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Effect of tort reform in Australia and the impact on pricing liability insurance

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If we cast our minds back 5 years we will remember with a grimace the headlines that proclaimed ‘the end of fun’ – huge public liability insurance costs meant country fairs, school fetes, and kids’ sports days had been shut down. The world had gone mad, claimed the newspapers, and the insurance companies were behind it all.

Of course the government of the time couldn’t sit back and let this happen. And when the various States and Territories of Australia decided to respond to community concerns about the affordability of, and access to public liability, they decided that tort reform was the solution.

Some may call it a knee-jerk reaction, others called it much-needed reform. But whatever its name, tort reform has changed our industry significantly and we are yet to fully realize its implications. There have been accusations from the legal profession that the reduction in claims has not sufficiently fed through to reduced premiums. But because these critics don’t understand the time horizons we are working with, they have failed to see that many of the longer term effects are only beginning to emerge.

Today I would like to look at these issues, and examine some of the factors shaping the future of Public Liability.

Let’s start at the point when the road map for change was outlined by by Senator the Hon. Helen Coonan in a joint communiqué ministerial meeting on public liability press release in May 2002. It defines the expected outcome of a consistent nation-wide approach .¹

- increase certainty and predictability of costs of claims for insurers, critical in containing premium increases
- managing community expectations about personal responsibility and risk
- public liability cost reduction and containment

Can we say that, following the introduction of tort reform, prices for liability insurance have dropped? A resounding “Yes”.

In fact, I would contend that they have fallen so far and are in grave danger of falling much further, that there is a very real prospect of insurers under pricing public liability in the not too distant future. I will come back and explain this point further a little later.

I would suspect this is not necessarily a populist view?

Can we also say that liability insurance is freely available for the risks of the community? Again, a resounding “Yes”. There are generally many options available to the buyers of this product.

The next logical question must be to what extent has this available and very affordable (esp. 2005/06) public liability insurance been a result of tort reform?

¹ Press Release 30/5/02 P.2

There are those who would contend that the environment facing insurers in the Australian marketplace in 2002 were nothing other than a normal market cycle. They would go on to suggest market forces would have, in the fullness of time, reversed the cycle and things would be just as good as they were at the start of the cycle.

I have been in the business for over 30 years and have experienced market cycles throughout this period. What we saw in 2001/02/03 was not adequately explained as part of a normal market cycle. There was a lot more substance behind it. I recall saying to my colleagues at the time that what we were experiencing was something never seen in this country before, and I doubt that all the ducks that created the phenomena would line up in a row like that again, before I retired.

Dallas Booth's response from the ICA in July 2005² on behalf of the industry goes into more detail on these factors that created the rare market conditions. They were also referred to in the Trowbridge Deloitte report of March 2002, and described by that independent observer as a crisis.³

The pricing increase and lack of insurance availability was clearly sparked by something more than just simple market gyrations.

The Federal Labour member for Denison, Hon. Duncan Kerr, alleged late last year that the insurance industry constructed a crisis, imposing much higher premiums for voluntary organizations and small business with no risk profile to force federal and state governments to respond in ways that would increase the profits.⁴

To propose this, it would have required

- collusion amongst the many insurers who walked away from the business or who restricted their portfolio
- insurers would have had to consciously leave their clients in the lurch without cover when allegedly their secret true motivation was to come back shortly after and write their account at a much larger premium
- confidence that an oversupplied market place would allow the insurers who walked away back into market share

Clearly, this scenario of the Member for Denison just doesn't make much sense.

Has tort reform provided the silver bullet to pricing and availability? Has it been the sole cause for the reversal of fortunes for buyers? The answer is "not really".

To be a little more positive about its benefits, I would say that the potential for tort reform to impact pricing and availability in the future is greater than its current impact. This presupposes that those calling for the reforms to be wound back in one form or the other don't succeed.

² Industry Response to the Liability Challenge in Australia, ICA, July 2005.

