



Solicitors  
Regulation  
Authority

**Application made by the Solicitors Regulation Authority Board  
to the Legal Services Board under Part 3 of Schedule 4 of the  
Legal Services Act for the approval of changes to regulatory  
arrangements relating to Compensation Fund contributions  
2013.**

**25 July 2013**

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**Application made by the Solicitors Regulation Authority Board to the Legal Services Board under Part 3 of Schedule 4 of the Legal Services Act for the approval of changes to regulatory arrangements relating to Compensation Fund contributions.**

**A. Proposed Alterations**

***Compensation Fund Contributions***

1. The SRA needs to set the Compensation Fund contributions for the practising year 2013/14. The methodology used to allocate the cost of the Fund throughout the regulated community remains the same as last year. 50% of the funding requirement will be met by a fixed contribution from regulated individuals, and 50% by a fixed contribution from regulated firms. Initial indications were that a contribution level of £13.4m would result in an individual contribution of £56 and a firm contribution of £836. Last year the equivalent contributions were £92 and £1,340 respectively.
2. The proposed level of contribution has been calculated in line with the methodology used in previous years and refined to take account of relevant more specific information where available. Over the last 12 months, the value of open claims on the Fund has reduced significantly, mainly due to the closure of a significant number of mortgage related claims.
3. The calculation uses the best view of predicted numbers and costs of interventions for 2013/14 onwards, continuing trends for business as usual and mortgage related claims, the impact of the impending closure of the ARP with consideration also being given to any high risk potential liabilities where known.
4. The contributions are not Practising Fees under the Legal Services Act (LSA) 2007, and so approval is required under part 3 of Schedule 4 rather than under s 51 of the LSA 2007.

**B. Details of the relevant Regulatory Arrangements**

***Nature and effect of the existing position***

5. The SRA is required by statute to provide a Compensation Fund to compensate consumers who lose money due to the dishonesty or failure to account of solicitors (REs and RFLs) or recognised bodies. The Law Society's application and subsequent approval to become a Licensing Authority extends the same Compensation Fund provisions to Licensed bodies. This required statutory amendments under s69 LSA 2007 which were made after the necessary consultation by the Legal Services Board (LSB).
6. The statutory powers permit the SRA to require the regulated community to contribute to the Compensation Fund. The Compensation Fund Rules require both regulated individuals and regulated firms to make an annual contribution, collected mainly during the annual renewal/data collection exercise. Payment is required by 31 October for the following practising year.
7. In the absence of any evidence to suggest that the current approach to the apportionment of Compensation Fund contributions is fundamentally flawed, and given that we are proposing a fundamental review of compensation arrangements for implementation in 2014/15, it is proposed that the arrangements for the collection of the Compensation Fund contributions remain the same as previous years. This proposal supports principles: 3 (predictable income) and 4 (stability) of the fees policy

8. Each year the SRA Board reviews the funding requirement for the following practising year and sets the individual and firm contributions at a level which ensures that the funding requirement is met. The contributions are required to fund the cost of claims, reserves and the cost of handling the claims. The SRA Finance and Resources Committee reviews the claims experience, level of reserves and budget for staff to handle the claims before making a recommendation to the SRA Board. The SRA Board then makes a recommendation to the Law Society Council which is required, under the General Regulations, to approve the overall funding requirement. The SRA Board then makes the final decision on apportionment and sets out the contribution by resolution (the Compensation Fund determination).

### **C. Nature and effect of the proposed change**

9. The Finance and Resources Committee, having gone through a detailed review, recommended that the funding requirement for 2013/14 should be £14.3m. The recommendation approved by the Finance and Resources committee are included in the paper to the SRA Board attached as Annex A which sets out the relevant financial analysis to support the £13.4m requirement. The SRA Board approved the recommendation based on scenario 1, and made the same recommendation to the Law Society Council. The SRA therefore now seeks the approval by the LSB of the following determinations:

#### ***Annex B: Compensation Fund determination***

This prescribes the individual and firm Compensation Fund contribution

#### ***Annex C: Licensed Body Compensation Fund contribution determination***

This prescribes the contribution payable by the Licensed Bodies.

### **D. Rationale for change**

10. The funding requirement for the Compensation Fund will vary year on year depending on claims experience. The proposed level of contribution has been calculated in line with the methodology used in previous years and refined to take account of relevant, more specific information where available, with consideration being given to additional high risk potential liabilities. Over the years there have been variations with sometimes significant increases, for example, during property recessions. The reserving policy referred to in the Annex 1, and forward forecasting seeks, as much as possible, to avoid large swings and has been refined to take account of relevant, more specific information where available, with consideration being given to additional high risk potential liabilities

### **E. Statement in respect of the Regulatory Objectives**

11. The existence and effective operation of a Compensation Fund primarily protects and promotes the interests of consumers, in ensuring that they receive compensation if their money is lost while in the hands of a solicitor or firm. However it also promotes the public interest and improves access to justice in giving the public the confidence to entrust funds to solicitors and so facilitate many legal transactions. That is why statute requires such funds to be provided by the legal profession. Given the existence of such funds it is also in consumers' interests to ensure that they are adequately funded and so able to meet claims without undue delay.

### **F. Statement in respect of the Better Regulation Principles**

12. The way in which the Compensation Fund requirement is allocated among the profession was reviewed in 2010 particularly in order to improve transparency and accountability. Following the Board's review in February 2013, the structure remains the same this year, it is only the amounts that have changed. Although the final requirement was not set by the Council until July the SRA's

early communications with the profession made it clear that the contributions would reduce this year compared to the level last year, and the on-line calculator, which has been available on the SRA web site, included realistic indicators of the likely contributions. This too has been reported in the legal press.

