

7th September 2001

Dear Member,

Re: Hong Kong Solicitors' Indemnity Fund "SIF"

The Law Society has recently received a number of expressions of concern relating to the contribution increase which will be levied upon the renewal of the Professional Indemnity Insurance Scheme on October 1st, 2001. Comments were also received regarding the feasibility of implementing a Qualified Insurer's programme similar to that adopted by the Law Society of England and Wales (LSE&W). There were suggestions that the adoption of such a scheme may reduce insurance premium costs to the membership.

This letter provides information which shows the underlying reasoning of the Board of SIF in implementing and in maintaining the current Professional Indemnity Insurance Scheme until its expiry on September 30th, 2005 and also a commentary on why the implementation of a qualified insurer's programme may not be appropriate immediately, although well worthy of consideration at a somewhat later stage.

The Compulsory Professional Indemnity Insurance Scheme

- 1) The overwhelming factor in the cost of any insurance scheme is its claims experience.

Currently, SIF provides coverage of \$10 million each and every claim to its membership. Of this amount, the SIF retains the first \$1 million of every claim and reinsures the remaining \$9 million. To further limit the aggregate impact of the \$1 million retention for each claim, the SIF also purchases Stop Loss Reinsurance which provides coverage if the aggregation of retention is in excess of a predetermined amount.

- In the early years of the Scheme, loss experience was generally favourable and costs moderate.
- For indemnity years from 1987/88 through to 1998/1999 which ended on September 30th, 1999, a total premium of \$379.7 million was paid to

insurers of SIF who provided the \$9 million excess of \$1 million coverage (Excess of loss reinsurance). During the same period, paid and reserved claims against those insurers totalled \$593.3 million.

- More pertinently, for the recent years 1994/5 – 1998/99 premiums totalled \$229.4 million and paid and reserved losses totalled \$525.3 million, a ratio of 229%. Of the losses, \$194.1 million have already been paid so even on a cashflow basis the insurers are fast approaching 100% loss.
- Under the Stop Loss reinsurance, a total premium to date of \$64.1 million has been paid, with paid and reserved claims of \$170.2 million.
- While it is still too early to predict the results of the 1999/2000 underwriting year, our information to date would seem to indicate that actual claims will again far surpass premiums.

Clearly no insurers, whether under a SIF-type of arrangement or under a Qualified Insurer Scheme, will absorb loss ratios of this magnitude, and this is the reason for the premium increases.

To look at the matter from another angle, the amount of total contributions from members from 1987/88 to 1999/00 was \$874 million, whereas the total amount of claims paid and reserved for the same period was \$1,104 million. If SIF had not reinsured part of its liabilities with insurers, the deficit that would have been incurred would have been \$230 million. This is another indication that the level of contributions from members which has not been raised since the inception of the Scheme is insufficient and has to be raised to meet the rising number and amount of claims.

- 2) Sensing a deteriorating loss environment, on October 1st, 1998 (the commencement of the 1998/1999 indemnity year), SIF replaced the previous annual reinsurances with a 3-year insurance arrangement on fixed terms with various insurers to provide the \$9m excess of \$1m (Excess of Loss) reinsurance as well as Stop Loss insurance. This 3-year arrangement was due to expire on September 30th, 2001.

By June 2000 (21 months into the 3-year policy period), the 1998/99 policy year (which expired on September 30th, 1999) had already experienced paid and reserved claims of \$178.5m against premiums paid for Excess of Loss reinsurance of \$61.2m. Against Stop Loss premiums of \$11 million paid, there were \$63.7 million of potential claims, and as the 3-year SIF retention had already been exceeded, every new claim would add to that total.

During discussions with the Scheme's insurance advisors and brokers, the Aon Group, it became clear that the Scheme was faced with critical choices. While the 3-year policy was on very attractive terms relative to the losses, and was not due to expire until September 30th, 2001, a very substantial premium increase could be guaranteed on October 1st, 2001. Our review of the market at that time indicated an increase in the region of 400% of expiring premiums, even if we assumed insurance market conditions to remain largely unchanged. As you may know, the insurance market is in fact entering a hardening cycle with substantial premium increases on all lines of coverage. Had the Law Society undertaken no action in the summer of 2000, we would be facing a renewal on October 1st this year with premiums far in excess of the renewal premiums which we are currently proposing.

