LPLC LEGAL PRACTITIONERS' LIABILITY COMMITTEE

ACCESS TO JUSTICE ARRANGEMENTS

Submission of the Legal Practitioners' Liability Committee to the draft Productivity Commission Report, draft Recommendation 7.3

Executive Summary

1. The Recommendation 7.3 gives rise to the question of whether a sole provider or multiple providers for professional indemnity insurance for legal practitioners is preferable.

2. An extensive review of this question was conducted in 2004 by PWC, which recommended retention of a single provider scheme.

3. APRA has no role or legislative mandate to approve insurance products.

4. Removal of the requirement for regulatory approval in respect of insurance provided by single provider products for legal practitioners means there will be no minimum standards and will result in legal practitioners and their consumer clients suffering disadvantage with poorer quality cover with no guarantee of availability.

5. The regulatory cost of sector-specific insurance for legal practitioners in each state or territory is negligible. Once a year, each regulator considers the terms and conditions of cover.

1. Introduction

The Productivity Commission has made a recommendation being draft Recommendation 7.3 stating that:

> **"State and Territory Governments should remove the sector-specific requirement for approval of individual professional indemnity products for lawyers. All insurers wishing to offer professional indemnity insurance products should instead be approved by the Australian Prudential Regulation Authority."**

This recommendation mistakes the role played by the sector-specific schemes. Their purpose goes well beyond approval of professional indemnity insurance products for the legal profession.

The sector-specific schemes mandate a sole provider model. In other sectors, there are multiple providers.

The first question which needs to be addressed in connection with any review of professional indemnity insurance for the legal profession is whether a sole provider or multi provider model is preferable.

This question was carefully considered by PWC when it reviewed the scheme in Victoria in 2004. PWC concluded that the single provider model was preferable because it better facilitated the universal availability of high quality cover at an affordable price.

The report, which was adopted by the Victorian Government, concluded that any imputed cost of single provider sector-specific schemes, such as that in Victoria, s outweighed by public benefit.

The single provider model was retained in Victoria for solicitors and the option was offered to Victorian barristers to transition from a multi provider model to a sole provider model. The barristers opted for the latter model in 2005 and they and their clients have reaped the benefits since then.

England and Wales are a prime illustration of the deficiencies of the multi provider model. Around a decade ago, the Law Society of England and Wales migrated from a sole provider model to a multi provider model. The move has been an unmitigated disaster. The quality and availability of cover has declined markedly whilst the average cost has increased.

The Productivity Commission's recommendation has been drawn as a result of a number of assumptions which, LPLC submits, are **incorrect.** These assumptions are addressed at paragraph 3 below.

2. Background to professional indemnity insurance for legal practitioners in Australia

The legal profession is in a unique position because of its proximity to the administration of justice. A single provider ensures that consumers of legal services are appropriately compensated where legal practitioners have been negligent or have acted wrongfully.

2.1 What the Report calls "sector-specific" insurance has been provided to solicitor legal practitioners by state and territory insurance schemes for more than 30 years.

2.2 All state single provider schemes have provided comprehensive, high quality cover, with limited exclusions and has guaranteed run-off cover so that consumer protection continues after a practitioner dies or retires with no further payment of premium required.

Only a single provider can provide these benefits.

The rationale for the model is similar to that of the single providers of compensation to transport accident victims and work accident victims in Victoria, whose needs are met by the Transport Accidents Commission and Worksafe respectively.

The conclusion of PriceWaterhouseCoopers was that only a single provider model can meet consumer needs with quality cover at affordable cost.

It is also the reason why all states and territories have continued with single providers for professional indemnity insurance for legal practitioners.

2.3 Ceding provision of this very comprehensive cover to multiple APRA regulated, providers will lead to:

- higher insurance costs;
- lesser quality cover resulting in severe compromise of compensation available to consumers;
- diminution and probably extinguishment of transparent data and risk management has contributed to a low level of claims against Australian lawyers, premiums remaining relatively low, as effective risk management (drawn from data held by the single state providers) leads to higher standards of practice for legal practitioners, ultimately for the benefit of consumers.

3. PriceWaterhouseCoopers report for the Victorian Government

3.1 This report concluded that insuring with LPLC, as a single provider, meant:

- the provision of high quality, comprehensive cover;
- the provision of universal cover;
- lower and more stable premiums;
- availability of run-off cover to retired, deceased and disgraced firms or firms that have ceased to practice;
- lower administrative and management costs;
- increased transparency of premiums and financial performance;
- improved information from which to assess risks and inform risk management requirements;
- increased incentives to invest in risk management programs;
- improved consumer protection due to:
  - the universal coverage of all practitioners on the same terms and conditions; and
  - guaranteed provision of runoff cover for lawyers who are no longer practising;
- reduced search costs for consumers to find a practitioner with suitable terms and conditions of coverage;

- financial stability due to the ability to increase premiums to cover risks and to levy practitioners where it considers reserves are likely to be insufficient to meet liabilities;
- reduced transaction costs to lawyers of arranging PII cover;
- reduced likelihood of disputes between insurers; and
- reduced regulatory costs associated with ensuring that minimum terms and conditions of cover are met.

The relevant pages of the PWC Report are attached.

3.2 The conclusions remain applicable today and apply to the insurance arrangements currently operating in the states and territories.

4. Incorrect assumptions in Productivity Commission Report

4.1 The first assumption is that existing APRA regulated insurers will be able to offer cover

While it is true that there are insurers which will offer cover, cover can become difficult to obtain at affordable cost and on terms that offer adequate consumer protection.

The experience of other professions buying professional indemnity insurance has been that it is not possible to obtain high quality cover of the type currently mandated in all states and territories for legal practitioners. The statement that APRA regulated insurers will be able to offer cover must be qualified by the fact that that cover will be on more restrictive terms, have aggregate limits and that universal run off cover will not be available to all. The experience of financial advisers is one such example.

This is the conclusion reached by PWC.

4.2 The second assumption is that compliance costs for existing sector-specific insurance provided to legal practitioners are unnecessary and are a regulatory duplication as many professional indemnity products are provided by APRA approved organisations

There is no regulatory duplication.

Underlying this second assumption is a misunderstanding of the role played by current state regulators of the legal profession, which oversee these schemes, and the role of APRA.

APRA's role is to regulate insurers to ensure they remain solvent and can meet capital requirements.

APRA has no role in mandating minimum, or indeed any terms and conditions of cover for any profession or sector and has no legislative mandate to do so.

The relevant state regulators of the legal profession in the states and territories oversee and approve the terms and conditions upon which legal practitioners are insured, to ensure high quality universal cover. There is no quality control in terms of the cover offered by multiple APRA regulated providers.

The compliance costs are not comparable. The compliance costs in each state for approving single provider policies are minimal.

Minimum terms and conditions of cover are prescribed in respect of financial advisers (and other ASIC licensed financial services retail licensees) pursuant to ASIC regulations. This has nothing to do with APRA.

Otherwise, there is little prescription of terms and conditions of cover required in other professions as compulsory professional indemnity insurance. Other than what is prescribed by their membership organisations, the prescribed cover usually only refers to the amount required. For example, minimum cover required for members of the Institute of Chartered Accountants is $1M, with no requirements as to quality of cover. This has been demonstrated by the poorer quality cover provided to most professionals by multiple, APRA regulated providers. This poorer quality cover is prejudicial to both insured professionals and their clients or customers.

4.3 **The report states that as part of the National Reform Report for the legal profession, one option was that professional indemnity insurance would not need to be approved if it was provided by insurers regulated by APRA**

This was considered and rejected. All states and territories wished to maintain their single provider schemes. APRA has no legislative mandate to approve terms and conditions of cover, and indeed, does not do so. This is the role of each of the relevant regulator of legal practitioners in each state or territory.

4.4 **Other professions have accepted regulation by APRA as appropriate for their insurance requirements**

Regulation by APRA is directed at capital adequacy and not terms and conditions of cover. Professions who buy insurance in the insurance market, have inferior terms of cover to that provided by the sector-specific insurers for legal practitioners. One example is financial advisers. This is dealt with at paragraph 4.5 below.

While ASIC prescribe minimum requirements for licensed retail financial services providers, there is no other mechanism in relation to insurance for other professions to ensure that quality cover is provided to protect consumers- unlike the single provider schemes for legal practitioners in every state and territory which mandate terms and conditions.

In the case of medical practitioners, run-off cover is only provided because the cover is almost entirely funded by the Federal Government under the Retired Practitioners Scheme. This is because assured universal run-off cover cannot be provided by multiple APRA regulated providers. In addition, the Federal Government funds large claims for medical practitioners.

4.5 **Regulation provided by APRA is sufficient for legal professional indemnity insurers**

This is incorrect. Repeating the point made in paragraph 4.2, APRA does not regulate the quality of cover, and this is evident from the inferior quality cover provided by APRA regulated providers. It is not APRA's role and it has no authority to do this. Cover for other professionals insured in the insurance market, is inferior, with significant consequences for consumers.

The state regulators of the legal profession ensure that there is adequate protection for consumers and monitor the quality of the cover by ensuring there is:

- non avoidance cover
- cover for dishonesty
- universal run-off cover

ASIC prescribes terms and conditions for compulsory insurance in respect of retail financial services licensees, such as financial advisers and insurance brokers. These prescriptive terms are significantly less onerous for the commercial market. Even then, the cost of this insurance has become very high and there are significant gaps in cover as a result of the cover having features which compromise its quality and ultimately prejudice consumers.

The Australian Government report, entitled "The Review of Compensation Arrangements for Consumers of Financial Services" of April 2011 by Richard St John, highlights these deficiencies, which are not features of single provider polices for legal practitioners in the states and territories under the current arrangements.

In that report, cover for financial advisers was found not to react to a claim in a number of circumstances, namely:

- no run off cover and the licensee has ceased to operate
- licensee becomes insolvent and the policy is subsequently cancelled
- the licensees breaches contractual obligations under the policy
- the claim falls within an exclusion
- the claim exceeds a cap on the cover

These gaps in cover described in the St John report are typical of multi provider policies.

Save for the operation of some exclusions, none of these issues arise in the current single provider arrangement for legal practitioners.

This is because the quality of cover is effectively prescribed by the current relevant state regulator and only single providers are able to meet these policy conditions.

The relevant chapter of the Australian Government report, appears at pages 45-61. The link to the full report is at http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_CP/downloads/Compensation

5. Conclusion

5.1 There would be no "saving" in the cost of regulation by adopting the recommendation. Even if legal practitioners were insured by multiple providers, each regulator would still need to prescribe minimum terms and conditions but it is unlikely that multi providers would provide complying policies. In any event, the current cost of regulation by each state and regulatory authority is minimal, and APRA performs no equivalent role.

5.2 For more than 30 years, legal practitioners in Australia have enjoyed the most comprehensive cover of any profession - unlimited reinstatements, no aggregate limits and protection for consumers from dishonesty of a practitioner together with unlimited run-off cover. Regulatory cost has been extremely small, with great benefits for consumers.

5.3 To change the requirement that legal practitioners be insured by of a number of APRA regulated insurers would lead to higher costs and a significant diminution in the quality of cover, to the disadvantage of consumers of legal services.