#### **G. Statement in relation to desired outcomes**

13. The desired outcome in relation to the alteration is to achieve a properly funded Compensation Fund that is able to meet claims as they fall due without undue delay. The Fund is reviewed annually and is also subject to audit. Regular reports on claims experience are made to management and the financial status of the Fund is a key priority for the SRA Financial Services Committee.

#### **H. Statement in relation to impact on other Approved Regulators**

14. The changes in the contribution amounts should not have an impact on other approved regulators.

#### **I. Implementation Timetable**

15. The SRA Board and the Law Society Council finalised the total funding requirements on 12 June and 24 July and seek LSB approval. During August final preparations for this years renewal exercise will be made and in September firms and individuals will be contacted and asked to make the various renewal applications on line and submit the relevant Compensation Fund contributions and other fees by 31 October 2013.

#### **J. Stakeholder engagement**

16. A comprehensive communications plan was drawn up to support the decision by the SRA Board that there should be no changes to the 2013/14 practising fees structure, including the proportion of Compensation Fund contributions. The purpose of the communications plan was to ensure that the regulated community and relevant stakeholders were informed of:

- The 2013 fees structure
- The availability of the fees calculator to help them and
- To alert them to the fact that a full fees review had been launched in the spring of 2013, which would be a two-year project.

(A separate communications plan has been developed to support the Compensation Arrangements Review. This is cross-referenced with communications relating to the fees structure whenever appropriate)

As at 31 May, the following elements of the communications plan for fees and compensation fund activities have been delivered:

- News release issued on 6 February 2013 announcing the fee structure for 2013/14 remains unchanged
- The news release was tweeted on the same day
- An article appeared in April edition of SRA Update, the SRA's on-line newsletter that goes to all individuals holding a mySRA account, plus others who choose to subscribe to it

Planned communication activity comprises:

- Updating the fees pages on the SRA website – June 2013 (with caveat that LSB still needs approval)

- Online calculator made live, with the caveat that the fees structure requires final approval by the LSB. The availability of the online calculator will be publicised via a news release, tweet and inclusion in SRA Update
- Reference to the online calculator going live in Professional update
- News release to coincide with SRA Board approval of SRA Budget, compensation fund budget and draft fee determinations – June 2013
- Placement article for websites/magazines for representative groups such as sole practitioners, etc.
- Updates in forthcoming issues of SRA Update
- SRA staff to be informed of availability of online calculator
- News release and tweet when fees structure is approved by LSB
- Communications to support the fees review – Spring 2013.
- Communications to support the Compensation Arrangements Review - early Summer 2013

17. There is no policy change therefore the information provided last year through this application, and the on-line calculator, has given all those who have to pay the practising fees the following information:

- the level of the fees, and through the turnover table and on-line calculator the means to work out the firm fee
- information on how the level of the fee has been set
- an indication of how the income will be spent including a breakdown of the amount spent on regulatory functions, non-regulatory functions and shared services.

#### **SRA contact for matters relating to this application**

Helen Herniman  
 Director Post Enforcement  
 Solicitors Regulation Authority  
 The Cube  
 199 Wharfside Street  
 Birmingham  
 B1 1RN  
 Email:Helen.herniman@sra.org.uk

#### **Annex A - 12 June SRA Board paper on the Compensation Fund requirement**

#### **Annex B - Draft Determination of Compensation Fund contributions 2013**

#### **Annex C - Draft Determination of Compensation Fund contributions for Licensed Bodies 2013**

# **ANNEXES**

# Annex A: June SRA Board paper of Compensation Fund requirement

SRA BOARD  
12 June 2013  
Public - Item 08



CLASSIFICATION - PUBLIC

## Compensation Fund Contribution for 2013/14

### Purpose

1. This paper:
  - a) sets out the SRA's financial projections for the Compensation Fund for the forthcoming years;
  - b) seeks the Board's approval of alternative proposals for the Compensation Fund contribution for 2013/14 based on two scenarios; the first, scenario 1, assumes that the SRA's proposal to pay intervention costs from the Compensation Fund is authorised by the SRA Board after the current consultation. The second, scenario 2, assumes that the proposal is not authorised and that the costs paid by or recharged to the Compensation Fund remain in line with the current policy.
  - c) the recommendations included in this paper were approved by the Finance and Resources Committee at its meeting on 8th May 2013.
  - d) following the Board's decision in relation to the proposed funding levels for the 2013/14 Compensation Fund contribution, the matter will be considered by the Law Society Council at its meeting in July 2013.
2. This paper is for decision.

### Executive Summary

3. The proposed level of contribution has been calculated in line with the methodology used in previous years and refined to take account of relevant, more specific information where available.
4. The methodology forecasts future cash outflows and inflows and calculates the minimum reserve using the formula shown in paragraph 35. Consideration is also given to additional high risk potential liabilities.
5. The calculation uses the best view of predicted numbers and costs of interventions for 2013/14 onwards as set out in the paper presented to the Board in April 2013.
6. The calculation also takes into account the continuing trends for business as usual claims, adjudicated decisions for mortgage fraud claims and the impact of the impending closure of the ARP.
7. Alternative proposals have been prepared based on two scenarios, depending on the Board's decision at its June meeting to authorise, or not, the payment of intervention costs from the Compensation Fund. A four week consultation on this proposal ended on 31st May 2013.

