

Liability insurance

A report on an OFT fact finding study

August 2003

OFT659b

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The UK liability insurance market – summary of key findings (OFT659)

An analysis of current problems in the UK liability insurance market (OFT659a)

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LIST OF ABBREVIATIONS

ABI	Association of British Insurers
ACE	Association of Consulting Engineers
AIFA	Association of Independent Financial Advisers
APIL	Association of Personal Injury Lawyers
ATE	After The Event insurance
BIBA	British Insurance Brokers' Association
CFA	Conditional Fee Agreement
D&O	Directors' and Officers' Liability insurance
DWP	Department for Work and Pensions
EL	Employers' Liability Insurance
FSA	Financial Services Authority
FSB	Federation of Small Businesses
FSMA	Financial Services and Markets Act 2000
GISC	General Insurance Standards Council
IFA	Independent Financial Adviser
IIDB	Industrial Injuries Disablement Benefit
OFT	Office of Fair Trading
PI	Professional Indemnity Insurance
PL	Public liability insurance
PR	Product liability insurance
SME	Small- and medium-sized enterprise

1 INTRODUCTION AND SUMMARY OF KEY FINDINGS

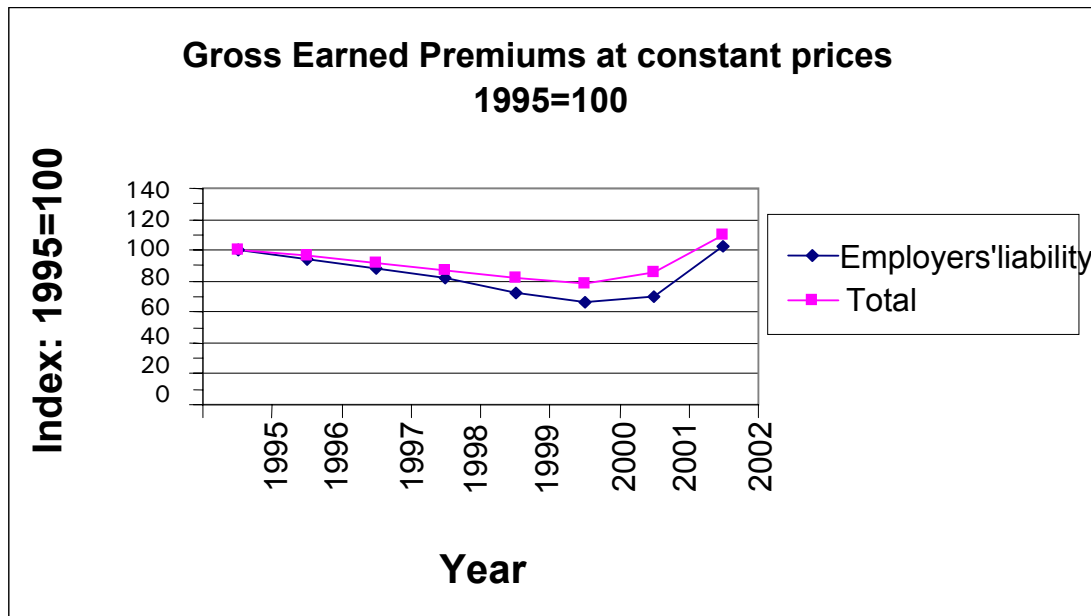
Prices and profitability

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

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

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

GRAPH 1.1: GROSS EARNED PREMIUMS AT CONSTANT PRICES
1995 = 100



Note – see over.

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

Note to Graph 1.1

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

In the absence of major changes in business volumes, changes in GEP are expected to be a close reflection of premium prices. This assumption may hold less well for GEP Total liability, where levels of cover may vary, than for GEP Employers, liability.

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

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

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

Effect of premium increases on business

- 1.3 We did not find evidence to support reported concerns that recent increases in premiums were such that many businesses had been unable to secure liability insurance at any price, and were consequently trading illegally or closing down.
- 1.4 Nevertheless, we recognise that certain types of business have suffered particular adverse effects as a result of premium increases. These include Independent Financial Advisers (IFAs) (who are required by the Financial Services Authority (FSA) rules to have PI cover); SMEs (for whom increases in premiums are likely to have a more significant effect than larger businesses); businesses in 'high risk' sectors for example roofing or scaffolding; businesses in Northern Ireland; and the voluntary sector.

Reasons for increases in premiums

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

Changes to costs incurred

1.6 The following possible sources of cost increases were suggested:

- expansion of liability – including new and uncertain types of liability, in particular 'long-tail' claims²
- loss shocks, such as those arising from the World Trade Centre and claims relating to asbestos
- increases arising from changes in the legal system such as the introduction of CFAs and ATE insurance, higher damages for individual claims and the Woolf reforms
- lower investment returns, which have reduced insurers' investment income (which can be used to offset underwriting losses) and increased the upfront cost of lump sum damages awards.

1.7 While each of these changes will clearly have had an inflationary impact on premiums, we are not persuaded that these factors alone account for the large increases in premiums experienced over the last year. There are other factors that may have had an impact on premiums.

Changes in the competitive environment

1.8 While the overall structure of the industry is relatively fragmented, some specialised risks may have a limited choice of insurer. This may limit competition between insurers for such risks. The widespread practice of giving policyholders short renewal periods may restrict further the extent to which they can consider alternative suppliers and reduce the level of switching and degree of competition. However we found no evidence of collusive agreements.

1.9 It was put to us that over the past five years at least, insurers had been competing in a way which was unsustainable and appeared to ignore the

² i.e claims which have a long latency period

commercial realities of the business with decisions seemingly based on short term growth rather than long term profitability. This argument is consistent with the reductions in real premiums over this period described above.

- 1.10 Major insolvencies in the liability insurance sector following this period of intense competition have had the effect of increasing payments to the Financial Services Compensation Scheme (FSCS) and brought about a stronger demand from shareholders to restore profitability across liability lines and a reduction in capacity. This in turn appears to have encouraged insurers to reconsider their underwriting practices, taking a more selective approach to the risks they are prepared to cover.
- 1.11 Reductions in capacity have led to a short term upward pressure on premiums. However, in a competitive market we would expect to see new capital provided in response to opportunities for profitable business, although it is not clear how likely this would be in the long-term, particularly for EL.
- 1.12 The factors discussed at 1.9 to 1.11 above should not lead to continuing upward pressure on premiums over the long term.

Areas of improvement

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

2 BACKGROUND AND METHODOLOGY

- 2.1 This fact-finding study, which was announced on 10 December 2002, has been initially carried out under section 2 of the Fair Trading Act 1973 and, as from 20 June 2003 has been carried out under section 5 of the Enterprise Act 2002 (EA) to review commercial activities in the United Kingdom that may adversely affect the economic interests of UK consumers. This report is published under section 4(4) of the EA.
- 2.2 Parallel work on this sector was also carried out by the Department for Work and Pensions (DWP) on EL insurance, and the FSA on liability insurance and professional indemnity insurance for IFAs. The OFT will continue to assist and support any further work that arises from these pieces of work.

Why are we looking at liability insurance?

- 2.3 This study was undertaken in the light of widespread concerns over sharp, and often sudden, increases in the cost of premiums charged for employers', public and product liability and professional indemnity insurance policies - collectively referred to as liability insurance. The purpose of the study was to determine how well the markets for liability insurance are working. We aimed to establish the scale and nature of recent price rises and identify the factors that were driving those rises.
- 2.4 Accordingly we looked at the following issues:
- the scale and nature of problems being experienced now and over time, including the extent to which these are cyclical
 - the structure of UK liability insurance markets - concentration and trends over time, including whether there are any barriers to entry
 - how the markets operate including:
 - how liability insurance is sold and the impact this has on premiums
 - the role of, and relationship between, the various players in the supply chain (in particular insurers, reinsurers and brokers)
 - how risks are priced now and over time
 - the extent to which customers shop around or are able to do so for cover

- market capacity and trends in sectors where obtaining affordable insurance is most problematic
- profitability, now and over time
- factors that can impose pressure on liability insurance premiums and/or contribute to shortage of capacity: cost increases including changes to claims and legal costs; falling investment returns and other cyclical factors, and competition across the sector
- finally we noted some measures which might improve the functioning of the markets, some of which are already in hand

2.5 During the study views were sought from a wide variety of organisations including insurers and their customers, reinsurers, brokers, independent businesses, SMEs, trade, employee and voluntary representative organisations and other government departments.

2.6 Contributions to the study were received from:

- 9 liability insurers and 1 reinsurer
- 22 insurance brokers
- 475 independent businesses
- 23 trade organisations
- 6 government departments

2.7 We would like to thank all those who contributed to the study.

2.8 A questionnaire was sent to SMEs across a variety of business sectors including manufacturing, construction, health and wholesale, to try to establish the scale and nature of changes to premiums. The questionnaire was also distributed via a number of trade associations, including the AIFA. It was also made available on our website. We wish to thank all those businesses who co-operated in this exercise. Their responses are summarised at **Annexe E**.

2.9 We commissioned Dr Chris Parsons of the Cass Business School to undertake some of the detailed research. Dr Parsons' work is incorporated in this report, and is also published in full on the OFT website at:
[http://www.oft.gov.uk/News/Publications/leaflets + Ordering.htm](http://www.oft.gov.uk/News/Publications/leaflets+Ordering.htm) (see Reports/Consumer protection to download copies of the report).

3 THE MARKETS FOR LIABILITY INSURANCE AND HOW THEY OPERATE

- 3.1 This chapter looks at the markets for liability insurance and examines the size and structure of the sector as a whole, the market players, profitability of the sector and barriers to entry. It also provides a snapshot of the regulatory context and information on how the product is bought and sold and premiums are priced.
- 3.2 This report is concerned with three major types of liability insurance in the UK:
- employers' liability
 - public liability – often termed general liability (GL) outside the UK – and often combined with product liability
 - professional indemnity
- 3.3 A closely related line is Directors' and Officers' liability insurance (D&O). D & O is neither a legal nor regulatory requirement as with EL or PI, nor is it considered essential in order to trade, as with PL. We are not aware, at present, of any problems related to D & O which do not occur with other liability lines. We have not given it detailed consideration in the remainder of this report. Further classes of liability insurance which are not considered here include libel (defamation) insurance, environmental impairment liability insurance, liability risks associated with the use of motor vehicles and the operation of ships and aircraft, and cover of liability claims made against policyholders in their private capacities or their capacities as property owners.
- 3.4 Key features of the three liability lines that are covered in this report are described briefly below.

Employers' liability insurance (EL)

- 3.5 EL insurance is designed to cover the liability that might devolve upon an employer if an employee is injured in the course of employment. Essentially, EL insurance covers tort claims against employers, which are normally founded on the negligent behaviour of the latter. The UK is one of few countries where injured employees are allowed to sue their employers on the basis of ordinary negligence. Elsewhere workers' compensation schemes are more common. Under these schemes employers pay for insurance that covers employees' costs and lost earnings and in some cases, pain and suffering. They are often 'no

fault' schemes (although disputes do occur). Workers' compensation is an employer funded form of insurance, analogous to UK employers paying for employees' private health and disablement (loss of earnings) insurance. This is in contrast to EL insurance which provides funds to the employer to cover the costs they incur from employees' litigation. 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.

- 3.6 EL insurance is compulsory for the vast majority of employers under primary legislation,³ and is written on what is known as a 'causation basis'. This means that the insurer meeting a claim is the one that provided the cover when the injury or disease **was caused**, rather than the date when the harm became apparent or the claim by the employee was made, both of which may be much later. This arrangement should give good security to employers and employees. Provided that 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.
- 3.7 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 customers buy cover in the £10 - £50 million range. EL policies cannot contain policy exclusions other than general ones relating to all insurance policies and they cannot include excesses or deductibles.

Public liability insurance (PL)

- 3.8 PL insurance 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 businesses or members of the public (i.e. not employees) who suffer bodily injury or damage to their property through the negligent conduct of business activities. For the vast majority of businesses there is no primary legislation that requires them to buy PL cover. In practice, however, it is essential for the majority of business, and not just for reasons of general prudence. This is because the customers and trading partners of many firms often demand that PL insurance be in place as a condition of doing business with them. This is almost invariably the case with the trades (builders, construction, civil engineering firms and the like) where a contract will usually

³ Employers' Liability (Compulsory Insurance) Act 1969. This legislation came into force on 1 January 1972.

stipulate that the contractor should have adequate PL cover. Our survey showed that the vast majority of firms in manufacturing and construction have PL cover.

