

An analysis of current problems in the UK liability insurance market

A supplemental report to OFT659 Liability insurance prepared for the Office of Fair Trading by Dr Christopher Parsons, Faculty of Finance, Sir John Cass Business School, City of London

JUNE 2003

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1 BACKGROUND AND TERMS OF REFERENCE

1.1 Towards the end of 2001 the Competition Enforcement Division of the Office of Fair Trading began to receive an increasing number of complaints concerning liability insurance. These complaints focused on three main issues:

Substantial rises in premium

1.2 Upon policy expiry, and normally with very short notice, insurers had allegedly increased premiums for certain commercial risks by between 50 per cent and 700 per cent (and sometimes even in excess of 1500 per cent). The highest price increases appeared to be associated with employers' liability insurance. For this line of business the largest price rises seemed to have been levied in industries classed as 'high risk' by insurance companies. These include metal processors, scaffolders, quarries and mines, haulage companies, skip hirers, roofers, transport companies, coach operators, couriers and dockers.

Capacity reduction

1.3 It was alleged that insurers were leaving the market or reducing the range of risks that they were prepared to underwrite. As a consequence, brokers were finding it hard to place liability cover in certain sectors; in particular, in heavy industries.

Increases in excess levels

1.4 Many insurance policies have 'excess' provisions whereby the insured is required to meet the first part of any loss. The size of any excess is normally negotiated bilaterally between the parties, the insured making its decision regarding the appropriate level of excess in the light of its financial capacity and risk management strategy. The CE received reports that insurers were now dictating the terms and deciding excess levels. This might operate in practice like an increase in price, with the insured getting less cover for its premium.

1.5 In the light of the above, on 10 December 2002 the OFT began a fact finding study of the UK liability insurance market, covering public, product, professional and employers' liability insurance. The purpose of the study is to inform the debate on how well the liability insurance market is working and to decide whether further action by the OFT is needed. As part of this study the OFT asked the author to carry out research on the liability insurance market jointly with the OFT and report on the following:

- the structure of the UK liability insurance market in terms of the number of insurers that write the main lines of business, market concentration and trends in both over time
- barriers to entry for liability insurers
- the operation of the liability insurance market including the methods by which liability insurance is bought and sold, the relationship between the various player in the supply chain, how risks are priced and the ease with which buyers are able to access the insurance market
- the profitability (or otherwise) of the liability insurance market at present and over time
- market capacity and trends in sectors where the obtaining of affordable insurance is most problematic at the present time
- the scale and nature of the problems being experienced at the present time and over time
- the extent to which these problems are cyclical
- factors that can impose upward pressure on liability insurance premiums and/or contribute to a shortage of capacity
- conclusions that may be drawn from the research concerning the origin of the problems in the liability insurance market that have been identified.

2 KEY FINDINGS

- 2.1 Research by the author has revealed no positive evidence of collusion between liability insurers or breach of competition law by them.
- 2.2 In any event, the nature of liability insurance products and their pricing is such that collusive price-fixing agreements between liability insurers would be quite difficult for the conspirators to police.
- 2.3 The most plausible explanation for the current problems of the UK liability insurance is that the situation has been brought about by the unusual conjunction of a number of factors that have exerted upward pressure on liability insurance premiums and restricted its supply.
- 2.4 These factors are analysed in detail in this report. However, in broad terms, its conclusions can be summarised as follows:
- a consistent pattern of substantial losses and under-pricing of liability risks over many years has built up pressure amongst liability insurers for changes in underwriting and pricing that might restore profitability to the market
 - the impetus for change has been reinforced by a number of current trends that continue to impose upward pressure on premiums. Some of these are cyclical and some related to the economic and legal environment in which liability insurance is written. The 'shock' effect of extraordinary events such as the World Trade Centre disaster has changed insurers' perception of risk and impacted unfavourably on the reinsurance markets upon which primary (liability) insurers depend
 - uncertainty as to future trends that might affect liability exposures has led to a lack of confidence on the part of insurers as to their ability to price certain risks (such as of gradually developing disease) accurately.
- 2.5 Whereas most of the trends summarised above affect liability insurance markets as a whole, some sectors of industry appear to have seen much higher premium rises than others and have experienced much greater difficulty in securing cover – particularly high-risk trades in the SME sector. However, the dynamics of the insurance market are such that small high-risk firms are always likely to suffer most when there is constraint on insurance capacity or a general rise in prices.
- 2.6 Evidence suggests that liability insurance rates will probably continue to rise, at least in the short term, though not so steeply as in the last year or so.
- 2.7 Employers' liability insurance is the one area, albeit a large one, where there may be long-term structural problems rather than short or medium-term difficulties.

Reform in this area may be necessary if the system of work-place compensation is to function effectively.

- 2.8 Since there is no **prima facie** evidence of breach of competition law within the insurance industry in respect of liability insurance, the author takes the view that and no major action on the part of the OFT is required at the present time, other than the maintenance of a watching brief.

3 METHODOLOGY

3.1 The information contained in this report was gained through:

- a literature review
- an analysis of primary data and published information relating to the liability insurance market
- questionnaires and structured interviews with stakeholders in the liability insurance system.

Literature review

3.2 There is a very large body of academic and practitioner work on the economics and more general aspects of liability insurance systems in the UK, USA and Europe. The Report draws on this literature on a number of occasions.

Data collection and analysis

3.3 Information on liability insurance premiums, claim payments, profitability, market structure and trends was obtained from a number of insurance industry sources (including Lloyd's of London, the Association of British Insurers and a number of individual insurance firms) and a variety of government departments and agencies.

Interviews and questionnaires

3.4 Meetings and structured interviews were arranged between OFT staff and representatives from organisations that have an interest in the liability insurance system. The author attended a number of these meetings and obtained notes from others. The organisations included the following:

Department of Work and Pensions
H.M. Treasury
Association of British Insurers
Financial Services Authority
Association of Independent Financial Advisers
Federation of Small Businesses
British Insurance Brokers Association
British Chamber of Commerce
Engineering Employers Federation
General Insurance Standards Council
Institute of Directors
Professional Affairs Board of the Actuarial Profession

Trades Union Congress
LeBoeuf, Lamb, Green and McCrae
Irish Competition Authority
AXA insurance
AON group
Office of the Rail Regulator
Lloyd's of London (four underwriters)
Institute of Chartered Accountants

3.5 Further information was obtained from questionnaires circulated to:

- insurance companies with large liability insurance accounts
- insurance brokers
- small and medium size enterprises that buy liability insurance.

4 INTRODUCTION: THE NATURE AND DEVELOPMENT OF LIABILITY INSURANCE

- 4.1 Liability insurance has its roots in the early nineteenth century, or a little before. Its growth was encouraged by rapid developments in industry, trade and transport around this time.¹ Hitherto, only three forms of insurance were commonly available. They were marine insurance, life insurance and fire insurance, the regular practice of which, in Europe, dates (approximately) from the fifteenth, sixteenth and seventeenth centuries respectively.
- 4.2 Industrialisation and the growth of the railways created new risks that could lead to accidents, and liability insurance originally formed part of a broad and miscellaneous class known as 'accident insurance'. This name was used to describe any form of insurance that was neither marine, life, nor fire and which covered losses arising from some sudden harmful event, unintended and unexpected by the insured, such as a boiler explosion, or a road or rail accident. These risks were assumed initially by specialist insurers, the 'accident offices'. However, in the first quarter of the twentieth century many of these were bought up by the large fire insurance companies, which thus became the familiar British 'composite' insurers. The liability (or 'third party') risk referred to compensation claims which victims of accidents might make against insured persons who caused them, as distinct from direct claims which latter might make against insurers for damage to their own property or person. Eventually, liability insurance grew into a class in its own right, and at the same time, the term 'accident insurance' fell into disuse.²
- 4.3 An alternative term, 'casualty insurance' (which seems to have originated in the United States), originally had a meaning that was roughly equivalent to that of accident insurance. However, it has now come to be associated with liability insurance in particular. Thus, the two main branches of general (non-life) insurance are now 'property' and 'liability' (or 'property' and 'casualty').
- 4.4 At the present time there are five major lines of liability insurance in the UK. They are:
1. Employers' Liability ('EL')
 2. Public Liability ('PL') – more commonly known as General Liability ('GL') outside the UK

¹ See generally, Parsons, C., 2002, 'From Accident to Liability: a Brief History of Liability Insurance', *Journal of Insurance Research and Practice*, 17, 2 pp. 23-34.

² Though the term 'personal accident' is still used to describe policies that cover accidental bodily injury.

3. Product Liability ('Products') – often combined with 2. (Public Liability)

4. Professional Indemnity ('PI')

5. Directors' and Officers' liability ('D&O')

4.5 There are other classes of liability insurance that are not considered in this report. First, there are some rather specialised types of liability insurance, including libel (defamation) insurance, and environmental impairment liability insurance ('EIL'), which are of little relevance to most businesses. Second, there are liability risks associated with the use of motor vehicles and the operation of ships and aircraft. These liabilities are insured, often in conjunction with the associated 'property' risks, in specialised insurance markets (motor, marine, and aviation respectively). Finally, there are contracts that insure the property and activities of private individuals, such as home insurance policies which, amongst other things, cover liability claims made against policyholders in their private capacities or their capacities as property owners. At the present time there seems to be little concern about the competitiveness of the market for any of these forms of liability insurance, hence their omission.

4.6 Some key features of the five main liability lines are described below.

Employers' liability insurance

4.7 As the name suggests, employers' liability insurance is designed to cover the liability that might devolve upon an employer if an employee is injured in the course of employment. This form of insurance dates from 1880 in the UK, although similar insurance was offered in other European countries at an earlier date. Essentially, EL insurance covers tort claims against employers, which are normally founded on the negligent behaviour of the latter. However, towards the end of the nineteenth century many countries, including the UK, started to introduce workers' compensation laws that allowed injured employees to claim compensation even when there was no fault or liability on the part of the employer. In a number of countries (including Germany and most US states) workers' compensation laws eventually replaced employers' liability altogether, and the right of an employee to sue his employer in tort was effectively abolished. In other countries the tort remedy was retained, as an alternative or a supplement to workers' compensation benefits. However, in most of these countries tort claims were severely restricted. For example, they were often limited to cases where the employer was guilty of gross negligence or actual intent to injure.³ The UK is one of very few countries where injured employees

³ See Parsons, C., 2002, 'Liability Rules, Compensation Systems and Safety at Work in Europe', *Geneva Papers on Risk and Insurance*, 27, 3, pp. 364-369.

were, and still are, allowed to sue their employers on the basis of ordinary negligence. As a consequence of this, the employers' liability risk, and the insurance that covers it, is more highly developed in the UK than in any other large country. At the present time the total value of claims paid by EL insurers exceeds the total for payments made under the state Industrial Injuries Scheme (which is, effectively, a workers' compensation programme, once privately insured, that was 'nationalised' in 1948 under the post-War 'Beveridge' reforms).

- 4.8 At the present time, the viability of the employers' liability system is being questioned. The possible substitution of an alternative model is now under discussion in Government and insurance industry circles. This alternative model might involve greater emphasis on workers' compensation insurance or involve different arrangements for 'accident' and 'disease' claims.
- 4.9 Employers' liability insurance is compulsory for the vast majority of employers, under primary legislation.⁴
- 4.10 It is important to note that EL insurance is written on what is known as a 'causation basis'. This means, in simple terms, that the insurer which meets a claim is the one that was on risk when the injury or disease was caused, rather than date when the harm became apparent or the claim by the employee was made, both of which may be much later. In fact, it may be that the current law effectively requires insurance to be written on this basis, though the point has never been settled.⁵ On the face of it, this arrangement gives good security to employers and employees: provided EL insurance was in place when the injured employee was working, the insurer will always be liable to meet a claim by him, even if it is made many years later and even if the policy has been cancelled in the meantime. However, potential security problems remain; for example, when insurance records have been lost or doubt exists about the precise time when the injury was caused. Furthermore, this arrangement creates severe pricing problems for insurers, who have to collect premiums that are sufficient to fund 'long-tail' claims, especially for disease, that may still be coming in decades later. The longer the potential time span for claims, the greater is the level of uncertainty for insurers.
- 4.11 The wording of employers' liability insurance policies is, to some extent, standardised across the UK market, partly as a consequence of regulations that stipulate what the policy must cover and prohibit certain exclusions.⁶ However,

⁴ Employers' Liability (Compulsory Insurance) Act 1969. This legislation came into force on 1 January 1972.

⁵ See Parsons, C. 1999, 'Industrial Injuries and Employers' Liability – A Search for the Cure', pp. 39-40. *Chartered Insurance Institute*, London.

⁶ Employers' Liability (Compulsory Insurance) Regulations 1998, S.I. 1998 No. 2573. Most of the Regulations came into force on 1 January 1999. For a general discussion see Parsons, C.

some differences in detail still exist amongst the wordings used by different insurers.

- 4.12 The law requires employers to secure EL cover with an indemnity limit of at least £5 million in respect of any one occurrence. In practice, most businesses buy cover in the £10 - £50 million range.

Public (general) liability insurance

- 4.13 Public liability is a broad residual class of insurance, intended to cover claims that are not met by more specific forms of cover, such as EL, motor or PI. Claimants are firms or members of the public (i.e. not employees, hence 'public' liability) who suffer bodily injury or damage to their property through the negligent conduct of the insured's business activities. For the vast majority of firms, there is no primary legislation that requires them to buy PL insurance. In practice, however, it is essential for the majority of business, and not just for reasons of general prudence. This is so because the employers and trading partners of many firms often demand that PL insurance must be in place as a condition of doing business with them. This is almost invariably the case with the 'contracting' trades (builders, engineering firms and the like) where the contract under which work is done will usually stipulate that the contractor should have adequate PL insurance.
- 4.14 PL insurance has traditionally been written on an 'occurrence' basis, which means that the insurer that meets the claim is the one that was on risk when the damage or injury happened. This arrangement works well for claims that arise from accidents (i.e. traumatic injuries or sudden property damage) but is less effective when the claim is for injury, damage or financial loss that occurred gradually. In this case there may be disputes about the precise date of the harm, and doubt about which insurer should meet the claim resulting from it. For this reason, PL insurance and (more frequently) Product Liability insurance (see below), is sometimes written on a 'claims-made' basis. Claims-made cover is discussed later, in the context of PI and D&O liability insurance.
- 4.15 There is no standard policy for PL or Product Liability. 'Core' cover is much the same across the market, but there is considerable variation in the policies offered by different insurers as regards detail. Again, many insurers use special policy forms for certain business sectors (e.g. for 'contracting' trades). Because, as we have seen, EL policies may also differ somewhat from one insurer to another, it may be prudent to place the EL and PL risk with the same

(1999) 'Employers' Liability Insurance – How Secure is the System?', *Industrial Law Journal*, 28, 2, pp. 109-132.

insurer when possible. This will ensure that the two policies dovetail precisely, with no gaps or overlaps.

4.16 Typical cover limits for PL and Products are broadly similar to those for EL.

Product liability insurance

4.17 This form of insurance covers liability that arises in connection with dangerous or defective goods that are manufactured, supplied or handled by the insured. It works in much the same way as PL insurance. In practice, the 'PL' and 'Products' risk are often insured together, under the same insurance contract. However, Products insurance is rather more likely to generate long-tail claims, particularly when the product in question (such as drugs or other pharmaceuticals) are capable of causing injury or harm that may take some years to develop. In the UK there is no general legislation requiring any business to buy product liability insurance. However, the customers of some firms may demand it as a condition of doing business and, in some industrial sectors (such as pharmaceuticals), the risk is so great that it must be properly financed, with insurance the most obvious option. There are no standard policy wordings and, if anything, Products insurance is subject to even greater variations than PL.

Professional indemnity insurance

4.18 As the name suggests, professional indemnity insurance is a form of cover that professional firms secure to cover claims against them for breach of professional duty. It is different in character from the lines of insurance discussed above because the vast majority of claims are purely in respect of financial loss. Claims for bodily injury are rare outside the medical profession and claims for property damage are common only in the case of professional firms that provide services to the manufacturing, construction and engineering sectors.

