around 1.5% of all law firms regulated by the SRA would have to source alternative insurance by necessity.

4.7 It is acknowledged that there is some uncertainty surrounding whether the other two unrated firms would obtain a rating. It is possible that they do not which would leave some 2,560 firms in need of finding an alternative insurer. The uncertainty surrounding this is considered throughout the impact assessment.

Impact on costs for insurers

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[3] A further two insurers have signed the Participating Insurer's Agreement but currently have not issued any policies in the current indemnity period and would not seek the required rating.

4.8 For insurers that were previously unrated and need to obtain the minimum rating to be able to operate in the market, this is likely to bring additional costs including:

- Fees charged by rating agencies to obtain a rating – these are estimated as around £40,000 along with a similar level of fees for annual monitoring;
- Management time in order to engage with the rating agencies; and
- Costs related to adopting more stringent measures and underwriting practices in order to meet the standards necessary to obtain the rating. This could include additional staff to improve governance standards, improved risk management and underwriting systems, or holding additional capital.

4.9 For insurers that already meet the necessary standards but simply need to obtain the actual rating these costs would therefore be expected to be less than £100,000. The two largest unrated insurers currently both insure over 1,000 firms and these increased costs represent 1% or less of premiums. If a potential new entrant only insured 200 firms and did not already have a rating this would be expected to represent 5% of premiums.

Impact on new entry to the solicitors PII market

4.10 A rating requirement in the 'B's represents a barrier to entry compared to having no rating requirement. Firms that are currently unrated would need to incur modest costs as described above.[4] However, other firms already have the rating needed to enter the solicitors PII market.

4.11 Considering only those property and casualty insurers monitored by Marsh that have a rating from S&P, there are 247 insurers domiciled in the European Economic Area, of which 229 have a rating of BBB or above (188 of which have ratings in the 'A's).[5] For the insurance market as a whole this therefore represents a fairly modest barrier to entry - any of these insurers would therefore be eligible to enter the solicitors PII market although not all of them would have experience in writing PII business.

4.12 Insurers that have existing experience in PII markets would be considered to be particularly strong candidates as potential entrants. There are 28 UK or EU regulated insurers that are currently active in writing PII for surveyors or accountants in the UK but do not currently participate in solicitors PII.[6] Of these, however, 12 have previously participated and five do so through a different entity within their group. If prices and profitability of solicitors PII was to increase suddenly these insurers would have the capabilities necessary to enter (or re-enter) the solicitors PII market.

4.13 In addition, the Assigned Risks Pool (ARP) previously imposed certain cost and liability requirements on insurers but has now been removed. Hence entry would

[4] This cost would remain modest even for much smaller insurers who might wish to enter the market in the future. For example, for an insurer that insured 200 firms with an average premium of £10,000 and total premiums of £2 million, the increased costs of £100,000 would represent only 5% of premiums. Another way of considering these costs is that with average premiums of around £10,000 to £15,000 for currently unrated insurers, this would represent the premiums associated to around 7-10 law firms.
[5] Source: Information provided to the SRA by Marsh.
[6] Source: Information provided to the SRA by Marsh.

be seen as more attractive to insurers than in the past. Again this makes the potential for new entry a plausible response to any price and profitability rises that might be experienced.

4.14 Overall therefore the extent to which a minimum rating in the 'B's represents a barrier to entry is considered to be relatively modest.

Impact on availability of insurance

4.15 As noted above, 134 firms (1.5% of all firms) would be expected to need to find an alternative source of insurance. There is little reason to believe that existing insurers within the market would be unable to absorb this additional capacity. This is particularly clear from the significant changes in market share for different insurers that are regularly observed in the market. Over the last 7 years, there have been 22 occasions in which a single firm has increased its market share by at least 134 firms – around 70% of these insurers were rated and 30% unrated. The direct impact of the need for some firms to find an alternative insurer is therefore expected to be minimal in terms of availability of insurance.

4.16 However, it is possible that any improved underwriting standards needed to obtain and retain minimum ratings could cause insurers to no longer provide insurance to some firms due to improved underwriting standards. It is therefore possible that this would lead some currently unrated insurers to refuse to insure some firms that they would otherwise have been willing to insure. This is expected to be minimal, but if it does arise it would be likely to be limited to those firms with poor claims histories which are currently insured by unrated insurers who do not obtain the minimum rating.

4.17 If, however, the larger unrated insurers do not seek or obtain the desired insurance, some 2560 firms would have to source new insurance. The great majority of these firms would be expected to be able to obtain insurance – indeed 11 other Participating Insurers already insure more than 100 sole practitioner or 2-4 partner firms indicating their existing willingness to insure similarly sized firms to those insured by the unrated insurers (see Equality Impact Assessment for comparison of firms insured by different types of insurers).

4.18 Such a large opportunity for insurers could result in existing insurers who have moved away from writing business for small firms returning to this part of the market as they would be able to write a considerable volume of it. Alternatively new entry might be attracted for similar reasons. Despite the potential for other insurers to serve the majority of these firms, there is clearly a greater risk of firms being unable to obtain insurance should all three unrated insurers exit.

4.19 Although minimal impacts from the policy are expected now, it is possible that imposing the rating requirement could have impacts at other times in the insurance market cycle. In particular, to the extent that this is an additional entry barrier, it could be of concern during periods of hard markets in the insurance sector (i.e. where capacity is reduced and prices rise generally).