- 3a) Having evaluated all alternatives with Aon in the summer of 2000, the Society decided to take proactive action and authorized Aon to negotiate what effectively was a cancellation and rewriting of the Excess of Loss policy so that the SIF entered into a new 5-year policy which took effect from October 1st, 2000 (expiring on September 30th, 2005). In order to lessen the impact on the SIF fund of a very substantial increase it was agreed that the total premium payable would be spread over the 5 year period on an escalating basis. As an incentive to a better claims record some underwriters within the programme have agreed to a reduction in premium if the number of claims falls below 340 in the preceding year whilst others have agreed to a profit sharing arrangement with SIF if the amount of claims is reduced to such an extent to enable a profit to be made by the underwriters. The benefits thus accruing will be passed on to members as and when they are achieved.

The rationale for this was that while the premium increases were large, they are "back-loaded" towards the later years, SIF will have the opportunity to fund these before they occur, rather than face a staggering increase at 1 October 2001, and contribution increases from members will – though large – thereby hopefully be manageable.

It must be emphasized that had there been a Qualified Insurer Scheme since the mid-1990s, it is virtually certain that at this point there would be few if any insurers willing to continue except perhaps at exorbitant prices, and it is only the "bulk-buying" power of SIF that has left us in the position where we are.

- 3b) As a condition of these terms, the reinsurers insisted that effective 1 October 2001 (when their policy would have expired in the normal course of events) the SIF retention will increase from 1 million to 1.5 million per claim.
- 3c) As the 3-year SIF retention under the Stop Loss had already been well-exceeded, it was determined that no possible replacement package could compensate for the benefits provided by the current Stop Loss, and so this will continue until its natural expiry at 30 September 2001. This type of protection may not thereafter be available.
- 4) Having arrived at this decision, the Board of SIF communicated to the membership through circulars issued on 11th September and 3rd October, 2000 which provided background explanations, invited members to attend a forum on insurance as well as informing members of the outcome discussed during the forum.

Although the new insurance arrangement took effect on October 1st, 2000, the 50% premium increase which should have been implemented (which the SIF actually paid to its insurers) was not charged to the membership. The current proposed increase on October 1st, 2001 actually charges the membership for an increase which was implemented one year earlier.

- 5) During the membership forum held on September 15th, 2000, most of the background information along with the critical issues being deliberated by the Society were included in a presentation by Aon. The general consensus of the meeting was to agree to the 5 year programme with knowledge of the likely level of increases in contributions.

A Qualified Insurer's Program as an alternative

- 1) Aon's presentation to the membership forum on September 15th, 2000 also outlined a Qualified Insurer's Program as a possible option. While Aon's presentation already pointed out the advantages and disadvantages associated with such an arrangement, I would like to reiterate a number of issues.
- 2) Since the Law Society of England and Wales (LSE&W) only adopted such a programme on September 1st, 2000, it is too early to tell whether such an arrangement will be successful in lowering premium cost in the medium to long term. It should be pointed out that once we abandon a "mutual" concept of insurance purchase, some members will be able to purchase cheaper insurance while others will have to pay more. Furthermore, some members

may find it impossible to obtain insurance in which case their ability to practise will be determined by the insurance industry rather than the legal profession.

- 3) To ensure that all members will be able to purchase the requisite insurance, LSE&W also created an “assigned risk pool” which is obliged to insure any member (for a maximum of 2 years) who cannot otherwise obtain insurance. To create this assigned risk pool, the LSE&W required all qualified insurers to participate in proportion to their share of the overall professional indemnity premium. To the extent that the LSE&W’s pool of premiums (estimated to be in the range of £160m) is significant, insurers were persuaded to participate in the assigned risk pool. A similar arrangement in Hong Kong may meet with more opposition since the amount of available premium is much smaller, and less likely to attract insurers into accepting their share of what will be the worst risks under the Assigned Risk Pool.
- 4) Ultimately the cost of insurance is determined by the amount of losses. It is unrealistic to expect commercial insurers to underwrite at a loss and, firms with poor loss records or a large proportion of what is considered high risk work will be penalized or may not be able to buy insurance at all. This may be considered perfectly reasonable but will tend to adversely affect small firms where conveyancing plays a more important role in their portfolio of business, and who have a smaller premium and hence much less bargaining power than the large firms.
- 5) It is important to appreciate that in Hong Kong there is no relevant legislative protection for private policyholders as there is in the UK where policyholders have the benefit of the Policyholders Protection Act. This allows private policyholders to receive benefits due to them in respect of insurances in the event of the liquidation of an insurer. No doubt this was borne in mind when the LSE & W moved to a Qualified Insurers Program.
- 6) A list of advantages and disadvantages associated with a Qualified Insurer Scheme is set out in Appendix 1 for your information. The Society is not opposed to such a scheme. To properly introduce such a programme, however, requires substantial research and implementation with many very difficult issues to be resolved as well as legislative amendments which will take time. By entering into the current 5-year arrangement, the Society originally expected a period of stability during which alternatives were to be investigated. The programme still provides reasonable coverage and the time necessary to evaluate the success and pitfalls of the LSE&W Scheme and to

implement alternative arrangements. This plan was disrupted by the failure of HIH.

