Service Development • Professional Indemnity Insurance • Risk Management

ProfessionsUK's Response to ARP Abolition and Successor Practice Option

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1 Introduction

ProfessionsUK (PUK) offers service and risk management expertise, together with a unique PII (Professional Indemnity Insurance) facilitation service primarily to the legal profession, although from time to time, does work with other professions and service businesses. The organisation was formed in 2004 after the principal director had created a £5m PII book for a solicitor network client. In recent years, PUK has worked with over 20 firms who have found themselves in the ARP (Assigned Risks Pool), helping 4 to exit to date and discussed implications with dozens more. Its own research over the past 2 years has seen a worrying trend in the provision of PII, the behaviour of underwriters and brokers and the 10-fold increase in the number of organisations going into the ARP.

In addition, PUK shares a widespread concern over the speed of suggested implementation of not only the two consultation papers discussed here, but also in the proliferation of other consultation papers currently being circulated which are not only connected, but require careful consideration from an holistic and strategic perspective, not simply operational effectiveness. However, in a general sense, we do support the majority of these well-intended proposals, but foresee the critical need for an integrated approach for what could be portentously called, 'A Paradigm Shift' in the provision and delivery of legal services across England and Wales.

Views represented here are not only developed with the experience of PUK, but also from 25 years of working with service organisations, large and small, legal, financial, retail, entertainment and advertising companies, as well interviews with current and recent clients and attendees at a recent ProfessionsUK conference entitled: 'The Future of the Legal Profession 2010'.

The rest of this document comments on both the proposals regarding the ARP and 'Successor Practice' definition in tandem for ease of submission, and the author trusts that this will not cause too much of a problem in analysis and dissemination.

Mark Langley-Sowter

Director

Professions UK Limited

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2 Views on the Abolition of the ARP and other proposals

2.1 Fundamental Issues

Whilst the ARP Review proposes 3 different proposals, it is not only clear which one is preferred, but the strength of conviction it displays is quite significant yet it appears to miss much of the implications of such a move. The recent, again hurriedly released, 'Impact Assessment' (IA-SRA January 2010) does little to dispel the observation of a rushed and seemingly forced approach, although it does show better understanding now and is perhaps more aware of the implications of such a move. Consequently, I make no apology for repeating some of the comments made in the impact assessment since much of these were already gleaned during December 2009 and refined in January 2010 before the IA was published.

When the consultation paper was first read, the most striking observation was contained in Section 1.12 (i) as follows:

"When setting up the current arrangements there were some important features of the SIF arrangements which the Council wished to preserve including:

(i) The decision whether a firm should continue in practice should be that of the regulator, not the insurance market".

As published in the recent PUK Market Update, 'this vital premise does look to be at risk, since without the safety net of the ARP (and being closed down within a month of not being able to obtain open-market cover as the recommendation refers), the existence of ANY practice no matter how long they have existed, could be down to the whim of a disaffected underwriter or broker. And then what role do the SRA have in regulating the profession?'

To be clear, I personally feel that the abolition of the ARP is a good idea, particularly as it has been run no better than SIF in its final years of existence, plus, it is costing the insurers too much which in turn is a contributor to higher premiums in the open market. But in order for the abolition to work effectively, and this includes clients not just insureds, certain safeguards and processes need to be considered and put in place.

Crucially, any change affecting the legal profession here must have a corollary effect on the insurance and broker community. Nor I am I saying be blindly sympathetic to poorly run firms or those who have nefariously suffered from 'rogue partners' or 'dishonest staff'. Sure, identify, target and rid the profession of bad firms and individual solicitors, for whom the rest of the profession and ultimately, clients, have to pay for. But at least create a system whereby firms can seek support, help and relevant advice in developing a culture that not only talks good risk management, but implements it too!

So, returning to this elemental question: "what role do the SRA have in regulating the profession?" I do not wish to be provocative but I do seek solutions for creating a more robust and effective PII system. Nevertheless, passing over complete responsibility to insurers without a safety net, or at least a period of transition, will dangerously bring more good firms down than bad, since it is the latter who already know 'how to play the system' and will be looking for ways round the impending problem (and opportunity?) as we speak!