Impact on the price of insurance

4.20 We cannot predict with certainty the change in the price of insurance at the next renewal because the introduction of a rating requirement for insurers would be

only one of a number of factors affecting price. Other factors affecting price include: the expected level of claims and how this is changing over time; the availability of insurers' capital; the relative attractiveness of the solicitors' insurance market compared to other insurance markets; and the dynamics of competition within the solicitors' insurance market.

4.21 Even *after* the event we will not know to what extent any price change was caused by the introduction of a rating requirement compared to these other factors. The figures provided below therefore should be seen as illustrative of the possible effects of the proposed policy and not predictive of the actual price changes that will be seen in the next indemnity year.

4.22 Since there would be limited withdrawal of insurers from the market, there is no reason to expect that competition would be radically altered. However, some prices would nonetheless be expected to increase slightly as explained below.

4.23 Unrated insurers who obtained a new rating would have incurred some costs to do this and would inevitably seek to recover these costs through higher prices. As noted in paragraph 4.9, these costs are expected to be around 1% of premiums for the relevant insurers. Even if we were to use a figure of a 5% increase in premiums for the affected insurers, this would represent a total increase in premiums of £1.5 million in the price of insurance representing less than 1% for the insurance market as a whole. It is also possible that some firms may face additional price rises if higher underwriting standards are required through the ratings process which leads to a removal of any under-pricing that has previously been in place.

4.24 We carried out a survey of one to ten partner firms and from a random sample of 4000 firms invited to take part, 540 completed responses were received. The headline findings are set out in **Appendix 4**. Marsh Risk Consulting helped us with our engagement with other key stakeholders. The key findings are set out in **Appendix 3**.

4.25 As noted in paragraph 5 of Appendix 3, on average unrated insurers offered prices around 15% lower than rated insurers in the 1-10 partner firms. Assuming that law firms using unrated insurers did so because this was the lowest price they could find, it is therefore not unreasonable to assume that unrated insurers will be able to pass through the increased costs of around 1% or even 5% that they incur due to becoming rated. This increase in cost would be expected to impact only those firms currently served by unrated insurers; other firms would not be expected to see price rises since no major change in competitive dynamics in the market are anticipated.[7]

4.26 If, however, all three unrated insurers exit the market, it is possible that higher price rises might be observed. It is possible that this could lead to price rises up to 15% for the firms affected representing £4.6 million additional premiums. Prices may also rise for other similar firms if competitive dynamics also change. However, it should be noted that some of this price rise could reflect the removal of under-pricing by unrated insurers. To the extent that this does happen, it would

[7] In reality, price rises above 5% may be seen for individual firms or for the market as a whole due to wider insurance market trends but such price changes would not be due to this policy proposal.

represent a movement from inaccurately under-pricing risk to more accurate, but higher, prices.[8]

Impact on consumers and law firms

4.27 As highlighted above, our primary concern in developing this policy is the protection of clients. The major benefit that would arise for both clients and for law firms comes through a reduction in the risk that claims will not be met along with the reduced costs linked to the associated disruption of dealing with defaulting insurers when making a claim.

4.28 As well as considering this benefit to clients and law firms, we also set out the impacts regarding increases in the price of insurance and potential reduction in the availability of cover for law firms with the associated implications for the level of fees and access to justice.

Greater likelihood of maintaining cover for claims leading to greater client protection

4.29 Introducing a financial strength rating requirement reduces the expected probability of default of insurers compared to insurers that do not have a rating. This brings benefits to both consumers and law firms through reducing the likelihood that law firms find themselves in a position of having a valid claim against that insurer either not met or else only met in part by the FSCS. Although imposing a financial strength rating does not remove the possibility of default, it would at the very least provide a greater level of security to clients that their law firm's insurer is more likely to protect them.

4.30 In the event of an insurer being unable to meet its financial obligations, law firms face the risk of their claim not being met in a number of ways:

- Difficulty obtaining settlement from an insurer which has defaulted;
- Claims not met by FSCS;
- Claims only partially met by FSCS; and
- Awards by the Legal Ombudsman not being met.

4.31 All of these issues also lead to clients facing the risk that their law firms are therefore unable to pay legitimate claims. The introduction of the minimum rating therefore brings benefits through reducing the likelihood that clients face this risk.

4.32 Further, default leads to disruption and difficulties for clients whose law firm is insured by the defaulting insurer. The impact of these various problems is likely to be significant for each client affected in this way, particularly where clients are individuals. Having a valid claim against their legal adviser is itself likely to have caused some degree of distress to the client. Insurer default will exacerbate this distress through the uncertainty caused by not knowing whether the claim will be paid. It is also likely to increase the time needed to pay the claim which may

[8] Under-pricing by unrated insurers could be a deliberate policy in order to gain rapid market share but may also represent mis-pricing which is plausible given that in the past unrated insurers have defaulted and left the market suddenly due to their under-pricing of risk in this market. (It is also possible that removal of under-pricing could attract entry by more informed insurers which would limit the overall increase in price.)

cause further financial difficulties for clients. This represents another substantial benefit for clients from the proposed policy through reducing the likelihood that clients will face this extra distress.

