

The UK liability insurance market

Summary of key findings

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1 OUTLINE OF KEY FINDINGS

Prices and profitability

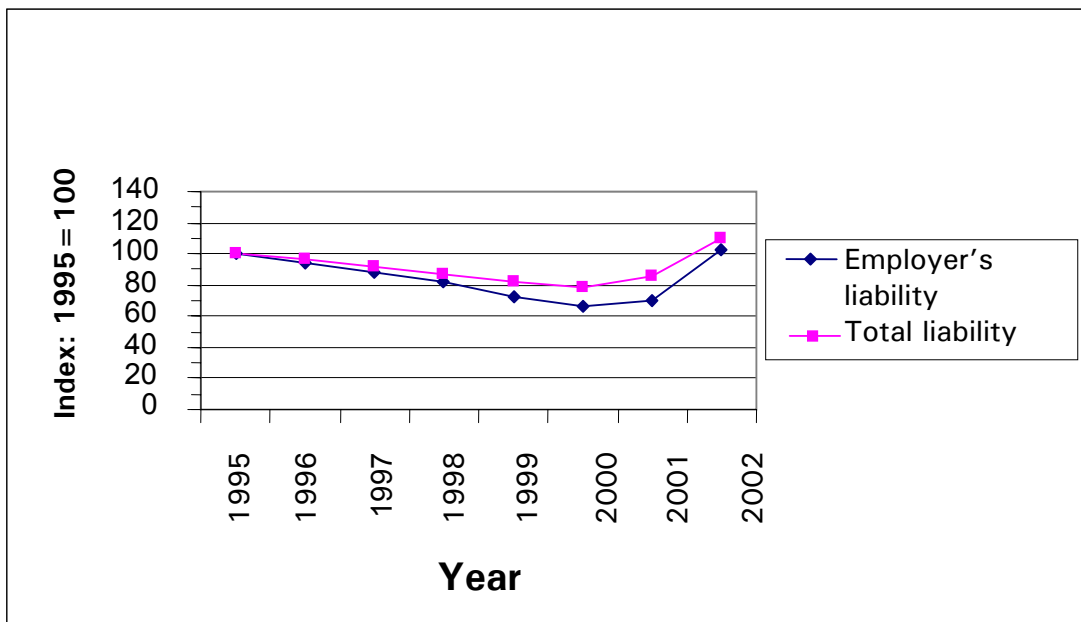
1.1 This study was undertaken against the background of concerns about increases in premiums for liability insurance.¹ We found that premiums had indeed risen substantially in 2002:

- 50 per cent for employer’s liability (EL).
- 30 to 40 per cent for public liability (PL – also includes product liability insurance).
- 30 to 60 per cent for professional indemnity (PI).

There were also wide variations in the increases observed, with some premiums rising by over 200 per cent.

GRAPH 1.1: GROSS EARNED PREMIUMS AT CONSTANT PRICES

1995 = 100



Note

Calculation of gross earned premium (GEP) at constant prices has been performed using a general Gross Domestic Product deflator – Source: National Statistics.

¹ Liability insurance comprises employers’, public and product liability and professional indemnity insurance policies.

In the absence of major changes in business volumes, changes in gross earned premiums (GEP) are expected to be a close reflection of premium prices. This assumption may hold less well for GEP Total liability, where levels of cover may vary than for GEP Employer's liability.

Between 1995 and 2001 both series showed an overall downward trend amounting to 14 per cent for GEP Total liability and to 30 per cent for GEP Employer's liability.

The year on year change between 2001 and 2002 for these data are respectively +27 per cent for GEP Total liability and +47 per cent for GEP Employer's liability.

1.2 It should be noted, however, that these increases followed several years of falling premiums. Between 1995 and 2001 liability premiums fell relative to prices by about 14 per cent. For EL they fell relative to average earnings by 37 per cent over this period. In addition, liability insurers as a group have been making underwriting losses (i.e. losses before investment revenues are included) for the last decade with underwriting ratios of 120 per cent i.e. claims plus expenses exceeded premium income by 20 per cent.

Effect of premium increases on business

1.3 We did not find evidence to support reported concerns that recent increases in premiums were such that many businesses had been unable to secure liability insurance at any price, and were consequently trading illegally or closing down.

1.4 Nevertheless, we recognise that certain types of business have suffered particular adverse effects as a result of premium increases. These include Independent Financial Advisors (IFAs) (who are required by Financial Services Authority (FSA) rules to have PI cover); Small and Medium Enterprises (SMEs)² (for whom increases in premiums are likely to have a more significant effect than larger businesses); businesses in 'high risk' sectors; businesses in Northern Ireland; and the voluntary sector.

Reasons for increases in premiums

1.5 Possible explanations given to us for the increases in premiums fall into two main categories: increases in insurers' costs and the competitive environment across the sector.

² For the purposes of the study, an SME is defined as a firm with between 10 and 249 employees.

Changes to costs incurred

- 1.6 The following possible sources of cost increases were suggested:
- expansion of liability – including new and uncertain types of liability, in particular ‘long-tail’ claims.
 - loss shocks, such as those arising from the World Trade Centre and claims relating to asbestos.
 - increases arising from changes in the legal system such as the introduction of Conditional Fee Arrangement (CFAs) and After The Event insurance³ (ATE), higher damages for individual claims and the Woolf reforms
 - lower investment returns, which have reduced insurers’ investment income (which can be used to offset underwriting losses) and increased the upfront cost of lump sum damages awards.
- 1.7 While each of these changes will clearly have had an inflationary impact on premiums, we are not persuaded that these factors alone account for the large increases in premiums experienced over the last year. There are other factors that may have had an impact on premiums.

