

## **Transitioning towards an insurance backed compensation scheme**

Summary of responses and CILEx Regulation response.

### **Introduction**

1. On 10 March 2017 we issued a consultation document seeking views on changing our compensation arrangements to transition towards an insurance backed scheme.
2. This consultation made a number of proposals to change the CILEx Compensation Fund Rules with a view to moving towards a largely insurance backed compensation scheme as opposed to the maintenance of a substantial fund. This is intended to achieve a more proportionate and cost effective regime while maintaining robust consumer protection.
3. The consultation closed on 5 May 2017. This report summaries the key points emerging from the responses together with our response.

### **Responses received**

4. We received eighteen responses from a variety of stakeholders including members
5. A list of respondents who consented to their information being published is set out at the end of this paper.

### **Overview of responses**

6. We were pleased to note broad support for the proposals. The analysis below sets out in more detail the issues which were raised and our response. Though all submissions have been considered carefully our responses below may focus upon more in-depth feedback provided by key stakeholders during the consultation where available.
7. The Legal Services Consumer Panel (LSCP) as part of its response raised concern about the increasing disparity in approaches between legal services regulators in the context of compensation arrangements. We sympathise with the concerns raised and would welcome discussions in this respect looking to the future. For the moment however we feel strongly that we need to ensure the sustainability and effectiveness of the compensation scheme for CILEx Authorised Entities. A unified sector wide approach to client compensation arrangements if achievable is not a short to medium term option for addressing the issues raised in this consultation.

**Question 1. Do you agree with our proposal to transition towards a largely insurance backed compensation scheme rather than continuing to rely on a large fund?**

8. Fifteen of the eighteen respondents agreed with the proposal to transition towards a largely insurance backed compensation scheme.
9. Seven were very positive in support for the proposal and one respondent asked whether it would lead to substantial savings in the Compensation Fund contributions.
10. The one respondent (anonymous) who expressly disagreed was concerned that by relying upon insurance it may have an adverse effect on the ability to support consumers.
11. CILEx were supportive of the move recognising that an insurance backed model is more proportionate and offers important safeguards that a single fund may not be able to offer in the event that the fund were depleted.
12. The Legal Services Consumer Panel (LSCP) were not opposed to moving to a largely insurance backed scheme in principle but found it difficult to assess the proposal given the evidence base available. The LSCP were particularly concerned that a change in policy was suggested, namely that dishonesty would for the first time need to be demonstrated by claimants on the Fund (as explained below, this is a misunderstanding). The LSCP indicated that publication of claims data would be helpful in assessing the evidence base.
13. The Council of Mortgage Lenders (CML) agreed on the assumption that lenders will be able to make a claim under the fund and that CILEx is confident that there will be insurers available in the market. The CML would like to understand whether additional insurance backing is available and/or is it dependent on reducing the potential claimants under the Fund, such as the carve-out for business clients as proposed.
14. Another respondent commented that there may be challenges with largely insurance backed scheme if there are a limited number of specialist insurers in this area.

**CILEx Regulation response**

15. We are encouraged that the vast majority of the respondents were in favour of the proposed move to a largely insurance backed compensation scheme. The responses very much support our preliminary view that such an approach represents a more effective, proportionate and sustainable approach. Although one respondent did consider that the move would not support consumers no evidence has come to light during the consultation to contradict our original assertion that the practical impact upon potential claimants is neutral. In some areas the protections will be improved.

16. In terms of the need to demonstrate dishonesty this has been a requirement of the scheme since its inception. No change is proposed in this respect. Currently the requirements in this respect are set out in criteria which sit underneath the rules. This approach was envisaged by article 2(5) of the 'section 69 order' which established the scheme (The Legal Services Act 2007 (Chartered Institute of Legal Executives) (Modification of Functions) Order 2014) and allowed for decision making criteria to be set out in guidance. However we consider that it would be clearer if this requirement was set out in the rules themselves. This is why we are proposing to change the rules to clarify this point. No change in policy or approach under the regulatory arrangements as a whole is proposed however.
17. For the avoidance of doubt there is no claims data available as regards CILEx Authorised Entities. No claims on the Fund have yet been made and are not anticipated in the immediate future given the current number of entities regulated. This would of course have been published were it available. Instead we have looked where possible to comparable data available from other regulators.
18. We are grateful for the CML response to the consultation but should stress that it is difficult to envisage a scenario by which a lender could satisfy the hardship test for making a claim on the fund.
19. We are conscious of the need to obtain insurance on the open market for a largely insurance backed compensation scheme. A number of our proposals are intended in part to provide a level of clarity which will better facilitate the insurance of the risks posed. We have arrangements in place already to expand the insurance of claims under the compensation scheme and the changes proposed will assist further in ensuring the sustainability of the regime. On balance we remain of the view that an insurance backed scheme remains a more sustainable model given current numbers of authorised entities. As numbers grow we will keep the position under periodic review.