4.33 We cannot accurately quantify the consumer detriment from past events of insolvency for various reasons. First, many claims will have been made but not yet settled. Settlement often takes a considerable amount of time in normal circumstances and is likely to lengthen as a consequence of insurer insolvency. Second, some law firms may have already notified insurers regarding the potential for a claim to be made, but details may not yet be available as to the extent of the claim. Third, claims made under run-off cover may not yet have been notified to the insolvent insurer since these policies run for six years. These reasons highlight why it takes a considerable length of time to discover the full impact of insurer insolvency on law firms. Given the relatively recent unplanned exit of various insurers, it is therefore not possible to accurately quantify these claims.

4.34 Further, law firms with low turnovers may receive FSCS protection but other law firms will be left to pay any claims out of their own resources. Since the settlement of claims is not yet complete, it is not possible to quantify the extent to which firms will be unable to pay these claims.

4.35 In addition principals of the firms face additional costs and risks such as;

- Having to replace PI cover mid term;
- Potentially receiving no refund of premium (and therefore having to pay twice for the same cover for some part of the indemnity year);
- Principals and/or estate may be personally liable to pay claims;
- Damage to reputation as a result of claims not being met; and
- Particular difficulties may arise in respect of 'run-off' cover and being able to obtain this cover elsewhere.[9]

4.36 The point regarding run-off is considered to be of particular importance since run-off insurance lasts for six years. Having an insurer that is unlikely to default over that period is clearly of benefit to firms or individuals that buy run-off cover. Further, replacement run-off may be especially difficult or costly to obtain should an insurer default.

4.37 Reducing the likelihood that insurers default and the corresponding increase in the likelihood that law firms can continue to use the same insurer for multiple years is valued by many law firms and therefore also represents a benefit to law firms.

4.38 Many law firms are sophisticated purchasers of insurance. As such, law firms selecting their insurer should be in a position to factor in these various issues and do not require the regulatory intervention to help to protect them. However, we recognise that the expertise of lawyers lies in advising on the law not on

[9] Run-off cover is provided for six years and is specified within the normal insurance policy which means that there is not usually demand for separate run-off cover. A request for such cover on a standalone basis would therefore be relatively unusual.

insurance markets and it may be the case that not all lawyers will understand their rights (or lack thereof) under the FSCS should their insurer default. Further, small firms are the firms that are less likely than others to have a full understanding of insurance conditions and the risks that they expose themselves to when selecting an unrated insurer and it is precisely these firms that are typically covered by unrated insurers. Therefore it is considered to be legitimate to view the greater likelihood of maintaining cover for claims as a benefit to law firms arising from the policy.

4.39 Finally, even if law firms understand the risks that they face when choosing unrated insurers, the law firm may not sufficiently take into account our concern to ensure that their clients are protected. The value of this additional protection to clients is therefore likely to exceed the value to law firms, yet it is the latter that purchase the insurance. It is therefore for the SRA to take action to ensure that clients are protected.

Price and availability of insurance

4.40 The immediate impact on law firms follow directly from the impacts in the insurance market which would be:

- Up to 2,560 or 26% of all firms would face an increase in premiums of around 1%; even if this was estimated at 5% this would represent £1.5 million additional premiums reflecting the increased costs associated to obtaining a rating. These firms may also face a greater increase in premiums to the extent that unrated insurers had previously been under-pricing in this segment; and
- A small proportion, much less than 1.5% of firms, would be at risk of not obtaining insurance due to higher underwriting standards being applied by insurers who are newly rated.

4.41 Since insurance is a compulsory requirement, those firms that are unable to obtain insurance would be forced to exit the legal services market.

Level of fees for consumers

4.42 Just as increased costs faced by unrated insurers will be passed on to law firms, the increase cost of PII premiums faced by firms will also be passed on to clients.

4.43 Previous research for the SRA indicated that PII premiums represented around 1.4% of gross fees for the sector as a whole. However, this is likely to be an underestimate for the small firms that are currently served by unrated insurers.

4.44 As an example, if PII premiums represent 5% of gross fees for small firms, an increase in the cost of these premiums by 5% (see paragraph 4.40) would represent an increase in the law firm's cost base of 0.25%.[10] This increase would be expected to be spread across all clients and therefore the increase in the prices faced by clients would therefore be expected to be only 0.25%. This is a

[10] The Law Society found that PI premiums as a percentage of gross fees had a median of 3.6% with sole practitioners paying a median of 6.4%. Source: Paragraph 4.21 Professional Indemnity Insurance 2012 Prepared for The Law Society by IFF Research, 18 February 2013.

very modest increase which is considered unlikely to lead to a significant change in demand for legal services from those clients.

Access to justice

4.45 As highlighted in paragraph 4.40, a small proportion, less than 1.5% of firms, would be at risk of not obtaining insurance and would therefore have to exit the market.

4.46 Given that these firms tend to be in the large conurbations (see paragraph 2 of Appendix 3), it is reasonable to assume that the impact on access to justice will be low as there will be other firms or providers within a reasonable distance that will provide similar services.

Summary

4.47 The impact assessment sets out the expected benefits and costs of this proposal which can be summarised as:

- Clients and their law firms would face a reduction in the likelihood of insurers defaulting with the attendant disruption and costs that this brings. There would be a removal of uncertainty for clients with legitimate claims and the associated distress that this causes which is a very substantial effect for each client concerned;
- Price rises of around 1% for insurance premiums could arise for those firms currently insured by unrated insurers reflecting the increased costs due to obtaining insurance. If this price rise was actually 5% this would increase premiums by around £1.6 million. These price rises would be passed on to law firms who would pass them on in turn to clients who might face fee rises of less than 0.25%;
- A small number of firms (well under 134) may not be able to obtain insurance and could therefore close if they cannot find alternative options. These are likely to be firms with poor claims histories who may have been at risk of not obtaining insurance; and
- Limited impacts would be expected on new entry in the short-run but the SRA acknowledges that this impact may only be observed during a hard market.

