Executive Summary

(A) The appointment of the Broker/Manager to the Scheme had been subjected to tender prior to the 1 October 1998 renewal of the Scheme. Virtually all Hong Kong brokers were invited to tender and many did so, including Jardine Lloyd Thompson Ltd. (JLT), (the advisers on the Horvath & Giles ("H&G")Report)

Professional Indemnity Insurance is negotiated, not tendered.

(B) The current arrangement consists of Hong Kong Solicitors Indemnity Fund Limited ("HKSIF") providing cover to all Members up to a limit of $10 million per claim, and buying reinsurance for:

- $9 million excess of $1 million per claim (Excess of Loss reinsurance) – to become $8.5 million excess of $1.5 million at 1 October 2001.

- $100 million in the aggregate, excess of $90 million in the aggregate for 3 years, for the HKSIF retention of $1 million stop loss insurance.

(C) Since Scheme Year 1995/96 the claims experience has deteriorated badly and the last few years have been disastrous, The loss experience of the Scheme reinsurers has followed that of the Scheme itself with total premium from 1994/95 to 1998/99 of $229.4 million and losses of $546.3 million, and severe losses also on the stop loss insurance.

Neither reinsurers of a Fund nor insurers under a Qualified Insurer Plan (QIP) will absorb losses of this magnitude without drastic premium increases, and had a QIP been in effect it is quite likely that most insurers would have withdrawn from the market.

(D) It was apparent in the summer of 2000 that if the Scheme reinsurance was allowed to run to its natural expiry at 30 September 2001, the reinsurance costs would soar dramatically. The Law Society had instructed its Broker/Manager to investigate alternatives.

(E) Aon, the Broker/Manager, was able to persuade HIH and the other Excess of Loss reinsurers to agree, in consideration of them being released from the last year of a contract that was enormously disadvantageous to them, to issue if required a new 5 year non-cancellable programme with the essential premium increases phased in over the 5 years (and with premiums for the early years that were clearly inadequate to cover historic losses) in order that HKSIF might fund the increases over time rather than face the full brunt of the increase at renewal in 2001.

Three alternatives were examined. They were: a) do nothing, b) change the scheme to a QIP and c) cancel and rewrite. The Law Society in 2 separate circulars to members had informed members and also held a members forum before a final decision was made.

(F) Having reviewed the alternatives it was decided that to cancel and rewrite was the best choice in the circumstances.

(G) The Law Society decided that QIP though a programme worthy of further investigation could not be implemented immediately.

(H) At the same time consideration began to be given to a QIP similar to that being implemented at the time by the Law Society of England and Wales (LSE&W), whereby Members could buy coverage from any insurer that agreed to abide by contract terms and other provisions promulgated by the Society. Contrary to the inferences in the HoG Report, there can be strong disagreement about the appropriateness of such a plan. Along with the advantages, there are substantial disadvantages and serious issues which would need to be resolved, which would take a great deal of time and require legislative changes.

The principal advantages are:-

i) Competition among insurers for individual Members rather than just the Scheme as a whole.

ii) Removal of concern that some Members (particularly those who do not have substantial conveyancing practices) are subsidising others

iii) Sense of empowerment to Members who can negotiate their own terms.

The principal disadvantages are:-

i) No bulk-buying power nor bargaining power of the Law Society.

ii) Less guarantee of continuance of coverage.

(Both of these features were identified by JLT, the Advisor to H&G, in 1998 when they were arguing against a QIP as part of their Tender to be Broker/Manager).

iii) Less economic efficiency. The Scheme clearly costs less to operate than would a QIP which would pay brokerage and other costs.

iv) Lack of credit for investment income.

v) Commercial insurers may be influenced in their pricing by losses in other classes of business or parts of the world.

vi) Unless a Member is able to buy coverage from a Qualified Insurer, he would be unable to practise.

vii) Problem if an insurer becomes insolvent, as Members and the public are unprotected. This is not a problem for LSE&W as Policyholder Protection Board meets 90% of losses of Policyholders of an insolvent authorised UK insurance company.

viii) In hard markets, larger firms have more bargaining power, thus disadvantaging smaller ones.

ix) Difficulty providing cover for former Members who were not part of a current insured firm.

(I) The Society is not at all opposed to the concept of a QIP provided the advantages and disadvantages are fully considered, and the difficult issues resolved.

(J) The competitive open-market indications secured by JLT offer very attractive discounts. However, they are so low for a profession-wide basis (ranging from 36% to 73% of average Scheme losses for the last 5 years) that one has to question their viability and sustainability, particularly as the insurance market is starting to harden.

In England & Wales, after only 1 year, there are already documented complaints that first year premium savings have been almost negated by renewal increases, even in a no claim environment.

(K) Were it not for the insolvency of HIH, a major professional indemnity insurer writing around 50% of the Scheme reinsurance, the HKSIF would have been a success.

(L) The HIH insolvency is likely to eventually cause cash flow problems to HKSIF but it is hoped that annual contributions plus investment income will provide sufficient cash flow to cover losses until 2004/5.

(M) The Society has taken considerable steps following the HIH insolvency, including:-

i) replacing the HIH proportion with other reinsurers.

ii) commencing studies on cash-flow issues and exploring methods of ameliorating the situation such as loss portfolio transfer, alternative risk transfer, and loss deterioration patterns.

(N) Consequently it is the Society's plan to fully evaluate a conversion to a QIP in the light of the advantages, disadvantages, and issues to be resolved with a view to reporting to Members in 2004 and implementing such a Plan at 1 October 2005 if the Members so wish. This timetable will allow all aspects to be addressed including forLegCo to consider a Policyholder Protection Ordinance and Limitation of Liability for solicitors and other professionals and to learn from the experience of the LSE&W QIP after 5 years of existence.

1. Introduction

This is the response of the Hong Kong Law Society ("the Society") to the Report submitted to the LegCo Panel on Administration of Justice and Legal Services by Horvath & Giles and Erving Brettell ("the H&G Report").

