

REPORT TO THE LSB ON THE RESTRICTIONS CREATED BY RUN-OFF INSURANCE

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PART 1 – INTRODUCTION

CILEx REGULATION

CILEx Regulation is the independent regulator established by the Chartered Institute of Legal Executives (CILEx). CILEx Regulation authorises and regulates entities, members of CILEx and CILEx Practitioners.

CILEx Regulation is able to authorise and regulate individuals under the Legal Services Act (LSA) 2007 to undertake reserved legal activities. In January 2015 CILEx Regulation became a regulator of entities delivering reserved legal activities.

THE ISSUE – RUN-OFF

CILEx Regulation is aware of an issue that is acting as a barrier to the free movement of legal entities from one regulator to another regulator. The issue is the requirement for these entities to take run-off insurance if they wish to change regulator.

CILEx Regulation is concerned about the anti-competitive repercussions that the requirement to take run-off is having on legal entities, which is developed in more detail below.

CILEx Regulation has been researching this issue since January 2015. This submission brings to the attention of the LSB the concerns identified.

RESOLVING THE ISSUE

To work towards resolving this issue CILEx Regulation requests that the LSB carry out a thematic review of the barriers and restrictions being caused by run-off. CILEx Regulation notes the work streams in the LSB's Business Plan for 2015/2016, which includes a thematic review of restrictions on choice of insurer. CILEx Regulation is asking that this review be extended to include restrictions on choice of regulator due to the rules on professional indemnity insurance and run-off.

Because of the detrimental impact (explored in more detail below) that this issue is having on regulated legal entities and the regulatory objectives under the LSA, CILEx Regulation looks to the LSB to direct regulators to review their regulatory arrangements and to work together in resolving this issue by developing a mechanism to support a transfer of regulator.

PART 2 – BACKGROUND, BARRIERS & REGULATORY OBJECTIVES

IMPORTANCE OF RUN-OFF

CILEx Regulation acknowledges that the minimum run-off period is a long standing arrangement, required by regulators to provide important consumer protection, supporting the regulatory objectives in the LSA. It ensures that consumers are compensated for claims that arise after an entity closes down. Run-off also provides financial security to retired partners. It is understood that the six year period is based upon the principle limitation periods for contract and tort claims under the Limitation Act 1980.

For these reasons it is important to note that CILEx Regulation supports the basic principles of run-off and that it is not challenging the requirement to take run-off where an entity ceases to practice.

UNINTENDED BARRIERS CREATED BY RUN-OFF

When a legal entity wishes to switch regulator they must relinquish authorisation from their current regulator. As soon as the entity stops being authorised by their regulator the entity is deemed to have ceased practising and required to take run-off insurance (usually six years).

The LSA has been instrumental in opening up the legal services market. This, coupled with the government's de-regulation agenda for the legal sector, provides entities with more opportunities.

One of these opportunities is the freedom to explore a choice of regulator that is most suited to understand their business needs. This choice gives entities more options to compete for business through the outcomes focussed and risk based approach to regulation which encourages innovation and growth within the legal services sector. However, the compulsory requirement to take run-off insurance is hindering the intention of the LSA and undermines the de-regulation agenda by acting as a barrier to free movement and consequently a barrier to competition within the regulated market.

The research carried out by CILEx Regulation (see part 3, below) supports that an unintended consequence of run-off is that it is acting as a financial mechanism to constrain the free movement of legal entities between regulators.

OUTDATED PROFESSIONAL INDEMNITY INSURANCE

Up until now professional indemnity insurance has fared well, however, a lot has changed since the commercial market of insurance came into being in 2000.

The legal services industry has not been able to predict the developments introduced by the LSA. As a result most professional indemnity insurance schemes are outdated.

In 2000 there was not the same choice of regulator as there is today. Only entities that were closing would cease to be authorised and under those circumstances taking run-off insurance was correctly required to deliver consumer protection.

Because the rules on professional indemnity insurance have not taken into consideration a choice of regulator the true sense and purpose of run-off seems to have been lost. CILEx Regulation maintains that an entity that is switching regulator is not technically 'closing' and therefore run-off should not be required.

