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THE LAW SOCIETY OF HONG KONG
香港律師會

4th 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 Society reports regularly to the Panel on the progress of the review; the last report was submitted on 27 October 2009.

1.4 In this progress report, the Society advises on the developments since October 2009.

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 principals, (ii) assistant solicitors and consultants and (iii) gross fee income.

2.2 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?

2.3 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.

2.4 The Working Party has commissioned Towers Watson Risk Consulting Ltd. (previously known as Watson Wyatt Insurance Consulting Limited) ("Towers Watson") in 2009 to conduct an updated review.

2.5 Towers Watson's scope of review is as follows:

(i) to assess the appropriateness of the contribution formula given that it was first established more than 20 years ago;
(ii) whether the contributions are too expensive for some member firms;
(iii) whether cross subsidization exists between law firms; and
(iv) whether the formula appropriately reflect the risks and claims profiles of firms.

2.6 Towers Watson's findings were presented in 2010, as follows:

(a) <u>Appropriateness of the contribution formula</u>

Adequacy analysis shows that the current formula is sufficient to cover the total claims and expenses of administering the Scheme.

The total cost and total contribution for the indemnity years from 1995/96 to 2007/08 were HK$1.8 billion and HK$2.2 billion respectively, meaning the total contribution collected based on the current formula over the 13-year period was adequate to cover the total cost of the Scheme.

There were bound to be fluctuations from year to year where cost exceeded contribution and vice versa.

(b) <u>Correlation between rating factors currently used and cost of the Scheme</u>

The 3 rating factors currently used in the formula, namely the (i) average number of principals, (ii) average number of assistants solicitors and consultants and (iii) gross fee income are all positively correlated with the net incurred costs and the number of reported claims.

(c) Cross subsidization

Cross subsidization exists in the current formula structure but some cross subsidization will inevitably exist regardless of which formula structure is chosen. In particular:

(i) large firms were found to clearly contribute more than the cost attributable to them;

(ii) small firms contributed less than or equal to their share of the cost;

(iii) medium size firms showed mixed results.

Switching to a Qualifying Insurers Scheme (QIS) where firms need to obtain cover from the open market may therefore not be beneficial to small firms.

(d) Conveyancing claims

Out of the total net liabilities of HK$728 million for the indemnity years from 1995/96 to 2007/08, HK$518 million were from conveyancing claims (71%) and HK$102 million were from litigation-related claims.

Towers Watson was asked to propose a list of potential rating factors that may be considered to be collected from members and incorporated in the contribution formula. These factors include those used by other jurisdictions, as follows:

- Area of Practice
- Court work/ Non Court work
- Attendance at accredited risk management programs, CPD requirements, peer review
- Internal control systems
- No. of years in practice

It was noted any additional information to be collected from law firms must be verifiable and not cause excessive burden on the firms in providing the data. It would also be necessary to devise some means of ensuring that firms which claim they do no conveyancing work do not in fact do so.

It may be difficult to provide a fair allocation of the burden of contribution between different areas of practice when the claims numbers vary from year to year. For instance in 2010/11, the number of claims received on litigation (67) outnumbered those received on conveyancing (37).

Members' approval and amendments of the Rules will also be required to empower the Society to collect the suggested additional information from law firms and to make changes to the contribution formula.

QIS would theoretically allow commercial insurers to individually assess the risk profile of each firm but members already voted against a QIS in 2005 by an overwhelming majority.

(e) <u>Alternative formula for calculating contributions as suggested by Towers Watson</u>

The alternative formula suggested by Towers Watson has the same structure and factors as the current formula but only charges a slightly lower rate on each principal and assistant solicitors and consultants. The suggestion was noted but not adopted.

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

3.1 As mentioned in the last report Lockton Companies (Hong Kong) Ltd. ("Lockton"), an insurance broker, was appointed to compare the cost of insurance to law firms under a MPS and the Scheme.

3.2 The cost comparison exercise involves 5 stages:

(i) First stage - Review of the Scheme's claims statistics, reinsurance arrangement and the management structure and claims handling arrangement of the Scheme.

(ii) Second stage - Risk profiling 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 – Preparation of proposals on MPS for the Society and marketing the proposals to prospective MPS insurers to solicit underwriting submissions. This stage involves identifying qualified and interested prospective insurers; negotiating terms; and producing multiple proposals.

(iv) Fourth stage – Evaluation of the underwriting submissions from MPS insurers and advising on the cost of MPS for the whole profession compared with the cost under the Scheme.

(v) Final stage - Reporting to the Working Party 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 cost of insurable risk.

3.3 Lockton has reached stage 3 but the preliminary coverage obtained from the commercial insurance market is less comprehensive than the Scheme. It provides an aggregate limit of HK$10 million only for the policy year (the Scheme provides <u>unlimited</u> aggregate cover) and excludes all loss related in any way to the depreciation in value of any investments. Lockton will revert to the Working Party again when terms comparable to the Scheme become available from the commercial markets.

4. Reinsurance of the Scheme

4.1 The reinsurance contract of the Scheme runs from 1 October 2009 to 30 September 2013, with an option to terminate in 2011 in case the Scheme is replaced by an alternative form of indemnity arrangement. The option was not exercised.

5. Conclusion

5.1 As of 30 April 2012, the unaudited accumulated surplus of the Hong Kong Solicitors Indemnity Fund is approximately HK$1.3 billion. The Scheme has consistently maintained a surplus of over HK$1 billion in the past 2 years where contribution reductions of 33⅓% have been provided to member firms in both indemnity year 2010/11 and 2011/12. In view of the volatile global economy, it has been resolved that a prudent approach be taken and no contribution reduction will be provided in indemnity year 2012/13.

5.2 In light of the findings of the Towers Watson actuarial study on the contribution formula, the absence of comparable coverage available from the commercial insurance market and the strong financial position of the current Scheme, cover will continue to be provided to members under the Scheme.

The Law Society of Hong Kong
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