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# Assessment of the current regulations of the provision of PII to barristers

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Bar Standards Board

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## Executive summary

### Context

The Bar Standards Board (BSB) has asked Oxera to undertake an economic analysis of the current regulatory restrictions in the provision of professional indemnity insurance (PII) to barristers, in the context of the thematic review by the Legal Services Board (LSB) on the provision of PII to legal service providers in England and Wales. This analysis will inform the BSB's consideration of regulations on the choice of insurer for single person entities (SPEs), and for self-employed barristers. In particular, the BSB is considering: 1) whether self-employed barristers should continue to be obliged to take their primary cover from Bar Mutual Indemnity Fund (BMIF) or if private provision should be allowed; and 2) whether SPEs should be obliged to take their primary layer of cover from BMIF in a similar way to self-employed barristers.

### Summary of analysis and conclusions

In this context, this report assesses the costs and benefits of the current model of provision of PII to barristers through BMIF and the likely impact on the market of changing the restrictions.

There are a number of models for the provision of insurance, and their relative benefits depend on the context, including in terms of how much risk-based pricing is possible, the costs of collecting data, the extent of adverse selection and moral hazard, and public policy objectives. The provision of PII by a mutual, as is the case in the barrister market, may have a number of benefits.

For instance, provision of PII by BMIF may lower operating costs due to economies of scale and lower acquisition and underwriting expenditure, as BMIF is the sole provider of basic cover. It guarantees availability of cover for all practitioners, thereby potentially reducing barriers to entry, facilitating competition within the barrister market and ensuring that under-served areas of law are not adversely affected. It may also mitigate the informational asymmetry between the insured and the insurance provider because BMIF's market share of 100% may facilitate better monitoring of relevant barrister markets and identification of trends within the market.

In principle, however, the current structure may give rise to some concerns. In particular, it could lead to high operating costs due to a lack of incentive to be efficient in operations and/or in claims handling due to lack of competition; costs could be higher due to inability to achieve economies of scope (private insurers benefit from economies of scope as a result of offering other types of insurance policies); and the limited degree of risk-based pricing could potentially lead to a problem of moral hazard and substantial cross-subsidisation between members.

Overall, the available evidence indicates that BMIF, despite being a sole provider of PII to barristers, does not appear to raise material concerns for barristers, and for consumers. In particular:

- BMIF premiums are consistent with it delivering stable market outcomes;
  - BMIF's operating costs appear to be low relative to those of other providers, including relevant mutuals, private providers and the overall UK general insurance market;
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- while more risk-based pricing may be possible, there is no clear evidence that there are additional risk factors that would substantially improve conduct, or that the current pricing creates issues of moral hazard.

The BSB may consider putting in place certain processes to maintain and potentially enhance the efficiency of the market. This report provides some suggestions, including assessing—using BMIF’s database of claims history—whether there are additional factors that may be influencing risks and that can be taken into account when setting the premium ratings for individual barristers.

This assessment also analyses the likely counterfactual without the restriction. The analysis suggests that, in the short term, the removal of the restriction of self-employed barristers (and continuation of choice for the SPEs) would appear to be unlikely to result in significant switching by barristers. Hence, the BMIF model is likely to continue to deliver benefits, and the restriction may not be necessary to achieve the benefits.

Removing the compulsory BMIF provision for self-employed barristers could result in a significant change for the market in the long term. While there are significant uncertainties regarding the long-term outcomes—as these depend on the strategy of private insurers, and BMIF’s response to it—there is a possibility of significant entry by private insurers and subsequent switching by a large number of barristers. If such switching occurs, it is likely to lead to an increase in the barristers’ overall costs and ultimately premium ratings of those who remain with BMIF. If, on the other hand, BMIF responds effectively to reduce switching, it may be able to co-exist with private insurers, and potentially continue retaining a majority of its members. As demonstrated in other PII markets, mutual insurers can, in principle, co-exist with private insurers.

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# 1 Introduction

## 1A Context

- 1.1 The Legal Services Board (LSB) has conducted a thematic review of the existing regulatory restrictions on the provision and choice of professional indemnity insurance (PII) for different legal service providers (LSPs) in England and Wales.<sup>1</sup> As stated by the LSB, the aim of this review is to inform the considerations and decisions of the relevant Approved Regulators (ARs) in relation to the choice of insurer for the different legal service professionals. These include self-employed barristers and entities regulated by the Bar Standards Board (BSB), solicitors and entities regulated by the Solicitors Regulatory Authority (SRA), trademark and patent attorneys regulated by the Intellectual Property Regulation Board (IPRB), conveyancers and probate practitioners regulated by the Council for Licensed Conveyancers (CLC), and other LSPs such as cost lawyers and chartered legal executives.
- 1.2 As set out in the LSB review, different business models and regulatory controls are adopted for the provision of PII to different groups of LSPs.<sup>2</sup> Different insurance models exist in different markets, and, while private insurance provision is currently the most common approach, mutual insurance pools and public insurance do continue in a number of markets, including in legal services as well as more generally in areas such as health<sup>3</sup> and protection against natural disasters.<sup>4</sup> Different insurance models have their advantages and disadvantages, as explored in section 2 below.
- 1.3 In legal services, some markets have mainly private insurance (e.g. solicitors), while some have both mutual and private provision (e.g. patent insurers). For barristers, there is a compulsory mutual stipulating that all self-employed barristers should use a specific insurer—the not-for-profit Bar Mutual Indemnity Fund (BMIF)—for the primary layer of cover. In some cases, the insurance markets have changed over time—for example, the market for solicitors consisted first of private insurance, then a mutual (SIF), and has since returned to private insurance provision.
- 1.4 The LSB highlights the importance of consumer choice, quality and cost in ARs' consideration of regulation around PII provision in their markets. The LSB sets out the potential positive and negative effects of restricting choice on the relevant practitioners (in the context of the BSB, barristers) as well as consumers or clients of practitioners. This includes consideration of the following factors.<sup>5</sup>
- Cost of PII to practitioners, including premiums, broker fees, administrative costs and costs of uncertainty.
  - Consumer choice in legal service provision, including the number of practitioners available across and within practice areas (and therefore access to justice), and innovation in services offered.

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<sup>1</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer. Analysis of the current arrangements', July (henceforth, the 'LSB report'). See also the advice provided by the Regulatory Policy Institute (RPI) to the LSB in the context of this review: Yarrow, G. (2016), 'Regulatory issues surrounding PII arrangements in legal services provision', May.

<sup>2</sup> LSB report, paras 14–22 and Annex A.

<sup>3</sup> Public insurance is the norm in many health insurance markets around the world, and, where there is private provision, there are often regulations to ensure comprehensive coverage that may not occur in a truly liberalised market.

<sup>4</sup> See section 2.

<sup>5</sup> LSB report, paras 23–43.

- Client protection, in particular ensuring a high quality of service provided by practitioners, stability and continuity of legal service provision, and mitigation of consumer harm from claims management.
  - Regulation, such as the structure of minimum terms and conditions and other regulations to manage risks to consumers/clients. The LSB also highlights the need for transparent and targeted regulations.
- 1.5 The LSB also highlights the need for any regulation to be consistent with the relevant legislation, in particular the LSB's and ARs' regulatory objectives and principles,<sup>6</sup> and competition law.

## **1B Objective of this report**

- 1.6 In this context, the BSB has asked Oxera to undertake an economic analysis of the current regulatory restrictions in the PII market for barristers in order to inform the BSB's approach on the following two separate, but interrelated, issues.
- **The choice of insurer for single person entities (SPEs):** as of January 2015, the BSB is allowed to authorise entities (with one or more fee-earners) whose range of services, risks, and regulatory requirements are similar to those of the self-employed Bar. Since then, the BSB has authorised 56 entities. Of these, 47 are SPEs, and most of the others have only two barristers. Unlike the self-employed barristers, SPEs can currently choose between BMIF and private insurers when obtaining PII. The BSB is currently considering whether SPEs should be obliged to take their primary layer of cover from BMIF in a similar way to self-employed barristers, or whether it should continue to have the choice.<sup>7</sup>
  - **The choice of insurer for self-employed barristers:** currently, all PII self-employed barristers (or sole practitioners) are obliged to use BMIF for the primary layer of insurance (which is defined as any cover up to £2.5m). The BSB is considering whether this restriction (i.e. the obligation to use BMIF) should be kept in place, or removed so that the barristers have the choice to take cover from private insurers.
- 1.7 The fundamental question for the BSB is therefore whether it should maintain the single provider status of BMIF by keeping it compulsory, or whether the mandatory nature should be removed to open the market to private insurers such that barristers are free to choose their insurer. Hence, it is relevant to consider the benefits and costs of the current model relative to those in any alternative arrangement (or, in the 'counterfactual' scenario without the obligation to use only BMIF).
- 1.8 This report therefore addresses the following two key questions.
- What are the costs and benefits of the current model of provision of PII to barristers through BMIF? Mutuals may have particular advantages over the open market (such as being better able to address informational

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<sup>6</sup> The relevant regulatory objectives are: protecting and promoting public interest and interest of consumers; improving access to justice; promoting competition in the provision of legal services; encouraging an independent, strong, diverse and effective legal profession; and promoting and maintaining adherence to the professional principles. Regulation needs to be transparent, accountable, proportionate, consistent and targeted (see LSB report, paras 62–94).

<sup>7</sup> For further details, see BSB (2015), 'Consultation: insurance requirements for single person entities'.

asymmetries<sup>8</sup>). However, the consequence of mandatory mutual provision on costs and premiums is uncertain, and requires examination.

- What is the likely impact on the market of changing the restrictions—i.e. what is the most plausible counterfactual scenario(s) in the absence of the obligation to use only BMIF?

- 1.9 This report is based on information and evidence obtained from a number of sources. In particular, we conducted interviews with a range of stakeholders including the BSB, BMIF, private insurers, brokers and barrister representatives, as well as third parties such as other mutual insurers that provide PII for other professions, to understand the current structure and likely alternatives. The data analysis presented in this report is based on publicly available data and data provided by BMIF.
- 1.10 The analysis was undertaken within a challenging timetable. Although sufficient analysis was undertaken to inform the BSB's assessment of the current model for the provision of PII for barristers, there are areas that could potentially be explored in more detail. Furthermore, the analysis focuses on the restriction in choice of PII provider—an analysis of the minimum terms for PII, as prescribed by regulation, is beyond the scope of this report.