Because this issue affects all legal entities, all regulators need to re-consider their rules so that these entities are given an opportunity to switch regulator, if they wish.

OPPOSING EFFECT ON THE LEGAL SERVICES ACT

CILEx Regulation can demonstrate that this issue is having an opposing effect on the LSA and in particular regulatory objective Five 'Promoting Competition in the Provision of Services'.

CILEx Regulation acknowledges that it, along with other legal service regulators is under an obligation to proactively promote this positive duty of competition between legal entities and entities should be encouraged to compete for capital and consumers. It is this competition that will ultimately help drive better performance and consumer choice as envisaged by the LSA.

Moreover, CILEx Regulation advises that this issue is acting as a barrier to entry into the legal services market and as asserted under Regulatory Objective Five, regulators need to be challenged to find other ways of managing this risk.

By tackling this issue CILEx Regulation believes that access to justice will improve (regulatory objective Three) and it will encourage an independent, strong, diverse and effective legal profession (regulatory objective Six). This will be achieved by empowering legal entities to seek out a regulator of their choice that understands their business, ultimately allowing these entities to provide legal services more competitively.

WIDER CONSEQUENCES

More generally, if this issue is not tackled there are wider consequences that need to be considered, one of which is the risk of double insurance. For example, where an entity successfully transfers from one regulator to another and takes run-off insurance but works on a continuous retainer there is the question that if something goes wrong which of the two insurers (run-off or new insurer) will take responsibility? The risk of double insurance could allow insurers the scope to dispute claims, ultimately leaving consumers and entities in a vulnerable situation.

PART 3 – EVIDENCE

THE EVIDENCE – DEMAND

CILEx Regulation became a regulator of legal entities in January 2015. In this short period CILEx Regulation has received numerous enquiries from legal entities seeking to switch regulator.

These entities, having made their own enquiries, have been advised that to switch regulator they will be required to take run-off insurance. Most of these entities have been advised that this will amount to three times their current premium, which in most cases they cannot afford to pay. The cost of this has prevented these entities from making an application to be regulated by CILEx Regulation resulting in enquiries not progressing further.

One firm has advised CILEx Regulation that they have explored transferring regulator but made the difficult decision to opt against transfer due to the financial burden of run-off, which in their opinion is restricting the free movement of legal entities between regulators. The firm advised that they are prepared to switch regulator immediately as soon as this unnecessary financial burden is removed.

CILEx Regulation is able to provide details of an entity that has successfully transferred regulation to CILEx Regulation from another regulator. Having explored all of its options this entity was forced to take run-off insurance before it was able to seek regulation from CILEx Regulation.

The run-off insurance paid by this entity was three times its last year's premium. It was only because of the determination by this entity to change regulator and because the original premium paid by this entity was low that this entity was able to switch regulator. Had the original premium paid by the entity been any higher it is likely that the opportunity to switch to a regulator of its choice would have been denied. Furthermore the entity advised that as a result of having to take run-off insurance it did not have sufficient resource for marketing, which consequently affected its business.

The evidence collected by CILEx Regulation over the last eleven months clearly supports that there is a demand for entities seeking to switch regulator but that these entities face an unfair barrier and constraint. These entities are being put at a clear disadvantage by having to take run-off insurance.

THE EVIDENCE – MARKET RESEARCH

CILEx Regulation has undertaken widespread research, discussing this issue with individuals and brokers with extensive experience of insurance within the legal sector.

CILEx Regulation commissioned this research to understand the constraints on entities of having to take run-off and to explore whether there are any other options available to legal entities looking to switch regulator. Having explored the various options it was concluded that there does not appear to be a solution to the requirement to pay the run-off insurance where an entity is looking to switch regulator.

Specifically, CILEx Regulation has corresponded with five leading insurers who are also qualifying insurers for CILEx Regulation. These insurers have been asked:

- Q. If they would be able to take on the run-off exposure for an entity that was seeking to switch regulator:
- Would the insurer take this on (selectively)?
 - Would the insurer charge it differently or the same as required under the regulators' Minimum Terms and Conditions?