From the outset we would stress that the Society is in no way opposed to the concept of a Qualified Insurer vehicle to provide for the Mandatory Professional Liability Insurance requirements. However we will seek to demonstrate that the issues in considering and implementing such a scheme are far from being as clear-cut and simple as the H&G Report suggests, and moreover that the Society has been in no way as indifferent to the legitimate needs and interests of the Members as might be inferred from that Report.

2. Section 3 of the H&G Report – Fundamental Principles of Compulsory PI Insurance

Before turning to the more substantive issues raised in the H&G Report, we would take issue with a few of the items in a section with which we are otherwise generally in agreement and which the Society and the existing Scheme follows, lest by acquiescence we appear to agree:

a) Subsection 3 of Section 3 of the H&G Report – insurance by its very nature consists of the subsidizing of those who have losses by the premiums of those who do not. It is only when the subsidization becomes unfair that an issue may arise.

b) Subsection 4 of Section 3 of the H&G Report – there can be differing views on this statement that maximum levels of deductible should apply, so that a Firm does not take on unsustainable amounts of liability in order to attempt to minimise premium costs. Moreover the H&G Report, in commenting on page 8 on the new Law Society of England and Wales ("LSE&W") Qualified Insurer Scheme, says "Cleverly, there is no regulation of the level of excess…. Excesses will be a matter for commercial negotiation…..". This seems at odds with the prior statement in the H&G Report that a "key fundamental" is that the Society should establish a maximum deductible.

c) We do not accept that it is a "key fundamental" that "Minimum limits of indemnity should be prescribed in accordance with a formula that is geared to correlate gross fee income to limits of indemnity" (Subsection 5 of Section 3 of the H&G Report). That is certainly one approach but not, it appears, one that

LSE&W, or any of the other Schemes detailed in the Report for benchmarking purposes, have adopted. The Society has also opted for the view that a flat limit of indemnity is preferable since even smaller Firms will routinely handle transactions up to the current limit of $10 million.

3. Appointment of Manager and Reinsurers for the Professional Indemnity Scheme

The Report contains questions to, and perhaps infers criticism of, the HKSIF for agreeing a 5 year arrangement with reinsurers in 2000 and for extending the appointment of the Broker/Manager for the same period, without formal tender.

a) Tender for Broker/Manager

It is unusual for any large organisation (or indeed corporation) to frequently change insurance brokers. The relationship involves a great deal of knowledge of the needs, aims, and culture of the organisation which can only be gained with the passage of time. This is particularly the case in this instance, where the Broker/Manager provides claims management functions and is also involved in performing numerous administrative functions on behalf of the Society, such that it could be expected that any change would result in considerable dislocation of services until the new appointee becomes familiar with complying with the requirements.

In 1998 the Society undertook a full Broker/Manager tender, to which virtually all brokers in Hong Kong were invited to submit a proposal and most of the major ones did so, including JLT. The Selection Board consisted of Members nominated by the Society, plus the Society's legal consultant. Based on the reports submitted, including the brokers' experience in handling major Professional Liability programmes in Hong Kong and elsewhere; local in-house insurance and legal resources capable of managing claims on behalf of HKSIF in an efficient and economical manner; local and global Professional Liability marketing and consulting capacities; concepts for the renewal of the Scheme at 1 October 1998; and general value-for-money, Aon were re-appointed as Broker/Consultant and their subsidiary ESSAR Insurance Services Ltd as Claims Manager. During Aon's previous tenure, there had been few complaints from Members relating to their services.

While technically the appointment was for 3 years, thus allowing the Society to re-bid in 2001 in the event of dissatisfaction with the services provided, absent such dissatisfaction it would not have been the intent to re-tender the

Broker/Manager function for around 5 years, that is until about 2003/2004. Consequently the decision to extend the appointment until 30 September 2005 was only slightly longer that the period which we would normally have envisaged Aon performing the role until the next tender, and coincided with the revised programme which they had negotiated.

Additionally, the Society wishes to encourage initiative and innovation from all of its service providers. It was Aon who drew to our attention the dire loss situation facing the Members in 2000 (see separate Sections on Loss Experience of the Scheme and Loss Experience of Reinsurers of the Scheme) and suggested negotiating options to alleviate the probable outcome of that situation. If such initiative is seen as likely to trigger an automatic advance review of the supplier's status, it would seem to discourage rather than encourage such affirmative activities.

b) Tender for Insurers

The nature of a Scheme such as this does not lend itself to a formal tendering process. The reinsurance terms are developed during extensive negotiations with potential reinsurers, and advantages are commonly gained one step at a time during such negotiations. It is not considered practical or desirable that one single reinsurer be appointed to cover the entire programme, so the coverage is placed on a syndicated basis. These negotiations are carried out by the Broker/Manager, with the Society in the background to assist where necessary.

Aon advised us that, faced with the loss experience to which we have previously referred, they had approached both likely local insurers and foreign ones, including the London market, to endeavour to develop favourable terms to cancel and re-write the existing programme, or to replace it at its expiry. While certain Hong Kong insurers did offer tentative terms, they were far less viable than those indicated by HIH and the other existing reinsurers. This makes sense, because we were able to offer a level of incentive to the existing reinsurers (by agreeing to release them from the final year of a contract which was clearly devastatingly disadvantageous to them) whereas with new reinsurers we would have no such leverage.

4. <u>The Current Arrangements</u>

The current arrangements of the Scheme are reasonably summarised in sub-section 1 of Section 4 of the H&G Report. To give a little more detail, HKSIF currently provides a limit of $10 million per claim per Firm, including Firm's retention, and purchases the following reinsurance:

a) Excess of Loss Reinsurance for a limit of $9 million excess of $1 million (including the Firm's retention) which $1 million is retained by HKSIF. Effective 1 October 2001, in accordance with the new reinsurance programme, the HKSIF retention is scheduled to increase to $1.5 million (including the Firm's retention) so that the coverage will be for $8.5 million excess of $1.5 million.