4.19 When financial loss results from the negligent provision of professional advice or services it often accumulates gradually. Furthermore, there is often a considerable time delay between the provision of the advice and the loss that flows from reliance on it. Largely for this reason, PI insurance is written on a 'claims-made' basis. Under this arrangement the insurer that meets a claim is the one on risk at the date of that claim. Usually, it is the claim for compensation which the third party advances against the professional firm that 'triggers' coverage, rather than the claim by the insured for protection under their insurance policy. Under a claims-made policy, in its purest form, insurers effectively go on risk for only one year at a time (assuming that the policy is an annual one). Cover continues only if the policy is renewed. This arrangement is advantageous to insurers, because it allows them to re-price the risk at each renewal – there is no possibility of having to pay claims under policies issued at

the wrong price many years ago. Because, in effect, claims are met by the current insurer, claims-made cover also has some advantages for buyers of insurance: the policy will be an up-to-date one, cover limits should be adequate and the risk of the insurer becoming insolvent is likely to be small. However, there is a key disadvantage to buyers of 'claims-made' insurance: that is the possibility that the insurers will 'walk away from the risk' – refuse to renew or agree to do so only on terms that are very disadvantageous to the insured. This might happen, for example, if claims experience starts to deteriorate rapidly. Owing to this difficulty, claims-made policies have sometimes been declared illegal in jurisdictions outside the UK.⁷ In practice the problem is alleviated by the use of clauses that protect the insured from any sudden withdrawal of cover.⁸

- 4.20 Unlike employers' liability and motor (third party) insurance, PI insurance is not mandatory under primary legislation. However, for most professions PI insurance is in effect compulsory, because it is nearly always a precondition for registration, authorisation or certification by the professional association or regulatory body that governs the profession in question. In some cases the authority to demand PI insurance is conferred on that body by statute.⁹
- 4.21 There are no standard policy wordings across the market for PI insurance. Insurers tend to tailor their policies to the particular needs of each profession, so a solicitor's PI policy may differ somewhat from that of an accountant or surveyor.
- 4.22 Cover limits for PI vary enormously, from as little as £2 million to £100 million or more for the biggest international firms.

⁷ Including Belgium and Spain and France. The issue has been resolved in a reasonably satisfactory way in the former two countries but there are continuing difficulties in France. The root of the problem is the tendency of the French judiciary to modify and reinterpret liability insurance contracts, which began in 1990 when the *Cour de Cassation* demanded the substitution of an 'occurrence' trigger in the interpretation of a claims-made policy.

⁸ First, insurers always agree to indemnify policyholders, not only in respect of claims made against them during the period of insurance, but also for claims arising from incidents, events or occurrences notified in the period of insurance which **subsequently** give rise to a claim, even if the policy has been cancelled by the time the claim actually arrives. Second, insurers normally give the insured an 'extended reporting period' (ERP) of up to a year combined with the right to buy cover for a longer period (perhaps up to six years) at an agreed price if the policy is cancelled. However, these extensions operate only for claims arising from events which took place when the insurers were originally on risk: there is no cover for claims arising from any wrongful act after cancellation.

⁹ E.g. Solicitors (Amendments) Act 1974.

Directors' and officers' liability insurance

- 4.23 In simple terms, D&O insurance covers claims made against company directors and officers (or 'executive managers') who have breached their duty in that capacity, usually through some failing in the proper stewardship of the company. Possible claimants include buyers of securities, existing shareholders, receivers or liquidators, regulatory bodies, employees and other third parties who deal with the company in some way.
- 4.24 D&O insurance is a fairly recent innovation. It was devised by the British broker Minet in the wake of the Wall Street crash, when a number of directors faced legal action by disappointed shareholders and other third parties. Minet thought that this risk might be made the subject of liability insurance and, in the 1930s, some policies were written in the London market to cover American risks. However, even in the USA D&O insurance was relatively uncommon until the late 1960s¹⁰ and in Europe there was little development until ten years later. D&O insurance may be viewed as a British export¹¹ which the United States has re-exported to Europe and beyond. However, a more distinctly 'European' form of D&O insurance has also developed from the separate class of legal expenses insurance, written for managers, and PI insurance, which often covered the activities of lawyers and others as members of corporate boards of European companies. 'Common Law' wordings from the USA or UK have influenced these local contracts to varying degrees, making European D&O insurance something of a hybrid.
- 4.25 At present D&O insurance is not compulsory in any business sector. However, from time to time there have been calls for compulsory cover for directors. Professional advisors to corporate bodies have often expressed support for such a move. This is because, under a regime of joint and several liability, their 'deep pockets'¹² may have to meet the whole of a damages claim arising from a corporate failure, with no hope of a contribution from insolvent and uninsured directors who were equally or more to blame. Nor surprisingly, auditors have been strong proponents of compulsory D&O insurance.¹³
- 4.26 Although it is not mandatory, there is a strong case for buying D&O insurance, because firms may find it difficult to attract good people to serve on company

¹⁰ It has been suggested that only two D&O policies were sold in the USA in 1962, with the number rising to 50 in 1966. However, a 1967 survey of 753 US corporations showing that nearly 20 per cent carried D&O insurance (see Bishop Jr., J. W. 'Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers' (1968) *Yale Law Journal* p. 1078, note 1).

¹¹ London was the only real market for D&O until the 1970s.

¹² Or those of their semi-mandatory professional indemnity insurers.

¹³ See ICEAW Memorandum, *Auditors' Professional Liability*, FRAG 8/94, March 1994 and DTI, *Professional Liability: Report of the Study Teams* (1989) (the 'Likierman Report').

boards if directors are given no protection against the threat of personal liability. The likelihood of such a claim may be small, but in the absence of insurance, firms would probably have to pay massively enhanced fees to directors to compensate for even a small risk of uninsured personal liability; so D&O insurance is clearly the cheaper option.

- 4.27 In the UK about 65 per cent of companies with an annual turnover in excess of £100m. already buy D&O, but only about 10 per cent of companies with an annual turnover of less than £5m. do so.¹⁴

¹⁴ From a 1997 survey by UAP Executive Partners. Not surprisingly, the tendency to buy D&O cover generally increases with the size of the company, as does both the size and frequency of D&O claims. An earlier (1991) survey by the Wyatt company suggested that 74 per cent of British companies with a turnover in excess of £100m. hold D&O insurance, but only six per cent of companies with a turnover less than £5m. do so. About a third of respondents in the Wyatt survey said they would change their decision not to buy insurance if a regime of joint and several liability was introduced for directors and 24 per cent said they would do so if the burden of proof were reversed.

5 THE MARKET FOR LIABILITY INSURANCE - INSURERS

The size of the market – premium income

- 5.1 According to ABI statistics¹⁵ the size of the UK liability insurance market in terms of premium income declined from a peak of £2.883 bn. Gross Written Premium in 1994 to £2.6623 bn in 1999. Since 1999 there has been growth, with a sharp increase (27 per cent) from 2000 to 2001, when GWP reached over £3.5 bn.
- 5.2 Insurance companies that are ABI members had a 75 per cent share of the liability insurance market in 2001 and Lloyd's had a market share of 21 per cent.
- 5.3 Employers' liability insurance, the largest class, currently accounts for approximately one-third of total liability insurance premium income.

The principal liability insurers

- 5.4 The tables that follow show the market shares of the major (company) liability insurers over the 1996-2000 period for the main classes of public and employers' liability insurance.

¹⁵ ABI Analysis of the UK liability market 2001.

Table 108: Total public and general liability market share, by competitor, 1996-2000

	% GEP	1996	1997	1998	1999	2000
1	Royal & SunAlliance	12.2%	10.7%	11.9%	12.0%	13.4%
2	New Hampshire	11.7%	12.7%	11.8%	12.0%	12.9%
3	CGNU	18.0%	17.2%	15.8%	13.1%	10.6%
4	AXA	7.8%	7.2%	6.3%	6.5%	6.5%
5	Zurich FS	6.4%	6.1%	5.0%	4.3%	5.2%
6	St Paul	0.9%	1.7%	1.7%	2.2%	3.4%
7	Allianz Cornhill	2.8%	2.6%	2.3%	2.9%	2.3%
8	NFU & Avon	2.0%	1.8%	1.8%	1.8%	2.1%
9	Winterthur	3.0%	2.1%	2.5%	2.2%	2.1%
10	Groupama GAN	1.9%	1.6%	1.5%	1.3%	1.5%
11	NIG	0.6%	0.6%	0.6%	1.0%	1.1%
12	Underwriter	na	na	na	0.0%	1.0%
13	ICHEM	0.8%	1.4%	1.2%	1.0%	0.9%
14	Astrazeneca	0.8%	0.8%	1.0%	1.0%	0.9%
15	MMA	0.3%	0.3%	0.3%	0.4%	0.7%
16	Berkshire Hathaway	0.6%	0.5%	0.5%	0.5%	0.7%
17	Iron Trades	1.2%	1.0%	0.9%	0.8%	0.6%
18	Ecclesiastical	0.4%	0.4%	0.4%	0.4%	0.5%
19	CIS	0.8%	0.7%	0.5%	0.4%	0.4%
20	Electrical Contractors	0.2%	0.2%	0.2%	0.2%	0.2%
21	Pearl	0.2%	0.1%	0.1%	0.1%	0.2%
22	Fortis	0.1%	0.2%	0.1%	0.1%	0.1%
23	Unionamerica	na	na	na	0.1%	0.1%
24	Tokio	na	na	na	na	0.1%
25	Chiyoda	<0.1%	<0.1%	<0.1%	0.1%	0.1%
26	Sterling	0.1%	0.1%	0.1%	0.1%	0.1%
27	Harworth	0.6%	0.1%	0.1%	0.1%	0.1%
28	Stewart Title	<0.1%	<0.1%	<0.1%	0.1%	0.1%
29	Chemists	0.1%	0.1%	0.1%	0.1%	0.1%
30	Ansvar	<0.1%	<0.1%	0.1%	0.1%	0.1%

Source: Datamonitor analysis of SynThesys NonLife database

DATAMONITOR

% GEP	1996	1997	1998	1999	2000
1 Zurich FS	15.4%	15.4%	16.3%	14.6%	15.6%
2 CGNU	12.5%	13.7%	16.1%	15.6%	13.7%
3 Royal & SunAlliance	8.1%	9.1%	10.6%	10.7%	10.7%
4 Iron Trades	5.3%	5.6%	5.2%	6.3%	7.1%
5 AXA	8.3%	8.1%	9.2%	7.5%	6.5%
6 NFU & Avon	1.6%	1.8%	2.0%	2.3%	3.0%
7 Allianz Cornhill	2.0%	2.2%	2.5%	2.3%	2.6%
8 St Paul	1.2%	1.5%	1.5%	1.8%	2.5%
9 Winterthur	0.9%	1.1%	1.9%	2.2%	2.3%
10 Ecclesiastical	0.6%	0.7%	0.8%	0.9%	1.3%
11 Harworth	0.3%	0.6%	0.8%	0.9%	0.8%
12 CNA	<0.1%	<0.1%	<0.1%	<0.1%	0.7%
13 Groupama GAN	0.4%	0.5%	0.7%	0.7%	0.6%
14 CIS	0.5%	0.5%	0.4%	0.3%	0.3%
15 Pearl	0.1%	0.1%	0.1%	0.1%	0.1%
16 Yasuda Kasai	na	<0.1%	0.1%	0.1%	0.1%
17 Independent	1.7%	1.5%	3.3%	5.0%	na
Total of above	58.7%	62.3%	71.5%	71.3%	68.0%
Other	41.3%	37.7%	28.5%	28.7%	32.0%
Total market	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Datamonitor analysis of SynThesys NonLife database DATAMONITOR

5.5 The latest figures for the EL market, supplied by the ABI, show some changes. RSA takes over from CGNU as the second largest EL insurer and QBE, which acquired the then fourth-largest EL insurer, Iron Trades, is now in eighth place:

TABLE 5.1: THE LARGEST EL INSURERS - 2001

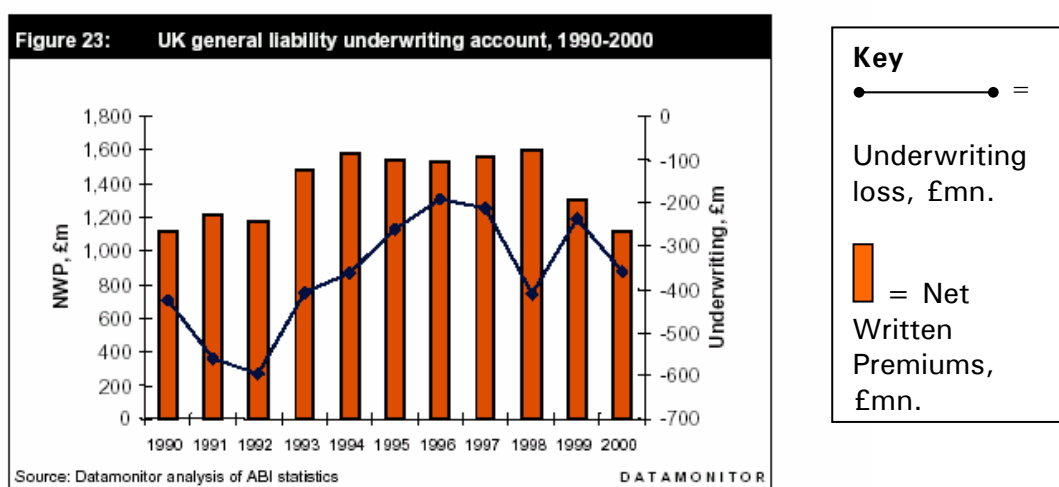
		Gross Earned Premium £000
1	Zurich Financial Services	171,227
2	RSA	125,125
3	CGNU	93,976
4	AXA	52,680
5	NFU Mutual	33,080
6	St Paul	28,803
7	Cornhill	26,845
8	QBE	22,050
9	Winterthur	21,624
10	Ecclesiastical	12,774

Market concentration

- 5.6 The liability insurance market has tended to become more concentrated over time. This is partly as a result of insurers withdrawing from the liability market, partly as a consequence of insurer insolvencies (e.g. Independent) and partly as a result of merger and acquisition activity in the insurance market as a whole, including mergers involving some of the major offices in the last few years.
- 5.7 In 2000 the public and general liability had a C4 ratio of 43.4 per cent, and a C10 ratio of 60 per cent. The employers' liability market is rather more concentrated with a year 2000 C4 ratio of 47.1 per cent and a C10 ratio of 65.3 per cent.

Profitability of the liability insurance market

- 5.8 There is abundant evidence that liability insurance has been unprofitable in the UK for many years, and employers' liability insurance especially so. For example, the ABI recently reported¹⁶ an overall liability insurance underwriting loss for its members of £566 mn. in 2001, significantly higher than the £344 mn. loss for 2000 and close to the worst ever loss of £595 mn. made by the market in 1992.
- 5.9 The ABI reported that in 2001 97 per cent of premiums were paid out in claims compare to 81 per cent in 2000 and 83 per cent in 1999, although expenses fell somewhat, the ratio of expenses to premiums now standing at 25 per cent.
- 5.10 The chart below shows the industry wide view, confirming the net underwriting loss for the sector:



¹⁶ ABI Analysis of the UK liability market 2001

5.11 Employers' liability is especially unprofitable and has been so for many years:

- The ABI is reported as saying recently that insurers have lost money on this line of business in every year from 1993 and 2001: 'For every £1 of premium underwritten, about £1.30 to £1.35 was paid out in claims or set out in claims reserves.'¹⁷
- In 1998 the ABI estimated that between 1987 and 1992 insurance companies made underwriting losses of £588 million on employers' liability business.
- A 1994 report by Smith New Court estimated that the major composites incurred underwriting losses of £200 million on EL business for the 1992 financial year alone. This report suggested that, even allowing for investment income, none of the insurers analysed had made any profit on employers' liability business since 1987.

5.12 The results of individual insurers confirm the general picture set out above:

TABLE 5.2: MAJOR LIABILITY INSURERS' UK CLAIMS EXPERIENCE 1999

Company	Category	Gross earned premiums £ mn.	Claims ratio %
Eagle Star (Zurich)	Employers' liability	114	115.3
	General liability	26	83.4
CGNU	Employers' liability	111	108.4
	General liability	151	92.2
Royal and SunAlliance	Employers' liability	97	95.7
	General liability	155	83.4
Iron Trades (QBE)	Employers' liability	57	87.7
	General liability	14	81.2
Independent	Employers' liability	46	61.2 *
	General liability	55	35.8 *
AXA UK	Employers' liability	20	116.3
	General liability	70	61.1

Source: Insurance Intelligence Unit and FSA annual returns

* In the light of Independent's subsequent collapse, these figures are literally incredible.

¹⁷ 'Rising liability cover struggle', Guardian 9 August 2002.