### **1C Competition law framework**

- 1.11 As noted above, any regulation, and associated restriction, needs to consider compatibility with competition law under the UK Competition Act 1998. The specific provision that is most relevant in this context is Chapter I of the UK Competition Act 1998, or Article 101 of the Treaty on the Functioning of the European Union ('TFEU').
- 1.12 In particular, Article 101(1) prohibits agreements that have, as their object or effect, the prevention, restriction or distortion of competition in the relevant market.

The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:

- (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
- (b) limit or control production, markets, technical development, or investment;
- (c) share markets or sources of supply;
- (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

- 1.13 However, Article 101(3) provides for the possibility that even if an agreement infringes Article 101(1), it may not be found to be anti-competitive if it delivers benefits to consumers, and is necessary to achieve these benefits.

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<sup>8</sup> As also recognised in Yarrow, G. (2016), 'Regulatory issues surrounding PII arrangements in legal services provision', May, pp. 2 and 4.

The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings,
  - any decision or category of decisions by associations of undertakings,
  - any concerted practice or category of concerted practices,
- which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
- (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
  - (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

- 1.14 The obligation for all barristers to use only BMIF does not allow the scope for competition in the provision of PII to barristers, and may therefore infringe Article 101(1). However, it is necessary to consider whether the restriction is likely to have an appreciable negative effect on consumers or is likely to deliver benefits. If the restriction is likely to deliver benefits, it may be found to have not infringed Article 101(1) and/or may satisfy Article 101(3).
- 1.15 The analysis of costs and benefits of the current PII provision presented in this report therefore informs the assessment of whether the restriction has potential benefits for consumers within the meaning of Article 101(3). The analysis of the counterfactual further informs whether the restriction is likely to be necessary to achieve the benefits above, within the meaning of Article 101(3).

## **1D Structure of the report**

- 1.16 The report is structured as follows:
- section 2 briefly sets out the key economic aspects relevant to the assessment of PII;
  - section 3 presents our analysis of the benefits and costs of using BMIF; and
  - section 4 outlines the plausible counterfactual scenarios and implications for BSB's regulation.
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## 2 Economic aspects relevant to PII

- 2.1 In essence, any form of insurance involves the transfer of risk from an unknown event faced by the insured individual or entity (e.g. accident or fraud) to the insurance provider, in return for a payment in the form of a fee or premium. For a private insurance market to function and be viable, insurers need to collect sufficient income from premiums so that they can cover anticipated claims from the insured. This means that they must be able to estimate the average expected cost of claims and their frequency in order to set the premium level(s) appropriately.<sup>9</sup>
- 2.2 This leads to two basic principles of private insurance provision:
- risk-based pricing—insurers have to price insurance on the basis of the risk of the insured, including the probability of a claim being made against the policy and the cost of that claim;
  - risk solidarity within risk pools—risk is shared between individuals within risk pools, and the premiums of the many pay for the losses of the few.
- 2.3 By placing individuals into risk categories and pooling risks within these categories, insurers set prices such that they reflect the average of the expected claims cost within the category. Other costs include marketing costs, claims-handling costs and the costs of assigning potential customers into risk pools based on their expected claims frequency and severity.<sup>10</sup>
- 2.4 There is ‘solidarity’ within risk categories or pools—those in the pool who are fortunate and do not suffer damage contribute to meeting the costs of those who do. Insurers form risk pools such that there is relatively low and predictable within-group risk variation (i.e. the group contains individuals with similar risk characteristics) and relatively large between-group risk variation.
- 2.5 Insurers typically use a range of characteristics to determine the risk profile of an individual. Some of these characteristics are outside the individual’s control, whereas others are controllable. However, not all of this information may be available to the insurer, or even identifiable, and collecting and analysing the required information comes at a cost. This explains why some insurance markets show a high degree of risk-based pricing (for example, motor insurance, where a lot of data is available at relatively low cost) and other markets show less risk-based pricing (for example, mainstream life insurance, where detailed information would require a costly medical examination).

### 2A Adverse selection and moral hazard

- 2.6 Risk-based pricing helps to address two potential problems in insurance markets: adverse selection and moral hazard.

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<sup>9</sup> The economic characteristics of insurance markets are well documented in the academic literature. See, for example, Rothschild, M. and Stiglitz, J. (1976), ‘Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information’, *The Quarterly Journal of Economics*, **90**:4, November, pp. 629–49; and Stiglitz, J. (1977), ‘Monopoly, non-linear pricing and imperfect information: The insurance market’, *The Review of Economics Studies*, **44**:3, October, pp. 407–30. For a short summary, see Regulatory Policy Institute (2016), ‘Regulatory issues surrounding PII arrangements in legal services provision’, May. See also Oxera (2010), ‘The use of gender in insurance pricing: analysing the impact of a potential ban on the use of gender as a rating factor (ABI research paper 24)’; and Oxera (2012), ‘Why the use of age and disability matters to consumers and insurers’, October.

<sup>10</sup> The process of estimating the risk and premium for each applicant is known as underwriting. Insurers use the results of statistical analysis and sector knowledge to assess information provided by the applicant in their application. Underwriting ensures that similar risks are pooled together and that premiums reflect the likelihood of the insured event happening.

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- Adverse selection—if low- and high-risk individuals were grouped together and charged the same price based on the average risk in the group, the low-risk individuals would pay a price that is higher than their own risk would indicate, and thereby subsidise the individuals in the group that have higher-than-average risk. This cross-subsidy could result in the low-risk individuals leaving the group as their own policies become too expensive. As they begin to leave, the average risk of the remaining individuals would rise, and could therefore threaten the financial stability of the insurance activity and the insurer.
- Moral hazard—if insurance reduces incentives for individuals to avoid the occurrence of insured events (e.g. car crashes), it can cause ‘moral hazard’ as individuals undertake more risky behaviour. This can be addressed by increasing premiums if individuals act in a risky manner or have had past claims, and thereby discourage risk-taking behaviour. Individual pricing of insurance can therefore reduce moral hazard if the pricing relates to factors that individuals are in control of (such as risk-taking behaviour).

2.7 Risk-rating factors will be used to categorise consumers by risk type when the cost of doing so produces a net gain—i.e. when the rating factor improves the insurer’s ability to set cost-reflective prices and control the risk in its insurance portfolio. In a competitive market, insurers may be able to win additional (lower-risk) customers by taking account of additional risk factors that indicate that customers have a lower risk than other insurers realise. If the transaction costs involved in using the additional information are lower than the potential profits from winning new customers, the competitive insurer will be incentivised to use the additional information in risk-based pricing.

2.8 In sum, the degree to which such individualised risk-based pricing is feasible and desirable depends on the balance between its effectiveness and benefits, and the associated costs. Competitive insurance markets tend to see increasing use of risk-based pricing as insurers compete for lower-risk customers.

## **2B Different models for the provision of insurance**

2.9 There are a number of models for the provision of insurance. While private provision (where companies compete to offer insurance) is most common, certain types of insurance are more often provided by mutual insurers, the state (such as health insurance and protection against natural disasters), or a cooperation between the industry and the public sector.<sup>11</sup>

2.10 The relative benefits of the different models depend on the context, including in terms of how much risk-based pricing is possible; the costs of collecting data; the extent of adverse selection and moral hazard; and public policy objectives.

2.11 In some markets, there may be high-risk individuals who become essentially uninsurable in a private insurance market due to the risk of adverse selection and moral hazard—which can lead to the breakdown of insurance markets. For example, it is difficult for private health insurance to cover pregnancy, as to do so would attract customers expecting to become pregnant, and the costs would become prohibitively high. Private insurance therefore often includes exemptions for these types of event. Mutual insurers and public insurers, however, can insure pregnancy, as all customers (whether or not they are

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<sup>11</sup> Examples in the UK include Pool Re and Flood Re. For the economics of Flood Re, see: Oxera (2011), ‘Why does it always rain on me? A proposed framework for flood insurance’, *Agenda*, September.

intending to become pregnant) have to use the insurance pool and so there is no risk of adverse selection.

- 2.12 Consequently, unlike with many other markets, a competitive private insurance market is not necessarily the most efficient and beneficial for consumers. A mutual, on the other hand, can in certain circumstances ensure that the entire market is served.
- 2.13 This ‘solidarity’ aspect of a mutual insurance pool is relevant for the legal services market, due to the potential risks to consumers’ access to justice (albeit this risk may be mitigated by regulatory interventions, such as the pool set up in the solicitors market in England and Wales). More generally, a mutual helps to reduce the informational asymmetries and conflicts of interest between the insured (the buyer) and the insurer (supplier), and helps to take account of the reputation of the group as a whole. For example, a private provider would have an interest in reducing claims payments, irrespective of whether the claims are meritorious, thereby risking the reputation of the relevant LSP group and increasing the potential for consumer harm.<sup>12</sup>

## **2C PII in the legal services market**

- 2.14 Historically, various regulatory arrangements have been possible in the market for LSPs’ professional indemnity. The difference lies in the approach to the choice of insurer. In some communities (such as solicitors), practitioners are able to choose their own PII provider from among private insurers. Others (such as barristers) organise themselves into mutuals and pay premiums into a common fund. A third group (such as trademark and patent attorneys) allow the coexistence of mutuals and private insurers.
- 2.15 Until 1986, the solicitor PII market was served by private insurers. However, a significant increase in the number of claims (mainly relating to conveyancing) following the recession in the early 1980s resulted in significant losses for underwriters. Continuing losses and an inability to recover highlighted a need for reform.<sup>13</sup>
- 2.16 In 1986, a mutual—the Solicitors Indemnity Fund (SIF)—was set up to address these issues. However, it was disbanded on 1 September 2000, reportedly due to a combination of reasons including high and volatile premiums, an inability to smooth premium variations, inefficient cross-subsidisation among members, an inability to obtain stop-loss cover, and under-pricing in certain market segments. Ultimately, there was a shortfall in the fund (triggered by the property market), and it was made unviable.<sup>14</sup>
- 2.17 Overall, due to the shortfall and concerns regarding cross-subsidisation, it was felt within the profession that private provision would better incentivise risk management. There is some evidence of under-provision of insurance to smaller firms,<sup>15</sup> which was the reason why the SRA set up the Assigned Risks Pool.<sup>16</sup>

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<sup>12</sup> Stigler, G. (1951), ‘The Division of Labour is Limited by the Extent of the Market’, *Journal of Political Economy*, 1951.