4.48 As highlighted throughout the impact assessment, there is some uncertainty regarding whether the two largest unrated insurers will seek and obtain the necessary rating. Should they fail to do so, the impacts in terms of both price and the availability of insurance would be expected to be somewhat greater than that set out above.

4.49 The impact of the reduced likelihood of default and the benefits to clients from reduced disruption and distress has not been quantified. However, we consider these benefits to outweigh the value of the associated costs described above.

Equality impact

4.50 An equality impact assessment has been carried out and is attached as **Appendix 5**.

Question 4	**Do you have any further comments you wish to make about this proposal?**

Rating of insurers

What is an insurer financial strength rating?

A rating is an “opinion” on the ability of entity to meets its obligations to policy-holders as and when they may fall due. In this consultation we are referring to an interactive public rating which is paid for by the company being rated. The most common agencies utilised by UK and EEA insurers are Standard & Poor’s (S&P), A.M. Best, Fitch and Moody’s.

Each agency has their own methodology but ratings are usually organised on a scale based on letter grades to indicate the degree of credit risk. For example A.M. Best range from C- to A++ illustrated in Figure A1.1 shown below:

Figure A1.1 - A.M. Best’s Financial Strength Ratings

	Rating	Description	Definition
Secure	A++, A+,	Superior	Assigned to companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.
	A, A-	Excellent	Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.
	B++, B+	Good	Assigned to companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.
Vulnerable	B, B-	Fair	Assigned to companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
	C++, C+	Marginal	Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
	C, C-	Weak	Assigned to companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.

Rating costs vary by rating agency, with the average cost at around £40,000. There is a similar annual monitoring fee to maintain the rating. The process typically takes six to eight weeks to complete.

Effectiveness of a financial strength rating

Ratings are not static. Rating opinions may change to reflect new information received which was not expected at the time the rating was assigned. Data provided by Fitch shows that ratings are stable in the short to medium term, with a lower default rate for higher rated insurers compared to lower rated insurers.

The Fitch data based on a starting point of 2003 (chosen in order to have a ten year view) shows that none of the rated insurers defaulted within one or three years.

- All of the CCC to C rated insurers in 2003 failed within 10 years.
- 20% of insurers rated BB- in 2003 and 11% rated BBB defaulted within 10 years.
- 6% of AA and 3.5% of AA- rated insurers also defaulted within 10 years.

Ratings are a good indication of the risk of default but they are not a guarantee that any particular insurer will or will not be able to meet its obligations to policyholders.

Draft amendments to the Participating Insurer's Agreement

Proposed amendments to the Participating Insurer's Agreement for the indemnity period commencing on 1 October 2014 (**2014 PIA**) in respect of the implementation of a minimum financial strength rating requirement on participating insurers

1. Definitions

It is proposed that the following new definitions be included in the 2014 PIA:

> **Approved Ratings Agency** means each of A.M. Best Company, Fitch Ratings, Moody's and Standard & Poor's or any other financial strength rating agency approved by the Law Society from time to time for the purposes of this Agreement
>
> **Minimum Rating Requirement** means, in respect of each Approved Ratings Agency, the long term insurer financial strength rating specified below:
>
> (a) in respect of A.M. Best Company, a rating of B+;
>
> (b) in the case of Fitch Ratings and Standard & Poor's, a rating of BBB; and
>
> (c) in the case of Moody's, a rating of Baa.

NOTE: The above minimum requirements are based on the recommendations of Marsh, and seek to apply a minimum rating consistent across the approved ratings agencies.

2. Operative provision

It is proposed that the following amendments are made to clause 3.1 and 3.2 of the 2014 PIA to introduce the minimum ratings requirement:

3.1 The Insurer warrants and represents to the Law Society that, both as at the date of this Agreement and as a continuing warranty and representation for the duration of this Agreement:

(a) it is an Authorised Insurer for the purposes of both effecting and carrying out contracts of insurance; ~~and~~

(b) it shall effect and carry out Qualifying Insurance and shall otherwise conduct its operations and activities in relation thereto at all times in compliance with all applicable laws and regulations, including but not limited to applicable provisions of the Equality Act 2010; and

(c) it has and will maintain a long term insurer financial strength rating from an Approved Ratings Agency that is equal to or representing a higher degree of financial security than the Minimum Rating Requirement.

NOTE: ***The requirement to have a financial strength rating is included as a warranty and representation, in the same manner as presently applies to an Insurer's regulatory authorisation. The Insurer must have a rating that meets the minimum standard from the date of signing the agreement, and throughout the course of the agreement.***

3.2 The Insurer undertakes that it shall notify the Law Society in writing immediately if, at any time after the date of this Agreement:

3.2.1 ~~the~~ any warranty set out in clause 3.1 ceases to be true in any respect; or

3.2.2 it is the subject of an Insolvency Event.

NOTE: The Insurer must notify the Law Society immediately if it no longer meets the minimum rating requirement after execution of the agreement.