**Question 2. Do you agree with our proposal to introduce eligibility criteria and the threshold proposed for placing certain organisations outside the protections of the compensation arrangements?**

20. Respondents were again mostly supportive of this proposal, though a few respondents did expressly disagree.
21. One respondent questioned why charities should be outside of the scheme, as they viewed that both individuals and charities should be covered. Another indicated that everyone should be compensated under the scheme.
22. The CML considered that lenders in conveyancing transactions should fall within the remit of the scheme but that clarity as to eligibility would ultimately be welcomed.

23. The LSCP were concerned about the impact of the proposal upon micro-businesses. The LSCP considered that the financial hardship test was sufficient but that if eligibility criteria were to be adopted then clearer definitions should be provided for consumers.
24. CILEx were supportive of the principle that limiting access to the scheme to those who most needed it was the right balance to strike given the limited resources available. CILEx suggested that the level be reviewed in due course as claims data becomes available.
25. Comments as to the specific test proposed for eligibility included:
- that the criteria would need to rely on careful professional and unbiased assessments;
  - whether the spirit of the approach could be compromised in a scenario in which a company has significant turnover but no profits;
  - a clearer definition of what is considered assets and income was needed;
  - whether property value in London may mean that individuals without significant income may;
  - whether a two stage test would be better whereby a claim could still be made where hardship is satisfied;
  - whether unincorporated associations and charities would be covered by the term 'person';

### **CILEx Regulation response**

26. The intention of the proposal was to provide greater clarity as to who would definitely not be able to claim on the compensation scheme. There is no proposal to alter the 'hardship test' and as such the principle that the scheme be restricted to those most likely to suffer as a result of a loss is intended to remain. We agree with CILEx that this is an important principle to maintain given the limited resources available.
27. We have considered carefully the concerns raised as to the potential for impact upon small businesses and those with low profit margins. We have looked again at the approach taken by other regulators and complaints bodies in this area and note that a number including the SRA work to a higher eligibility 'cut off' point of £2 million assets / turnover. Bearing in mind that there will remain a hardship test to satisfy, and in order to reduce the risks of scenarios raised as potentially problematic during the consultation, we are proposing to increase the eligibility criteria for non-consumer clients to turnover of up to £2 million (or a net asset value of £2 million plus solely for trusts). Having reflected upon the concerns and scenarios raised in the consultation we consider that this is a more proportionate and balanced approach.
28. In terms of the impact on individuals with high value residential property (as is common for those living in London as was pointed out during the consultation) we would highlight that individuals acting in a non-business capacity will fall under the definition of 'Consumer'. A high-value home would not therefore typically impact upon an individual's eligibility to claim

on the fund in connection with a loss arising from work undertaken for them personally outside of working life.

29. It should be noted that the rules would be interpreted in accordance with the Interpretation Act 1978 and as such the term 'person' would include unincorporated associations and charities.

**Question 3. Do you foresee any issues with CILEx Regulation seeking to fund professional indemnity insurance run-off premiums where firms are in default but continue to incur liability?**

30. Broadly the respondents were not in favour of this proposal. Seven respondents thought there could be technical issues with CILEx Regulation seeking to fund professional indemnity insurance run-off premiums.
31. One respondent commented that membership subscriptions should not be used to fund firms who knowingly do not pay run-off. CILEx, in common with some other respondents, felt that the costs of the proposal would be too onerous. The LSCP similarly raised concerns as to sustainability.
32. One respondent commented that to incur liability would only increase insurance for those firms which follow procedures and guidelines.
33. The CML supported the concept but believed there is the potential to incentivise firm non-payment. They wished to see assurances that this could be afforded and the ability to raise additional funds from the sector if required. Alternatively insurance firms should be asked to cover as per the SRA arrangements.