5.4 Compulsory professional indemnity insurance provided by multiple providers is fraught with difficulty, as financial advisors have found.

Similarly, in England and Wales, where the insurance market took over from a sector-specific sole provider for legal practitioners in 2000, there has been:

- a number of insolvencies of regulated insurers
- prohibitive costs of insurance for small practices causing many to close down
- the regulator of solicitors, the Solicitors' Regulation Authority, and other professionals, is now considering a significant diminution in the minimum amount of cover required and quality of that cover, in order to manage what has become spiralling costs for smaller practitioners.

Legal Practitioners' Liability Committee
20 May 2014

7.4 Legal Practitioners Liability Committee

As discussed in Chapter 4, Victorian solicitors are currently required to hold a minimum level of PII cover ($1.5 million) in order to obtain a practicing certificate, and this insurance is required to be obtained through a statutory monopoly insurer, the LPLC. While Victorian barristers are also currently required to hold a minimum level of PII cover, barristers are required to obtain that insurance through the private insurance market. It is proposed that the current arrangements for solicitors be carried forward to the Bill, and that barristers also be required to obtain primary PII cover through the LPLC.

The primary restriction on competition arising from the proposed PII provisions contained in the State-based provisions of the Bill is that the primary level of PII cover for Victorian solicitors and barristers must be obtained from the statutory monopoly insurer, the LPLC.

As noted in Chapter 1, the requirement to hold PII arises from the national provisions of the Bill. This provision will therefore be assessed as part of the review to be prepared for COAG, and is outside the scope of this review. Rather, this review takes as given the requirement for practising lawyers to hold PII, and assesses the best way to provide compulsory PII cover by assessing the benefits and costs of the monopoly provision of primary PII cover through the LPLC compared to alternative approaches to providing cover. This assessment includes the proposal that the LPLC be the monopoly provider of primary PII cover to barristers.

Monopoly provision of PII by the LPLC

Nature of restriction

The proposal that Victorian legal practitioners be required to obtain a minimum level of compulsory PII cover through a statutory monopoly provider, the LPLC, restricts competition in the market for PII insurance by preventing other potential providers of primary PII insurance from competing to provide the primary level of PII cover.

The impacts of the restriction are likely to be borne by commercial providers of PII, who would be prevented from entering the market to provide primary PII for Victorian practitioners, by Victorian legal practitioners, who are the consumers of PII cover, and by consumers of legal services provided by Victorian practitioners. To the extent that the restriction has flow-on effects to upstream and downstream markets, participants in those markets are also potentially affected.

This restriction can be regarded as promoting the legislative objective of consumer protection, by addressing problems associated with information asymmetry and ensuring that cover is available to meet claims arising through disputes between practitioners and their clients.

Effect on competition and the economy

The effects of restricting competition in the market for PII provision to Victorian legal practitioners are of both a theoretical and a practical nature.

In theory, because a monopoly provider of insurance has no threat of effective competition, monopoly provision of PII may result in:

- increased costs of providing PII, because competitive pressure to achieve efficient production costs is lacking;
- increased prices to practitioners for PII cover, due to higher production costs and an absence of competition for market share;
- lower service standards; and
- reduced innovation, resulting in a reduced choice of PII products available to practitioners.

Increased prices to practitioners for PII cover has potential to increase the price of legal services provided to consumers. This in turn can result in a reduction in the overall consumption of legal services in the Victorian market. To the extent that it results in higher prices for services than is incurred by consumers in other jurisdictions, increased prices for PII cover can also result in increased provision of services in the Victorian market by interstate lawyers.

The restriction may also have impacts in upstream and downstream markets, such as reduced competitiveness of Victorian businesses which consume legal services and reduced demand for legal education services in Victoria through its impact on the costs and overall level of consumption of legal services. Increased prices for legal services may also reduce the accessibility to legal services for those with limited capacity to pay.

As discussed in Chapter 5, the existence of a monopoly insurance provider usually reflects that a legislative monopoly has been created by government on the basis that insurance may not be adequately provided by the market. The inherent risk, however, is that a statutory monopoly may act in a similar manner to a private monopolist – that is, because their market position is assured and re-enforced by legislation, there may be little incentive to improve processes or act in a manner that reflects competitive conditions.

The extent to which these theoretical impacts are borne out in practice depends on the extent to which outcomes under a monopoly insurer diverge from those that would occur in the market. The experience of Victorian barristers in obtaining primary PII cover in the market can help inform an assessment of the likely outcomes that would occur were all Victorian legal practitioners required to obtain primary PII cover in the market.

It appears that there are a number of practical considerations in the market for PII for legal practitioners that mean that to a large extent the theoretical costs of a statutory monopoly provider of PII are not borne out in practice.

The benefits and costs of the proposed regulatory approach are discussed in more detail below.

Benefits

Provision of the primary level of PII cover to Victorian lawyers through the LPLC appears to have a number of practical benefits, including:

- the provision of high quality, comprehensive cover;
- the provision of universal cover;

- lower and more stable premiums;
- availability of run-off cover to retired, deceased and disgraced firms or firms that have ceased to practice;
- lower administrative and management costs;
- increased transparency of premiums and financial performance;
- improved information from which to assess risks and inform risk management requirements;
- increased incentives to invest in risk management programs;
- improved consumer protection due to:
  - the universal coverage of all practitioners on the same terms and conditions; and
  - guaranteed provision of runoff cover for lawyers who are no longer practising;
- reduced search costs for consumers to find a practitioner with suitable terms and conditions of coverage;
- financial stability due to the ability to increase premiums to cover risks and to levy practitioners where it considers reserves are likely to be insufficient to meet liabilities;
- reduced transaction costs to lawyers of arranging PII cover;
- reduced likelihood of disputes between insurers; and
- reduced regulatory costs associated with ensuring that minimum terms and conditions of cover are met.

High quality, comprehensive cover

It appears the LPLC is able to offer higher quality, more comprehensive cover than would be available in the market. This is supported by the experience of the Bar, solicitor PII schemes in other states, and overseas. For example, commercial insurers generally include a non-disclosure clause in their policy wording, which means they do not provide cover for liabilities where the insured has not disclosed, or has misrepresented, certain information. The LPLC does provide this 'non-avoidance' cover, which means that consumers are not denied redress for actions of the lawyer over which the client has no control. Similarly, the private market is unlikely to provide cover where the insured has been dishonest. The LPLC does provide dishonesty cover. While it could be argued it is not unreasonable that insurers provide an exclusion for dishonesty, ultimately it is the consumer who bears the cost if redress is unavailable on the basis that his lawyer has been dishonest.

The experience of the Bar in seeking insurance in the market provides evidence that commercial insurers are unwilling, or unable, to offer terms and conditions of cover which match those provided by the LPLC, including the provision of non-avoidance and dishonesty cover. In both 2003-04 and 2004-05, the Bar received only one complying response to its tender seeking cover. In both cases the terms and condition were inferior to those of the LPLC policy for solicitors and was from an overseas insurer not authorised in Australia, Great Lakes Reinsurance. This means it is not regulated by the Australian Prudential Regulation Authority (APRA), and should problems arise could not be pursued through the Australian legal system. It could also increase the difficulty resolving claims which arise after it ceases to provide insurance.

Universal cover

By providing universal PII cover across the profession, a monopoly insurer ensures that practitioners who may be unable to obtain insurance in the market are able to obtain cover. Given that PII cover is required in order to practice law in Victoria, this means that practitioners are not excluded from practice on the basis they are unable to obtain cover.

While it can be argued that it may be appropriate that not all practitioners are able to obtain cover (for example, those who are assessed as being high risk on the basis of claims history), as discussed in Chapter 5, difficulties that insurers have in accurately identifying high and low risk individuals can mean that some practitioners may be unable to obtain insurance who do not pose a significant risk, and where it would be socially optimal that they be able to obtain cover, and where the bodies with legal responsibility for determining who is able to practice have no concerns about a practitioner's competence.

Private insurers attempt to underwrite a profitable portfolio by carefully evaluating and selecting each risk in their portfolio. This behaviour can lead to availability problems in some segments. For example, a sole practitioner or small firm may find it difficult to obtain PII because they can't afford a high premium, and it is not worth the insurance company's effort to invest in evaluating the risk they pose. Large firms, on the other hand, may be a more profitable proposition for insurers, even if they have had claims, because they can afford to pay high premiums and it is worth the insurer's while to invest in effort to evaluate their risk. The experience of the LPLC suggests that competent practitioners and firms can incur claims for a variety of reasons, such as an incompetent employee, troublesome client, a difficult or controversial matter etc. Given the large proportion of Victorian firms that comprise sole practitioners or a small number of partners (see Chapter 4), this may raise significant equity concerns, particularly in rural and regional areas, especially considering the compulsory nature of PII insurance. This has been the case in some other professions, including the architectural profession.

It is consumers of legal services who are the ultimate beneficiaries of PII cover. Universal cover on consistent terms and conditions ensures that all consumers are afforded protection. The importance of this is illustrated by the high proportion of practitioners who operate in small practices, have limited years of experience, and are located in suburban or regional areas (see Chapter 4).

A further example is conveyancing. As noted in Chapter 4, ABS data suggests that smaller firms receive a much greater proportion of their income from conveyancing than large firms. In 2002-03, 121 of a total 555 claims incurred by the LPLC related to conveyancing. The value of these claims was $4.6 million (of a total cost of claims of $20.4 million). Of these, 79 claims (with a value of $2.9 million) were incurred by firms with 2 or less partners. These smaller firms are also more likely to have difficulty obtaining affordable PII cover in a commercial market. Given that property represents a large investment for many people, in the absence of universal cover on consistent terms and conditions, there is considerable scope for these consumers to be left without means for redress.

The problem outlined above could be addressed through an 'assigned risks pool', whereby those who are unable to obtain insurance are provided insurance from an 'insurer of last resort'. The cost of claims are allocated across providers according to market share. Such an approach has been adopted in the UK in combination with a multiple provider model. However, the size of the pool in the UK is much greater than that in Victoria, and therefore there is greater scope to spread the risks. The feasibility of such an approach in Victoria is unclear. If the LPLC were to become the insurer of last resort, this may jeopardise its financial viability.

Lower and more stable premiums

While it may appear at odds with the theory of the behaviour of a monopoly, there appear to be sound practical reasons that a statutory monopoly insurer is able to offer lower, more stable premiums (for cover of equivalent or better quality) than would be offered by multiple competing providers or a monopoly private provider.