8. The recommended level of contribution for 2013/14 based on the Board authorising the proposal to pay intervention costs from the Compensation Fund is £13.4m. This contribution ensures a minimum level of reserve of £33.3m plus an additional £2.4m at the end of October 2014.
9. The additional £2.4m contribution relates to a specific case where we have been notified of claims of £7.4m. Initial indications show that potential grants in respect of these claims are circa £2.4m which could be paid in 2013/14.
10. The recommended level of contribution of £13.4m equates to an indicative fee for individuals of £56 and for firms holding client money of £836 (compared to £92 and £1,340 in 2012/13).
11. If the Board does not authorise costs of intervention to be borne by the Compensation Fund, no contribution is required because the expected balance exceeds the minimum reserve. However, we would recommend minimum contributions of £10 for an individual and £150 for a firm raising a contribution of circa £2.4m

## **Background**

12. The Compensation Fund contribution is currently split evenly between firms holding client money and regulated individuals on a flat fee basis.
13. The SRA Board agreed at its February meeting that there would be no change in policy in respect of this split pending the outcome of the Compensation Arrangements Review.
14. The contribution for 2013/14 has been calculated by forecasting future cash outflows and inflows and calculating the minimum reserve using the formula as shown in paragraph 36.
15. The contribution is the balancing figure required once all cash outflows and inflows are calculated to ensure that the minimum reserve is maintained at the end of the year.
16. The process and drivers of the calculation are broken down into four stages as follows:
  - Stage 1 – Revised forecast of the closing balance for the Compensation Fund for 2012/13
  - Stage 2 – Calculation of the minimum reserve for 2013/14
  - Stage 3 – Forecasting of Cash Inflows and Outflows for 2013/14 onwards
  - Stage 4 – Consideration of Additional High Risk Potential Liabilities for Inclusion

Each of these stages is considered in detail below.

## Stage 1 - Revised Forecast of the Closing Balance for the Compensation Fund for 2012/13

17. The Compensation Fund accounts for the first five months of the 2012/13 practising year show a balance of £67.1m (see Annex 7). The cash inflows and outflows are extrapolated for the remaining seven months of the year to 31 October 2013.
18. The closing balance of the revised forecast provides the most accurate balance on the Compensation Fund at the end of the 2012/13 practising year.
19. A number of factors have also been taken into account, set out in the following sections.

### Number of Interventions - April to October 2013

20. The SRA Board paper dated 24 April 2013 explains in detail why it is difficult to predict the number and cost of future interventions, although it is fairly clear that the legal profession is under financial strain exacerbated by a sluggish economy, increased competition and overstretch before the financial crisis and so the level of firm failure and potential intervention is likely to be high.
21. The prediction in this paper of the number of future interventions for 2013/14 onwards is the best view scenario of 64 interventions (12 actual interventions in the 3 months to March 2013 and 52 forecast for the remaining 9 months).

### Grants Paid - April to October 2013

22. The grants to be paid in 2012/13, based on the original value of open claims at the end of March 2013 of £110.6m, is estimated to be in the region of £25.1m, broken down as follows:

£ 6.0m actual grants paid to date (Nov12 to Mar13)  
£ 4.7m forecast grants on open BAU claims  
£12.2m forecast for open MF claims based on revised values  
£ 1.9m forecast for grants relating to future claims  
£ 0.3m forecast for negligence claims re uninsured firms  
£25.1m

23. The grants relating to BAU and mortgage fraud expected to be paid in the remaining 7 months of 2012/13 (ending 31st October 2013) were considered separately.
24. Given that there has been no significant change in their level or nature, BAU claims in progress have been evaluated using the same methodology as in previous years; the expected future payout and the timing of such a pay out is based on historical payout rates in relation to claim size and complexity of the claim respectively.
25. The forecast of grants relating to future claims assumes that all future claims are BAU claims and were calculated using the methodology outlined in 23 above.
26. It is not appropriate for this existing methodology to be applied to open MF claims given the composition of the claims. A significant proportion of the open MF claims are nearing completion and await adjudication.
27. As at 30 April 2013, 48 MF claims with an original value of £12.2m had been adjudicated by Panel which recommended payments on 4 claims totalling £0.5m, equating to 4% of the original value of those claims. Where payments were adjudicated, they represented partial payment only of the original amount claimed.

28. Accordingly, the expected payment value has been revised. The total of these revised values for open MF claims has been used as a more accurate indicator of future MF grants. There may be an unusual level of legal costs incurred in the next 2 years if lenders decide to seek judicial review of refusal or reduction of grants (usually on the basis of their contributory conduct).
29. As at 31st March 2013, the revised value of likely payments relating to these matters is £15.7m <sup>1</sup>. Due to the time taken to investigate and pay claims, these grants are forecast to be paid throughout the 2012/13, and 2013/14 practising years.
30. The final element of grants paid in the remainder of 2012/13 relates to the additional £0.5m potential grants per annum attributable to the impact of the changes to the ARP. Given that no payments have been made during the first 5 months of 2012/13, 7/12ths of £0.5m (£0.3m) have been included as future grants for the remainder of 2012/13.

#### Costs recharged or borne by the Compensation Fund - April to October 2013

31. As explained above, calculated for the revised forecast of the closing balance at 31st October 2013 have been based on two scenarios.
32. In scenario 1, (if the SRA Board authorises the proposal to pay intervention costs from the Compensation Fund) the SRA element paid from the Fund has been increased by £7.0m.
33. In scenario 2, (if the SRA Board does not authorise the proposal), the SRA costs from the Compensation Fund remain in line with the original budget for 2012/13 at £4.0m.

#### Other Cash Inflows and Outflows

34. All other cash inflows and outflows have been extrapolated from historical trends for the remaining 7 months of the fee year.

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<sup>1</sup> These payments are expected to be paid evenly throughout the remainder of 2013 with £12.2m falling into the 2012/13 practising year and £3.5m in the 2013/14 year.