Pleased though I am to see the new paper on 'Achieving the Right Outcomes' and the proposed, fundamental change in approach to regulation (this truly is a paradigm shift!), I do feel the need to repeat a currently-held criticism of the SRA and the ARP, in not identifying the good firms and helping them to get out of the ARP. From experience of dealing with over 200 firms during the past 3 years, I have found that the main role of the SRA when visiting not only ARP firms is simply checking accounting practice, compliance and procedure and a review of some files. Quite rightly so, though assessing if firms are getting monies in the wrong column with no detriment to the client or evidence of dishonesty really is the easy bit! And sadly, much of it is not only desk-based, but visited firms are rarely re-visited to assess improvement or decline.

However, I keep seeing bad firms escape attention and generally good ones dealt with to the extreme and heavy-handedly. Similar to the recent complaint of Ofsted *(Office for Standards in Education)*, in that they appear to concentrate more on test results than assessing the quality of teachers, the school's ethos or culture or how well pupils are learning and parents are satisfied (particularly those schools in challenging locations, much like solicitor firms working with disadvantaged groups under the LSC), the SRA appears to concentrate on the easy bits- quantitative and not qualitative evidence.

Staying with the Ofsted analogy (it is interesting the SRA call them 'Monitoring Visits'), a case of inspectors allegedly spending most of their 1½ days visit 'in their car checking test results', is similar to a 50+ partner firm I know who was visited by SRA 'inspectors' during 2009 and in less than 2 days, they left saying all was fine! How is this possible (I have pitched for work with this firm and since they have over 1000 employers, my 'Stage 1: Familiarisation & Review', takes in interviews with at least 10% of staff and 40% of partners, so you can work out how long we take to gain an understanding of the organisation's culture and assess risk management attitudes; And only then do we carry out file reviews and quality procedures!)?

'Achieving the Right Outcomes' is most welcome, but that is for separate discussion.

'The decision whether a firm should continue in practice should be that of the regulator, not the insurance market' surely must remain as a principle for the SRA to ensure one of its core roles of regulation. If not, the 'power to close' will be with 'the power of the pen' unless safeguards can be created to avoid such potential, or at least minimise the opportunity. To be clear, this is not a slur on the PII industry, nor underwriters, but a deep understanding of how PII business is written in the City and there are already, as will be discussed later, other inhibitors which are restricting even good firms from obtaining competitive PII premiums in the open market.

The second fundamental issue coming out of this review is how badly the ARP has been run over the past 10 years with the ARP fund currently 'burning' at 600% (in some years it was over 1000%!) and the appalling success rate of premium collection. I will not dwell here, but the profession should be given answers as to what the SRA has been doing to monitor and penalise the performance of Capita? And why they were awarded a further 3 years control, neatly expiring this October, when results were so dismal?

Thirdly, both the SRA and ARP have been remiss and effectively absent in enabling and helping the 'good firms' out of the pool, concentrating on already cash-strapped firms that hold no risk to the public, yet are required to fund unwanted monitoring visits and exorbitant ARP calculated premium. This key issue may begin to be addressed when outcomes-focused regulation comes into being, but what is to be done in the meantime?

This third area also raises a different kind and somewhat unnoticed discrimination against smaller firms; in that a lower income practice is calculated to pay significantly more proportionately than a larger firm (27½% of turnover vs 11% is one example). In addition, a monitoring visit fee of between £2000-3,000+VAT is again punitive and proportionately higher for smaller organisations than large ones. Not only an anomaly, but another reason why perhaps, the SRA/ARP has been less than successful in collecting premiums from the majority of incumbent firms, who are generally 1-3 partners in size.

Taking into account the current recession and the significant drop in turnover of many small firms, maintaining an already distorted formula of using previous years' turnover figures, knowing they have dropped often by more than 50%, is quite ludicrous and self-defeating, never mind care-less.

Additionally, little help, if at all, is given to ARP firms to enable them to exit the pool, save for an unqualified list of usually impotent brokers. As a side, PUK has perfected a process that has had success in the past 2 years in not only helping firms to exit the ARP early, but also to enhance their position in the eyes of insurers, as well as supporting them in growing their business on sound risk management principles. Interestingly, I am not aware of any competition in this area, nor conscious of any similar support coming from the SRA. Maybe in the future?

