Law Mutual (WA)®

Changes to the Law Mutual Insurance Arrangements

2021-2022 Insurance Year

November 2020

IMPORTANT NOTICE

As we have indicated in previous correspondence, from the 2021-2022 Insurance Year, there will be significant changes to the way Law Mutual calculates the Annual Contribution (commonly known as 'the premium') and the Insured's Contribution (commonly known as 'the excess') payable by insured practices.

A summary of the changes and reasons for them is set in this document.

Changes to the Law Mutual Insurance Arrangements – 2021-2022 Insurance Year

Background to the Insurance Arrangements

1. In the 2020/2021 insurance year, the Law Mutual insurance arrangements cover more than 1130 practices comprised of approximately 3000 practitioners.

Cost of the Insurance Arrangements

2. The expected total cost of providing the insurance arrangements each year is calculated by reference to three areas of expected expenditure:
   i. The expected cost of claims for that insurance year (in present day dollar value) as calculated by an actuary for the layer of cover paid from the Law Mutual Fund (in 2020/2021 this was up to $250k/claim to an aggregate maximum of $6m);
   ii. The premiums charged by insurers to provide cover above the Law Mutual layer up to $2m for each claim and additional aggregate cover for the Law Mutual layer in 2020/2021 this was $5m); and
   iii. The budgeted operational costs of Law Mutual for each year.
3. These costs must be collected from all insured practices.

Rating Methodology

4. Law Mutual utilises a published (in the Annual Information Booklet) rating methodology to collect the required funds. At an insured practice level, the amount to be collected is referred to as “the annual contribution”. Up to and including the 2020/2021 insurance year, the primary rating factor in the methodology was the practitioner count for each insured practice split into two types:
   i. Principals (Partners and legal practitioner Directors) – one rate whether full or part time (‘the Principal rate’)
   ii. Employed practitioners – charged at up to 50% of the Principal rate, depending on number of hours worked/week.
5. Other rating factors were:
   i. Number of General Employees (full time and part time – 8.5% and 4.25% of Principal rate respectively)
   ii. Discounts –
      i. Low Fee Earners (ranging from 10% to 90% of Principal rate according to Gross Fee Income (‘GFI’) band up to $100k)
      ii. Criminal Law Practices (30% of the annual contribution)
      iii. No Claims Discount referred to as ‘NCD’ (10% on Principal rate only)
      iv. Quality Practice Standard (‘QPS’) accredited (5% of base annual contribution)
      v. Risk Management training (5% of base annual contribution)
   iii. Claims Loading up to 50% of base annual contribution calculated on a formula of amount of claim paid divided by annual contribution paid
6. In addition, a relatively small ($100) Administration Levy is charged at a per practitioner level.
7. As can be deduced from the above, it is the Principal rate that determines the other rates to charged. Prior to setting

the Principal rate before each insurance year, Law Mutual can estimate, with a high degree of accuracy, the expected number of Principals, employed practitioners and General Employees, and expected amounts of discounts and loadings for the insurance year.

8. Having estimated these numbers, a theoretical Principal rate is calculated that will result in a total collection of the required amount to meet the expected expenditures. There is no allowance for any profit or loss.

9. However, before finalising a Principal rate, Law Mutual makes a further allowance for two factors:

   i. The investment income it is likely to earn on its prudential capital for the preceding year; and

   ii. The need, if any, to increase its prudential capital holdings to ensure its ongoing viability or, alternatively, the ability to release funds that are surplus to its prudential capital requirements.

   For example, for the 2020/2021 insurance year, it was determined that expected investment income and a release of some surplus funds would reduce the amount required to be collected, allowing for a reduction in the Principal rate of over 18%.

10. The above rating methodology has been utilised by Law Mutual, subject to minor variations, for over twenty years. Most importantly:

    i. it all but ensures that the amount collected will be sufficient to meet expected expenditures; and

    ii. it spreads the cost burden of all the local profession's professional indemnity claims' costs amongst all insured practices on a basis that is affordable for all. This is often referred to as 'community-based pricing'.

Shortcomings of Current Rating Methodology

11. While community-based pricing ensures that all practitioners that are qualified to practice (as determined by the regulator) can afford to practice and meet the obligation to have PI insurance, it is important to ensure that the pricing (or rating) at an insured practice level reflects that community as it changes from time to time.