<sup>13</sup> Charles River Associates (2010), ‘Review of SRA client financial protection arrangements’, September, p. 37.

<sup>14</sup> Charles River Associates (2010), ‘Review of SRA client financial protection arrangements’, September, pp. 50–2.

<sup>15</sup> Charles River Associates (2010), ‘Review of SRA client financial protection arrangements’, September, p. 71.

<sup>16</sup> Charles River Associates (2010), ‘Review of SRA client financial protection arrangements’, September, p. 91.

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- 2.18 The Society of Licensed Conveyancers and the trademark and patent attorneys opted for a mutual alongside freedom of choice of provider. PAMIA, for instance, provides PII to 95% of UK and Irish patent and trademark attorneys in private practice. This model has operated successfully without regulatory compulsion. PAMIA appears to use a risk-based pricing that is more in line with those of private insurers (than that of BMIF, for example), by taking account of claims history when calculating individual premiums.<sup>17</sup>
- 2.19 It should be noted that there are significant differences between legal services markets. In terms of size, there are around 13,000 barristers in England and Wales; PAMIA has only 300 members; and the SRA regulates more than 130,000 practising solicitors.<sup>18</sup> A majority of barristers are sole practitioners, unlike in other markets. Risk factors also vary: for entities, risk can arise from the system or management, whereas risk factors for self-employed barristers are more likely to arise from individual traits and attributes.
- 2.20 A competitive private PII market for barristers might not, therefore, yield similar outcomes to those observed in the solicitor and conveyancer markets. It is necessary to identify the benefits of the mutual model, and in particular the current provision BMIF, and assess these against the likely costs.

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<sup>17</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer', July.

<sup>18</sup> This number does not include solicitors firms.

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### 3 Benefits and costs of using BMIF

3.1 This section assesses the benefits and costs that are likely to come from the current mutual model for barristers' PII—i.e. a single mutual, BMIF—in order to inform what is likely to be the net impact of changing the current regulations.

3.2 The sections below assess the reasonable expectations from the current market structure (section 3A), and whether there is any evidence of harm to members or consumers (section 3B).

#### 3A Benefits and costs

3.3 The BSB requires all self-employed barristers to take out PII with BMIF. Within this market, BMIF has a monopoly in providing PII up to a maximum cover of £2.5m (top-up insurance above this level is provided by private insurers).

3.4 BMIF is also a not-for-profit company that is owned and controlled by its members. Effective control of BMIF's affairs rests with its Board of Directors, all of whom are self-employed barristers.

3.5 These key characteristics lead to certain expectations about the advantages and disadvantages of the present structure. Some of these have previously been identified in the LSB's review of the PII market.<sup>19</sup>

3.6 The position accorded to BMIF as the sole provider of PII for barristers may give rise to the following concerns:

- a lack of incentives to efficiently manage operating costs, as BMIF does not face price competition from other insurers;
- higher operating costs arising from an inability to achieve economies of scope or scale—private insurers typically also offer PII to other professions and a range of other insurance policies;
- a lack of incentives to effectively manage claims costs, as a monopoly provider does not need to minimise premiums in the face of competition from other insurers; and an absence or limited degree of risk-based pricing, which could potentially lead to a problem of moral hazard and substantial cross-subsidisation between members.

3.7 On the other hand, there may be a number of advantages to the current structure:

- lower operating costs, as BMIF does not need to compete with other insurers through marketing and acquisition expenditure;
- lower operating costs due to economies of scale, as BMIF is the sole provider of basic cover (as explained above, private insurers benefit from economies of scope or scale by offering multiple types of insurance, but BMIF may benefit from economies of scale by being the sole provider of PII for barristers);
- reduced underwriting, risk-management and information costs arising from the ability to provide cover to members without facing competition from other providers;

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<sup>19</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer', July. See also Yarrow, G. (2016), 'Regulatory issues surrounding PII arrangements in legal services provision', May.

- potentially better standards of service due to a lack of profit motivation, as BMIF is owned by and for its members. In theory, the interests of the insurer and insured may be better aligned and therefore allow for better standards of service (for example, in terms of handling claims based on their merits rather than pecuniary considerations);
- guaranteed availability of cover for all practitioners, which in turn facilitates competition within the barrister market and ensures that underserved areas of law are not adversely affected;
- mitigation of informational asymmetry between the insured and the insurance provider resulting from 100% market share, which may facilitate better monitoring of relevant barrister markets and identification of trends within the market.<sup>20</sup>

3.8 As noted in the LSB's reports, the issues described above regarding BMIF's operations need to be supported by evidence.<sup>21</sup>

3.9 Oxera has therefore conducted an analysis based on data that is available from BMIF and other market sources to unpick whether the evidence supports the concerns described above. These issues are examined in terms of:

- **trends in PII premiums**, to assess whether the current market structure is delivering stable market outcomes (see section 3B);
- performance in terms of **operating costs**, to see whether the cost advantages of compulsory mutual provision outweigh its potential disadvantages, as described above (see section 3C);
- **claims costs**, which is another way of assessing BMIF operations, being the flip-side of operating costs (see section 3D);
- the functioning of **risk-based pricing**, to explore whether there are issues in terms of moral hazard and informational asymmetries (see section 3E).

### **3B Trends in PII premiums**

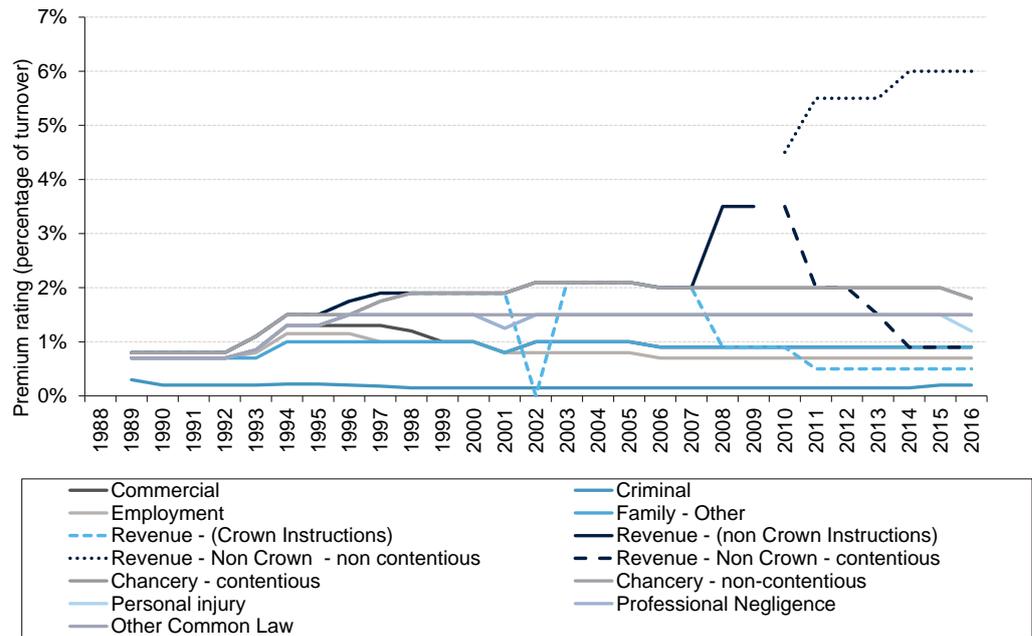
3.10 Recent trends in PII premiums can help to show whether the current market structure ensures a degree of stability in the market for the provision of legal services, or whether mutual provision is instead failing to deliver stability.

3.11 Figure 3.1 illustrates the trends in BMIF's premiums charged for the top practice areas by premium income.

<sup>20</sup> Smith, B.D. and Stutzer, M.J. (1990), 'Adverse Selection, Aggregate Uncertainty, and the Role for Mutual Insurance Contracts', *The Journal of Business*, 63:4, October, pp. 493–510.

<sup>21</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer', July.

**Figure 3.1 Premium ratings for top practice areas by premium income**

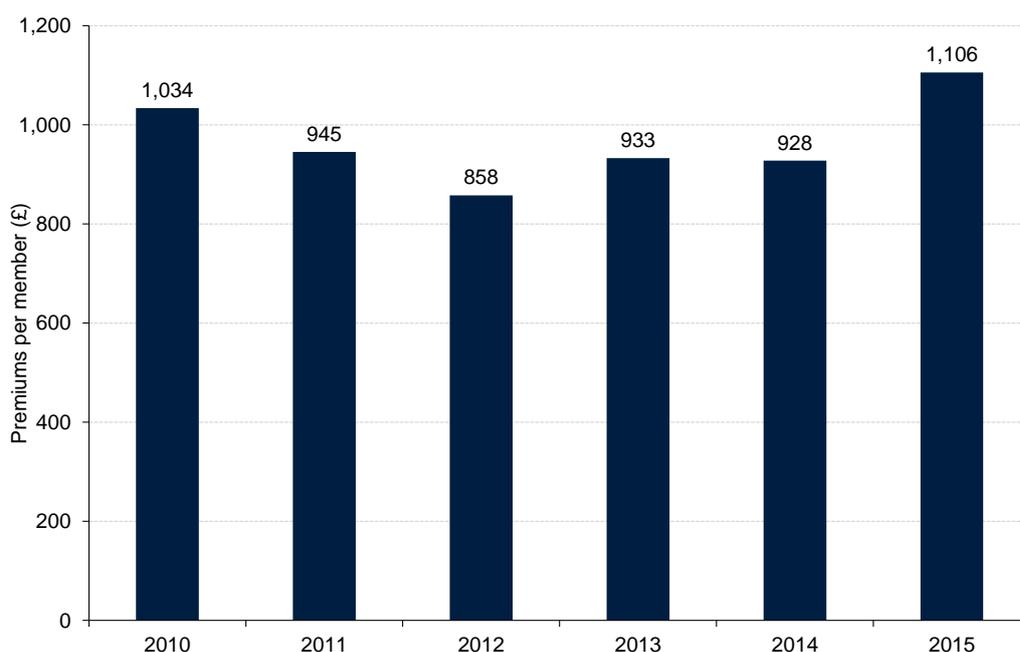


Note: 2016 data is year to date.

Source: Oxera analysis, based on data from BMIF.