   The present program is for 5 years commencing 1 October 2000.

b) Stop Loss reinsurance to protect HKSIF if its aggregation of retentions exceeds a specified figure. Until 1998, the Stop Loss covered excess of an aggregate retention of $30 million annually. Currently it is a 3-year cover for $100 million excess of $90 million for 3 years. The $90 million HKSIF 3 year retention has already been well exceeded and all new claims go into the reinsurance. The programme expires at 30 September 2001, and it is possible that this protection may no longer be available at any rational price, although negotiations are continuing.

The H&G Report, in Section 4 sub-section 12, comments that "The existing arrangements and the full detail that goes with them relating to the performance and structure of the programme and the reinsurance support has not been independently reviewed for several years…..". In fact as JLT, the advisers on the H&G Report, will no doubt recall, they themselves (then known as Jardine Insurance Brokers prior to a merger) along with another major Hong Kong insurance broker issued a lengthy commentary and recommendations in 1997 as part of an approach to be appointed Broker/Manager to the Scheme. In that commentary they observe "It would appear to JIB/HSBC that the current Mutual/Excess of Loss/Stop Loss Insurance arrangements are fundamentally correct". This view was repeated in JLT's Response to Tender as Scheme Broker/Manager document in 1998, and the Society took comfort from the knowledge that two other major brokers endorsed the HKSIF approach. We do not know why JLT's position has changed so substantially since then, nor why major objections to a Qualified Insurers Scheme which they raised in both those reports – which we will discuss later in this response – have not been identified currently by them.

5. The Loss Experience of the Compulsory Scheme

In the early years after the formation of HKSIF in 1986, the loss experience was generally moderate and Members Contributions quite modest as a result. This began to change in

Scheme year 1994/1995, since when the experience (as at 31/3/2001) has been as follows for the full $10 million limit.

Scheme Year	Total Contribution ($million)	Paid and Reserved Losses ($million)	Loss Ratio
1994/95	71.1	65.4	92.00%
1995/96	72.0	107.6	149.44%
1996/97	88.9	107.3	120.69%
1997/98	106.8	218.2	204.30%
1998/99	112.2	360.5	321.30%
1999/00	85.2	96.2	112.91%

As far as the apparent improvement in 1999/2000 is concerned, it should be stressed that although each Scheme Year only covers claims made against the Members in that year, Professional Indemnity claims of this nature are notoriously difficult to evaluate in the early stages, and history shows that incurred losses continue to deteriorate for several years after the claims are made. The 1999/2000 losses are, at the same evaluation date (6 months after the end of the Scheme Year) worse than any year except the two disastrous immediately preceding ones.

In the more recent years much of the incurred loss is in the form of claim reserves rather than payments and it is the reserves which historically prove inadequate for several years. These reserves are established by Panel Solicitors, and development trends are calculated by independent Consulting Actuaries, in each case without input from the reinsurers who therefore have no ability to influence the amount of the reserves.

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6. The Loss Experience of the Reinsurers of the Scheme

The loss experience of the reinsurers tracks that of the Scheme generally:

a) For Scheme Years 1987/1988 through 1998/1999 a total premium of $379.7 million (less in recent years discounts allowed by the reinsurers to HKSIF in lieu of brokerage) has been paid to the Excess of Loss reinsurers. During the same period, claims of $593.3 million have been incurred. As most of the claims have arisen in the last 6 years, the loss ratios of these reinsurers (based on gross not net premium) have been :

Scheme Year	Loss Ratio
1994/95	92.26%
1995/96	175.92%
1996/97	169.63%
1997/98	321.54%
1998/99	329.72%

Total gross Excess of Loss premiums during this 5 year period totalled $229.4 million and paid and reserved losses totalled $525.3 million, a ratio of 229%. Of the losses, $194.1 million has already been paid so even on a cash-flow basis the reinsurers are fast approaching 100%. While it is still too early to predict the outcome of Scheme Year 1999/2000 it appears likely that claims to Excess of Loss Reinsurers will again substantially exceed premiums.

b) For the same period since 1987/1988 HKSIF paid a premium of $64.1 million (less discounts as previously mentioned) to its Stop Loss Reinsurers, and paid and reserved claims are currently $170.2 million. This, however greatly understates the loss outcome, since the current policy is on a 3 year basis until 30 September 2001 and HKSIF's 3 year aggregate retention of $90 million has already been exceeded, so every additional loss within HKSIF's $1 million retention will go against the Stop Loss Reinsurers.

7. The Restructuring of the Reinsurance Commencing 1 October 2000

In the light of the loss experience that was developing for the previous several years, Aon approached us in the early summer of 2000 to warn that if the then – current reinsurance was allowed to run to its natural expiry, the consequences in insurance costs for many Members would be little short of catastrophic. Aon recommended that they be authorised to make a review of the market to determine if terms could be developed to either replace the then-current reinsurance mid-term but for a longer-guaranteed period, or alternatively to secure guaranteed renewal terms for when the reinsurance expired in 2001. They were particularly concerned that although the insurance markets remained "soft" (competitive) there were signs of hardness developing. We authorised them to proceed with this study and to report back to us.

a) Aon subsequently advised us that after discussing with many potential reinsurers, embracing these in Hong Kong and in the international markets including London, they had persuaded HIH to agree, if HKSIF wished, to cancel the then-current Excess of Loss reinsurance at 30 September 2000 and replace it with a new non-cancellable 5 year programme.

   The existing reinsurance premium of $61.2 million had clearly been proven to be grossly inadequate to cover the exposures of the Hong Kong profession in recent years and HIH were looking for substantial increases. However, they agreed to phase these increases in over the 5-year period, so that the Society would have the opportunity to fund them progressively rather than face the full impact at 1 October 2001 when the existing programme expired. They also required the HKSIF to assume an increased retention of $1.5 million rather than $1 million, effective 1 October 2001.