Changes in the competitive environment

- 1.8 While the overall structure of the industry is relatively fragmented, some specialised risks may have a limited choice of insurer. This may limit competition between insurers for such risks. The widespread practice of giving policyholders short renewal periods may restrict further the extent to which they can consider alternative suppliers and reduce the level of switching and degree of competition. However we found no evidence of collusive agreements.
- 1.9 It was put to us that over the past five years at least, insurers had been competing in a way which was unsustainable and appeared to ignore the commercial realities of the business with decisions seemingly based on short term growth rather than long term profitability. This argument is consistent with the reductions in real premiums over this period described above.
- 1.10 Major insolvencies in the liability insurance sector following this period of intense competition have had the effect of increasing payments to the Financial Services Compensation Scheme (FSCS) and brought about a stronger demand from shareholders to restore profitability across liability lines and a reduction in

³ ATE insurance policies help to cover the cost of litigation once a dispute has arisen. Insurance cover can be purchased to cover both parties’ legal costs and disbursements.

capacity. This in turn appears to have encouraged insurers to reconsider their underwriting practices, taking a more selective approach to the risks they are prepared to cover.

- 1.11 Reductions in capacity have led to a short term upward pressure on premiums. However, in a competitive market we would expect to see new capital provided in response to opportunities for profitable business, although it is not clear how likely this would be in the long-term, particularly for EL.
- 1.12 The factors discussed at 1.9 to 1.11 above should not lead to continuing upward pressure on premiums over the long-term.

Areas of improvement

- 1.13 There are a number of measures which could be taken which should lead to the market working better, some of which are already starting to be put into practice by insurers' bodies, trade associations and government. These include:
- better communication between insurers and policyholders (largely through brokers) on:
 - longer renewal notice periods
 - likely premium increases and reasons for them
 - initiatives to improve information and risk management, so that premiums more accurately reflect risks by e.g. taking better account of good health and safety practice
 - greater use of rehabilitation for those injured at work which should reduce damages claims.

2 INTRODUCTION AND MARKET OVERVIEW

- 2.1 This study was undertaken in the light of widespread concerns over sharp, and often sudden, increases in the cost of the premiums charged for employers', public and product liability insurance and professional indemnity insurance policies – collectively referred to as liability insurance.
- 2.2 The purpose of the study was to determine how well the markets for liability insurance are working. We aimed to establish the scale and nature of recent price rises and identify the factors that were driving those rises. Accordingly we looked at cost increases, including changes to claims and legal costs; falling investment returns and other cyclical factors; and competition across the sector. These factors are discussed in summary below and in more detail within the main report. Finally, we noted some measures which might improve the functioning of the markets, some of which are already in hand.
- 2.3 We consulted a wide variety of interested parties including the insurers and their customers, representative organisations – including the Association of British Insurers (ABI) and trade organisations such as the Federation of Small Businesses (FSB) – independent businesses and other government departments. We also carried out a survey of SMEs across a number of sectors including construction, manufacturing, health and wholesalers. We commissioned Dr Chris Parsons of the Cass Business School to undertake some of the detailed research. Dr Parsons' work is incorporated in this report, and is also published in full on the OFT website at:
<http://www.offt.gov.uk/News/Publications/Leaflet+Ordering.htm> (see Reports/Consumer protection to download copies of the report).
- 2.4 Parallel work on this sector is also being carried out by the Department for Work and Pensions (DWP) on employers' liability insurance, and the FSA on liability insurance and professional indemnity insurance for independent financial advisers. The Office of Fair Trading (the OFT) will continue to assist and support any further work that arises from these pieces of work.

Liability insurance markets

- 2.5 **EL insurance** is designed to cover the liability that might devolve upon an employer if an employee is injured in the course of employment. **PL insurance** covers businesses against claims by members of the public (i.e. not employees) who suffer bodily injury or damage to their property through the negligent conduct of business activities. **Product liability insurance (PR)** covers manufacturers and suppliers against claims by customers arising in connection with dangerous or defective goods. For the purposes of this report we have included product liability insurance alongside PL. **PI insurance** covers

professional firms and individuals against claims for breach of their professional duty.

- 2.6 ABI estimates that in 2001 the gross written premiums of the UK liability insurers was around £3.5 billion. EL insurance is the largest single class, accounting for approximately one third of this total. According to Health and Safety Executive research, this equalled about one quarter of one per cent of the total UK wage bill.
- 2.7 Lloyd's syndicates are said to write about 50 per cent of PI and 15 per cent of EL and PL. The liability insurance sector has become less concentrated in recent years with the top ten players accounting for less than 50 per cent of the sector in 2001. No player has more than 15 per cent of the whole liability insurance sector. However, there is more concentration in particular specialised areas.

A snapshot of the regulatory context

- 2.8 The system of insurance regulation in the UK has been subject to a major overhaul in recent years. The process of reform, which is still underway, has been prompted both by international developments and by the coming into force of the Financial Services and Markets Act 2000 (FSMA), which has established the FSA as a single integrated regulator for financial services. While it is beyond the scope of this paper to discuss the reform of the regulatory landscape, we have highlighted below how the new approach to regulation of insurance introduced by the FSA may impact on the way insurers will be conducting and accounting for their business from now onwards.
- 2.9 All UK insurers, including Lloyds of London, are required to be authorised by the FSA and are subject to its regulation and supervision. It is worth noting that from January 2005, firms carrying on insurance intermediation will also need to obtain authorisation from the FSA. The FSA is currently consulting on its proposed rules and requirements for insurance intermediaries.⁴
- 2.10 Authorisation is granted only for the specific classes of business (e.g. liability insurance) for which the applicant has applied, and is conditional, among other things, on the insurer showing that it has adequate resources, both of a financial and non-financial nature, to support that business.
- 2.11 Of particular relevance to this study are the introduction by the FSA of its risk-based regulatory approach and the implications that this has had for what is required of an insurer to be granted authorisation, to carry on its business and to show its ongoing compliance with FSA regulation. In particular, this has