3. Effect of breach – termination of right to underwrite

It is proposed that the following limited amendments are made to clause 11 of the 2014 PIA (for the purpose of clarity only). The mechanism that already applies to a breach of the warranties in clause 3.1 will also apply to a breach of the minimum rating requirement.

11.1 The Law Society may by giving notice in writing to the Insurer at any time terminate forthwith the right granted to the Insurer under clause 2.1 if:

11.1.1 the Insurer is in fundamental breach of its obligations under this Agreement; or

11.1.2 ~~either~~ any of the events referred to in ~~clause 3.2~~ clauses 3.2.1 or 3.2.2 occurs; or

11.1.3 the Insurer is in material breach of its obligations under this Agreement; and

(a) (where such breach is capable of being remedied), the Insurer has failed to remedy such breach within such reasonable time as the Law Society has specified; or

(b) the Insurer has previously been in material breach of its obligations under this Agreement on at least one occasion during the previous six months or on more than one occasion within the previous two years.

NOTE: The Law Society may, by serving notice on the Insurer, terminate the Insurer's right to underwrite solicitors PI policies in the event that if, any stage after 1 October 2014, it does not meet the minimum ratings requirement.

…

11.3 The effect of any notice given under clause 11.1 or 11.2 shall be that:

11.3.1 (in the case where notice has been given under clause 11.1) the right granted to the Insurer under clause 2.1 shall terminate on:

(a) the date of that notice; or

(b) the date on which either of the events the relevant event referred to in clause 3.2 clause 3.2.1 or 3.2.2 occurs (where applicable);

whichever is the earlier; or

…

11.4 The date on which the right granted to the Insurer under clause 2.1 terminates in accordance with clause 11.3 shall be referred to as the **Run-off Date**.

NOTE: Where notice is served, the Insurer's right to underwrite solicitors PI policies is terminated from the date that the Insurer no longer met the minimum ratings requirement – this being the "Run-off Date".

11.5 With effect from the Run-off Date, the Insurer shall cease to be a Participating Insurer and accordingly the Insurer shall not write any Policy which incepts or renews after the Run-off Date, or hold itself out as being a Participating Insurer after the Run-off Date.

NOTE: From the Run-Off Date, the Insurer is no longer a Participating Insurer, and can no longer write (or renew) any Policy incepting after the Run-Off Date.

11.6 Clauses 11.1 and 11.3 shall each be without prejudice to the rights of either party under this Agreement either before or after the Run-off Date in respect of any act or omission of any other party under this Agreement, which shall otherwise remain in full force and effect.

11.7 This Agreement shall terminate upon the final settlement of all claims made and capable of being made under and the expiry of all relevant periods of limitation in respect of all of the Policies written by the Insurer under this Agreement, but without prejudice to the rights of any party under this Agreement as at that date.

NOTE: termination of the right to underwrite new policies is without prejudice to existing rights, and does not terminate the agreement otherwise – the agreement continues until settlement of all claims that have or could be made under Policies issued pursuant to the Agreement.

4. Other relevant amendments

It is proposed the other incidental amendments are made in respect of the minimum ratings requirement, as follows:

(a) references to the Insurer's "credit rating" be changed to the Insurer's "long term insurer financial strength rating" throughout (see page (i) and clauses 6.5 - 6.6 and 10.3); and

(b) references to credit ratings agency be changed to "Approved Ratings Agency" throughout (see page (i) and clause 10.3).

Profile and purchasing rationale of firms insured by unrated insurers

1. We carried out a survey of one to ten partner firms and from a random sample of 4000 firms invited to take part, 540 completed responses were received. The headline findings are set out in **Appendix 4.** Marsh Risk Consulting helped us with our engagement with other key stakeholders. The key findings were as follows.

Profile of firms using unrated insurers

2. Based on an analysis of the data gathered from our survey we found that:

   - firms using unrated insurers typically have one to four partners;
   - firms with turnovers between £150,000 and £1 million, those first established from 2010 onwards and with a higher proportion of BME (Black or Minority Ethnicity) solicitors all use a higher proportion of unrated insurers than the average;
   - firms in London, North West England and West Midlands show a higher proportion of firms using unrated insurers compared to the proportions using rated firms; and
   - firms working in Immigration, Landlord and Tenant, Personal Injury, Debt collection and Probate Estate Administration all show a higher proportion of unrated insurers compared to rated insurers.

Rationale for using unrated insurers

3. From our survey and the Law Society's 2012/13 PII survey we established that the main rationale for firms to use unrated insurers is savings in premiums. There are varying sources of evidence regarding the extent of the price differential between rated and unrated insurers.

4. We surveyed 1-10 partner firms and asked firms about the difference in price between rated and unrated insurers. Many firms received quotes from both rated and unrated insurers. In comparing quotes:
   - 39% of respondents believed unrated quotes were more than 20% cheaper than rated insurers;
   - 23% of respondents believed unrated quotes were 10-20% cheaper than rated insurers;
   - 19% of respondents believed unrated quotes were 0-10% cheaper than rated insurers; and
   - 19% of respondents believed rated quotes were cheaper than unrated insurers

5. This leads to an overall estimate of unrated insurers being 15% cheaper on average.11

[11] This is based on a weighted average of: 39% being 30% cheaper for unrated firms (used for those stating rates were "more than 20% cheaper); 23% being 15% cheaper; 19% being 5% cheaper; and 19% being 10% more expensive (for those stating rated insurers were cheaper)

6. Analysis from The Law Society's 2012-2013 PII survey indicated that the median price for 1-4 partner firms from unrated insurers was £12,000 and that from rated insurers was £17,350. This suggested that unrated insurers were around 30% cheaper than rated insurers.