12. The nature of legal practice and the type of law practices covered under the insurance arrangements have changed in recent years. The most substantial of these changes are:

    i. The number of larger law practices covered by the insurance arrangements has significantly reduced as they have become part of national law practices that are insured elsewhere

    ii. The significant and increasing use of Incorporated Legal Practices (ILPs) with fewer Principals i.e. less legal practitioner Directors than former Partners

    iii. The development of (relatively) high fee earning personal injuries practices with few Principals and relatively larger numbers of employed practitioners and para legals.

13. These changes have resulted in some law practices with relatively larger numbers of Principals paying a disproportionate amount relative to the amount paid out for any claims they may make. For example, over the last 5 insurance years*, the overall gross loss ratio** for practices with more than 9 Principals was 29% compared with 90% for practices with one Principal.

14. This imbalance is amplified as these larger practices pay a higher 'excess' for any claim as the primary basis for calculating the excess is the number of Principals (currently $5k/Principal to a maximum of $75k***) without receiving any relief from the amount they pay for cover (the amount paid for cover is known as 'the annual contribution' but more commonly referred to in the insurance context as 'the premium').

* 1st July 2014 to 30th June 2019

** claims incurred (paid and reserved) as a percentage of annual contributions

****the maximum is both per claim and in the aggregate. A few very large practices may qualify for an even higher excess and associated premium relief*

15. There is also an increasing use of 'para-legals' and other types of employees in carrying out substantive legal work, albeit under the supervision of legal practitioners.

16. Insured practices that have certain broad similarities yet very different business models currently bear the same cost burden of the portfolio's risk of claims despite a disparate ability to pay for cover. For example, a generalist regional Sole Practitioner earning $100k of GFI is paying the same premium as a specialist city Sole Practitioner earning $1m or more of GFI.

Pricing Policy

17. Law Mutual is subject to a Pricing Policy that documents its commitments and expectations in relation to the pricing of the insurance arrangements for insured practices. As part of this Policy, Law Mutual is to ensure that the pricing of the insurance arrangements (as evidenced by the Annual Contribution and Administration Levy) is:

    - fair and equitable;
    - competitive (compared to similar schemes);
    - stable and sustainable;
    - transparent (to stakeholders); and
    - designed to encourage "good behaviour".

18. In view of the matters set out above, it has become clear that the current methodology for pricing may not be fair and equitable. It is also arguable that it gives rise to premiums (annual contributions) for larger law practices that may inhibit their competitive position against similar sized law practices in other jurisdictions.

Gross Fee Income Rating

19. The Law Mutual Professional Indemnity Insurance Management Committee (the PIIMC) that oversees the making of the insurance arrangement on behalf of the Council of the Law Society, reviewed other rating methodologies that will give rise to a fairer and more equitable allocation of premiums across insured practices. It identified that utilising gross fee income (GFI) of a practice as the primary rating factor enables a preferable allocation.

20. It is generally accepted by the commercial insurance market that GFI is the best primary indicator of the exposure to the risk of a professional indemnity claim.

21. Our current actuaries, Finity, have undertaken analysis of legal profession PI portfolios and concluded that there is a much clearer correlation between claims costs and GFI, than between claims costs and practitioner headcount.

22. Basically, the higher the GFI, the more likely there will be a claim. However, and importantly, the chance of a claim will be less for each incremental amount of GFI.

23. GFI rating allows the insurer to reflect levels of risk in the rating by, in the case of legal practices, adopting lower rating factors for higher GFI bands. In this way the lower risk profile of larger practices is reflected in the lower "price" they will pay for incremental amounts of GFI.

24. GFI is utilised as the primary rating factor by several legal profession insurers in Australia including Lawcover in NSW, Lexon in Queensland and the LPLC in Victoria. It is also utilised by commercial PI insurers that offer top-up cover to law practices throughout Australia. Law Mutual currently utilises a GFI rating factor in assessing the level of discount for Low Fee Earners.

25. The GFI figure used for rating purposes is usually either (or both of) the previous financial or calendar year (a known and auditable amount), or the upcoming financial or calendar year (an estimated amount).

26. Based on the PIIMC's recommendation, the Council determined in November 2018 that GFI will be used as the primary rating factor for the 2021/2022 insurance year and thereafter.