Out of the five insurers that responded three insurers advised that they would take on the run-off selectively and two advised that they would prefer not to do so.

The insurers' exact responses are recorded in the table below:

Insurer	Would you take on the run-off exposure (selectively)	Would you charge it differently or the same as [REDACTED] MTC entity	Comments
1	Prefer not, would prefer the run-off parked, might perhaps do this for a very good firm with no claims.	Charge same as [REDACTED] entity for all past activity	Claims and pricing would be messy, on balance not at all keen.
2	Would do it selectively.	Charge same as [REDACTED] entity if a run off - would	This is all very theoretical. It would depend really on

Insurer	Would you take on the run-off exposure (selectively)	Would you charge it differently or the same as ████████ MTC entity	Comments
		be 300% of annual premium	the true nature of this 'run off' regime e.g. true run off means they are not touching this work again whereas in your example below they could be merely moving themselves from one membership to another (██████████) and therefore they could have cause to work on their previous business, making this more of a full retro basis. Therefore we could charge less than our normal 'run off' percentage to give them full retro cover – each one on its merits.
3	Would do this selectively - might consider taking the run-off on but subject to the full claims and practice history of the firm.	The applicable run-off premium would be determined on the individual risk information	
4	Would not want to take on run-off exposure but might do so on a one-off basis.	Would charge on a risk based basis according to the individual case. Would not necessarily base on a fixed amount that the ██████ insurer would charge (e.g.	Would want a cancellation clause for the run-off cover if the premium was not paid

Insurer	Would you take on the run-off exposure (selectively)	Would you charge it differently or the same as ██████ MTC entity	Comments
		300% or some other figure.	
5	Would do it selectively.	Would treat as part of the normal retro cover of the ongoing business and rate annually based on the perceived exposure – rates likely to be the same as for and ██████ practice as a result.	

These insurers have indicated that the premiums they require for the six year run-off can vary between 225% and 350% of the last annual premium, which is to be paid upfront at the inception of the run-off period.

CILEx Regulation has conducted further research with another qualifying insurer (in addition to the five insurers identified above) to try to understand the cost to entities of switching regulator.

The insurer provided four real case examples on the assumption that an existing legal entity had to take run-off to become a CILEx Regulation regulated entity. The likely cost to these entities is attached in the table below:

Firm	Current Premium/£	Run off/£	Premium for new entity/£
A	5,026	12,974	3,088
B	33,920	84,741	21,500
C	74,670	240,274	47,726
D	148,400	452,768	94,766

Although the research highlights that by switching regulator entities might receive a discounted rate on their annual premium the insurer confirmed that the discount is only likely to be applied over the first 24 to 36 months period of practising. After this period the annual premium is likely to revert back to what they were paying with their previous regulator.

WHAT THE EVIDENCE & RESEARCH DEMONSTRATES

The research conducted confirms that entities seeking a change of regulator must take run-off insurance.

Insurers indicated that no discount off the normal run-off cost was likely to be given, even though the entity's practice would be ongoing with a new regulator. Although the premium as a CILEx Regulation entity is lower, the amount of the reduction appears insufficient to make it practical to fund the cost of the change out of cash-flow, for example, from the premium reductions over approximately three years.

The research demonstrates that normally over a six year period an entity would pay 600% of an annual premium (100% each year). However by switching regulator insurers have advised, taking into consideration run-off and all other rebates, these entities are likely to pay up to 915% (an extra 315%) of an annual premium over six years. This means the cost associated with taking run-off to switch regulator amounts to 52.5% more insurance premium having to be paid over the six year period than if an entity had not switched regulator. The figures clearly demonstrate that entities looking to change regulator will be adversely prejudiced.

The research further indicates that in most cases it would take approximately seven years before overall savings can be achieved by an entity changing regulator.

Insurers also support CILEx Regulation's concerns of double insurance and have acknowledged that these entities are merely moving regulator and not actually closing. Therefore they are likely to continue to work on their previous business once they have moved. This raises concerns with insurers as to what part of a continuous retainer is covered by the run-off insurance and what part is covered by the new insurance. The potential for double insurance could have a detrimental effect on consumers and entities.