- 3.9 PL insurance has traditionally been written on a 'losses occurring' basis which is similar to causation for EL, where the insurer that meets the claim is the one providing cover when the damage or injury occurred rather than when it is reported to the insurer.
- 3.10 There is no standard policy for PL. The policies may differ somewhat from one insurer to another and customers often consider it prudent to place the EL and PL risk with the same insurer when possible. This will ensure that the two policies dovetail precisely, with no gaps or overlaps.

Product liability insurance (PR)

- 3.11 PR insurance covers manufacturers and suppliers against claims by customers arising in connection with dangerous or defective goods. 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, PR insurance is rather more likely to generate 'long-tail' claims, particularly when the product in question (such as drugs or other pharmaceuticals) is capable of causing injury or harm that may take some years to develop. Long-tail claims are discussed in more detail later in the report. In the UK there is no general legislation requiring any business to buy PR 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 such that it must be properly financed, with insurance the most obvious option. Our survey of SMEs indicates that around two-thirds of manufacturers and wholesalers had PR cover. There are no standard policy wordings and, if anything, PR is subject to even greater variations than PL.
- 3.12 Typical cover limits for PL and PR insurance are broadly similar to those for EL. In the remainder of this report PR is considered alongside PL.

Professional indemnity insurance (PI)

- 3.13 PI insurance covers professional firms and individuals against claims for breach of their 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. PI 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.

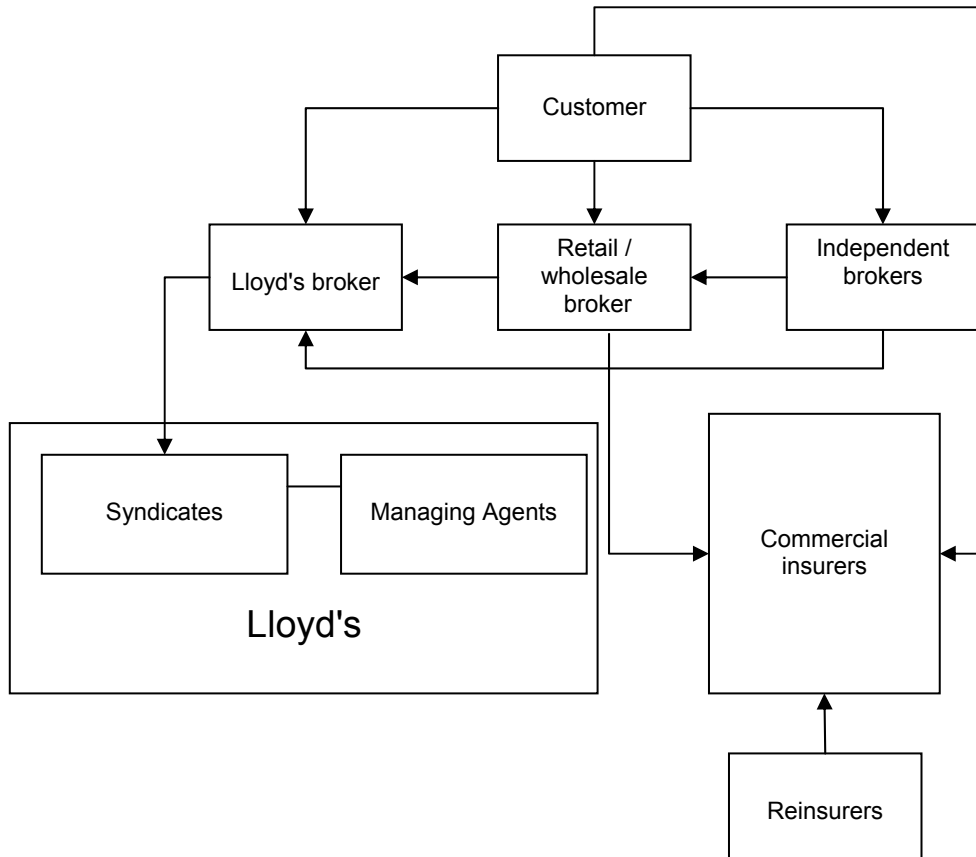
- 3.14 Unlike other forms of liability insurance PI insurance is written on a 'claims-made' basis. Under this arrangement the insurer that meets a claim is the one providing the cover **at the date of the claim** (although the cost of these claims, particularly large claims, may take as much as ten or more years to establish). Under a claims-made policy, in its purest form, insurers effectively are liable 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 and there is no possibility of having to pay claims under policies issued at the wrong price many years ago.
- 3.15 For most professions, PI insurance is a necessity, since 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 cover is conferred on that body by statute.⁴ PI insurers tailor their policies to the particular needs of each profession as set out in the relevant professional rules, so a solicitor's PI policy may differ somewhat from that of an accountant or surveyor.
- 3.16 Cover limits for PI vary enormously, from as little as £2 million to £100 million or more for the biggest international firms. PI is usually subject to excesses and deductibles. These can exert an influence on capital and solvency requirements.

Size and structure

- 3.17 The supply chain for general insurance involves a number of levels from international reinsurers to local brokers and insurance agents operating from suburban shopping centres. Figure 3.1 shows the relationships between the different levels involved in the provision of liability insurance. Insurance companies that are ABI members had around 75 per cent of the liability insurance sector in 2001 and Lloyd's had a market share of approximately 21 per cent.

⁴ E.g. Solicitors (Amendments) Act 1974.

FIGURE 3.1 - RELATIONSHIPS BETWEEN LEVELS IN THE SUPPLY CHAIN



3.18 According to ABI statistics⁵ the size of the UK liability insurance market in terms of Gross Written Premium (GWP) declined from a peak of £2.8 billion in 1994 to £2.6 billion in 1999. Since 1999 there has been growth, with a sharp increase (27 per cent) in 2002 from 2000 to 2001, when GWP reached around £3.5 billion. EL insurance, the largest single class, currently accounts for approximately one-third of total liability insurance premium income. According to Health and Safety Executive research, this equalled about one quarter of one per cent of the total UK wage bill.

3.19 According to Datamonitor⁶ the UK professional indemnity market grew from £630 million in 1997, to £758 million in 2001.

⁵ ABI Analysis of the UK liability market 2001.

⁶ Datamonitor report 'UK Commercial General Insurance 2003'.

Market players

- 3.20 **Annexe B** contains tables (produced by Datamonitor) which show the market share of the major commercial liability insurers over the 1996-2001 period for the main classes of EL, PL and PI insurance. No player has more than 15 per cent of the whole sector. However, there is more concentration in particular specialised areas.
- 3.21 Within the top ten insurance companies operating in the liability sector, there exist both large composite insurers and more specialised insurers. The '...more specialist insurers tend to sell such policies as a stand-alone entity...' (Datamonitor, 2001)
- 3.22 The Lloyd's market has its most significant presence within the general liability sector, compared to other forms of general insurance. The ABI has indicated that Lloyd's syndicates currently write about 50 per cent of PI, but only about 15 per cent of EL and PL.
- 3.23 In the 1980s / 90s the liability insurance sector became more concentrated over time as insurers withdrew from the market (partly as a consequence of insurer insolvencies, e.g. Independent Insurance Company Limited, and partly as a result of merger and acquisition activity in the insurance market as a whole). However, this trend has recently been reversed as seen in falling concentration ratios, with the top ten players in the sector overall accounting for less than 50 per cent of the sector in 2001, compared to 60 per cent in 2000. The top ten players in EL accounted for 54 per cent in 2001 compared to 65 per cent in 2000. These are the most up to date figures available.

Profitability of liability insurance

- 3.24 Table 3.2 shows that insurers (in aggregate) operating within the liability sector have written policies at an underwriting loss (excludes investment income) for much of the last decade – see over.

TABLE 3.2 – ALL LIABILITY INSURANCE

	Claims ratio - per cent	Underwriting ratio - per cent
1985	115.9	146.6
1986	98.3	131.7
1987	92.3	121.5
1988	96.8	127.5
1989	138.6	186.2
1990	119.1	154.4
1991	123.7	149.4
1992	107.1	128.6
1993	88.2	112.0
1994	80.3	104.5
1995	73.6	97.5
1996	78.6	108.8
1997	90.6	117.8
1998	105.1	140.7
1999	112.5	151.2
2000	108.9	145.7
2001	95.5	120.3

[Source: ABI's submission to the OFT – 2003] – based on gross earned premium figures.

3.25 Two key ratios, the claims ratio and the expense ratio, guide underwriting profits. The underwriting ratio is the expense ratio plus claims ratio. An underwriting ratio under 100 indicates an underwriting profit, an underwriting ratio over 100 indicates an underwriting loss. Care must be taken when interpreting the aggregated data because of the lagged realisation of claims cost. Nonetheless the important point to note is the **consistency** of the underwriting loss over the last sixteen years.

3.26 The ABI reports⁷ an overall liability insurance underwriting loss (calculated on a net written premium basis which excludes any reinsurance expense) for its members of £566 million in 2001, significantly higher than the £344 million loss for 2000 and close to the worst ever loss of £595 million made by the market in 1992.

EL Insurance

3.27 EL insurance is especially unprofitable, and has been so for many years, with underwriting ratios averaging over 150 per cent:

TABLE 3.3 - EL INSURANCE

	Claims ratio - per cent	Underwriting ratio - per cent
1985	147.7	179.2
1986	134.0	168.9
1987	125.9	160.4
1988	137.8	172.6
1989	150.8	193.9
1990	140.9	182.4
1991	139.2	166.4
1992	127.9	146.0
1993	102.5	123.6
1994	94.3	128.3
1995	86.6	120.8
1996	94.4	128.7
1997	102.7	136.9
1998	123.3	157.7
1999	132.1	167.6
2000	139.5	171.3
2001	118.0	149.7

[Source: ABI's submission to the OFT - 2003] – based on gross earned premiums.

⁷ ABI Analysis of the UK liability market 2001

3.28 The ABI is reported as saying recently that insurers have lost money on this line of business in every year from 1993 to 2001: 'For every £1 of premium underwritten, about £1.30 to £1.35 was paid out in claims or set out in claims reserves.'⁸

3.29 In 1998 the ABI estimated that between 1987 and 1992 insurance companies made underwriting losses of £588 million on EL business.

Company level analysis

Table 3.4 sets out a selection of insurers' claims experience for particular insurance types. It relates to UK business written on an accident-year basis only.

TABLE 3.4 - INSURERS' CLAIMS EXPERIENCE

Company	Risk group	Gross claims ratio - per cent
Axa Group	Employers' liability	138.9
	Other liability	69.9
CGU International	Employers' liability	90.1
	General liability (includes public and product)	88.9
	Professional Indemnity	52.6
Cornhill Insurance	Employers' liability	132.6
	Other liability	87.9
Royal and Sun Alliance	Employers' liability	99.5
Sun Alliance	General liability	96.0
	Professional Indemnity	70.6
St Paul International	Employers' liability	89.2
	Professional Indemnity	85.3
	Public Liability	73.9
Zurich Insurance UK branch	Employers' liability	126.1
	Professional Indemnity	136.7
	Public Liability	74.6

Source: Liability, Risk and Insurance (January 2003 Issue 150) calculations based on FSA Annual returns. Note: general liability includes PL and PR.

⁸ 'Rising liability cover struggle', Guardian 9 August 2002.

3.30 The table confirms the general picture set out previously. Clearly PI insurance, and to a lesser extent PL, have lower claims ratios than EL.

3.31 Interestingly Datamonitor⁹ report that 'the average loss ratio of the top ten players in 2001 was 108.1 per cent. However, the average loss ratio of those competitors ranked 11 to 20 (excluding Berkshire Hathaway) was 86.8 per cent, indicating that smaller players were writing risks more profitably in 2001.'

How have insurers coped with persistent underwriting losses?

3.32 UK insurers have adopted, to varying degrees, two methods to offset the underwriting loss and maintain an adequate return on capital to shareholders. First, and probably most important, they seem to have relied heavily on investment returns to bridge the gap between premiums and claims.