## Stage 2 - Calculation of the Minimum Reserve for 2013/14

35. The minimum reserve was calculated for 2013/14 onwards using the previously established calculation, as follows:

*Minimum reserve = (1.5 times average grants paid in previous 7 years) + (3 months' recharges & costs borne)*

36. Annex 3 sets out the detailed calculation of the minimum reserves for forthcoming years.
37. The SRA policy in relation to the payment of SRA and Law Society costs from the Fund was revised in 2010<sup>2</sup> and implemented in two stages in November 2010 and November 2011. The effect of these changes was to reduce significantly the amount recharged to the Fund. The amount forecast to be recharged in the current and subsequent practising years based on this is £4.0m.
38. However, in April 2013, the Board approved a 4 week consultation on the proposal that the cost of interventions should be borne by the Compensation Fund in addition to those costs already paid from or recharged to the fund.
39. The cost of interventions is made up of the following (all inclusive of VAT where applicable):
- Fees of external Intervention Service providers for effecting interventions
  - Archiving costs related to interventions
  - Cost of the internal SRA Interventions team
40. The costs recharged to and borne by the Compensation Fund are used in the calculation of the minimum reserve and also as a key cash outflow.
41. The proposed amendment will increase the amount of costs recharged and borne by the Fund.

## Stage 3 - Forecasting of Cash Inflows and Outflows for 2013/14 onwards

### Cash Inflows

42. Annex 1 shows the cash inflows and outflows of the Compensation Fund, together with the basis of calculation.
43. Forecasting of cash inflows is based on the extrapolation of historical distributions, returns and recoveries.
44. The main cash inflows to the Fund, excluding contributions, are transfers from Statutory Trust accounts (STAs) through rights of subrogation<sup>3</sup> and the transfer of residual balances<sup>4</sup>.
45. Based on evidence from previously closed STAs and the ongoing work on live STAs, residual funds are expected to total £4.0m in this year, reducing to £2.7m in 2013/14 as older accounts are investigated and closed.

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<sup>2</sup> As approved by the Financial Protection Committee at its meeting in April 2010 and by the SRA Board at its meeting in June 2010

<sup>3</sup> Recovery of grants paid where funds are found to be held by the Society in STAs

<sup>4</sup> Remaining funds in STAs once all reasonable efforts have been made to trace beneficiaries

## Cash Outflows

46. The significant cash outflows from the Fund are the payment of grants, the recharge of SRA and Law Society costs to the Compensation Fund and, subject to approval by the Board, intervention costs. The Fund also bears its own costs of legal challenge or protection (such as the Willmott case in which the application of an aggregation clause by insurers could cause claims to fall on the Fund which it is considered should be paid by insurers).
47. The main factors in forecasting the grants are the current open claims in progress and the expected number of future claims, which in turn is determined by the expected number of interventions.
48. All claims in progress were evaluated using a methodology similar to that used in previous years; the expected future payout, and the timing of such a pay out, is based on historical pay out rates in relation to claim size and complexity of the claim respectively.
49. For the calculation of the contribution for 2013/14, the various different elements of claims were reviewed individually to ensure they reflect the most current information. The drivers can be summarised as follows:
  - Number of future interventions (see paragraphs 20 and 21)
  - Business as usual claims (see paragraphs 22 to 25)
  - Mortgage fraud claims (see paragraphs 26 to 29)
  - Claims arising from ARP and Uninsured firms (see paragraphs 50 and 51)
  - SRA costs paid from or recharged to the Compensation Fund – in scenario 1 the total SRA costs to be paid (including intervention costs) has been increased by £12.3m in 2013/14 and future years. In scenario 2 the SRA costs therefore remain in line with the original budget for 2012/13 at £4.0m.
50. The ARP is to close on 30 September 2013. Any firm unable to secure open market insurance from 1 October 2013 will be given an extended policy period of 3 months during which time they are expected to engage with the SRA Supervision team to facilitate the process of orderly wind down. Any negligence claims arising from uninsured firms after that time will fall to the Compensation Fund.
51. An additional £0.5m was incorporated into the Compensation Fund contribution for 2012/13 to account for the potential impact of changes to the ARP. Although the potential claims arising in respect of uninsured firms are below the initial forecast of £0.5m in 2012/13, it seemed sensible to include a further £0.5m in 2013/14 as a provision against grants arising from similar claims for the 12 months following the closure of the ARP.
52. Grants paid totalled £17.3m in the 2011/12 practising year. Grants are forecast to be £25.1m in the current practising year, £18.2m in 2013/14 and £12.7m in 2014/15. The reduction in future years is the expected result of reducing the work in progress, particularly relating to MF claims, to a more usual level by the end of the current practising year.

### **Stage 4 - Consideration of Additional High Risk Potential Liabilities for Inclusion**

53. Post Enforcement reviewed the following additional information in order to identify any potential liabilities that may give rise to claims on the Fund in 2013/14 and thereafter:
  - Ongoing contentious claims

- Claims currently categorised as "enquiries" in respect of mortgage fraud claims.
- Any other available intelligence (e.g. from the Financial Stability Programme)

54. Where required, the minimum reserve was increased to take account of further reserves which potentially would be required during 2013/14.

#### Contentious Claims

55. The Fund is dealing with applications in which there are legal disputes. These eight cases were considered to assess whether any additional provision should be made.

56. The potential liability amounts to £81m of which £49m is considered low probability and the balance is medium probability.

57. In one specific case we have been notified of claims of £7.4m. Initial indications show that potential grants in respect of these claims are circa £2.4m which could be paid in 2013/14. A contingency of £2.4m has therefore been made for this.

58. Aside from that case, it is unlikely that there will be any significant payments in the 2013/14 practising year arising from the contentious claims. Therefore no additional contingency, other than the minimum reserve of £33.3m and the additional £2.4m referred to above, has been included in the contribution for 2013/14.