   As incentive to a better claims records some underwriters within the programme have agreed to a reduction in premium if the number of claims fall below 340 in the immediately preceding year, whilst the others have agreed to a profit sharing arrangement if the amount of claims is reduced to such an extent to enable a profit to be made by the underwriters. The benefit thus accrued will be passed on to members as and when they are achieved.

   Aon had in addition obtained tentative indications from two Hong Kong based insurers to replace the existing Excess of Loss programme at 1 October 2000. The indicated premiums were in the range of $210 million to $220 million for a 1 year contract, compared to the HIH price of $186,691,083 at 1 October 2000. No reinsurers were willing to give guaranteed quotes for the renewal of the programme in 2001.

After considerable evaluation and debate, and unpalatable though it was, HKSIF decided to cancel and replace the Excess of Loss reinsurance at 1 October 2000, to protect HKSIF from an enormous increase at natural expiry of the programme at 1 October 2001, and to enable the increased premiums to be funded over time.

Supporting this decision was the thought that claims experience would indeed start to improve, in which case claims should fall below 340 per year and the proportionate premium reduction would be triggered (along with the possibility of profit share) and the large premium in the later years of the programme might never arise. Aon were able to persuade the remaining Excess of Loss reinsurers to go along with this re-arrangement.

b) As far as the Stop Loss reinsurance was concerned, the HKSIF 3-year retained retention had already been reached at only 18 months into the programme, and it was determined that nothing that could be offered would replace the value of that coverage so it will be allowed to run to its natural expiry at 30 September 2001.

Along with providing the cancellation and re-write offer, Aon also suggested that the Society consider a Qualified Insurer Scheme similar to that being implemented at that time by Law Society of England and Wales (LSE&W). We felt this suggestion had considerable merit but that numerous aspects needed to be considered and factors evaluated, many of which would require considerable work and input from Members. In addition, legislative change would be needed. In short, we did not believe that such a change was anything like as quick and easy, or as necessarily beneficial, as the H&G Report would suggest. We will comment on some of these concerns later.

In any event, we instructed Aon to commence the necessary research and studies to enable the contentious issues to be put before the Society with the view that such a change could, if agreed upon, be implemented at the end of the new 5 year reinsurance programme by which time we would also have a better understanding of the success or otherwise of the LSE&W Qualified Insurer Scheme.

The information concerning the necessary increased Contributions was communicated to the Members by circulars of 11 September and 3 October 2000 and at a Membership Meeting on 15 September 2000.

The H&G Report remarks that it is unusual for insurance to be placed without a cancellation clause. This is by and large true, but was essential in this case as the reinsurers were knowingly offering a 5 year coverage where the premium in the early years was inadequate to cover historical losses, but with a "back-loading" of higher premium in later years, to enable the Society to fund the premium gradually. This would clearly not have been acceptable to them if the HKSIF could have accepted the early year lower premiums and walked away from the higher premium years. Having said that, Aon have offered if necessary to try – with no guarantee of success – to negotiate a basis of mutual cancellation if the Society were to decide to change the nature of the Scheme to a Qualified Insurer one.

8. <u>Law Society of England & Wales Situation</u>

In view of the fact that the H&G Report refers in numerous instances to the new LSE&W program and suggests perhaps a Hong Kong Scheme should be modelled on it, it is worthwhile to review our understanding of the LSE&W situation.

The H&G Report refers to LSE&W having successfully put in place a Qualified Insurer Program. We assume that "successfully" refers to the mechanical implementation of the program, and to the fact that the total premiums were in the range of £160 million compared to about £250 million under the last year of the former Fund. Presumably the H&G Report is not saying that after only 12 months the Scheme can conceptually be considered a proven success – the acid test will be if and when loss experience deteriorates again or the commercial insurance market hardens. Moreover, LSE&W loss experience has been improving for the last several years, so a true comparison with what premium would have been set by the former Fund is not possible since the Fund never promulgated 2000 rates, but they could quite possibly have been less than the 1999 premium cost.

It is important to bear in mind that based on what it thought to be superior claim experience, all reinsurance for the LSE&W Mutual Fund Scheme was discontinued in 1991. Massive adverse loss development occurred in the very late 1980s and early 1990s but was not immediately recognized. The principal problem was conveyancing claims during a property slump, in many ways similar to some of the problems recently besetting the Hong Kong Scheme.

LSE&W had not even employed independent consulting actuaries at the time, and by the time the magnitude of the losses (at one point estimated at £432 million in excess of contributions for the first 10 years of the Scheme) became apparent a few years later, the Fund (lacking any reinsurance protection in some severe loss years) was insolvent by a substantial amount, and remains insolvent despite contribution levels being increased and despite more recent years showing improvement in loss experience and even the bad years turning out not to be quite as dire as independent actuaries, finally employed, had earlier projected. As a result, large supplementary contributions have been required from Members to cover the shortfall and will be required annually for some years to come, in addition to the premiums paid to the Qualified Insurers.

Turmoil resulted in the profession, with the exacerbation of old contentions that certain types of practice, and certain sizes of firm, were unfairly being required to subsidize others as a result of what was basically a unitary rating system. This was compounded by the belief that the conveyancing problems of the late 1980s, and early 1990s, were now history, and a continuing much improved loss picture could be expected.

As far as premiums are concerned, many U.K. insurers have been commenting that they believe the current levels to be inadequate. The H&G Report observes that "There are signs of a current hardening of the P.I. market in the United Kingdom and an increase in the rates for Solicitors… though even after this, it is expected that premium levels will still on the whole be below those charged by SIF in the 1999 year."

Aon confirm that there is indeed an attempt to increase rates for LSE&W and point out that even before these claims can be fully evaluated it has already become apparent that the commercial insurers' loss assumptions have proved inadequate.

