



**3rd Report on the Progress of the
Review of the
Professional Indemnity Scheme**

**A report by the Law Society of Hong Kong
to the Legislative Council Panel on the
Administration of Justice and Legal Services**

1. Introduction

- 1.1 The Panel may recall the present review of the Professional Indemnity Scheme ("Scheme") emanated from a decision by the general membership of the Law Society ("Society") to vote against the Qualifying Insurers Scheme ("QIS") in the Extraordinary General Meeting of the Society in April 2006.
- 1.2 The Society subsequently set up the PIS Review Working Party ("Working Party") with the following terms of reference:
 - (i) To review the structure and operation of the Scheme;
 - (ii) To invite and consider the views of the Members of the Society;
 - (iii) To make recommendations to the Council in connection therewith.
- 1.3 The review will cover the following aspects of the Scheme:
 - (i) The limit of indemnity provided by the Solicitors Indemnity Fund ("Fund") and whether it is necessary to alter the limit;
 - (ii) The methodology of calculating the contributions in other jurisdictions including England and Wales, Malaysia, Singapore, and various States in Australia and Canada;
 - (iii) Risk banding;
 - (iv) The level of deductibles;
 - (v) Loadings/levies on specific areas of practice which entail higher risk eg. conveyancing;
 - (vi) Composition of the Claims Committee;
 - (vii) The amount of claims loadings to be imposed on law firms indemnified by the Fund and the fee earners on which the loadings may be imposed;
 - (viii) Master Policy schemes in other jurisdictions including Western Australia, Queensland and Singapore.
- 1.4 The Society reports regularly to the Panel on the progress of the review; the last report was submitted on 23 April 2008.

1.5 In this progress report, the Society advises on the developments since April 2008.

2. **Contributions**

2.1 Under paragraph 2(1)(a)(i) of Schedule 1 to the Solicitors (Professional Indemnity) Rules Cap. 159M ("the Rules"), the contribution payable by a law firm is calculated by reference to the following rating factors:

(i) the number of partners

(ii) assistant solicitors

(iii) consultants

(iv) gross fee income

2.2 Partners are rated differently from assistant solicitors and consultants in the standard formula as the former are perceived to carry higher risk, and the work they conduct in general command a higher level of income.

2.3 The Society conducted an actuarial analysis in July 1996 on the fairness of the contribution formula by looking into the following questions:

(i) Is it fair to rate differently between partners and assistant solicitors?

(ii) Is it fair to distribute the contributions amongst firms by reference to their gross fee income only?

(iii) Is there inequality between the rates paid by small and large firms?

(iv) What is the correlation between the claims experience and the number and ratio of unqualified staff to solicitors?

(v) Is there any correlation between the size of firm and claims experience?

(vi) Is the type of practice relevant?

2.4 At the conclusion of the 1996 review, no changes were made to the formula. However, the formula was amended once in 2001 to reflect the increase in reinsurance premia and claims.

2.5 The Working Party has commissioned Watson Wyatt Insurance Consulting Ltd. ("Watson Wyatt") to conduct an updated review.

- 2.6 Watson Wyatt will assess the appropriateness of the contribution formula in the light of the current demographics of law firms and their claims experience and will address the following concerns expressed by some Members:
- (i) whether the contributions are too expensive for some law firms;
 - (ii) whether cross subsidization exists between law firms; and
 - (iii) whether the formula appropriately reflect the risks and claims profiles of firms.
- 2.7 Watson Wyatt's review is separated into 2 parts.
- 2.8 The first part involves a review of the adequacy of the contributions in recent indemnity years by comparing the total contributions collected with Watson Wyatt's estimate of the ultimate cost of claims and associated expenses of the Fund. The cost of claims is assessed by using data from current and past actuarial analyses of outstanding liabilities of professional negligence claims. The expenses are assessed in accordance with the audited financial statements of the Fund for the past 5 years.
- 2.9 Apart from these subjective factors, Watson Wyatt will also take into account objective factors like the global financial crisis, the general state of the economy, and their implications for the claims experience of law firms. Some brokers have predicted the insurance market will harden and the global recession may accelerate the process; the hardening in the insurance market is likely to coincide with lower fee income for practitioners. Data from past economic downturns, (including the late 1990s when heavy claims were experienced, particularly in the 1997/98 and 1998/99 indemnity years) will be considered.
- 2.10 In the second part, Watson Wyatt will consider whether the rating factors i.e. numbers of partners, assistant solicitors, consultants and gross fee income are still appropriate drivers of the Scheme's claims experience and whether a firm's area of practice is also a reliable predictor. For this purpose, Watson Wyatt will carry out a statistical analysis of the claims and exposure data. It will analyse the effects of each of the potential rating factors and will use, where possible, regression analysis to determine which of the rating factors are statistically significant and which weighting should be applied to each factor.
- 2.11 Watson Wyatt will then produce alternative formulae for calculating contributions if it decides other rating factors are significant. A series of tests will be conducted to identify the cost implications to law firms if

any one proposed formula were to be adopted. In this respect, Watson Wyatt will also consider the formulae employed in other jurisdictions to calculate their contributions.