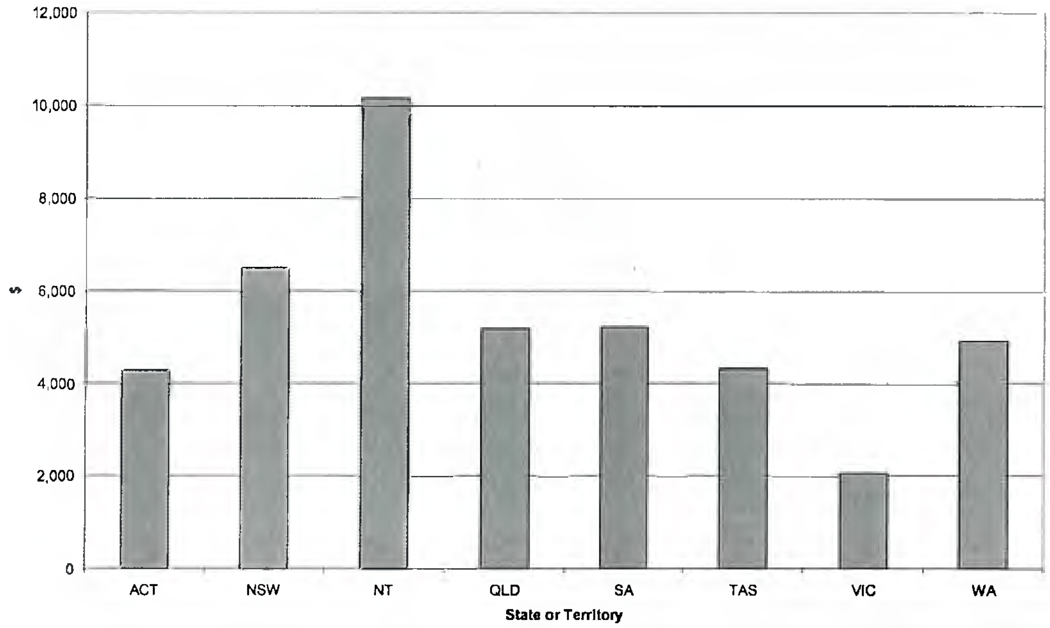
While a change to a multiple provider model may initially result in reduced premiums in order to gain market share, in the long term these costs would need to be recouped in order to ensure the financial viability of providing insurance.

Recent experience in the PII market in Australia and overseas has seen premiums increase dramatically, with further increases forecast. The LPLC, on the other hand, has been able to offer insurance for premiums which are not only lower than those available to solicitors in other jurisdictions, but have declined in real terms since 1993, as Figures 7.1 and 7.2 illustrate.

The primary reasons for this appear to be that:

- as a statutory monopoly the LPLC is not required to make a profit;
- the guaranteed right to provide cover means that it does not have to build a significant risk premium into its prices in order to provide for the cost of claims which may arise after it ceases to collect premiums (due to the long tail nature of claims – see below);

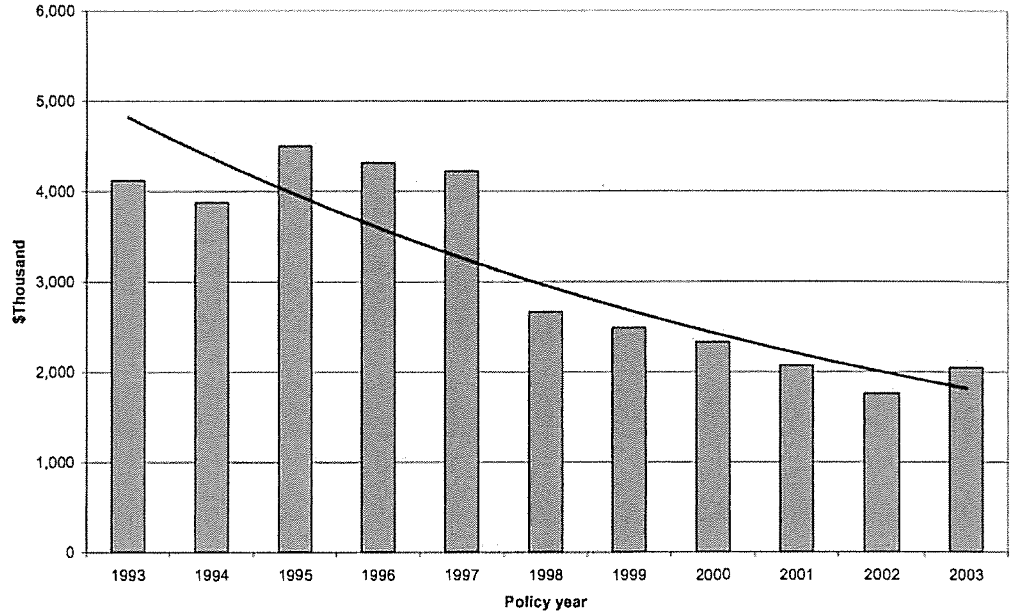
- its administrative and management costs are relatively low due to the fact it does not incur brokerage, commission, advertising or other such costs; and
- its monopoly status means it has good quality information to use as a basis for setting premiums



and identifying areas where investment in risk management programs may reduce the cost of claims (see below).**Figure 7.1 Premiums per practitioner for PII insurance in Australian states and territories, 2004 ($2004)**

Source: LPLC, pers.comm., 26 April 2004.

Figure 7.2 LPLC premiums per practitioner for PII insurance, 1993 to 2003 ($2004)



Source: LPLC, pers.comm., 26 April 2004.

A report by Trowbridge Consulting prepared for the 1998 review of PII arrangements by the LPB (the Trowbridge report)[1] illustrated the reasons underlying the LPLC's ability to provide cover for lower premiums than commercial insurers using the example in Table 7.1:

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[1] Trowbridge Consulting, Actuarial Review of Cases for Retaining LPLC as Monopoly Insurer, in Legal Practice Board, 1998, *Review of Professional Indemnity Insurance Arrangements for Solicitors in Victoria: the Role of the Legal Practitioners Liability Committee, A Report and Recommendations to the Honourable Jan Wade, MP, Attorney-General for the State of Victoria*, June, Volume 3, p. 5.

Table 7.1 Premium comparison between the LPLC and commercial insurers ($)

	LPLC	Commercial insurer
Net claims cost	116	116
Expenses	5	13
Commission	-	13
Reinsurance	8	8
Profit margin	-	9
	129	159
Less investment return	29	29
Required premium	100	130

A monopoly provider of insurance is more likely to be able to offer stable premiums over time due to the fact it is shielded from competitive pressures that may otherwise result in fluctuating premiums that are not related to risk. Because a monopoly provider has a guaranteed right to provide cover in the future, it is able to smooth fluctuations in premiums over time that occur due to year to year changes in claims outcomes and investment returns. Competing commercial providers may be less able to do this.

The Trowbridge report found that a monopoly provider can reduce premium instability compared to the market due to the fact that it is not subject to the 'underwriting cycles' that insurance markets are prone to. Key drivers of these cycles are changes in claims and investment returns and competition for market share.

In its report, Trowbridge Consulting expressed the view that:

> There are a number of good reasons why the LPLC is in a better position to provide greater stability in premium rates than the commercial insurance market –
>
> - it does not need to cut premium rates in response to increases in competitive pressures which are driven solely by market share aspirations
> - it can afford to take a longer term approach to returning premium rates to a break-even level when claims or investment experience deteriorates

- it has flexibility as to how to distribute accumulated surpluses through reduced premiums when claims or investment experience is more favourable than expected
- it does not have to comply with the rigid ISC solvency requirements imposed on private insurers and can therefore operate at a low or negative surplus[2, 3]

Discussions held with insurers in the market for PII supported the suggestion that private insurers may experience competitive pressures driven by market share considerations.

There is a degree of competition between the PII schemes in Victoria, NSW, Queensland, the ACT and the Northern Territory to provide cover to national firms, as these jurisdictions exempt firms from obtaining cover in each jurisdiction if they have cover in one of these jurisdictions. That the LPLC is able to offer lower and more stable premiums than insurers in these other jurisdictions is supported by the fact that the LPLC now provides cover to 36 of the 39 national firms (and 95 per cent of the solicitors practising in national firms). However, while this may be evidence that a national market for PII for legal practitioners is emerging, it is impossible to say at this point in time whether this is the case.

Affordable and stable premiums, as well as providing obvious benefits to practitioners, also result in benefits to consumers of legal services by ensuring that practitioners are able to afford cover (and hence practice, which may have implications for access to legal services, particularly in rural and regional areas) and that the costs of providing services are lower and more stable.

Run-off cover

PII cover is provided on a claims made basis, and there is frequently a period of some years between providing a legal service and a claim arising from it being made (reflecting that it can be difficult to judge the quality of legal services provided until some time after the service is provided, as discussed in Chapter 5). This means that PII cover is required for many years after a practitioner or firm has ceased to practice, and that while a claim may

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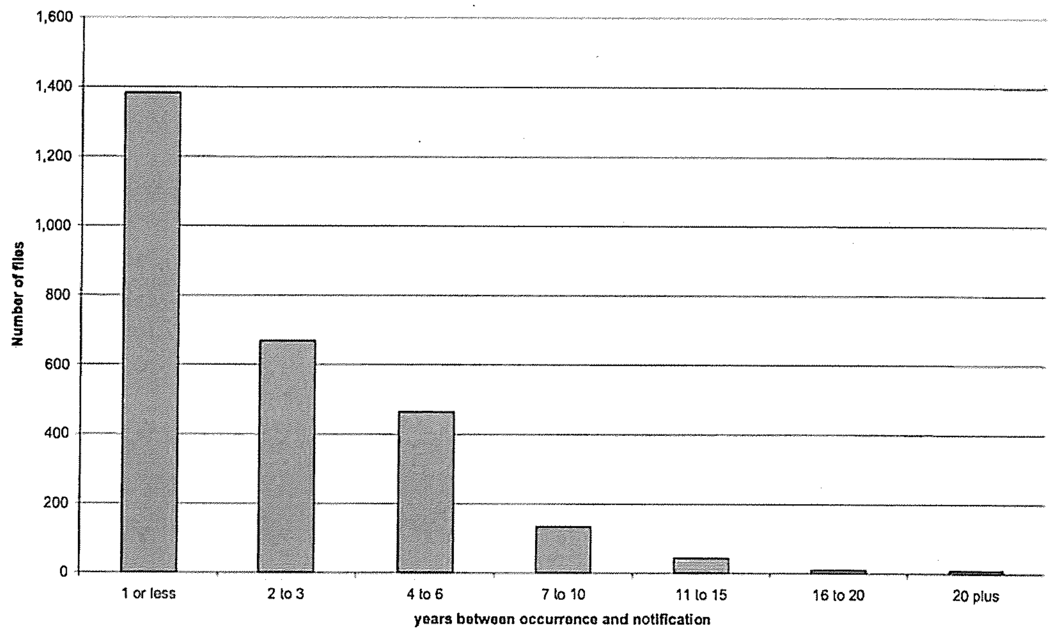
[2] Ibid, p. 7.
[3] The LPLC comfortably meets APRA's minimum capital requirements.

relate to a period when a practitioner was insured with an insurer, the claim itself may not be made until after the insurer has ceased to provide the practitioner with cover. The long-tail nature of claims is illustrated by Figure 7.3, which shows the number of years between a service being provided and a claim being notified for all LPLC claims over the period 1998 to 2003.

Figure 7.3 Years between provision of service and notification of claim, 1998 to 2003



Source: LPLC, pers.comm., 26 April 2004.

