SRA BOARD
20 October 2021

CLASSIFICATION – OFFICIAL

Solicitors Regulation Authority

Explanation of SIFL/Fund Accounts provided by SIFL

1 This annex is intended to summarise the financial position (income and expenditure) of both the Solicitors Indemnity Fund (the "Fund") and Solicitors Indemnity Fund Limited ("SIFL"), the entity which manages and administers the Fund. All the figures below are based on those in the most recent prepared accounts for the year end 31 October 2020. The balance sheet figures should not be read in isolation, but in the context of the solvency assessment made by the SIFL Board in line with actuarial assessments.

2 As a limited company, SIFL is required to file accounts and these primarily reflect the operating costs and expenses incurred by SIFL in managing and administering the Fund and are entirely funded by the Fund. These can be found here: https://find-and-update.company-information.service.gov.uk/company/02143641/filing-history

3 Separate accounts are prepared for the Fund due to its own status as a statutory fund. These can be found here: https://www.sifund.co.uk/wp-content/uploads/2021/03/Signed-SIF-Accounts-2019-2020.pdf

SIFL Accounts

4 Given the nature of SIFL its accounts reflect only the administrative expenses it incurs on behalf of the Fund, which are funded by the Fund. SIFL itself does not hold any reserves, nor make any profit or loss.

5 The Turnover of SIFL (£1,135,000 to 31 October 2020) represents only the reimbursement of expenses incurred on behalf of the Fund by the Fund to SIFL to cover its expenses (also £1,135,000). These expenses are also reflected within the Fund accounts but only incurred once. These administrative expenses include:

a. Staff Costs

b. Audit Costs

c. Director Costs

d. Other operating costs of running the Fund

Fund Accounts

6 The Balance Sheet of the Fund included Assets of £32.9m. The core aspect of this are the "investments" held in a managed investment fund of £30,808,000. As set out in the accounts, "*The Fund's investment strategy is to hold a varied and diversified portfolio to maximise returns at a level of risk agreed by the Directors of the Company. The Fund holds an investment portfolio consisting of equities, sovereign and investment grade bonds as well as other securities and cash. This provides the Fund with a constant income from investment."* The Fund's investments are managed by the same investment manager as that of The Law Society and the Fund's investment strategy is aligned with

that of The Law Society. The investments are held within two "funds" - one broadly representing the surplus capital and invested with a longer term view and the balance broadly representing the potential known liabilities.

7 The Liabilities of the Fund for the same period were £10.4m, primarily comprised of provisions for claims. The Fund has provisioned £10,087,000 for claims, made up of:

a. Gross Claim Reserves – provision is made for known notified claims based on estimates made by specialist claims experts and panel solicitors of the likely damages and costs of settling a claim. This reserve (and the IBNR reserve below) are based on the "best estimate" of the likely costs i.e., the reserves are equally likely to be too high as they are to be too low. They are not the worst case scenario - capital (the "surplus") is held to protect the Fund against more adverse outcomes.

b. Incurred but not reported (IBNR) – an estimated provision is made for those cases where the event that triggers a claim has already happened, i.e. an act of negligence has occurred at some time in the past but is presently unknown to the Fund because it has not been reported. All insurance companies have to make provision on this basis.

c. Claims Handling Costs – Provision for a proportion of the Fund's future claims handling costs which are recognised to the extent they can be separately identified as specifically relating to claims handling expected to be incurred due to known claims and IBNR cases.

8 Based on this assessment, at year ending 31 October 2020, the Fund had a surplus of £22,483,000. As set out below, this surplus must be understood in the context of both the actuarial analysis and assessment of the Fund's "solvency" on a similar basis as an insurer would be assessed.

9 The key points to note with regards the Fund's annual income and expenses are as follows:

a. The Fund has two sources of income, both of which are uncertain:

i. Investment income - £806k gains and £391k interest were made in the year ending 31 October 2020. The gains consisted of both realised and unrealised – unrealised being those investments which aren't sold but the value has increased (and may fall again the next day). During the fiscal year there were £437k realised (actual) losses in the year and £1,243k unrealised gains resulting from increases in the listed value over the year.

ii. Claims recoveries - These recoveries generally arise as a result of a past claim settlement on historic claims. In most cases an assignment or a charge has been obtained against a third party as security.

b. The Fund has various expenses, the core elements being:

   i. Claims - £1,315,000 was incurred inclusive of claims costs

   ii. Insurance Costs – the Fund also purchases insurance to limit the Fund's exposure to IBNR risk with regards the PSYROC coverage. A one-year extension to this arrangement to September 2021 was agreed during early 2021 which cost £800k. This cost will be reflected in the Fund's 2021 accounts.

   iii. Ongoing management and associated professional fees of around £700,000 each year. A proportion of these costs are provided for within the Claims Handling Costs Provisions to the extent they are directly attributable to claims handling as permitted by UK Accounting standards. However, a significant proportion of these on-going costs are not provided for and expensed each year. So it is imperative that future costs which cannot be provided for must be set aside and ring-fenced from surplus for the future. As at 31 October 2020 it is estimated that the future costs of running the Fund which have not been provided for are £2.6m.

Constraints on the Fund's Surplus

10 Notwithstanding the current balance sheet position of the Fund, given the nature of the activities with which the Fund is involved, any assessment of the viability of the Fund must consider an actuarial analysis and assessment of the Fund's solvency as well as ongoing costs and other financial risk factors not taken into account when arriving at an "accounting" surplus.

11 With regards ongoing costs, based on SIF continuing in its current form, those related to the administration of the Fund (including unavoidable fixed costs of managed and professional fees) are likely to remain similar. As mentioned above a significant proportion of future costs have not been provided for so must be funded from surplus. This would likely include further substantial insurance costs similar to those paid for previous extensions.

12 The Provisions mentioned in 7 above are provided for on a Best Estimate basis which is the mean average of the range of possible outcomes. Broadly, this means that the provision is equally likely to prove to be too high or too low.

13 In order to ensure they are able to meet their financial commitments to policyholders, insurance companies regulated in the UK are required to hold capital over and above their provisions to ensure they can withstand a 1:200 shock over the next year and still conduct an orderly exit. While not an insurance company the SIFL Board has chosen to follow a similar principle and ensure it holds sufficient free assets to be able to withstand a similar likelihood shock over the duration of its run-off. These free assets are held within the surplus.

[PRA Rulebook as a reference https://www.prarulebook.co.uk/]

14 When assessing their required target capital, insurance companies are typically required to consider a number of sources of risk, including:

- Insurance - costs of claim and associated expenses risks
- Market - interest rate and rate spread, investment return and foreign exchange rate risks
- Credit - counterparty default risks
- Operational - losses resulting from inadequate or failed internal processes, people, systems or external events

15 There are a number of additional but unquantified risks in addition to the target capital requirement which may quickly erode the surplus of £22.5m. These include:

a) New or re-opened historic claim where no IBNR is held nor has the benefit of insurance protection
b) Future loss of investment value due to market fluctuations
c) Inadequacy of the Fund's long term expenses budget
d) PSYROC claims exceeding IBNR provisions and insurance cover
e) Insurance costs and other expenses to bring the Fund to a close
f) Changes to future tax rates or the taxation base
g) Insurance counterparty default or dispute risk
h) Operational risk

16 Based on actuarial projections and advice, the SIFL Board deem it necessary to hold a capital buffer to protect against the above risks and have concluded that a further extension would not be prudent. SIF is not an insurer but in economic terms it operates as if it were and SIFL's directors assess its solvency on the same principles as would apply under modern insurance regulation. Its surplus can be quickly eroded by significant large events which by their nature are hard to forecast.