³ Trowbridge Consulting, Public Liability Insurance, Analysis for Meeting of Ministers 27th March, 2002.

⁴ AAP 14th September, 2005

Before we can further explore the detail, it is crucial we understand the long tail nature of liability insurance and the delay that occurs in observable incurred loss development.

Some of the legal fraternity who will commentate on the lack of temporal relationship between tort reform and price relief, are seeking instant gratification. In some way there was an expectation that the insurance market would collude → in this case to lower premiums and not increase them → from the very first reform.

I can recall my New York colleague saying that Australian lawyers are as smart as the US, and in his experience when certain avenues are closed to them, lawyers can be the mothers of invention. Was there a way around the impact of tort reform? This earlier view has been echoed for me in an interview with the Australian Financial Review, High Court Chief Justice Murray Gleeson said that lawyers are doing their best to get around the liability caps.⁵

Unless you have a more informed exposure to the business of insurance, I can see how one might expect to see an immediate correlation between reform and price reductions.

If one had an agenda against the reforms it would be quite easy (and with need for little evidence) to allege that insurers have not lived up to expectations of Government and haven't reduced prices.

In his December 2005 end of year message to members, John North, President of the Law Council of Australia said that "Insurers are making record profits at the expense of the injured and passing none of the benefits to the community, through premium reductions". I am very pleased to be able to inform Mr. North there are significant premium reductions coming through.

The Hon JJ Spigelman AC, Chief Justice of New South Wales noted in his "straws in the wind" speech "there is an active debate in Australia as to whether or not the statutory changes have gone too far. This debate is to some degree fuelled by the modest reduction in premiums that has occurred to date, in contrast with the considerable increase in insurance company profits and their escalating share prices".⁶

Undeniably, the insurance companies have experienced strong results over the past couple of years, however you would have to highlight that the insurance index wasn't the only one in the past 5 years showing escalating share values.

I can only say again, there has been significant discounts given out in the market place for liability insurance.

To assist in visualizing what has been happening, let us look at pricing over the past 6 years, including 2006 and also make a prediction for 2007. If we assume that 2000 premium

⁵ Insurance and Risk Professional April – May, 2006.

⁶ "Negligence: Is Recovery for Personal Injury too Generous?" The Hon JJ Spigelman AC, Chief Justice of New South Wales, 14th Commonwealth Law Conference, London. 14th September, 2005

represents 100% price adequacy, the cumulative effect on prices since that time, given market rate movements are:-

However, to say that the year of 2000 is price adequate is a big stretch. The Net Loss Ratio for that year (APRA data) exceeded 120%.

More likely, is that 2001 prices were adequate (although even that Loss Ratio is in excess of 100%, I have tried to reflect on the differences in underwriting year and financial year figures). If we accept that 2001 prices are right, then the price fluctuation looks like:

- I have used ACCC figures from 00 – 04 and JP Morgan (Corporate) figures for 05. As there are no other market figures available, I have used roughly my own firm's rate movements for 06. By any scrutiny, may I say that these figures are conservative. I have used 15% for 2006 and the same, 15% for 2007.

Premiums are going down in 2006 and as an outlook for 2007. There is no question of that. But I don't just want you to take my word for it. That's why LIU conducted a survey of the brokers in the insurance industry, and the results were a clear snapshot of industry sentiment.

The views were unequivocal. The vast majority of brokers have seen rates reduced: around half (or 47 per cent) believe they have moved by 10-20 per cent. A quarter of respondents saw a 20-30 per cent reduction. And 1 in 5 brokers have seen prices move by more than 30 per cent. What this means is that the brokers are seeing price reductions – as we speak – of an average of 20%.

And that trend is set to continue for the next year at a similar rate. 46 per cent see a 10-20 per cent reduction on the horizon, 14 per cent see a 20-30 per cent and 11 per cent predict 30 per cent or more. In 2007, the brokers are today predicting an average reduction of 15%.