⁴ FSA consultation paper 174, March 2003. Consultation ends on 13 June 2003.

meant that the focus is now very much on the specific risk profile and financial strength of a firm and on its risk management strategy. In assessing a firm under the new regime, the FSA places emphasis on a firm's overall strategy, its risk profile, the quality of its management, the adequacy of its financial resources, its risk management of both financial and non-financial risks, and its systems and controls.

- 2.12 Under the FSA's new regime insurers are required to understand the nature and scale of the underlying risks that their business presents and to be able to demonstrate their ability to manage such risks effectively. These changes are likely to encourage insurers to improve their measurement and monitoring of risk and to focus more on longer term profitability as opposed to increasing their market shares regardless of the implications for the commercial sustainability of their underwriting policy in the long run. This should lead to more competitive and steadier pricing while reducing the likelihood of insolvencies like those of Independent Insurance Company Limited and Chester Street Insurance Holdings Ltd. It is generally accepted, however, that the changes may also result in increased costs and a need for capital by firms writing higher risk lines of business, such as EL. It is therefore possible that firms will need to raise premiums for riskier lines of business to reflect the need for more capital to support that business.

Barriers to entry

- 2.13 There are no absolute barriers for new entrants to the liability insurance sector as a whole. There are a number of factors that might discourage, or certainly not facilitate, entry. In addition to authorisation by the FSA, insurers need access to capital and access to historical claims data for the class of customer. A further consideration for an insurer is the cost of running off its liabilities when it wishes to exit the market and where a liability to pay claims in the future continues. This can take a number of years. This is particularly the case for EL which is characterised by 'long-tail' claims - i.e. those which extend for many years beyond the year the policy is written. However, none of these general factors seem to place a substantial limit on entry.
- 2.14 Insurers who already write a line of business enjoy an advantage in terms of their superior knowledge of the risks, particularly the more specialised risks such as those in the construction industry. Concerns about market entry relate less to the sector as a whole, than to cover for a particular trade or profession which requires specialised knowledge of the risks. We have been told both by insurers and by trade associations that for some types of risk the number of insurers writing policies can be limited. Entry into one of these areas is more likely to involve an existing liability insurer for whom it might represent a modest diversification, rather than an entirely new entrant.

How liability insurance is bought and sold

- 2.15 Over 90 per cent of liability insurance is sold through brokers. PI is almost always sold as a stand-alone product, while EL and PL insurance is sold either as a stand-alone product or as part of a package containing other insurance covers (property, theft, motor etc). Packages are more common, particularly for small businesses. The benefits to customers of a package include ensuring that there are no gaps in the cover provided and reduced administration costs. Around 70 per cent of the respondents to our SME survey bought their liability insurance as part of a package.

How insurers rate the risks

- 2.16 Insurers rate their clients by group (or class) rating (commonly referred to as book rating), by experience rating or, more commonly, by a mixture of the two. Book rating is a method used by insurers to create an average premium price in different industrial sectors, and experience rating is a method used to price a risk on the past claims experience of individual firms.
- 2.17 In practice, liability insurers often modify the book rates that they would otherwise apply in light of the client's own claims experience and any other relevant factors peculiar to the client, applying a loading or a discount as appropriate. Pricing then becomes a process of classification (i.e. what class does this risk fall into?) and risk appetite (i.e. is it a good risk of its type or a bad one?).
- 2.18 The experience rating method might appear the fairest for policy holders, but the reality is that for small firms the claims history that is available may have little statistical significance and so may not provide a reliable guide to future claims trends. With a larger number of risks it is possible to estimate the statistical probability of loss more accurately and to charge a premium that is low relative to the risk. Insurers may rule out experience rating where the cost of a detailed survey would be disproportionate to the premium. For that reason SMEs tend to be book rated, while larger businesses are generally experience rated.

Problems in pricing liability business

- 2.19 The rating and underwriting of liability insurance is generally more problematic than other types of insurance. Some forms of liability, including EL, and to a lesser extent PL, are characterised by long tail claims.

2.20 Where there is a long delay between underwriting a risk and settling the claims there is uncertainty about the final cost and hence in the level of premium that is necessary. The uncertain effects of inflation, investment yields and potential increases in the size of court awards over long time periods are likely to make pricing inherently difficult.

Reinsurance

2.21 Reinsurance is taken out by insurers wishing to spread their risks and provide more cover than they can by themselves. Reinsurers have recently become more selective about the risks they are willing to take on, leaving more of the risk to be borne by insurers.

3 WHAT HAS HAPPENED TO PREMIUMS?

3.1 The nature of insurance means that it is difficult to measure changes in prices over the industry as a whole, for particular sectors or even for the individual customers of insurance companies. The main measure available, the change in premium paid, conceals any changes in the nature and volume of the risk covered. For example it does not correct for differences in number of employees insured, changes in occupations or those applying to changes in excesses or deductibles.⁵ Our observations relate to premium increases.