#### Claims now categorised as "enquiries" in respect of mortgage fraud claims

59. In addition to the MF claims referred to in 32 above, there are also MF 'enquiries' with an original value of £143.9m as at 31 March 2013. These matters are recorded as 'enquiries' rather than claims for specific reasons, as shown in Annex 6. While the technical team remains confident that these claims should be closed, the potential liability from these enquiries is reported because the claim cannot be eliminated until the claimant agrees formally to close the claim or the claim is adjudicated and any ensuing appeal completed.

60. These enquiries were discussed with the technical team and considered in light of the recent panel decisions on Mortgage Fraud claims which are in line with the recommendations made by Post Enforcement, as explained above. It needs to be borne in mind that the approach of the panel may be subject to judicial review which could lead to a different outcome (and legal costs). For example, Annex 6 includes a figure of £75,420,392 for "Applicant to exhaust other remedies" which will sometimes mean that it is the Fund's view that insurers should cover the losses: insurers are well-resourced to bring or withstand legal challenges to their refusal to pay. On balance, it is recommended that no provision is required in the Compensation Fund contribution calculation for 2013/14, but this may be something to keep under review up to the final paper that determines the recommended contribution.

#### Any other available intelligence (e.g. Financial Stability Programme)

61. Post Enforcement has been working with Supervision to compile a "pipeline" of potential interventions as shown in Annex 8. The best scenario used in the SRA Board paper dated 24 April 2013 is based on this work. Accordingly, it is recommended that no further provision is required in the contribution calculation for 2013/14.

62. We have reviewed the issue of the Compensation Fund's exposure to claims arising from firms that had been insured with a qualifying insurer following the issue of a Notice of Disclaimer by the liquidator.

63. Our current view is that the risk of claims on the Compensation Fund is low and accordingly no further provision is required in the contribution calculation for 2013/14.

### **Assumptions and Risks**

#### Assumptions

64. The following assumptions have been made in preparing this paper:

- 64 interventions in the 2012/13 practising year and each year thereafter
- Rates of recovery from existing and future statutory trust accounts will not differ significantly from previous accounts
- The introduction of Alternative Business Structures will not have a significant impact on the Fund in 2012/13 or 2013/14, either through increased contributions or increased claims.
- The value of claims on the Fund from uninsured firms will remain in line with the forecast of £0.5m for 2012/13.

## Risks and mitigation

65. There is a risk that any departure from the assumptions above may result in lower than expected inflows to the Fund or higher than expected outflows, both of which would result in lower than expected reserves. A particular concern is the failure of large firms (such as Cobbetts) or well-established firms (such as Blakemores and Atteys) which is a new feature in the legal services market. Problems with the accounts of firms of that type have been seen and there is a risk that one will fail in the context of potential claims to the Fund. Indeed, even if there is ultimately not a shortfall in client account, the disorderly failure of a large firm including unreliable accounts could lead to the Fund having to make substantial payments while the accounts are verified and reconciled (which would lead to money being paid into the Fund by way of subrogation).
66. There is also the (ever-present) risk of a major fraud causing very substantial losses. Given the precarious position of many firms, it is important to maintain a proper reserve to deal with what cannot currently be foreseen.
67. These assumptions are based on all available information at the time of writing the paper. The underlying assumptions surrounding the forecast are regularly reviewed to ensure that there have been no significant changes that will affect the Fund in the future.
68. Overall, the risk to the Fund of increased outflows or reduced inflows is mitigated by maintaining a robust reserve.

## Required 2013/14 contribution

### Recommendations

69. The Board is invited to approve the level of Compensation Fund contribution for the practising year 2013/14.
70. Based on scenario 1, the Board is asked to approve a contribution for 2013/14 of £13.4m which is required to maintain at least the minimum level of reserve of £33.3m plus an additional £2.4m contingency in respect of additional high risk potential liabilities at the end of October 2014.
71. If the Board do not authorise costs of intervention to be borne by the Compensation Fund (scenario 2 above), no contribution is required because the expected balance exceeds the minimum reserve. However, the Board is asked to approve contributions of £10 for an individual and £150 for a firm raising a contribution of circa £2.4m.
72. It is also recommended that a version of this paper be prepared for the public session of the Board to explain the recommendations.

## **Impact on those we regulate**

73. The recommended level of contribution for scenario 1 equates to an indicative fee for individuals of £56 and for firms holding client money of £836 (compared with £92 and £1,340 in 2012/13)
74. Scenario 2 requires contributions from individuals and firms holding client monies of £10 and £150 respectively.

## **Annexes**

- Annex 1 Calculation of the Compensation Fund Contribution**
- Annex 2 Compensation Fund forecast 2012-2016**
- Annex 3 Minimum reserve calculations**
- Annex 4 Compensation Fund funding requirements and indicative fees**
- Annex 5 Compensation Fund year end balances and grants paid**
- Annex 6 Categorisation of ENQ matters**
- Annex 7 Accounts for the first 5 months**
- Annex 8 Board risk assessment**

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**Author: Helen Herniman, Director of Post Enforcement**

**Date: 31<sup>st</sup> May 2013**

**This paper is for decision**

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 1

### Calculation of the Compensation Fund contribution

	<b>Basis of calculation</b>
<b>Opening balance</b>	<b>As per accounts</b>
<b>Less Cash Outflows:</b>	
Compensation Fund grants paid	Forecast based on work in progress, historical payout rates, expected future claims based on historical claim numbers and expected number of interventions.
Fees, taxes and other charges	Expected tax and audit costs
SRA support costs recharged	SRA budget / forecast figures
<b>Add Cash Inflows:</b>	
Subrogated claims	Expected receipts from existing Statutory Trust Accounts (STAs) based on historical distributions as well as forecast receipts from STAs in relation to future interventions.
Compensation Fund recoveries	Assumed to be broadly in line with previous years.
Residual funds (previously dormant funds)	Expected receipts from existing Statutory Trust Accounts (STAs) based on historical distributions as well as forecast receipts from STAs in relation to future interventions.
Bank & investment income	Expected balances in the Fund and rates of return on investments
<b>Compensation Fund Contribution</b>	<b>Balancing figure</b>
<b>Closing balance = Minimum Reserve</b>	<b>Calculation based on formula</b>