2.2 Role of Insurers

In whatever form the abolition of the ARP takes, or its timing, the role of insurers needs to change too, particularly in the area of service and meeting minimum obligations.
Too often the relationship is one-sided and lawyers find themselves at the mercy of avarice brokers.

2.3 Role of Brokers

Similarly, the role and behaviour of brokers need to change and liaison with the FSA is crucial here to create an enforceable code of practice and not just voluntary.

The culture within both professions, with notable exceptions, is generally one of greed over client need and mystery over transparency. The sooner the FSA impose similar regulations as those adopted in the wake of pension and endowment mis-selling, to name but two on the life and investment side, the better, and the SRA can help here too.

PUK has potentially suffered here as a number of large and well-established brokers have warned the author NOT to publish what has been loosely titled, "The PII Secret". To what end you may wonder and I will leave you wondering. The Law Society's well intentioned link up with AON in the publication of *'Insurance Matters'* though helpful is mis-guided to say the least, since its independence is now in question.

2.4 Role of SRA

The key concerns have already been highlighted, though I wish to stress that where the planned changes are welcome and overdue in the main, an integrated and timely approach is vital, along with continued consultation with the profession and other stakeholders. The demise of the 'high street practice' is much heralded and somewhat exaggerated; much like 'the death of the IFA' was in the 1980s. Yet the SRA must remain vigilant in ensuring the public has access to alternative forms and models of advice, not just institutions and major corporates! As already mentioned, the paradigm shift outlined in changing to an 'outcomes-focused' regulator is welcomed, but again, culture change within the SRA is also essential to achieve successful implementation of service strategy.

2.5 Creating a SLA (Service Level Agreement)

In order to smooth the transition to only having open market PII, a SLA is crucial to its success, since too many firms are 'held to ransom' by local and national brokers alike in the slow release of renewal terms, a lack of transparency when it comes to market access and insurer-broker relationships, to name but three areas of concern. An FSA enforceable SLA for insurers and brokers would help all concerned and ideas as to its form are detailed in the 'Recommendations and Considerations – ARP' section.

2.6 Discrimination and other issues

Like the recent 'Impact Assessment', solid data and verified evidence has been difficult to quantify, but evidence there is, both anecdotal and witnessed. Some of this is even confirmed by the SRA especially as regards the disproportionate number of BMEs in the ARP (the actual number is much higher since the 'Unknown' column is 3 times higher than the overall firm figure for 2008/09, and although the figures for 2009/10 have yet to be released, the 42% of BME firms already identified might suggest the truer statistic could be as high as 60%).

Words and phrases such as a 'Namist approach/culture', 'Postcode avoidance' (one insurer we are told, will not insure anyone with an Ilford (IG) postcode), 'Lawyers with a vowel at each end of their surname are not welcome', 'we don't like the mix of Immigration and Conveyancing' (even if the firm has a spotless record and an 80/20 split), and outright racist comments (not to printed here for obvious reasons) have become increasingly common in the past 3 years and mostly emanating from the City. 'Feeling victimised' is also a common response when talking with hapless clients and the author has found it particularly bewildering when a complete set of responses from a market survey simply says 'Declined to quote' – and I mean insurance terms here! Whether it is institutional, to use the emotive epithet is hard to assess, but it is real and affecting many good firms.

At the time of writing, PUK has 8 clients it has been helping to exit the ARP and most since November 2009. In each case, a Risk Management Review has been carried out and report put to the insurers but to no avail, even though 3 of the 8 are 'whistle clean', 2 with a few blemishes, and the remaining 3 improving, after suffering from careless supervision. In no case has dishonesty or concern for the public been alleged, nor has any client suffered a loss, yet no insurer is interested in quoting them out of the ARP, whether or not at a higher premium.

In addition, I have 4 'start-ups' who are also 'whistle clean' from my experience and assessment of them. Still, I am unable to obtain PII despite presenting validated business plans, realistic cash flow forecasts, office manual and risk management procedures, experienced and bona fide CVs and unconditional Practicing Certificates, anticipating a premium of 12-15% of turnover for the first year. And all 12 organisations are black!