Run-off cover is provided by the LPLC on the same terms as for current practitioners, and the costs spread across all insured practitioners. However, the experience of the Bar suggests that commercial insurers can be reluctant to provide run-off cover. In 2001, Suncorp Metway offered runoff cover for barristers who were insured with them at the time they ceased to practice, on the basis that the cover continued only while the insurer continued to provide cover to practising Victorian barristers. Suncorp Metway subsequently ceased to provide this cover. Run-off cover was then only available to some barristers, on the basis they apply and pay an annual premium.

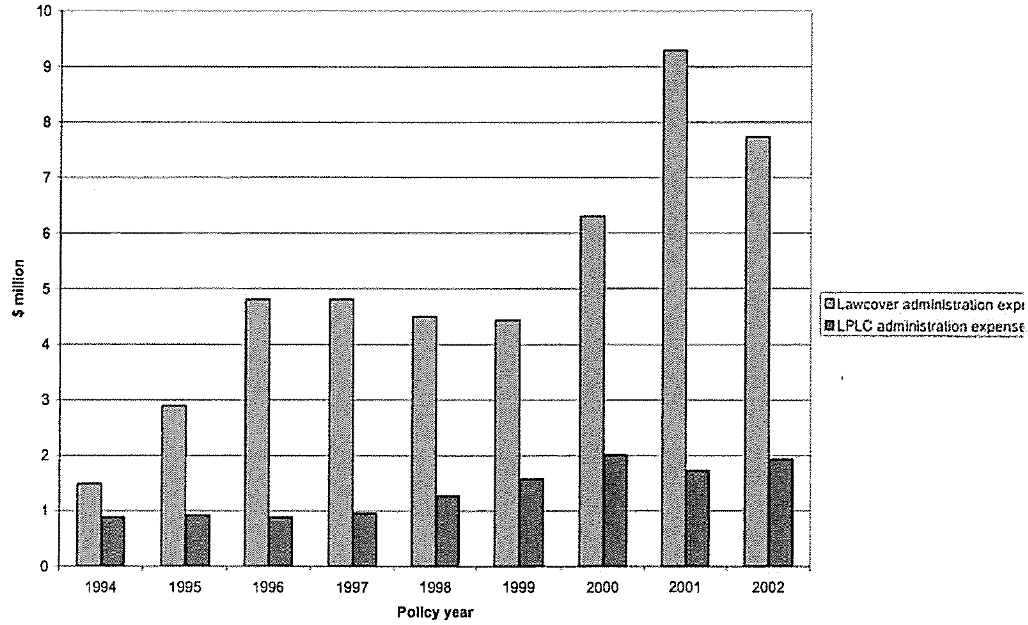
In 2003-04 and 2004-05, the LPB made it a preferred term of the tender to the market that the successful tenderer provide automatic run-off insurance for all former barristers, ideally at no cost to former barristers. The successful tenderer provided this cover, however no other insurer which responded to the tender in either year provided this benefit. While all former barristers currently have run-off cover, it is not clear that this cover would be provided in a competitive market. This potentially would leave consumers without redress in the event of a claim. Further, it may increase the likelihood of disputes between insurers regarding who is responsible for the claim (this is discussed in more detail below).

Lower administrative and management costs

While in theory monopoly service providers are likely to be less efficient and incur greater costs of service delivery than would be the case in a competitive market, there is practical evidence to suggest that the LPLC is able to deliver services at lower cost than would be the case in a competitive market. The Trowbridge report suggested that the operational costs of a monopoly provider would be lower than those of a commercial insurer for reasons including lower expenses for commissions and brokerage, and reduced advertising, marketing and underwriting costs.

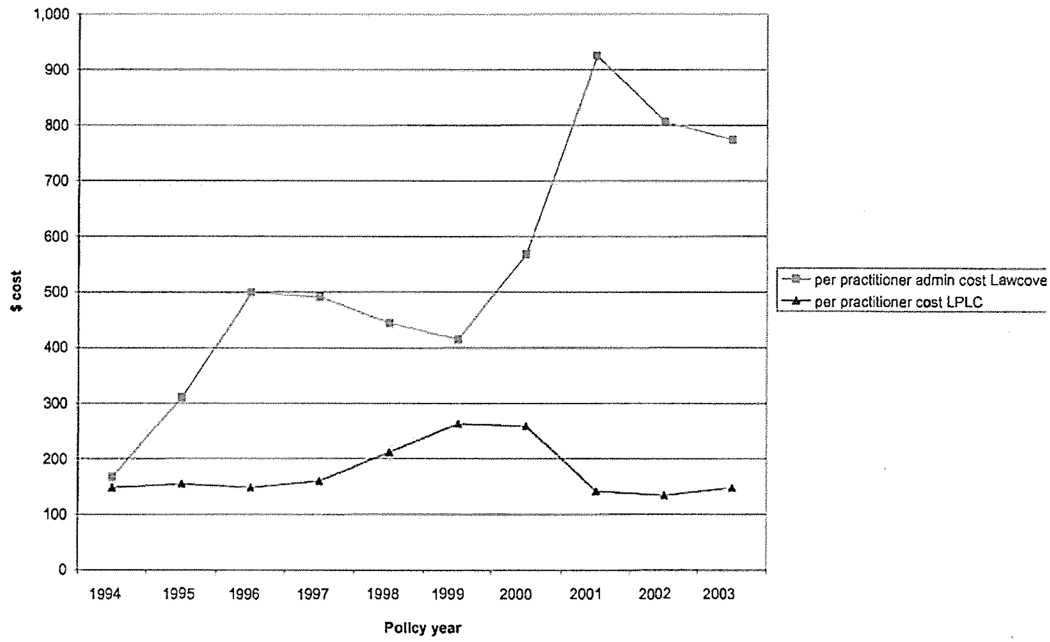
Data on general and administration expenses from the financial statements in LPLC and LawCover (a company owned and controlled by the New South Wales Law Society) annual reports provided by the LPLC suggests that the LPLC's administrative costs are significantly lower than those of LawCover in NSW, both in total and on a per practitioner basis, as shown in Figures 7.4 and 7.5.

Figure 7.4 Administration expenses for the LPLC and LawCover, 1994 to 2004 ($ million)



Source: LPLC, pers.comm., 26 April 2004.

Figure 7.5 Administration expense per practitioner insured for the LPLC and LawCover, 1994



to 2003 ($)

Source: LPLC, pers.comm., 26 April 2004.

While it is difficult to be definitive about the reasons for this because detailed information on LawCover's administrative costs is not publicly available, the difference is likely to be due at least in part to the costs incurred in outsourcing to the market and assessment of premiums for individual practitioners and firms in NSW which arise due to the differences in the models under which the two organisations provide PII.

PII for solicitors in NSW had a similar history to Victoria in the 1980's, with a mutual fund monopoly introduced in the mid 1980s in response to poor availability of cover with commercial insurers and steep premium rises. In 1998, LawCover changed to a commercial insurer monopoly with HIH, which was the sole provider of insurance until its collapse in 2001. Since then, Great Lakes Reinsurance has provided cover. Examination of the organisational charts of LawCover and the LPLC indicates that the difference in costs is also likely to be due to differences in staff costs – in 2003 LawCover had 38 employees (including several claims solicitors and underwriters) while the LPLC had 12 employees.

As discussed in Chapter 5, monopoly insurance providers may be able to capture some of the benefits of competitive markets if they contract out certain functions. In the case of the LPLC, limited functions are undertaken 'in-house', with activities outsourced where it is efficient to do so, including funds management, defence panel legal services and actuarial services.

Information provided by the LPLC suggests it has been able to provide cover at a high loss ratio, representing premium value for policy holders. The value provided by the LPLC compared to commercial insurers can be at least partly explained by the fact it does not incur expenses associated with advertising, underwriting, brokerage etc.

Figure 7.6 shows the LPLC's expense ratios[4] compared to general insurers.

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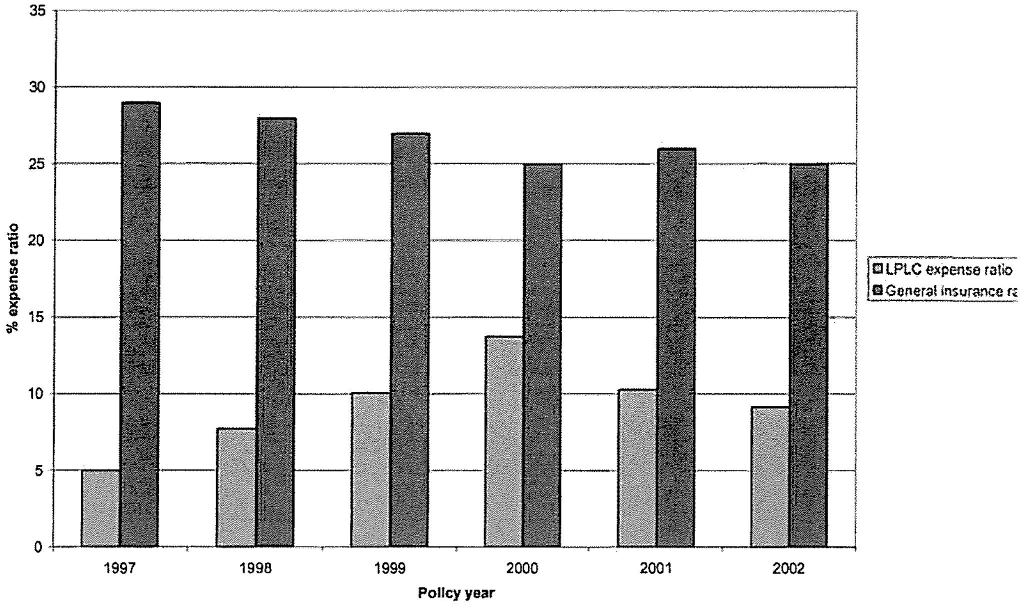
[4] The expense ratio is ratio of underwriting expense to premium revenue.