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 2

### Compensation Fund forecast 2012-2016

#### Scenario 1

£000's	PY 12-13	PY 13-14	PY 14-15	PY 15-16
<b>Compensation Fund forecast 2013-2016</b>	Full year	Full year forecast	Full year forecast	Full year forecast
<b>Opening balance as at 1st November</b>	<b>47,693</b>	<b>45,556</b>	<b>35,740</b>	<b>33,734</b>
<b>Cash Outflows</b>				
Compensation Fund Grants	25,052	18,153	12,727	13,674
Fees, tax and other costs	72	122	122	122
SRA support costs recharged	10,960	16,320	16,320	16,320
<b>Total cash outflow in period</b>	<b>36,085</b>	<b>34,594</b>	<b>29,168</b>	<b>30,116</b>
<b>Cash inflows</b>				
Subrogated claims	7,494	8,364	6,285	8,099
Compensation Fund recoveries	70	90	90	90
Residual balances from STA's	3,972	2,657	2,168	2,247
Bank & investment income	204	221	221	221
<b>Total cash inflow before contributions</b>	<b>11,740</b>	<b>11,332</b>	<b>8,764</b>	<b>10,657</b>
<b>Net cash inflow / outflow before contributions</b>	<b>(24,345)</b>	<b>(23,262)</b>	<b>(20,404)</b>	<b>(19,458)</b>
<b>Balance before contributions</b>	<b>23,348</b>	<b>22,294</b>	<b>15,335</b>	<b>14,276</b>
<b>Compensation Fund contributions</b>		<b>13,445</b>	<b>18,399</b>	<b>17,598</b>
<b>Net cash inflow after contributions</b>	<b>(2,137)</b>	<b>(9,817)</b>	<b>(2,005)</b>	<b>(1,860)</b>
<b>NET BALANCE AFTER CONTRIBUTIONS</b>	<b>45,556</b>	<b>35,740</b>	<b>33,734</b>	<b>31,874</b>
variance from minimum reserve after contributions	12,696	2,400	2,400	2,400
<b>Calculated minimum reserve:</b>	<b>32,860</b>	<b>33,340</b>	<b>31,334</b>	<b>29,474</b>

## Scenario 2

	PY 12-13	PY 13-14	PY 14-15	PY 15-16
<b>Compensation Fund forecast 2013-2016</b>	Full year	Full year forecast	Full year forecast	Full year forecast
<b>Opening balance as at 1st November</b>	<b>47,693</b>	<b>52,569</b>	<b>44,040</b>	<b>38,369</b>
<b>Cash Outflows</b>				
Compensation Fund Grants	25,052	18,153	12,727	13,674
Fees, tax and other costs	72	122	122	122
SRA support costs recharged	3,948	4,006	4,006	4,006
<b>Total cash outflow in period</b>	<b>29,073</b>	<b>22,281</b>	<b>16,855</b>	<b>17,802</b>
<b>Cash inflows</b>				
Subrogated claims	7,494	8,364	6,285	8,099
Compensation Fund recoveries	70	90	90	90
Residual balances from STA's	3,972	2,657	2,168	2,247
Bank & investment income	204	221	221	221
<b>Total cash inflow before contributions</b>	<b>11,740</b>	<b>11,332</b>	<b>8,764</b>	<b>10,657</b>
<b>Net cash inflow / outflow before contributions</b>	<b>(17,333)</b>	<b>(10,949)</b>	<b>(8,091)</b>	<b>(7,145)</b>
<b>Balance before contributions</b>	<b>30,360</b>	<b>41,620</b>	<b>35,949</b>	<b>31,224</b>
<b>Compensation Fund contributions</b>		<b>2,420</b>	<b>2,420</b>	<b>2,420</b>
<b>Net cash inflow after contributions</b>	<b>4,876</b>	<b>(8,529)</b>	<b>(5,671)</b>	<b>(4,725)</b>
<b>NET BALANCE AFTER CONTRIBUTIONS</b>	<b>52,569</b>	<b>44,040</b>	<b>38,369</b>	<b>33,644</b>
variance from minimum reserve after contributions	22,787	13,779	10,113	7,248
<b>Calculated minimum reserve:</b>	<b>29,782</b>	<b>30,261</b>	<b>28,256</b>	<b>26,396</b>

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 3

### Minimum reserve calculation

#### Scenario 1

Practising year ↓	Contribution Year			
	2012/13	2013/14	2014/15	2015/16
2006/07	£9.8 m			
2007/08	£8.8 m	£8.8 m		
2008/09	£13.5 m	£13.5 m	£13.5 m	
2009/10	£28.3 m	£28.3 m	£28.3 m	£28.3 m
2010/11	£15.4 m	£15.4 m	£15.4 m	£15.4 m
2011/12	£17.3 m	£17.3 m	£17.3 m	£17.3 m
2012/13 (forecast)	£25.1 m	£25.1 m	£25.1 m	£25.1 m
2013/14 (forecast)		£18.2 m	£18.2 m	£18.2 m
2014/15 (forecast)			£12.7 m	£12.7 m
2015/16 (forecast)				£13.7 m
Weighted average	£19.2 m	£19.5 m	£18.2 m	£16.9 m
Average * 1.5	£28.8 m	£29.3 m	£27.3 m	£25.4 m
3 months recharge	£4.1 m	£4.1 m	£4.1 m	£4.1 m
<b>Minimum reserve</b>	<b>£32.9 m</b>	<b>£33.3 m</b>	<b>£31.3 m</b>	<b>£29.5 m</b>

