



ANNEX 1

THE IPS RISK FRAMEWORK

BACKGROUND TO THE REGULATION OF LEGAL SERVICES

Developments in the Regulation of Legal Services

1. The LSB and approved regulators must ensure that regulation in the legal services sector is carried out in the public interest, and that the interests of consumers are placed at the heart of the regulatory system. The Act places an obligation on the LSB and the approved regulators (ARs) to comply with the same regulatory objectives.
2. The regulatory objectives are: protecting and promoting the public interest; supporting the constitutional principle of the rule of law; improving access to justice; protecting and promoting the interests of consumers; promoting competition in the provision of services that are provided by authorised persons (including services which do not involve the carrying on of activities which are reserved legal activities); encouraging an independent, strong, diverse and effective legal profession; increasing public understanding of the citizen's legal rights and duties; and promoting and maintaining adherence to the professional principles.
3. Furthermore, ARs must have regard to the principles of Better Regulation under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted at cases where action is needed.
4. IPS, as the body responsible for carrying out regulatory functions in respect of CILEx members will carry out a risk based approach to regulation that promotes the regulatory objectives and which supports the Better Regulation Principles.

Opportunities for CILEx Members

5. The Legal Services Act opens the opportunity for IPS to seek practice rights for CILEx members and for CILEx members to thereby become owners and

managers in entities. The availability of practice rights will enable CILEx members to become the Head of the Legal Practice (HoLP).

6. IPS will therefore seek practice rights for CILEx members and develop itself as a regulatory body for entities through which CILEx members and others may deliver legal services, including reserved legal services. IPS commissioned CFE (Research and Consulting) Ltd, an independent specialist research consultancy, to undertake research into and develop a Risk Framework for the authorisation and monitoring of entities regulated by IPS.
7. The research identified that CILEx members want to see IPS develop as a robust regulator, and although they do care about the financial cost and regulatory burden, this was secondary to IPS not being seen as a poor quality alternative. CILEx members consulted by CFE expressed a positive attitude to regulation stating that regulation should be decisive and gather the information necessary, but on the basis that it avoids becoming overly cumbersome and intrusive.
8. CILEx members also agreed that IPS must be able to become an entity regulator to supervise them in independent practice if the extended Practice Rights are to be fully meaningful.
9. Following the research a framework was developed that IPS can use for the authorisation and monitoring of entities. This consultation seeks views on the proposed framework and approach to risk based regulation.

Note – the term 'entity' is used in this document to describe any business, including sole practitioner businesses, providing legal services. The term 'legal services' is used in the widest sense to include both reserved and non-reserved activities.

THE IPS RISK-BASED APPROACH TO REGULATION

Risk-Based Regulation

10. IPS' proposed risk-based regulatory regime will support the regulatory objectives including protecting the public interest and the interests of consumers. The risk based approach to regulation will enable IPS to take a proportionate approach to regulation. IPS will be able to target its regulatory resources more effectively at those entities that present higher risks, and thereby ensure that protection of consumers lies at the heart of IPS activity.
11. IPS is developing 'Outcomes' that its regulatory regime must deliver. It is also identifying factors that present a risk to the achievement of those Outcomes. IPS has also developed measures and indicators designed to assess the probability and impact of the risk factors. IPS will use this mechanism during its regulatory processes to assess risks posed by entities seeking regulation by IPS or which are

regulated by IPS. The assessment of risk against the Outcomes will identify the action that IPS will take to the regulation of entities.

12. IPS will work with entities to minimise the likelihood that Risk Factors will significantly impede the achievement of Outcomes and will use proportionate disciplinary and enforcement processes against those entities who do not engage constructively in support of this aim.

13. The following table summarises Risk Framework.

Perspectives	Component	Description
Why and What	Outcomes	Describes the results that IPS wants to ensure in regulating supervised legal services entities.
	Risk Factors	Describes the key sources of risk (positive and negative) in conducting legal services.
	Risk Measures and Indicators	Describes how Risk Factors are assessed in terms of their Probability and Impact.
How, When, Who, Where	Assessment and Prioritisation	Describes how Risk Measures and Indicators are used to evaluate entities and determine how IPS will ensure that they are properly regulated.
	Application, Monitoring and Enforcement	Describes how Risk Measures and Indicators are captured from specific entities in entering and sustaining IPS regulation.
	Governance	Describes how Assessment, Prioritisation, Application, Monitoring and Enforcement processes are directed and improved.