27. The relevant GFI figure for previously insured practices will be the previous calendar year's GFI i.e. for the 2021/2022 insurance year it will be the GFI invoiced or receipted (as usually accounted for in a law practice's ATO returns) for the period 1 January 2020 to 31 December 2020.

28. New practices will be required to provide

an estimate of GFI for their initial 12 months of trading.

29. It is important to note that the total amount of premium Law Mutual will seek to collect from all insured practices (the premium pool) will be the same as under the current rating method, all other things being equal.

Insured's Contribution

30. The Insured's Contribution is the amount of damages the insured practice must pay towards each claim. This is usually known as the 'excess' or 'deductible' on an insurance policy.

31. The current methodology for calculating an Insured's Contribution is:

- $7,500 for a sole practitioner; or
- $5,000 per each partner/director (to a maximum of $75,000)

based on the number of principals in the insured practiced at the time the work that gave rise to the claim was undertaken.

There is a maximum amount payable in respect of all claims in an insurance year being five times the single claim amount or $375,000, whichever is the lower. Further, the amount may be varied according to the particular circumstances of the claim or where the insured practice is considered to be high risk (in limited circumstances).

32. An excess is usually based on the insured's willingness to assume that level of risk and to be provided with some premium relief for paying a greater excess. This involves a consideration of the insured's capacity to pay the excess. Clearly that does not happen under the current methodology.

33. The methodology for calculating the Insured's Contribution will be changed to relate directly to the GFI band of the insured practice.

34. Each GFI band will have a different Insured's Contribution, ranging from $7,500 to $55,000, with a maximum aggregate in any insurance year of $275,000.

Claims against ceased practices will be subject to an Insured's Contribution equivalent to the formerly insured practice's Insured Contribution level at the time it was last covered under the insurance arrangements.

35. Insured practices with GFI above $25M will have the option to take up a higher Insured's Contribution and receive a discount on their base annual contribution.

36. This methodology takes into account the insured practice's ability to pay at the time of the claim and the reduced cost to the insurance arrangements of higher levels of insured's contribution; the latter being reflected in the rate for the higher GFI bands.

37. The current 'penalty' increases in the Insured's Contribution for certain types of claims will not change.

Comparative Annual Contributions

38. The table below shows the intended GFI Banding and Insured Contributions for each band together with indicative marginal rates for each band.

GFI Band ($)	Marginal rate (Indicative)	Insured's Contribution ($)
0 - 50k	5.18%	7,500
>50k - 100k	4.40%	7,500
>100k - 250k	1.08%	7,500
>250k – 500k	1.03%	7,500
>500k – 2M	0.98%	10,000
>2M – 5M	0.93%	15,000
>5M – 10M	0.73%	25,000
>10M	0.45%	55,000

Note: there will be a small fixed charge added to all premiums.

39. As stated, the marginal rates above are indicative only; the actual rates for 2021/2022 will not be determined until February 2021 when the total expected costs of the insurance arrangements for the 2021/2022 insurance year are known.

40. The marginal rating methodology works in a similar way to income taxation, except that the marginal rate decreases as revenue (GFI) increases.

41. An example calculation of an insured practice's indicative base annual contribution is set out below.

Insured Practice's GFI for the 2021 Calendar year was $175,000. Its base annual contribution would be:

$2,590 (50,000 x 5.18%), plus

$2,200 (50,000 x 4.40%), plus

$810 (75,000 x 1.08%), plus

$370 (fixed charge)

Total = $5970 (excl GST)

Note: this would then be adjusted by any applicable discounts, loadings, and capping or cupping as set out below.

Discounts and Loadings

42. The Council, on the recommendation of the PIIMC, has also determined that it will simplify the discounts and loadings applied to the base annual contribution (i.e. the annual contribution before any discounts or loadings are applied). The reasons for this and details of changes are set out below.

    i. Discounts –

        i. Low Fee Earners – there will be no separate category of Low Fee Earners as these sole practitioner practices will be assessed under the lower GFI bands

        ii. Criminal Law Practices will continue to receive a 30% discount on base annual contribution.

        iii. The NCD will be discontinued. See the explanation below under Loadings.

        iv. QPS accredited practices will continue to receive a 5% discount on base annual contribution (7% in their first year of accreditation)

        v. Risk Management training qualifying practices will continue to receive a 5% discount on base annual contribution

    ii. Loadings

        Annual Contributions are currently adjusted by two factors relating to claims experience being:

        - Loss of the 10% NCD in certain circumstances; and
        - A Claims Loading when payments made to settle a claim result in a "loss ratio" above 100%

43. The loss of a NCD is a factor usually found in motor vehicle insurance. It is applied when the insured is at fault in an accident. It is not an appropriate rating factor for professional indemnity insurance.