'There is no doubt that insurers were able to cushion the impact of very poor loss ratios on business written in the late 1990's by investing in equities.'¹⁰

3.33 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 link investment income directly 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.

3.34 However the ABI state that in the late 1990s it was normal practice for investment returns to bring the general insurance loss ratio down from between 130 and 140 to 110.

'...over the last 20 years, an average annual return of 25per cent would have been required to cover the whole of the underwriting loss.' [ABI answers to OFT questions on its Quarterly Statistics]

⁹ Datamonitor, UK Commercial General Insurance, 2003

¹⁰ Tillinghast – Towers Perrin: Focus on: Riding the insurance cycle (2 parts) 2003

3.35 Secondly a number of companies reported that it was not uncommon to cross-subsidise liability insurance with premium income from other more profitable insurance lines. A recent survey¹¹ found that 80 per cent of insurers wrote liability insurance in order to support other more profitable lines of insurance, with only 10 per cent writing for its attractiveness.

A snapshot of the regulatory context

3.36 The system of insurance regulation in the UK has been subject to a major overhaul in recent years. The process of reform, which is still underway, has been prompted both by international developments and by the coming into force of the Financial Services and Markets Act 2000 (FSMA), which has established the FSA as a single integrated regulator for financial services. While it is beyond the scope of this paper to discuss the reform of the regulatory landscape, we have highlighted below how the new approach to regulation of insurance introduced by the FSA may impact on the way insurers will be conducting and accounting for their business from now onwards. **Annexe C** provides more detail about the regulatory context.

3.37 All UK insurers, including Lloyd's of London, are required to be authorised by the FSA and are subject to its regulation and supervision. It is worth noting that from January 2005, firms carrying on insurance intermediation will also need to obtain authorisation from the FSA. The FSA is currently consulting on its proposed rules and requirements for insurance intermediaries.¹²

3.38 Authorisation is granted only for the specific classes of business (e.g. liability insurance) for which the applicant has applied, and is conditional, among other things, on the insurer showing that it has adequate resources, both of a financial and non-financial nature, to support that business. An overview of the main requirements for authorisation is provided in **Annexe C**.

3.39 Of particular relevance to this study are the introduction by the FSA of its risk-based regulatory approach and the implications that this has had for what is required of an insurer to be granted authorisation, to carry on its business and to show its ongoing compliance with FSA regulation. In particular, this has meant that the focus is now very much on the specific risk profile and financial strength of a firm and on its risk management strategy. In assessing a firm

¹¹ Moral Hazard and Behavioral Aspects of Liability Insurance, by C. Parsons, 2002

¹² FSA consultation paper 174, March 2003. Consultation ended on 13 June 2003.

under the new regime, the FSA places emphasis on its overall strategy, its risk profile, the quality of its management, the adequacy of its financial resources, its risk management of both financial and non-financial risks, and its systems and controls.

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

Barriers to entry

- 3.41 There are no absolute barriers for new entrants to the liability insurance sector as a whole.
- 3.42 There are a number of factors that might discourage, or certainly not facilitate, entry. In addition to authorisation by the FSA to carry on that business, insurers need access to capital and access to historical claims data for the class of customer. A further consideration for an insurer is the cost of exit when running-off its liabilities when it wishes to exit the market and where a liability to pay claims in the future continues. This can take a number of years. This is particularly the case for EL which is characterised by long-tail claims, i.e. those which extend for many years beyond the year the policy is written. However, none of these general factors seem to place a substantial limit on entry.

- 3.43 The vast majority of firms purchase EL and PL alongside other cover for their business risks, such as motor and property. Decisions by insurers to withdraw from writing EL or PL cover are also likely to be influenced by the present and future profitability of this associated business.¹³
- 3.44 The ABI told us that between 1999 and 2001 the FSA authorised thirteen companies to write liability insurance,¹⁴ which were new entrants to the market or which did not previously write the class.
- 3.45 Overall figures for market shares or market entry can give a misleading impression of the number of insurers competing for a particular policyholder's business. Concerns about market entry relate less to the sector as a whole than to cover for a particular trade or profession which requires specialised knowledge of the risks. We have been told both by insurers and by trade associations that for some types of risk the number of insurers writing policies can be limited. Often this reflects the size of the sector involved and the degree of specialist knowledge required to accurately price and reserve for the risks involved. Entry into one of these areas is more likely to involve an existing liability insurer for whom it might represent a modest diversification, rather than an entirely new entrant. The importance of knowledge of the particular line of business is underlined in a report by European Union insurance supervisors.¹⁵
- 3.46 Insurers who already write a line of business enjoy an advantage in terms of their superior knowledge of the risks, particularly the more specialised risks such as those in the construction industry. Insurers entering a line or sector in a soft phase face the need to compete for new business with a generally low level of premiums, in addition to the likelihood of attracting a disproportionate number of poor risks.
- 3.47 A further pre-requisite to new entry, whether for a new firm or diversification by an existing firm, is the provision of capital. Here the main obstacle is likely to be the expectation of future profitability. Many of the insurers authorised to write liability business are part of a larger group, in some cases with a parent company located outside the UK and unfamiliar with this particular business. In a hard phase insurers may be more selective about taking on new areas of

¹³ Tillinghast-Towers Perrin: Focus on: Riding the insurance cycle (2 parts); Tillinghast-Towers Perrin, 2003

¹⁴ ABI response to OFT study of liability insurance, March 2003.

¹⁵ Prudential Supervision of Insurance Undertakings: Conference of the Insurance Supervisory Services of the Member states of the European Union, December 2002, under the chairmanship of Paul Sharma, Head of Prudential Risks Department, Financial Services Authority

business unless they are expected to be as least as profitable as existing business or sufficiently profitable to justify raising additional capital to extend underwriting capacity.

How liability insurance is bought and sold

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

The role of insurance brokers

3.49 While some liability insurance is sold direct, (for example Norwich Union has a direct sales arm), the vast majority (over 90 per cent) is sold via insurance brokers. This seems unlikely to change in the near future.

3.50 Insurance broking comprises:

- 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.

3.51 The broker market has consolidated, primarily at the smaller level. This merger and acquisition activity, though slowing, is still evident. There are also an increasing number of broker networks.

3.52 Although brokers can write cover, most is written by the insurers. For general insurance, brokers can use a wide range of insurers, but the provision for liability insurance has shrunk to a number of specialist insurers. For the larger business the broker may have a greater input in 'tailoring' a particular policy to the needs of the client. For SMEs, brokers may put together a package consisting of products from a number of general insurers.

- 3.53 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 business sector (e.g. construction firms, SMEs, schools and colleges) or specialise in placing a particular form of insurance (e.g. PI). Small businesses 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 direct. Large businesses with complex insurance needs are more likely to use the services of the major international insurance broker. Firms with very particular insurance needs, including those in high risk sectors, are more likely to use specialist brokers.
- 3.54 In some cases two or even three brokers may be involved in an insurance transaction. For example, a small provincial broker may need to use the services of a specialist broker in order to access all of the market for his client. This sort of arrangement is common in the Lloyd's market, which only a limited number of accredited brokers can access.
- 3.55 Brokers have a key role in presenting the risk they wish to place to insurers. Insurers told us that they relied on brokers to give an accurate view of the risks and valued the relationships built up with those brokers who generated 'quality' business, judged in terms of subsequent claims experience. This is not to say that individual insurers tend only to deal with a limited number of brokers. Most dealt with a significant number and wide variety of brokers.
- 3.56 Other bodies may play a part in setting up 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 consortiums 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 are affected 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.

Remuneration of brokers

- 3.57 Insurance intermediaries are traditionally rewarded by means of commission payable by the insurer, based on a percentage of the premium paid. The rates of commission depend on the size and status of the broker, the benefit of the services that it provides to the insurer and the attractiveness to the insurer of the business that the broker brings in. Thus, large insurance broking firms that produce a substantial volume of business and take on much of the insurer's administrative work, will be able to command higher rates of commission than small insurance agents that introduce clients in relatively small numbers. Generally, current commission rates for liability business range from seven per cent to around 15 per cent. Insurers told us that commission rates had been squeezed recently and that brokers were being expected to undertake more work to justify commissions paid.
- 3.58 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.

How insurers rate the risks

- 3.59 The level of the premium rate is influenced by a number of factors:
- the cost of meeting expected claims for a given class (type) of risk
 - the cost of handling claims
 - the level of deductible or 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 they hold
 - the rating method used

Two main rating methods are used: group (or class) rating and experience rating.

Group (or class) rating

- 3.60 The group rating method, or 'book rating' as it is commonly referred to, is used for the majority of liability insurance risks and particularly for smaller businesses. The basic rate of premium for a given group or type of risk is based on the average claims frequency for risks in that group, and the present value of average claim size for such risks.
- 3.61 Insurers divide the total pool of risks into sub-groupings of similar characteristics and charge similar premium rates for all items in a group. Factors that are most likely to influence annual claims costs, known as rating (or underwriting) factors, are used to distinguish one group from another. For example, for PR the main rating factor is the nature of the goods sold or supplied. For EL, the main rating factor is the trade or business of the customer. Additional factors are used in each case. 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 lose overpriced 'good' risks to competitors and collect insufficient premium to cover losses on the under- priced 'bad' business that it will retain.

Experience rating

- 3.62 The experience rating (individual rating) method is the pricing of a risk on the basis of past claims experience, or rating a risk on its own merits. A firm with a large number of employees, for example, should have enough accident statistics and claims experience to provide a reasonably reliable guide to future claims experience. To whatever degree it is used, this method might appear the fairest for policy holders, but its use is subject to limiting factors. It is inappropriate for most small risks where past claims experience and data will often have little statistical significance and so will not provide a sufficiently reliable guide to future claims trends. With a larger number of risks it is possible to estimate the statistical probability of loss more accurately and to charge a premium that is low relative to the risk. Insurers may rule out experience rating where the cost of a detailed survey would be disproportionate to the premium. For that reason SMEs tend to be book rated, while larger businesses are generally experience rated.

Combining the two

- 3.63 In practice, insurers will use a combination of group and experience rating. Liability insurers often modify the book rates that they would otherwise apply in light of the client's own claims experience and any other relevant factors

peculiar to the client, applying a loading or a discount as appropriate. Pricing then becomes a process of classification (i.e. into which class the risk falls) and discrimination (i.e. whether it is a good risk of its type or a bad one).

Problems in pricing liability business

- 3.64 Insurers may have difficulty in identifying high-risk policyholders in advance. To remedy this, premium loadings or restrictive policy terms may be applied as a corrective, after claims have occurred.
- 3.65 There is also some tension between the need for accurate risk discrimination and the basic risk-spreading and loss-sharing principles of insurance. Precise risk discrimination may lead to insurance being unaffordable or even unobtainable for very high risks. 'Moral hazard' is a problem that affects insurance generally. To discourage this, insurers generally seek to restrict cover to losses which are accidental ('fortuitous') and restrict payments to indemnity only, i.e. exact compensation for the loss and no more. A problem occurs where the dividing line between losses caused by carelessness (which insurers must be prepared to cover) and losses caused deliberately (which are uninsurable) is difficult to draw.
- 3.66 However, there is also a commercial need for cover that gives more than full indemnity, e.g. 'new for old' cover on personal possessions. Moral hazard can be reduced by a number of other techniques in these cases. These include exposing the customer to part of the risk by means of excess or co-insurance (self-insurance), the use of policy conditions to restrict coverage for high risks either in advance of losses occurring or as a consequence of claims experience, and levying variable premiums according to risk. The absence of complete information about the risk, and the cost of control mean that insurers cannot hope to influence a customer's behaviour fully and decisively, but attempt to ensure a customer takes on some of the responsibility for keeping the insured item safe.
- 3.67 The rating and underwriting of liability insurance is generally more problematic than other types of insurance. Some forms of liability, including EL, and to a lesser extent PL, are characterised by long-tail claims. The long time delays in the development and reporting of claims means that current loss experience may reflect the state of the risk thirty or forty years ago, rather than the present state of the risk. The longer the time span of the whole insurance transaction, the greater the risk that changes in legislation, scientific knowledge or accident

victims' general propensity to claim will make claims greater in size and frequency than was anticipated. This creates uncertainty about the final cost of such claims and the level of premium that is necessary to cover them.