IPS Principles and Outcomes

14. IPS Outcomes are statements which will flow from core Principles and describe the goals which IPS is committed to achieving for consumers of legal services, and to which it expects IPS authorised legal entities to similarly commit and work to achieve.

15. The following nine Principles currently appear in the IPS Code of Conduct. These Principles are being reviewed and will be supplemented by Outcomes expected of entities regulated by IPS. A further consultation on revised IPS rules will follow.

The current IPS Principles state that those regulated by IPS must:

- (1) Uphold the rule of law and the impartial administration of justice
- (2) Maintain high standards of professional and personal conduct
- (3) Behave with honesty and integrity
- (4) Comply with the CILEx and IPS rules and bye-laws
- (5) Act in the best interests of your client
- (6) Treat everyone equally and fairly
- (7) Ensure your independence is not compromised
- (8) Respect confidentiality and trust
- (9) Act within your competence

Risk Factors, Risk Measures and Indicators - The IPS Risk Matrix

16. The aim of the Risk Framework is to ensure that IPS can assess whether the entities it regulates will meet the Outcomes. The factors which may affect the achievement of the Outcomes will be assessed through measures and indicators.
17. The following assessments will be undertaken using the Risk Matrix to consider the measures and indicators:
 - (i) Basic Risk Assessment (Desk-Based)
 - (ii) Advanced Risk Assessment (Visit-Based)
18. The Risk Matrix provides a combination of theoretical and practical models to ensure that IPS can effectively measure the broad range of risks posed by each entity it regulates in the public interest. Risk Assessments will be conducted against all the services provided by the legal service entity encompassing both reserved and non-reserved activities.
19. IPS recognises that risk factors can change, for example, due to technological changes, economic and other environmental changes. The Risk Matrix is therefore a guide to assist IPS in measuring Risk. It will be supplemented on an ongoing basis to factor in any new or emerging risks.

Basic Risk Assessment – Summary

20. The Basic Risk Assessment is a desk-based assessment of the information received by the IPS Risk Unit (IRU). Information received when the entity applies for authorisation will include details of the structure of the entity, its processes and procedures including how it will manage risk, and the activities it seeks to undertake. The information will be supplemented with additional applications for the approval of individual managers and the HoLP (Head of Legal Practice) and HoFA (Head of Finance and Administration). All the information supplied by the entity will be cross-referenced with other information held about the entity. This will include information which could have been gathered from other sources, e.g. other regulators or from CRB checks. The information gathered will be combined with further factors, including the IPS Assessment of the external environment in which the firm operates. Once authorised the entity will be responsible for submitting annual returns to IPS which will include a Risk

Register detailing how it has dealt with risk throughout the year. The entity will also have ongoing obligations throughout the year including being responsible for advising IPS when any material risks have or are anticipated to occur, which will include any significant changes to the structure of the firm.

21. The Environment Assessment provides a Risk Grade for each area of law and will be reviewed and updated where necessary to factor in increased or emerging risks in all areas of legal services that IPS encounters through its regulatory operations. Responsibility for authorising reviews and updates of the Environment Assessment by the IRU will rest with the IPS Operational Risk Board (ORB) who will review the Environment Assessment as part of a wider quarterly review of the Risk Framework to ensure that the framework is being operated and updated where necessary.
22. Each entity will need a Basic Risk Assessment both at the application stage and at least annually thereafter. The Basic Risk Assessment will also inform the IRU whether an Advanced Risk Assessment (Visit) is needed after the initial application stage. This could occur for example if IPS receives intelligence either from the entity itself or from a third party which significantly affects the entity's profile.
23. Where there is a significant change in the Risk Profile, (or intelligence indicates a potential change), the first stage for the IRU will be to undertake a further Basic Risk Assessment having first contacted the entity, if necessary, to gather further information. The IRU will then need to decide whether the risk level has changed to a degree significant enough to recommend a visit. All visit recommendations will be made to and authorised by the Operational Risk Board (ORB). A representative of the ORB will decide whether to authorise if and when a visit should be made based on the recommendation received. IPS resources will be prioritised and targeted in the case of high risks requiring urgent further investigation.