TABLE 5.3: MAJOR LIABILITY INSURERS' UK CLAIMS EXPERIENCE 2000

Company	Category	Gross earned premiums £ mn.	Claims ratio %
Eagle Star (Zurich)	Employers' liability	113	101.0
	General liability	27	81.1
CGNU	Employers' liability	89	118.4
	General liability	113	87.4
Royal and SunAlliance	Employers' liability	87	107.3
	General liability	186	62.8
Iron Trades (QBE)	Employers' liability	58	101.0
	General liability	14	81.1
AXA UK	Employers' liability	53	112.2
	General liability	93	76.5
Cornhill	Employers' liability	21	158.9
	General liability	39	99.3

Source: Insurance Intelligence Unit and FSA annual returns

TABLE 5.4: MAJOR LIABILITY INSURERS' UK CLAIMS EXPERIENCE 2001

Company	Category	Gross earned premiums £ mn.	Claims ratio %
Zurich Insurance (UK Branch)	Employers' liability	108	126.1
	General liability	70	74.6
CGU International	Employers' liability	78	90.1
	General liability	118	88.9
Royal and SunAlliance	Employers' liability	125	99.5
	General liability	167	96.0
St Paul International	Employers' liability	29	89.2
	General liability	41	73.9
AXA UK	Employers' liability	53	138.9
	Other liability	117	69.9
Cornhill	Employers' liability	27	132.6
	Other liability	51	87.9

Source: Liability Risk and Insurance survey of FSA annual returns

Notes to tables

- The term 'general liability' (GL) is equivalent to 'public liability' (PL) and includes product liability insurance but not professional indemnity (PI) or directors' and officers' liability (D&O).

- The term 'other liability' may include not only PL and products but also PI, and D&O and other specialised liability lines. However the contribution to premium income by the latter classes is likely to be small, because most insurers with major PI and/or D&O accounts provide separate figures for them.
- The term 'claims ratio' describes the ratio of claims paid (including legal and other specific claims handling costs) to premiums earned. It does not include expenses (e.g. commission, general overheads etc) and does not take into account investment income.

Barriers to entry

- 5.13 There are no major barriers to entry in the liability insurance market apart from the general requirement imposed by the Financial Services Authority (FSA) for the authorisation of new insurance firms. Authorisation is granted only for the specified classes for which the applicant has sought a licence. The classes of risk have been defined in an EU Directive and are reflected in the UK legislation.
- 5.14 The applicant for authorisation must satisfy a number of conditions. These include legal requirements as to the form of its undertaking (e.g. a company incorporated in the UK in accordance with the Companies Act), share capital (which must be fully paid up) and management (directors, controllers and managers of the insurer must be 'fit and proper persons' to hold the position concerned). The applicant must also submit a business plan showing, amongst other things, that it has adequate financial resources to support the business to which the licence relates.
- 5.15 However, new entrants to the liability insurance market also need access to statistics, because actuarial modelling of liability business requires access to data on historical claims. The level and validity of industry data and detailed statistical information in the UK is variable, and this may act as a barrier.
- 5.16 The ABI note that between 1999 and 2001 the FSA authorised thirteen companies, which were new entrants to the market or which did not previously write the class, to write liability insurance.¹⁸

¹⁸ ABI Response to OFT study of liability insurance, March 2002.

6 HOW LIABILITY INSURANCE IS BOUGHT AND SOLD

Who buys liability insurance?

6.1 Buyers of liability insurance include:

- private individuals
- government (including local government) agencies and other public bodies
- commercial firms and businesses.

6.2 The main form of liability insurance bought by private individuals is third party motor insurance. The only other form of 'private' liability insurance of any significance is the cover provided under home insurance policies for accidents arising in connection with the ownership and occupation of domestic property or other non-business activity (sometimes called 'personal liability' cover). Of much greater significance for the purpose of this report are the buyers detailed in chapters 2 and 3. We can use the term 'commercial liability insurance' to cover these sectors as, in principle, there is very little difference between the insurance needs of public bodies and private businesses, the cover provided for them and the factors that inform their buying decisions.

How do buyers choose which forms of cover to buy?

6.3 For obvious reasons, most organisations secure the two main forms of cover that are compulsory by law (employers' liability and third party motor) assuming that they employ labour and use vehicles. Some public bodies (e.g. Government departments and local government councils) are exempt from the requirement to secure one or both of these covers but, in practice, many of them do insure these risks, though not necessarily in respect of small losses and claims. Although it is not mandatory, most organisations secure public and product liability insurance, for the reasons given earlier. Similarly, professional firms are effectively obliged to secure professional indemnity cover. As we have suggested earlier, D&O insurance is rather less common, at least amongst smaller firms.

How do buyers choose how much cover to buy?

6.4 The size of an organisation, whether public or purely commercial, is the most significant factor in determining how much liability cover it secures and the way in which the cover is structured. Large organisations almost invariably secure higher limits of indemnity. This is simply a reflection of the scale of their activities and of their potential for causing harm to others when such activities

are conducted negligently. Conversely, large firms have a greater capacity for absorbing loss than small organisations and are likely to self-insure to a greater extent, taking bigger deductibles on their cover and, in some cases, establishing 'captive' insurers to fund some or all of their risks.

How do buyers access the insurance market?

6.5 A few buyers of liability insurance arrange their cover directly with an insurer, often as part of a 'package' policy (see below). However, the vast majority of buyers of commercial liability insurance access the market via an intermediary of some sort.¹⁹ The intermediary may be a professional insurance broker that has access to a large number of insurers or an insurance 'agent' that is effectively tied to one or a small number of insurance carriers.

Insurance brokers

6.6 The insurance broking sector includes:

- major international companies, including two firms that are very much larger than any of the rest (the Marsh and AON groups)
- national firms that operate throughout the UK
- small local brokers that draw most of their business from their own immediate area.

6.7 Some brokers aim to achieve a broad portfolio of clients and readily arrange all forms of insurance for them. Other brokers target clients in a particular sector (e.g. construction firms, SMEs, schools and colleges) or specialise in placing a particular form of insurance (e.g. professional indemnity)

'Agents' and other intermediaries

6.8 An agent in law is simply one who acts for another. However, in insurance the term is often reserved for the individuals or firms whose main occupation is in another field. For example, estate agents, law firms, accountants, garage proprietors, banks and building societies may be appointed as insurance agents: their clients may require insurance cover and these intermediaries are in a good position to arrange it. Insurance agents range in size from sole traders to very large firms (e.g. the retail banks).

¹⁹ The ABI suggest an 80 per cent figure and BIBA 85 per cent, with a slow but steady increase in the use of intermediaries in recent years. In the OFT survey of SMEs 92 per cent of respondents used a broker.

Remuneration of intermediaries

- 6.9 Insurance intermediaries are traditionally rewarded by means of commission payable by the insurer, based on a percentage of the premium paid. Rates of commission depend on the size and status of the intermediary, the benefit of the services that it provides to the insurer and the attractiveness to the latter of the business that the broker brings in. Thus, a large insurance broking firm that produces a substantial volume of business and takes on much of an insurer's administrative work will be able to command higher rates of commission than a small insurance agent that simply introduces clients in relatively small numbers. Similarly 'unattractive' business such as employers' liability will generate less commission than lines of insurance that are more profitable for insurers. Generally, commission rates for liability business range from 7½ per cent to around 15 per cent at the present time.
- 6.10 Some insurance brokers enter into fee-based arrangements with their larger clients. These are schemes whereby the broker returns to the client the commission that the broker would otherwise earn on that client's insurance business in exchange for a negotiated (and normally lower) fee. The fee is based on the extent and value of the services which the broker provides for his client. It is reviewed periodically, sometimes annually.

What factors determine the choice of intermediary?

- 6.11 Once again, there is a strong link between the size of the firm that buys insurance and the way in which it gains access to the insurance market. Small firms with relatively simple insurance needs are more likely to use an agent or a small local broker or, in some cases, to buy their insurance directly. Large firms with complex insurance needs are more likely to use the services of one of the major international insurance brokers. For reasons that are obvious, firms with very specialised insurance needs, including those in high risk sectors, are more likely to use specialist intermediaries.
- 6.12 In some cases two or even three intermediaries may be involved in an insurance transaction. For example, a major insurance broking firm may channel business to the insurance market that has been fed to it by 'producing' brokers. The latter are likely to be small, non-specialist or overseas brokers that need the services of the 'placing' broker to access the market for them. This sort of arrangement is common in the Lloyd's and London insurance markets.
- 6.13 Other bodies may play a part in arranging insurance. For example, special schemes are often set up for groups of firms in a particular (often specialist) trade sector or profession or for other 'affinity' groups such as consortia of schools and colleges. The scheme may be run through a trade or professional

association, a local authority, trade union or other body. Typically, the design of the insurance cover and the placing of the business in the insurance market is effected by an insurance broker or other specialist insurance firm. Often the risk is placed not with a single insurance carrier but with a panel of insurers, each of which agrees to underwrite a certain percentage of each risk that comes under the scheme. The insurers on the panel may be insurance companies, Lloyd's syndicates or both. The composition of the panel may well fluctuate from year to year, with insurers that withdraw or reduce their line (percentage) being replaced by others.

Forms of policy and policy design

6.14 Liability cover is provided under three basic forms of insurance policy:

- an individual policy providing only one form of liability cover (e.g. employers' liability or professional indemnity)
- a combined policy which includes a range of liability, property and other risks within a single contract, but with a separate section for each form of cover (sometimes described as a 'traders' combined' insurance)
- a package policy.

6.15 Under a combined policy (second bullet point above) the insured is allowed to select the covers that he needs from the range that is offered. He may choose, say, only six forms of cover from ten that are available, in which case four sections of the policy will not apply. The insured is usually allowed to tailor the sections of the policy that do apply to his own needs, choosing sums insured (for property and financial risks) and limits of indemnity (for liability risks) that are appropriate to his business. By contrast, a package policy (third bullet point above) is an 'off the peg' product where there is little flexibility. There is no facility to pick some covers and reject others, and little opportunity to tailor the cover to the insured's individual needs except as regards the selection of the sum insured for property risks.

6.16 Large enterprises tend to arrange individual policies for their liability exposures, perhaps using different insurers for different lines. SMEs are more likely to buy combined policies. Package policies are used only for small firms in business sectors where risks do not vary much one from another and where insurance needs are fairly simple, e.g. small shops, offices, restaurants and public houses. They are not suitable for manufacturing or contracting businesses.

6.17 As one would expect, package and combined policies are designed largely by insurers, and based on their perceptions of market needs. The same is true of many individual liability policies. However, for large enterprises and specialised risks cover is often tailored to the client's specific needs. In this case an

insurance broker may play a major role in negotiating the precise terms of the cover or even propose its own wording for the whole contract. Similarly, policy wordings for 'scheme' business are often tailor-made, with considerable input from brokers and the other parties involved in organising the programme.

7 CURRENT PROBLEMS IN THE LIABILITY INSURANCE MARKET

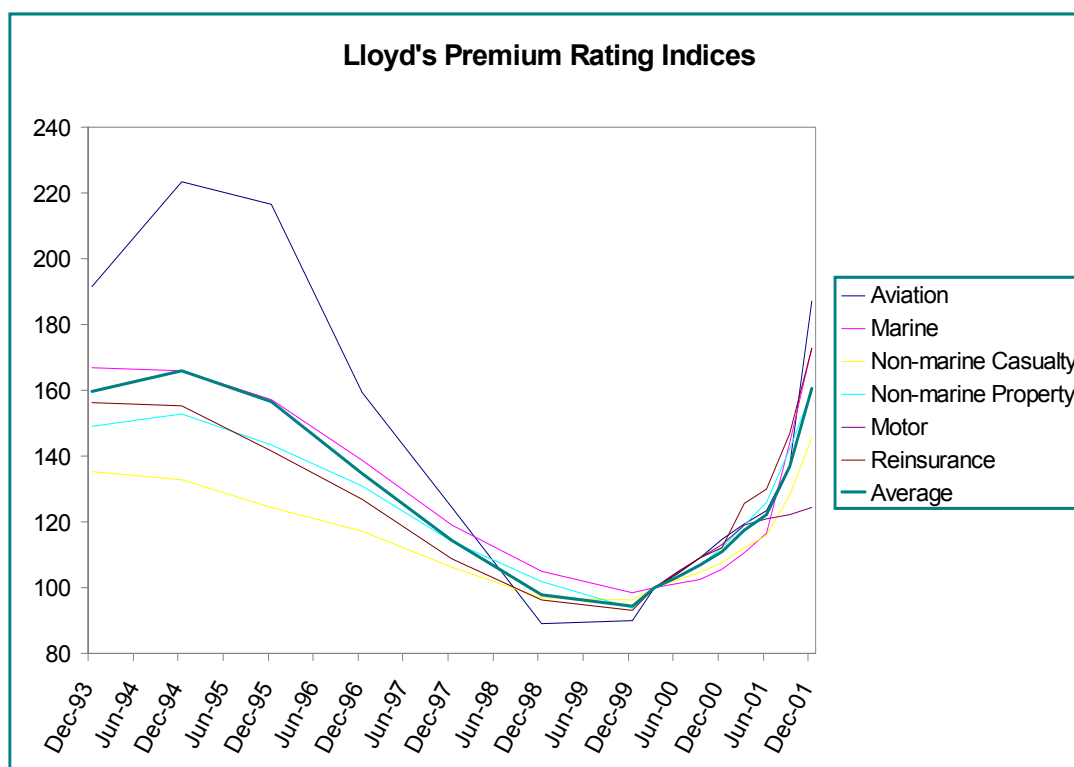
- 7.1 The central problem, and the source of most complaints that have reached the OFT, is the sharp rise in premium experienced by many firms and, allegedly, difficulty in securing any cover at all in some cases.

By how much has the price for liability insurance risen?

- 7.2 It is notoriously difficult, if not impossible, to measure precisely changes in insurance rates (prices) over time because there are no reliable indices of insurance prices. Data on changes in **premiums** (i.e. changes in the spending on insurance) are available as a proxy for insurance rates. However, this is an imprecise proxy, because changes in premiums can result from a change in rates, or a change in the quantity of insurance that is bought, or a combination of both. For example, if insurance rates rise people may buy less insurance (for example, by taking bigger deductibles), so spending on insurance may remain more or less constant, masking the real price increase that has taken place.
- 7.3 The sections that follow review the available evidence on liability insurance rate increases.

Lloyd's of London rating index

- 7.4 Lloyd's of London's Reporting and Analysis department has been developing, with their internal actuaries, an index of insurance rates across 37 lines of business including non-marine casualty (i.e. liability). The index was compiled annually from 1993 to 2000, but since January 2000 it has been compiled quarterly. The price indices are based on an internal questionnaire and interviews with most underwriters in the Lloyd's market. The indices seek to build in subjective factors that will have influenced rates, including changes and variations in policy wordings and deductible levels.
- 7.5 The chart below shows a steady decline in liability (and other) insurance rates from December 1993 onwards, followed by an upswing from the beginning of the year 2000 that sharpens notably from the middle of the year 2001. This is reasonably consistent with other evidence on rate increases (see below) and also reflect the typical cyclical pattern of insurance rates that we find in insurance markets generally: see the discussion of underwriting cycles in chapter 9 following.



Source: Lloyd's

Other evidence from the insurance sector and industry bodies

7.6 No other hard data on rate increases is available from the insurance industry. However, the figures suggested by various industry bodies for *average* rate increases in 2002 are reasonably consistent (see below). The figures give by the ABI and BIBA are based on their view of rate increases across the market as a whole. The figures supplied by individual insurers (NU, AIG and RSA) are for their own achieved rate increases.

TABLE 7.1: ESTIMATED 2002 LIABILITY INSURANCE RATE INCREASES

	Employers' Liability	Public Liability	Professional Indemnity
ABI	50%	40%	30%
BIBA	50%	30%	60%
Norwich Union	40%	-	-
AIG	30%	30%	33%
RSA	60%	40%	25%

7.7 There is also some evidence of firms being unable to secure at any price the liability insurance cover they require. For example, according to a BIBA survey of 100 member brokers, in July 2002, more than 60 firms were out of business because they could not get cover and a further 60 were trading without any cover.

7.8 A recent British Chambers of Commerce survey²⁰ of its members reported that 6 per cent of businesses and over nine per cent of manufacturers had been refused cover. They also reported that a significant number of businesses were refused cover on more than five occasions.

What lines of insurance and what businesses have been most affected?

