

What's new for 2011?

Quick summary:

- The base premium will be \$3,350.
- No special levy is required to cover the \$10 million HST impact on past claims
- The age restriction of 65 years will be removed from Exemption (c) Temporary Leave of Absence

No special levy to cover HST impact on past claims

LAWPRO has stated that the Law Society does not need to proceed with the proposed \$450 per lawyer special levy to address the extra \$10 million liability that the HST added to claims costs.

Due to the timing of substantive enactment of the legislation, the required \$10 million for the HST-related one-time reassessment of existing claims reserve liabilities automatically flowed to LAWPRO from the Law Society's E&O Fund at the end of 2009, in accordance with agreements between the Law Society and LAWPRO in place at that time. Thus, the levy will not be required.

Premiums set at \$3,350 per lawyer

The base premium will be \$3,350 in 2011, up from \$2,950 in 2010. Factors that contributed to this decision include:

- Record-level claims costs over recent years
- Continuing weak investment returns
- Decline in the discount rate
- Impact of the harmonized sales tax (HST)
- Depletion of the Premium Stabilization Fund
- Need to maintain minimum capital ratio at a prudent level

RIISING COST OF CLAIMS

Claims costs represent about 80 per cent of LAWPRO's revenue requirements. As LAWPRO has said repeatedly in the past year, claims in the primary professional liability program are now costing LAWPRO more than \$80 million a year.

For the first five years of the past decade, annual claims costs hovered in the \$55 to \$60 million range. But for 2007, 2008 and 2009, we are projecting total losses in the range of \$83 million to \$91 million per annum.

The current trend is no different: Claims numbers reported to date for 2010 are consistent with the higher numbers seen over the past few years. We expect claims costs to be in the \$89 million range for 2011.

Why are claims costs up so much? In summary, because there are more lawyers, lawyers are reporting more claims, and the claims are becoming more complex and expensive.

Number of lawyers: Between 2000 and 2010, the number of lawyers in private practice increased 28 per cent to about 22,200 from about 17,400 – that's 4,803 more lawyers in practice.

Number of claims: Lawyers reported 2,272 new claims in 2009. That's 4.5 per cent (100 claims) more than the 2,175 claims reported in 2008, and 27 per cent higher than 1,788 claims reported in 2000. At this point, it appears the ultimate claims numbers for 2010 will be consistent with 2009.

Claims frequency is up: Claims frequency – the number of claims reported per 1,000 lawyers – is up to 103.1 in 2009 from a low of 90 in 2005. In other words, there are 13 more claims for every 1,000 lawyers in practice than there were five years ago.

Cost per claim is up: The average cost per claim file has increased from a low of \$24,000 in 2001 to \$39,000 in 2007 – a 62 per cent increase.

More large claims are being reported: Claims that cost the program \$100,000 or more increased by 66 per cent between 2000 and 2007. The biggest increase has been in claims in the \$100,000 to \$500,000 range. Results for 2008 and 2009 indicate that this trend is continuing.

For more on the rising number and cost of claims, see "E&O claims: The trend is up," LAWPRO Magazine, May/June 2010 (www.practicepro.ca/LAWPROmag/EO_trends.pdf). See also "Why be concerned about what's happening with claims?"

CONTINUING WEAK INVESTMENT RETURNS

LAWPRO benefited from a strong investment market that in 2007, for example, generated more than \$27 million in investment income for the company. In the current economic climate, we're not likely to see results like that for some time: Equity markets are stabilizing but generally at lower levels; and rates of return on

fixed income securities have dropped significantly. We expect interest and investment income to continue to be lower than it was in past years. For 2011, for example, we are projecting investment income to be about \$18 million. This means LAWPRO has less investment income to help pay operating and claims expenses.

LAWPRO has always taken a prudent approach to its investment portfolio. About 90 per cent of our portfolio is invested in fixed-income securities, and about 10 per cent in equities and other investments. The very low Bank of Canada rate of 0.25 to 1.0 per cent (as of the most recent increase on Sept. 8, 2010) has resulted in lower interest rates overall, so that conservative investments of the type we tend to own generate lower returns than in the past.