If LSE&W had reduced its rates by a modest 10% per annum for 2000 and 2001 and the commercial market increased its rates by 25% over the same period, the differential in total premium would have been eliminated. Interestingly, a letter in the (U.K.) Law Society Gazette of 23 August 2001 bemoans the fact that the premium for the author's firm had declined by 70% in 2000, but in 2001 – with no claims and only a slight increase in gross fee income – the lowest quote that could be found was a 70% increase, thus almost negating in one year all the savings. The writer wonders how firms with even a few claims are faring. While it is not Aon's sense that this is a typical situation, a cynic may wonder whether, having helped in the demise of SIF, the commercial market is gearing up to take advantage.

Except perhaps for the feeling that major conveyancing problems are now solely a feature of the past, this situation in large measure is reflected in the Hong Kong Law Society. However, it cannot be over-emphasized that had it not been for the failure of HIH, which has of course affected not just the Society but a broad cross-section of business in Hong Kong and elsewhere, the Hong Kong Law Society SIF would have been considered a success:

(i) Substantial reinsurance was maintained throughout, not withstanding excellent loss ratios in the first years.

(ii) Independent actuarial studies were undertaken throughout, thus enabling some evaluation of the deteriorating losses to be made at the early stages.

(iii) The Fund was very healthy.

(iv) The Membership were protected against large premium increases – which otherwise would most certainly have been demanded by insurers – as a result of the 3-year reinsurance during the difficult years for the profession in the late 1990s, when there was pressure on fees.

Notwithstanding, this in no way means that it may not be opportune to change to a Qualified Insurer Program, provided all of the positive and negative factors of such a change are thoroughly considered.

9. Points for Consideration before Switching to an Qualified Insurer Scheme

Advantages

The advantages to such a Scheme are certainly manifold and worthy of fullest consideration. Included are the following:

A. Competition for individual Members (as compared only to reinsurance of the membership program as a whole) would be brought into play. This would probably have the effect of reducing the cost for some Members although in anything other than the short-term, the cost for others may rise. However, the decision on price would be made by independent contractors, the insurers.

B. The view expressed by some Members that they are "subsidizing" others would be removed. Of course, all insurance represents a "subsidization" whereby the losses of the few are paid by the premium of the many. The issue presumably is whether the "subsidy" becomes unfair. Although the Society does not maintain statistics to show the total fees generated by the profession from conveyancing (and thereby enable a calculation of the extent to which the proportion of conveyancing losses exceeds the proportion of fees and therefore contributions from that source) it does seem certain that, in recent years especially, conveyancing has represented higher risk than other practice areas. Thus, it is likely that conveyancing work would be rated higher by the commercial market than other work, and probably much higher in circumstances such as have occurred from the mid-1990s. Conveyancing tends to form a much greater proportion of the practice of sole Practitioners and small Firms than it does of the large Firms which would strongly suggest that higher rating for such work would most adversely affect those single Practitioners and small Firms, who would be required in the long term to pay a disproportionately higher premium than those for whom conveyancing is a smaller part of their practice.

C. It should not be underestimated that there is a sense of empowerment for Members when they are able to negotiate with several insurers to accept the best terms, rather than the frustration that arises where presented with a non-negotiable Fund contribution.

D. If commercial insurers underprice their coverage, there is no obligation on their insureds to allow them to recover their losses in the future. While such insurers may try to increase premium to make such recoveries, as long as other insurers can be found who have not suffered the past losses and therefore may be willing to price based on assumption of future loss only, the original insurers are constrained since the Members can switch carriers.

Under a Fund arrangement, if the portion retained by the Fund, (i.e. the part not reinsured) is inadequately priced, the membership would be expected to make up the shortfall from future contributions, or from the existing assets of the Fund.

Conversely, of course, if the premium under a Qualified Insurer Scheme proves excessive, the insurer would not be required to refund any portion, nor would it be practical to expect them to do this since their client base and rating would change from year to year. This is not unreasonable – any "windfall" profits would be compensation for them accepting the risk of premium being greatly inadequate. Better-than-expected losses should of course result in reduced premium in the future but that would reflect lowered future loss expectation based on historical experience, and not a refund of previous premium.

With a Fund Scheme, any profit generated from the portion of exposure retained by the Fund (plus associated investment income) is retained for the benefit of the Membership in one form or another. Furthermore, because the Excess of Loss reinsurers handle the exposure for the entire profession, this has enabled a substantial profit sharing arrangement to be negotiated. Frankly in the light of the massive losses since 1993/94, this has been academic in the recent past. However, if the increase in premium required by reinsurers at 2001 and future years proves excessive and a profit arises, a significant portion of such profit (effective 1st October 2001 the formula provides for 50% on part of the placing, 25% on the remainder) will ultimately be returned to the Fund for the benefit of the Members.

Disadvantages and Issues to Resolve

As we have previously emphasized, we have no objection whatsoever to the principle of a Qualified Insurer Scheme. However, we must stress that there are drawbacks with which the Membership must be comfortable, and difficult issues to resolve, none of which are mentioned in the H&G Report.

A. In the review conducted by JIB/HSBC in 1997, to which we have previously made reference, and in the JIB Response to Tender in 1998, they argued strongly against the appropriateness of a Qualified Insurer Scheme in the following words:

1) The Society as a whole would have no bargaining power – particularly when a Member faces serious difficulty or in the event of a borderline claim. (To this we would add that this is also a serious problem at a time of hard insurance markets or poor loss experience).

2) Members could not be guaranteed the same degree of comfort as to continuity of cover when compared to a Master Policy or mutual concept.

It would have been helpful to our deliberations if JLT had explained why they no longer consider these issues to be material.

Our Broker/Manager endorses these concerns and explains that the traditional response of the commercial insurance market to adverse loss experience has been dramatic premium increases, reduction in scope of coverage so as to exclude the perceived problem areas, and withdrawal from the class of business. Aon stress this is not hypothesis – it has happened on numerous occasions, and in fact was the very reason that the LSE&W and somewhat later, in 1986, the Society switched to a fund. Prior to having a fund, LSE&W had a Master Policy insured with various commercial insurers and one of the triggers in the change to a fund was that on one occasion they were within a week of expiry of Practice Certificates and the commercial cover could not be completed.