7.9 Average rate increases for 2002 appear to be in the range 30 per cent - 50 per cent, with the biggest increases for EL and rather smaller increases for PL and PI. However, it is clear that increases in premium have varied enormously, with much bigger rises in some sectors. For example, the major international insurance brokers AON suggest that increases in liability insurance premiums for its clients have ranged from 10 per cent to 300 per cent.²¹

7.10 Most evidence suggests that the biggest increases in premium have been experience in small and medium sized firms operating in sectors that liability insurers regard as high risk, including a number of trades in the construction sector. For example, the OFT's own survey of SMEs, based on 276 responses suggested that 15 per cent of respondents experienced rises in premium of over 200 per cent and a similar percentage had experience difficulties in obtaining cover in the last two years. Around 80 per cent of businesses in this survey employed under 50 workers and 75 per cent were from the construction and manufacturing sectors.

7.11 The Federation of Small Businesses (which represents 170,000 businesses) warned that thousands of small companies could face closure because of premium increases.²²

²⁰ 11 November 2002

²¹ AON response to OFT questionnaire.

²² See Commercial Insurance Crisis: Rocketing premiums make it harder to do business, FT, 8 August 2002.

8 HOW ARE LIABILITY INSURANCE PREMIUMS SET?

8.1 At one time many British insurance offices (the 'tariff' companies) subscribed to compacts whereby they agreed to apply a common pricing structure to various lines of insurance and to make use of standard policy wordings. These agreements applied to some liability lines, including employers' liability. There are no tariffs now²³ and, at the same time, there is no government control of liability insurance pricing: insurance companies are free to write liability insurance on any terms they like provided they have the funds to set up the necessary actuarial reserves against their liabilities.

Rating methods

8.2 First, some preliminary points. An insurance premium is often (although not always) the product of two factors:

- a measure (or unit) of exposure
- a premium rate.

8.3 The measure or unit of exposure reflects the extent to which the insured subject matter is exposed to the risk of loss. In the case of property insurances the measure is usually value (either the total value of the property or maximum possible loss). In liability insurance it is usually something that reflects the amount of activity generated by the insured business, such as payroll (used for all employers' liability and some public liability risks) or turnover (used for product liability).

8.4 The premium rate is generally expressed as a rate per unit of exposure, e.g. a rate of £0.50 per cent of payroll or sum insured.

8.5 In practice, insurers employ two main methods for setting premiums rates: group (or class) rating and experience rating.

Group (or class) rating

8.6 Group rating is the classic method, and is used for the majority of liability insurance risks. Because the probability of loss varies from one risk to another, insurers seek to divide the total pool of risks into a number of sub-groups, placing risks with similar characteristics in the same group and charging similar rates of premium. In a competitive insurance market, an insurer that does not segregate the risk pool in this way and fails to charge accurate differential premiums is likely to suffer adverse selection. It will tend to lose (overpriced)

'good' risks to its competitors and collect insufficient premium to cover losses on the (underpriced) 'bad' business that it will inevitably tend to retain.²⁴ Accurate pricing is also necessary to reduce moral hazard.²⁵

- 8.7 The factors that are most likely to influence annual claims cost are used to distinguish one group from another. These are known as rating (or underwriting) factors. For example, in the case of motor insurance rating factors include the type of vehicle that is insured, the use to which it is put, the area of the country in which it is used, the age of the main user, and so forth. For employers' liability insurance the main rating factor is the trade or business of the insured and for product liability it is the nature of the goods that are sold or supplied by the insured although, of course, various other factors are used in each case. The basic rate of premium for a given group or class of risk is based, at least in theory, on the average claims frequency for risks in that group and the present value of average claim size for such risks.

Experience rating

- 8.8 Experience rating is the pricing of a risk on the basis of the proposer's own past claims experience, or rating a risk on its own merits. For obvious reasons this method is inappropriate for most small risks where past claims experience (if any) will not provide a sufficiently reliable guide to future claims trends.

²³ The last, the fire insurance tariff, ended in 1985.

²⁴ It may not be possible to identify high-risk policyholders in advance, in which case premium loadings and/or restrictive policy terms may be applied as a corrective after claims(s) have occurred. To some extent, there is a tension between the need for accurate risk discrimination and the basic risk-spreading and loss-sharing principles of insurance. For example, precise risk discrimination may lead to insurance being unaffordable or even unobtainable for some very high risks. As a result, insurers may be accused of 'red-lining' – denying cover to vulnerable people such as those with homes and businesses in socially deprived areas where crime and vandalism is rife. Unfortunately, the unavailability of insurance (and, sometimes, of local banking services) may contribute to the further decline of the area.

²⁵ Moral hazard is a problem that affects insurance generally: it is the risk that, by giving insurance cover, the insurer will bring about a change in human behaviour which makes the adverse and economically undesirable insured event more likely to happen. For example, insured persons may become less careful or even cause losses deliberately in order to get the insurance money. To discourage this, insurers generally seek to restrict cover to losses which are 'fortuitous' (accidental) and restrict payments to an indemnity only – i.e. exact compensation for the loss and no more. However, this is not always simple. For example, the dividing line between losses caused by mere carelessness (which insurers must be prepared to cover) and losses caused deliberately (which are uninsurable) is difficult to draw. Again, there is a commercial need for cover that gives **more** than a full indemnity, e.g. 'new for old' cover on personal possessions. Moral hazard can be reduced by a number of standard techniques. These include the exposing of the insured to part of the risk by means of deductibles or coinsurance, the use of policy conditions to restrict coverage for high risk insureds, either in advance of losses occurring or as a consequence of claims experience, and the levying of variable premiums according to risk. In this way the incentive for taking care is provided by the insurer, rather than by the threat of suffering a loss, a risk which is now (mainly) transferred to the insurer. Of course, the absence of complete information about the risk, and the cost of control, means that insurers cannot hope to influence the insured's behaviour fully and decisively.

However, where a single insurance contract effectively covers a large number of individual risks past claims experience can give a statistical base that is wide enough to predict future loss patterns with reasonable accuracy. For example, experience rating can be used successfully for motor fleet risks (where there is a large number of vehicles under one ownership) and non-proportional reinsurance risks (e.g. excess of loss treaties).

- 8.9 Experience rating can also be used for large liability risks. For example, if a firm has a large number of employees accident statistics and claims experience for the last few years should, on the face of it, provide a reasonably reliable guide to future claims experience, allowing the employers' liability risk to be experience rated.

The combining of 'group' and 'experience' rating

- 8.10 In practice, insurers often use a combination of group and experience rating, rather than just one or the other. The familiar no-claims discount (NCD) system, used by virtually all motor insurers in the U.K. since 1932 provides a good example. Here *ex-ante* experience rating is effectively used to modify a premium that is initially set by the group (class) method discussed above. Policyholders that do claim enjoy a discount on the 'book' premium, the discount accumulating to a maximum that is retained as long as the policyholder's record remains claims-free.
- 8.11 In much the same way, liability insurers often modify the 'book' rate that they would otherwise apply in the light of the proposer's own claims experience and any other relevant factors peculiar to the client, applying a loading or discount as appropriate. Effectively, pricing then becomes a process of **classification** ('what general class does this risk fall into?) and **discrimination** (is it a good risk of its type or a bad one?).
- 8.12 Experience rating, to whatever degree it is used, is without question the most efficient method for insurers, the fairest for policyholders and the most beneficial in controlling moral hazard. Unfortunately its use is subject to a number of limiting factors. For one thing, experience rating cannot be used effectively in the case of small risks, because claims data for such risks often has little statistical significance. Furthermore, other steps that insurers might take to discriminate between small risks will often be ruled out on the basis of expense. For example, it may not be cost-efficient to carry out a detailed survey (physical inspection) of small risks, because the cost of the survey is likely to absorb much of the premium.

- 8.13 A further key difficulty lies in the fact that experience rating may be impractical even for large liability risks if such risks are of the type that generate long-tail claims. This point is developed in the section that follows.

Problems in pricing liability business

- 8.14 It is fair to say that the rating and underwriting of liability insurance is generally more problematic than that of other lines. As we have seen, some forms of liability insurance (including employers' liability) are characterised by a 'long tail' of claims, which extends many years beyond the periods of insurance where the claims have their origin. The potentially long delay between underwriting a risk or group of risks and settling the last claims that arise from the years of insurance in question creates considerable uncertainty as regards the final cost of such claims and the level of premium that is necessary to cover them. The uncertain effects of inflation, investment yields (see below) and potential increases in the size of court awards over long time periods are likely to make pricing inherently difficult. Furthermore, the longer the time span of the whole insurance transaction, the greater is the risk that changes in legislation, scientific knowledge or accident victims' general propensity to claim will make claims greater in amount or more frequent than was anticipated. It is well known, for example, that a failure to predict accurately the level of future claims for asbestos related illness²⁶ and environmental damage has caused the collapse of many insurers in the United States this century²⁷ and contributed significantly to the problems of the Lloyd's insurance market in recent years.
- 8.15 It is also worth noting that problems of moral hazard are particularly complex and acute in the case of liability insurance, adding further to the problems of accurate pricing.²⁸
- 8.16 Finally, we should emphasise a key difficulty suggested above – the fact that experience rating may be impractical even for large liability risks if such risks are of the type that generate long-tail claims. The point here is that when there are long time delays in the development and reporting of claims the current loss experience may reflect, not the present state of the risk, but rather the state of the risk thirty or forty years ago.²⁹ This problem is particularly acute in respect of employers' liability risks that generate a high proportion of claims for latent or gradually-developing diseases.

²⁶ There have been around 265,000 asbestos-related deaths in the USA

²⁷ 106 American insurers became insolvent between 1988 and 1990, asbestos-related and pollution claims being a major source of failure.

²⁸ See Parsons, C. (2003) 'Moral hazard in liability insurance' *The Geneva Papers on Risk and Insurance* (July) and 'Moral hazard and behavioural aspects of insurance: some new dimensions, Nottingham University Insurance Economists Conference paper, April 2002.

²⁹ See Parsons, C. (1999) 'Industrial injuries and employers' liability – a search for the cure' *Chartered Insurance Institute*.

Other determinants of the price of insurance

8.17 Whatever rating method is used, the ultimate price of insurance will depend not only on the cost of meeting expected claims for a given class of risk and the cost of handling those claims, but on a number of additional factors. These will include:

- the level of deductible (excess) taken by individual policyholders
- the cost effects of reinsurance that is purchased by insurers
- loadings applied by insurers for contingencies (uncertain future events or trends)
- expenses (e.g. in respect of commission, renewal costs, claims handling costs and general overheads)
- investment income generated by the funds that insurers hold.

8.18 As we shall see, the effects of market forces and market behaviour may have a powerful effect on the price of insurance. The next section examines the effect of all these factors in the context of current problems in the UK liability insurance market.

9 WHY SHOULD THE PRICE OR AVAILABILITY OF LIABILITY INSURANCE CHANGE?

- 9.1 We now summarise factors that might bring about a change in the price (and/or availability) of liability insurance, either in general or for particular risks. We then try to assess the impact of these factors at the present time and their potential impact in future.
- 9.2 The price and/or available of liability insurance is likely to alter if there is an actual or prospective change in any of the following:
- the frequency of claims
 - the size (cost) of claims
 - expenses incurred by insurers
 - the economic and financial environment in which liability insurance is written (e.g. interest rates and equity prices)
 - market conditions and market behaviour.
- 9.3 Each of the above can be affected by a number of things. For example, the first bullet point, (the frequency of claims) is likely to change if there is a rise or fall in accident or disease rates or a change in the propensity of accident victims to claim. The latter, in turn, may be affected by a number of factors, such as changes in the administration of justice which makes claiming more or less easy, or the availability of alternative compensation sources (such as state benefits) which may make a liability (tort) claims more or less worthwhile. Some of the factors that affect the second bullet point above, (the size of claims) will be different. For example, the size of damages awards made by the courts will affect claim size markedly but will not have much effect on claim frequency. On the other hand, some of these underlying factors, such as the availability of alternative compensation sources may affect **both** claim frequency and claim size. For this reason factors affecting claim frequency and size are considered together rather than separately.

Claims frequency and cost

- 9.4 There is only limited evidence on claim frequencies in respect of liability insurance. Some figures on claim **numbers** are available but these are apt to be distorted by the long delays that occur in both the reporting and settlement of liability claims (especially for employers' liability). Further distortion arises from 'spikes' in claims of a particular type, such as the (mainly 'low value') EL claims

in respect of deafness that peaked in the mid 1990s and have tailed off since. Since there is an absence of data on the number of insurance policies to which claims relate, it is often difficult to assess trends in claim frequency with any degree of precision.

- 9.5 However, as far as employers' liability is concerned, there appears to have been a rise in the total **number** of claims between 1980 and 1990 followed by gradual tailing-off since.³⁰ This is consistent with the significant decline in underlying rates of industrial injury and ill-health that have occurred in the UK during the 1990s, produced by a combination of improved health and safety standards and a decline in mining, manufacturing and heavy industries (see below).
- 9.6 In contrast to evidence on claim numbers and frequency, there is evidence of quite sharp increases in liability insurance claims cost. For example, Greenstreet Berman estimate that the average cost per EL claim has increased three fold between 1996 and 2002,³¹ Zurich Insurance claim that there has been a doubling in the size of the average EL claim in the last five years³² and RSA suggest that the average settlement cost of liability claims has increased from £1,235 in 1991 to £6,817 in 2000, a real increase of 335 per cent.³³ None of these bodies give the exact source of their information but figures such as this are corroborated by detailed studies of personal injury claims settlements arising from motor accidents, which suggest settlement costs are currently rising by around 15 per cent per year.³⁴
- 9.7 We now consider some underlying factors that affect claims frequency and/or cost.

Changes in the substantive rules of liability law

- 9.8 Clearly, there must be some link between the level of liability insurance claims and the content of liability rules. If there is an extension in the reach of such

³⁰ Based on figures supplied to the author by the ABI in 1998. According to Greenstreet Berman '... if anything the overall number of [EL] claims paid is falling.' (Greenstreet Berman (2002) *Workplace compensation: costs, trends and options for change*, p 11 && 15). The ABI note a 'fall in [liability] claims incurred between 1998 and 2000 (Analysis of the UK Liability Market 2001).

³¹ Greenstreet Berman, *op cit* note 30, p. 11.

³² Zurich Insurance (2002) *Rate increases explained*.

³³ Neil Clutterbuck, RSA Liability Insurance Manager, CII Liability Insurance Seminar, Leeds May 2002.

³⁴ According to an in-depth study of motor claims the cost per unit of exposure to insurers from serious injuries rose at an annual rate of approximately 13 per cent between 1986 and 1995 - six per cent faster than average earnings (*LIRMA UK Bodily Injury Study*, London International Insurance and Reinsurance Association (1997)). The more recent *Third UK bodily injury awards study* (IUA, March 2003) confirmed this general trend.

rules accident victims may find it easier to claim or may be able to claim in circumstances where previously they could not. Conversely, if there is a contraction in the scope of liability law the number of claims is likely to fall, making liability insurance cheaper. The body of law that most affects liability insurance is tort law. Has there been any recent expansion in the scope of tort liability and, if there has, what effect should we expect this to have on premiums?

- 9.9 Some writers claim that there has been a long-term trend of expanding liability in the field of tort law, characterised by a gradual move away from fault-based liability towards strict liability.³⁵ In fact, recent changes in the substantive rules of tort law present a mixed picture: there has been a contraction of tort liability in some areas and an expansion in other. For example, after a long period of expansion from 1932 until the early 1980s there has been a general retrenchment or, at the very least, a slowing down in the development of the law of negligence up to the present day. This has been balanced, so far as liability insurance is concerned, by some expansion in particular areas, such as the law relating to some aspects of liability for the professional services, to employers' liability and to product liability. Taken altogether, it cannot be said that there has been any dramatic expansion of tort liability in recent years. Furthermore, possible and pending law reform, such as the Law Commission's proposals in relation to the law on psychiatric illness are unlikely to bring about any dramatic changes in the overall reach of tort law, even if they were to be implemented in full.³⁶
- 9.10 Finally, we should note the influence on liability insurance prices of changes in the content of tort rules is likely to be fairly weak when compared with the effect of other factors, such as the levels of damages which the courts are prepared to award, the ease with which claimants are able to operate the machinery of the administration of justice and economic, cultural and social factors that influence accident victims' propensity to claim. For example, it is commonly observed that differences between European and US product liability

³⁵ See, for example Spuhler, J. (2001) *Liability and liability insurance - Yesterday - today - tomorrow*, Swiss Re. Others argue that tort liability was originally strict. In any event, it has been suggested that the recent turn (or return) to strict liability is itself a result of the more widespread use and availability of liability insurance.