DECLINE IN THE DISCOUNT RATE

The discount rate is the interest rate used to find the present value of an amount to be paid in the future. LAWPRO needs to set aside – or make provision for – an amount of money now that will be sufficient to meet our claims liabilities in the future. If the discount rate is high, we don't need to set aside as much money for this purpose. If the discount rate is low, we need to set aside more money.

The large drop in recent years in central bank rates caused a significant decrease in our claims provision discount rate. This resulted in a \$7 million increase in claims liabilities in 2009.

The Bank of Canada rate has started to rise again. But continuing low interest rates require us to set aside bigger claims reserves, as the investments we buy now are still at lower interest rates than the ones purchased in previous years that are maturing.

IMPACT OF HST

The introduction of the HST affected the insurance program in three principal ways:

1. It increased our costs for rent, utilities, consulting work and general services that previously were only subject to the five per cent GST but are now subject to the 13 per cent HST – i.e., costing us eight per cent more. We estimate that the HST will increase our annual program administration expenses by about \$250,000.
2. More significant was its impact on claims costs – specifically on legal fees we pay defence counsel and on claimants' legal and other consulting fees that factor into indemnity payments made by LAWPRO. We estimate that the HST will add \$3.2 million to our claims costs in 2010.
3. It affected the amount we need for our reserves for reported but unresolved claims. For example, we estimated that because of the HST an additional \$10.2 million would be needed to pay our pre-existing claims that remained open as at July 1, 2010.

Based on current claims trends, we expect the HST to add \$3 million or more to claims costs each year. This added cost will be factored into the total claims costs projected for each year and the base premium will reflect this overall higher claims cost.

DEPLETION OF THE PREMIUM STABILIZATION FUND (PSF)

A sub-fund of the Law Society's Errors & Omissions Insurance Fund (E&O Fund), the PSF was created in 1999 to help guard against any future shortfall in transaction levy receipts. It

has also acted as a buffer against the need for increases in base premiums.

Money in this fund came from two sources: (1) revenues from transaction levies and claims history surcharges that were in excess of what LAWPRO had forecasted during the planning process and (2) a "refund of premium" provision by which any surplus in funds resulting from claims costs from prior fund years being lower than budgeted transferred to the fund for future insurance purposes.

Transaction levies have trended downwards, largely the result of the widespread use of title insurance in real estate transactions (title-insured transactions usually do not attract the \$65 real estate levy surcharge when the lawyer is acting for the purchaser and lender), and more recently of lower economic activity. At the same time, claims costs have been steadily rising.

Years in which base premium and transaction levy revenues declined significantly while claims costs increased required LAWPRO to draw funds from the PSF to offset the shortfall. Between 2000 and 2008, for example, we drew close to \$30 million from the PSF.

The PSF has now been completely depleted. The balance in the fund stands at \$0.

In September 2009, Convocation of the Law Society agreed that LAWPRO should now retain any positive developments from past years in the company. Therefore, the PSF will not likely grow again.

However, the E&O Fund will contribute \$2.5 million to LAWPRO for 2011, representing about \$110 per insured lawyer.

MINIMUM CAPITAL TEST

As a licensed insurance company, LAWPRO must prove to its regulator, the Financial Services Commission of Ontario (FSCO), that LAWPRO is viable and meets prescribed solvency tests.

The most important of these tests is the Minimum Capital Test (MCT). The MCT is the ratio of the company's available capital (net assets) to the amount of capital required, expressed as a percentage.

The capital required is a defined calculation set by FSCO that takes into account, among other things, an insurer's claims reserves (i.e., its unpaid claims).

FSCO requires LAWPRO to have a minimum MCT of 150 per cent. That is, at an absolute minimum we need \$1.50 in net assets for every \$1 in capital requirements. If LAWPRO fell below this minimum, it would be placed under close FSCO supervision. But even an MCT around 200 per cent, while above the minimum threshold, might not provide LAWPRO with sufficient capacity to absorb unexpected losses or weather deteriorating market conditions that lead to poorer than expected investment returns.