We would venture to suggest that in the light of the loss experience of the last few years for the Society, had the coverage been placed in the commercial market these characteristics would have been manifest for some time. It is unrealistic to suppose that, for anything other than the short term, the commercial insurance market would subsidize the legal profession in Hong Kong by writing professional indemnity coverage at less than the cost of the losses plus the insurer expenses and profit. As previously mentioned, in fact Aon in August 2000 approached 2 local insurers who may be among the ones to which JLT submitted their own enquiries (since there are not too many Professional Liability insurers in Hong Kong) to determine their terms for reinsurance of Excess of Loss. One gave a preliminary indication of $210 million premium, the other $220 million. In the Spring of 2001, one of these reinsurers actually indicated a still higher cost. If an estimate of the necessary premium for the first $1 million (assuming these reinsurers were to write the full $10 million in limit) is added to this, based on average loss experience for this segment of the current program for the last 3 completed years, plus an estimate for insurer expenses and profit, it would suggest that these insurers may consider an annual premium <u>well</u> in excess of $300 million appropriate for the entire profession.

B. (i) In subsection 15 of Section 4 of the H&G Report, reference is made to the importance of measuring the efficiency of the current arrangements and seeing what percentage of every $ premium is available to meet claims. We totally agree, and believe that the existing fund approach is managed very economically. Apart from the fees of the Broker/Manager (including claims handling), the only other major costs are the internal costs of the reinsurers, which are a fraction of what they would be as direct insurers handling the coverage and claims for each Insured from the ground up. On the other hand, commercial insurers would pay commission to brokers, probably at a rate of around 15%. In the extraordinarily unlikely event that the entire premium for the profession were at the beginning even as low as $100 million, this would amount to $15 million which is still more than the total costs currently incurred (even if part of the commission was rebated to Members), without taking into account the internal handling costs of each policy and claim from the ground up. These frictional costs, though impossible to quantify, all subtract from the pool available to pay losses.

(ii) One never receives full credit from the commercial market for investment income. This is so irrespective of whether the coverage is placed as reinsurance of a Fund or as a Qualified Insurers Scheme. However, under the former, the fund receives the "premium" for the portion which it retains and over the years this has enabled a very satisfactory annual investment income to accrue to the fund and for the ultimate benefit of the Members.

(iii) Unlike a fund, the commercial insurance market needs to make a profit.

Thus, it seems virtually certain that over the long run, unless the quantum of losses or expenses is lower under a Qualified Insurers Scheme than is the case with a Fund, the commercial market will need more premium to cover the exposures of the Members than would a Fund. However, there will certainly be a revaluation as to how premiums (contributions) are allocated and some members will be likely to benefit and some to suffer as a result.

We have already discussed the fact that expenses under a Qualified Insurers plan are likely to be greater than with a Fund, and we do not see how claims are likely to be less. Presumably under either option of protection the same claims will be made against the profession, and unless the Qualified Insurers are better able to settle them at lower cost – and there is no apparent reason why this would be so – the cost would be the same also.

C. It was a major complaint in the past with LSE&W Members that the commercial market would consider loss experience from other professionals (e.g. accountants) and trends in other jurisdictions (e.g. USA) when promulgating rates for solicitors in England and Wales. Although the market always denied that this was the case, it was a source of considerable concern to the profession in England and Wales. Closer to home, in the mid-1980s insurers participating on the Hong Kong Scheme attempted to increase prices because of losses suffered elsewhere.

D. A major problem with a Qualified Insurer Scheme is what happens to Members who fail to purchase insurance from a Qualified Insurer. The H&G Report correctly states that under the new LSE&W Qualified Insurer Scheme, a safety net for 2 years is provided for such Firms by way of an Assigned Risk Pool.

The Assigned Risk Pool is a Pool to which all Qualified Insurers subscribe in the proportion that their premium income from this class bears to the total premium for the class. This is naturally not a proposition that any insurer relishes. The concept of being obliged to accept a share of the liability of Members deemed to be the worst risks (and ones that likely have been declined by the insurer directly) is not an appetizing one. In the UK, the premium pool is so large (some £160 million) that a number of insurers overcame their reluctance on the basis that the profit potential from the profession made involvement in the Pool acceptable. We question whether the amount of premium available in Hong Kong would have the same attraction, and whether many insurers would therefore wish to become qualified.

If there were no such Pool implemented, and provided the requirement for compulsory PI insurance remained in effect, the Member unable to obtain commercial insurance would go out of business immediately.

Interestingly, although around 37 insurers qualified under the LSE&W Scheme, some 50% of the business was written by 3 of them, and a handful of others wrote the bulk of the remainder. One can only speculate as to the reasons why others did not participate more actively, having gone to the trouble of qualifying, and doubtless these reasons would vary from insurer to insurer. Possibly, for some of them, was the thought that at the level of premium they were encountering, it was not worthwhile writing business and assuming the risks of the Assigned Risk Pool.

E. In times of severe difficulties in the insurance area, such as those caused by the massive losses of the last few years, Members' ability to secure ongoing coverage would vary tremendously. Larger firms, especially those with satisfactory loss records, would have much more bargaining power than would small firms and Sole Practitioners. The Members may determine that this "discipline of the market" is acceptable, and that smaller Firms suffer the consequences.

F. Under a Qualified Insurer Program, some larger international firms, with global insurance programs may in effect abandon the Hong Kong placements when prices are high. For example, already under the new LSE&W Qualified Insurers Scheme, a number of USA – based member firms with large deductibles have arranged for a Qualified Insurer (usually one participating on their global program) to issue a UK policy for a nominal fee to cover their LSE&W obligations, subject to such insurer being indemnified for losses by the firm itself if the losses fall within the global policy deductible, or by the global policy insurers to the extent the loss falls on the global policy. There is nothing improper about this, as the firm complies with its LSE&W obligations, but it essentially removes the premium such firm would have otherwise paid (a relatively minor matter in the light of the size of the UK profession) and gives such firm a clear cost advantage when local premiums are high.