- 3.68 Furthermore the uncertain effects of inflation, investment yields and potential increases in the size of court awards over long time periods are likely to make pricing inherently difficult. Chapter 5 provides a more detailed discussion of these issues.

Reinsurance

- 3.69 Reinsurance is taken out by insurers who wish to spread their risks and provide more cover than they can by themselves.
- 3.70 The reinsurance industry is global, and in recent years has seen much merger and acquisition activity. In parallel with the insurance industry, it has been a hardening market which is driving premium increases. Reinsurers have also experienced poor underwriting results and a depletion in reserves.
- 3.71 Four major companies, Swiss Re, Munich Re, ERC Frankona and General/Cologne Re (plus its parent Berkshire Hathaway) have a commanding position in the market, followed by a large number of smaller companies.

4 WHAT HAS HAPPENED TO PREMIUMS?

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

Wide variations

- 4.2 Broad brush averages of 2002 premium rises across all sectors given by the ABI and the BIBA, suggest that premiums for EL have risen by 50 per cent, PL by 30 to 40 per cent and PI by 30 to 60 per cent. These figures mask a wide variety of increases. Our survey indicated that rises vary from zero to more than 200 per cent across the different liability insurance lines.

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

- 4.3 There appears to be more of a uniformity of experience than anecdotal evidence might suggest, but premium rises alone will not determine what has happened in liability insurance markets over the last year. The Federation of Small Businesses (FSB) reported that many customers are paying higher premiums for reduced cover. For example, a thermal insulation business saw its premiums rise from £1,200 in 2001 for £10m of cover, to £8,000 for £1m cover. Twelve per cent of respondents to our SME survey reported a reduction in the level of cover from the previous year. While it is possible that this was sometimes at the request of the insured, anecdotal evidence suggests that this is not always the case. Either way, it is a reduction in value for many businesses.

Excesses and deductibles

- 4.4 Both PL and PI are subject to excesses, deductibles or both. For statutory reasons EL is not, though large businesses may operate a system of reimbursing the insurer after a claim has been paid. For PI in particular many businesses have seen substantial increases in both the level of premium and the level of

excess. From our survey, 25 per cent of customers experienced an increase in excess on their policies.

- 4.5 The Construction Industry Council has indicated that excesses on PI for construction consultants have risen to around one per cent of turnover in the past year. The Royal Incorporation of Architects in Scotland indicated that from January 2002 insurers 'fixed' the level of excess at a mandatory one per cent on fees - a move away from clients being able to choose their own level of excess to reduce premium costs. High levels of excess pose an additional threat to the solvency of the business concerned. For some businesses the increase in excess has effectively led to them self-insuring.

Restrictions and exclusions

- 4.6 We received evidence that for PL and PI cover the use of exclusions or restrictions has increased. Examples include:
- cover limited to claims in negligence only, where in the past policies covered breach of professional duty or civil liability
 - aggregate cover rather than cover for each and every claim
 - wide exclusions concerning work undertaken, e.g. exclusions of personal injury claims arising in connection with work for the rail industry

Exclusion of asbestos related risks

- 4.7 The most notable exclusions seem to be the type of work which may be undertaken, of which the main concerns related to asbestos related risks. Asbestos exclusions appear to be the direct result of reinsurers applying blanket asbestos exclusions to reinsurance treaties. These exclusions can be applied across PI and PL and PR policies.
- 4.8 As an example, it has been reported to us that one reinsurance exclusion reads:
- 'This contract shall not apply to and does not cover any actual or alleged liability whatsoever for any claim or claims in respect of loss or losses directly or indirectly arising out of, resulting from or in consequence of, or in any way involving asbestos, or any materials containing asbestos in whatever form or quantity.'

4.9 We understand that primary insurers are passing these all-encompassing exclusions onto policyholders. We have been told that the public and product liability section of one underwriter's policy reads:

'.....this policy shall not apply to liability for any claim arising in connection with handling removal stripping out demolition storage or disposal of asbestos and/or any other substance or compound that incorporates asbestos....'

4.10 Policy exclusions do not appear to distinguish between asbestos work requiring a licence from the Health and Safety Executive, and that which does not. As well as hearing concerns from brokers acting on behalf of the construction sector, we have also heard concerns from surveyors who have been prevented or restricted from carrying out inspections in the light of such PI exclusions.

4.11 Some of the larger insurers have indicated that they have some negotiation leverage with reinsurers, but it is not clear if this applies to asbestos exclusions. Anecdotal evidence suggests that cover for asbestos risks may be restricted to a small number of Lloyd's syndicates, possibly only one, and it is not clear how long that capacity will last.

4.12 While businesses may be able to get PL and PI cover for most or some elements of their business, the use of exclusions could have the same effect on some business activities as the refusal of cover.

Professional indemnity

4.13 Increases in PI premiums seem to have affected some professions more than others. In the professions where the rises seem to have been less acutely felt, representative organisations, such as the Law Society and The Institute of Chartered Accountants for England and Wales, have agreements in place with a number of insurers, using expert brokers, which, while they will differ from organisation to organisation, provide the minimum amount of PI cover a member must have, and the scope of cover to be provided by the policy. They also provide 'safety nets' to guarantee cover should a firm not be able to secure cover from other commercial routes (albeit this may be more costly for the firms concerned). These safety nets generally take the form of Assigned Risks Pools. Of the organisations operating these schemes, few of their members had taken the assigned risks pool route, suggesting that it was possible to secure PI cover elsewhere.

4.14 But businesses such as IFAs and consulting engineers, which are generally considered by insurers to be 'higher risk' groups by virtue of their poor loss records, have expressed much more concern about premium rises. The Association of Consulting Engineers (ACE) has indicated that over the last year its members saw premiums increase by an amount equal to 1.3 per cent of each customer's fee turnover. For example, following an anticipated 20 per cent increase in 2003, a medium sized consultancy practice with a fee turnover of £20m per year now pays an annual PI premium of £1m.

Past increases in premiums

4.15 Premium increases in 2001 and 2002 need to be viewed in the context of trends over the past five or ten years (all percentages below are based on gross earned premiums). For ABI members, liability premium levels in 2001 were similar to 1995 and had declined slightly relative to prices in the intervening period by about 14 per cent over what was described as a soft phase. EL premiums in 2001 were 18 per cent lower than in 1995.

4.16 For much of the last decade insurers (in aggregate) operating within the liability insurance sector have written liability policies at an underwriting loss. In 2001 the underwriting ratio for all liability insurance was 120 per cent i.e. claims plus expenses exceeded premium income by 20 per cent. This is fairly typical of the losses made over the last decade. EL insurance has been especially unprofitable, with underwriting ratios averaging over 150 per cent over the last decade.

Affordability v availability

4.17 This study was launched against widespread concern that many businesses had been unable to secure liability insurance at **any** price and were trading illegally or were closing down. Estimates of over 200,000 small businesses being affected were quoted. Trade associations said that up to 10 per cent of members contacting them for assistance had not been able to secure EL cover.

4.18 The extent to which this has happened in reality is hard to determine, but during this study we saw no evidence of it being a widespread occurrence. Only 12 per cent of respondents to our survey said they found it difficult to obtain cover and it is not clear whether this translated to an actual failure to obtain cover. Further, we did not come across any sectors from which all insurers had withdrawn. With limited exceptions, brokers indicated that it has been difficult, but not impossible, to secure cover even for high risk trades. However, we understand that most insurers will quote high prices rather than refuse cover.

So for some businesses 'unaffordable' equates to 'unavailable', for practical purposes.

4.19 Table 4.1 summarises the response to the OFT's survey of SMEs. Of the areas we covered, manufacturing and construction sectors are being hardest hit by increasing premiums. Twenty-seven per cent of the businesses responding saw no change in their premiums as a whole. For EL insurance, increases in premiums of 20 per cent or more were recorded by 56 per cent of respondents in manufacturing and 46 per cent in construction. This compares with around 15 per cent of the hotel and catering, health and wholesale firms. The figures are similar for those who buy their insurance in package form. While the numbers responding were small in the context of the UK as a whole, the figures given in Table 4.1 follow a similar trend to anecdotal evidence received from interested trade groups. For that reason they provide some indication of the spread of premium rises. The figures given by brokers who contributed to the study show how varied the mix has been, with rises reported from as low as 10 per cent up to 1000 per cent.

TABLE 4.1: PERCENTAGE CHANGE IN PREMIUMS ACROSS ALL BUSINESSES DURING 2002

	No change	Per cent change (increases)					
		< 20	20-49	50-99	100-149	150-199	200+
Employers liability	38	22	15	10	3	2	10
Professional indemnity	68	11	6	4	3	1	7
Public liability	40	24	14	9	2	2	9
Product liability	62	15	7	8	3	1	4
Package	38	20	19	13	2	1	7

Source: Compiled from OFT survey of SMEs 2003

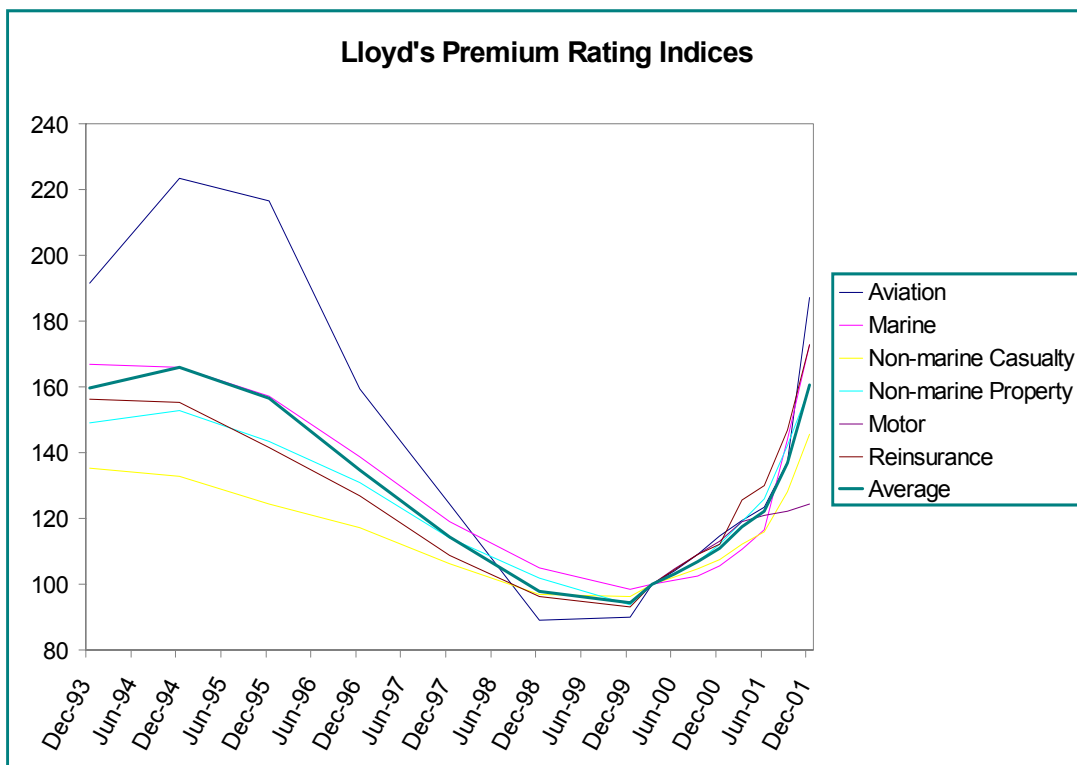
Lloyd's of London rating index

4.20 Lloyd's of London's Reporting and Analysis department has been developing, with their actuaries, an index of insurance rates across 37 lines of business including non-marine casualty (i.e. liability). 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.

4.21 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 appears consistent with other evidence on rate increases and also reflects the typical cyclical pattern of insurance rates that we find in insurance markets generally.

FIGURE 4.2



Source: Lloyd's

Areas which may be particularly adversely affected

4.22 The sensitivity of any business to increases in the cost of their insurance will depend on the percentage of turnover that insurance costs represents. The competitive environment in which a business operates will affect the extent to which these costs may be passed down the supply chain, particularly in view of the sharp increases. Overall, EL premiums represent around 0.25 per cent of UK national payroll costs, but anecdotal evidence, supported by our survey,

suggests that there are variations around this figure.¹⁶ The same applies to other liability lines when seen in relation to turnover. The speed with which premium increases were applied took many businesses by surprise and many complained that they were given little warning about the changes and had little time to plan for them.