7. Marsh estimates that prices in the 1-4 partner space were around 30-50% higher from rated compared to unrated firms for 2012/13. This difference is based on a comparison of composite average cost per policy rates for unrated insurers (Balva Insurance Company AAS, Alpha Insurance, Enterprise Insurance Company PLC, Elite Insurance Company) versus rated insurers active in this sector (First Title, Travelers & Liberty) based on 2012 insurer declarations (£12,675 versus £18,777).

8. Following the reduction in unrated capacity for the 2013 renewal and increased competition from some rated insurers, this differential is reducing.

9. It should be noted that both the TLS survey and the Marsh calculation are based on comparisons firms which used rated with those that use unrated insurers. They therefore do not take into account that the sample of firms using rated insurers is likely to be larger (within the 1-4 partner space) than the sample of firms using unrated insurers. Hence a straight comparison of the cost of insurance from rated versus unrated insurers would overstate the differential for the same firm.

10. By contrast, the SRA's survey gathers information from rated and unrated insurers from the same firm. For this reason we use an estimate of a 15% price differential in the impact assessment although the conclusions would not alter if a 20% price differential suggested by Marsh was used.

11. Other evidence of relevance from these surveys included that:

    - some firms were not able to obtain acceptable terms from rated insurers. This will be mainly on price but some rated insurers may not have offered cover particularly to firms with poor loss experience, historical disciplinary issues or practicing certain areas of law, notably conveyancing;
    - the majority of firms that responded to our survey had not used unrated insurers (69%);
    - 46% of those firms actively marketing their 2013 renewal had sought quotes from a mixture of rated and unrated insurers (only 2% had only sought quotes from unrated insurers) with 62% of these reporting quotes from unrated insurers as over 10% cheaper than rated insurers; and
    - reasons given for considering unrated insurers were:
        - cheaper quotes;
        - not sure how good of an indicator the financial strength ratings actually are;
        - lack of interest from rated insurers; and
        - advice of insurance broker.

Survey Responses – Law Firms

SRA has undertaken a survey of the profession. The survey was sent out to over 4000 firms with 1 to 10 partners from all different regions of England and Wales in September 2013 and was closed two weeks later. They received 540 completed responses to find out what the respondents thought about unrated and rated insurers.

There was a wide range of respondents, from sole practitioner firms to firms with five or more partners.

How do the firms select a qualifying insurer?

- 66% of respondents first shop around and get quotes from different insurers, whereas the remaining 34% renew their quotes with their existing insurers.
- Looking deeper at those who shop around and get a wide variety of quotes first;
  - 46% of the 66% get quotes from a mix of rated and unrated insurers
  - 42% of the 66% say that they only gather quotes from rated insurers,
  - Only 2% of respondents state that they gather quotes from unrated insurers only.

Were unrated quotes are substantially cheaper than rated quotes?

- 39% of respondents believe that unrated quotes were more than 20% cheaper than the rated insurer alternatives.
- 23% of respondents think that unrated quotes are 10% to 20% cheaper than rated quotes.
- 19% of them think that unrated insurers are less than 10% cheaper than rated insurers
- And finally, only 19% of the respondents believe that rated insurers are actually cheaper than unrated insurers.

What factors are considered when finding an insurer for their PI insurance.

- The top three factors which the respondents consider are price, reputation/credibility and financial stability of the insurer.
- However, there were many similar comments from the smaller firms across the regions. Many respondents stated that due to the size of their firms a lot of the rated insurers do not find them good enough to quote and hence the smaller firms are left with no choice but to go to unrated insurers as they are the only ones which will bother to give them a quote!
- Some comments from respondents include;
  - *'My Firm didn't have a choice! An unrated insurer was the only one to offer terms (despite a totally clear claims record going back to the Firm's creation in 1994)'*
  - *'As a conveyancing firm we are stuck with the few insurers who will take us on - only 1 this year who is unrated. We have no choice'*

69% of firms had *not* purchased qualifying insurance from an unrated insurer. Of that 69%, only 19% stated that they *would* consider buying unrated insurance. The reasons given were:

- cheaper quotes,
- lack of interest from rated insurers
- on advice from their insurance brokers.

Why would you not consider purchasing insurance from an unrated insurer?

- The main answer to this question was the financial stability concerns arising from purchasing unrated insurance. This was followed by recommendation of their insurance broker.
- None of the respondents which were surveyed had a bad experience with unrated insurance, their fear from purchasing it purely came from the markets perception of it instead.

Have you switched to an alternative insurer as a result of the insurance company being insolvent/ withdrawing from the market?

- 26% of respondents said yes, 21% said no and finally the remaining 53% said it was not applicable to their firm.

Have you been left without insurance as a result of an insurance company being insolvent/ withdrawing from the market?

- Here, a tiny 2% said yes, 40% said no and the remaining 58% said it was not applicable.
- This links back to the previous question where respondents have not had bad experiences in regards to unrated insurers, it is their perception of the unrated insurers and the potential concerns which prevents them from being used.