#### Scenario 2

Practising year ↓	Contribution Year			
	2012/13	2013/14	2014/15	2015/16
2006/07	£9.8 m			
2007/08	£8.8 m	£8.8 m		
2008/09	£13.5 m	£13.5 m	£13.5 m	
2009/10	£28.3 m	£28.3 m	£28.3 m	£28.3 m
2010/11	£15.4 m	£15.4 m	£15.4 m	£15.4 m
2011/12	£17.3 m	£17.3 m	£17.3 m	£17.3 m
2012/13 (forecast)	£25.1 m	£25.1 m	£25.1 m	£25.1 m
2013/14 (forecast)	N/a	£18.2 m	£18.2 m	£18.2 m
2014/15 (forecast)			£12.7 m	£12.7 m
2015/16 (forecast)				£13.7 m
Weighted average	£19.2 m	£19.5 m	£18.2 m	£16.9 m
Average * 1.5	£28.8 m	£29.3 m	£27.3 m	£25.4 m
3 months recharge	£1.0 m	£1.0 m	£1.0 m	£1.0 m
<b>Minimum reserve</b>	<b>£29.8 m</b>	<b>£30.3 m</b>	<b>£28.3 m</b>	<b>£26.4 m</b>

These tables show the calculation of the minimum reserve in forthcoming practising years. The reserve is set at one and a half times the weighted average grants in the previous seven periods plus three months expected recharge. The minimum balance shown is as at the end of the relevant contribution year (e.g. the minimum balance at the end of 2013/14 is £33.3m in scenario 1).

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 4

### Compensation Fund funding requirements and indicative fees

Minimum funding requirement to maintain reserve above agreed level

#### Scenario 1

	2010-11 Actual fee	2011-12 Actual fee	2012-13 Actual fee	2013-14 forecast	2014-15 forecast	2015-16 forecast
Total contribution	£2,200,000	£14,200,000	£22,000,000	£13,445,000	£18,339,000	£17,598,000
Indicative individual Fee	£10	£60	£92	£56	£76	£72
Indicative firm Fee	£60	£772	£1,340	£836	£1144	£1080
Firm / Individual split	50/50	50/50	50/50	50/50	50/50	50/50

This table provides an indication of the individual and firm fees that would be payable based on the contribution levels proposed in this paper. These fees are based on an estimate of 121,000 regulated individuals paying a Compensation Fund contribution and 8,050 regulated firms paying a contribution.

#### Scenario 2

	2010-11 Actual fee	2011-12 Actual fee	2012-13 Actual fee	2013-14 forecast	2014-15 forecast	2015-16 forecast
Total contribution	£2,200,000	£14,200,000	£22,000,000	£2,420,000	£2,420,000	£2,420,000
Indicative individual Fee	£10	£60	£92	£10	£10	£10
Indicative firm Fee	£60	£772	£1,340	£150	£150	£150
Firm / Individual split	50/50	50/50	50/50	50/50	50/50	50/50

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 5

### Compensation Fund year end balances and grants paid

#### Scenario 1

Year	Grants paid	Year end balance
2008-09	£13.5 m	£51.1m
2009-10	£28.3 m	£56.2m
2010-11	£15.4 m	£44.9m
2011-12	£17.3 m	£47.7m
2012-13	£25.1 m	£45.5 m

#### Scenario 2

Year	Grants paid	Year end balance
2008-09	£13.5 m	£51.1m
2009-10	£28.3 m	£56.2m
2010-11	£15.4 m	£44.9m
2011-12	£17.3 m	£47.7m
2012-13	£25.1 m	£52.6m

## Annex A: June 2013 SRA Board paper of Compensation Fund requirement

### Annex 6

<b><u>Categorisation of ENQ matters – WIP ENQ's split by complexity</u></b>		
<b>Complexity – Mortgage Fraud</b>	<b>no. Claims</b>	<b>Total original claim amount</b>
Comp Fund Applicant to complete application form	3	£127,750
Comp Fund Applicant to exhaust other remedies	257	£75,420,392
Comp Fund Assessed applicant contributed to own loss	84	£20,081,492
Comp Fund Assessed losses outside the remit of the Fund	19	£7,058,608
Comp Fund Assessed title to property registered – loss due to other factors	62	£18,689,399
Comp Fund Assessed: Other	6	£553,616
Comp Fund Customer has not responded	172	£24,281,969
Comp Fund Original Amount Claimed to be established	1	£90,585
<b>Mortgage fraud total</b>	<b>604</b>	<b>£146,303,811</b>

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Annex 7

### Accounts for the first 5 months

£000's	PY 12-13
<b>Compensation Fund forecast 2013-2016</b>	Actual November - March
<b>Opening balance as at 1st November</b>	47,693
<b>Cash Outflows</b>	
Compensation Fund Grants	5,961
Fees, tax and other costs	1
SRA support costs recharged	1,669
<b>Total cash outflow in period</b>	7,631
<b>Cash inflows</b>	
Subrogated claims	2,472
Compensation Fund recoveries	18
Residual balances from STA's	2,305
Bank & investment income	75
<b>Total cash inflow before contributions</b>	4,870
<b>Net cash inflow / outflow before contributions</b>	(2,761)
<b>Balance before contributions</b>	44,932
<b>Compensation Fund contributions</b>	22,208
<b>Net cash inflow after contributions</b>	19,448
<b>NET BALANCE AFTER CONTRIBUTIONS</b>	67,140

# Annex A: June 2013 SRA Board paper of Compensation Fund requirement

## Board Risk Assessment

### Summary of issues for consideration:

There are insufficient funds in the Compensation Fund for the practising year 2013/14 to meet the grants paid out during that year.