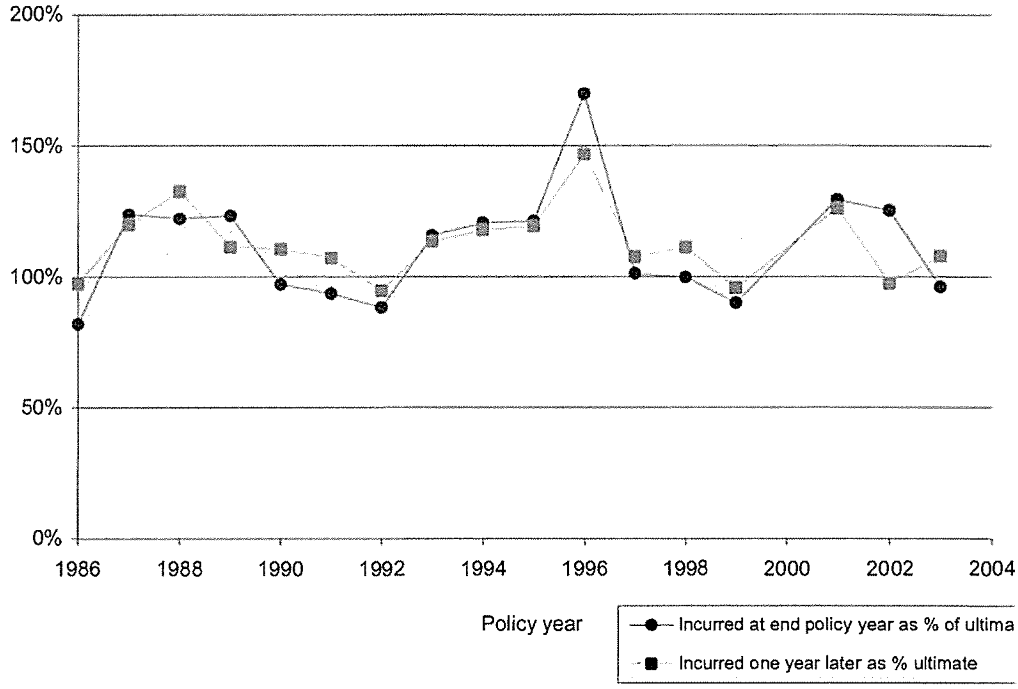
Figure 7.6 LPLC and general insurer expense ratio to premium (net of reinsurance), 1997 to 2002 (%)



Source: LPLC, pers.comm., 26 April 2004.
* APRA 2004, General Insurance Trends: September Quarter 2002 (Updated 24 February 2004)

Data provided by the LPLC also suggests it has a good record in terms of estimating its claims exposure (in contrast with some commercial insurers), as shown in Figure 7.7.

Figure 7.7 LPLC incurred estimates as a percentage of ultimate expenses incurred, 1986 to 2003 (%)



Source: LPLC, pers.comm., 26 April 2004.

Increased transparency

The level of transparency of LPLC premiums and financial performance is high compared to a competitive market. This is because the LPLC has no incentive to hide this information from competitors.

Through its annual report, statutory accounts and website, the LPLC reports extensive information about its operations and financial position, including the dollar amount of premiums and claims, operational costs, investment returns etc. By contrast, the annual cost of claims, premium pool and formula for allocating the premium pool across the profession are not made publicly available by private insurers and providers in other jurisdictions such as LawCover in NSW. This limits scrutiny of these insurers' operations by the profession and the public.

Improved information from which to assess risks and inform risk management requirements

Because it insures all Victorian legal practitioners, and has a guaranteed right to do so in the future, a statutory monopoly provider of PII cover has better quality information to assist it to accurately assess the risk in relation to a particular firm or practitioner than would be the case in the market, where there is a commercial incentive not to disclose claims history and other relevant information to competitors. As the sole provider of PII cover to solicitors in the past, the LPLC has an extensive claims history database on which to base its assessment of risk in relation to a particular firm or practitioner.

Access to up-to-date information on the whole of the profession, particularly in relation to claims history, is important in order to make sound actuarial projections and for effective risk management programs. In turn, this enables premiums to be set with a greater degree of accuracy, which helps to ensure the stability of the scheme and prevent under or over pricing.

As discussed in Chapter 5, regulation of the insurance industry in the United States recognises the problem that commercial insurers have obtaining appropriate information by providing for insurers to pool claims information in order to generate class rates, as individual insurers could not develop enough claims experience to rate on the basis of their own portfolios.

While commercial insurers in Victoria could be required to report PII claims and underwriting statistics for legal practitioners to a central regulator, this would be likely to impose significant regulatory costs.

The reluctance of commercial insurers to disclose claims and underwriting statistics is demonstrated by the experience of the Bar, which has had significant problems obtaining claims history information from previous insurers (most recently, Suncorp Metway refused to provide claims information) in order to construct a claims database for use in the tender process. This means that other insurers do not have access to the same information as Suncorp Metway when formulating their offer of insurance and thus must be more conservative in setting their premiums (that is, build in a great risk factor, resulting in higher premiums). Similarly, Zurich Professional has recently refused to reveal the number of claims made under policies it has written in the UK solicitors insurance scheme.

Incentives to invest in risk management programs

Effective risk management can reduce the amount and number of losses incurred as a result of a practitioner's negligence or incompetence. This is clearly in the interests of practitioners, their clients, and PII providers.

As discussed in Chapter 5, while insurance companies have an incentive to invest in activities that reduce the risks within their portfolio, there is no incentive to minimise risk in the broader market due to the risk that others will free-ride on this investment. In fact, there is a disincentive to minimise risk outside their portfolio, as higher risk will increase the overall market size and potentially damage competitors. This is likely to be particularly the case where an insurer has no guarantee it will provide cover the following year, especially given that benefits arising from risk management activities are likely to accrue over a period of time. Monopoly providers are likely to have an increased incentive to invest in risk management activities.

The LPLC has engaged in extensive risk management programs, and is widely recognised as being very proactive and professional in its activities in this area.[5] The areas targeted by risk management programs are identified through information in the LPLC's claims database and through monitoring of changes which may affect the conduct of legal practice. Recent examples are the LPLC 's risk management programs on the GST, VWA[6] and 'Armadio'[7] claims.

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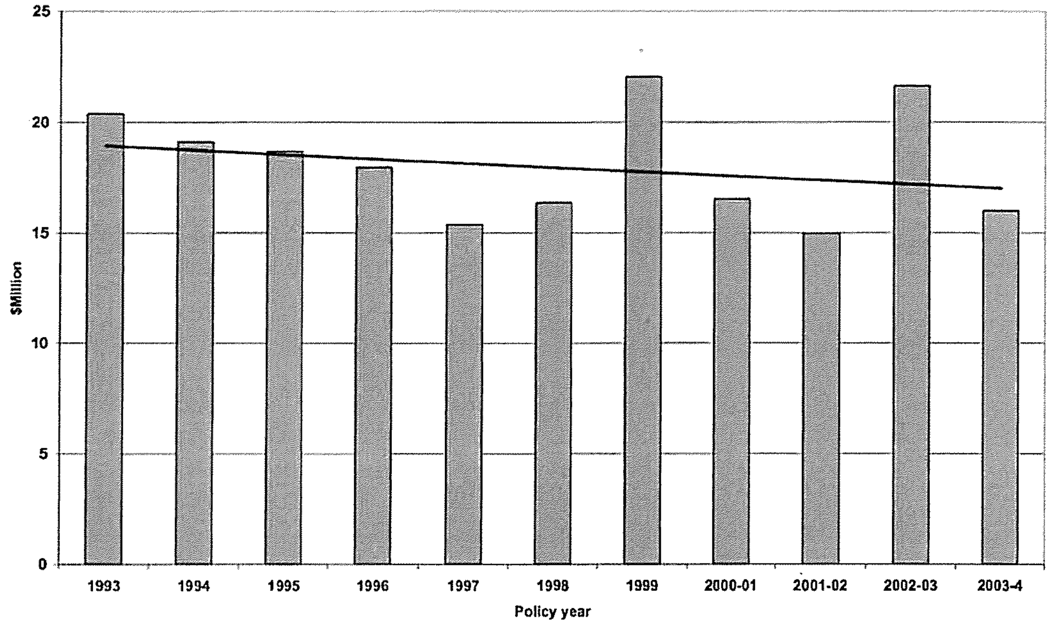
[5] The risk management activities of the LPLC complement the risk management and educational activities undertaken by the professional associations and Legal Ombudsman.

[6] Changes to accident compensation laws in 1999 imposed a deadline for the notification of existing rights, which were potentially confusing to practitioners and consumers.

[7] Claims relating to third party guarantors and mortgagors who were seeking to avoid their obligations to lending institutions on the basis that they did not understand their obligations and the nature of the transaction at the time they signed the relevant documentation.

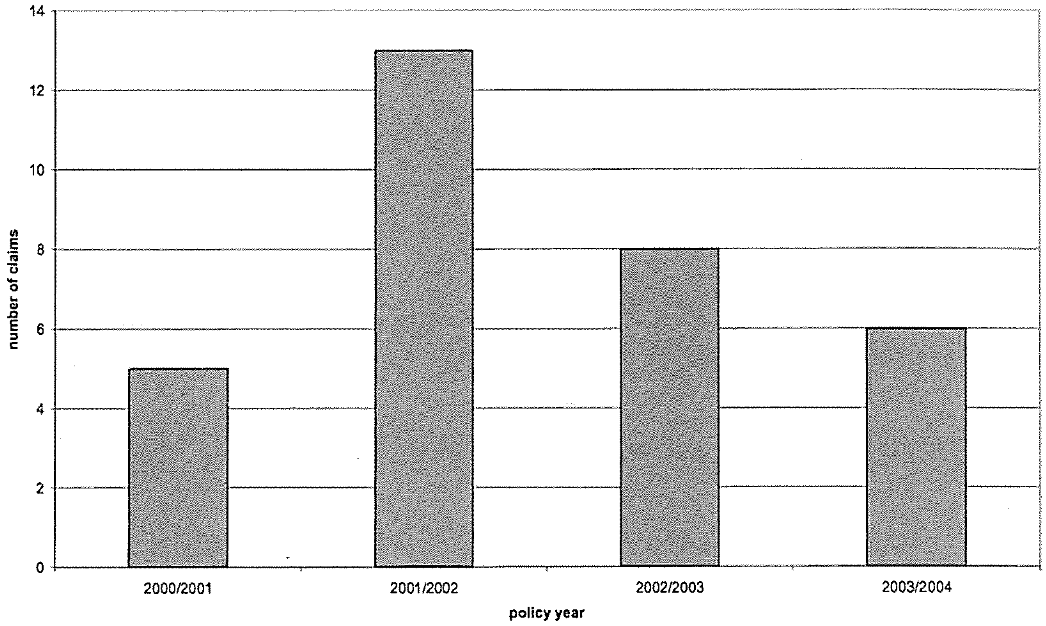
While there are likely to be a range of factors at work, data provided by the LPLC suggests that its risk management activities have resulted in tangible benefits in the form of a lower incidence of claims, as illustrated in Figures 7.8 to 7.11.