PI Insurance and IFAS

- 4.23 With the possible exception of asbestos related risks, the part of the liability sector where problems of non-availability appear to be most significant is in respect of PI cover for IFAs. IFAs are required to have PI cover under existing financial services regulation (see **Annexe D**). Under the existing rules, a personal investment firm, i.e. an IFA, is required to effect and maintain at all times adequate PI insurance cover for all the business activities which it carries on, or for which it is responsible. The rules also specify how firms may effect and maintain adequate cover and what requirements should be incorporated within that cover. A survey by the AIFA of 143 members in December 2002 showed that 22 per cent had no cover at all, 37 per cent had non-compliant cover and a number had no application pending.
- 4.24 IFAs are generally regarded as a high-risk category by insurers. The key reason given by insurers for the non-availability of cover or significant rises in premiums and excesses for IFAs focuses on concerns about a noticeable increase in the number and frequency of complaints and, in particular, possible future business reviews by the FSA (along the lines of the review into the misselling of pensions) which could translate into huge costs for insurers.
- 4.25 The FSA has been seeking to address the problems for IFAs. In October 2002 it introduced a number of provisional changes to its rules mainly aimed at clarifying their application, in order to help PI underwriters to write, and brokers to place, more business for personal investment firms. In short, the proposed changes mean that each claim an insured firm makes on the insurer may be subject to an excess. PI underwriters and brokers will be able to apply the excess on each and every claim or each and every claimant basis, and on an each cause basis in the event of dishonesty or loss of documents by the customer (the insured). Also, it will be possible for the excess to be applied to defence costs. Importantly, the proposed changes also include the introduction of a clause clarifying that the minimum insurance requirements are those under

¹⁶ The OFT survey of SMEs asked for total liability insurance as a percentage of turnover so while absolute figures are not comparable, the survey proves a useful indication of variability.

the rules relevant to the firms in question at the date of the PI policy's inception or renewal, and that any subsequent rule changes will not apply, hence will not supersede their policy terms. This should bring clarity and increase legal certainty for both the customer and the insurer.

- 4.26 The FSA felt this was needed, because there were strong indications that reluctance by some underwriters to provide IFAs with PI cover was partly due to the fact that some of the FSA's original provisions were unclear. As a consequence, they were open to different interpretations by underwriters and brokers and, more importantly, they contributed to reducing availability of PI in the market. The FSA now proposes to make these changes permanent.
- 4.27 The changes may not have increased the supply of PI cover (for IFAs) – insurers continue to see them as high risk – but without them the supply of PI for IFAs might have reduced further or cover might have been offered on worse terms. It is worth noting that in May this year the FSA authorised a mutual, Magian Mutual, which will provide new PI capacity exclusively to IFAs. The FSA is continuing to look at the issue and further proposals for change are expected during the summer of 2003.

The voluntary sector

- 4.28 Problems with liability insurance are not confined to the commercial sector. The voluntary and community sectors have also felt the impact of rising premiums, particularly for PL. A report by the National Council for Voluntary Organisations indicates that, as with commercial businesses, increases for EL and PL have ranged from 30 per cent to 100 per cent, and a number of organisations have reported larger rises. For example, the British Trust for Conservation Volunteers has seen increases of 350 per cent for PL and EL policies. Concerns have been expressed that the rise in premiums will increasingly mean that voluntary and community groups restrict their activities, or may force them to cease their operations.

SMEs

- 4.29 A 50 per cent premium rise is likely to account for a much higher percentage of turnover for an SME than for a larger business. For those businesses who responded to our survey, overall liability premiums represented an average seven per cent of turnover. This may be higher than the norm given the propensity for those most affected to respond to surveys. The fact that many SMEs are book rated means they are more likely to be affected by factors which impact across the whole group or type of risk, including expected claims for a given type of risk. SMEs are also more likely to use local, provincial brokers who

may be less likely to be able to access all markets, especially specialist insurers, thereby restricting choice which may ultimately affect price.

Northern Ireland

- 4.30 The situation across Northern Ireland is reported to be particularly acute. This is likely to be due to the high proportion of small businesses with fewer than 20 employees¹⁷ (around 33 per cent¹⁸), combined with fewer insurers writing liability insurance compared to the rest of the UK – approximately five.

'High risk' business sectors

- 4.31 In the last year at least, insurers have been taking a far more selective approach to the assessment and pricing of risks. This reappraisal of risks appears to have been felt most in a minority of high risk trades and professions. Individually, insurers indicated that they were tending to concentrate on those sectors where they had the greatest knowledge or expertise in assessing or pricing the risk. This more selective approach on the part of individual insurers has left some trades and professions with a much reduced choice of insurers and, on the whole, higher premiums. While the risks avoided varied from insurer to insurer, certain trade sectors, which would be commonly be classed as 'high risk', such as roofing and scaffolders, were mentioned more frequently. Nevertheless, all the insurers we spoke to indicated that they were continuing to take on new business, even in some cases 'high risk' sectors. At least one major insurer, has set up a 'high risks' department and is prepared to take on such risks if properly priced.

Projections of rate rises over the next two years

- 4.32 In such an uncertain market, it is difficult to predict future premium increases with any accuracy. However, the BIBA indicated that, provided there is no single significant effect (such as another loss shock – see Chapter 5 below), the bulk of corrective action will have been taken by Autumn 2004, although it seems likely that rises of 20 to 30 per cent for EL, 15 to 20 per cent for PL and 20 per cent for PI (with restricted cover and excesses imposed) would not be uncommon. We will look again at premiums in late 2004 to determine the level of premiums at that time and to make an assessment of how far corrective action has been taken and of likely future trends.

¹⁷ 'SME Statistics for the UK' published by the Small Business Service

¹⁸ Note: around 64 per cent have no employees.

5 WHAT MIGHT BE DRIVING PREMIUM RISES?

5.1 This chapter is concerned with the factors that might be driving the premium rises. Possible explanations given to us for these rises fall into two main categories:

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

5.2 Conscious that premiums have been high before, we asked insurers what, if anything, made the current situation different. Their overwhelming response was that insurers were now faced with a combination of circumstances which have not occurred previously. For example:

- There are fewer insurers transacting liability business as a result of mergers and acquisitions, leaving the market, re-shaping their books or company failure
- Reduction in investment income which had previously offset underwriting losses
- The emergence of asbestos claims and other adverse trends
- The events of 11 September which hit many reinsurers severely and led them to recoup their losses by strengthening reinsurance premiums

Changes to costs incurred

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

5.4 In January 2002 Zurich Insurance published a booklet 'Rate Increases Explained' which examined the effect on premiums of the various changes made to personal injury law (and general personal injury claims inflation and new types of claim). These are set out in Table 5.1 below. While the booklet applies these factors specifically to EL, the ABI has indicated that the effects of the various changes to the law (which we discuss in more depth below) have affected the cost of both EL claims and PL claims. They state that the effect has probably been somewhat less on EL than PL, because PL policies cover property damage as well as personal injury claims.

TABLE 5.1 - ZURICH INSURANCE: 'RATE INCREASES EXPLAINED' 2002

	Rate increase (per cent)	Average claims increases on affected cases (per cent)
Legislation		
Discount rate as applied to the Ogden Tables (1)	8	
Conditional Fee Agreements (CFAs)	8	50
Law Commission reforms (2)	2-3	20
Civil Justice reforms (Woolf Report)	2	20
Abolition of claims agreements (3)	5	25
Recovery of NHS charges (4)	2	
Levies		
Policyholders Protection Board (5)	1	
Claims		
Personal Injury claims inflation	12	
New types of claims (6)	5	20

Notes:

(1) Based on a fall in the discount rate from 4.5 per cent to 2.5 per cent

(2) Based on 'Pain and suffering' reforms

(3) Refers to the abolition of claims agreements between insurers and trade unions

(4) Potential cost

(5) Recent collapses include Chester Street Insurance Holdings Ltd and Independent Insurance Company Limited

(6) New types include: stress, violence, abuse, sick building syndrome

5.5 The ABI has indicated that since January 2002, when the Zurich booklet was produced, CFAs have increased the cost of personal injury claims by a total of

25 to 30 per cent, rather than the eight per cent set out in the booklet. We were told that this increase in costs is attributable to the success fees being charged by solicitors and the costs of ATE insurance (see discussion of legal costs below).

- 5.6 Despite being a year old, the Zurich table was the only evidence presented to us by the insurance industry to demonstrate the impact changes to personal injury law have had on premiums. The factors listed in the table, along with a number of other factors, are discussed in more detail below.

Expansion of liability

- 5.7 There is only limited evidence on claims frequencies in respect of liability insurance, much of it focusing on EL. The absence of data on the number of insurance policies to which claims relate make it difficult to assess trends in claims frequency with precision. Some figures on claim **numbers** are available but these are apt to be distorted by the long delays that sometimes occur in both the reporting and settlement of liability claims. Further distortion arises from 'spikes' in claims of a particular type, such as the mainly 'low value' (i.e. in monetary compensation terms) deafness¹⁹ EL claims that peaked in the mid 1990s and have tailed off since.
- 5.8 As far as EL is concerned, there appears to have been a rise in the total number of claims between 1980 and 1990 followed by a gradual tailing-off since.²⁰ This is consistent with the 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.
- 5.9 The body of law that most affects liability insurance is tort law. Some commentators 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, particularly for EL.²¹ In fact recent changes in the substantive rules of tort law present a mixed picture: there has been a

¹⁹ The number of claims for deafness rose greatly in the early 1990's after the introduction of the Noise at Work regulations that defined noise levels that can cause harm.

²⁰ Based on figures supplied 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).

²¹ 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

contraction of tort liability in some areas and an expansion in others. 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.

Long-tail claims

- 5.10 For EL and PL the key concerns for insurers are not simply the **number** of claims but the fact that many of these are long-tail claims. Long-tail claims relate predominantly, but not exclusively, to occupational diseases and are characterised by long latency periods: for example the average latency period for mesothelioma (a condition arising from asbestos exposure) is 33 years. Insurers argue that 25 per cent of EL claims are in respect of long-tail claims and they have expressed concern about the emergence of new types of claims in recent years. These include stress, violence, employment disputes, abuse, environmental tobacco smoke, sick building syndrome and acoustic shock. Some of these new emerging claims are in respect of PL, for example sexual and other types of abuse on the parts of the clients of the policyholder, underlining that long-tail claims are not confined to EL.
- 5.11 Insurers argue that, by their nature, long-tail claims are difficult to predict, and are therefore difficult to take into account when pricing risks that might never occur and in reserving for such claims. Premiums have to be set to allow for long-tail claims that current working practices may be causing, but that may not manifest themselves for 20 or 30 years. They also argue that policy holders would argue vehemently that they should not be charged for a liability which might never emerge. Moreover, a single insurer that tried to increase premiums to charge for this contingent liability would almost certainly be unable to charge these higher premiums in a competitive market.
- 5.12 The general legal principle is that a disease claim will succeed only where it can be shown that, at the time the harm was caused, the employer knew, or ought to have known, that harm (not necessarily the specific disease) was likely to occur. Liability can arise:

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.

- **Under the common law rules of negligence** i.e. if the employer's common law duty of care is breached. In disease claims, the duty of care would appear to be breached if, from the time the employer should reasonably have known of the link between certain workplace conditions and the disease, they did not take sufficient steps to protect their employees from it. The time the employer should have known about the risk is referred to as 'the date of knowledge'. The courts will look at the literature that would have been available to the employer at the time (e.g. publications of the Factory Inspectorate/Health and Safety Executive). It is not strictly necessary that the employer was aware that its actions could result in the specific disease that resulted, it will be sufficient if it was reasonably foreseeable that the action would result in harm to the employee.
- **As a result of a breach of a statutory duty** – for example in the case of asbestos, s47 of the Factories Act 1937 or specific regulations e.g. the 1931 Asbestos Industry Regulations. To succeed it must be shown that the injury or damage suffered was of the kind which the statute was intended to prevent. There is scope for differences in interpretation of the wording of the statute that could result in retrospective liability for employers/insurers. For example, up until 2001 the courts consistently upheld the view that the 1931 Asbestos Regulations applied only to firms **making** asbestos. However, the case of *Shell Tankers v Jeromson*²² held that it was clear from the Factory and Workshop Act 1901 (s79 under which the Regulations were made) that the Regulations were intended to apply to any factory or workshop where a process involving the manipulation of asbestos was used. As a result, EL insurers were faced with many decades of negligent exposure from all the firms insured that had used asbestos products.