To put it simply, 97 per cent of brokers surveyed have seen a reduction in rates, and 96 per cent expect it to continue.

The good news is that there is a high level of support for tort reform, and indeed, most are optimistic that tort reform will achieve its aims. Four out of five of those surveyed believe it will successfully reduce rates in the long term and 93 per cent believe it will create a more equitable and sustainable tort environment.

If, as the market predicts, the rates continue to tumble next year for the 4th year in a row, the simple prediction is that the required pricing will slide below the minimum needed to support the capital tied up in the class. We then run the risks of seeing this capital redeployed into a product or class (or country) than can provide adequate returns. This is a loss position only saved by investment income.

The questions insurers face and have faced ever since reforms were accurately known, is how to calculate the savings we can expect to realize as a result of tort reforms. How do we price a product written today that accurately reflects the impact of tort reform and will produce the

required level of return in 5 to 10 years time when all of our liabilities under the policy have been recognized.

We know we can expect reduced claim numbers and are already experiencing this, particularly at the lower end of quantum.

Actuaries are heavily relied upon in the exercise to calculate the financial impact of tort reform. It is interesting to hear their views.

Actuaries will say -

- there is a volatile and long tail nature to public liability claims. This causes concern when there is a possibility of roll back as proposed by some. It has every chance to muddy the waters in attempts to calculate the ultimate cost of claims.
- NSW CTP tort reform showed up the difficulties of interpreting current legislation when there was rapid erosion of thresholds in the first couple of years of the scheme.
- For claims under \$20,000 legal and investigation costs totaled over 57% of claims pre tort reform. If there is (and there would seem to be) a large reduction in this number, there would be a clear impact in total cost. (But it also highlights the cost of delivering small claims via the legal system).
- However it is crucial to remember that the smallest **70%** of claims numbers comprise only **10%** of claims dollars.
- It is reasonable to consider that tort reform has led to a sizeable decrease in the smaller end losses.

The actuaries struggle with providing clear advice, so early on in the assessment of tort reform.

As they themselves have said “Tort reform is currently around 2 to 3 years old and we would expect 30% or less of the impact of the first year of post tort reform claims to be represented by payments. This makes it difficult to be conclusive about the overall impact of tort reforms on claims costs.

This is not helped by the claims frequency of personal injury claims being less than 1 in 100 policies. At this frequency, the probability of an individual insured having no claims is:

- 99% over a 1 year time period
- 95% over 5 years
- 90% over ten years⁷.

⁷ “Public Liability – Assessing the Impacts” Maitra, Pearson, Pettifer, Turner, Wilson. Institute of Actuaries Australia, XV General Insurance Seminar, 2005.

However, PricewaterhouseCoopers (PwC) was engaged to provide an Actuarial assessment⁸ of the recommendations arising from the Ipp review.⁹

The conclusions of the assessment estimated that the net effect of all the proposed (quantifiable) changes will reduce public liability claims by 14.7%. This reflects a reduction of 19.6% in personal injury matter and nil property damage. All things considered, PwC proposed that the reductions in claims costs might translate into reductions in premiums of 13.5% on average. It is interesting to note that since 2002 when the PwC report was prepared, even after a further rate rise in 2003, rates overall have reduced by 27%!

Remember this → tort reform impact on losses in 2003/04, will take until 2008 or so before some real certainty can be put around the outcome.

In the meantime, prices have gone down considerably and wide availability exists. Tort reform has played a strong part and will continue to play a vital part, so long as it remains consistent.

At a time during the past 2 – 3 years when reforms should have been the driver for price reductions, it has become the almost total public rationale for continued discounting. Also, reforms have provided confidence for some new capacity/ new insurers to come into the marketplace. However, once committed to the marketplace, they have to look for marketshare. To achieve this in a downward looking rate cycle means that they have had to give hyper discounts to achieve this market share.

