The Law Society

The importance of insurer solvency

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Introduction

First there was Quinn. Then there was Lemma. Is your insurer next?

The financial security of your insurer is important.

This advice is designed to raise solicitors' awareness of the importance of considering whether their insurer will be able to meet claims under their professional indemnity insurance (PII) policy.

There remains a misconception held by some members of the profession that because the Solicitors Regulation Authority (SRA) publishes a list of qualifying insurers that these insurers are vetted by the SRA in some way.

This is not the case. The SRA does not undertake any solvency checks on insurers and does not require a minimum level of financial security for participation in the solicitors' PII market. The SRA has, however, introduced a transparency requirement for all qualifying insurers. Insurers must now disclose whether or not they have a financial security rating and the provider of this rating. You should use this information when assessing PII quotations.

The recent financial collapses of two insurers, Quinn and Lemma, should make solicitors think twice between accepting a quote without checking an insurer's financial stability.

The most objective measure of a firm's financial security is their rating. The existence of a rating is indication that the firm has been assessed by an independent rating agency. Unrated insurers are an unknown quantity. They have not been subject to independent scrutiny from a ratings agency.

Are you content to make one of the most important purchasing decisions for your practice blindfolded?

The other source of advice on a firm's financial security that you can seek is from your broker. Your broker should advise about the suitability or otherwise of accepting a quotation from a particular qualifying insurer taking into account the specific circumstances of your firm.

Solicitors should, however, consider whether their broker is able to provide independent advice or if their advice is constrained by a tied arrangement with a particular insurer or if they are providing an execution only service. For more information about choosing an independent broker see the Society's PII Buyers' Guide.

This guide has some general information about what these ratings may mean to help you assess the financial security of insurers. Information about specific insurers is contained in the Society's Insurers' Guide.

Status of this guide

While care has been taken to ensure that the information in this guide is accurate, up-to-date and useful, the Law Society will not accept any legal liability nor warrant the accuracy of the information within.

Insurers’ financial security is important

Every insurance policy in existence is only as good as the paper it is written on. In other words, the financial strength of the company that issues the policy will determine whether a claim can be paid.

Given the long-term nature of solicitors’ PII, particularly run-off cover which must be provided for six years, it is important to know that your insurer is financially secure and will be able to meet any claims made on the policy.

The purpose of a PII policy is for insurers to pay claims, so that liability of the insured is limited to the policy excess up to the indemnity limit of the policy. You should consider whether the indemnity limit of your policy is sufficient to cover the potential liability of your firm. The Law Society has prepared additional guidance about top-up and excess layer cover.

You want to be confident that an insurer will meet its obligation to pay claims. This means that an insurer’s ability to pay should be foremost in your mind when selecting an insurer.

Should an insurer be unable to meet its obligations, there may be a high price to pay. If there are outstanding claims on the policy that are not met from the insolvent estate; at best, a practice will find itself relying on its eligibility for the FSA’s Financial Services Compensation Scheme (FSCS) which only covers small businesses and does not pay the entire claim; at worst, practices that are not eligible for protection could find themselves wholly uninsured. See the section Am I covered by the FSCS?

Depending on your firm’s business structure, uninsured loss can have devastating personal consequences. The following are real life case examples.

Example 1

Insurer A goes into liquidation. Firm B is a three partner firm with an annual turnover of £1.5m. Firm B had been insured with an A-rated insurer from its commencement in 2000 until 2009.

It switched to Insurer A, an unrated insurer, in the 2010-11 indemnity period because the premium quoted was substantially lower than its renewal quotation. When Insurer A becomes insolvent in 2012, there are two outstanding claims notified on the policy for the 2010-11 year that are yet to be paid.

C is a former partner of Firm B who left the firm in 2008. C did not have any input into the decision to switch insurers in 2010. The alleged negligent act that forms the basis of one of the claims notified in 2010 relates to work undertaken in 2005 when C was a partner.