5.13 Assertions that such claims were wholly unexpected appear to overlook the tendency of the courts to interpret the law in a manner which entitles people with occupational diseases to compensation.²³

5.14 It is, we are told, the **uncertainty** surrounding long-tail claims that is one of the key drivers behind insurers' proposals for separate funding for long-tail occupational disease claims from short-tail diseases and accident claims, which are subject to a parallel review by the DWP.

²² *Shell Tankers v Betty Irene Jeromson*: (1) *Cherry Tree Co Limited* (2) *Shell Tankers UK Ltd v Ruth Mary Dawson*[2001] EWCA Civ 101

²³ Lord Bingham mentions in *Fairchild v Glenhaven Funeral Services Ltd* ((2002) UKHL 22) that as a matter of policy, the courts will interpret the law in a way that will compensate those that have suffered grave harm.

- 5.15 We have not been able to establish that there has been a dramatic expansion of liability for such claims in recent years. The current risks of asbestos, vibration white finger and deafness are well known and new claims emerging such as stress and sick building syndrome tend to be less clear cut when it comes to proving causation. Given the nature of disease claims, some degree of uncertainty will remain, but it is not clear that they will have the long term impact, at least in terms of the number of cases, that insurers claim. There appears to have been a levelling out of long-tail claims. One of the large brokers we contacted indicated that it was unlikely that the industry would see another crisis on the scale of the asbestos problem in either EL or PL. A report by Greenstreet Berman²⁴ for the ABI shows that it is injury claims which have risen for EL from 54 per cent in 1996 to 66 per cent in 2000.
- 5.16 Possible and pending law reform, such as the Law Commission's proposals in relation to the law on psychiatric illness, seems unlikely to bring about any dramatic changes in the overall reach of tort law, even if all were to be implemented in full.²⁵
- 5.17 Parsons concludes in his report²⁶ that 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.

Impact of CFAs on claims numbers

- 5.18 We discuss in more detail below the question of whether the introduction of CFAs or 'no win, no fee agreements' as they are sometimes known, has significantly increased the **cost** of claims. Insurers also argue that the use of

²⁴ Workplace compensation: costs, trends & options for change 2002

²⁵ 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 per cent. Parsons has indicated that this view is difficult to challenge, since any estimate is largely a matter of speculation. However, he goes on to say that 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.

²⁶ An analysis of current problems in the UK liability insurance market – June 2003

CFAs has increased the **number** of claims made. The evidence on this is inconclusive. CFAs were intended to increase access to justice and any rise in claims could be viewed as positive. The report by Greenstreet Berman on EL notes that the attractions of CFAs may have been dented by recent adverse publicity about bankrupt claims agencies, such as Claims Direct, and reports of legal costs swallowing up awards. Furthermore, unionised employees have always had ready access to legal representation and active encouragement to pursue their legal rights for compensation.

- 5.19 The Association of Personal Injury Lawyers (APIL) argues that the use of CFAs may have decreased the number of claims since, given the costs of losing, solicitors screen out low probability and spurious claims.

PI claims

- 5.20 Insurers expressed similar concerns about PI claims as they did about EL and PL claims. While there is very little information available to us on PI claims, Datamonitor²⁷ indicates that an examination of the gross claims incurred for a sample of companies reveals that most of the top ten players have experienced rises averaging 78 per cent over 2001. Part of the problem seems to be that while they are not subject to long-tail claims it can take many years to establish the cost of these claims. For IFAs the increased nervousness on the part of PI insurers about possible business reviews by the FSA, and the subsequent costs they might face, has also contributed to the rise in premiums (and excesses).

Increases arising from changes in the legal system

Introduction of CFAs and ATE Insurance

- 5.21 CFAs were introduced in 1995 as a means of widening access to justice for a greater proportion of the population. Personal injury claims, except those for clinical negligence, were taken out of the scope of Legal Aid in 2000. Since 2000 both 'reasonable and proportionate' success fees and the cost of ATE insurance can be recovered from the losing side, so someone making a claim on this basis cannot lose financially. CFAs allow lawyers to take cases on a 'no win, no fee' basis, so claimants can take forward their case knowing that if it is lost no legal fees would be payable by them. Lawyers can charge a 'success fee', uplifting their normal level of fees if they win to compensate them for the cases they take on and lose (and for which they receive no fee). Previously, under Legal Aid, lawyers were always paid whatever the outcome. This risk of

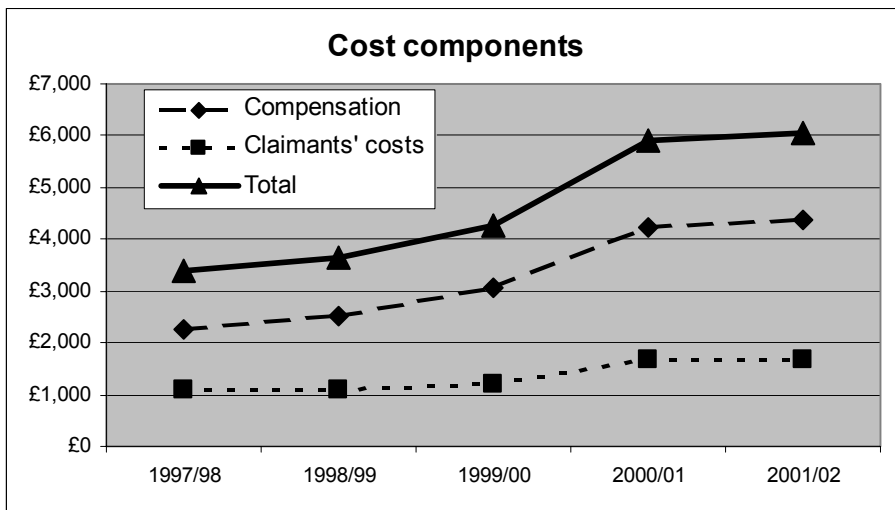
²⁷ UK Commercial Liability Insurance 2003, Counting the claims

losing has led to the rise of legal expenses insurance, namely ATEs and Before the Event cover (ATE is discussed further below).

5.22 Concerns have been expressed by a wide variety of organisations about the impact of legal costs on premiums, particularly for EL. Insurers have indicated that on average 40 per cent of claims expenditure is accounted for by legal costs, rising to up to 95 per cent for small claims (up to £5000) which make up the majority of claims. This cost will include CFAs and ATEs.

5.23 The report by Greenstreet Berman for the ABI looking at legal costs in EL cases, indicates that using insurers' data the average claimant's costs (legal and medical assessment) have risen by about 50 per cent since 1997, an average of 12 per cent per year to around £1,700 per case. Changes associated with CFAs represent only part of these increases.

FIGURE 5.2 - AVERAGE CLAIMANTS' COSTS
(LEGAL AND MEDICAL ASSESSMENT)



(Source: Greenstreet Berman Ltd)

5.24 Despite these concerns the report goes on to note that claimants' costs are a declining proportion of an increasing total settlement cost, falling from nearly 50 per cent of compensation awards, to just under 40 per cent. This may simply reflect the higher damages awarded.

5.25 The Greenstreet Berman report puts forward a number of factors which may have contributed to rising claimants' costs:

- above average inflation increases in solicitors and expert fees
- an increasing need for a second expert due to rising claims for psychological injury components of standard injury claims
- the introduction of success fees whereby the solicitors on a 'no win no fee' arrangements apply an additional charge averaging 40 per cent of standard fees
- the cost of ATE insurance – where claimants insure the legal costs of a claim, a cost paid by insurers

The ABI suggests that CFAs (and ATE insurance) have increased the cost of EL claims by 25 to 30 per cent.

- 5.26 The issue of success fees has been subject to much debate, with judges examining the level of fee uplift that can reasonably be agreed for simple cases. In *Halloran v Delaney*²⁸ it was decided that in cases involving CFAs, where simple claims were settled without court proceedings, judges should ordinarily allow an uplift of five per cent on the claimant's costs including the costs of any costs only proceedings unless the judge was persuaded that a higher uplift was appropriate in the particular circumstances of the case. The Court said that this approach should be applied retrospectively to the extent that it should apply to all CFAs entered into after 1 August 2001.
- 5.27 Prior to *Halloran v Delaney*, the principles set out in *Callery v Gray*²⁹ had been relied on. In that case the Court concluded that where a CFA is agreed at the outset, 20 per cent is the maximum uplift that can reasonably be agreed for simple Road Traffic Act (RTA) cases. In effect 20 per cent was the minimum success fee as there could scarcely be any lower risk cases. The *Callery* case was very small value and was a simple RTA case. However the court understood that success fees had to be worth having or there would be problems with access to justice. Effectively uplifts started at 20 per cent and could go up to 100 per cent if the risks merited it.
- 5.28 It is not clear what the long term effect of the *Halloran v Delaney* case will be on success fees, and ultimately on insurers' costs.
- 5.29 Insurers claim that they are increasingly paying claims on a CFA basis - hence paying a success fee and an ATE premium on top of the amount they would

²⁸ (2002) EWCA Civ 1258, (2003) 1 WLR 28 (CA)

²⁹ (2002) UKHL 28, (2002) 1 WLR 2000 (HL)

otherwise have paid. Even if insurers settle as soon as they learn of a claim, they are still expected to pay a success fee and an ATE premium.

- 5.30 Insurers also argue that lawyers will only take on a CFA case if it has at least a 70 per cent chance of success. This means that the typical uplift in fees (the 40 per cent estimated by the ABI) is much greater than the statistical probability of losing a case. Insurers argue that in a truly competitive market, the mark up for CFAs should vary to reflect the risk of losing, but this does not appear to be the case for EL where most cases (over 90 per cent) win. Conversely, lawyers argue that CFAs require solicitors to take on the financial risks of losing cases, as they do not recover any costs at all in the cases they lose. Losing a case can be extremely expensive for even the largest of law firms and to reflect this, lawyers are entitled to recover a success fee in winning cases, allowing them to absorb the cost of losing cases. Furthermore, given the financial burden of losing, the use of CFAs may have led to a reduction in claims with lawyers only choosing cases with a strong chance of winning.

ATE insurance premiums

- 5.31 Given the high success rates in EL cases, insurers believe that taking out an ATE premium is unnecessary, and simply adds to the overall costs. An example of the cost of an ATE premium was a £300 policy on a routine RTA case with £1000 of damages. Anecdotal evidence suggests that these premiums may have risen by up to 80 per cent in the last year or so. Insurers have raised concerns in the courts about what constitutes a 'reasonable' ATE premium and there have been refusals to meet the costs of 'unreasonable' ATE premiums. Insurers claim that, as with success fees, the standard charges for ATE premiums are not particularly linked to the risk. Concerns also relate to accident management companies whose premiums reportedly covered not only solicitors' costs, but also a significant contribution towards advertising costs and internal administration expenses. In a test case involving Claims Direct a premium of £1,250 was deemed to be unreasonable and insurers were ordered to pay half this amount. Despite a number of recent court cases the question of what is a reasonable ATE premium remains unresolved.
- 5.32 Lawyers have themselves expressed concern about the cost of ATE premiums, sharing similar views to those of insurers on the apparent failure to link charges to the risk. However they also argue that the number of ATE policies being taken out is fairly low because the cost of premiums is prohibitive.