Advanced Risk Assessment – Summary

24. The Advanced Risk Assessment is undertaken by conducting a visit to the entity. Factors that influence the nature of the visit will include the size of the entity, its history including with other regulators, and the details and nature of the risks identified at the Basic Risk Assessment stage. The purpose of the Advanced Risk Assessment will be to test and support the entity in improving its risk processes (if improvement is necessary), and thereby to ensure that the entity can meet the Outcomes set out in the revised IPS Code of Conduct, thus protecting consumers.
25. The visit to the entity will have a further purpose in making sure that the entity has the necessary procedures in place to provide the information required by IPS at the annual return stage, and for the HOLP (Head of Legal Practice) and HOFA (Head of Finance and Administration) to understand their responsibilities in

recording risk events on an ongoing basis, which will include notifying IPS in the event of any material risks occurring.

The Output

26. The Risk Assessment on each entity will consist of an information sheet containing the Basic Risk Assessment and Advanced Risk Assessment calculations. The Operational Risk Board (ORB) will consider the assessment and determine the next steps. The next steps will include Authorisation, Conditional Authorisation, and consideration of disciplinary and enforcement action following an Advanced Risk Assessment.

Comparing the Assessments

27. The main purpose of the Basic (desk-based) Risk Assessment is to assess the level of risk posed by the entity and to consider the next steps. At the Authorisation stage the next step could be to either authorise the entity, or to visit the entity. Once an Advanced Risk Assessment (visit) is carried out the advanced risk rating process will show whether the Basic Risk Assessment score is an accurate representation of the risk posed by the entity. The comparison of Basic and Advanced Risk Assessments from all entities visited will also provide useful data to the Strategic Risk Board (SRB) on whether Basic Risk Assessments are proving to be accurate.
28. The specific measures and criteria IPS proposes to use when undertaking the Basic Risk Assessment is shown below. The Advanced Risk Assessment visit process will test the information provided for the Basic Risk Assessment through a combination of interviews with senior staff at the entity, reviews of systems and procedures, reviews of files and complaints, and a review of accounting information.

THE BASIC RISK ASSESSMENT

The Basic Risk Assessment is measured using the following calculation:

IMPACT X PROBABILITY = RISK

Impact Factors are those that determine the effect an entity may have on the IPS regulated marketplace should its risks crystallise and consumers are not served in accordance with IPS Outcomes.

Probability Factors are those that determine how likely it is that those effects happen – i.e. that the entity cannot service consumers in a way which contributes to the achievement of IPS Outcomes.

The following six Risk Factors will be used to assess the entity's Impact and Probability:

Impact Factors

Impact is a function of the following two factors:

- (i) Environment: a function of the clients the entity works with and the services it delivers to them
- (ii) Size: as entities take on a greater number of clients and cases they can have a much greater impact if risk crystallise

The above factors are multiplied together to reach an Impact rating.

Probability Factors

Probability is a function of the following four risk factors:

- (iii) History: the track record of the entity in terms of its owners and key employees, its history with IPS and with other regulatory bodies, and its history of receiving and managing complaints
- (iv) Leverage: the relationship of caseload to the number of approved competent persons to deliver them
- (v) Dependency: The relationship of the entity to its largest clients
- (vi) Systems: relative to the entity's size and complexity

The aforementioned four risk factors are treated individually and then added together to reach a rating for Probability.

PROBABILITY SCORE = HISTORY + LEVERAGE + DEPENDENCY + SYSTEMS

TOTAL SCORE: IMPACT SCORE X PROBABILITY SCORE = BASIC RISK ASSESSMENT RATING