As of June 2010, LAWPRO MCT stood at 186 per cent – a significant decline from 206 per cent at the end of 2009. A major factor contributing to this decline: claims for previous years are costing more to resolve than had been anticipated, driving up the amount of capital that the regulator requires LAWPRO to have.

Sound fiscal planning dictates that LAWPRO move towards an MCT that ensures the long-term stability of the company –

somewhere, it is believed, in the 220 to 230 per cent range – over the next five years. And to do so, the company needs to budget for a profit of about \$5 million to \$7 million annually.

At a 220 per cent MCT, LawPRO would still be below the levels of other comparable insurance companies – such as commercial insurers whose MCT, for example, often exceeds 300 per cent. So this target MCT range for LawPRO seems entirely reasonable and fiscally responsible.

The question is: How do we get to this 220 – 230 per cent level?

We need to increase the amount of capital available, either by generating more net income (revenues exceed expenses) or by increasing the value of the company's surplus investment portfolio – extremely difficult to do in today's economy over which, of course, we have no control.

That leaves us with only one option: To increase net income. How do we increase net income? We must either bring down claims costs – and this is not happening – or increase insurance premiums.

Hence the need for the \$400 premium increase. We need to increase premiums not only because claims costs are high, but also because we need to move in the direction of a sound, stable MCT ratio – one that strengthens the long-term viability of the insurance program and ensures that it continues to benefit the whole of the practising bar.

For more on the importance of a healthy and stable MCT, see "Insurance Biz 101: Why profit is not always a bad word," LawPRO Magazine, September 2010 (www.practicepro.ca/LAWPROMag/InsuranceBizProfit.pdf).

Age restriction removed

Under Exemption (c) category, lawyers on a temporary leave of absence from practice are eligible for exemption from the payment of the insurance premium levies, provided the absence is not more than five years if taken for reasons of family or illness, or two years if taken for any other reason.

Under this form of exemption, lawyers are provided with \$1 million per claim/\$2 million aggregate limit protection without making premium payments. This contrasts with the usual \$250,000 per claim/aggregate limit protection offered under most other forms of exemption.

At present, this exemption is said not to apply if the lawyer is 65 years of age or older or has taken alternative employment.

The age restriction will be removed in 2011.

Have you considered Excess insurance?

Why should you consider buying Excess insurance this year? Consider these facts:

- One out of every two lawyers who read this article will report a claim or potential claim against them in their career. Of these, one in 100 claims will top the \$500,000 mark.
- Think you're immune to claims because you're an experienced lawyer? Think again: 67 per cent of lawyers who reported a claim or potential claim had 15 years of experience or more. In other words, of the 11,500 claims reported in the past five years, 7,500 were reported by experienced lawyers.

Traditionally, lawyers begin to take on more complex cases with more experience which increases chances of a claim. Lawyers also take on greater workloads and enter into fields they might not have much experience in, such as dabbling in real estate or corporate law. This increases the likelihood of mistakes.

- Further, keep in mind the work of your partners, associates and employed lawyers, which can potentially expose you to a claim. While you might be diligent, your associates might make a mistake. You could be personally liable for any costs

over and above the \$1 million per claim provided by the primary liability insurance program.

With claims costs on the rise (\$1 million isn't nearly as much as it used to be,) the time may be right for you to consider purchasing Excess insurance. It only takes one claim to seriously dent your coverage limits, and Excess insurance acts as a backstop should you top out on your mandatory plan.

Applying for Excess insurance is easy: Contact our Customer Service department at (416) 598-5899 or 1-800-410-1013 or email at service@lawpro.ca and ask about our Excess insurance policy. They will send you a no obligation quote. If you chose to increase your coverage limits, you need only apply once. Your Excess insurance is automatically renewed each year and no extra paperwork is involved.

Placing your Excess coverage with LawPRO also simplifies your reporting obligations if you have to report a claim: You report only once – as your primary and Excess insurer are one and the same.

The comfort of knowing you're covered is priceless. Call LawPRO today to get your no obligation quote.