Some of the negative comments emanating from opponents to tort reform try to gain credibility from the profits being reported by insurers.

I touched briefly on IBNR/ER with my first slide. If we are to have a serious debate about profitability, there has to be a clear understanding by all concerned about the differences between

- Financial Year
- Accident Year
- Underwriting Year

particularly when dealing with a long tail account.

Moving on, I want to highlight an emerging issue alluded to in my earlier slide regarding the cumulative impact of the discounted premiums we have seen over the past several years and an immediate outlook of continued discounts.

Let me be one of the first in this marketplace to say that the relative good fortune of liability insurance over the past few years is under real threat. The financial year results have been strong, and insurers have taken early profits because of tort reform and a rosy outlook

⁸ Report to the Insurance Issues Working Group of Heads of Treasuries, Actuarial assessment, 7th November 2002, p.3.

⁹ Review of the Law of Negligence under the Chairmanship of The Honourable Justice David Ipp.

generally. The President of the Law Council, John North has highlighted this matter for us previously.

The 2006 financial year results will not be the same as the fiscal outcome of the 2006 underwriting year.

As Australia experienced in 2001/02 it is a very uncomfortable and unacceptable position for the community to be in if there is no viable public liability insurance market.

But with such a publicly robust marketplace in 2006, how can there be such a negative outlook?

As The Honourable JJ Spigelman AC, NSW Chief Justice, observed in his “straws in the wind” address¹⁰, the Australian experience in the years 2002/03 occurred in a unique context : the business cycle in the insurance industry transformed a buyer’s market into a seller’s market, virtually everywhere. Quite quickly, demand exceeded supply and this was reflected in premiums. The cumulative effect caused the explosion in premiums.

Absolutely right.

What happens when the market cycle is 180° advanced from this position? Clearly it is where

- supply exceeds demand
- premiums reduce, to the point where they are clearly unprofitable

We currently sit close to the cusp of this outlook.

Let me be frank. As John Singleton once so succinctly observed, Australia is too small for demographics. We are a

- country of 20 million people
- we are a mature buying community of insurance and have been for over 20 years
- the premium pool is finite and small for liability insurance. Without taking into account market gyrations, it will not organically expand annually beyond very small single digit figures .

However, even faced with a finite but still reducing market, many insurers are under pressure to grow their top line from their stakeholders – particularly in light of the past few strong financial year results.

From my own experience, there is quite a deal more competition now in 2006 than there has been in the recent past. The picture is clear

- the financial year results are strong for the liability class

¹⁰“Negligence: Is Recovery for Personal Injury too Generous?” The Hon JJ Spigelman AC, Chief Justice of New South Wales, 14th Commonwealth Law Conference, London. 14th September, 2005.

- as a direct result, most companies are seeking growth in their top line
- we have seen a proliferation of MGA's over the past 2 to 3 years. These are organizations who gain, usually, insurance capacity from offshore insurers and participate actively in the market. These guys put food on the table by the commission they get in selling liability insurance. The skin they have in the game is virtually nil – they have to sell liability insurance to survive and so they have to make the market to sell. Soft market conditions will still see MGA's trying to gain market share and grow GWP.
- The market is heading downwards and many brokers are worried that if they don't remarket their accounts, an attacking broker may blindside them. This constant and common remarketing of accounts make it more difficult to rely upon continuity.
- If you have a finite premium pool and there are more people wanting to take a share - and most people – even the existing guys – want more, then simple economics 101 will tell you with supply outstripping demand there will be and has been significant discounting.

It's not rocket science to work out that with a finite (indeed reducing) premium pool, and with a majority of the numerous participants in the liability market wanting top line growth, any semblance of underwriting discipline will disintegrate, and in the medium term profits will disappear to be replaced by losses.

Andries Terblanche said at an AILA meeting that there was tension in the insurance industry because of the inability to grow. Underwriting and investment returns were leveling off, and that could signal "the onset of typical cyclical behaviour". It is my duty to inform you that typical cyclical behaviour is certainly occurring!