Wide variations

3.2 Broad brush averages of 2002 premium rises across all sectors given by the ABI and the British Insurance Brokers Association (BIBA), suggest that EL has risen by 50 per cent, PL by 30 to 40 per cent and PI by 30 to 60 per cent. These figures mask a wide variety of increases. Our survey indicated that rises vary from zero to more than 200 per cent across the different liability insurance lines. The figures follow a similar trend to anecdotal evidence received from interest groups. The figures given by brokers responding to the inquiry in respect of rises for their clients vary from 10 per cent up to 1000 per cent.

Other forms of price increase: reduction in cover, increases in excesses or deductibles and the increased use of restrictions and exclusions

3.3 Premium rises are not the only changes to take into account when considering what has happened to the cost of liability insurance over the last couple of years. Many businesses appear to be paying higher premiums for reduced cover. 12 per cent of respondents to our SME survey reported a reduction in the level of cover from the previous year. While it is possible that this was sometimes at the request of the insured, anecdotal evidence suggests that this is not always the case. Either way it is a reduction in value for many businesses.

3.4 Insurers also appear to be increasing the use of exclusions or restrictions. The most notable exclusions concern the type of work which may be undertaken. While businesses may be able to get cover for most elements of their business, the use of exclusions could have the same effect on some business activities as the refusal of cover. Asbestos related risks seem to have been particularly acutely hit by blanket reinsurance exclusions, to the extent that there are now few primary insurers prepared to cover the risk.

⁵ An excess is defined as the amount of any loss that is not included in the cover provided (e.g. a loss falling below the excess is not a claim). A deductible on the other hand eats into the cover. This difference only really matters where there is an upper limit on the amount of cover such as reinstatements or an annual aggregate.

- 3.5 Both PL and PI are subject to excesses or deductibles. For PI in particular, many businesses have seen substantial increases in both the level of premium and the level of excess. For some businesses the increase in excesses has effectively led to them self-insuring. High levels of excesses pose an additional threat to the solvency of the businesses concerned.

Past increases in premiums

- 3.6 Premium increases in 2001 and 2002 need to be viewed in the context of trends over the past five or ten years (all percentages below are based on gross earned premiums). For ABI members, liability premium levels in 2001 were similar to 1995 and had declined slightly relative to prices in the intervening period by about 14 per cent over what was described as a 'soft' market (see paragraph 4.21 for further details). EL premiums in 2001 were 18 per cent lower than in 1995.
- 3.7 For much of the last decade insurers (in aggregate) operating within the liability insurance sector have written liability policies at an underwriting loss. In 2001 the underwriting ratio for all liability insurance was 120 per cent i.e. claims plus expenses exceeded premium income by 20 per cent. This is fairly typical of the losses made over the last decade. EL insurance has been especially unprofitable, with underwriting ratios averaging over 150 per cent over the last decade.

Affordability v availability

- 3.8 The study was launched against widespread reported concern that many businesses had been unable to secure liability insurance at **any** price and were trading illegally or were closing down. Estimates of over 200,000 small businesses being affected were quoted. Trade associations said that up to 10 per cent of members contacting them for assistance had not been able to secure EL cover.
- 3.9 The extent to which this has happened in reality is hard to determine, but during this study we saw no evidence of it being a widespread occurrence. Further, we did not come across any sectors from which all insurers had withdrawn. With limited exceptions, brokers indicated that it has been difficult, but not impossible, to secure cover even for high risk trades. However, we understand that most insurers will quote high prices rather than refuse cover. So for some businesses 'unaffordable' equates to 'unavailable' for practical purposes.

Areas which may be particularly adversely affected

- 3.10 The sensitivity of businesses to increases in the cost of their insurance will depend on the percentage of turnover that insurance costs represent. The competitive environment in which a business operates will affect the extent to

which these costs may be passed down the supply chain, particularly in view of the very sharp increases. Many businesses felt they had been given little warning about the changes which were taking place and had little time to plan ahead.

Professional indemnity insurance for IFAs

- 3.11 With the possible exception of asbestos related risk, the part of the liability insurance sector where there appear to be major problems of non-availability, is in respect of PI cover for IFAs. IFAs are required to have PI cover under existing financial services regulation. A survey by the Association of Independent Financial Advisers (AIFA) of 143 members in December 2002 showed that 22 per cent had no cover at all, 37 per cent had non-compliant cover and a number had no application for insurance pending.
- 3.12 IFAs are generally regarded as a high risk category by insurers. The key reason given by insurers for the non-availability of cover or significant rises in premiums (and/or excesses) for IFAs, focuses on concerns about a noticeable increase in number and frequency of complaints and, in particular, possible future business reviews by the FSA, along the lines of the review into the mis-selling of pensions, which could translate into huge costs for insurers.
- 3.13 The FSA has been seeking to address the problems for IFAs. In October 2002 it introduced a number of provisional changes to its rules in order to help PI underwriters to write, and brokers to place, more business for personal investment firms. It now proposes to make these changes permanent. The changes may not have increased the supply of PI cover (for IFAs) – insurers continue to see them as high risk – but without them the supply of PI for IFAs may have reduced further or cover offered on (even) worse terms. The FSA is continuing to look at the issue and further proposals for change are expected during the summer of 2003.

SMEs and the voluntary sector

- 3.14 A 50 per cent premium rise may account for a much higher percentage of turnover for a SME than for a larger business. For those businesses responding to our survey, overall liability premiums represented an average of seven per cent of turnover. This may be higher than the norm given the propensity for those most affected to respond to surveys. The fact that many SMEs are book rated means they are more likely to be affected by factors which impact across the whole group or class of risk.
- 3.15 The voluntary and community sectors have also felt the impact of rising premiums, particularly for PL. Rises of between 30 and 100 per cent are not

uncommon. Concerns have been expressed that the rise in premiums will increasingly mean that voluntary and community groups restrict their activities, or may force them to cease their operations.