G. A protocol must be determined for resolving inter-insurer disputes, such as ones where different insurers protect different practices on the same claim and each tries to shift responsibility to the others, or ones where a Member changes insurer and a claim spans two policy periods with different insurers on each. In situations like this, there is a real danger that the claimant member of the public will be left waiting until the insurers resolve their own disputes.

H. The H&G Report very properly identifies as a major concern the possibility of an Insurer becoming insolvent, as not only the Member but also the public may be left unprotected. They are, we believe, incorrect in stating in their "Survey Questionnaire" that LSE&W "only approves well-rated insurers". It is our understanding that LSE&W – wisely in our opinion – leaves the financial analysis of insurers to the appropriate regulators, and approves any insurer that is licensed in UK and complies with the other requirements. However, they can do this safe in the knowledge that the U.K. Policyholder's Protection Board (a vehicle funded by licensed insurance companies) will provide protection for individuals or partnerships for 90% (100% for certain compulsory insurances) of claims under policies issued by licensed insurance companies. Hong Kong has no such protection.

The idea of a fund to apply in such eventuality has been raised. Even if it is only occasionally called upon (and this is a big assumption, given the recent insolvencies identified in the H&G Report of professional indemnity insurers such as Reliance, HIH, and Independent) there is no reason why an insolvency could not occur early in its life, before it has been adequately funded. Furthermore, who would fund it – the Members by levy? How would they feel about possibly contributing large amounts to a fund to protect other Members who may have been reducing insurance costs by insuring with less financially secure carriers? Qualified Insurers? We doubt they would be willing to give an open-ended commitment to protect policyholders of their competitors, when not required by law to do so, and in any event will surely pass on the costs to their own insureds.

Given the speed with which insurers can go from respectable to insolvent, this is a major issue to resolve.

I. A system must be established for protecting former Members who have ceased private practice, for liability for acts while in private practice. Under SIF, this is relatively simple to accomplish. Under a Qualified Insurer Scheme it is much more difficult – while a policy for a firm would normally cover "former solicitors", there would be no coverage for former solicitors who had been Sole

Practitioners or whose firm no longer exists in identifiable form. Possibly the Qualified Insurers may be required to pick up some of these liabilities (a further drawback to them becoming Qualified) or possibly they will have to revert to SIF, but there are complex issues that will need resolution.

J. Meritorious but not covered claims

Currently SIF is able to consider the provision of coverage on the basis of overall fairness and justice. An example is the situation where the Member has breached the conditions of the risks such as notification due to serious illness or other personal circumstances. Under a Qualified Insurer arrangement, this may be more difficult to achieve.

10. Comparative Premium Secured by JLT from Open Market Insurers

JLT's benchmarking of pricing in the open market does indeed reveal the possibility of eye-popping savings. While not questioning in the slightest the good faith of the insurers "indicating" the terms, nonetheless they do create substantial questions as to their viability, viz:

(i) The very extent of the differentials between them is remarkable. One insurer thinks that these 15 clients are worth some 50% more than the lowest price; another thinks they are worth approximately twice as much. Such differentials on a meaningful block of primary coverages are surely unusual to say the least from experienced underwriters.

(ii) Although a precise figure cannot be determined, the 15 accounts appear to represent about 7% of the HKSIF. On this basis, the insurers would appear to value the account of the entire profession, net of an estimated 15% brokerage, as follows:

Insurer 1 - $ 95 million
Insurer 2 - $115 million
Insurer 3 - $ 56 million

The Incurred Losses of the entire profession over the 5 Scheme Years 1995/96 to 1999/00 are as follows, excluding the virtual certainty that at least the 1999/00 Year will see adverse loss development as it is still very immature:

1995/96 - $105 million

1996/97 - $107 million
1997/98 - $233 million
1998/99 - $349 million
1999/00 – $ 98 million

Average over 5 years = $178 million

On these figures, if these insurers were to obtain the business for the entire profession at these prices, not one would have received enough net premium to cover the average losses of the profession over the last 5 years; the highest would have only received enough to cover 73% and the lowest only enough to cover around 36% of such average losses. JLT indicate that other insurers, and competitive pressures, may reduce premium still further. We realise, however, that this is not truly a fair comparison as JLT explain that:

(a) the deductible may be up to $1 million for the larger firms compared to a $200,000 maximum under HKSIF. This will clearly reduce total losses somewhat, but given the limited number of larger firms, by not much.

(b) JLT point out that some insurers would evaluate administrative systems and controls, and may institute a peer review system for larger firms, although we are curious as to whether this would be acceptable in the fiercely competitive Hong Kong legal practice field, and whether client confidentiality issues would not preclude anything other than a very cursory review. Based on this, however, the pricing could be revised 25% up or down.

    Perhaps it would be fair to assume that the increases would approximately be offset by the reductions, so the total premium remains unchanged.

(c) However, the benchmark terms assume nil or low claims, therefore, if these insurers are indeed experienced and aware of the loss exposure, it is only from those firms that have had claims that they can seek to obtain the additional premium necessary to make this book of business viable to them. This would surely require a claims loading of a size that would drive many firms out of business.

In this respect between 1 October, 1991 and 31 July, 2001 out of a total of 630 law firms in Hong Kong the number of claims from law firms is as follow:.

Number of Claims (with or without payment)	Number of Firms
1	98
2	58
3	26
4 or more	128
	310

Number of Claims (with payments)	Number of Firms
1	41
2	41
3	20
4 or more	105
	207

In other words there are 128 law firms that have during the period brought 4 claims or more that may have resulted in payments being made.