Woolf reforms

- 5.33 In April 1999 reforms were introduced into the civil courts of England and Wales. These were designed to tackle the problems of cost, speed and complexity in the civil justice system. The new rules also introduced the principle of proportionality, which means that costs incurred in any one case should be proportionate to its complexity and overall value. Pre-action protocols were introduced which seek to reduce costs by encouraging early settlement of cases, thereby reducing costly trials. The personal injury protocol imposes three main obligations on defendants: to acknowledge the letter for claim within 21 days; to respond within three months thereafter, stating whether liability is denied; and third, if liability is denied, to disclose any documents in their possession which are material to issues between the parties. The courts can now apply severe financial penalties for defendants/insurers for failure to comply with the new procedures.
- 5.34 Insurers argue that the reforms have not only failed to speed up the settlement of claims, but have also brought about an increase in costs as they have led to more work needing to be done in the early stages of a claim ('front-loading'). This, they say, leads to a delay in the formulation of a claim and its being reported to insurers. In addition, it is argued that the new procedures include onerous timetables for completion of investigation work and for obtaining all information necessary to settle the claim. This, insurers claim, leads to higher average claims settlement, as insurers are forced to settle claims near the top of the potential value, rather than contesting the claim and investigate fully with the risk of incurring even higher costs/penalties.
- 5.35 Personal injury lawyers are unsympathetic to this argument, pointing out that anecdotal evidence suggests that insurers routinely fail to comply with the mechanisms in place, such as the pre-action protocol, to reduce legal costs.
- 5.36 Research by The Law Society and Civil Justice Council³⁰ indicates that the reforms, combined with an increasing wish of insurers to settle claims quickly, seem to have been successful in speeding up the process and reducing its adversarial nature. However, the cost of litigation has not changed. The front-loading of costs may be partly to blame for this.

³⁰ 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

- 5.37 Research by Paul Fenn and Neil Rickman, on behalf of the Civil Justice Council, looking at the cost of low value (less than £15,000) road traffic act claims from 1997 to 2002³¹, found that there was little difference between CFA and non-CFA claims with respect to agreed base costs (i.e. solicitors hourly fees), and that disbursements, success fees and ATE premiums remain a relatively small part of overall costs recovered from insurers. Therefore, the report concluded, the cost increases observed (approximately 25 per cent in base costs over the previous 18 months) could not be readily ascribed to recoverability rules introduced in April 2000 (i.e. claiming success fees and ATE premiums from the losing side). The report indicates that trends in costs reported **appeared consistent with** the effect of the Woolf reforms on the front-loading of casework. It should be noted that this research related only to small value RTA claims and does not necessarily apply to other kinds of personal injury work. The results should therefore only be seen as a guide.
- 5.38 We have not been able to give the issues on legal costs detailed attention within the scope of what has been a five month study. The short length of time in which CFAs have been in existence suggests the system may still be subject to change – costs may settle at an appropriate level over time. It has also contributed to the lack of available data on these issues. As a result the evidence on legal costs is inconclusive. There are questions about the competitiveness of the market both in respect of whether the uplift of success fees and the pricing of ATE premiums are fully representative of the risks involved. We will look again at the subject following publication of the report and consider whether it requires further research on our part.

Increases in damages per claim

- 5.39 In contrast to evidence on claim numbers and frequency, there is evidence of quite sharp increases in liability insurance claims costs. For example, Greenstreet Berman estimate that the average cost per EL claim has increased three fold between 1996 and 2002, one insurer claims that there has been a doubling in the size of the average EL claim in the last five years³² and another suggests 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

³¹ Jan 31 2003

³² Zurich Insurance (2002) *Rate increases explained*

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

these bodies give the exact source of their information, nor have they broken down the increases to indicate more clearly what is driving the increases. Nevertheless, figures such as these 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

5.40 A number of factors have contributed to this³⁵. They include the following:

Change to the discount rate and use of the Ogden tables

5.41 Insurers have indicated that the vast majority (over 90 per cent) 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 judgment.

5.42 The discount rate and the Ogden tables are used in personal injury and fatal accident cases to calculate the lump sum appropriate as compensation for a continuing future pecuniary loss or consequential expense, such as care. Ogden tables, whose use by the courts is mandatory, are actuarial tables of life expectancy.³⁶ Defendants (and their insurers) are able to pay a lower settlement (the discount rate) to take into account the interest claimants will earn on the lump sum over their lifetime. Following historically low investment returns the House of Lords reduced the discount rate from three per cent to 2.5 per cent in June 2001³⁷. Settlement figures may be higher to compensate for this reduction. Insurers claim that the recent reduction has cost them around £500 million and added to the cost of premiums.

Damages for pain and suffering

5.43 In the *Heil v. Rankin case*³⁸ the Court of Appeal stated that damages awards for non-economic loss (pain and suffering and loss of amenities) in personal injury cases could rise. The court proposed that for the very gravest injuries damages

³⁴ According to a recent 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 - 6 per cent faster than average earnings (*LIMRA 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.

³⁵ Sources, Zurich, LIMRA UK Bodily Injury Study

³⁶ As a result of *Wells v Wells* (1999) 1 AC 345 (HL)

³⁷ The Lord Chancellor by virtue of his powers under the Damages Act 1996

³⁸ (2001) QB 272 (CA)

should rise by 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. These increases were lower than those which had been proposed by earlier Law Commission recommendations³⁹.

- 5.44 The Law Commission has also proposed the removal of restrictions in psychiatric illness cases which limits those that can claim (e.g. the claimant no longer has to have witnessed the accident or its aftermath). This will lead to increases in PL and Motor claims.

Recovery of NHS charges

- 5.45 To date employers have not had to pay the full cost of diseases that they have caused. The costs of treatment by the NHS for sick employees (or indeed those injured in accidents) have not been recovered from employers. 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. One insurer estimated that employers' liability premiums would need to rise by two per cent as a result although, according to the ABI, the Department of Health estimates that this will increase EL premiums by about eight per cent.
- 5.46 We are aware that the full extent of the impact of the changes in damages on premiums have been challenged by personal injury lawyers, who point out that the Court of Appeal did not increase damages by as much as had been recommended earlier by the Law Commission, and that the reduction of the discount rate is simply in line with falling investment returns.

Investment returns

- 5.47 The ABI has said that,

'whilst the liability class produces an overall loss, insurance companies hope that their investment income will more than underwrite losses.'⁴⁰

Over the last year or so these hopes have not been realised. Investment income had been especially important in the liability classes of insurance because of the extended period between receipt of premium and claims payment. Although

³⁹ Damages for Personal Injury: Non-pecuniary loss (1999) Law Comm No 257

⁴⁰ ABI Insurance Trends No 36, January 2003

investment returns, especially on equities, have turned out to be low in the last few years (just as they turned out to be high over a number of years previously), it might be anticipated that general insurance underwriters would take into account an expected future investment return when pricing a particular risk. Insurers have stated that investment returns of around eight to twelve per cent per annum were factored into general liability prices during the mid to late 1990s, falling after 2000 to between nought to four per cent. We are not clear how far these figures were derived from rigorous analysis of expected returns. Assuming the underlying insurance risk remains the same, any fall in expected return will need to be offset by an increase in premium or a reduction of cover.

- 5.48 It is possible that a level of inertia is associated with the 'expected return factors' whereby, as actual investment returns fall, underwriting standards do not immediately correct the balance. Those involved in the detailed setting of individual premiums may now be adopting an overly pessimistic view of the investment income, which will in turn accentuate other factors associated with a hardening of the market.

Reinsurance

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

Loss shocks

- 5.50 Loss shocks such as the World Trade Centre and unexpected long term claims such as asbestos have placed a strain on reinsurance capacity, at least in the short term, and triggered some re-appraisal of risks.

Conclusions on cost increases

- 5.51 It is difficult to quantify the relative importance of each of these factors in terms of the rise in costs. While each of these changes, with the possible exception of reinsurance prices, will clearly have had an inflationary impact on premiums, we are not persuaded that these factors alone account for the very

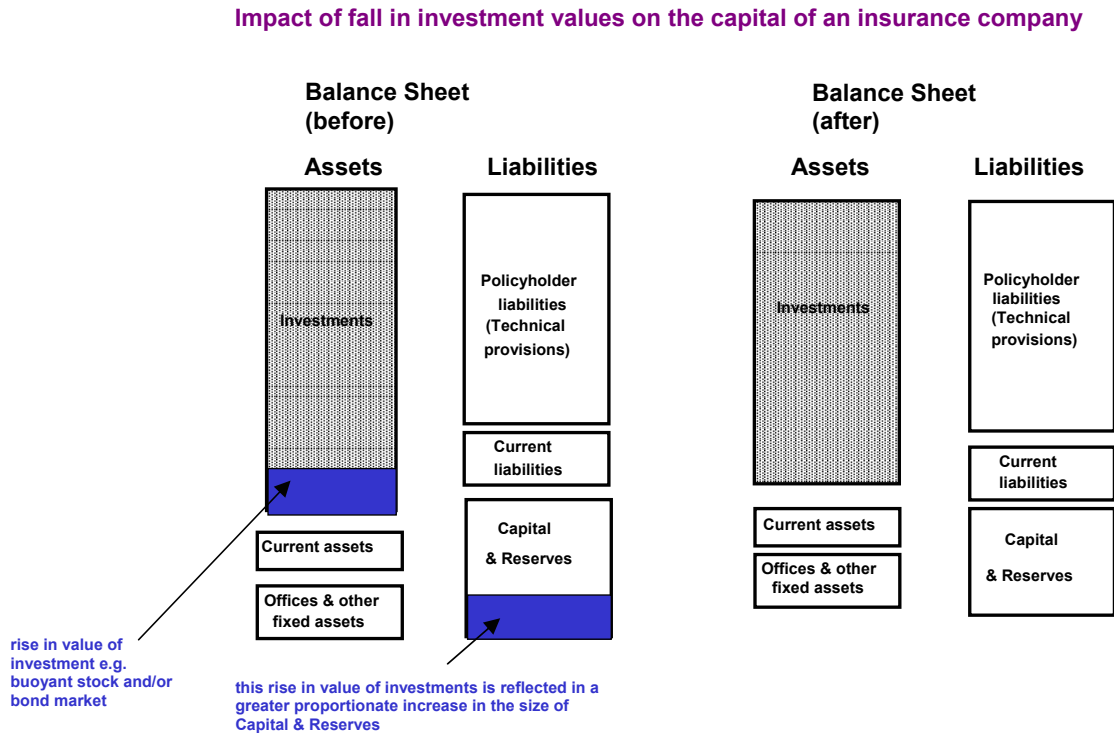
large increases in premiums experienced over the last year. We discuss below a number of other factors that may have had an impact on premiums.

The competitive environment

- 5.52 Market forces and market behaviour can play a powerful role in shaping insurance premiums and levels of cover and can contribute, to a certain extent, to prices fluctuating in a cyclical fashion, between high and low premiums (**Annexe F** shows diagrammatically how this might work). These are commonly known as 'hard' and 'soft' phases. The liability markets have been going through a hard phase for the last 18 months or so, certainly when measured in terms of constraints on capacity and rising premium rates.
- 5.53 Over the period from 1998 to 2001, total premiums fell in real terms. Insurers appear to have been competing aggressively, and in some cases destructively, for new business. Reductions in capacity during 2001, for the reasons discussed below, brought about a very rapid correction from the previous trends. Decisions based on short term growth will conflict with long term profitability and may have contributed to the recent insolvencies we refer to overleaf.

Pressure on capacity

FIGURE 5.3 - IMPACT OF FALL IN INVESTMENT VALUES ON THE CAPITAL OF AN INSURANCE COMPANY



5.54 Insurers invest, or at least they used to invest, much of the long-term capital which supports their business in equities, which tended to deliver the best returns over time. Falling investment returns affect the level of premiums which insurers will charge and hence may put pressure on the capacity of insurers to renew existing policies or to write new business. The reduction in capacity to absorb business comes about because the solvency margin which regulators require for general insurers under UK law (which is largely based on European Directives) is effectively expressed as a percentage of premium.⁴¹ This reduction in capacity leads to a far more selective approach to renewals or to new business, with the risks seen as less desirable being refused cover or only offered cover at a substantially increased premium. In this way the reduction in investment income contributes to the hardening of the market. Unless they can secure increases in capacity via more capital backing, insurers will tend to concentrate on the most profitable existing business. This scarcity effect will tend to provide an upward pressure on premiums. A more detailed description

⁴¹ Conventionally regarded as approximately one third of written premium so £1 of an insurers capital can support £3 of premium.

of current solvency requirements, how they work and their main implications is set out in **Annexe C**.