44. A claims loading, which is currently applied in addition to the NCD (thus creating a version of double jeopardy for an insured), is a well-established insurance rating factor but not appropriately focused at present.

45. A claims loading should be targeted to "penalise" insureds who, over a period of time, incur claims of sufficient frequency or severity such that they should contribute more to the "premium pool" than a generic annual contribution. An insured should not be penalised for suffering one PI claim that creates a single year loss ratio above 100% when it may have been paying insurance premiums for several years.

46. A fairer and more focused claims loading is one based on a "rolling" 5 year loss ratio where the amount of the loading will vary according to the size of the loss ratio. This is the usual way in which professional indemnity insurers will price the additional risk of an insured with a poor claims' history.

47. Accordingly, a claims loading based on an insured practice's rolling 5-year loss ratio will be adopted. The loss ratio will be calculated by dividing the total amount of defence costs and damages incurred on relevant claims by the total annual contribution paid, for the previous five completed insurance years, subject to:

    i. Minimum of two claims that include an incurred amount for damages

    ii. applied minimum annual contribution ($20k) and ($100k) over 5 years;

    iii. applied maximum percentage (75%) of damages reserved (and 100% of paid)

    The 'incurred' amount is both the paid and reserved amounts applicable to a claim.

    "Relevant' claims do not include claims where:

- the incurred amount is only in respect of defence costs; or
- it is determined that the insured has no liability to pay damages, but an allowance is made for damages to settle the claim for nuisance value
- Law Mutual determines, in exceptional circumstances and in its absolute discretion, that the claim will not be included in the loss ratio calculation.

48. The amount of the claims loading will range from 20% for a 100% loss ratio to 50% for a 300% or greater loss ratio.
49. This type of loading will also encourage insured practices that suffer a claim to adopt better risk management to avoid further claims and avoid the financial penalty of a loading.
50. The "high frequency, high severity" (minimum 3 claims, greater than 300% loss ratio) possible loadings on both the annual contribution and the excess will continue to apply.
51. For the purposes of the calculation, the minimum annual contribution of $100k will be applicable to insured practices that have less than 5 years insurance history.

Other Considerations and Changes

Capping and Cupping

52. To reduce the impact on annual contributions payable due to the change in the rating methodology, it is intended that capping (on increases) and cupping (on decreases) will be applied for the first three years of the changed rating methodology so that the amount payable for the annual contribution (not including discounts and loadings), all other things being equal, will be an increase or decrease of no more than 20% on what it would have been under the rating methodology applicable to the previous year.
53. As capping and cupping will not be applied in the fourth year, all practices will then be charged the technical premium applicable to their level of GFI and any applicable discounts and loadings.

Administration Levies

54. A separate Administration Levy will no longer be payable with an Annual Contribution. This is consistent with moving away from charging based on practitioner numbers and will simplify calculations and documentation. However, a levy may be charged in certain circumstances, such as payment of a pro-rated Annual Contribution in respect of coverage for part only of the insurance year.

Low Fee Earners

55. The Low Fee Earner classification will be removed as there is no need for it under a GFI primary rating factor methodology. These insured practices will be rated according to their GFI, much as they are at present.

Other

56. There will be financial and administrative benefits as there will be no mid-term applications and additional payments for employing practitioners or 'upgrades' in status.
57. However, it will remain an obligation to inform Law Mutual (and the Legal Practice Board) of practitioners joining or leaving the law practice or a change in status of existing practitioners.

Please Note: *The changes outlined above are correct at the time of publication. However, there may be some alterations required for operational reasons prior to implementation of the changes for the 2021/2022 insurance year. Law Mutual will keep you informed of any alterations. An up to date copy of this Booklet will be available on the Law Mutual website.*

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