Northern Ireland

- 3.16 The situation across Northern Ireland is reported to be particularly acute. This could be due to the high proportion of businesses with fewer than 20 employees (around 33 per cent⁶), combined with the relatively small numbers of insurers operating there (approximately five).

'High risk' business sectors

- 3.17 Insurers have been taking a far more selective approach to the assessment and pricing of risks. This re-appraisal has been felt most in a minority of high risk trades and professions. Individually, insurers indicated that they were tending to concentrate on those sectors where they had the greatest knowledge or expertise in assessing or pricing the risk. This more selective approach has left some sectors with a much reduced choice of insurers and, on the whole, higher premiums. While the risks avoided varied from insurer to insurer, certain trade sectors which would commonly be described as 'high risk', such as roofing and scaffolders, were mentioned more frequently. At least one major insurer has set up a 'high risks' department and is prepared to take on such risks if properly priced.

Projections of rate rises over the next two years

- 3.18 In such an uncertain market, it is difficult to predict future premium increases with any accuracy. However, the BIBA indicated that, provided there is no single significant effect (such as another loss shock – see below), the bulk of corrective action will have been taken by Autumn 2004 although it seems likely that further rises of 20 to 30 per cent for EL, 15 to 20 per cent for PL and 20 per cent for PI (with restricted cover and excesses imposed) would not be uncommon before then.
- 3.19 We will look again at premiums in late 2004 to determine the level of premiums at that time and to make an assessment of how far corrective action has been taken and of likely future trends.

⁶ Around 64 per cent have no employees.

4 WHAT MIGHT BE DRIVING PREMIUM RISES?

4.1 Possible explanations given to us for the increases in premiums fall into two main categories:

- changes to costs (including an expansion of liability, higher damages, legal costs) and falling investment returns (which have affected the cost of damages, the offsetting effects of investment income and erosion of the capital base)
- changes to the competitive environment (including pressure on capacity, the impact of insurer insolvencies, possible collusion, possible high levels of concentration and short notice periods).

Changes to costs incurred

4.2 Cost factors will tend to impact differentially on particular types of liability insurance. For example, cost increases in personal injury claims will largely affect EL and PL, while for PI financial loss is the key factor. PL also tends to be subject to claims for property damage.

Expansion of liability

4.3 There is only limited evidence on claim frequencies in respect of liability insurance, much of it focusing on EL. The absence of data on the number of insurance policies to which claims relate makes it difficult to assess trends in claims frequency with precision. As far as EL is concerned, there appears to have been a rise in the total number of claims between 1980 and 1990 followed by a gradual tailing off since. This may be related to the decline in heavy industries, to improved health and safety standards, or both.

4.4 For EL and PL the key concerns for insurers are not simply the **number** of claims, but the fact that many of these are long-tail claims. Long-tail claims relate predominantly, but not exclusively, to occupational diseases and are characterised by long latency periods: for example the average latency period for mesothelioma (a condition arising from asbestos exposure) is 33 years. Insurers argue that these claims are difficult to predict and therefore difficult to take into account when pricing risks that might never occur, and when reserving for claims. It is the uncertainty surrounding long tail claims that is one of the key drivers behind the insurers' proposals which are subject to a parallel review by the DWP.

- 4.5 We have not been able to establish that there has been a dramatic expansion of liability for such claims in recent years. The current risks of asbestos, vibration white finger and deafness are well known and new claims emerging such as stress and sick building syndrome tend to be less clear cut when it comes to proving causation. Nevertheless, the courts would generally appear to interpret the law in a manner which entitles people to compensation.⁷ Given the nature of disease claims some degree of uncertainty about long-tail claims will always exist, but it is not clear that they will have the long term impact that insurers claim, at least in terms of numbers of cases. Indeed a report by Greenstreet Berman⁸ for the ABI suggests that it is injury, not disease, claims which have risen most for EL.
- 4.6 Insurers have also argued that the introduction of conditional fee arrangements (CFAs - or 'no win, no fee') for personal injury claims in 2000 has increased the number of claims. Personal injury lawyers disagree and suggest that numbers of claims may have actually decreased as solicitors screen out low probability and spurious claims. The findings on this are inconclusive.
- 4.7 Insurers expressed similar concerns about **PI claims** as they did about EL and PL claims. While there is very little information available to us on PI claims, Datamonitor⁹ indicates that an examination of gross claims for a sample of companies suggests most of the top ten insurers experienced rises averaging 78 per cent over 2001. For IFAs the increased nervousness on the part of PI insurers about possible business reviews by the FSA and the subsequent costs they might face, has also contributed to the rise in premiums (and excesses).

Loss shocks

- 4.8 Loss shocks such as the World Trade Center and an unexpected rise in long term claims such as those related to asbestos, have placed a strain on reinsurance capacity and triggered some re-appraisal of risks.

Increases arising from changes in the legal system

Introduction of conditional fee arrangements (CFAs) and ATE

- 4.9 Concerns have been expressed by a wide variety of organisations about the impact of legal costs on premiums, particularly for EL. Insurers have indicated

⁷ This general policy was stated most explicitly by Lord Bingham in the *Fairchild v Glenhaven* judgement in 2002 UKHL, although the policy appears to have been developing for many years before that.