- 2.12 Watson Wyatt is expected to report to the Working Party at the end of October 2009. Its recommendations will be considered in conjunction with the Working Party's previous review on the level of deductibles, levy on conveyancing transactions, claims loadings, and risk banding before comprehensive recommendations are submitted to the Council of the Society.

3. **Master Policy Scheme ("MPS")**

- 3.1 When Willis Ltd. ("Willis") conducted its review in 2003, it recommended the Society consider replacing the Scheme with the MPS. Any decision on whether or not the unacceptable aspects of MPS were outweighed by the benefit of transferring all the risks to the commercial market had to be considered carefully.

- 3.2 Willis has updated its advice and a fifth draft of the report is being considered by the Working Party.

- 3.3 In this report, Willis advises on the advantages and disadvantages of MPS in comparison with the current Scheme structure and a hybrid MPS; its suitability, feasibility, acceptability and sustainability in Hong Kong, particularly in terms of the availability of run-off cover for firms in the present economic conditions; the extent to which the Fund can retain control over claims handling for the benefit of the profession and the public; and whether in general, smaller firms will be worse off despite terms being collectively negotiated between the Society and insurers. The current discussion in the Legislative Council on the establishment of a Policyholders' Protection Fund in Hong Kong is also noted in the report.

- 3.4 Willis ranks various insurance arrangements eg. MPS, mutual, QIS, Open Market based on 5 criteria:

- (i) freedom of choice
- (ii) public interest
- (iii) lowest long term price
- (iv) protection to law firms from being driven out of practice by uninsurability

- (v) effectiveness to cap the aggregate liability of individual firms and the profession against insolvency of insurers and adverse development of claims
- 3.5 A case study of MPS in other jurisdictions, including Scotland, Northern Ireland, Malaysia, and on licensed conveyancers in the United Kingdom is set out in the report.
- 3.6 One of the factors which affects the suitability of MPS in Hong Kong is its pricing. This is determined by a number of factors:
- (i) whether the insurance market is hard or soft
 - (ii) how much data is available to assess the risk
 - (iii) how keen the insurer is in underwriting the business
 - (iv) whether the insurer is more interested in gaining market share than underwriting profit for that year
 - (v) the economic conditions which will affect the return on investments
 - (vi) the overwhelming determinant of price will be the claims experience of the profession
- 3.7 To enable the Working Party to consider the suitability of MPS in terms of its pricing, a tender was conducted by the Society in February 2009 to appoint a firm of brokers to compare the costs of insurance to law firms under the MPS and the Scheme. At the conclusion of the tender, Lockton Companies (Hong Kong) Ltd. (“Lockton”) was appointed.
- 3.8 The costs comparison exercise involves 5 stages:
- (i) First stage concerns the review of:
 - claims statistics
 - reinsurance arrangement
 - the management structure and claims handling arrangement of the Scheme and risk management issues

Interviews will be conducted with those involved in the administration and claims handling of the Scheme.
 - (ii) Second stage, Lockton will compile risk profiles by combining the demographics of the Society’s Members (number of firms;

number of solicitors; fee income; type of work etc.) with historical claims data.

- (iii) Third stage, Lockton will prepare its proposals on MPS for the Society and will market the proposals to prospective MPS insurers to solicit underwriting submissions. This stage involves indentifying qualified and interested prospective insurers; negotiating terms; and producing multiple proposals.
- (iv) Fourth stage, Lockton evaluates the underwriting submissions from MPS insurers and advise on the costs of MPS to the whole profession compared with the costs under the Scheme.
- (v) Final stage, Lockton will report to the Working Party, and where appropriate, will advise on the qualitative advantages and disadvantages of the Scheme moving to an MPS, together with any protective measures which could be taken to insulate the MPS against price volatility in order to reduce the total costs of insurable risk.

3.9 Lockton has almost completed the first stage of the exercise. Lockton has also embarked on the second stage of compiling the risk profiles of firms, pending claims information to be provided by the Scheme Manager, and has made preliminary contacts with insurers under the third stage.

3.10 At the conclusion of Lockton's exercise, one MPS premium will be procured for comparison with the total price offered by the Fund. The Working Party will consider the findings in conjunction with the updated report from Willis before it considers whether to proceed to conduct a comparison of the costs to individual firms. This will entail another major actuarial and marketing exercise pursuant to which a risk model will be created to determine the retention costs of firms, deductibles and premiums paid by law firms under an approved MPS structure. Such costs, premiums and deductibles will then be compared to the costs paid by individual firms under the Scheme.

4. **Reinsurance of the Scheme**

4.1 The reinsurance contract of the Scheme has been extended from 1 October 2009 for a period of 4 years, with an option to terminate after 2 years should the Scheme be replaced by an alternative form of indemnity arrangement.

- 4.2 The Society will consider whether to exercise the option upon the conclusion of the review of the contribution formula and the costs comparison exercise.
- 4.3 Any changes to the structure of the Scheme and amendments to the Rules will be made with reference to the duration of the reinsurance contract of the Scheme. Any decision to terminate the arrangement will be made by 1 July 2011.

The Law Society of Hong Kong
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