The level of contribution and in turn the fees required for 2013/14 will be higher if the proposal to pay intervention costs from the Compensation Fund is approved by the Board.

### Report is for:

Noting / Information

Decision

Approval

### Business /Operational Risk:

A prudent position has been taken in respect of calculating the overall level of contribution which considers the continuing trends for business as usual and mortgage fraud claims and additional high risk potential liabilities. The risk of insufficient funds being available to meet all claims can be mitigated by the time taken to receive and investigate such claims.

The risks associated with the proposal that the cost of interventions are borne by the Compensation Fund is covered in the Interventions paper to the Board dated 24 April 2013.

### Finance:

None

### Communications:

The fees will be communicated to the profession for payment.

### Equality and Diversity Implications:

We are not proposing to change our approach to calculating the compensation element of the fee which was covered by a full equality impact assessment in 2010 and reviewed in 2011. We will be looking at fees as part of a much wider Compensation Arrangements Review and a full regulatory and equality impact assessment will be carried out as part of that review.

The shifting of the cost of interventions to the Compensation Fund will have an impact on those who meet that cost. This proposal has been subject to consultation and any associated risks are covered in the Interventions paper to the Board dated 24th April 2013.

**Author:** Helen Herniman

**Date:** 31 May 2013

## **Annex B - Draft Determination of Compensation Fund contributions 2013**

This determination is made by the Solicitors Regulation Authority Board under rule 2.3 of the SRA Compensation Fund Rules 2011, with the approval of the Legal Services Board under paragraph 19 of Schedule 4 to the Legal Services Act 2007.

- (1) Every person who applies for a practising certificate to commence on or after 1 November 2013, or who applies for initial registration or renewal of registration as a registered European lawyer or registered foreign lawyer to commence on or after 1 November 2013, shall pay with the fee payable in respect of that application, a contribution of £56 to the Fund.
- (2) Every recognised sole practitioner that:
  - (a) applies for renewal of authorisation as a recognised sole practitioner to commence on or after 1 November 2013; and
  - (b) has held or received client money (as defined in the SRA Accounts Rules 2011) during the period 1 November 2012 to 31 October 2013 shall pay with the fee payable in respect of that application, a contribution of £836 to the Fund.
- (3) Every recognised body that has held or received client money (as defined in the SRA Accounts Rules 2011) during the period 1 November 2012 to 31 October 2013, shall pay with the annual periodical fee, a contribution of £836 to the Fund.
- (4) Every person that:
  - (a) applies for initial authorisation as a recognised sole practitioner or initial recognition as a recognised body to commence during the period 1 November 2013 to 31 October 2014; and
  - (b) intends to hold or receive client money (as defined in the SRA Accounts Rules 2011) at any time during the period 1 November 2013 to 31 October 2014shall pay with the fee payable in respect of that application, a contribution to the Fund as follows:
  - i. £836 on applying for initial recognition to commence in the period 1 November 2013 to 31 December 2013;
  - ii. £627 on applying for initial recognition to commence in the period 1 January 2014 to 31 March 2014;
  - iii. £418 on applying for initial recognition to commence in the period 1 April 2014 to 30 June 2014;
  - iv. £209 on applying for initial recognition to commence in the period 1 July 2014 to 31 October 2014.
- (5) The SRA may waive the contribution payable under paragraph (4) above in circumstances where the initial application is made by a body which is changing its legal status or is succeeding to the practice of another recognised body or recognised sole practitioner and the predecessor body or practitioner has already paid a contribution to the Fund.

(6) In this determination:

**Fund** means the Solicitors' Compensation Fund established and maintained under rule 2.1 of the SRA Compensation Fund Rules 2011; and

All other terms are to be interpreted in accordance with the Practising Certificate Fee Determination 2013.

(7) This determination shall come into force on 1 November 2013.

## Annex C - Draft Determination of Compensation Fund contributions for Licensed Bodies 2013

This determination is made by the Solicitors Regulation Authority Board under rule 2.3 of the SRA Compensation Fund Rules 2011, with the approval of the Legal Services Board under paragraph 19 of Schedule 4 to the Legal Services Act 2007.

- (1) Every licensed body that held or received client money (as defined in the SRA Accounts Rules 2011) at any time during the period 1 November 2012 to 31 October 2013, shall pay, with the annual periodical fee, a contribution of £836 to the Fund.
- (2) Every licensed body that intends to hold or receive client money (as defined in the SRA Accounts Rules 2011) at any time from the date on which the body is authorised to 31 October 2014, shall pay, with the initial periodical fee, a contribution to the Fund as follows:
  - i. £836 on being authorised in the period to 31 December 2013;
  - ii. £627 on being authorised in the period 1 January 2014 to 31 March 2014;
  - iii. £418 on being authorised in the period 1 April 2014 to 30 June 2014;
  - iv. £209 on being authorised in the period 1 July 2014 to 31 October 2014.
- (3) The SRA may waive the contribution payable under paragraph (2) above in circumstances where the initial application is made by a body which is changing its legal status or is succeeding to the practice of a recognised body or recognised sole practitioner and the predecessor body or practitioner has already paid a contribution to the Fund.
- (4) In this determination:

**Fund** means the Solicitors' Compensation Fund established and maintained under rule 2.1 of the SRA Compensation Fund Rules 2011; and

All other terms are to be interpreted in accordance with the Licensed Body Fee Determination 2013.
- (5) This determination shall come into force on 1 November 2013.