⁸ Workplace compensation: costs, trends and options for change

⁹ Datamonitor, Liability insurance 2003

that an average of 40 per cent of claims expenditure is accounted for by legal costs. This includes the cost of CFAs and after the event insurance premiums.¹⁰

- 4.10 CFAs, were introduced for personal injury cases in 2000. They give greater access to justice, allowing the claimant to take forward a case knowing that if it is lost, no legal fees will be payable by the claimant. Lawyers can charge an additional 'success fee', uplifting their normal level of fees if they win to compensate them for the cases they take on and lose (and for which they receive no fee). Previously, under legal aid, lawyers were always paid whatever the outcome. The risk of losing has led to the rise of ATE for legal expenses, the cost of which, along with the lawyer's fee (which includes the success fee), can be recovered from the losing side.
- 4.11 Insurers claim that they are increasingly paying claims on a CFA basis and the ABI suggests that they (along with ATE) have increased the cost of EL claims by 25 to 30 per cent. They argue that in a truly competitive market the mark-up should reflect the risk of losing, but the risk of losing an EL case is small and this is not reflected in the mark-up. They also argue that the small risk of losing makes taking out an ATE premium unnecessary and that the standard charges are not particularly linked to the risk.
- 4.12 Conversely lawyers argue that it is still too early to reach conclusions on the impact of CFAs. Their recent introduction means that there is very little research which can be relied upon to show the differences between CFA and non CFA cases. Furthermore, they may have led to a **reduction** in claims with lawyers choosing only cases with a strong chance of winning, given the financial burden of losing.

Wolf reforms

- 4.13 In April 1999 reforms were introduced into the civil courts in England and Wales which were designed to tackle the problems of cost, speed and complexity in the civil justice system. Insurers argue that not only have the reforms failed to speed up settlement of claims, but they have also led to an increase in costs as more work has to be done in the early stages of a case. Personal injury lawyers representing claimants are unsympathetic to this argument, pointing out that insurers often fail to comply with the mechanisms designed to reduce costs.
- 4.14 We have not been able to give the issues on legal costs detailed attention within the scope of what has been a five month study. The short length of time CFAs have been in existence suggests the system may still be subject to

¹⁰ After the event insurance is taken out once an injury has occurred and the individual has decide to pursue a claim against the liable party. It covers the risk of incurring any costs relating to the case in the event of an unsuccessful claim

change – costs may settle at an appropriate level over time. It has also contributed to the lack of available data on these issues. As a result the evidence on legal costs is inconclusive. There are questions about the competitiveness of the market in respect of whether the uplift of success fees and the pricing of ATE premiums are fully representative of the risks involved. We will look again at the subject following publication of our report and consider whether it requires further research on our part.

Increases in damages per claim

- 4.15 Research¹¹ suggests that damages for personal injury are currently rising at a rate of around 15 per cent per annum, (varying with the size of the claim). A number of factors have contributed to this including a reduction in the **discount rate**. This rate allows for the returns which claimants will earn on lump sum awards over their lifetime. This rate has recently been reduced. The returns are now based on the low risk products¹² in which a prudent claimant might invest a lump sum. Awards may therefore be higher to compensate. Insurers claim that a recent rate reduction from three per cent to 2.5 per cent has added to the cost of premiums and has cost them around £500 million.
- 4.16 There have also been recent increases in **damages for pain and suffering**, although a Court of Appeal decision¹³ did not increase damages in line with earlier Law Commission recommendations, limiting the increases from that suggested.

Investment returns

- 4.17 The ABI has said that

‘whilst the liability class produces an overall loss, insurance companies hope that their investment income will more than underwrite losses’.¹⁴

Over the last year or so these hopes have not been realised. Investment income had been especially important in the liability classes of insurance because of the extended period between receipt of premium and claims payment. Although investment returns, especially on equities, have turned out to be low in the last few years (just as they turned out to be high over a number of years previously), it might be anticipated that general insurance underwriters would take into account an expected future investment return when pricing a particular risk. Insurers have stated that expected investment returns of around eight to twelve per cent per annum were factored into general liability prices

¹¹ Greenstreet Berman – Workplace compensation: costs, trends and options for change

¹² Index Linked Government Stocks rather than equities

¹³ Heil v Rankin 2000 IRLR 334

¹⁴ ABI Insurance Trends No 36, Jan 2003

during the mid to late 1990s, falling after 2000 to between nought to four per cent. We are not clear how far these were derived from rigorous analysis of expected returns.

- 4.18 We understand that, in practice, investment income tends to be pooled across the whole of an insurer's general insurance business. Moreover, as indicated above, with the exception of PI, liability cover is frequently offered as a package with other business insurance. Pricing is therefore influenced by the overall profitability of the customer account and by the degree of competition faced at the time.

Reinsurance

- 4.19 The reinsurance industry is global and has also been subject to a hardening market (see below) which is driving reinsurance premium rises. The cost of reinsurance has risen for major liability insurers by 60 to 80 per cent, but we are told that this is only a small proportion of the insurers' overall costs. The ABI has said that the effect of increased costs from reinsurance is negligible. Reinsurers have become far more selective about the risks they take on, but it is not the prices charged, but rather the restrictions on availability, as with asbestos, which are critical to the market.

Conclusions on cost increases

- 4.20 It is difficult to quantify the relative importance of each of these factors in terms of the rise in costs. While each of these changes, with the possible exception of reinsurance prices, will clearly have had an inflationary impact on premiums, we are not persuaded that these factors alone account for the very large increases in premiums experienced over the last year. We discuss below a number of factors that may have had an impact on premiums.