- 3.12 The evidence suggests that premiums have remained stable, except intermittently, where changes were necessary to reflect the claims costs associated with the practice area.
- 3.13 Indeed, for some practice areas (e.g. ‘non-Crown non-contentious’ and ‘non-Crown instructions’) premiums have increased, whereas for others (e.g. ‘non-Crown contentious’ and ‘commercial’) premiums have decreased.
- 3.14 A review of the evidence based on the entire barrister market (Figure 3.2) also does not suggest any systematic increase in average premiums charged over time.

**Figure 3.2 BMIF average premium per member (2010–15)**



Note: 'Premiums per member' is defined as earned premiums divided by total number of registered members within BMIF.

Source: Oxera analysis, based on data from BMIF.

- 3.15 In fact, the compounded annual growth rate (CAGR) of premiums between 2010 and 2015 has been less than 1%, which is considerably below UK inflation over the same period.<sup>22</sup>
- 3.16 The average premium per member does not show a systematic increase. This evidence is consistent with BMIF delivering stable market outcomes.

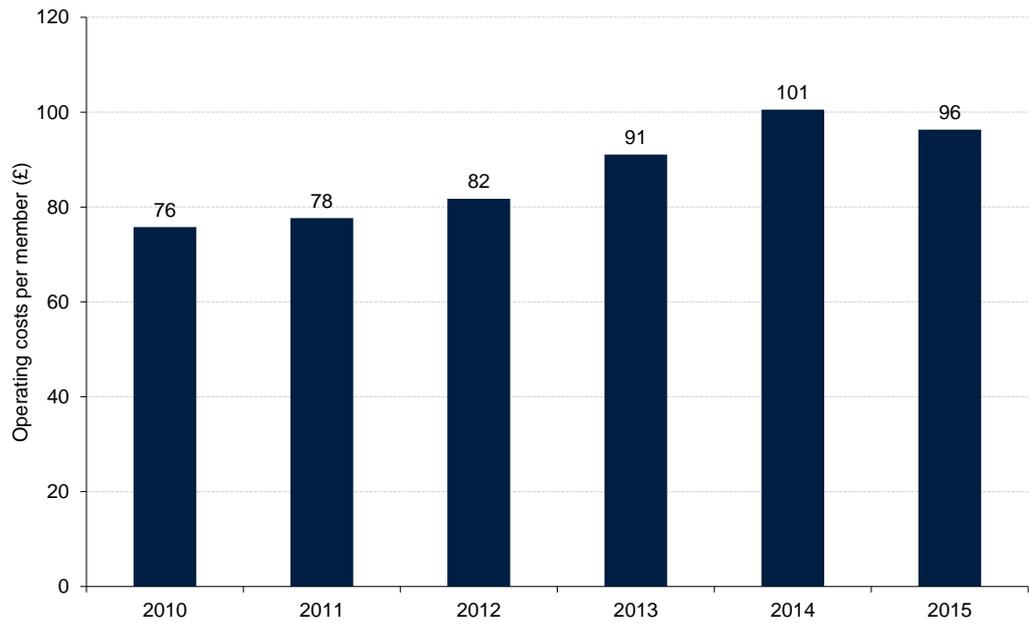
### **3C Operating costs**

- 3.17 As discussed above, the current market structure could result in relatively high operating costs if there are insufficient incentives on BMIF to be efficient,<sup>23</sup> or if it lacks economies of scope. On the other hand, BMIF's operating costs might be relatively low as it does not need to compete through marketing and acquisition expenditure; it benefits from economies of scale as the sole provider of basic cover; and it does not conduct individual underwriting. It is therefore necessary to examine BMIF's operating costs relative to those of other insurers in order to understand this balance.
- 3.18 Figure 3.3 traces the evolution of BMIF's operating costs per member over the period 2010–15.

<sup>22</sup> Office for National Statistics (2016), 'Additional analysis of the Producer Price Index (PPI) and Consumer Price Index (CPI): Aug 2016', August, p. 4.

<sup>23</sup> Notwithstanding the non-profit nature of BMIF, it could, in principle, entail higher operating costs due to the lack of competitive pressure from private providers that might be run more efficiently.

**Figure 3.3 BMIF average operating costs per member (2010–15)**

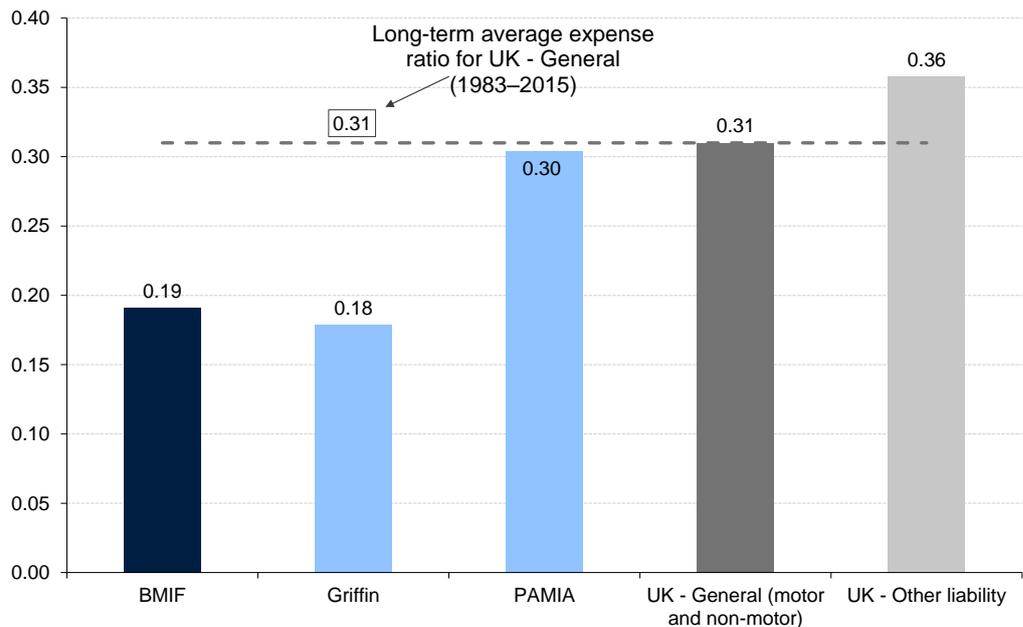


Note: 'Operating costs per member' is defined as net expense divided by total number of registered members in a given year.

Source: Oxera analysis, based on data from BMIF.

- 3.19 The increase in BMIF's operating expenses (of c. 3% year) is broadly consistent with UK inflation over the same period, albeit marginally higher. This is primarily due to spikes in 2013/14, which can be attributed to an upgrade of IT systems, including the installation of an online renewal facility for members.
- 3.20 Figures 3.4 and 3.5 benchmark the expense ratios for BMIF, by comparing them with those of other mutuals and the overall UK general insurance market.

**Figure 3.4 Comparison of average expense ratios (2010–15)**

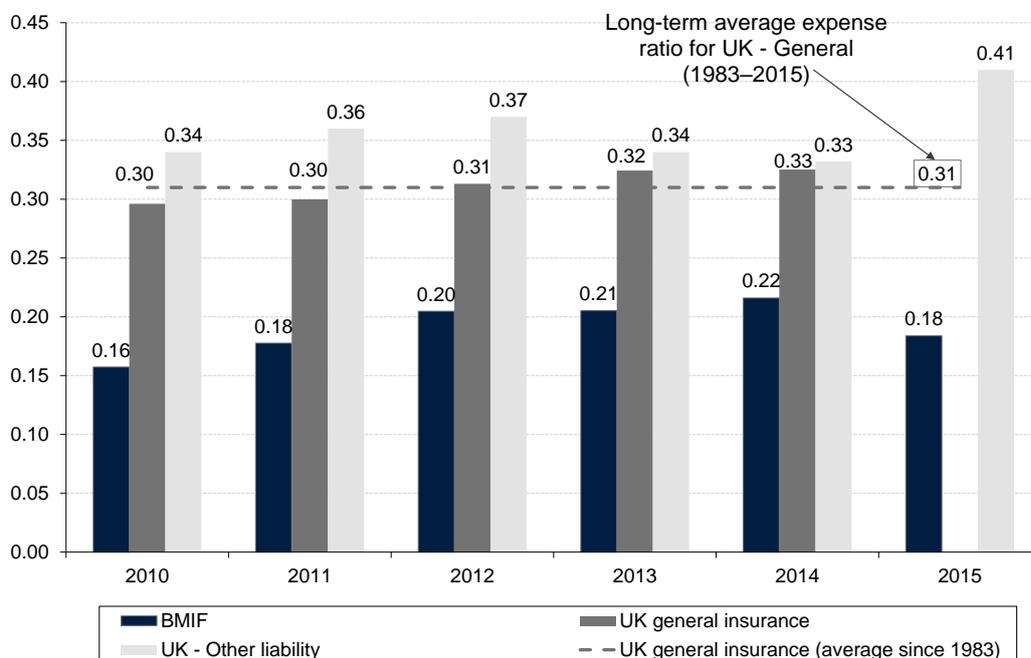


Note: Expense ratio is defined as net expense as a proportion of earned premium income, and includes claims-handling costs. The data excludes deferred premiums for BMIF data. Accounts for PAMIA and Griffin do not report claims-handling costs, and to that extent their expense ratios

may have been underestimated. Data for Griffin is over the period 2009–14. Data for PAMIA and UK-General is over the period 2010–14. Commission expenses are excluded.

Source: Oxera analysis, based on financial statements of companies and data from the ABI.

**Figure 3.5 Comparison of BMIF’s annual expense ratios with overall industry data (2010–15)**



Note: Expense ratio is defined as net expense as a proportion of earned premium income, and includes claims-handling costs. The data also excludes deferred premiums for BMIF data. General industry data for 2015 was not available. As per industry standards, external legal costs are excluded from the operating cost base.

Source: Oxera analysis, based on financial statements of various companies and data from the ABI.

3.21 While there is no perfect comparator for benchmarking BMIF, a comparison across the industry and other mutuals provides helpful insights regarding the expectations surrounding BMIF’s operating expenditure. As shown above, BMIF’s expense ratio (including claims-handling costs) is at the lower end of the spectrum when compared to peers, and considerably below those observed at the industry level.<sup>24</sup>

3.22 Part of the underlying reason for these observations is that BMIF is able to make significant cost savings due to having limited acquisition and underwriting costs. For example, PAMIA’s acquisition costs in 2014/15 were c. 15% of net premium, relative to c. 4% for BMIF.