³⁶ The ABI, when asked by the Law Commission to comment on their proposal in relation to liability for psychiatric illness, suggested that the number of personal injury claims might increase by 10 per cent, requiring an increase in premiums of between two and five percent. This view is difficult to challenge, since any estimate is largely a matter of speculation. However, a 10 per cent increase in the *total* number of personal injury claims seems remarkably high. Since only a relatively small percentage of claims are in respect of psychiatric illness it would seem to imply a very large percentage increase in the latter. Given that the Law Commission's recommendations would have a marked effect on only one of the many classes of potential claimant – the 'secondary' victim – it is difficult to see how this could happen.

law cannot begin to explain the massive differences in the levels of product liability claims that exist in these two continents.³⁷

- 9.11 We can conclude that there has been no very dramatic expansion of tort liability in recent years and that the effect of any such expansion on liability insurance premiums should be fairly insignificant.

Changes in accident and disease rates

- 9.12 As suggested earlier, there has been a steady decline in the number of workplace accidents and diseases in the UK in recent years. This trend is mirrored by UK road accident rates, which have been falling steadily for many years. However, the decline in work injuries is only partly the result of declining accident rates – it is also attributable to a steady diminution in the numbers employed in high risk trades such as mining.

- 9.13 Clearly, declining injury rates should exert some downward pressure on liability insurance claims frequency and at least partly counteract forces that have an opposite effect, such as increases in damages awards (see below). However, injury and disease rates, at least in the workplace, are already very low compared with the rates in comparable countries, such as the USA, Germany, France and Italy so the scope for further improvement must be limited.³⁸ The insurance industry can exert some influence on safety standards by demanding improvements as a condition of cover being granted and various other initiatives, but the overall effect of such measures is likely to be fairly small. The author concludes that although general decline in accident rates is likely to continue, the rate of decline is likely to be small, and will not significantly affect claims cost.

Changes in levels of damages

- 9.14 The vast majority of liability insurance claims are settled out of court. However, for reasons that are obvious, insurance settlements tend to closely reflect the levels of compensation that claimants would receive if they were to sue their cases to judgement.³⁹

- 9.15 Liability insurance claims may be made in respect of:

³⁷ See generally Pfennigstorf, W. with Gifford, D.G. (1991) A comparative study of liability law and compensation schemes in ten countries and the United States, Insurance Research Council.

³⁸ See Parsons, C. 'Liability rules, compensation systems and safety at work in Europe' *Geneva Papers on Risk and Insurance*, Vol. 27 No. 3 July 2002 pp.358-382.

³⁹ On the basis that insurers are likely to fight hard over large claims and not waste money in defending small ones, it is often suggested that accident victims are under-compensated when their injuries are serious but over-compensated when they are trivial.

- death or bodily injury
- damage to property
- financial loss.

9.16 Employers' liability claims are in respect of (a) alone, professional indemnity and directors' and officers' liability claims are largely in respect of (c) and public and product liability may be in respect of any or all of them. Claims for (b) (property damage) and (c) (financial loss) are for concrete and readily ascertainable amounts. The average size of such claims is likely to increase over time as a consequence of the rise in the cost of rebuilding or repairing buildings and other forms or material property and as a result of the increase in the amounts of money that are at stake in business activity. However, claims of this sort are largely unaffected by legislative action or judicial policy. By contrast, claims in respect of (a) death or bodily injury are so affected, and there is abundant evidence of strong upward pressure on damages awards in respect of death and personal injury in recent years.

9.17 Research suggests that damages for personal injury are currently rising at a rate of between nine per cent and 15 per cent per annum, depending on the size of the claim.⁴⁰ A number of factors have contributed to this. They include the following:

- **Wells v. Wells (2000).** In this case the House of Lords confirmed that the discount rate to be used in calculating multipliers for future loss in personal injury cases should be based, not on the rate of return that a 'prudent investor' investing partly in equities might expect to receive, but on a rate of return that a risk-averse investor investing in Index Linked Government Securities (ILGS) would secure. The effect was to substitute a discount rate of three per cent (now reduced to 2 ½ per cent as a consequence of further falls in interest rates) for one of five per cent, greatly increasing the amount of damages awarded for future loss or earnings and cost of future care in grave personal injury cases. In effect, disabled accident victims now receive larger sums for their future needs because it is expected that they will derive less investment income from their damages than hitherto. If the trend of falling interest rates continues discount rates may fall further, with corresponding rises in damages awards for serious injuries.
- **Heil v. Rankin (February 2000).** In this case the Court of Appeal effectively stated that damages awards for non-economic loss (pain suffering and loss of amenities) in personal injury cases should rise. The Court proposed that for the very gravest injuries damages should rise should rise by

⁴⁰ See LIRMA and IUA UK Bodily Injury Studies, *op cit* note 34.

approximately one-third with progressively smaller rises for less serious injuries, tapering down to relatively minor injuries where victims today receive around £10,000, for which there should be no increase at all.

Possible future reform

- 9.18 Bereavement damages awarded under the Fatal Accident Acts to the relatives of those killed by the wrongful act of another have risen from the current limit of £7,500 per death to £10,000 per bereaved claimant (capped at £30,000 per death). It is further proposed that new categories of claimant should be eligible, including bereaved persons in same-sex relationships with the deceased accident victim.
- 9.19 Recent academic research by Lewis *et al*⁴¹ at Cardiff University suggests that the methods currently used by the courts for assessing damages for future loss of earnings are flawed in that they do not provide the 'full compensation' that tort damages purport to provide. These researchers suggest that if the UK courts adopted North American approaches, which use more detailed labour market information and more precise methods, damages awards for lost earnings would rise still further.
- 9.20 We can conclude that a variety of factors, including judicial and legislative developments have exerted strong upward pressure on damages awards for personal injury in recent years and that this upward pressure is more likely to increase than diminish in the short and medium term.

Changes in the relationship between liability insurance and alternative compensation sources

- 9.21 Tort damages backed by liability insurance is not the only means by which accident victims receive compensation. There is a variety of other compensation sources, including first-party (e.g. life, health and accident) insurance. Historically, however, it is the state that has provided the main alternative form of support for accident victims, through social insurance programmes and other mechanisms, such as publicly-funded hospitals, fire and other emergency services.
- 9.22 For a number of years now, both in the UK and elsewhere, there has been a tendency on the part of governments to trim social insurance programme. This has been accompanied by a steady upward trend in the deployment by governments of private liability insurance as a means of extending social

⁴¹ See Lewis, R. K., McNabb, R., Robinson, H. & Wass, V. (2002) 'Court awards of damages for loss of future earnings: an empirical study and an alternative method of calculation, *Journal of Law and Society*.

security systems.⁴² All this is part of the current world-wide trend of economic liberalisation, supported by increasing confidence in market mechanisms to meet human needs. Governments, almost everywhere, are anxious to cut welfare spending. Ideology apart, the desire to trim ambitious social security schemes has arisen as a result of demographic factors, with ageing populations, rising dependency ratios⁴³ and increasing public demand for sophisticated and costly health care. In this climate, it is not surprising that governments should look more closely at the relationship between social security systems and private insurance mechanisms.

9.23 Governments are increasingly reluctant to allow accident victims to accumulate social insurance benefits and tort compensation recovered from a person, or the liability insurer of a person, who caused the accident.⁴⁴ Double recovery of this sort is increasingly denied, not just to prevent 'unjust enrichment' of the victim but to ensure that public funds are used in the most economical way. To achieve this, social insurance benefits may simply be deducted from the damages payable by the wrongdoer, without any recovery by the social insurer;⁴⁵ in other cases, the victim may be required to choose one remedy or the other.⁴⁶ Most common of all, however, is a system of reduction **plus** recovery: i.e. a mechanism whereby the damages claim of the victim is extinguished or reduced to the extent of the social insurance payments that he has received, and where the social insurer is allowed to recover its outlay, either from the wrongdoer or his liability insurer. The recovery, which may be total or partial, can take various legal forms – e.g. an independent claim or subrogation to the congruent claim of the accident victim. Of course, there is a need to keep the costs of recovery to a minimum, otherwise the economic benefits of subrogation will be lost.⁴⁷

⁴² Generally, see Cane, P. *Atiyah's Accidents, Compensation and the Law*, Sixth Edition, (1999) pp. 199-208.

⁴³ See Liedtke, P. M. (2001) 'Driving potential pension solutions' *Journal of Insurance Research and Practice*, Vol. 16, Part 2 p. 40.

⁴⁴ Again, there are exceptions. For example, some states (including Russia and Cyprus) allow the accumulation of tort damages and state workers' compensation benefits.

⁴⁵ Deduction without recovery is a logical solution when the both parts of the system - private and public - are funded from the same source: for example, where employers that are exposed to direct tort claims by employees also fund the public worker's compensation system.

⁴⁶ For example, 'election' between a damages claim against an employer and workers' compensation benefits – the English system until 1948 – still applies in a number of countries. However, the worker's compensation carrier is not always a social insurer.

⁴⁷ This has led to extreme rationalisation in Germany, where subrogation usually takes place through collective or 'wholesale' settlement agreements between social security carriers and liability insurers. Under these *Teilungsabkommen*, or loss-sharing agreements the liability insurer pays an agreed standard percentage of any claim reported by the social insurance carrier based on an accident in which one of the liability insurer's clients was involved. Payments are made regardless of fault or causation unless the claim exceeds an agreed ceiling (e.g. Euro 30,000) in which case there is a full evaluation of the facts and the law. There are, apparently, about

- 9.24 In the UK we have seen a tightening of such recoupment schemes in recent years. For example, there has been a progressive extension in the powers of the Compensation Recovery Unit (CRU) of the Department of Social Security (now Department of Work and Pensions) to recover from private liability insurers the value of benefits paid to injured employees under the state worker's compensation programme (the Industrial Injuries Scheme), when an employee succeeds in a tort-based claim against his employer.⁴⁸ More recently, the CRU has been given enhanced powers to recover from motor insurers the costs incurred by public hospitals in treating road accident victims.⁴⁹ In future, NHS Trusts may be given a right to recover from wrongdoers, or their insurers, the treatment costs of accident victims generally, including people injured at work.⁵⁰
- 9.25 It is clear that this process of switching accident costs from public to private sector could be taken further. Elsewhere the author has suggested that agencies such as the police and fire brigades, and inspectorates such as the UK Health and Safety Executive, could be given powers to recover costs from those who cause the accidents that occasion their attendance, and from the liability insurers of the latter.⁵¹ Indeed it was recently suggested, in the context of the current fire-fighters dispute, that the funding of the fire service could be enhanced in this way.
- 9.26 Of course, quite apart from strengthening the recovery rights of their social insurers, many governments have, at the same time, actually reduced the scope of social insurance programmes that are offered by the state. Some countries, such as the Netherlands, have adopted quite radical measures in recent years, completely dismantling major elements of their social insurance schemes.⁵²
- 9.27 Although some components of UK government provision, such as the Industrial Injuries Scheme, have been identified as a potential candidate for abolition or

1800 individual wholesale agreements in Germany: see Pfennigstorf, W. with Gifford, D. G. *op cit* note 37 pp. 131-139.).

⁴⁸ See the Social Security (Recovery of Benefits) Act 1997.

⁴⁹ See the Road Traffic (NHS Charges) Act 1999, Road Traffic (NHS Charges) Regulations 1999, SI 1999 No. 785 and Road Traffic (NHS Charges) Reviews and Appeals Regulations 1999, SI 1999 No. 786.

⁵⁰ See the Law Commission Consultation Paper 144 *Damages for Personal Injury: Medical, Nursing and Other Expenses*. Zurich Insurance estimate that employers' liability premiums would need to rise by two per cent as a result (Zurich Insurance (2002) *Rate Increases Explained*).

⁵¹ See Parsons (2002) An essay on liability insurance and accident compensation.

⁵² See Faure, M. & Hatlief, T. (2000) 'Social security versus tort law as instruments to compensate personal injuries: a Dutch Law and Economics perspective', working paper, Maastricht University Faculty of Law, pp. 21-25 for a description of recent changes in the Netherlands.

9.28 'privatisation'⁵³ there has been no such radical change in this country. However there has been pruning back of social security provision in some areas. Cuts in the Industrial Injuries Scheme, most of which took place in the 1980s, provide a good example. This subject is of particular significance, because of the relationship between the IIS and employers' liability insurance. The two schemes, state and private, are intended to complement one another. Whereas the Industrial Injuries Scheme provides compensation on a 'no-fault' basis, employers' liability insurance, at least in theory, comes into play only when the employer is at fault, and the injured employee has a tort claim against the employer.⁵⁴ However, since the 1969 Act came into force the balance between the two schemes has changed quite strikingly, with private employers' liability insurance becoming increasingly important as a source of compensation. In 1972 employers' liability insurance was still relatively insignificant when compared with the Industrial Injuries Scheme, total annual payments running at only about half the level of the latter. The position is now very different, with total employers' liability insurance payments⁵⁵ actually exceeding those under the state scheme from 1994 onwards.⁵⁶ See chart below.

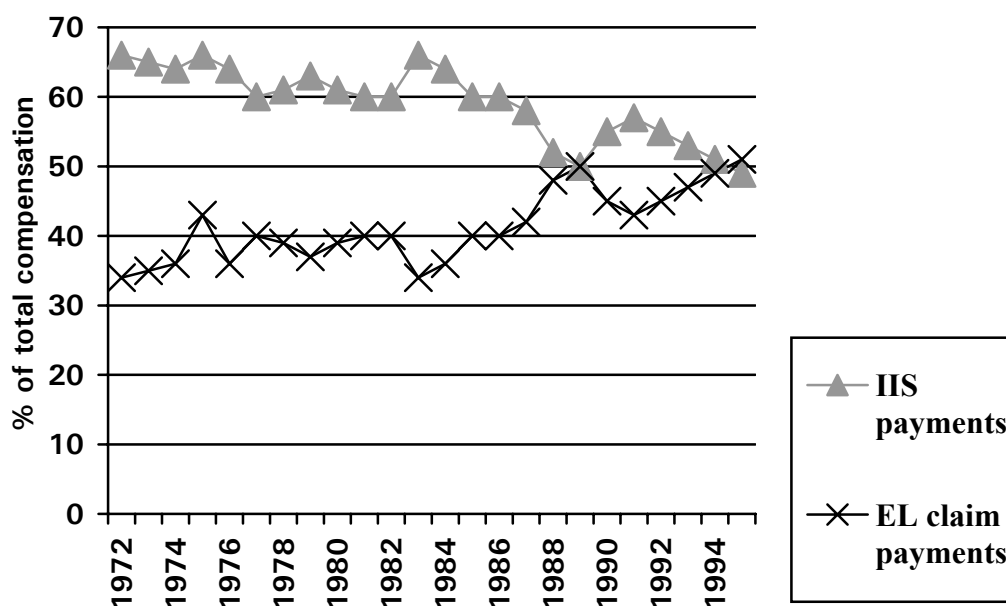
⁵³ The possible abolition of the Industrial Injuries Scheme, the main plank of state provision for work-place accidents, has been under discussion since 1994. This would almost certainly promote an expansion in the fields of tort liability and employers' liability insurance, unless a privately-insured workers' compensation scheme were introduced to replace the state programme. See, generally, Parsons, C. (1999) *op cit* note 5.

⁵⁴ In fact, there are substantial areas of strict liability in employers' liability law, largely the result of statutory duties imposed by regulations made under the Health and Safety at Work Act 1974. Atiyah is highly critical of strict liability in this context, because it fudges the boundaries between tort compensation and the state scheme. He notes: 'It is difficult enough to justify the continued existence of liability based on fault in industrial accidents despite the existence of the Industrial Injuries Scheme; but it is impossible to justify the continued existence of strict liability.' (Cane, P. (1993), *Atiyah's Accidents, Compensation and the Law*, 5th edition, p. 83).

⁵⁵ £738 million in 1995.

⁵⁶ £731 million in 1995.

CHART 9.1: INDUSTRIAL INJURIES SCHEME PAYMENTS AND EMPLOYERS' LIABILITY CLAIM PAYMENTS AS A PERCENTAGE OF TOTAL PAYMENTS 1972-1996



Source: Association of British Insurers and Department of Social Security)

9.29 There are a number of reasons for this trend. First, there have been a number of cuts in the Industrial Injuries Scheme since 1972, most of which took place in the 1980s. As a result, the total cost of the Scheme is lower in real terms than it was in the late 1970s. Second, whilst Industrial Injury Scheme benefits are raised annually, they are linked to price inflation rather than earnings' indices, which rise more rapidly. By contrast, tort damages for personal injury, and hence employers' liability claim payments, have risen at a much higher rate than either prices or earnings, as we have seen. Third, as mentioned earlier, the recoupment scheme introduced by Social Security Act 1989,⁵⁷ and progressively tightened since,⁵⁸ enables the Compensation Recovery Unit to claw back from employers' liability insurers a substantial portion of the benefits paid to those who are injured at work, further shifting the balance of responsibility for industrial injuries away from the state and towards the employer and his insurers.⁵⁹

9.30 We can conclude that cuts in social security programmes and mechanisms that transfer accident costs from the state to private liability insurance programmes

⁵⁷ Now repealed and replaced by the Social Security Administration Act 1992.