The partners of Firm B are jointly and severally liable to meet losses that arise from wrongful acts or omissions arising from the ordinary course of business of the firm. This includes the uninsured claim. There is no recourse to the FSCS because the firm does not meet the eligibility criteria because its annual turnover exceeds £1m.

C, as a former partner, is covered under Insurer A’s policy. If the liquidators of Insurer A are unable to fully meet the claim, C is jointly liable with the firm’s partners for any shortfall in the claim that arises from work undertaken while C was a partner in the firm. C has retired and needs to sell C’s house in order to meet this personal liability.

Example 2

D is a sole practitioner who retired in 2010 with an annual turnover and net assets of £500,000. D did not have a successor practice and therefore entered into run-off.

Insurer E was D's last insurer and must cover the mandatory six years run-off cover policy as required under the minimum terms and conditions. Insurer E goes into liquidation in April 2012. A £2m claim is made on the run-off policy in May 2012.

D is eligible for compensation from the FSCS. The FSCS will only cover 90% of the claim. D is personally liable for the remaining £200,000. As D has retired, D has limited income to meet this claim and faces bankruptcy.

Example 3

Insurer F becomes insolvent on 2 November 2013. There are 1,000 firms insured by Insurer F for the 2012-12 indemnity period. Each of these firms have four weeks to find alternative open market insurance. There is no recourse to the assigned risks pool as it was closed on 1 October 2013.

Insurer G is willing to insure 900 of these firms. It will, however, charge a higher premium than firms were paying under Insurer F because it considers that F's under-pricing of risks was the reason for its collapse.

These firms must pay this additional premium to become insured with G for the remainder of the indemnity period or else face closure.

The 100 firms that were unable to obtain alternative insurance are required to closed by the SRA. If this requires intervention by the SRA, the cost to the firm and its principals can be substantial.

Any PII claims that are made while the firm is in the first six years of run-off will fall on the insolvent estate of the insurer. Principals may be eligible for partial compensation from the FSCS but otherwise may be personally liable for any uninsured shortfall in claims.

Transparency requirement

The Solicitors Regulation Authority (SRA) has changed the qualifying insurers agreement (from 1 October 2012) to make it mandatory for qualifying insurers to disclose credit and financial strength ratings. Insurers must state any rating and the name of the agency that has provided the rating on any quotations provided to you.[1]

Insurers must also state if they are unrated and notify the SRA within 5 business days of any changes to the rating throughout the indemnity year.

The Law Society supports increased transparency within the solicitors' PII market.
The Law Society's Insurers Guide lists information about insurers prepared to insure different segments of the profession. For the most up-to-date ratings, please see the SRA's website.

[1] See clause 10.3 of the Qualifying Insurers Agreement.

Why doesn't the SRA do more to regulate insurers?

Neither the SRA nor the Law Society vets, approves or regulates insurers. The SRA has only required transparency of financial security ratings without mandating that insurers must have a certain rating or indeed any rating at all.

This is part of the agreement that the SRA enters into with insurers each year to ensure that they provide policies in accordance with the minimum terms and conditions in the SRA Indemnity Insurance Rules.

Regulation of qualifying insurers is undertaken by the Financial Services Authority, or, where an insurer from another jurisdiction is passported into the UK system, the financial regulator of that jurisdiction.

Financial security ratings

What do the ratings mean?

The existence of a rating is an important factor that you should consider when choosing an insurer. However, ratings do not guarantee an insurer's financial solvency.

A rating means that an insurance company has been through an independent process by which a rating agency has assessed its financial strength. The two major rating agencies for insurers are Standard & Poor's (S&P) and AM Best – see **Appendix A** for an explanation of the individual ratings provided by each of these agencies. The view within the insurance industry is that S&P is generally regarded to be the stronger rating agency.

Even though the SRA has required transparency from qualifying insurers about whether or not they are rated or unrated, the SRA has decided not to take any further steps to require a certain level of financial stability from qualifying insurers.