HIH

- 1) HIH was a substantial Australian insurer which participated in the Excess of Loss Reinsurance of the SIF scheme in varying percentages throughout the years. It was a specialist in professional indemnity insurance and it purchased FAI which was also a specialist insurer in professional indemnity insurance and participated in several major schemes in Hong Kong. In the 5-year policy which commenced on October 1st, 2000, HIH underwrote approximately 50% of the insurance. Following the failure of HIH in March 2001, the Society working with its advisors Aon Group, were able to replace HIH's share on the Excess of Loss reinsurance with other insurers. To the extent that HIH was substituted by other insurers, the terms and conditions of the programme did not change in any major way. New reinsurers refused to agree to reduced premium if the number of claims in a prior year fell below 340, but agreed increased Profit Share in compensation. The current premium increase which will take effect on October 1st, 2001 is therefore totally unaffected by the HIH failure.
- 2) The HIH failure, however, presented the SIF with a different dilemma. As a result of HIH's participation, both in excess of loss and stop loss insurance of prior years, claims paid by the SIF which exceed its retention of \$1m per claim, will result in a shortfall in recovery from insurers for the SIF. The total amount of outstanding reserves for which HIH is responsible is estimated at approximately \$360 million.

SIF will continue to settle all valid claims from members. Along with renewal premiums each October and investment income, our preliminary analysis would indicate that there are sufficient cash resources to meet all claims presented until some time in the year 2004/2005. Before that time, the Society will have to evaluate various alternatives on how the HIH shortfall will be funded. This issue will be further discussed during the forthcoming Members' Forum to be held on September 12th, 2001 and all members are encouraged to attend.

I hope that this letter has provided you with useful information associated with the existing professional indemnity scheme and issues which need to be deliberated during the upcoming membership forum. Should you have any further questions, please do not hesitate to contact me, the chairman of Hong

Kong Solicitors Indemnity Fund Limited, Vincent Liang or my colleague, Vivien Lee. Otherwise, I look forward to seeing you at the forum.

At the request of Messrs. Horvath & Giles and Erving Brettell there is enclosed with the papers now sent to you a report to the LegCo Panel on the Administration of Justice & Legal Services regarding the Solicitors (Professional Indemnity)(Amendment) Rules 2001.

Yours sincerely,

Patrick Moss
Secretary General

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Appendix 1

A Qualified Insurer Scheme

Advantages	Disadvantages
<ul style="list-style-type: none"> - Some members – perhaps many in the early year(s) where insurers may be tempted to “buy” business at below realistic cost - will enjoy cheaper insurance. - A sense of empowerment in negotiating ones own deal, and shopping between different insurers. - Insurers will differentiate between firms and will quote different premium depending on the firm’s underwriting profile. - If Insurers underprice their product, and incur losses, no obligation on the profession to make good those losses as long as new insurer can be persuaded to offer future cover. 	<ul style="list-style-type: none"> - Some members whose underwriting profile is less attractive to insurers may in the early year(s) pay more than under SIF, and certainly will in the longer term when they may not be able to buy insurance at all. - This will tend to penalize smaller firms, who may depend more on conveyancing and for whom a quite modest loss may make their business unprofitable to insurers in light of their low premium. - No “bulk buying” power in times of profession-wide poor loss experience or hard insurance market. The largest firms in those circumstances have an advantage over the smaller ones. - If an insurer fails, the public and insurers are left unprotected. To cover this by way of a contingency fund may be costly and difficult. - Inability to purchase insurance at all, or at an acceptable cost, will cause a member to cease practice. An “Assigned Risk Pool” may ameliorate this, but may reduce the number of insurers willing to become Qualified.

- Reduced ability to implement risk management controls because of fragmentation.
- No relevant legislative protection in Hong Kong in the event of Insurer Insolvency as there is in the UK.