⁵⁸ Most recently in the Social Security (Recovery of Benefits) Act 1997 which extends the clawback to 'small payments' of £2,500 or less, which were previously exempt.

⁵⁹ The CRU recovered £145 million in benefits in 1996/7 and £173 million in 1997/8.

have exerted some upward pressure on liability insurance premiums in recent years and are likely to continue to do so.

Changes in funding methods for litigation and in the administration of justice

9.31 There have been two major recent developments in this area.

- First, lawyers have been allowed since 1995 to enter into Conditional Fee Arrangements (CFAs or 'no win-no fee' deals) and, since April 2000, to charge a success fee if they win a case, to compensate them for other cases that they lose. This fee is recoverable from the defendant/insurer. The claimant can also take out 'After The Event insurance' (ATE) which insures the claimant to meet the expense of the defendant's legal costs if he loses. If he wins, the premium can also be recovered from the defendant/insurer. A large number of claims management companies or agencies have been established to exploit this new environment. It is commonly argued that CFAs have increased claims cost because the typical uplift in fees (the ABI suggests that 40 per cent is typical) is much greater than the statistical risk of losing a case, 90-95 per cent of personal injury actions being successful.⁶⁰ It is also alleged that the vigorous promotion of no-win no-fee arrangements by claims management companies feeds a 'compensation culture' and increases the propensity of accident victims to claim. The ABI suggest that CFAs have increased the cost of EL claims by 25-30 per cent⁶¹ and Zurich Insurance suggest that EL rate increases of 8 per cent are necessary to meet the added cost.⁶²
- Second, changes in Civil Claims procedures following the Woolf Report have had a significant impact on the conduct of personal injury claims. Courts can apply financial penalties to defendants/insurers who fail to comply with the new procedures. These procedures include strict timetables for completion of investigation work and for obtaining the information that is needed to settle the claim. Some insurers argue that the new procedures are leading to settlement of claims at a higher level than previously.⁶³

9.32 The precise effect of all this is uncertain. Claimants' costs (which include medical as well as legal costs) have certainly risen steadily in recent years. For example, Greenstreet Berman suggest, in relation to EL, that there has been a rise of about 50 per cent in such costs since 1997, an average of around 12 per cent per year, with an average cost of £1,700 per case. However, they note

⁶⁰ However, the Court of Appeal recently suggested that the success fee should be only five per cent in simple cases (*Halloran v. Delaney*, CA 6 June 2002).

⁶¹ ABI response to OFT review, p. 28.

⁶² Zurich Insurance Rate Increases Explained.

⁶³ Zurich Insurance suggest that the Woolf reforms have led to EL rate increases of two per cent.

that average compensation has risen by about 20 per cent per year, so claimants' costs are a declining proportion of an increasing total settlement cost. Fenn and Rickman⁶⁴ note that over the last two years there has been a substantial rise in legal costs⁶⁵ following the settlement of low value (motor insurance) claims for personal injury but suggest that this cannot be ascribed to the recoverability rules introduced in April 2000. They note that there being little difference between CFA and non-CFA claims with increased to agreed base costs and disbursements, and success fees remain a relatively small part of overall costs recovered from insurers. They suggest that this trend in costs appears consistent with the effect of Lord Woolf's reforms on the 'front-loading' of case-work, i.e. many costs are simply borne earlier in the process.⁶⁶

- 9.33 In summary, it seems unlikely that the cost of individual claims has risen substantially as a result of the reforms and structural changes in the litigation process mentioned above. It is also unclear whether they have had a significant impact on the frequency of claims. It has frequently been suggested that the number of claims (especially for trivial injuries) has risen because the reforms have made the claiming process easier and the associated publicity has drawn more attention to the availability of compensation for accident victims, but the evidence for this seems largely anecdotal.⁶⁷

Expenses incurred by insurers

- 9.34 The cost of liability insurance will clearly depend, to some degree, on the level of insurers' expenses. Besides the cost of handling particular claims, discussed above, there are costs that are largely proportional to premium (e.g. commission), expenses per policy (e.g. renewal costs) and a variety of general overheads.

⁶⁴ Study by Paul Fenn and Neil Rickman commissioned by the Civil Justice Council.

⁶⁵ About 25 per cent in base costs (solicitors' hourly fees) and 10 per cent in disbursements over the period March 2000 to December 2001.

⁶⁶ See also Goriely, T., Moorhead, R. and Abrams, P. (2002) *More Civil Justice? The impact of the Woolf reforms on pre-action behaviour*. Research Study 43, The Law Society and Civil Justice Council ISBN 85328 836 5 and (2002) *Civil Justice Reform Evaluation. Further Findings* Lord Chancellor's Department.

⁶⁷ For example, the ABI, in their response to the OFT, suggest that CFAs and associated advertising by lawyers and others 'has greatly increased the number of minor personal injury claims made against major retailers and local authorities ... their increased incidence has, in the opinion of one major insurer, increased the aggregate cost of claims against major retailers by about 70 per cent.' (p. 27).

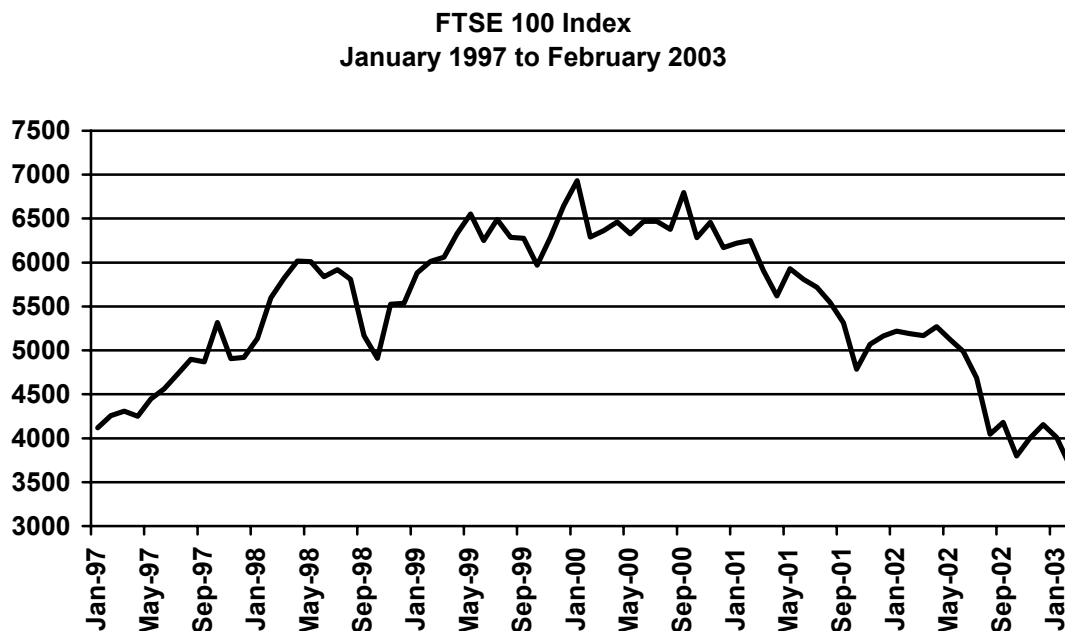
- 9.35 As regards expenses, it is easy to say that they should be as low as possible: insurers everywhere try to keep expenses down to gain a competitive edge. This is seen most dramatically in 'personal lines' business where there has been a move towards direct marketing (to reduce acquisition and distribution costs), simplified underwriting (which can be carried out by less well-qualified and less highly-paid staff) and streamlined policy processing and claims handling techniques.
- 9.36 It is worth noting, however, that the optimal level of expenses is not necessarily the lowest that can be achieved. For example, expenses can be lowered by a reduction in the number and/or quality of risk surveys, simplified underwriting that disregards some of the finer distinctions between risks, and less thorough claims investigation. However, the result may well be an influx of lower quality business, more claims and more fraud. Insurers must therefore maintain a balance between containing costs and maintaining quality. These principles are no less applicable to liability insurance than to other insurance lines.
- 9.37 ABI figures suggest that the ratio of expenses to net premiums has averaged around 30 per cent over the last 20 years or so. Major fluctuations in the ratios seem to be mainly attributable to changes in premium volumes. For example, the relatively high expense ratios for 1999 (35.8 per cent) and 2000 (36.7 per cent) coincide with quite sharp declines in premium volumes and the steep drop in 2001 (to 24.7 per cent) is largely a product of a very substantial increase premium volumes, which itself must be the result of substantial rate increases.
- 9.38 The ABI figures also indicate that the amounts spent by liability insurers on commission and expenses have fallen in each of the last four years for which figures are available, from a total of £520m in 1998 to £444m in 2001.
- 9.39 The scope for further savings in insurers' expense must be limited, given that commission levels are probably now at an all-time low, and that insurers seem now to be demanding both better quality information from intermediaries and more careful underwriting on the part of their own staff.

Economic and financial factors: equity prices and interest rates

Equity prices

- 9.40 Insurers invest much of the long-term capital which supports their business (shareholders' funds) in equities, because these have tended to deliver the best long-term returns over time. However, falls in equity markets over the last few years (see charts below) have substantially reduced the capital base of the insurance industry. This has reduced its capacity to absorb business, 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.⁶⁸



9.41 As the ABI observes,⁶⁹ there is also a curious effect whereby the same solvency regulations can also effectively limit the capacity of insurers to accept business at a time of hardening rates. When premiums are rising (as in the 'hard' phase of an insurance cycle, see below) insurers are actually able to write fewer risks (unless they can raise more capital) because the premiums they are charging have increased. It follows that insurers are able to write less business when rates - and often profitability - are highest, but more business when rates are lowest, even though the possibility of insolvency greatest).⁷⁰

⁶⁸ Conventionally regarded as approximately one third of written premiums, so £1 of an insurer's capital can support £3 of premium.

⁶⁹ ABI response to OFT enquiry.

⁷⁰ The ABI also note that, partly because of this counter-intuitive effect, the FSA is moving to a risk-based approach to regulation of insurers. As part of this approach the FSA will expect insurers to allocate capital according to the risks which specific lines of business present. While this change is likely to mean certain lines of business, such as motor, will require less capital to support them, it is likely to increase the amount of capital required to support most liability lines, including EL. This will affect the pricing of EL, if the initial analysis of it is correct, because firms will be required to hold more capital against it and will be required to make a return on capital to shareholders.

9.42 The ultimate consequence of reductions in capacity is pressure for insurance prices to increase, with insurers that remain in the market being able to carry the premium increases that are necessary to restore profitability. We should also note that in this environment there is likely to be more emphasis by insurers on risk selection as they seek to make optimal use of the capacity that they have. Thus, the appetite of insurers for classes of insurance risks that they regard as unattractive, marginal or 'high risk' will reduce, making it harder for the businesses concerned to find affordable cover.

Investment income

- 9.43 General (non-life) insurers once regarded investment income as an extra 'windfall' on top of the underwriting profit that they expected to make. However, most general insurers have seen little in the way of underwriting profit in recent years and have depended heavily for their trading profits on investment income, which is now taken into account by general insurers when setting premium rates. The life offices have always done this, because life insurance contracts are long term and investment income is likely to be substantial. Although investment earnings are likely to be modest for most lines of general insurance business, they can be rather more significant for 'long-tail' business, such as employers' liability insurance. Claims reserves are one of the sources of investment income⁷¹ and, in the case of liability insurance, these usually stand at a level that is about 400 per cent of premium income. Thus, for every £1 of new premium collected by liability insurers each year there is likely to be about £4 set aside in a reserve for outstanding claims. Substantial amounts of investment income can be generated from this source, but, of course, if investment yields fall this expected income will not be realised and profits will tend to fall.
- 9.44 The precise effect of recent falls in interest rates on the profitability of liability insurers is difficult to assess. Insurers' funds are centrally invested and it is not possible to directly link investment income to the individual classes. The underwriting results across all lines of business are aggregated and the total investment income is then applied at a company level. For this reason it is not possible to ascertain precisely the extent to which investment income bridges the gap between claims and premiums in any particular line of business. However, conventional wisdom has it that when investment yields are healthy investment income in respect of liability insurance business enhances the underwriting ratios by around 15 per cent, whereas the enhancement at present may be no more than 5 per cent.

⁷¹ Investment income is also derived from unexpired premium reserves and shareholders' funds – the capital base of the business.

Market conditions and market behaviour

9.45 We will consider a number of factors, some of which are linked, under this heading. They include:

- the effect of underwriting cycles
- changes in reinsurance markets
- the impact of the World Trade Centre terrorist attack
- the effect of recent insurer insolvencies.

Underwriting cycles

9.46 From a purely actuarial viewpoint the underwriting and rating process is one of observation and statistical modeling, with the establishing of distinct classes of risk as its object. However, market forces and market behaviour also play a powerful role in fixing insurance premiums and levels of cover. In a so-called 'soft' market, when insurance cover is generally cheap and readily available, underwriters may be prepared to accept business at rates of premium that they know to be inadequate in order to retain their market share. Conversely, in a 'hard' market, when insurance is expensive and more scarce, insurers may be able to achieve rates of premium that are higher than the levels that are necessary to cover costs and make a normal profit. The phenomenon, whereby insurance markets tend to swing between 'hard' and 'soft' markets, with periods of (relative) profitability and (relative) unprofitability alternating over a cycle of 6-9 years is commonly known as the underwriting cycle.

9.47 There are various theories that attempt to explain underwriting cycles. These are summarised briefly below.⁷²

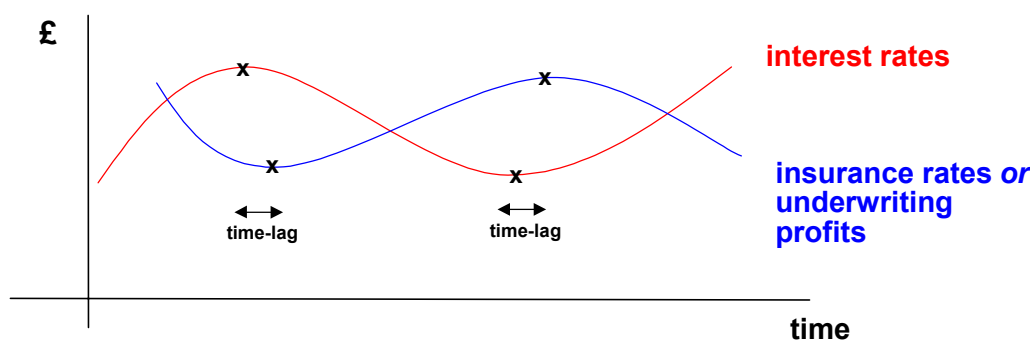
Interest (or rate of return) theories

9.48 When the level of interest rates rises unexpectedly insurance companies are prepared to cut their insurance rates to get funds for investment purposes. With a time lag, underwriting profits will fall. This form of market behaviour is known as 'cash flow underwriting'. The reverse also applies. When interest rates fall

⁷² The sections that follow draw on material supplied by Professor Gerry Dickinson of Cass Business School, City of London, whose assistance is gratefully acknowledged.

unexpectedly insurance companies are more prepared to increase their rates and with a time lag underwriting profits rise.⁷³

Cycle caused by interest rate movements ('cash flow' underwriting)



Inverse relationship, with a time lag

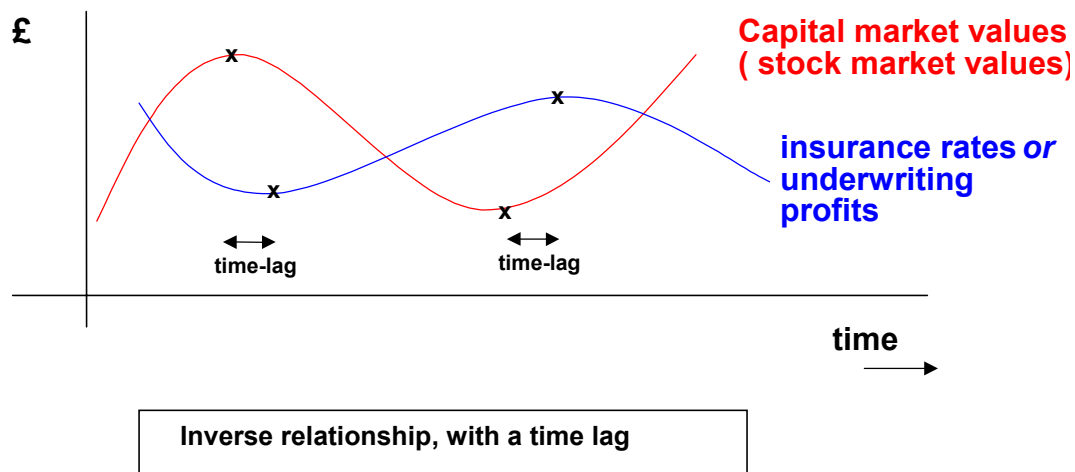
Capital theories

9.49 When the capital (stock) market values fall unexpectedly capital and reserves fall unexpectedly and hence insurance companies, individually and collectively, are less able to write business. This reduction in supply (capacity) causes the price of insurance to increase. This can also imply that there are some capital market imperfections operating (e.g. high costs or delays in raising new capital). The opposite also holds. In a buoyant capital (stock) market, existing insurance companies obtain a windfall gain on their capital and reserves (solvency margins), and they use this capital to write more business by being prepared to cut insurance rates. When capital markets are high the cost of new equity capital is also low, and new companies can also enter the market more easily. The increase in supply implies that insurers do not foresee the collective consequences of their decisions, since all insurers will gain from an increase in capital and reserves at the same time.⁷⁴

⁷³ For academic papers proposing and empirically testing this see N. Doherty and H. Kang (1988) 'Interest rates and insurance price cycles' *Journal of Banking and Finance*, Vol. 12, pp. 199-214. and L. Haley (1993) 'A cointegration analysis of the relationship between underwriting margins and interest rate' *Journal of risk and insurance*, Vol. 60, pp. 490-493.