### 3D Claims costs

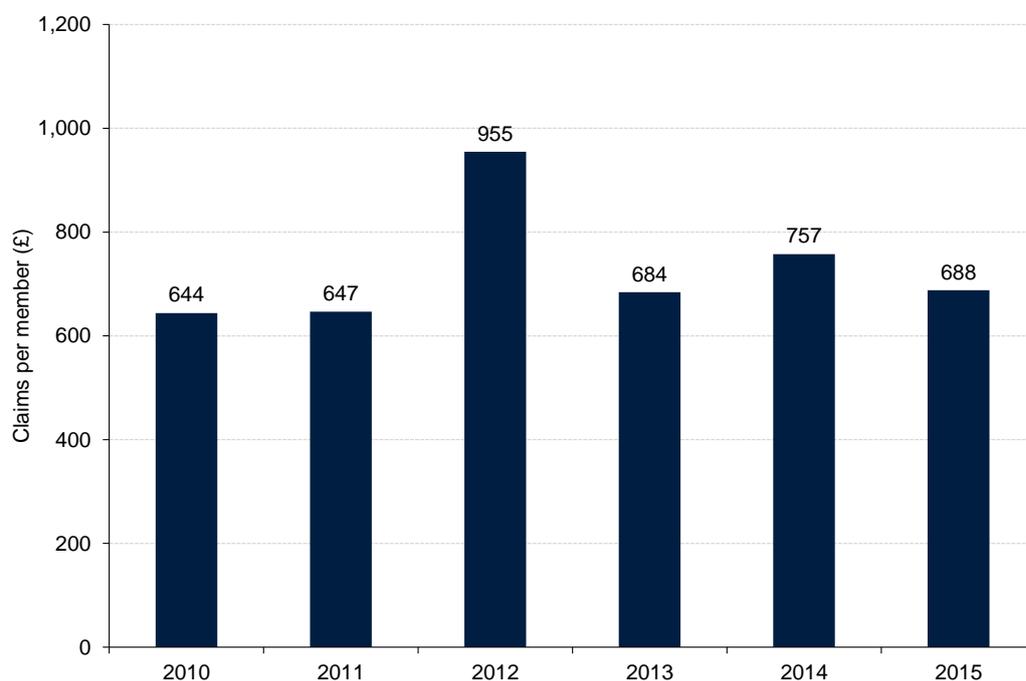
3.23 Another way of assessing BMIF’s performance is by assessing claims—the claims ratio is the other side of the expense costs ratio.<sup>25</sup>

<sup>24</sup> It may also be useful to compare claims-handling costs across insurers. ABI statistics do not report these costs separately, but some individual insurers do, including PAMIA, Direct Line and Ageas (source: financial statements). To make the figure comparable across companies, we divided claims-handling costs by gross claims paid. This gives the claims-handling costs as a percentage of claims paid: BMIF (12%); PAMIA (34%); Direct Line (11%); and Ageas (9%). Although the available data is limited, BMIF’s claims-handling expenses do not seem to be a concern.

<sup>25</sup> Net premiums equal claims plus operating expenses plus profits, or surplus as in the case of BMIF.

- 3.24 While it is not straightforward to assess the efficiency of BMIF’s claims-handling, trends in BMIF claims can help to shed some light on performance in claims management. BMIF should invest sufficient resources to appropriately defend members against claims, but the system should also ensure that consumers (clients) receive appropriate compensation for misconduct of barristers.<sup>26</sup>
- 3.25 Oxera has assessed the historical data on claims paid by BMIF between 2010 and 2015. Data on claims payments includes claims compensation, defence costs of claimants (where valid), and defence costs of BMIF members.<sup>27</sup>
- 3.26 Figure 3.6 illustrates the claims paid per member. It shows that average claims payments have been stable over time.

**Figure 3.6 BMIF average claims paid per member (2010–15)**



Note: Claims per member are defined as net claims paid divided by the total number of registered members within BMIF.

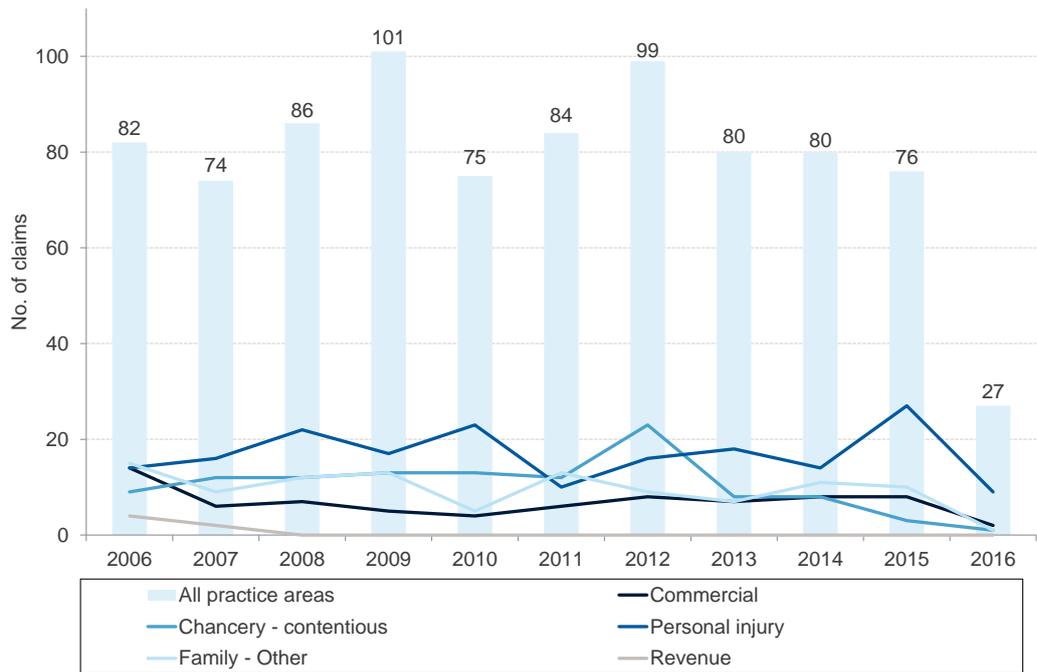
Source: Oxera analysis, based on data from BMIF.

- 3.27 The evidence does not indicate any systematic trend in claims payments. Furthermore, a more granular assessment of the data by the value of claims paid and the number of claims paid for each practice area also does not indicate any obvious trends.
- 3.28 Figures 3.7 and 3.8 illustrate the trends in the number and value of claims paid out respectively, by practice area.

<sup>26</sup> External legal defence costs associated with defending members against claims are included within the overall claims handling costs.

<sup>27</sup> Even if BMIF is successful in defending against a claim, it is not necessary that it will also receive compensation for external defence costs. To that extent, BMIF is likely to incur legal defence costs irrespective of the outcome of the case.

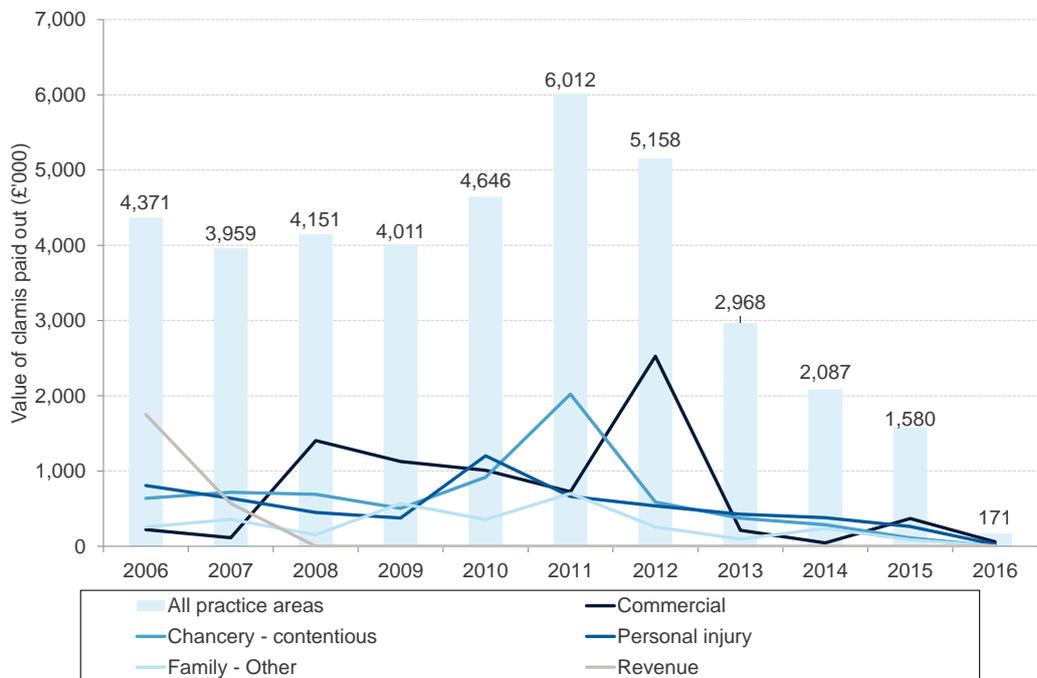
**Figure 3.7 Annual number of claims paid out for top five practice areas**



Note: 2016 values are year to date. The data reflects claims linked to a particular policy, and claims may have been incurred in years subsequent to that in which the policy was taken out. To that extent, data for recent years (e.g. 2014/15/16) may increase in future years.

Source: Oxera analysis, based on data from BMIF on the number of claims paid out for each practice area.