The competitive environment

- 4.21 Market forces and market behaviour can play a powerful role in shaping insurance premiums and levels of cover and can contribute, to a certain extent, to prices fluctuating in a cyclical fashion, between high and low premiums. These are commonly known as 'hard' and 'soft' phases.¹⁵
- 4.22 Over the period from 1998 to 2001, total premiums fell in real terms. Insurers appear to have been competing aggressively, and in some cases destructively, for new business. Reductions in capacity during 2001, for the reasons

¹⁵ A 'hard' phase is characterised by steep increases in premiums and restrictions on the type of business covered or the coverage that insurers are willing to provide, whereas a 'soft' phase is characterised by small premium increases and better policies.

discussed below, brought about a very rapid correction from the previous trends. Decisions based on short term growth will conflict with long term profitability and may have contributed to the recent insolvencies we refer to below.

Pressure on capacity

- 4.23 Falling investment returns affect the level of premiums which insurers will charge and may put pressure on capacity of insurers to renew existing policies or to write new business. The reduction in capacity to absorb business comes about because the solvency margin which regulators require for general insurers under UK law (which is largely based on European Directives) is effectively expressed as a percentage of premium.¹⁶ This reduction in capacity leads to a far more selective approach to renewals or to new business, with the risks seen as less desirable being refused cover or only offered cover at a substantially increased premium. In this way the reduction in investment income contributes to the hardening of the market. Unless they can secure increases in capacity via more capital backing, insurers will tend to concentrate on the most profitable existing business. This scarcity effect will tend to provide an upward pressure on premiums.

The impact of major insurer insolvencies

- 4.24 Although the level of insolvencies amongst insurers has not been especially high in recent years, some insurance company failures are regarded as significant for the purpose of this study. Two notable insolvencies have occurred recently; those of Independent Insurance Company Limited, which at the time of its insolvency had built up a market share of about seven per cent of the total EL market, and Chester Street Holdings Limited¹⁷ which prior to going into run off accounted for around nine per cent of EL in respect of heavy industry and was therefore liable for claims made by those risks.
- 4.25 We have been told that the collapse of Independent and Chester Street¹⁸ has contributed to the hardening of the market. It resulted in increased payments to the Financial Services Compensation Scheme¹⁹, brought about a stronger demand from shareholders to restore profitability across liability lines and a reduction in capacity. Insolvencies appear to have encouraged insurers to re-

¹⁶ Conventionally regarded as approximately one third of written premium so £1 of an insurers capital can support £3 of premium.

¹⁷ Which was a company in run-off i.e. no longer writing or renewing business at the time of its insolvency.

¹⁸ In respect of raising payments to the FSCS, as opposed to reducing capacity.

¹⁹ A levy of £150m (0.66 per cent of leviable income) was raised on 4 January 2002 against general insurance companies to cover estimated compensation payments for general insurance claims, including those against Independent Insurance and Chester Street.

focus on underwriting practices to avoid similar problems, along with changes to the FSA's prudential regime to encourage insurers to focus on long-term profitability and risk management systems.

Collusion

- 4.26 Another explanation offered for the hardening of insurance markets has been that insurers were colluding to increase rates or reduce capacity. We received no evidence of collusive agreements over liability insurance markets as a whole. The way insurance premiums are set (see chapter 2) makes such agreements difficult. There are other far more plausible explanations for the reduction in capacity which has been observed.

Possible high levels of concentration in narrowly defined markets

- 4.27 Over liability insurance markets as a whole, there are a large number of insurers competing for business, mostly through an extensive network of brokers. But from the viewpoint of the business buying insurance, what matters is the number of insurers and brokers competing at any one time for its custom. For the more specialised risks such as hot roofers or businesses working with asbestos, the number of insurers competing can be far more restricted than aggregate figures imply. We heard that insurers have become more selective in the risks they are prepared to cover and there is an increasing use of restrictions and exclusions which have the effect of reducing choice. There is the inherent risk that niche markets will develop where, at any one time, a very limited number of insurers will write for these particular risks. As the risks become more specialised, brokers too become specialists as the importance of presenting the risk properly grows.
- 4.28 On the evidence available to us it is not clear how much of total premium income comprises such niche markets or what the concentration levels in these markets might be. No evidence of anti-competitive practices has been presented to us. However, given that the possibility of such practices rises in a highly concentrated market, we will keep the situation under review.

Short notice periods for customers

- 4.29 Many businesses expressed concern about the length of time they were given to renew their policy, or the short notice informing them that the current insurer was no longer quoting for a particular risk. Our survey of SMEs revealed that renewal periods of one to two weeks were most common, but shorter periods were also reported. Short notice periods, coupled with large rises in premiums, give businesses little time to plan ahead and little opportunity to shop around for

insurers offering cheaper or less restrictive cover – a problem exacerbated by a hard market where insurers are being selective in the sectors they cover.

- 4.30 **Switching** can often be a sign of a competitive market. OFT's SME survey suggests that switching between insurers (although not brokers) has increased over the last year from 20 per cent in 2001 to 30 per cent in 2002. Nevertheless, liability insurance does not appear to be a sector where switching is commonplace and it is possible that the switching behaviour has been triggered by the recent and very sharp increases quoted on renewal or where renewal has been declined. In these circumstances switching does not allow an inference of competition.
- 4.31 There appear to be relatively **low barriers to existing insurers entering into new specific markets**, although the need to understand the more specialised risks may create a degree of information asymmetry between incumbents and new entrants. New entrants would, however, be interested in entering only if there were the expectation of sustainable profits and it is not clear whether this will be the case, long-term, across liability insurance lines, particularly EL.

Conclusions on changes to the competitive environment

- 4.32 Reductions in capacity, in which the recent insolvency of Independent seems to have been a factor, have undoubtedly changed the competitive environment and contributed to the recent increases in premiums. Such factors should not, however, lead to continuing upward pressure on premiums in the long term. In a competitive market we would expect to see new capital provided in response to opportunities for profitable business, although it is not clear how likely this would be in the long-term, particularly for EL.
- 4.33 Factors such as the limited choice of insurers available for certain risks, and the effect of short notice periods on switching, may limit competition to some extent, but do not in themselves account for the significant premium increases which have been observed.