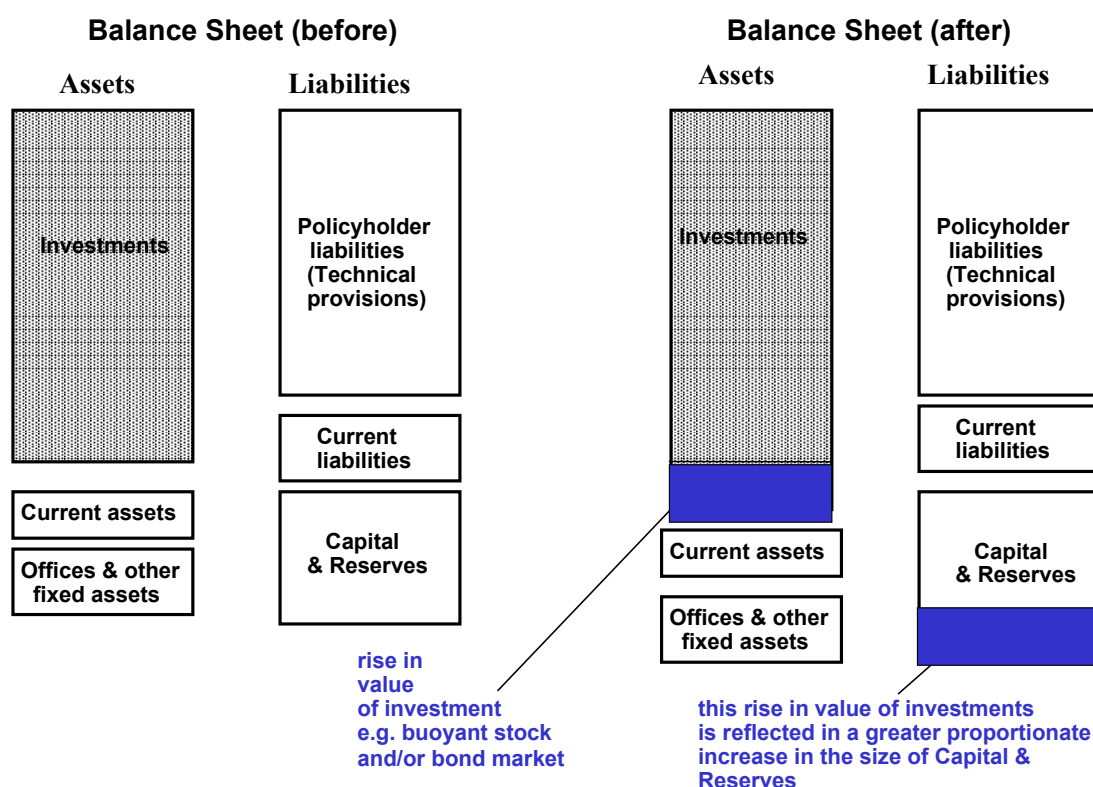
⁷⁴ Academic papers proposing and empirically testing this theory include those by L. Berger (1988) *Journal of Risk and Insurance* and A. Gron, 'Capacity constraints in property-casualty insurance markets, *Rand Journal of Economics*, Vol. 25, pp. 110-127.

**Cycle caused by impact of movements in stock market
i.e. increasing solvency margins and capacity:**



9.50 The capital theory effect can arise either from an increase in capital and reserves due to a prior period of high profits with a high plough-back of profits or from an increase in the capital and reserves from unrealised capital gains due to buoyant stock markets. An increase in capital and reserves from unrealised capital gains (or a fall due to unrealised capital losses) is likely to be more sudden and unanticipated and thus have the effect of a 'shock' on market behaviour. The increase in capital market values is analogous to the 'wealth effect' found in consumer spending. Consumer behaviour shows that when individuals have more recently-acquired wealth, because their houses and investments have increased quickly, they tend to spend more.

Impact of rise in investment values on the Capital of Insurance Company



9.51 The interest rate theory and the capital theory tend to conflict to some degree, since an unexpected rise in interest rates causes the value of fixed rate bonds to fall and hence might put a downward pressure on the capital base. The converse applies with an unexpected fall in interest rates and the related rise in the capital base. However, the conflict is only partial, since general insurance companies invest in shorter dated fixed interest securities as well as shares.⁷⁵

Theories based on forecasting of claims by insurers

9.52 According to these theories claims experience is the main driver of insurance pricing and underwriting profitability. Hence, if past claims have a cyclical pattern insurance prices will also exhibit a cyclical pattern over time. In fact, claims may indeed have a cycle since they reflect the more general cycle in the wider economy. During recessions claims increase because moral hazard and fraud increase. Conversely, in good economic times claims reduce.⁷⁶

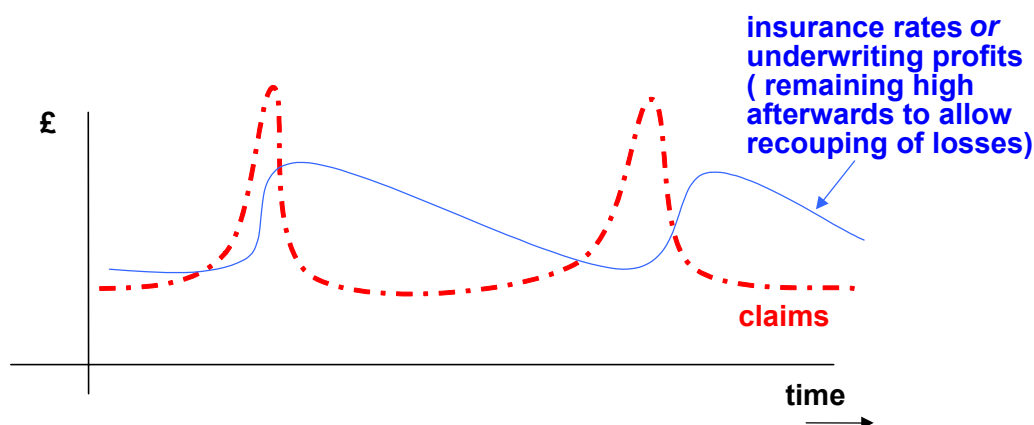
⁷⁵ An academic paper by N. Doherty and J. Garven (1995) *Journal of Business* combines the interest rate theory.

⁷⁶ See E. Venezian (1985) 'Ratemaking methods and profit cycles in property and liability insurance' *Journal of risk and insurance*, Vol 52 pp. 477-500.

Theories based on claim shocks or a failure to forecast claims

9.53 Catastrophic underwriting losses, especially if accompanied by insurer insolvencies, are likely to jolt insurers into raising their rates, partly to claw back some of their losses. Catastrophic losses are clearly random but the pattern of prices may appear cyclical. The impact of such large underwriting losses is likely to be asymmetric; that is, large losses will cause insurance rates to rise sharply while an absence of such losses will only gradually cause insurance rates to fall. High unexpected inflation can produce an unexpected level of claims which acts like a claim shock. This is likely to be more important for long-tail insurances such as the liability lines. The claim shock theory is an extreme case of failure of insurers to predict future claims, with forecasts tending to overshoot and then to undershoot, which can cause a cyclical pattern under certain assumptions.⁷⁷

Impact of a shock caused by large catastrophic loss (but could also be caused by large unexpected increase in inflation for long-tail business). This is a random event but might appear to have a cyclical effect on rates.



General

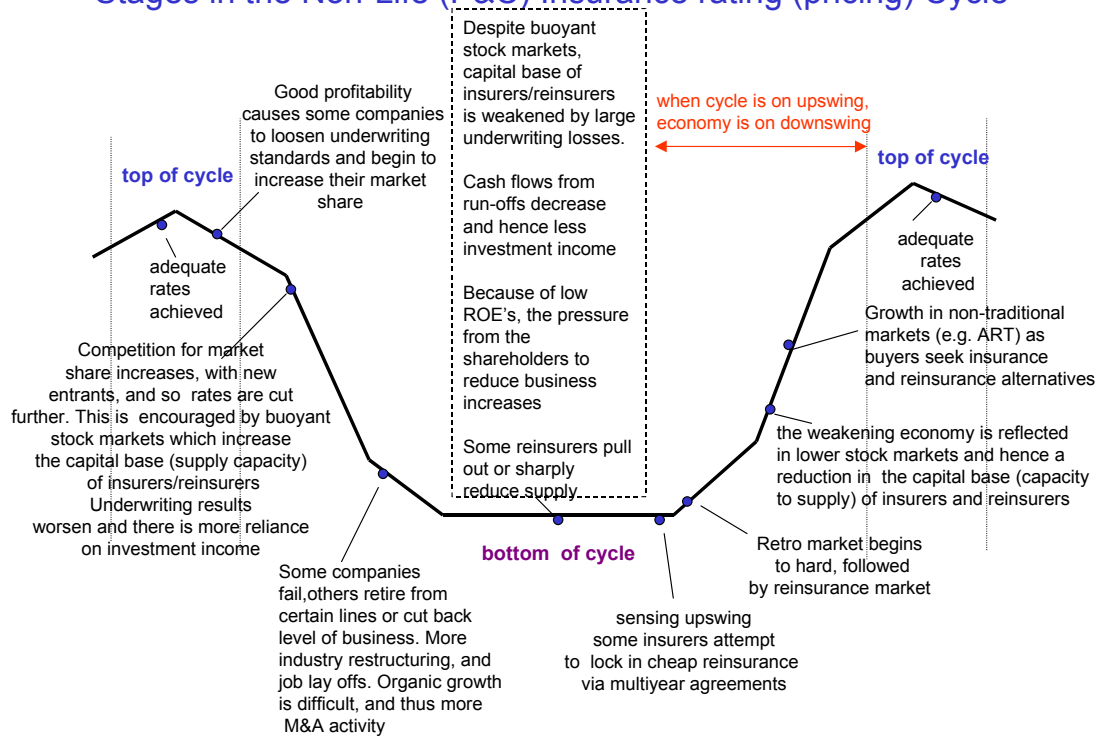
9.54 Empirical studies show that whilst there are different, varying, cycles for different lines of business, these different cycles are becoming more correlated. Evidence on what causes cycles is not clear-cut. Interest rate theories and capital theories both have support but capital theories have gained most empirical support during the 1990s. There is evidence that claims theories have explanatory power for some lines of business, especially those lines with low

⁷⁷ For an academic paper proposing and empirically testing this general theory see D. Cummins and J. Outreville (1987) 'An international analysis of underwriting cycles in property-liability insurance' *Journal of Risk and Insurance*, Vol 54, pp. 245-262. See also the recent work by Paul Fenn at Nottingham Business School, 'Cycles in underwriting profits for UK insurers: dynamic panel data results' – paper presented at Nottingham Insurance Economists' Conference, April 2003 based on the author's report to HM Treasury.

frequency and high loss severities, e.g. aviation insurances and catastrophe property insurances. There is some evidence that cycles in reinsurance rates precede cycles in direct insurance rates. Reinsurance markets react faster to events and to changing environments. Since reinsurance is a key cost element in the supply of direct insurance increases in reinsurance rates will cause direct rates to increase. Similarly, decreases in reinsurance rates will have a downward impact on direct rates, although the impact is likely to be slower as it works through the competitive dynamics of the market.

- 9.55 Underwriting cycles are probably the result of a combination of factors, the relative importance of which varies with the class of business and from cycle to cycle. Cycles for different lines of insurance tend to converge over time, due to greater economic interdependence and to increased 'packaging' of insurances.
- 9.56 Internationally, underwriting cycles in different countries tend also to converge over time, due to economic convergence and globalisation of business generally. Hence it less easy now for an insurance company to stabilise profits by expanding internationally.
- 9.57 The diagrammatic representation of the insurance cycle that follows combines some of the theories discussed above.

Stages in the Non-Life (P&C) Insurance rating (pricing) Cycle



The current cycle

9.58 It should be clear from the foregoing that a number of factors might contribute to create the underwriting cycle, including underwriting losses, investment returns, competitive forces and reinsurance premiums, although there is no consensus in the scholarly literature on the precise effect of each of these things. However, the recent sharp increases in liability insurance premiums can, at least in part, be descriptively explained as the product of the hard phase of the current insurance cycle, even if the 'cycle' does not in itself justify them.

9.59 In fact the 'hardening' of the market was already well under way by 2001, well before the 'claims shock' of the World Trade Centre disaster.⁷⁸ However, it is possible that this event added impetus to existing trend of rising rates. This is considered next, in the general context of recent changes in the reinsurance market.

Changes in reinsurance markets

9.60 The availability of reinsurance is an important part of the operation of the insurance market. Insurers rely on reinsurance, and reinsurers' capital, to protect themselves against large single losses or accumulations of smaller losses from single events. Although insurers are generally free to set the terms of

⁷⁸ ABI August 2002 – response following an early day motion. See also the data in Section 7 from the Lloyd's premium rating indices.

insurance risks and charge the premiums they think appropriate under a reinsurance treaty the latter may specify that certain types of high hazard risks are excluded, or that these risks cannot be accepted by the insurer without prior agreement by the reinsurer.

- 9.61 Recent consolidation in the reinsurance industry has led to its being dominated by four very large international groups and their domination of the market has a significant effect on the cover insurers are able to offer. If one or more of the major reinsurers decides they are not prepared to provide reinsurance for certain exposures, or only prepared to accept them in specially defined circumstances, then insurers have little option but follow reinsurers' position. For example, pressure from the international reinsurance market in the wake of the Piper Alpha disaster obliged primary insurers to stop writing 'unlimited' EL cover and reinsurers' concerns over liability for pollution has led them to greatly restrict cover in this field also.
- 9.62 Recently the cost of reinsurance has risen sharply, and it is commonly observed that massive claims arising out of the World Trade Centre disaster,⁷⁹ a major part of which were borne by the global reinsurance industry, has itself served to increase in the cost and decrease the availability of reinsurance, which has in turn impacted on the cost of direct insurance, including liability insurance.

The ABI note:

'The effect of this loss has been twofold. Coming on the back of a decade of poor profitability for reinsurers, the WTC loss has caused the cost of reinsurance to increase sharply. The typical increase in the cost of reinsurance for major UK liability insurers has been 60-80 per cent over the last year or two ... The second effect of September 11 has been a more subtle, but arguably more profound one. The size of the loss, and that it was caused in a way which had never been foreseen, has caused a fundamental reappraisal of risk and exposure by reinsurers. Reinsurers have undoubtedly become more cautious about the risks they will accept. The result has been that the reinsurance treaties of UK insurers now often carry terms which exclude certain types of risk, or require insurers to obtain reinsurers' agreement before accepting the risk. These terms apply for example to rail risks or those with any exposure to asbestos, (even for professional indemnity insurance for architects and others.)'⁸⁰

⁷⁹ The World Trade Center loss, at somewhere between \$40 bn to \$70 bn, is the largest insurance loss from a single event ever.