**Figure 3.8 Annual value of claims paid out for top five practice areas**

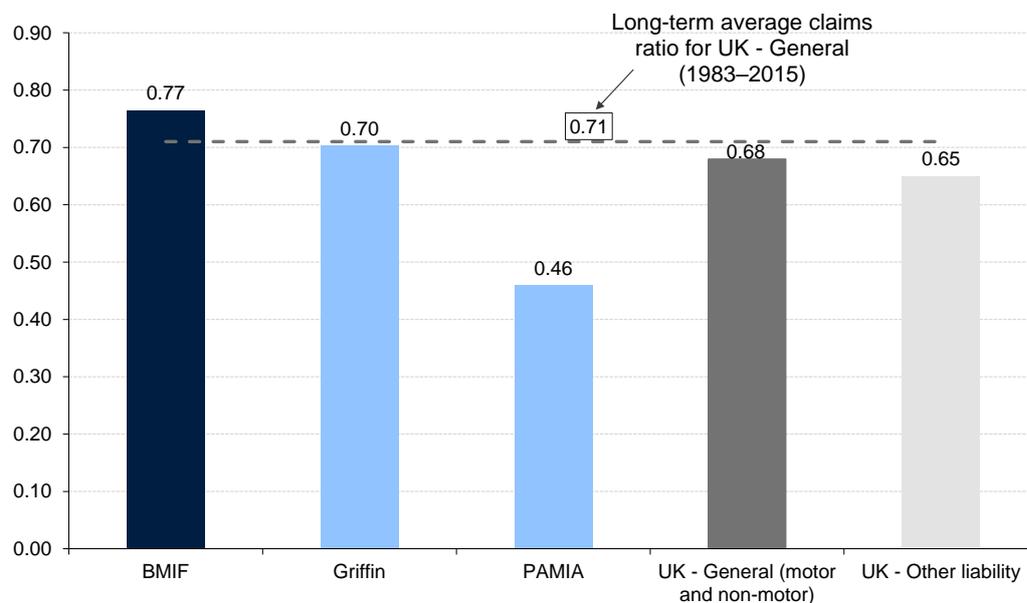


Note: 2016 values are year to date. The data reflects claims linked to a particular policy and claims may have been incurred in years subsequent to that in which the policy was taken out. To that extent, data for recent years (e.g. 2014/15/16) may increase in future years.

Source: Oxera analysis, based on data from BMIF on the value of claims paid out for each practice area.

- 3.29 The broad trends by practice area do not change if the sample is extended to cover the top ten firms. Controlling for the size of the practice area also does not change the results.
- 3.30 As expected given the lower operating expense ratio, the evidence reveals that BMIF has a higher claims ratio than peers and overall industry averages (Figure 3.9).

**Figure 3.9 Comparison of claims ratios over the period 2009–15**



Note: Claims ratio is defined as claims paid as a proportion of premium income, net of reinsurance. The years included depend on data availability for different companies. For BMIF, the figures are six-year averages for 2010–15; for Griffin, the average is for 2009–14; for PAMIA, it is a five-year average for 2010–14; for private companies, it is a five-year average for 2011–15.

Source: Oxera analysis, based on financial statements of companies and data from the ABI.

- 3.31 Over the past decade, BMIF has engaged in legal proceedings on behalf of members for approximately 16% of all claims notifications, with a success rate of c. 70% in court. Furthermore, in 80% of all cases, BMIF’s costs of defending its member exceeded the eventual value of the claim paid out.<sup>28</sup> This evidence supports the assertion that BMIF’s reputation for servicing its members in a fair and equitable manner is well founded.
- 3.32 Additionally, as a qualitative check, an internal audit of BMIF’s claims management process also concluded that the current measures in place were largely satisfactory.<sup>29</sup> For example, claims exceeding £250,000 need approval from a secondary claims handler. The audit also found that there is effective and timely senior management oversight of claims-handling issues and large claims, and that all payments need an additional authoriser to review all relevant information.
- 3.33 Lastly, the low number of complaints registered against BMIF also suggests that it provides a high-quality service to members.<sup>30</sup>

<sup>28</sup> This includes cases where BMIF was successful in defending the claim and did not make any pay-out, but was unable to recover its costs from the claimant.

<sup>29</sup> Thomas Miller (2016), ‘Thomas Miller Internal Audit – Bar Mutual Claims and Reinsurance’, June, pp. 13–4).

<sup>30</sup> See letters from Financial Ombudsman Service to BMIF.

### 3E Risk-based pricing

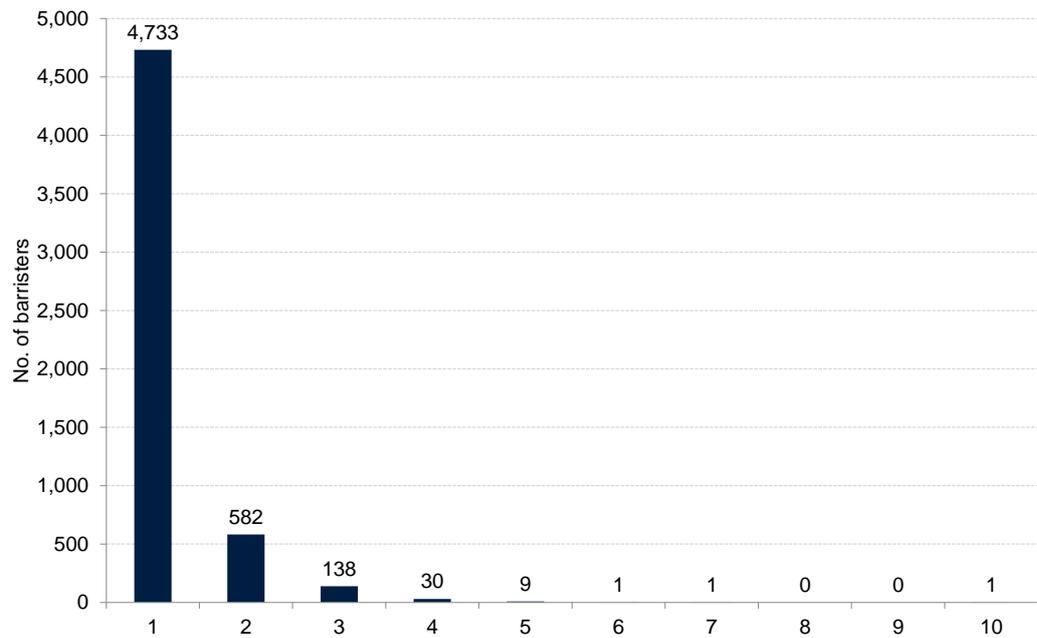
- 3.34 As noted in section 2, the pricing strategy adopted by an insurance provider is an important factor in the potential effect on adverse selection and moral hazard, and on the functioning of the market. As discussed above, the extent of risk-based pricing can vary from individual underwriting, to separate pricing for groups of users with similar risks, to a single price for all users.
- 3.35 As a provider becomes more granular in its approach to risk-based pricing, there is more of a trade-off between costs and the adverse selection issue. While individualised risk-based pricing limits the problems around moral hazard, it also leads to higher costs in terms of information-gathering and underwriting.
- 3.36 BMIF's pricing model involves charging different rates across different practice areas. Members pay premiums based on the type of work undertaken, the fee income, and the limit of cover. Individual claims history is not currently taken into account. According to data published in its 2016/17 rating schedule, basic policy fee rates vary from 0.15% to 6% of the published income of the barrister in the relevant practice area.<sup>31</sup>
- 3.37 Oxera understands that the variation in basic rates is driven by a combination of factors, including the history of claims in each practice area and the types of cases dealt with by barristers. For example, barristers dealing within the 'Revenue Non-Crown Instructions Non-contentious' area are potentially exposed to high-risk cases (such as tax-frauds), which are potentially more vulnerable to future claims. Within the 'Landlord and Tenant' practice area, residential property work attracts a lower rate (1.5%) than commercial property (2.0%).
- 3.38 Additionally, BMIF's policy renewal form questionnaire considers other factors such as the proportion of income from international practice, whether the member is involved in public or licensed access work, and whether they have the authority to conduct litigation.<sup>32</sup>
- 3.39 Where applicable, BMIF reflects significant changes in risk in the categorisation of each practice area and the associated premiums. For example, in 2010, the 'Revenue non-Crown Instructions' practice was divided into contentious (lower risk) and non-contentious (higher risk). After this segregation, ratings for 'Revenue non-Crown Instructions Contentious' declined from 3.5% in 2010 to 0.9% in 2014, whereas those for 'Revenue Non-Crown Instructions non-Contentious' increased from 4.5% to 6%. There has also been a separation of 'Professional Discipline' from the 'Criminal' practice area since 2010.
- 3.40 Based on these factors, BMIF does apply some risk-based pricing, albeit at an aggregated level. Private insurers typically apply a more comprehensive form of risk-based pricing through individual underwriting, which may include factors such as the past claims history of the policyholder and more information about their characteristics, which could include factors such as age and years of service.

<sup>31</sup> Bar Mutual (2016), 'Rating Schedule 2016/17', [http://www.barmutual.co.uk/fileadmin/uploads/barmutual/2016\\_documents/Rating\\_Schedule\\_2016.pdf](http://www.barmutual.co.uk/fileadmin/uploads/barmutual/2016_documents/Rating_Schedule_2016.pdf), accessed 6 October 2016.

<sup>32</sup> Bar Mutual (2016), 'Renewal of Cover for 2016/17', January, [http://www.barmutual.co.uk/fileadmin/uploads/barmutual/2016\\_documents/Renewal-form-2016.pdf](http://www.barmutual.co.uk/fileadmin/uploads/barmutual/2016_documents/Renewal-form-2016.pdf), accessed 4 October 2016.