70% of the survey respondents either agree or strongly agree that SRA should take more action in creating a more stable insurance market for law firms. Respondents reported that it is important for credibility of profession and security of clients as a whole for all firms.

Finally, respondents were asked whether they were provided with guidance on the factors to be considered when choosing an insurer if they arranged their insurance through an insurance broker. The majority, (67.4%) said yes.

To conclude, it is apparent that respondents do not actually want to purchase from unrated insurers. However, they sometimes feel like they have no choice.

Equality Impact Assessment

The aim of the SRA's recommended policy is to enhance protection for the clients of SRA regulated firms. This is a requirement that will apply across all SRA regulated firms and as such does not directly discriminate against any protected groups.

However, it is possible that there could be indirect discrimination among different groups and therefore we have conducted an Equality Impact Assessment (EIA) to understand the impact of the proposed policy. Evidence of indirect discrimination does not mean that the policy is unreasonable as long as the SRA is pursuing a legitimate policy aim and the approach is an appropriate and necessary means of achieving that aim.

Approach to the EIA

The EIA guidance requires consideration of the following six criteria: age, sexuality, religion, race, disability, and gender as well as human rights.[12]

We consider that there are no reasons to believe that there will be systematic effects according to sexuality or religion and neither is there reason to believe that there will be effects on human rights. No evidence has been identified during the process of developing these proposals of any link to these factors, hence no detailed analysis is provided on these factors. For the remaining four areas (age, disability, gender and race) analysis is provided below regarding potential equality impacts.

As with the impact assessment, the EIA is based around the SRA's recommended policy compared to the status quo. It is also important to note that the calculations are based on matching different sources of data regarding the insurers and the firms they insure. The data only covers around 80% of firms although it covers a higher proportion (93%) of the firms insured by unrated insurers. This will have the effect of exaggerating the impact of the policy in terms of some of the statistics quoted below.

Overview of law firms

Before considering the equality indicators it is important first to recognise that the unrated insurers typically insurer different types of law firm to rated insurers. In particular unrated insurers have a larger proportion of small law firms compared to large law firms that they insure when compared to the rated insurers.

Figure A5.1 - Type of firms insured by type of insurer 2013/14[13]

Insurer type	Sole practitioner	2-4 partners	5-10 partners	11+ partners
Won't seek a rating	24%	72%	4%	0%
All unrated insurers	40%	59%	2%	0%
All insurers	34%	53%	8%	4%

Under the recommended policy, only one insurer (Enterprise) is anticipated to exit and as is clear from the table above, they insure a larger proportion of the 1-4 partner firms than the typical insurer. Overall, this insurer represents less than 1.5% of all firms insured, but

[12] Solicitors Regulation Authority, Equality impact assessment guidance, January 2011.
[13] Each row will sum to 100% although actual figures may not do so due to rounding.

around 2% of firms with 2-4 partners. When considering all three unrated insurers, they have a larger proportion of both sole practitioners and 2-4 partner firms than insurers as a whole.

It is important to recognise this point since some equality indicators are also linked to the size of the firm. In as far as any negative effects of the recommended policy are observed with respect to these equality indicators, this is likely to reflect the fact that these insurers mainly insure small firms.

In terms of the number of solicitors as opposed to firms, because the unrated insurers are more likely than other insurers to be covering small firms, this means that they represent a smaller proportion of solicitors than they do firms.

Figure A5.2 - Unrated insurers 2013/14

Unrated Insurers	Proportion of firms	Proportion of solicitors
Alpha Insurance	14%	7%
Enterprise Insurance Company PLC	1.3%	0.8%
Elite Insurance Company	10%	4%
Total	**25%**	**12%**

Age

As can be seen in the table below, approximately 10% of solicitors are aged 61 or over. Unrated insurers are disproportionately likely to insure these older individuals as some 20% of solicitors insured by the firm expected to exit the market are aged 61 or over. However, this represents only 1.5% of all solicitors aged 61 or over.

Figure A5.3 - Type of firms insured by type of insurer 2013/14

Insurer type	Proportion of insurers' solicitors who are aged 61+	Proportion of all solicitors aged 61+ insured by insurer type
Won't seek a rating	20%	1.5%
All unrated insurers	16%	19%
All insurers	10%	100%

Under the proposed policy, it is anticipated that 134 firms would need to find alternative insurance cover. Most of these firms will be able to find alternative cover as capacity exists in the market to absorb the additional firms. As noted only 1.5% of all solicitors aged 61 or over would be affected by this.

In terms of whether the proposed policy is likely to have a detrimental effect on older solicitors, it is important to recognise that these solicitors will have built up a track record regarding their claims history. There is therefore no reason to believe that older solicitors would be badly affected by the policy since they will be able to demonstrate their own claims history.

Given the small proportion of those aged 61 or over who are expected to be affected by this and the fact that these solicitors will be able to demonstrate their own claims histories, no detrimental impact is anticipated related to age due to the proposed policy.

However, if all unrated insurers are unable to obtain a rating in the 'B's, then 2,560 firms would be required to seek alternative insurance cover. As highlighted in the main impact assessment the great majority of firms are expected to be able to find cover. It is possible that an issue may arise in connection with run-off cover if the remaining insurers (along with any new entrants) are may be reluctant to insure older sole practitioners whilst they remain active in the legal services market because the insurer may not wish to have a large exposure to run-off cover. This risk is considered to be relatively small.