As a further aside, an essence of my humble philosophy of life is that 'people are people', regardless of colour, creed or country. Sure, this is a cliché, but unless one completely believes this, as I know I do, other factors can creep in to alter 'other people's' perception of what is notionally real and what is not.

It is clear that discrimination is an issue and not simply from normal underwriting principles, therefore, action needs to be taken to expunge it from the process.

2.7 Exiting the ARP

Future plans of the SRA may begin to address the lack of support, guidance and education of firms currently in the ARP. Sadly, the current approach does little to help firms exit the pool early before crippling costs engulf or force individuals to take evasive action. In a bizarre sort of way, the focus on monitoring from a compliance-only point of view and simply chasing excessive premiums actually exacerbates the problem, particularly, with those firms that can be lightly described as 'good'.

Regardless of when the ARP abolition takes place, as it certainly is a 'when', not 'if', greater effort is required in establishing a procedure for exit which also requires support and greater understanding from qualifying insurers. Which leads to…..

2.8 Identifying 'bad' firms

Of course, the SRA is doing its utmost in this area, but greater collaboration and sharing of information between regulatory bodies, the insurers and brokers and members of the profession, both hard and soft data, is vital in targeting and identifying the corrupt or careless practices. It is incumbent on the profession as a whole in order to maintain the integrity of a much-maligned industry.

3 Client and Conference Feedback – ARP

At a recent conference run by ProfessionsUK in association with LawGroupUK, the following summary responses were recorded after debate and discussion on the implications of abolishing the ARP. Four key questions were asked at the end of the meeting:

'What does it mean to me/us?'

- Uncertainty
- It's a disadvantage to smaller firms
- There is a conflict of interest between the Law Society/SRA/Insurers
- BME solicitors are being unfairly targeted and penalised
- Responsibility for closing a firm will shift to insurers
- It affects the whole profession

'What are the barriers (to change)?'

- Not having a unified PII form and questionnaires
- Multiple forms and being inundated
- No relationship with brokers, which has led to
- Mistrust and uncertainty
- Lack of information from both insurers and brokers as regards underwriting criteria
- A lack of openness and transparency in the market
- The SRA's approach to the problem
- Inertia of the profession

'What help do I/we need?'

- Better risk management throughout the profession
- Measurement in quality not just quantity
- Layered insurance options to spread risk
- A unified proposal form to 'fit' all insurers
- Clarity and information on underwriting criteria
- The market (brokers and insurers) need to be more open

'What will I/we do differently?'

- Prepare and get in (to the PII process) early
- Provide more information and documentation on good practice
- Provide more information and documentation on claims/ notification
- Cheaper Risk Management Audits and Certified
- Ask more questions of my broker
- 'Perhaps we can all change our surname. That would fool them!'

4 Recommendations and Considerations – ARP

Set out below is a list of suggestions and ideas that we believe need either inclusion or careful consideration in there application to the process and implementation of abolishing the ARP. Proposals 2 and 3 are not considered since it is felt that they add little or no value in addressing the concerns previously outlined by the SRA.

a) Creation of an enforceable dual expectation SLA (Service Level Agreement) to include:

- Enforcement by SRA/BiBa/FSA
- Minimum period for Renewal Terms to be issued (at least 4 weeks before 1 October)
- Providing completed PII forms received a minimum of 2 weeks earlier
- Maximum 3 day turnaround of up to date historical Claims Summaries
- Disclosure and evidence of ALL insurers approached by brokers (and who they are unable to approach and why)
- SRA to publish core underwriting criteria of participating insurers, ideally by no later than 31 July each year (this will save time and effort by not going to an insurer that does not really want 'your kind of practice')
- Transparency of relationship with insurer and commission/incentives/fee levels
- Non-poaching agreement when Sole Appointment letter exists
- Broker TOBA (Terms of Business Agreement) to be issued in all transactions
- Minimum Mutual Service Expectations (i.e. what is expected of each other)
- PII Market to 'open' no later than 1 August each year unless a late entrant