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- 3.41 In considering whether BMIF's degree of risk-based pricing is insufficient, a key question is whether a more individualised risk-based pricing is feasible in this market, and indeed whether that would be beneficial for barristers and consumers. In particular, one question is whether there are certain risk factors that BMIF is not using and that could this result in moral hazard, as barristers would not be properly incentivised to avoid claims.
- 3.42 For example, in the solicitors market, private insurers typically take into account the individual claims history of the insured and a range of other factors such as the total fee income, a breakdown fee income by area of practice, details of staff members (solicitors and non-solicitors), and details about the partners (in the case of a partnership). Most of this relates to firm-level data rather than individuals, and hence may not be particularly relevant for the barrister market. Nevertheless, there could be scope for BMIF to further refine its approach to pricing. For example, factors such as number of years of experience, year of call to the bar, association with a particular chamber, and education, may be relevant in terms of risk-based pricing.
- 3.43 Within the range of possible risk factors, there is an important distinction between those that barristers can affect through their risk-taking behaviour, and those that they cannot. For example, factors such as age, years of service and education do not directly relate to the behaviour of barristers. Past claims history, however, can be controlled by a barrister, by varying activities and hence the risk of claims. If this latter factor is important in determining the risk of making claims, then there is a risk of moral hazard if this factor is not included in risk-based pricing.
- 3.44 Data on claims paid since 2006 indicates that the average number of claims per year is approximately 85 across all practice areas. The evidence indicates no or a limited correlation between claims history and the likelihood for a claim against individual barristers. Figures 3.10 and 3.11 document the number of barristers who have received repeated claims notifications and have been involved in repeated claims payments respectively. The analysis considers all claims notifications and claims paid since 2006.
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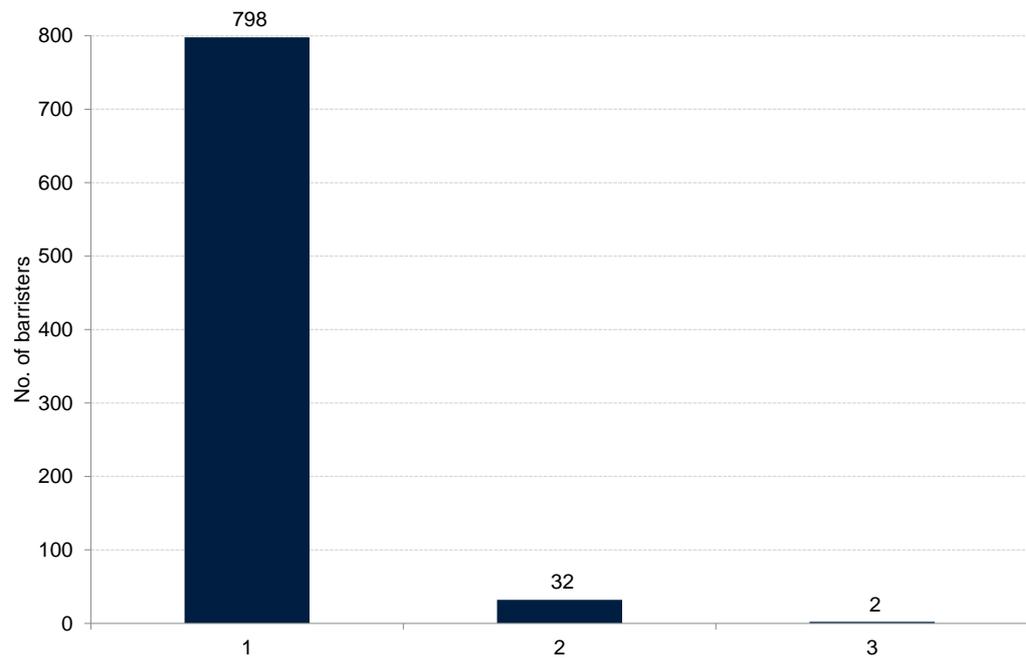
**Figure 3.10 Data on barristers receiving repeat notifications**



Note: 2016 data is year to date.

Source: Oxera analysis, based on data from BMIF.

**Figure 3.11 Data on barristers with repeat claims payments**



Note: 2016 data is year to date.

Source: Oxera analysis, based on data from BMIF.

3.45 While a large proportion of barristers have received at least one claim notification, the significantly lower number of actual claims paid indicates that the majority of the claims received were not valid. Furthermore, c. 5% of notified barristers have received more than one claim.

- 3.46 On average, only c. 6% of all barristers have incurred a successful claim against them in the ten years up to 2016. Within this sub-set, over 95% of barristers have been associated with only one successful claim against them.
- 3.47 Based on these findings, there does not appear to be any obvious or pressing requirement for a shift in BMIF's pricing strategy towards a more individualised risk-based pricing, and indeed it is not clear whether there are likely to be any significant benefits from improvements in the conduct of barristers. In sum, it may be possible to include more risk factors but there are likely to be limits, and it is unlikely that these would systematically relate to 'conduct' in terms of risk-taking behaviour.<sup>33</sup>

### **3F Conclusion**

- 3.48 A number of key messages emerge from the review of BMIF's operational, financial and member data.
- 3.49 First, the evidence suggests that BMIF premiums have been relatively stable, except intermittently, where changes were necessary to reflect the claims costs associated with the practice area. This is the case for the primary practice areas as well as for the overall market. Indeed, the growth rate of premiums between 2010 and 2015 has been considerably below UK inflation over the same period. Overall, this is consistent with BMIF delivering stable market outcomes.
- 3.50 Second, while BMIF's operating expenses per member have increased at a small rate over 2010–15, this is broadly consistent with UK inflation. Importantly, BMIF's operating costs appear to be low relative to those of other providers, including relevant mutuals, private providers and the overall UK general insurance market.
- 3.51 As expected given the lower operating expense ratio, the evidence reveals that BMIF has a higher claims ratio than peers and overall industry averages. Average claims payments have been stable over time and the evidence does not indicate any systematic trend in claims payments.
- 3.52 Another potential concern regarding the current market provision was the lack of individualised risk-based pricing by BMIF and whether this is leading to moral hazard problems through undesirable conduct by barristers. The assessment suggests that, while more risk-based pricing may be possible, there is no clear evidence that there are additional risk factors that would substantially improve conduct, or that the current pricing creates issues of moral hazard.
- 3.53 Overall, the available evidence indicates that BMIF, despite being a sole provider of PII to barristers, does not appear to raise material concerns for barristers, and for consumers. In fact, in addition to the cost advantages, BMIF may also deliver a number of other benefits due to its position as a single mutual—including, for example, better monitoring of undesirable conduct or other risks arising in specific practice areas; and reducing entry barriers into the barrister market by guaranteeing provision of PII.
- 3.54 The BSB may consider putting in place certain processes to maintain and potentially enhance the efficiency of the market. For example, it could consider:

<sup>33</sup> It may be helpful to subject BMIF's claims data to a sophisticated quantitative analysis to identify potential new risk factors. BMIF indicated that it has not undertaken such an analysis.

- reviewing and monitoring BMIF's claims-handling processes on an ongoing basis to ensure that it delivers the right outcome for barristers as well as for consumers;
  - assessing, using BMIF's database of claims history, whether there are additional factors that may be influencing risks and that can be taken into account when setting the premium ratings for individual barristers;
  - assessing barrister and customer satisfaction with the service that BMIF delivers (e.g. by undertaking surveys).
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## **4 Counterfactual scenarios and implications for BSB's review**

- 4.1 While the current mutual insurance model may deliver a number of benefits to barristers without imposing material costs (as detailed in section 3), in principle, it may be possible that the removal of its mandatory nature would not undermine the model.
- 4.2 This would depend on the market structure that is likely to exist in the counterfactual, in which it is no longer compulsory for self-employed barristers to insure with BMIF.
- 4.3 This section therefore considers the potential outcome in this counterfactual scenario. The outcome is determined by two interrelated factors:
- would private insurers attempt to enter the barristers' PII market if they were allowed to do so? If so, how would they price in order to win business?
  - would a substantial number of members switch? If so, who?
- 4.4 The extent of entry by private insurers and switching by barristers would then determine the likely impact on BMIF, and how BMIF would be likely to respond.
- 4.5 Finally, we consider these potential developments in terms of their implications for the regulatory framework.

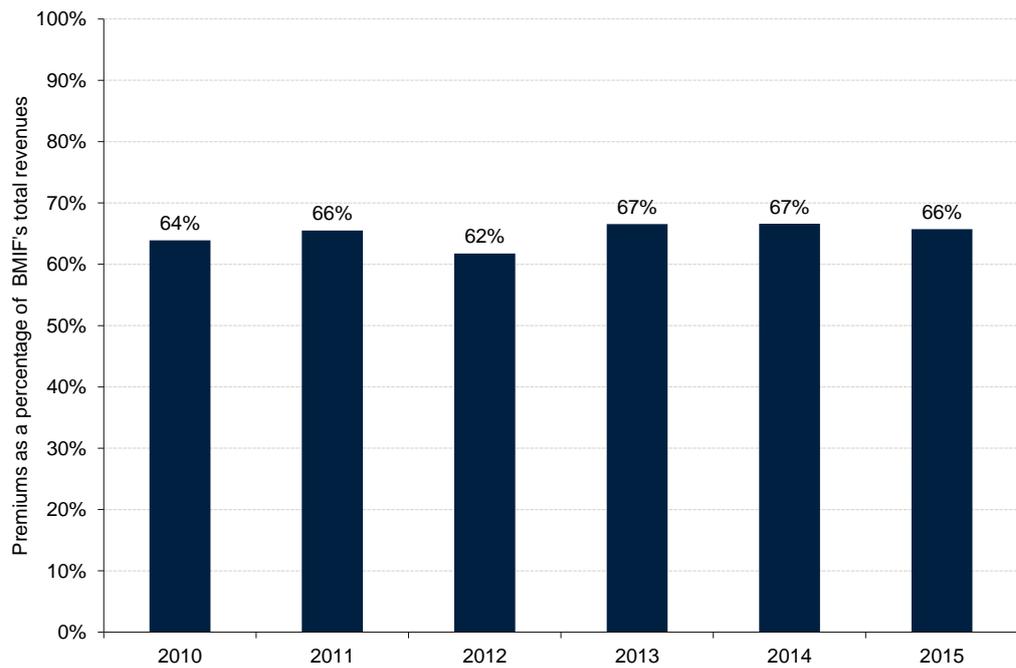
### **4A Entry by private insurers**

- 4.6 In principle, one would expect private insurers to be interested in entering the barristers PII market, as they entered the solicitors PII market when that was opened up to entry. Indeed, a survey of 26 insurers (by Marsh) indicated a reasonable level of interest from private providers in entering the barristers PII market.<sup>34</sup> Although this market is smaller than the market for PII for solicitors, there is in principle no clear reason why it would not be of interest.
- 4.7 The nature of the market also suggests that there would be opportunities for private insurers to win significant market share by offering lower prices (for at least a certain period of time, to incentivise barristers to switch) or better terms to specific groups or types of barrister. For example, Figure 4.1 shows that the top 20% practice areas by in terms of revenues, corresponding to 6 out of 31 practice areas, contribute approximately two-thirds of BMIF's total revenues. The top three practice areas and their contributions to revenues are: 'Personal injury': 19%; 'Commercial': 18%; 'Chancery contentious': 13%. Private insurers targeting practice areas such as these could gain a significant potential market share, which would help to incentivise entry.

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<sup>34</sup> Marsh (2015), 'Report on Professional Indemnity Appetite for Barrister Entities for General Council of the Bar and Bar Standards Board', 6 March.