We imagine that most of the business would flow to Insurer 3 in the H&G REport, since not only is it cheapest in total, it is the cheapest on each single firm. Insurers 1 and 2 do have some differentials between themselves on individual firms. Unless the loss experience immediately declines to the levels of around pre-1992, we anticipate that Insurer 3 would quite soon find itself with very serious underwriting losses.

Of course this would be immaterial provided Insurer 3 remains able to discharge its liabilities, and if there is a continuing supply of other insurers equally adventurous. Usually, however, when a dominant insurer in a particular market withdraws because of severe underwriting losses, others are reluctant to step in unless pricing increases dramatically, as they do not wish to suffer the same fate, and therefore tend to be over-conservative.

Interestingly, we understand from Members and brokers that signs of hardening terms are becoming visible in the commercial markets for coverage excess of $10 million. Reports of pricing increases for loss-free Members of 50-100% or even more are circulating, although negotiations are continuing to alleviate these, we gather. Couple this with the early developments on the LSE&W Qualified Insurer Scheme and we are compelled to muse about the seemingly inadequate terms from the commercial insurers approached for the JLT bench-marking exercise.

11. <u>The HIH Situation</u>

We are concerned lest Members have the impression from the H&G Report that the Society has done little or nothing following the failure of HIH in March 2001. Nothing could be further from the truth.

First the background:

1) HIH was a substantial Australian insurer who participated in the Excess of Loss insurance of the HKSIF Scheme in varying percentages throughout the years, in addition to other major schemes through other brokers in Hong Kong. It was a specialist in professional indemnity insurance and it had purchased FAI which was also a specialist insurer in professional indemnity insurance that had participated on the Scheme. In the 5-year policy which commenced on October 1st, 2000, HIH underwrote approximately 50% of the reinsurance. Following the failure of HIH in March 2001, the Society working with its advisors Aon Group, were able to replace HIH's share with other insurers. To the extent that HIH was substituted by other reinsurers, the terms and conditions of the program did not materially change, although new reinsurers were unwilling to agree the pro rata reduction in premium if number of claims fall below 340, but agreed an increase in Profit Sharing from 25% to 50% to compensate. 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 HKSIF 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 HKSIF which exceed its retention of $1 million per claim or its aggregate retention, will result in a shortfall in recovery from reinsurers for HKSIF. The total amount of outstanding reserves for which HIH is responsible is estimated at approximately $360 million at this time.

3) The HKSIF will continue to settle all claims from the Membership.

As to action already taken by HKSIF and its Broker/Manager:

(i) Replacement Reinsurers have already been identified and put in place effective from 1 April 2001 for retroactive contingent cover from 1 October 2000.

Aon advise that this innovative action is, to the best of their knowledge, unique among other major Hong Kong group programs where the HIH problem has arisen.

(ii) HKSIF has instructed Aon to explore loss portfolio transfer, alternative risk transfer, and loss deterioration for prior years losses where HIH participated, and this study is being undertaken.

(iii) HKSIF/Aon are jointly reviewing the outstanding claims and payment patterns and the funding requirements in the light of the available assets in the Fund. HKSIF also intends to engage KPMG for that purpose. Along with renewal premiums each October and investment income, our preliminary analysis would indicate that there is 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.

(iv) HKSIF has appointed legal counsel who are in constant touch with the liquidators of HIH with a view to maximising recoveries.

Thus, the review proposed in the H&G Report seems only duplicative of actions already taken. However, we have considered the "Programme Options" starting on Page 17 of that Report with a view to seeking ideas that HKSIF could incorporate. As these options are technical reinsurance issues, we imagine they may have been suggested by JLT from whom we seek clarification on some points as we are confused. Specifically:

Option 1 appears to suggest that HKSIF "sells" the HIH liabilities to an owned captive insurance company in Singapore, thereby removing the liabilities from HKSIF. Surely HKSIF cannot so readily remove its liability for any HIH shortfall – if the captive insurance company had insufficient assets to pay the HIH shortfall, the exposure would revert to HKSIF which issued the original indemnity.

The H&G Report then suggests that the captive could buy reinsurance protection. Why would HKSIF need to form a captive in Singapore or anywhere else to do that? Even if costs are modest, there would certainly be some, and HKSIF could buy such reinsurance directly.

Option 2 seems to require that HKSIF transfer funds to a reinsurer that would hold them in trust and pay interest, after an administration charge of 5-15%. Given current levels of interest rates on HK (or any other major currency if the reinsurer wished to take a currency risk) what additional interest rate could any reinsurer earn on secure investments, above that which could be earned by HKSIF itself, such as to justify a 5-15% administration fee.

As far as risk transfer is concerned (which would involve additional cost in Option 2) we will certainly be exploring its availability.

The conclusion of this Option 2 suggests alternatives for avoiding tax. JLT are certainly aware that HKSIF is a non-taxable entity, as they referred to this in their Response to Tender for Broker/Manager of the Scheme in 1998, so we are perplexed as to these ideas.

12. <u>The 2001 Contribution Increase</u>

The 2001 Contribution Increase of approximately 130% in 2001 (the first since inception of the Scheme in 1986) is intended to cover the increased Excess of Loss reinsurance premium in 2000 (which was paid to the reinsurers but not passed on to the Members) and further reinsurance premium increases in Scheme Years 2001-2004. Originally it was hoped that along with investment income this increase would enable the Society to avoid having to call on the Membership for further increases for the foreseeable future, absent major additional loss deterioration.

Unfortunately the HIH situation has removed that likelihood, but we are still optimistic that the new Contribution levels may be maintained until at least 2004/5.

13. Conclusions

Hopefully this rather lengthy Paper will have provided all of the information necessary to explain the Society's position.

To emphasise, we believe that the question of changing to a Qualified Insurer Scheme is indeed one that should and will be addressed. However, complex and major issues are involved that we do not believe will be capable of resolution in the short term, certain of which may have the potential to cause special difficulties for the smaller firms that will be most vulnerable. In the meantime, however, the Society has implemented actions to protect members against the consequences of the dreadful loss experience of recent years.

14 September 2001

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