**CILEx Regulation response**

34. The intention of this proposal was to improve consumer protection by stepping in to fund existing proposals to insure a risk, where the funds would otherwise be unavailable to protect the clients of the firm. It is perhaps significant that the Legal Services Consumer Panel were not in favour of this proposal, similar to the broad tenor of responses. We acknowledge that as firm numbers grow the ability of any remaining fund to pay consistently for run-off premiums in default could become problematic. Given the feedback received during the consultation we are not proposing to pursue this proposal further.

**Question 4. Do you agree with our proposal to introduce a £2 million aggregate limit on the value of claims which can be made under the compensation arrangements in respect of one firm?**

35. A minority of respondents did not agree with this proposal, the majority were in favour.

36. The LSCP stated that it was difficult to support the proposal without seeing CILEx Regulation claims data (as above, there is no claims data and so we have instead had to consider where available comparable data from other regimes).
37. One respondent commented that the limit was fine for a small firm but was it sufficient for a nationwide firm.
38. One respondent commented that if it was per claim then that should be sufficient.
39. Some respondents including CILEx sought to clarify whether the limit was an annual limit or for the life of the fund.
40. The CML supported the proposal to extend the time limit in exceptional circumstances.

### **CILEx Regulation response**

41. We are pleased to note that respondents were broadly in favour of his proposal.
42. As the rules specify, the aggregate limit per firm is not limited in time. The nature of claims on the compensation fund is such that it would be relatively unusual for a firm to have claims made on the fund and for the firm to be continuing in practice. Typically where there has been some form of dishonest misappropriation or failure to account which has not been covered by professional indemnity insurance (pre-conditions to claim on the fund) then a firm will be intervened into.
43. We acknowledge that claims data for CILEx entities is currently unavailable. Instead, as set out in our earlier consultation, considered claims data from other smaller legal services regulator. This has informed our proposed aggregate limit of £2 million which forms part of the wider proposals to move towards a largely insurance backed compensation scheme. However we have also taken account of the fact that current regime is already limited to £2 million in practice due to availability of funds. Current numbers of CILEx Authorised Entities do not indicate a significant increase in the available compensation funds is likely in the short to medium term either. As such there is no lowering of protection by virtue of this proposal. In fact, a greater level of protection will be available under the current arrangements given the proposed expansion of the overall aggregate limit for claims on the scheme to £6 million in on policy year. The intention is simply to maintain the current levels of protection, with some enhancements in fact, via a more sustainable means.
44. Overall we are reassured by the consultation responses that the aggregate limit is appropriate and set at the right level. However, we propose to keep this limit under review and in particular when claims data begins to develop.

**Question 5. Do you have any other comments on the drafting proposals set out at Annex 1 in the context of how the new approach would be implemented and the other changes proposed to the rules?**

45. One respondent commented that there should not be a discretionary grant in relation to the application of the timescale. They felt that a period of one year was more than sufficient to at least make a claim, even if it cannot be dealt with substantially in that period.
46. One respondent asked for greater clarity on the exceptional circumstances test in connection with the one year limit. It was also suggested that there should be a possibility of introducing a longstop deadline for the submission of a claim against the fund in the application of the exceptional circumstances rule.
47. The CML supported the other drafting changes and additional clarity.

**CILEx Regulation response**

48. We consider that the current timescales for claiming under the compensation scheme remain appropriate but are pleased for the support shown for expanding the time limits where exceptional circumstances are present case by case. We are grateful for the suggestions for areas where further detail would assist, such as precisely when the exception would be applied. We wish to avoid over prescription in specifying in too much detail the exceptional circumstances which may give rise to an extension of the period of time, as the wording is intended to cater for exceptional cases which are difficult to predict. To the extent that further detail on this point is appropriate however we consider that this level of detail would be better suited to guidance which sits underneath the rules which will be updated to reflect the new rules if approved.
49. We received a number of relatively detailed drafting queries and suggestions which have been extremely helpful. One small change is proposed as result of these (rule 7(1)(b), the removal of the word 'made' from the beginning of that sentence).

**Respondents to the Consultation**

Type of respondents	Number of respondents	Named respondents
CILEx Members	13	Compensation Fund adjudicators Council of Mortgage Lenders Legal Services Consumer Panel CILEx
Compensation Fund Adjudicators	1	
Representative groups, trade and membership associations	4	
<b>Total</b>	<b>18</b>	