**Figure 4.1 Revenue share of the top 20% practice areas (2010–15)**



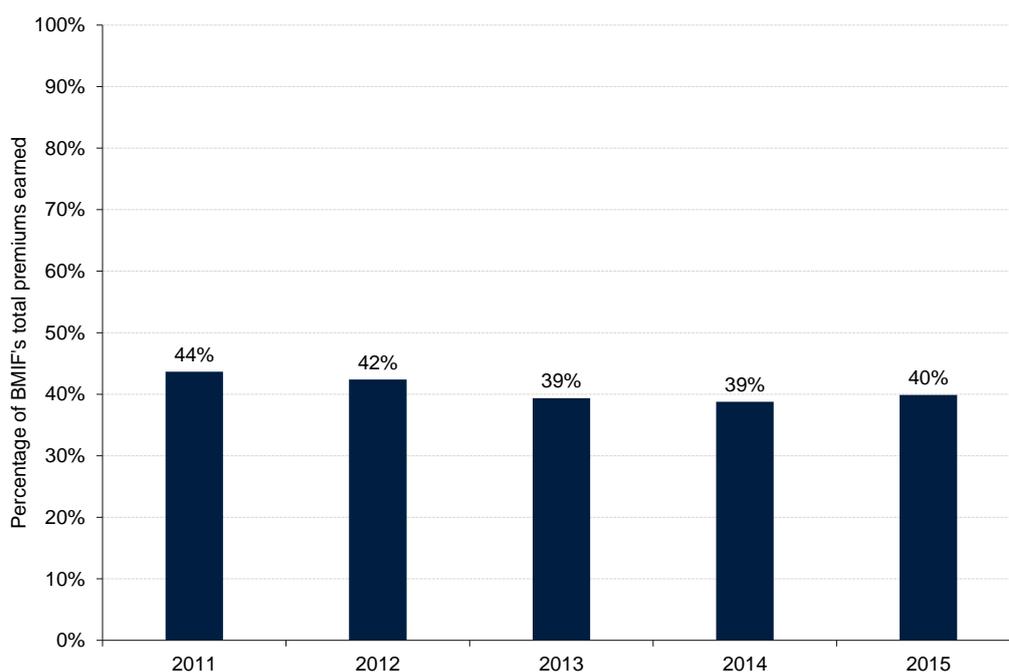
Note: Data reflects the proportion of premiums contributed by top 20% (six out of 31) practice areas by premiums paid.

Source: Oxera analysis, based on data from BMIF.

- 4.8 Similarly, when considering the chambers, the top 30 chambers—out of around 396<sup>35</sup>—represented more than 40%, on average, of BMIF's revenues across the period 2010–15 (see Figure 4.2). The top ten chambers contributed around 20% of BMIF's revenues. The top 20 represented around a third of BMIF's revenues.

<sup>35</sup> Average for the period 2011–15. See Bar Standards Board, 'Chamber statistics', <https://www.barstandardsboard.org.uk/media-centre/research-and-statistics/statistics/chambers/>.

**Figure 4.2 Revenue share of the top 30 chambers (2010–15)**



Note: Data reflects the proportion of premiums contributed by the top 30 chambers (out of around 396 chambers in total) by premiums paid.

Source: Oxera analysis, based on data from BMIF.

4.9 To enter the market, private insurers would need to offer more appealing terms or lower prices than BMIF. This could take a number of forms:

- simply undercutting BMIF on price, although this would be sustainable only in the short term unless the private insurer had a significant cost advantage, which seems unlikely given BMIF's current cost advantage (see section 3);
- undercutting BMIF for certain barrister types, by using risk-based pricing for variables not currently considered by BMIF;<sup>36</sup>
- offering different terms that allow for lower cost, such as with regard to the run-off period, which is currently provided by BMIF for free, while private insurers may be able to offer lower-cost insurance that does not offer this feature;
- providing innovations that increase the quality of service, although few such potential innovations have been noted (see section 3).

4.10 Private insurers therefore have a number of potential opportunities for entering the barristers PII market, which could allow them to gain significant market share.

4.11 In terms of past examples of entry by private insurers into PII markets, the evidence is mixed but does point to entry where there is a significant market opportunity. For example:

<sup>36</sup> Section 3 finds that there may be limited scope for using past claims in risk-based pricing, but there may be other factors that are more powerful indicators of the likelihood of claiming that are not related to an issue of moral hazard.

- private insurers supplied insurance to the solicitors market following the closure of SIF in 2000;
  - the CLC has indicated that so many firms opted out of its Master Policy Scheme (MPS) to take insurance with private insurers that the MPS had to be closed;<sup>37</sup>
  - in contrast, PAMIA has seen very little switching to private insurers, although it does not (and did not) offer insurance to all firms, but rather to a core group that supports PAMIA.<sup>38</sup> It is understood to make greater use of risk-based pricing than BMIF.<sup>39</sup>
- 4.12 Where there has been a significant market opportunity, as with solicitors and conveyancers, private insurer entry has been observed. In the case of PAMIA, however, the opportunity was much smaller, and there entry has been much more limited.
- 4.13 This is also consistent with the experience of barristers themselves, as it is already the case that barristers can, in principle, go to private insurers by first becoming an SPE or MPE. As only 57 such entities have been created so far, the market opportunity for private insurers has been very small, and hence only a single SPE has chosen to use TLO, the private broker providing top-up to barristers.<sup>40</sup>
- 4.14 Entry by private insurers into the barrister PII market would therefore seem feasible. But would barristers choose to switch to these new providers?

#### **4B Barristers switching to private provision**

- 4.15 A barrister's incentive to switch depends on a number of factors, including their level of premium with BMIF and their likely premium in the private market; the stability of premiums; the perceived quality of service (e.g. in claims-handling); and the extent and cost of run-off cover (and certainty about costs).
- 4.16 A barrister's incentives would therefore depend on the entry and strategy of private insurers. The extent of switching is therefore inherently difficult to assess, especially in the long run.
- 4.17 On the one hand, it is not impossible that, even if BMIF is not mandatory, a limited number of barristers will switch and BMIF's operation will not be affected to any material degree (although it might lead to some increase in costs). PAMIA (patent attorneys) and NDDUS (dentists) provide examples of where a mutual coexists with other providers.
- 4.18 If, on the other hand, a number of different private insurers target a number of major groups of barristers, much more significant switching is possible, as has been observed in the case of conveyancers.

#### **4C Potential impact on BMIF**

- 4.19 The impact on BMIF of allowing private insurers to enter the self-employed barrister PII market (beyond providing top-up cover) is highly uncertain, and depends on the extent of entry and switching, as discussed above.

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<sup>37</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer', July, para. 32.

<sup>38</sup> This contrasts to the situation for BMIF, which has a much larger and disparate group of customers who may have weaker ties to the mutual insurance concept than is the case with PAMIA.

<sup>39</sup> Legal Services Board (2016), 'Thematic review of restrictions on choice of insurer', July, para. 32.

<sup>40</sup> This single example is a firm that also provides solicitor services, so is also part of the solicitor PII market, where private provision is common.

- 4.20 If significant numbers of BMIF members were to switch to private providers, this would result in a significant loss of revenue for BMIF, and thereby a higher overhead cost per member, to the extent that BMIF faces fixed costs. While most claims-management costs can be expected to vary in line with the number of policyholders (which determines the number of claims), other costs, such as those of management and operations, are more likely to be fixed. Overall, this is likely to lead to an increase in premiums for members who remain with BMIF.
- 4.21 BMIF does not offer PII for other types of profession or other types of insurance. A very significant impact on BMIF may mean that BMIF's insurance pool would become too small to be viable, with relatively high overhead costs.
- 4.22 The threat of such loss of business can be expected to result in BMIF reacting to entry by private insurers. If private insurers adopt more risk-based pricing, it is likely that BMIF would adopt similar pricing if this allowed it to compete on prices (which would be expected). BMIF would also be likely to spend more on marketing and acquisition in response to competition. These changes would further increase its costs (due to underwriting and marketing/acquisition), and ultimately lead to a further increase in average premiums.<sup>41</sup>
- 4.23 The focus of private insurers on certain types of barrister, along with higher costs for BMIF, may mean higher premiums for less profitable practice areas/barristers and consequently an increase in the cost of access to justice in certain areas. Family law and criminal are understood to be examples of less profitable areas that are under financial pressure. On the other hand, other practice areas may benefit from lower premiums due to private insurers.
- 4.24 The overall impact is uncertain, however, as the response of BMIF, or perhaps even the expectation of a response of BMIF, could limit or even completely deter entry by private insurers and switching by barristers. As demonstrated in other PII markets, mutual insurers can, in principle, co-exist with private insurers.

#### **4D Conclusion**

- 4.25 In terms of the current regulation of barristers' PII, this analysis, while uncertain about the long-term outcomes of change, suggests that:
- the current arrangement of SPEs and MPEs being able to switch to private provision would appear to be unlikely to result in significant threats to the BMIF model, at least in the short to medium term. There has been very little switching to SPEs so far, and far less than would appear to be required to attract interest from private insurers;
  - however, removing the compulsory BMIF provision for self-employed barristers could result in more significant change for the market, as it would present a more attractive opportunity to private insurers than the current SPE/MPE market. The evidence suggests that there would be opportunities for private insurers to win significant market share by targeting a limited number of groups or types of barristers (such as those practising commercial law or personal injury) and/or specific chambers, thereby increasing their incentives to enter. Depending on the entry strategies of the private providers, there is a realistic potential for significant switching.

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<sup>41</sup> While some barristers would see premiums fall as BMIF competes with new entrants, other barristers of less interest to private insurers would be likely to see premiums rise.

- If a significant number of barristers do switch away from BMIF, it is likely to lead to an increase in their overall costs and ultimately the premium ratings of those who remain with BMIF. Overall, this would mean higher premiums for less profitable practice areas/barristers and a consequent increase in the cost of access to justice in certain areas, including those that are under financial pressure (such as family law and criminal work). At the same time, other practice areas may benefit from lower premiums from private insurers (at least for a certain period).
- However, the outcome also depends on the response from BMIF to such entry. If BMIF also adopts risk-based pricing and competes with private insurers—or is expected to compete—it may deter significant entry. In this case, BMIF could continue to operate with most of its current members and could continue to deliver benefits.

4.26 While the overall impact is uncertain, and depends on the strategies of the private insurers and BMIF, the analysis suggests that there is no clear evidence that the restriction, i.e. the obligation to use BMIF, is necessary to deliver consumer benefits. As demonstrated in other PII markets, mutual insurers can, in principle, co-exist with private insurers.

4.27 To further assess the likely counterfactual, the BSB could consider conducting a survey of barristers to gauge the level of switching in the counterfactual. This survey could also be designed to capture the barristers' responses to a number of alternative counterfactuals, including varying numbers of private providers and different price levels offered by them.

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