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Risk Dimensions

Welcome to our new law firm newsletter, which we aim to publish three times a year. Each edition will examine a selection of topical issues that are core to professional indemnity risk. In this edition, we discuss the current professional indemnity (PI) insurance market conditions, and the pros and cons of third-party managed accounts.

PI Insurance Market Update

For well over a decade, plentiful capacity and intense competition for market share drove down UK insurance rates, and increased the scope and availability of cover.

Those conditions generally started to plateau in 2017, which coincided with some syndicates exiting the market. Although small in number, the syndicates were significant in terms of capacity and position, adding to the realisation that increased focus on portfolio performance and longer-term stability was inevitable.

Against this backdrop, the Lloyd's review in 2018 delivered the impetus and requirement for many insurers to re-engineer their portfolio, and introduce dramatic measures to try to turn around their results, or risk being closed down.

Insurers seeking significantly increased rates, reduced capacity, and an increased focus on limiting coverage, have been common themes over the past 12–18 months. There is no sign of these approaches changing, as the market's final claims tail can take many years to come to fruition, as the individual estimates mature and reach their ultimate final value.

Almost all underwriters' action plans are driven by ongoing actuarial analysis, fine-tuning as they go, to back decisions aimed at delivering a longer-term strategy. This means an insurer's appetite can change quickly and significantly.

Areas of focus will always vary by profession, but the overriding stimulus for change has been a collective increased claims severity across multiple professions, combined with a year-over-year decline in rates.

During the same period, most firms' revenue grew year-over-year without increased premium. Revenue is the main yardstick for assessing exposure but, previously, premiums did not always follow from increased revenues, due to increased competition. Going forward, underwriters' focus on profitability is likely to lead to continued rate change – at least until there is more competitive pressure or a marked reduction in claims.

COVID-19's impact on the insurance market generally has created further uncertainty and made future trend analysis extremely difficult. Although potentially limited to certain professions as a direct source of claims, the likely economic downturn and concerns as to possible resultant negligence allegations will likely influence underwriters' approach for the rest of 2020.

Author: Stuart Mangion, senior vice president, Marsh JLT Specialty

Third-Party Managed Accounts: What Are the Pros and Cons?

Third-party managed accounts (TPMAs) seem to have a lot going for them. Essentially, a solicitor can "outsource" the operation of its client account to a separate FCA-regulated entity.

By doing so, they mitigate risks arising from third-party client account fraud, employee client account fraud, and "fat finger" negligence (that is, accidental keying errors, or the innocent payment to a wrong party).

Given that claims arising from such events are covered under Solicitors Regulation Authority (SRA) minimum terms and conditions (MTC) policies, insurers might also find TPMAs appealing. Particularly when:

1. Commentators have suggested that millions of pounds have been paid out in respect of such claims in recent years, as cyber criminals target money held by law firms.
2. Claims relating to loss of client funds tend to be determined based on trust principles, where asserting contributory fault and/or relying on S61 Trustee Act defences are difficult (see, for example, "Dreamvar: The Final Chapter").

Yet take up of TPMAs has not been widespread.

TPMA Benefits

A TPMA provider is a financial services firm that specialises in providing escrow services, and will routinely have IT security infrastructure beyond most solicitors' means.

The TPMA provider will enter into a contractual relationship with the solicitor, which specifies the instructions it will need to receive in order to disburse monies. For example, the solicitor can agree that instructions to make payments need to be verified and approved by the solicitor and its client.

The TPMA will then execute those instructions. Providers will receive instructions via a secure portal (or an app) and hence the current risk of email interception, phishing, or simple mis-transcription of instructions is reduced (albeit not eliminated). Access to account records will also be through the portal or app.

In addition to these risk management benefits, there appear to be clear commercial benefits for a solicitor, including:

- Overheads relating to finance and cashiering may decrease.
- Reduced risk of client account breaches.
- Transaction fees are payable by the client and not borne by the solicitor.
- Reduced or extinguished contributions to the compensation fund.
- Insurers may look favourably on such arrangements, as the risk of financial cyber fraud is mitigated if not extinguished.

Using a TPMA

So what must a solicitor do if it wishes to use a TPMA? First, it must tell the SRA that a TPMA arrangement is in use (permission to use is not required).

Second, when liaising with its clients, the solicitor must:

- Inform the client of the arrangement and obtain their consent.
- Explain to the client its right to terminate the TPMA agreement and dispute payment instructions given by the solicitor alone (hence the good risk management practice of requiring client participation in payment requests).
- Inform the client of the TPMA's FCA regulation.
- Explain that the regulatory protections are different to those provided by the SRA Code and SARs.