Disability

Around 1% of solicitors have declared that they have a disability for the market as a whole. The small number of solicitors with a disability introduces some volatility into the rates when compared for individual insurers especially when those insurers cover relatively small numbers of solicitors. Nonetheless, both the insurer anticipated to exit and unrated insurers as a whole have similar disability rates to the market as a whole (1.3% and 1.2% respectively).

Given these figures, we do not consider that the policy will be detrimental for solicitors with a disability.

Gender

As shown in the table below approximately 44% of solicitors are female, but this figure is slightly lower for the insurer expected to exit and for unrated insurers as a whole.

Figure A5.4 - Type of firms insured by type of insurer 2013/14

Insurer type	Proportion of solicitors who are female
Won't seek a rating	40%
All unrated insurers	39%
All insurers	44%

Given that unrated insurers insurer a slightly smaller proportion of female solicitors than the rated insurers, the proposed policy is not anticipated to have a disproportionate impact on female solicitors.

Race

As indicated in the table below, there is evidence of a substantial difference regarding the proportion of Black and Majority Ethnic (BME) solicitors that are insured by the unrated insurers compared to other insurers.

Figure A5.5 - Type of firms insured by type of insurer 2013/14

Insurer type	Proportion of insurers' solicitors who are BME	Proportion of all BME solicitors insured by insurer type
Won't seek a rating	27%	1.4%
All unrated insurers	33%	28%
All insurers	14%	100%

As is clear from the table, 14% of all solicitors are BME. However this increases substantially for the unrated insurers where some 27% of all solicitors insured by the firm expected to exit are BME and 33% of all solicitors insured by the unrated insurers as a whole are BME.

Despite the large proportion of solicitors who are of BME origin, given the small number of solicitors that are insured by the insurer expected to exit, this translates to only 1.4% of all BME solicitors having to seek alternative insurance. As this remains a modest figure, we the proposed policy is not expected to have a detrimental impact on BME solicitors.

However, if all unrated insurers are unable to obtain a rating in the 'B's, then a much greater proportion of BME solicitors will be affected by this (28%) than solicitors in general (12% - see Figure A5.2).

This reflects the fact that BME solicitors are disproportionately likely to be working in small firms: among sole practitioners and those with 4 or fewer partners, some 22% of solicitors are of BME origin compared to 14% for firms as a whole. Hence the main driver of this result is the fact that unrated insurers are targeted at small firms. As indicated in the impact assessment, the great majority of firms would still be expected to obtain replacement cover from other insurers, and those firms unable to obtain insurance would be expected to be those with poor claims histories. Nonetheless there would be a risk that BME firms would be disproportionately impacted by any lack of available insurance - the SRA would engage with BME representatives in these circumstances.

Summary

The recommended option of introducing a minimum rating in the 'B's is expected to have fairly limited equality impact effects. This reflects the main impact assessment conclusion that we expect limited impact regarding the number of firms that are unable to obtain insurance.

Under the recommended option, no substantial impact is expected in respect of age, gender or disability. In respect of BME solicitors there would be a disproportionate impact as these solicitors are more likely to be insured by the insurer that is anticipated to exit compared to other solicitors. Overall, however, this would be expected to represent only 1.4% of all BME solicitors being affected which remains modest. The SRA's judgement is that the policy provides the best balance between providing additional protection for consumers and minimising any negative impacts on consumers and law firms.

If all unrated insurers exit the market, no disproportionate impact is expected in respect of gender or disability. This would bring a small risk of some older, sole practitioners finding it difficult to obtain replacement cover because if the remaining insurers were reluctant to have a large exposure to run-off cover. In addition, a disproportionate effect would be expected in respect of BME solicitors.

Summary of consultation questions

Question 1: Do you agree with our recommendation to introduce a long term insurer financial strength rating requirement into the Participating Insurer criteria with a minimum rating set in the 'B's ("secure" group)?

> **Question 1.1:** If not, please explain why not?
>
> **Question 1.2:** Do you have an alternative proposal?

Question 2: Do you agree that the acceptable rating agencies should be limited to Standard & Poor's (S&P), A.M. Best, Fitch and Moody's coupled with a facility for other agencies to apply to be added to the list of recognised agencies?

Question 3: Do you agree that the minimum rating requirement should apply to the insurer itself?

Question 4: Do you have any further comments you wish to make about this proposal?

How to respond

The SRA welcomes views on these proposals and any other aspect of this consultation, and **you can respond in a variety of ways**.

Online

Use our online consultation questionnaire form to compose and submit your response. (You can save a partial response online and complete it later.)

Email

Download a Consultation questionnaire (DOC 5 pages, 100K) and an About you form (DOC 4 pages, 100K).

Please send your completed response to consultation@sra.org.uk.

Please ensure that

- you add the title "Introduction of a minimum financial strength rating requirement for Participating Insurers" in the subject field,
- you identify yourself and state on whose behalf you are responding (unless you are responding anonymously),
- you attach the completed consultation questionnaire and About You form,
- if you wish us to treat any part or aspect of your response as confidential, you state this clearly.

Post

If you wish to submit your response by post, please send your response and a completed About You form to

Solicitors Regulation Authority
FAO Policy - Financial Protection
The Cube
199 Wharfside Street
Birmingham
B1 1RN

Deadline

Please send your response by Monday, **24 March 2014**.

Confidentiality

A list of respondents and 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.