Figure 7.8 LPLC annual cost of claims, 1993 to 2004 ($2004 million)



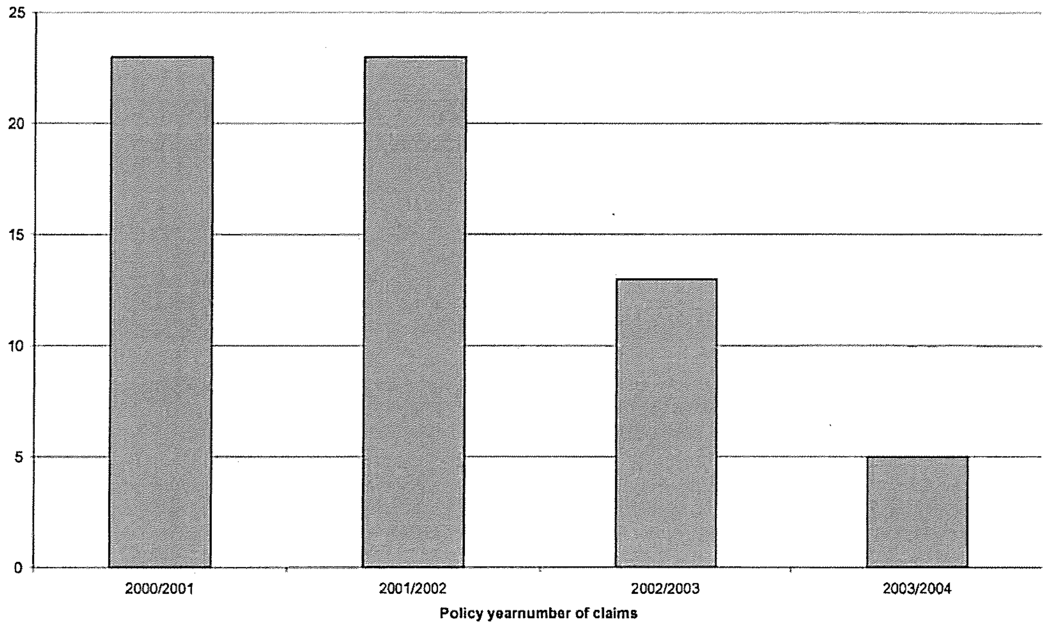
Source: LPLC, pers.comm., 26 April 2004.

Figure 7.9 Number of GST-related claims incurred by the LPLC, 2000 to 2003



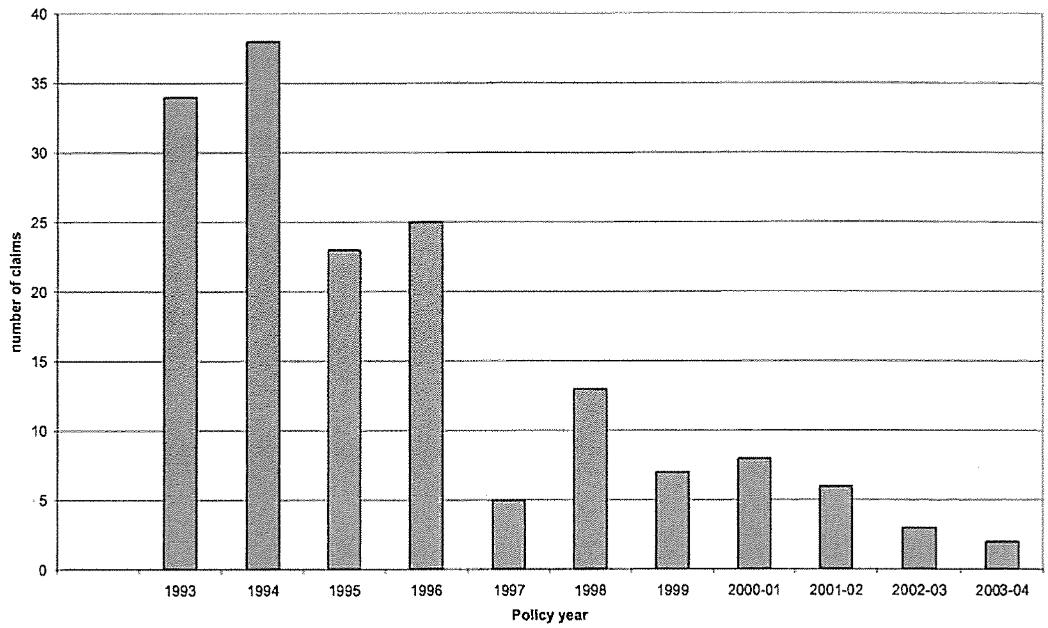
Source: LPLC, pers.comm., 26 April 2004.

Figure 7.10 Number of VWA-related claims incurred by the LPLC, 2000 to 2003



Source: LPLC, pers.comm., 26 April 2004.

Figure 7.11 Number of Armadio claims incurred by the LPLC, 1993 to 2003



Source: LPLC, pers.comm., 26 April 2004.

The risk management activities undertaken by the LPLC contrast with the experience of the Bar in seeking the collaboration of private insurers of its members in risk management activities. The Bar has suggested that its insurers do not actively engage in risk management activities among its members. When approached by the Bar to collaborate on a particular risk management program, a previous insurer was willing to do so only for a significant fee.

Improved consumer protection

Provision of PII through a statutory monopoly is likely to result in improved consumer protection compared to the competitive market, primarily through the provision of universal cover on consistent terms and conditions, and ensuring run-off cover is available to cover claims which arise after a firm or practitioner has ceased to practice. These issues are discussed in more detail above.

The importance of providing consumer protection through the provision of PII is illustrated by data presented in Chapter 4, which shows that a significant proportion of Victorian legal practitioners are in small firms and/or have less than 6 years experience. If these practitioners were unable to obtain affordable cover on consistent terms and conditions, the extent to which redress is available to consumer would be reduced.

While legal practitioners are the direct consumers of PII, ultimately, it is consumers of legal services that are the beneficiaries. It is therefore in the interests of consumers that practitioners are able to obtain affordable coverage on consistent terms and conditions that is stable, secure and ongoing. If such cover is not available, ultimately, it is the consumer that will pay, either in the form of higher prices for legal services, or through lack of redress in the event of a claim.

In recent years, the Bar has witnessed the collapse of HIH as its insurer in March 2001, the announcement by Suncorp Metway in February 2002 of its withdrawal from the PII market followed by a reversal of that position in May 2002, the withdrawal of St Paul from the Australian market, and the failure of QBE both last year and the previous year to bid for the primary layer of insurance for Victorian barristers.

The Bar's experience in recent years indicates that a very limited number of commercial insurers are interested in providing cover, and that only Great Lakes Reinsurance has been willing to do so on the terms and conditions required by the LPB.

In 2002-03, only AmRe met the terms required by the LPB – neither Suncorp Metway nor Ace Insurance were able to do so. In 2003-04, only Suncorp Metway and Great Lakes Reinsurance expressed interest in providing cover, and only Great Lakes Reinsurance offered cover that met the terms and conditions required by the LPB. In 2004-05, only two tenders were received – from Great Lakes Reinsurance and AIG. Great Lakes Reinsurance again offered cover that meets the terms and conditions required by the LPB, however AIG's terms do not comply. Suncorp Metway has not offered any terms for approval to the LSB, and neither Ace Insurance, QBE nor Vero expressed interest in providing the primary layer of cover to Victorian barristers.

The LPB has again approved Great Lakes Reinsurance as the insurer of Victorian barristers for 2004-05. However, Great Lakes Reinsurance is not an authorised insurer in Australia, and hence not subject to APRA regulation or the Australian courts. Should it withdraw from the Australian market, it would be significantly more difficult to pursue claims that arise in the future that relate to the period during which it provided cover than if it were an authorised insurer.

The experience of the Bar suggests that the commercial market is unwilling to provide PII cover that is stable, secure and on-going. Clearly, this is not in the interests of consumers.

Reduced search costs for consumers

By ensuring that PII cover is universally available on consistent terms and conditions, the search costs incurred by consumers to find a practitioner with suitable terms and conditions of insurance cover to provide the required services is reduced compared to those likely to be incurred in a competitive market.

Financial stability

The financial stability of the LPLC is enhanced by the fact it is able to make up any shortfall in premiums in a given year in the following year. This is not necessarily the case in the market, given there is no guarantee that an insurer will be able to provide cover in subsequent years.

The financial security of the LPLC is also enhanced by its ability to levy practitioners in the event that it considers its reserves are unlikely to be adequate to meet it liabilities. This also ensures there is no financial risk to the Government arising from the statutory monopoly provision of insurance.

Reduced transaction costs to lawyers

Statutory monopoly provision of PII cover to all Victorian legal practitioners is likely to result in significantly reduced transaction costs for practitioners compared to those likely to be incurred in a competitive market or a commercial monopoly provider.

The experience of the Bar is that significant transaction costs are incurred each year in its tender for the provision of PII. Large amounts of the time of its CEO and several senior barristers are devoted each year to putting the tender to the market, assessment of tenders and liasing with the LPB in relation to the tender. The LPB also incurs significant transaction costs.

While allowing individual practitioners to arrange their own PII cover would reduce the transaction costs incurred by the professional associations compared to market provision, the costs incurred by individual practitioners (and, depending on its role in approving terms and conditions, the LSB) would be significant.

Reduced likelihood of disputes between insurers

Provision of PII insurance by a single statutory provider reduces the likelihood of disputes between insurers (either between successive insurers or between the LPLC and insurers of barristers). When insurance is provided by multiple providers (either at the one time, or over time), there are inevitably disputes about who is responsible for a claim. This incurs significant costs and delays in the handling of claims. While clauses relating to arbitration and mediation of disputes between insurers could be included in minimum terms and conditions of insurance (as is the case in the UK), this imposes additional regulatory costs.

Disputes between insurers can also occur when a firm splits or merges. While under a statutory monopoly there is only one affected insurer, this is often not the case where there are multiple providers. This is an emerging issue in the UK market.

Reduced regulatory costs

Regulatory costs can be reduced through a statutory monopoly provider of PII. While regulation is required to ensure that the monopoly does not abuse its monopoly status, these costs are likely to be less than the significant costs incurred in developing, approving, and enforcing minimum terms of coverage. This is supported by the experience of the LSB in its role in approving the terms and conditions of insurance for the Bar.

Costs

The potential costs associated with provision of the primary level of PII cover to Victorian lawyers through a statutory monopoly are of both a theoretical and a practical nature, and include:

- a reduction in the choice of PII products available to Victorian lawyers;
- reduced incentives for innovation;
- theoretically higher premiums;
- a reduced ability for the insurance provider to spread risk across a range of services provided; and
- less potential for cost reductions due to economies of scope.

Reduction in the choice of PII products

Provision of PII cover through the market could allow practitioners a greater choice of policy terms and conditions and premiums to meet their particular circumstances than is available under the LPLC. However, as discussed above, it is in the interests of consumers that a minimum standard of terms and conditions is met. Ensuring that this occurred would increase regulatory costs (for example, if the LPB was required to approve terms and conditions of a range of policies available). Differences in the terms and conditions of cover is also likely to increase the transaction costs incurred by practitioners in obtaining cover, and consumers in finding a practitioner with appropriate insurance to provide the services required.

Reduced incentives for innovation

In theory, monopoly provision of PII through the LPLC reduces the incentives for innovation in relation to the services offered and their delivery. In this way, the market may be able to deliver a broader range of services or deliver services at lower cost than is the case under the LPLC. However, as discussed above, there appear to be practical reasons why the scope for these outcomes to occur is limited, including the need for regulatory intervention to ensure that minimum terms and conditions of cover are met, and that the LPLC appears to be able to deliver services at a lower cost than would commercial insurers.

Higher premiums

In theory, the absence of competitive pressures is likely to result in increased prices of services. However, practical experience suggests that this is not the case for provision of PII for Victorian legal practitioners (this is discussed in more detail above).

Reduced ability for the insurance provider to spread risk across a range of services provided

Commercial insurers usually offer a range of insurance products (both PII provided to other occupational groups, and the broader range of insurance products provided), which allows them to spread risk across the range of services provided. The LPLC, on the other hand, offers only PII for legal practitioners, and hence has less scope to spread risk across a broad range of services.