Tort reform has a role to play in a soft landing for both underwriters and clients.

After several years of showing strong results, obviously additional industry capital has been generated. This extra capital needs to be serviced or grow income to support this capital and hopefully show additional profits.

Most of the solutions to this simple strategy involve market share wars that impact policy pricing.

Conversely, after years of poor results this depletes the industry capital and with a view to protect what is left, insurers scale back their underwriting activity and appetite for risk.

The legal fraternity has used a lack of rate reductions to partly support an argument for a roll back in tort reform. They figure that if the goals that drove tort reform was introduced haven't materialized, then why continue with it. However I can absolutely assure you that there are discounts a-plenty in my market space.

My proposition early on was that we face the very real threat of underpricing the liability product in the near future.

The majority of the profits being recorded in the current financial year results of insurers is not emanating from current underwriting year efforts. They are being derived from releases from prior underwriting years claims reserves being dropped in a financial year P & L.

The earlier slide on price adequacy outlook is misleading.

It assumes that the cost of claims remains static throughout the period. This is not the case. Many of you will be familiar with the term “superimposed inflation”. The scourge of long tail third party underwriters. It is where the cost of a claim incurred in Year 1 of our IBNR slide blows out before it can be settled. This inflation figure has to be impacted by normal CPI inflation, but also tries to incorporate an allowance for shifts in the propensity to sue, judicial shift and tort reform.

It was a dark time in the decade of the 90’s when medical costs, wage costs, society’s transgression into a blame culture and a liberal approach to compensating plaintiffs all added up to an inflation in claims of 10% or more.

I will take an independent actuarial view of what has happened to superimposed inflation post tort reform.

There is a clear reduction in claim numbers, principally among the smaller claim bands.

- For recent years, only a small proportion of claims have been finalized. Hence it will be a number of years before definitive trends can be determined
- Could more complex claims be delayed following tort reform?
- Superimposed inflation can be difficult to estimate and apply post tort reform.
- Post tort reform will show a change in average claim size. They may well increase due to the reduction in small claims.
- Can tort reform cap superimposed inflation?
- If the effectiveness of tort reforms are gradually unwound then superimposed inflation over the next 3 to 5 years could be higher than longer term norm.¹¹

Frank O’Halloran said that current QBE claims inflation on liability is anywhere between 6-10%¹².

¹¹ “Public Liability Tort Reform – Assessing the Impacts”
XVth GI Insurance Seminar October 2005

¹² Interview with Michael Pascoe, Feb, 2004

So, while the good public have seen the return of the school fete and sports day, and have seen cheaper cover it is not going to be all fun and games for our industry in the next few years. Year on year rate reductions are bringing underwriting year rate adequacy closer to unacceptable levels. There is surplus capacity in the marketplace and in a reducing premium pool many insurers and MGA's are seeking to grow or at least hold on to their market share. This usually means a continuation of soft market conditions.

And while it's still too early to gauge the long term effects of tort reform, we can certainly make some educated guesses. The early benefits of tort reform are clear, and the marketplace has reacted favourably to the change in claims emergent patterns. If there is any roll back of tort reform, then the claims pattern will naturally alter. The pricing will also alter, and risk appetites will most likely need to be reconsidered.

If we continue to see increased competition and irresponsible discounting we will eventually underprice the liability product, and that will take us back to square one. An industry in turmoil, an unhappy public and nervous regulators. It is up to all of us in the industry to hold our nerve and continue to price responsibly and sustainably.

Data Capture for rate movements.

- a) ACCC September 2002 2nd Monitoring Report + January 2005 4th Monitoring Report into Public Liability and Professional Indemnity
- b) JP Morgan 2005 Market Survey Table 2005
- c) LIU and survey of brokers, May 2006 for outlook on 2006 and 2007 rate movements.