

MEMORANDUM

TO : LEGCO/LAW SOCIETY OF HONG KONG

CC : RICHARD WILMOT

FROM : PAUL WORDLEY

DATE : 15 October 2001

**RE : LAW SOCIETY OF HONG KONG-PROFESSIONAL
INDEMNITY INSURANCE SCHEME**

I understand that a number of issues have arisen following the discussions at the sub-committee meeting on Wednesday last week and arising out of the brief paper that I put together for that meeting. Dealing with some of the issues in turn I am setting out my understanding of the position below.

Policyholders Protection Act 1975

1. One of the issues apparently mentioned was that practitioners in England and Wales have the benefit of the Policyholders' Protection Board ("PPB") set-up under the Policyholders' Protection Act 1975. I can describe in general terms how this operates in England and Wales but am not yet aware of the equivalent position in Hong Kong.
2. The position in England and Wales is that for private policyholders — and importantly this includes partners in a partnership — and for insureds generally who are required to take out certain types of compulsory insurance the PPB will, in the event of insolvency of an authorised insurer transacting business in the United Kingdom, pay out approximately 90% of the unrecovered loss. Payments under the PPB are funded by way of a levy through the Association of British Insurers ("ABI"). The PPB have made significant payments in recent years as a result high profile insurance failures such as the H S Weavers Underwriting Pool Companies and, more recently, the PPB is expected to pay out significantly in respect of the insolvency of the Independent Insurance Group.
3. The Solicitors Indemnity Fund ("SIF") was not an approved insurer for the purposes of PPB

levies and accordingly any shortfall in SIF was funded by the profession as a whole. In contrast, under the new commercial insurance arrangements, any individual insurer who became insolvent would result in insureds being paid out the majority of their insurance loss by the PPB.

4. In practical terms my view is that little comfort is taken by law firms in England and Wales as a result of the PPB back-stop. Insurance brokers are obliged to advise insureds of the suitability of potential insurers when placing insurances. Suitability obviously includes financial solvency and also more esoteric qualities such as their understanding of the business in question (i.e. professional indemnity) and their willingness to pay claims (i.e. do they look for coverage points). In terms of a commercial business, it is far more important to have responsive insurance in the first instance than the comfort of knowing that, in due course, a mechanism such as the PPB will pay up the majority of claims. Any disadvantage that Hong Kong may have (and I would stress that I am not aware of the arrangements or the legislative regime in Hong Kong at present) should be counter-balanced by scrutiny of insurers in any Qualified Insurer Scheme. This scrutiny would be twofold: firstly, to qualify as a Qualified Insurer, local insurers would have to meet certain criteria laid down by the Law Society of Hong Kong. Secondly, although these criteria may be met, the local insurance brokers should advise insureds more specifically in terms of the suitability of potential insurers. In short the lack of any PPB equivalent (if this is indeed the case) can, in my view, be addressed by commercial considerations.

Sufficiency of Business Volume

5. I understand that a further issue is whether there are sufficiently large numbers of solicitors in Hong Kong to justify, in the view of the insurance market, an open market scheme. In my view this can be answered by reference two matters.
 - Firstly, there is clearly a sufficient interest in the current SIF arrangements in Hong Kong to attract reinsurers. These reinsurers are effectively confirming that, in view of the type of insurance and the volume of business, there is a business case for commercial insurance.
 - Secondly, Professional Indemnity Insurance ("PII") is a specialist class of

business for those insurers that write it. On the whole those insurers who specialise in PII do so on a global basis, with perhaps geographical exclusions such as North America where primarily for exposure reasons PII is written separately from PII elsewhere in the world. In short, PII insurers are looking for a volume of business in sometimes quite small markets in individual countries or geographical locations but, when put together, those markets or locations provide insurers with a spread of business and risk that they require in order to write on an insurance basis.

6. My understanding is that some of the specialist PII underwriters and brokers are already interested in the possibility of the Hong Kong legal market opening up and I suspect that the Law Society of Hong Kong could very quickly ascertain whether there was commercial support for such arrangements if indeed this was a concern.

Level of Contributions in England and Wales

7. The third area on which I understand you seek some clarification on relates to the level of contributions in England and Wales following introduction of the Qualified Insurer Scheme on the 1st of September 2000. The position is as follows:

- In its final year of SIF the volume of business equated to approximately GBP240 million in premium income.
- In its first year of operation the Qualified Insurer Scheme generated approximately GBP160 million in premium, as confirmed by returns to the Assigned Risks Pool ("ARP").
- In its second year of operation (i.e. after the first renewal at 1st September 2001) the overall volume of business, again as confirmed through ARP returns, has remained at approximately GBP160 million.

8. As is perhaps suggested by the issue you raise, there was some concern within the profession in England and Wales that insurers would seek to buy market share by reducing prices. Whilst on the whole the prices for the overall book of business that was in SIF has reduced by approximately a third, some of this can be attributed to the fact that most insureds indulged in laundry listing of claims and circumstances to SIF before

they went to the commercial market. In short, they notified to SIF anything that they thought might become a claim so that they would generate as clean as possible record with their new commercial insurers. More importantly the initial operation of the open market scheme in England and Wales has suggested that prices are not going to go up, all things being equal, but that certain firms might face a managed from the insurance market via the ARP if they do not raise their standards. However, since 11 September and the attack on the World Trade Centre and the Pentagon all things are not equal and it remains to be seen what the professional indemnity market will look like at next year's renewal.

9. I approach the likely cost issues in the open market arrangements on the following basis. The fundamental driver of the cost of insurance is the amount paid away by way of claims, the cost of dealing with those claims, the cost of the distribution channel, the cost of capital and the performance of investments. These variables are changing all the time. The instance of claims and the efficiency of the mechanism will drive the overall cost. I consider that what will happen in the open market is that the good firms who have good claims records or who embrace risk management to avoid claims in the first place will be able to obtain cover more cost efficiently than under the old SIF arrangements. However, those firms with poor records and particularly those who are unwilling to embrace risk management will face potentially significant increases in insurance costs. At the end of the day in my view the market is a better mechanism for raising risk awareness of solicitors. There is a lot to be said for the approach of solicitors in England and Wales in the SIF days being that their only risk management was to have their insurances with SIF.

Once again this note has been produced for discussion purposes only and is, as a result of the short turn around time necessarily brief. Accordingly it lacks certain detail which, given more time and some local research, could undoubtedly be provided.

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