Less potential for cost reductions due to economies of scope

That commercial insurers usually offer a range of insurance products also allows them to capture the benefits associated with economies of scope. The scope for the LPLC to reduce costs and provide innovative services through economies of scope is limited by the fact that it providers a much narrower range of services (though, as discussed above, the LPLC may be able to capture some of the benefits of competitive markets by contracting out certain functions). While this may be the case, practical evidence suggests that the costs incurred by the LPLC are low compared to commercial insurers. This is discussed in more detail above.

Net benefit/cost

On balance, it is considered that the provision of the primary level of PII cover to Victorian solicitors and barristers through the statutory monopoly provider, the LPLC, results in a net benefit to society.

Alternatives

The alternatives to providing the primary level of PII cover to Victorian solicitors and barristers through the LPLC can be grouped into four broad alternatives, which can be further broken down into various sub-options, as follows:

1. provision of cover through competing commercial insurers:
    - abolish the LPLC and allow individual practitioners to obtain compulsory PII through private insurance providers;
    - maintain the LPLC but remove its monopoly status and allow practitioners to choose whether to obtain compulsory PII through the LPLC or private insurance providers;
2. provision of cover through a statutory monopoly insurer:
    - maintain the LPLC as the statutory monopoly provider of compulsory PII, and strengthen the provisions relating to the operations and regulatory oversight of the LPLC;
    - maintain the LPLC as the statutory monopoly provider of compulsory PII to solicitors, but maintain current arrangements for PII for barristers (ie. maintain the *status quo*);
3. provision of cover through a commercial monopoly insurer:
    - abolish the LPLC and require practitioners to obtain primary PII through a commercial monopoly insurance provider;
    - abolish the LPLC and require practitioners to obtain primary PII through a managed general agency scheme with two or three providers;
4. provision of cover through a hybrid model:
    - introduce a hybrid model comprising elements of a mutual fund and competitive provision of PII.

Each of these four broad alternatives is discussed in more detail below. In the interests of brevity and to avoid extensive repetition of the discussion relating to the proposed regulatory approach, these alternatives are discussed briefly, with reference to the discussion above where appropriate. Any differences in the benefits and costs of each sub-option are drawn out where relevant.

The magnitude of benefits and costs are discussed relative to the proposed regulatory approach.

Alternative 1: Provision of cover through competing commercial insurers

This alternative could involve either:

- abolishing the LPLC and allowing individual solicitors and barristers to obtain compulsory PII through private insurers; or
- maintaining the LPLC but removing its monopoly status and allowing practitioners to choose whether to obtain compulsory PII through the LPLC or private insurance providers.

Benefits

The main benefits of this alternative relative to the proposed approach are:

- increased choice for consumers of PII;
- increased incentives for innovation; and
- in theory, reduced premiums, and hence prices for legal services to consumers.

However, as discussed previously, these benefits tend to be theoretical in nature, and may not be realised in practice.

Costs

The costs associated with this alternative relative to the proposed approach relate to:

- reduced consumer protection due to the fact the market is unlikely to provide universal cover to all practitioners on the same terms and conditions, and provide an appropriate standard of run-off cover;
- that some lawyers may be unable to obtain insurance, and hence practice law – while this may be appropriate for incompetent practitioners, it is likely some competent practitioners would be unable to obtain affordable cover even though they do not pose a significant risk;

- in practice, increased premiums, and hence prices for legal services to consumers;
- reduced incentives to invest in risk management programs, to the ultimate detriment of consumers;
- reduced transparency of premiums and financial performance (though financial performance of authorised insurers is monitored by APRA);
- increased search costs for consumers to find a practitioner with suitable skills, experience and insurance to provide the required services;
- increased transaction costs for lawyers to arrange cover; and
- potentially increased regulatory costs to the LSB (if it were to have a role in approving minimum terms and conditions of cover).

A potentially significant additional cost associated with allowing practitioners to choose whether to obtain compulsory PII through the LPLC or private insurance providers is that the financial viability of the LPLC is likely to be jeopardised if it was required to provide insurance to those who were unable to obtain insurance from private insurers (that is, if it were an insurer of last resort). This is because commercial insurers are likely to 'cherry pick' low risk practitioners and firms and those who have the capacity to pay high premiums. This would leave the LPLC to insure those who are higher risk or have limited capacity to pay for insurance. As the claims liability associated with these practitioners is not likely to be lower than those insured by the commercial market, it is likely that the financial viability of the LPLC would be jeopardised.

While the fact that the LPLC competes with insurers in other jurisdictions to provide PII for national firms could indicate that a national market for PII is emerging, it is impossible to say at this point in time whether this is the case. Therefore, on balance, this alternative does not appear to be a viable alternative to the proposed approach at this point in time.

Alternative 2: Provision of cover through a statutory monopoly insurer

This alternative would involve maintaining the LPLC as the statutory monopoly provider of compulsory PII and either:

- strengthening the provisions relating to the operations and oversight of the LPLC; or
- requiring that barristers continue to obtain PII cover in the market (ie. maintaining the *status quo*).

As discussed above, there is general agreement that the LPLC has been able to provide high quality PII cover at relatively low cost to Victorian solicitors over an extended period of time. The scheme has built up significant capital reserves, comfortably meeting APRA's minimum capital requirements, which means it is highly likely that it will be able to meet future liabilities. It also takes out reinsurance cover to enable it to meet claims arising from catastrophic events.

However, it could be argued that the proposed regulatory provisions relating to the manner in which the operations of the LPLC are carried out and regulatory oversight of the LPLC could be further strengthened to provide comfort that the LPLC will continue to operate in a manner that results in appropriate outcomes. There was general support among stakeholders, including the LPLC, for this approach.

The State-based provisions do not contain specific requirements relating to the information to be contained in the LPLC's annual report. As discussed previously, the LPLC currently reports extensive information about its operations and financial position in its annual report. Its financial statements are also audited by the Auditor-General. Consideration could be given to specifying the content of the annual report in order to entrench this transparency. This is discussed further below.

Consideration could also be given to diversifying the membership of the LPLC, which currently comprises a majority of members from the profession, to provide reassurance that the LPLC will continue to operate in a manner that results in appropriate outcomes.

Section 54(2) of the State-based provisions requires that at least one member of the LPLC must be a person who has knowledge of or experience in the insurance industry. The provisions contain no other requirements relating to the skills and experience of members of the LPLC. While the LPLC currently has a member who represents consumers of legal services, there is no requirement that it do so under either the Act or the Bill. Reassurance that the interests of consumers are represented could be provided by including a specific statutory requirement that the LPLC contain a member who represents the interests of consumers of legal services. Should the LPLC also become the insurer of Victorian barristers, it may also be desirable to require that one member of the LPLC represent the interests of solicitors and that one member represent the interests of barristers. Given that the LPLC is responsible for management of a significant amount of funds, it may also be appropriate to require that one member have financial knowledge or experience.

As noted in Chapter 4, development of provisions relating to PII is continuing under the National Project. In the interim, it is proposed that PII arrangements in Divisions 1 and 2 of Part 8 of the Act are carried forward to the Bill.

Section 228(5) of the Act requires that:

> In determining premiums and excesses in relation to contracts of professional indemnity insurance, the Liability Committee must take into account the following —
>
> (a) any significant differences in risk attaching to —
> (i) the different types of legal practices of practitioners or firms;
> (ii) the different types of matters handled by practitioners or firms;
> (b) the number of other practitioners employed by practitioners and the number of partners of, and practitioners employed by, firms;
> (c) the need to encourage proper management of risk;
> (d) the past claims records of practitioners or firms;
> (e) the cost and difficulty of differentiating between different classes of legal practitioners and firms;
> (f) whether the amount standing to the credit of the Liability Fund is likely to be sufficient to meet the liabilities to which it is subject.

Inclusion of such a provision in the Bill would help ensure that the LPLC takes into account appropriate considerations when setting premiums. Consideration could also be given to requiring the LPLC to obtain actuarial advice in determining premiums, and disclosing whether, why and the extent to which it adopted that advice, either in its annual report or a report to the body with ultimate responsibility for approving or determining premiums, terms and conditions (discussed further below).

The LPB is required under section 228(4) of the Act to approve the arrangements for, including the terms of contracts of, PII determined by the LPLC, though no guidance is provided on how the LPB is to undertake this approval process. It could also be argued that it is unclear whether the ultimate responsibility for the terms and conditions (including premiums) of PII rests with the LPLC or the LPB. This raises the potential for a 'stalemate' to occur should the LPB and LPLC disagree on the terms and conditions of PII.

This potential could be eliminated by making it clear in the provisions with whom the ultimate responsibility for determining terms and conditions of PII rests – the LPLC, LSB or another party.

Conferring ultimate responsibility on the LPLC has the advantage that the LPLC has the skills, experience and detailed information necessary to determine appropriate terms and conditions. However, the LPLC is not required under the proposed provisions to have regard to the interests of consumers, who are the ultimate beneficiaries of a PII scheme. Further, the current predominance of representatives of the profession on the LPLC at least in theory raises potential for the interests of the profession (in the form of low premiums) to be favoured over the interests of consumers of legal services or the community in general. These concerns could be alleviated by diversifying the membership of the LPLC as discussed above.

If ultimate responsibility for determining terms and conditions were conferred on the LPLC, consideration could be given to amending the provisions relating to the role of the LSB in approving terms and conditions. For example, the LSB could be given the power to 'review' terms and conditions, along with the power to make recommendations to the LPLC. The LPLC could also be required to take any such recommendations into account in determining terms and conditions. To provide transparency, the LSB could be required to publish any recommendations in its annual report, and the LPLC also required to publish these recommendations, along with whether, why and the extent to which it adopted the LSB's recommendations.

Concerns relating to the potential for the interests of the profession to override consumer or public interests could be overcome by conferring the ultimate responsibility for determining terms and conditions on the LSB, which has a legislative objective relating to the protection of consumers of legal services.

As outlined in Chapter 4, it is proposed that the LSB will comprise members of the profession, at least one member with experience in financial or prudential management, and at least one member who represents the interests of consumers of legal services. These requirements, in addition to its ability to seek external advice, provide reassurance that the LSB has access to the range of skills and experience necessary to determine the terms and conditions of PII. Consideration could be given to whether the LSB be required to have one member with prudential experience (rather than financial *or* prudential experience) to further strengthen this assurance.

However, the role of the LPB in approving terms and conditions of PII provided by the LPLC has not been rigorously tested in the past due to the fact that premiums have been adequate to cover the cost of claims without the need for significant changes in premiums from year to year or imposing a levy on practitioners to make up any shortfall.

If ultimate responsibility for determining terms and conditions of PII were to rest with the LSB, consideration could be given to making it explicit in the Bill that the ultimate responsibility for determining terms and conditions rests with the LSB, and providing further guidance on how the LSB is to implement its powers in this respect. For example, the LPLC could be required to recommend terms and conditions (including premiums), and the reasons underlying its recommendation (including whether, why and the extent to which it adopted actuarial advice) to the LSB. The LSB could then be required to make a determination on the terms and conditions of PII and provide reasons for its determination (including whether, why and the extent to which it adopted the LPLC's recommendation).