5 AREAS OF IMPROVEMENT

- 5.1 There are a variety of changes which could be made to improve the current situation, some of which are already afoot. Some of these initiatives are outlined below.

Lengthened renewal periods

- 5.2 We understand that the ABI, in conjunction with BIBA, are working on a minimum period of notice of renewal terms, ideally through a code of practice. BIBA would like to ensure agreements for at least 14 or 21 day renewal periods, or the extension of policies to enable businesses to explore their options. This is important, given that EL is mandatory. We welcome the work being carried out as a positive step in the right direction. Our concern is that if such a system were introduced in an informal, voluntary way there is a risk that defined notice periods will not be adopted by all, or will lapse over time. We believe that a minimum 21 day renewal period seems the most sensible and practical option. But a voluntary agreement is not the only option. Monitoring will be essential and the FSA may wish to consider whether there is scope to incorporate minimum periods, of at least 21 days, into its rules.

Initiatives to improve information and risk management

- 5.3 The system of book rating has been criticised for failing to take account of a business's risk management and health and safety (HS) practices of a particular business in determining its premium. Businesses with good claims records and HS practices are grouped together with those with poor records. To assess the exposure small businesses in that sector present, insurers have to aggregate the claims for all businesses. As a result businesses are concerned that premiums do not reflect sufficiently the differences between them. This failure to link premiums to HS records can also act as a disincentive to businesses to improve their HS practices and maintain performance.
- 5.4 While insurers can modify the book rate to take account of factors peculiar to the client, applying a loading or discount as appropriate, it does not seem to be filtering through to businesses in a way that is transparent to them i.e. through premiums. Part of the problem of book rating is that, as mentioned earlier, the cost of individually rating many small customers is likely to outweigh any reduction in premium.
- 5.5 The ABI and a number of trade associations, including the Federation of Small Business and the Construction Industry Council, are working together to find **ways to reward good health and safety practice** for businesses that meet the

standards of trade body health and safety schemes. Trade associations will need to ensure compliance with the requirements of the schemes and ensure continual and rigorous monitoring. Insurers will in turn need to ensure that the incentives are sufficient to motivate customers to improve and maintain their performance.

- 5.6 We welcome the role of trade associations seeking to provide better understanding of the risk by their members and by insurers. We would, however, be concerned if relationships between insurers, brokers and trade associations were to result in collusive or exclusionary behaviour which gave rise to market power. One example might be if a business finds itself having to join a trade association in order to secure cover, or affordable cover. Customers should not be denied the opportunity to apply for cover from a particular insurer simply because they are not a member of a particular trade association.
- 5.7 It would be easier for firms to meet the requirements of insurers if brokers and clients understood exactly what insurers were looking for. For their part, insurers rely on brokers to give an accurate view of the risks. Criticisms have been aimed at both sides, with insurers failing to provide clarity on the information they require and brokers, having been through a soft market for many years, having to provide more information on the risk than ever before – something, we are told, they haven't always done successfully. This prevents businesses from demonstrating effectively that they are a good risk. Both insurers and brokers need to take steps to improve the situation for their customers.
- 5.8 The ABI is considering whether it can provide customers with '**best practice**' **advice** for liability insurance (particularly EL) in the same way that the industry has set standards for customers on issues such as protection against fire and theft. This is a positive step and would provide greater clarity in the sector.

Voluntary groups

- 5.9 The Home Office has formed the Insurance Cover Working Group to look at, and offer solutions to, the problems faced by voluntary groups in obtaining insurance cover. Many of the solutions put forward so far are similar to those one might expect in the commercial sector, such as developing suitable risk management procedures, and trying to help insurers understand the risks better.

Initiatives to reduce legal costs

- 5.10 We understand that the DWP will be looking at whether various initiatives – for instance a scheme to structure costs in low value motor accidents – could be extended to EL. Outside the UK the Department of Enterprise, Trade and

Employment in Ireland announced its intention to set up a Personal Injuries Assessment Board to improve the efficiency of the insurance claims process. The emphasis is on reducing the costs of delivering compensation with a view to reducing insurance premiums.

Increasing the use of rehabilitation

- 5.11 Increasing the use of rehabilitation may help to reduce costs in the system. Rehabilitation can help a claimant to live more independently and have an increased chance of securing employment. This would mean that the defendant, or rather his insurer, would pay less in compensation, so both sides would benefit. At present the number rehabilitated in the UK is small.

Availability of data during the study

- 5.12 For a sector so reliant on data to function effectively, we are concerned at how little statistical information has been available for this study. For example, the explanations given by insurers for recent increases in premiums have not been as detailed or rigorous as we would have expected. This may be a reflection on the apparently limited role of actuaries in underwriting decisions. Furthermore, most of the information provided by insurers, particularly the statistical data, has focused on EL rather than PL or PI. Data are particularly lacking on claims (numbers and costs) and legal costs. While a lack of information on legal costs might be attributed to the fact that reforms have only recently taken place, it is not clear why better information on claims and claims costs is not available. As a result it has not been possible to quantify the relative importance of each of the factors highlighted at chapter 4 above in terms of the rise in costs.
- 5.13 The sector would undoubtedly benefit from collating data that allowed claims to be better forecast and show the differential impact between different classes of risk. Information on PI claims was particularly lacking. Ultimately this is a matter for the industry to consider, but the benefits of improving this information seem obvious.