⁸⁰ ABI response to OFT study, p. 26.

Insurer insolvencies

- 9.63 Insurance is no different from any other industry, in that insolvencies of participating firms occur on a fairly regular basis. When there is a spate of insolvencies, as there was in the late 1960s and early 1970s (twenty-four UK insurers went out of business between 1968-72) there is usually pressure for a tightening of regulatory controls. Although the level of insolvencies amongst insurers has not been especially high in recent years some insurance company failures must be regarded as significant for the purpose of this study.
- 9.64 Two notable insolvencies of major liability insurers have occurred recently, those of Independent Insurance, which at the time of its insolvency had about 7 per cent of the EL market, and Chester Street. Chester Street was a company that was running off a portfolio, comprising mainly EL risks from heavy industry, that was left over from the take-over of Iron Trades by QBE. The insolvency of Chester Street was undoubtedly due to the under-pricing and under-reserving of EL risks.
- 9.65 Independent's own EL account and share of the market grew rapidly from 3 per cent in 1997 to 7 per cent in 1999. Other insurers maintain that this growth came because, like Chester Street, Independent was severely under-pricing risks. It has been argued that the presence of Independent, and its subsequent insolvency contributed in several ways to the current problems of the liability insurance market, especially in respect of EL. First, it has been alleged that Independent's under-pricing acted as a 'drag' on the EL market which prevented other insurers from obtaining more realistic premiums. Second, allegedly, not only have other insurers been deprived of premium income by under-pricing on the part of Independent but also, due to the insolvency, they have been obliged to pay an increased levy to the Financial Services Compensation Scheme. This is because claims on the insolvent company's EL portfolio (and on other classes of insurance which are protected) are funded by all solvent insurers through the levies they pay to FSCS. Third, it has been suggested that the insolvency of Independent has resulted in stronger demands from shareholders to restore profitability across all lines of commercial insurance, forcing insurers to increase premiums.⁸¹

⁸¹ See ABI response to OFT study, especially p. 57.

10 CONCLUSIONS

Limitations of this study

- 10.1 The conclusions that can be drawn from this study must be somewhat tentative, as the research has been subject to a number of constraining factors, including the time available to complete it. However, the main limiting factor has been the availability of data and the reliability of the information that is available. As we have seen, accurate data on changes in the price of insurance are very hard to come by. Figures on premium volumes are available from insurance industry and other sources, but there is little reliable data on the **amount** of insurance being bought which can be correlated with premium income figures.
- 10.2 Equally, much of the evidence on price rises supplied by buyers of insurance is anecdotal. Some buyer surveys have been conducted, but they must inevitably contain some built-in bias. A higher response rate is obviously to be expected from the firms that have experienced the highest price increases and from those for whom the cost of liability insurance is most significant as a portion of business costs.
- 10.3 Again, whilst there is abundant evidence of many factors that can exert upward pressure on liability insurance premiums, it is difficult to gauge the precise effect of them, either individually or collectively. Various studies, produced by or on behalf of the insurance industry, purport to measure the effect of these changes in the liability insurance environment and the premium increases that are necessary to fund them, but little or no evidence is given to support the figures quoted.
- 10.4 There is also a tendency (perhaps understandable) on the part of the insurance industry, to exaggerate the effect of some drivers of liability insurance premiums, such as changes in tort law. Another unfortunate trait in some insurance industry literature is a blurring of the distinction between changes that **have** actually taken place and those which simply **might** take place at some future date.⁸² Again, some insurance industry commentators rely very heavily on anecdotal evidence of a worsening environment in order to justify price increases, quoting individual cases of highly doubtful or speculative claims that cannot be truly representative of claims in general. There is also a great deal of talk in the industry about the dire effects of a growing 'compensation culture',

⁸² For example, a number of commentators imply that major changes in the law on liability for psychiatric injury and wrongful death have already taken place, when they have not.

but very little analysis of what this term means, let alone proof that such a 'culture' exists.⁸³

- 10.5 On the other hand, some important factors are underplayed by insurers, such as the current trend of cuts in social security programmes and the steady shifting of accident costs away from the state. Equally, there is no exaggeration of the large losses made by liability insurers in recent years.

Evidence of collusion

- 10.6 As is well known, it can be difficult either to positively prove or disprove the existence of collusion within a particular commercial market. However, we should state at the outset that this research has revealed no positive evidence of collusion between liability insurers. Moreover, the study has identified a number of possible explanations for the recent problems of liability insurance affordability and availability that are far more plausible than any theory based on collusive price-fixing by insurers. These are summarised in the next section.
- 10.7 In any event, collusive price-fixing agreements between liability insurers would be quite difficult for the conspirators to police. Unlike many products, which are more or less identical in all characteristics except price, liability insurance policies are often quite individualised, with terms and conditions tailored to the needs of particular industry sectors or even particular firms (especially larger businesses). Different liability insurance covers can also be combined and packaged with other risks in a number of different ways. Products of this sort are much less likely to support successful collusion.
- 10.8 Again, it has been alleged that some would-be buyers of liability insurance in high-risk industries have been refused cover by a substantial portion of the market, or indeed the whole market. Such outright refusals to sell liability insurance to potential customers at any price hardly seems consistent with collusion.
- 10.9 Finally, it may be worth noting that collusion was specifically rejected as an explanation for the most notorious of all insurance 'crises' – that which affected the US liability market in the mid-1980s. A number of explanations were advanced for the US 'crisis', including various theories based on interest rates, investment returns and insurance cycles and others focussing on an apparently uncontrolled expansion in scope of tort liability. Although no consensus has ever been reached on the true cause of the US liability insurance crisis, the alternative explanation of the crisis being collusively engineered by insurance

⁸³ The recent study by a working party from the actuarial profession *The Cost of the Compensation Culture* (2003) is rather disappointing in this regard.

companies has been decisively ruled out. It may also be worth noting that the immediate effects of the crisis were short lived, being confined largely to the 1984-1986 period.

Sources of current problems

10.10 The most plausible explanation for current problems of the UK liability insurance is that the situation has been brought about by the unusual conjunction of a number of factors that have exerted upward pressure on liability insurance premiums and restricted its supply.

10.11 These factors have been analysed in detail in this report. However, in broad terms, we can summarise the situation as follows:

- a consistent pattern of substantial losses and under-pricing of liability risks over many years has built up pressure amongst liability insurers for changes in underwriting and pricing that might restore profitability to the market
- the impetus for change has been reinforced by a number of current trends that continue to imposing upward pressure on premiums. Some of these are cyclical and some related to the economic and legal environment in which liability insurance is written. The 'shock' effect of extraordinary events such as the World Trade Centre disaster has changed insurers perception of risk and impacted unfavourably on the reinsurance markets upon which primary (liability) insurers depend
- uncertainty as to future trends that might affect liability exposures has led to a lack of confidence on the part of insurers as to their ability to price certain risks (such as of gradually developing disease) accurately.

Past losses and under-pricing

10.12 There is clear evidence that the UK liability insurance market has made very substantial losses for many years, especially for employers' liability. There is no simple and obvious explanation for this, but the losses and under-pricing seem to have been attributable to a number of factors. These include, first, the failure of the market as a whole to anticipate and accurately quantify the effect of a number of emergent risks, including a variety of gradually developing diseases.

10.13 Second, a variety of market factors that may have tended to prolong the 'soft' phase of the insurance cycle. Third, insurers have frequently bundled liability exposures with other risks (e.g. property), subsidised the former from the latter, and neglected the need for proper liability insurance pricing.⁸⁴

Current trends

10.14 In Section 9 we explored a number of factors that act as drivers in the pricing of liability insurance and observed that most are moving in a way that is likely to exert upward rather than downward pressure on prices. Although the potential effect of some (e.g. expansion of tort liability) may have been exaggerated by the insurance industry others have probably been underplayed. Whilst it is difficult, if not impossible, to quantify the effect of each individual factor it is clear that claims cost (if not claim frequency) is rising steeply and is likely to continue to do so, at least for the immediate future. Simultaneously, there has been a significant deterioration in the economic and financial environment in which liability insurance is written.

10.15 We have seen that recent sharp rises in liability insurance premiums are also consistent with (though not, of course, 'explained' by) the upward turn in the insurance cycle that has been anticipated for some time. The sharpness and suddenness of the upturn is unusual, but the co-incidence of number of exceptional events, such as the WTC disaster, plunging world stock markets and the collapse of Independent Insurance may go some way towards accounting for it.

Future uncertainty

10.16 For liability insurers there will always be an element of uncertainty about future claims patterns and other factors that affect insurance prices, because the economic, financial, legal and technical environment of insurance will continue to change and develop. The ease with which insurers can accommodate this depends on the degree of doubt. Currently, there appear to be very high levels of uncertainty amongst liability insurers on a number of issues, accompanied by a general loss of confidence in their ability to price liability risks accurately. This has led to and a much more cautious and conservative approach to underwriting. Liability insurers now seem more ready to decline 'marginal' business than hitherto and more likely to demand bigger margins of error in pricing the liability risks that they do accept.

⁸⁴ Datamonitor suggest that 'a key factor that affects performance of the general liability market is that most underwriters do not sell liability as a stand-alone product, rather it is offered as part of a package alongside property and motor cover (i.e. cross subsidised). Furthermore, competition to retain market share in the commercial motor and property markets has led to the neglect of employers' liability and a continued softening of rates.'

10.17 The uncertainty referred to above appears to be partly based on specific concerns, including the difficulty of quantifying and pricing emerging and potential the risks such as work-related stress and illness attributable to electromagnetic fields (EMF). However, there also seems to have been a general shift in the perception of risk following extraordinary events such as those of September 11 2001 and various stock market scandals (Enron, WorldCom etc.). Similarly, the collapse of Independent Insurance, mentioned at various points in this report, appears to have had a major psychological impact on liability insurers. Independent's apparent ability to combine keen liability rates with a very low loss ratios seems to have inspired an unfounded optimism in other insurers. Now this has collapsed with Independent's own demise, causing liability underwriters to revert to their conservative instincts. Finally, there is a vague, generalised concern about the possible development of a US-style 'compensation culture' in the UK. There may be little hard evidence of such a 'culture', or even any agreement as to what the term means, but the threat of a burgeoning claims free-for-all seems to weigh heavily on the collective mind of the insurance industry.

The impact on particular market sectors

10.18 Apparently, some sectors of industry have seen much higher premium rises than others and have experienced much greater difficulty in securing cover – particularly high-risk trades in the SME sectors (see Section 7). This clearly needs accounting for, as most of the factors that impact upon liability insurance rates apply across the board, and not just to specific industry sectors.

10.19 First, however, we should note again the possibility of sample bias. A firm for whom a rise in liability insurance premiums has a major impact on business costs is much more likely to complain to a body such as the OFT or respond negatively to a survey than a firm for whom liability insurance costs are relatively insignificant. For example, for a firm specialising in high risk construction activities such as roofing or scaffolding, the cost of employers' liability insurance alone is likely to amount to 15 per cent of payroll. However, for a general building firm EL costs are typically only between one per cent or two per cent of payroll and, for a retailer, only a fraction of one per cent. Clearly, a 50 per cent premium rise for a high-risk construction firm is likely to be far more significant than a similar rise for the other firms mentioned.⁸⁵

10.20 Next, we should note that the dynamics of the insurance market are such that small high-risk firms are likely to suffer most when there is constraint on insurance capacity or a general rise in prices. There are a number of reasons for

⁸⁵ Greenstreet Burman (*op cit* note 30 p. 2) note that their own research reveals that workplace compensation costs exceeding 1 per cent of payroll start to cause concern amongst employers whilst rates above 2 per cent lead to strident demands for reform.

this. First, many non-specialist insurers, such as the large composite offices, will regard these firms as 'marginal' rather than 'core' insurance business. The relatively low numbers of such firms and the small premium volumes they generate, together with their relatively high administration and risk assessment costs, mean that insurers are less likely to devote capital and resources to them when there is constraint on either.⁸⁶ In times of stringency liability insurers will tend to concentrate on the retention and development of their core business areas. They are likely to decline to cover firms in marginal risk sectors or offer insurance only on terms that would virtually guarantee the insurer a healthy profit.

10.21 It is also well understood that small firms find it difficult to communicate their risk profile accurately to insurance companies. Their small size will deny them the benefit of experience rating⁸⁷ and make detailed risk surveys and safety audits uneconomic. Thus, a small firm in a high risk sector may be refused cover or face sharp premium increases even when it has a perfect safety record and there is a complete absence of claims.

10.22 On a connected point, the bargaining power of small firms is always likely to be small, particularly in the case of high risk trades in the construction sector. Apart from the general issue of size, and the relatively small premiums that such firms generate for insurers, they often have little or no attractive insurance business to offer in compensation for their unattractive liability risks. For example, a small scaffolding firm will usually have little in the way of premises and equipment to insure, so its property insurance premiums are likely to be small. This lack of bargaining power may not be improved much by the use of a broker, because the big international insurance brokers, which have most influence with insurers, usually regard small high-risk firms as marginal to their businesses also.

Outlook and recommendation

10.23 The key aspect for consideration here is whether market failure is occurring or whether published examples of steep premium increases and company difficulty in obtaining cover are largely symptoms of a 'hard' market. If the current situation is simply due to a turn in the insurance cycle, then it is plausible to expect that the market will correct itself in due course.

10.24 Historically, such a correction has always occurred, both in the UK and elsewhere. For example, although shortages of insurance capacity in specific

⁸⁶ For example, it will not be worth investing in specialised underwriters, risk engineers and other experts to support a small book of high-risk business.

⁸⁷ See Section 8 above. The main point is that the claims record of a small firm does not provide a wide enough statistical base to allow an accurate prediction of future claim patterns.

areas have arisen occasionally in this country, sometimes precipitated by particular events,⁸⁸ in no case have the effects been prolonged. Again, as noted earlier, the most notorious of all liability insurance 'crises', that which affected the US market in the 1984-6 period, though startling in its effects, was quite short lived.

10.25 There are some signs at the present time that the situation has eased, with firms that had been denied insurance by their present insurers and a number of other offices eventually managing to find cover. BIBA suggest that while some insurers have pulled out of the 'high risk' end of the liability insurance market cover is still obtainable for the vast majority of risks, although more effort is needed by the firms concerned (and their insurance brokers) in order to find it. BIBA have also conceded that there may have been an element of complacency amongst insurance brokers, who failed to read the mood of the market correctly, and were surprised to find that cover could not be obtained for their clients with the same degree of ease as they anticipated.⁸⁹ In any event, it appears that increasingly careful risk selection by insurers is resulting in the provision of better quality information by insurance brokers, which may help the market to operate more effectively, at least in the medium term.⁹⁰

10.26 All insurance market interviewees agree that, at least in the short term, liability insurance rates will probably continue to rise, though not so steeply as in the last year or so. This is based on the belief that rate rises achieved so far have not sufficiently corrected the historic under-pricing of liability insurance and that claims will continue to rise at much the same rate as in recent years.⁹¹

10.27 Employers' liability insurance is the one area, albeit a large one, where may be long-term structural problems rather than short or medium difficulties. There is not space here to analyse fully the problems of the EL market, but there is a growing view, both in the insurance industry and outside, that the current system may be inherently unstable and ultimately unsustainable. At the present time talks are continuing between the Government and the insurance industry in which a variety of alternative models for work-place compensation in the UK are being considered.

⁸⁸ For example, there have been shortages in auditors' professional liability insurance, terrorism cover (in the wake of IRA bombs in London), 'offshore' employers' liability cover (in the wake of the Piper Alpha disaster) and mortgage indemnity cover (following the collapse of the housing market in the 1980s).

⁸⁹ OFT/BIBA meeting 19 February 2003.

⁹⁰ Insurance brokers describe the risks for which they seek insurance in risk 'presentations', but in a 'soft' market, when insurance cover is cheap and plentiful the detail contained in these, and their general quality, tends to decline.

⁹¹ See, for example the Greenstreet Berman report (*op cit* note 30) and the IUA Third Bodily Injury survey (*op cit* note 34).

10.28 In conclusion, the author takes the view that there is no **prima facie** evidence of breach of competition law within the insurance industry in respect of liability insurance and no further major action on the part of the OFT is required at the present time, other than the maintenance of a watching brief.

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