Based on the evidence produced on demand and the evidence produced by the insurance sector it can be said with confidence that the cost to entities of changing regulator, due to run-off is prohibitively high and that the requirement to take run-off insurance is acting as a significant barrier to entities looking to change regulator.

PART 4 – WAY FORWARD

WORK NEEDED TO OVERCOME THE ISSUE

CILEx Regulation acknowledges that this is an industry wide problem affecting all regulators and all entities delivering regulated legal services.

CILEx Regulation also recognises that there are many difficulties in tackling this issue and that more work is needed by all regulators to address it. By way of example, one of the issues identified by CILEx Regulation is how regulators overcome the different levels and schemes of insurance currently in place.

Having researched this matter with the insurance sector CILEx Regulation is confident that these difficulties can be overcome.

It is evident that regulators already have in place robust schemes of professional indemnity insurance to cope with the difficulties identified. Where entities seek to switch regulator all parties involved can be satisfied that there is comparable insurance in place that will meet claims arising for the past six years of practice.

CILEx Regulation looks to the LSB to carry out a thematic review of this issue and to direct regulators to review their regulatory arrangements and to work together in resolving this issue by coming up with a mechanism to support a transfer of regulator.

CILEx Regulation has already mooted with its broker various solutions to tackling this issue. CILEx Regulation welcomes the opportunity to discuss these solutions with the LSB and other regulators.

CILEx Regulation appreciates that its own rules and procedures will need to change to make way for provisions to allow entities regulated by it to move more easily to another regulator. CILEx Regulation is willing to be the first regulator to review and make changes its own rules and procedures – leading on way forward to overcome this predicament.

LSB WORK STREAM

CILEx Regulation notes that the work streams in the LSB's Business Plan for 2015/2016 include a thematic review of restrictions on choice of insurer. CILEx Regulation is asking that this review be extended to include restrictions on choice of regulator due to the rules on professional indemnity insurance and run-off.

The LSB has stated that under the work stream it will analyse regulatory requirements that restrict an individual entity's choice of insurer. It aims to identify the potential positive or negative cost of such restrictions and the impact of removing them. CILEx Regulation is aware that the LSB will also consider whether the restrictions identified are consistent with general competition law, the regulatory objectives and Better Regulation principles.

CILEx Regulation submits that the issue of run-off is acting as a considerable restriction to general competition, the regulatory objectives and Better Regulation principles. CILEx Regulation is confident that the restriction posed by run-off can be removed but that it will need a cohesive willingness by regulators to work together, which CILEx Regulation is looking to the LSB to encourage and promote.

PART 5 - CONCLUSION

CILEx Regulation appreciates that run-off is an important and long standing arrangement to ensure that consumers can continue to obtain redress after a practice closes. For this reason CILEx Regulation is not challenging the requirement for an entity to have run-off insurance when it ceases to practice.

CILEx Regulation believes that run-off should not be required by legal entities that are simply looking to switch regulator. CILEx Regulation is of the view that these entities are not closing and therefore run-off should not apply.

The research and evidence produced by CILEx Regulation clearly demonstrates that there is sufficient demand by entities for this issue to be looked into and that the requirement to take run-off insurance is acting as a significant barrier to entities looking to change regulator, which consequently is acting as a significant and real barrier to competition within the legal services sector, hindering innovation.

CILEx Regulation has demonstrated that by not tackling this issue there is a clear threat to achieving the regulatory objectives under the LSA and principles of Better Regulation. For this reason CILEx Regulation looks to the LSB to carry out a thematic review of this issue and to direct regulators to review their regulatory arrangements and to work together in resolving this issue by coming up with a mechanism to support a transfer of regulator.

CILEx Regulation believes that collectively this issue can be resolved, thereby strengthening competition between entities and supporting the regulatory objectives and ultimately delivering choice for the consumer, whilst maintaining appropriate safeguards.

CILEx Regulation