It could also be made explicit in the Bill that the LSB is able to obtain actuarial, economic, legal or other advice for the purposes of this function. While it would be possible to *require* the LSB to obtain such advice, this may result in unnecessary costs in some years. An alternative approach would be to provide for the LSB to appoint or approve the actuaries to be used by the LPLC, and for actuarial reports to be provided to both the LPLC and LSB. This approach has the advantages that it eliminates the cost associated with the LSB obtaining additional actuarial advice and ensures the LSB has access to appropriate information in making its determination.

While it is current practice that the LPLC provides detailed information to the LPB on the reasons underlying its decision in relation to terms and conditions (including providing copies of actuarial advice received), it does so on a voluntary basis. Enshrining the requirement in the Bill would ensure that this practice continued.

The LSB could also be required to report on its determination of terms and conditions in its annual report, including whether, why and the extent to which it accepted the recommendation of the LPLC on the terms and conditions of PII, the reasons underlying its determination and whether it sought actuarial, economic, legal or other advice for the purposes of its determination.

Ultimate responsibility for determining terms and conditions could also be conferred on the Government, as is the case for both the VWA and the TAC. Under these schemes, the Government has the ultimate power to determine premiums or charges, and the Minister may request the Essential Services Commission to review premiums or charges and provide advice or make recommendations to the Minister in relation to those premiums or charges.

Conferring responsibility for determining terms and conditions on the Minister or the Government would, however, increase scope for political intervention and reduce the independence of the profession from the executive arm of Government. It may also be a time consuming and costly process, which could raise practical problems given that PII is a pre-requisite to obtaining a practising certificate. Further, while in the case of the TAC and VWA the Government bears a risk if a scheme becomes financially unstable, in the case of the LPLC the risk is borne by the profession[8] rather than the Government.

Consideration could also be given to whether requirements relating to the provision of insurance to barristers be made explicit in the provisions of the Bill – for example, whether barristers should be required to be insured through a separate pool in order to reduce scope for cross-subsidisation (or make transparent any cross-subsidisation that would occur). The LPLC has indicated that it would seek to set up a separate pool for barristers.

Benefits

The benefits of the proposed regulatory approach discussed above also apply to this alternative.

Amending the provisions relating to the operations and oversight of the LPLC has some additional benefits compared to the proposed approach in terms of ensuring there are appropriate checks and balances in place to help ensure the LPLC continues to be well managed, has adequate capital reserves to meet the cost of claims, invests funds appropriately, has suitable policy terms and conditions, charges appropriate premiums, operates in transparent manner etc.

On the other hand, the benefits of maintaining the *status quo* are likely to be smaller in magnitude than the proposed regulatory approach due to the exclusion of barristers from the LPLC scheme.

[8] Though this is likely to be passed on, at least in part, to consumers of legal services, who are the ultimate consumers of PII.

Costs

The costs associated with the proposed regulatory approach also apply to this alternative.

However, providing for additional requirements in relation to the operations and oversight of the LPLC is likely to result in some additional regulatory costs compared to the proposed approach (though to the extent that these measures are currently implemented on a voluntary basis these additional costs will be minimised).

Maintaining the *status quo* would also result in additional costs compared to the proposed approach due to:

- reduced consumer protection to the extent that the terms and conditions of cover are lower than those offered by the LPLC;
- transaction costs incurred by the Bar in arranging PII cover for barristers; and
- regulatory costs incurred by the LSB in relation to barristers PII.

On balance, this alternative appears to be a viable alternative to the proposed regulatory approach. Amending the provisions relating to the operations and oversight of the LPLC is likely to result in greater net benefits than the proposed regulatory approach. However, the net benefits of maintaining the *status quo* are likely to be of a lower magnitude than those of the proposed regulatory approach.

Alternative 3: Provision of cover through a commercial monopoly insurance provider

This alternative would involve abolishing the LPLC and requiring practitioners to obtain primary PII cover through either:

- a commercial monopoly insurance provider; or
- a managed general agency scheme with two or three providers.

Benefits

The main benefit of this alternative compared to the proposed regulatory approach is that it would remove the costs associated with the existence of the LPLC, including operational, overhead and regulatory costs.

It would also provide increased scope for the insurance provider/s to spread risk across a range of services provided, and for cost reductions due to economies of scope.

Requiring practitioners to obtain primary PII cover through a managed general agency scheme with two or three providers would also offer the additional benefits of:

- increased choice for consumers of PII; and
- increased incentives for innovation.

Costs

The costs associated with this alternative include:

- increased costs of providing services, due to the fact that a commercial insurer is required to make a profit, and the costs associated with outsourcing to the market and assessing premiums for individual practitioners and firms;
- reduced consumer protection if terms and conditions are reduced relative to those provided by the LPLC;
- in practice, increased premiums, and hence prices for legal services to consumers;
- limited incentives to invest in risk management activities given there is no guarantee that insurers will provide cover in the future, to the ultimate detriment of consumers;
- increased transaction costs associated with the tender process;
- increased regulatory costs associated with approval of the winning tender, oversight and monitoring of the incumbent insurer, and ensuring minimum terms and conditions are met;
- the likely short-term focus of commercial providers who have no guarantee that they will provide cover in the future;

- the limited number of firms in the market for PII has potential to limit any benefits associated with a competitive tender process;
- the commercial disincentive to disclose information relating to claims history etc, which may reduce the number of firms willing to provide insurance due to the limited nature of the information available to assess risks;
- reduced transparency of premiums and financial performance (though financial performance of authorised insurers is monitored by APRA);
- increased likelihood of disputes between successive insurers; and
- where the insurance provider is not an authorised insurer in Australia (and hence not subject to APRA regulation) increased transaction costs associated with ensuring they have sufficient financial standing to provide cover, and potential problems which may arise if they cease to provide cover and it becomes necessary to seek redress for subsequent claims.

An additional cost associated with the provision of PII through a commercial monopoly insurance provider is the uncertainty about whether the incumbent will withdraw from the market – decisions to provide PII are often driven by profit considerations, and there have been a number of firms withdraw from the market in recent years.

Requiring practitioners to obtain primary PII cover through a managed general agency scheme with two or three providers would also result in increased transaction costs for lawyers to arrange cover.

In summary, the benefits of this alternative are likely to be significantly less and the costs significantly greater than those associated with the proposed regulatory approach.

Alternative 4: Provision of cover through a hybrid model

This alternative involves provision of a base level of cover through a mutual fund, with the balance of cover provided through a commercial insurer/s acting in conjunction. Such a model has been adopted in South

Australia and Western Australia. In South Australia, solicitors and barristers are covered by a scheme providing cover partly from a mutual fund (up to $200,000), with the balance of cover provided through a master policy negotiated by the Law Society with commercial insurers (up to $750,000). In Western Australia, while the Act does not stipulate the form of insurance scheme, under current regulations practitioners must be insured under an arrangement between the Law Society and one or more commercial insurers. Currently, the first $100,000 of cover is provided through a mutual fund and the balance (up to $1.5 million) is provided through a master policy negotiated by the Law Society with commercial insurers.

Benefits

The mutual fund component of this alternative could confer many of the advantages associated with a statutory monopoly insurer, in particular lower and more stable premiums, lower administrative costs, increased transparency, increased incentives for risk management, improved consumer protection and financial stability. However, it is likely that these advantages would be of a lesser magnitude than those associated with a statutory monopoly, largely due to the fact that only a base level of cover is provided through the mutual fund.

The commercial component of this alternative could confer similar advantages to those of Alternative 3 (Provision of cover through a commercial monopoly insurance provider). These benefits include increased scope for the insurance provider/s to spread risk across a range of services, and for economies of scope. Multiple commercial insurers would have the additional benefits of increased choice for consumers of PII and increased incentives for innovation.

Costs

The practical costs of this alternative would also be likely to be similar to those for Alternative 3 – that is, increased costs of providing services, potentially higher and less stable premiums, reduced consumer protection (if commercial terms and conditions of cover are lower), increased regulatory costs, reduced transparency and increased likelihood of disputes between insurers. It would also be likely to incur greater administrative costs, due to the fact that both the costs associated with the mutual fund and those associated with the tender process to arrange the commercial component of the cover would be incurred, and because for claims which exceed the level of cover provided through the mutual fund, it would be necessary for both insurers to be involved in the claims handling process.

In summary, this alternative does not capture the full extent of the benefits of the proposed regulatory approach, and is likely to incur significant costs compared to the proposed approach.

Recommendation

After considering the benefits and costs of the proposed regulatory approach and alternatives, it is recommended that, at this point in time, the LPLC be maintained as the statutory monopoly provider of compulsory PII for Victorian solicitors, and that the LPLC also be the statutory monopoly provider of compulsory PII for Victorian barristers.

However, it is recommended that consideration be given to whether the provisions relating to the operations and regulatory oversight of the LPLC should be strengthened to ensure that appropriate legislative arrangements are in place to help ensure the LPLC continues to perform its legislative functions in an appropriate manner and that appropriate outcomes are achieved.

It is considered that this approach best achieves an appropriate balance between providing adequate consumer protection and ensuring stable and affordable PII cover for legal practitioners, while minimising any potential costs associated with a statutory monopoly insurance provider.

The Government should monitor changes in the market for PII insurance for other occupations, and for lawyers in other jurisdictions, arising from the introduction of professional standards legislation and other developments to determine whether the recommended approach continues to be the most appropriate approach in the future.

Summary

Restriction on competition	**Benefits**	**Costs**	**Recommendation**
Monopoly provision of primary PII cover for all Victorian legal practitioners by the LPLC	• High quality, comprehensive cover • Universal cover • Lower, more stable premiums • Availability of run-off cover • Lower administrative and management costs • Increased transparency of premiums and financial performance • Improved information from which to assess risks and inform risk management requirements • Increased incentives to invest in risk management programs • Improved consumer protection due to: – universal coverage on the same terms and conditions – guaranteed provision of runoff cover • Reduced search costs for consumers • Financial stability • Reduced transaction costs to lawyers • Reduced likelihood of disputes between insurers • Reduced regulatory costs associated with ensuring minimum terms and conditions of cover are met	• Reduction in the choice of PII products available • Reduced incentives for innovation • Higher premiums (in theory) • Reduced ability to spread risk across a range of services provided • Less potential for cost reductions due to economies of scope	It is recommended that, at this point in time, the LPLC be maintained as the statutory monopoly provider of compulsory PII for Victorian solicitors, and that the LPLC also be the statutory monopoly provider of compulsory PII for Victorian barristers. However, it is recommended that consideration be given to whether the provisions relating to the operations and regulatory oversight of the LPLC should be strengthened to ensure that appropriate legislative arrangements are in place to help ensure the LPLC continues to perform its legislative functions in an appropriate manner and that appropriate outcomes are achieved. The Government should monitor changes in the market for PII insurance for other occupations, and for lawyers in other jurisdictions, arising from the introduction of professional standards legislation and other developments to determine whether the recommended approach continues to be the most appropriate approach in the future.