However, brokers can advise on whether an insurer is suitable for a particular client. Indeed, some brokers will refuse to deal with insurers that they considered to be a financial solvency risk. Other brokers will deal with these types of insurers, but only after providing clients with detailed disclaimers.

How should I use this information?

You should use these ratings as a guide to help you assess an insurers' financial security.

If an insurer is unrated, it is difficult for you to assess its financial security as it has not been assessed by an independent rating agency.

The potential for grave personal consequences for individuals within firms in the event of insurer insolvency is outlined above. You should consider this risk when assessing quotations. Unlike rated insurers, the financial stability of unrated insurers is unknown and untested.

Obligation to find alternative insurance

In the event of insolvency of your existing insurer, you have an obligation to find additional cover within four weeks. Any replacement cover will involve payment of additional premium.

See the Law Society's practice note on insolvency of qualifying insurers for further details about your right and obligations if your insurer becomes insolvent.

Availability of compensation

What is the FSCS?

The Financial Services Compensation Scheme (FSCS) is a compensation scheme provided by the FSA in the event that a financial services provider becomes insolvent or ceases trading. The purpose of the FSCS is to assist individuals and small businesses who are consumers of financial services.

Is my insurer covered?

All qualifying insurers are covered by the FSA's scheme; however, there are limits and restrictions on the types of customers that are covered.

The FSA requires that all insurers must participate in the FSCS; this includes those firms from the European Economic Area (EEA) that are passported into the UK by the FSA.[2]

The FSCS does not apply to reinsurance contracts.

Am I covered?

It is important to remember that even if your insurer is covered, there are limits on eligibility and amount payable under the scheme. The purpose of the FSCS is to assist individuals and small businesses who are consumers of financial services. It will only pay 90% of an eligible claim.

The FSCS rules are complicated and there are several important restrictions on the scheme in so far as insureds under a solicitors' PII policy are concerned. The key points to note are:

- Partnerships (other than limited liability partnerships) are only eligible to bring a claim if their annual turnover does not exceed £1m and their net assets do not exceed £1.4m.
- Corporate bodies (including limited liability partnerships) are only eligible to bring a claim if their annual turnover does not exceed £1m, and either they have not more than 50 employees or their balance sheet net assets (as defined in section 247(5) of the Companies Act 1985 and section 382(5) of the Companies Act 2006) do not exceed £3.26m.
- Individuals are eligible to bring a claim irrespective of their turnover, net assets or number of employees. This will include sole practitioners and individuals whose practice has ceased and whose policies are in run-off.
- Compensation from the FSCS is limited to 90 per cent of the total amount claimed.
- If there is any shortfall or you are not eligible for the FSCS, you may be personally liable to meet claims.

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[2] See the definition of protected insurance contracts in COMP 5.4 of the FSA Handbook

For more information about whether or not you are likely to be covered by the FSCS, see the FSA's consumer information.

Appendix A: Main rating companies

As at April 2012

AM Best

Secure

A++, A+ Superior
A, A- Excellent
B++, B+ Good

Vulnerable

B, B- Fair
C++, C+ Marginal
C, C- Weak
D Poor
E Under regulatory supervision
F In liquidation
S Suspended

Standard and Poor's

Long-term ratings

Investment grade

AAA Extremely strong capacity to meet financial commitments. Highest rating
AA Very strong capacity to meet financial commitments
A Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances
BBB Adequate capacity to meet financial commitments, but more subject to adverse economic conditions
BBB- Considered lowest investment grade by market participants

Speculative grade

BB+ Considered highest speculative grade by market participants
BB Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
B More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
CCC Currently vulnerable and dependent on favorable business, financial and economic conditions to meet
financial commitments
CC Currently highly vulnerable
C Currently highly vulnerable obligations and other defined circumstances.
D Payments default on financial commitments

Ratings from AA to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.