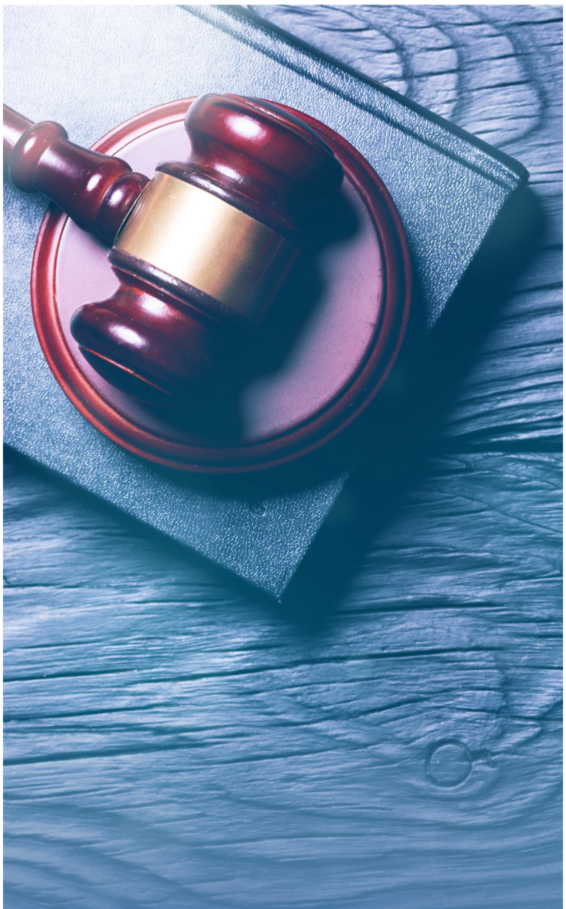
In the usual way, informed consent will be required. TPMA providers are likely to have proforma letters for solicitors to send to clients to discharge these obligations.

Associated Risks

Despite undoubted benefits, solicitors considering using a TPMA should consider the following:

- In addition to receiving transaction fees, the TPMA provider will retain all interest – the solicitor will therefore lose a revenue stream.
- The solicitor will be obliged to explain to a client that in the event of a TPMA fraud or cyber loss, the client may be in a worse position than if the client's funds had been held in a solicitor's client account. In a client account, the obligation to "replenish" arises in the event of loss (as many firms and insurers know to their cost). Breaches of the SAR are covered by the MTC, which operates with any one claim limits of indemnity. But what of the TPMA insurance arrangements? It is unlikely their policies will contain as broad cover as the MTC, and they may also have aggregate limits that cap insurers' exposure. The basis upon which TPMAs hold money is likely also be contractual rather than trust-based so client remedies may be less effective, and clients are likely to blame law firms if they do not get full compensation from the TPMA provider. Law firms are therefore in a difficult position "advising" the client on a product that reduces the risk of fraud, but may worsen the client's position in the event of fraud.
- Apportionment of blame between the TPMA and the law firm is likely to be governed and limited by the provider's contract.
- The giving of undertakings may become more complex – a solicitor presently can give a financial undertaking (for example, to discharge a disbursement) or on completion of a conveyancing transaction when it has "money on account". But what if funds are held in the TPMA and the client refuses to authorise the payment? The solicitor will be in breach of undertaking with no obvious means of discharging it from client monies, absent the pursuit of a dispute resolution provision.

Author: Paul Castellani, partner at Kennedys



Conclusion

PI insurance rates have transitioned over the last year for various macroeconomic reasons. But one solicitor-specific reason is the incidence of financial loss arising from client-account liabilities.

TPMAs offer the possibility of reducing a significant part of this core risk, as the hazard of holding client money is largely eliminated.

Hazards associated with directing payments will remain, but, given the losses that have emanated from client accounts over the last few years, we would expect insurers to look favourably on firms with such arrangements – particularly for firms with large active client accounts (commonly residential conveyancers), as some fraud and SAR exposure is reduced.

The recent trickle of firms taking up such arrangements may therefore become a steady flow.

We hope you enjoyed this edition. Currently our Risk and Error Management team is working closely with various clients to support their risk management efforts. If you would like to hear more about our service please get in touch with your normal Marsh JLT Specialty contact, or contact our team directly:

VICTORIA PRESCOTT
Risk & Error Management, Professional Liability
Financial and Professional Risks Practice
T: +44 (0)207 357 1241
victoria.prescott@marsh.com

JOHN KUNZLER
Risk & Error Management, Professional Liability
Financial and Professional Risks Practice
T: +44 (0)207 178 4277
john.kunzler@marsh.com