b) Uniform PII Proposal Form and questionnaires
c) Establish a 'Quote Guarantee' in that a PII Quotation will be issued by each participating insurer approached and so make 'declining' a thing of the past. To use car insurance as an analogy, if you have had claims, you are likely to pay a higher premium with corresponding higher excesses and possible conditions (such as retake test). Similarly in PII, the majority of quotations are 'engine-generated' and can be adjusted by the underwriter or broker. Whether the premium is excessive or not will then be the choice of the solicitor firm. This may be difficult to police, but would improve the status quo.
d) Copy of one PII form to go to SRA each year by 1 August in order to assess and identify struggling or bad firms (a potentially mammoth task initially, but once computerised after its first year of introduction, the process can become relatively automated as key indicators could be established which would flag up concerns). This is long overdue and should be a cornerstone of any changes along with a) above
e) Develop an 'exit strategy' for those currently in the ARP by identifying 'good' firms in parallel to targeting 'bad' firms (the SRA's approach here will need to change somewhat from its current processes)
f) Develop a more flexible approach for the calculation of ARP premiums in the light of the significant reductions in income, current recession and market conditions
g) Upon implementation, allow 2 months grace to ease the transition
h) Root out discrimination
i) Identify bad firms earlier through greater sharing and analysis of information across the profession and insurance market

5 Views on the 'Successor Practice' Definition

5.1 Impact of implementation

The proposed changes to the 'Successor Practice' definition are welcomed. However, we believe they do not go far enough in making them both workable and worthwhile for all interested stakeholders.

Whilst the option of triggering 'run-off' cover at the point of merger is deemed useful, research with over 50 small to medium-sized firms (sole and 2-5 partners) indicates an overwhelming concern as to the additional cost involved since the required amount to effect the change could be 2 or 3 times the current premium of the firm taken over. An example of this could be two, 2-partner firms whereby one has an annual PII premium of £30,000 and the other (the practice to be taken over), £20,000. Apart from the agreement to merge, any goodwill arrangement and attendant costs of merging (staff redundancy, office closure, revised marketing literature and advertising, to name a few), the additional cost of having to find between £40-£60,000 is likely to be a deal breaker and unattractive to all parties concerned. Plus, with the pressure of needing to apply and decide in 30 days of merger, some firms may needlessly put themselves in hoc to rue the action at a later date. Encouraging debt is not a sensible way forward as we have seen.

5.2 Alternative Model 1

There is another way that PUK believes could be advantageous in the proposal's implementation, not only for the profession but insurers too and it is based on current underwriting criteria in the market.

Historically, if two firms merged, the insurer who then carried the risk may or may not make an adjustment to the combined practice's PII premium. Either way, the effect of one becoming the successor practice is factored in, 'as if' the practice taken over was already in run-off (the reality is that as opposed to the normal 6 years, subsequent insurers are taking on the risk for a much greater length of time assuming the new entity survives and prospers).

Therefore, as an alternative model, the proposal could allow the following approach:

- **Make the option retrospective for 6 years**
- **Maintain the option each year until 6 years have elapsed from merger**
- **Which allows a consequent reduction each year until this point**
- **The effect is that it spreads the impact of cost and risk**
- **Other professions have a similar arrangement on closure**
  E.g. Insolvency Practitioners

There is some detail to be gone through to make this model work, but if the principle is adopted, working out an effective process should not take too long and the author would be happy to discuss this further.

5.3 Supporting the process

Regardless of the above alternative approach, the SRA and Insurers may also wish to consider creating spread finance, again, to minimise the impact of additional cost at the point of merger and spreading the risk.

6 Client and Conference Feedback – SP

Similar to the ARP review, at the recent conference run by ProfessionsUK in association with LawGroupUK, the following summary responses were recorded after debate and discussion on the proposed 'Successor Practice' option. Four key questions were again asked at the end of the meeting:

'What does it mean to me/us?'

- More mergers could be encouraged
- Greater consolidation of the profession
- The (attendant) cost may be unattractive
- Seems a good idea
- Additional finance is likely to be needed

'What are the barriers (to change)?'

- Its too expensive
- Negotiation of 'price'
- Different run-off conditions (x1,x2,x2.5,x3)

'What help do I/we need?'

- Finance alternatives
- A unified approach

'What will I/we do differently?'

- Lobby for the alternative model!