- 5.55 Since 2001 a number of insurers, especially those who underwrite long tail risks, have readjusted the asset mix underlying their business toward less volatile assets such as Gilts. To some extent this might be to protect solvency levels against further stock-market falls. The FSA, in moving to a risk-based approach to the regulation of insurers, will expect insurers to allocate capital according to the risks that specific lines of business present. Although such measures will probably not eradicate insurance price cycles, they might help to control the speed and depth of price swings.

The impact of major insurer insolvencies

- 5.56 Although the level of insolvencies amongst insurers has not been especially high in recent years, some insurance company failures are regarded as significant for the purpose of this study. Two notable insolvencies have occurred recently, those of Independent Insurance Company Limited which at the time of its insolvency had built up a market share of about seven per cent of the total EL market and Chester Street Holdings Ltd⁴², which prior to going into run-off accounted for around nine per cent of the EL sector in respect of EL risks for heavy industry and was therefore liable for claims made by those risks.
- 5.57 We have been told that the collapse of Independent and Chester Street⁴³ contributed to the hardening of the market. It resulted in increased payments to the Financial Services Compensation Scheme (FSCS)⁴⁴ because claims on an insolvent company's EL portfolio (and on other classes of insurance which are protected) are funded by other non-life insurance companies. The collapses also brought about stronger demands from shareholders to restore profitability across all lines of commercial insurance, forcing insurers to increase premiums. Independent's collapse also resulted in a reduction in capacity.

⁴² Chester Street was a company in run-off i.e. no longer writing or renewing business at the time of its insolvency.

⁴³ Chester Street's recent insolvency contributed to the raising of payments to the FSCS not to a reduction in capacity as it was in run-off.

⁴⁴ FSCS is the safety net for customers of financial services firms that have gone out of business. The scheme took over responsibility for paying compensation from 1 December 2001, replacing existing compensation schemes (including the Policyholders Protection Scheme) which did not have the legal powers to raise a levy for compensation costs incurred. The scheme is funded by the financial services industry and in the case of Chester Street requested a levy of £150m (0.66 per cent of leviable income) against general insurance firms.

5.58 Insolvencies appear to have encouraged insurers to re-focus on underwriting practices to avoid similar problems. All the insurers we spoke to stressed the need to set premiums at a level which will generate underwriting profits. One indicated that the changes made in response to the collapse of these companies are long term in nature. Changes to the FSA prudential regime have also encouraged firms to focus on their long-term profitability and risk management systems.

Collusion

5.59 Another explanation offered for the hardening of the insurance market was that insurers were colluding to increase rates or reduce capacity. We received no evidence of collusive agreements over liability insurance markets as a whole. The absence of concentration and the ways in which the prices of insurance products are set make such agreements difficult. Any concerted attempt to set particular rates or agree particular increases would be very difficult to enforce. Insurance is not a homogenous (standardised) product and unit prices are not easily defined or observed. Increases in premiums paid do not necessarily indicate changes in prices. Premium levels based on individual risk rating are inherently difficult to compare, and even those based on book rates are often subject to a variety of discounts. An increase in deductibles without a change in rates amounts to a price increase, the precise magnitude of which is difficult to define. There are other, far more plausible, explanations for the price increases and reduction in capacity which have been observed.

Possible high levels of concentration in narrowly defined markets

5.60 Over liability markets as a whole, there are a large number of insurers competing for business, mostly through an extensive network of brokers. But from the viewpoint of the business buying insurance, what matters is the numbers of insurers and brokers competing at any one time for its custom. For the more specialised risks such as hot roofers or businesses working with asbestos, the numbers of insurers competing at any time for business can be far more restricted than aggregate figures imply. We heard that insurers have become more selective in the risks they are prepared to cover and there is an increasing use of restrictions and exclusions which essentially have the effect of reducing choice. There is the inherent risk that niche markets will develop where, at any one time, a very limited number of insurers will write for these particular risks. As the risks become more specialised brokers too become specialists as the importance of presenting the risk properly grows.

5.61 On the evidence available to us it is not clear how much of total premium income comprises such niche markets or what the concentration levels in these markets might be. No evidence of anti-competitive practices has been presented to us. However, given that the possibility of such practices rises in a highly concentrated market, we will keep the situation under review.

Short notice periods for customers

5.62 The first time many businesses learnt about the changes taking place in the liability insurance sector was when they were required to renew their premium. Concerns were expressed by many businesses about the length of time given to renew, or the short notice given to them that the current insurer was no longer quoting for a particular risk. Our survey of SMEs revealed that renewal periods of one to two weeks were most common, but over 20 per cent of customers for EL and PL reported being given less than one week's notice. Some businesses said that notice periods were short even when they had approached insurers for renewal up to eight weeks in advance. Short notice periods, coupled with large rises in premiums, give businesses little time to plan ahead. They also give them little opportunity to shop around for insurers offering cheaper or less restrictive cover - a problem exacerbated by a hard market where insurers are being selective in the sectors they will cover.

5.63 There are exceptions to the rule. For example, one insurer indicated that it gives a three month notice period if it is not going to renew cover and will give at least a month when renewal is being offered.

5.64 **Switching** can often be a sign of a competitive market. The OFT's SME survey suggests that switching between insurers (although not brokers) has increased over the last year from 20 per cent in 2001 to 30 per cent in 2002. Nevertheless, liability insurance does not appear to be a sector where switching is commonplace and it is possible that the switching behaviour has been triggered by the recent and very sharp increases quoted on renewal or where renewal has been declined. In these circumstances the increase in switching does not necessarily indicate that competition is working well.

5.65 Anecdotal evidence suggested that there was a certain amount of caution on the part of insurers about taking on new risks. A lack of knowledge makes insurers wary of taking on new and unfamiliar business in conditions characterised by underwriting losses and there will be an understandable suspicion of adverse selection – i.e. only the bad risks will need to switch, while

good risks will be able to renew – which may cause insurers to think that new business is likely to be less profitable than existing business.

- 5.66 There appear to be relatively **low barriers to existing insurers entering into new specific markets**, although the need to understand the more specialised risks may create a degree of information asymmetry between incumbents and new entrants. New entrants would, however, be interested in entering only if there were the expectation of sustainable profits and it is not clear whether this will be the case in the long term, across liability insurance lines, particularly EL.

Conclusions on changes to the competitive environment

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

6 AREAS OF IMPROVEMENT

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

Lengthened renewal periods

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

Initiatives to improve information and risk management

- 6.3 The system of book rating has been criticised for failing to take account of a business's risk management and health and safety (H & S) practices in determining its premium. Businesses with good claims records and H & S practices are grouped together with those with poor records, and premiums do not reflect the differences between them. This failure to link premiums to H & S practices can also act as a disincentive to businesses to improve their H & S practices and maintain performance.
- 6.4 While insurers can modify the book rate to take account of factors peculiar to the client, applying a loading or discount as appropriate, the effect of such modifications does not seem to be transparent to businesses in terms of premiums. Part of the problem of book rating is that, as mentioned earlier, the cost of individually rating many small customers is likely to outweigh any reduction in premium.

- 6.5 The ABI and a number of trade associations, including the FSB and the Construction Industry Council, are working together to find **ways to reward good H & S practice** for businesses that meet the standards of trade body H & S schemes. Trade associations will need to ensure compliance with the requirements of the schemes and ensure continual and rigorous monitoring. Insurers will in turn need to ensure that the incentives are sufficient to motivate customers to improve and maintain their performance.
- 6.6 Examples of initiatives in this area include: The FSB is hoping to develop an Internet based product, with free access to a website which would provide H & S information and an online system explaining a step by step approach to managing H & S risks. It is hoped that the system will provide status reports to monitor the firms H & S compliance over a year. Insurers will then be able to differentiate between businesses in the same sector with no cost to themselves. The Association of Private Client Investment Managers and Stockbrokers (APCIMS) has developed a checklist for its members which they can use to prepare their own internal checks for areas of potential risk when considering PI cover. The checklist, which includes areas such as investment performance, financial control and record keeping has been looked at positively by APCIMS' main insurer. The National Specialist Contractors Council (NSCC) has formulated a checklist for membership of their organisation. Prospective members must pass criteria ranging from having codes of practice, complaints procedures, H & S procedures and training programmes.
- 6.7 We welcome the role of trade associations seeking to provide a better understanding of the risk on behalf of their members and for insurers. We would, however, be concerned if relationships between insurers, brokers and trade associations were to result in exclusionary behaviour which gave rise to market power. One example might be if a business finds itself having to join a trade association in order to secure cover, or affordable cover. The risk of this rises if the number of suppliers reduces and trade associations enter into agreements on behalf of their members. Customers should not be denied the opportunity to apply for cover from a particular insurer simply because they are not a member of a particular trade association.
- 6.8 It would be easier for firms to meet the requirements of insurers if brokers and clients understood exactly what insurers were looking for. For their part, insurers rely on brokers to give an accurate view of the risks. Criticisms have been aimed at both sides, with insurers said to have failed to provide clarity on the information they require and brokers, having been through a soft market for many years, having to provide more information on the risk than ever before – something, we are told, they haven't always done successfully. This prevents

businesses from demonstrating effectively that they are a good risk. Both insurers and brokers need to take steps to improve the situation for their customers.

- 6.9 The ABI is considering whether it can provide customers with '**best practice**' **advice** for liability insurance (particularly EL) in the same way that the industry has set standards for customers on issues such as protection against fire and theft. This is a positive step and would provide greater clarity in the sector.
- 6.10 Businesses should be aware that such changes will not happen overnight and they will need to be able to adequately demonstrate to insurers that they are a good risk. It will take time for good H & S practice to filter through to claims, particularly for diseases with long onsets and, in the short term at least, this will be reflected in the prices charged. Businesses must also accept that if there are to be any long term benefits, the action they take to improve H & S performance has to be seen as a long-term commitment. It is not enough to improve practices to demonstrate to an insurer at the point of renewal that they are a good risk. It has to be a continual process which will bring benefits to both insurers and their customers.

Voluntary groups

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

Initiatives to reduce legal costs

- 6.12 We understand that the DWP will be looking at whether various initiatives – for instance a scheme to structure costs in low value motor accidents – could be extended to EL. Outside the UK, the Department of Enterprise, Trade and Employment in Ireland announced its intention to set up a Personal Injuries Assessment Board (PIAB) to improve the efficiency of the insurance claims process. The emphasis is on reducing the costs of delivering compensation with a view to reducing insurance premiums.
- 6.13 It is estimated that the costs of delivering personal injury compensation within the Irish compensation system vary from 25 per cent to 40 per cent. The PIAB

is intended to provide an independent forum which will decide compensation for injured parties quickly. Its initial focus is on personal injury complaints arising from EL, but it will also assume responsibility for motor insurance claims. It is believed that the PIAB will reduce pre-court expenses such as insurance administration costs, costs of expert witnesses and costs of legal expertise.

Increasing the use of rehabilitation

- 6.14 Increasing the use of rehabilitation may help to reduce costs in the system. Rehabilitation restores an injured person to as productive and independent a lifestyle as possible through the use of medical, functional and vocational interventions. Claimants who are successfully rehabilitated are likely to be able to live more independently and have an increased chance of securing employment. This would also mean that defendants, or rather their insurers, would pay less in compensation, so both sides would benefit.
- 6.15 The ABI has indicated that over the last few years significant progress has been made in establishing procedures for the vocational rehabilitation of people injured at work or in motor accidents, and that most major insurers have such procedures. However, the ABI goes on to say that the number of people rehabilitated each year is still small – in the low thousands – and the effort has tended to be concentrated on severely injured people because theirs are the most expensive claims. A Datamonitor report⁴⁵ indicates that while 30 per cent of people who have suffered a serious injury in the US and 50 per cent in Scandinavia successfully return to work, just 10 per cent do so in the UK. The ABI suggests that the two main barriers to expanding the use of rehabilitation seem to be unfamiliarity with, and perhaps mistrust of, rehabilitation, and the lack of a national infrastructure to provide rehabilitation.

Availability of data during the study

- 6.16 For a sector so reliant on data to function effectively, we are concerned at how little statistical information has been available for this study. For example, the explanations given by insurers for recent increases in premiums have not been as detailed or rigorous as we would have expected. This may be a reflection on the apparently limited role of actuaries in underwriting decisions. Furthermore, most of the information provided by insurers, particularly the statistical data, has focused on EL rather than PL or PI. Data are particularly lacking on claims (numbers and costs) and legal costs. While a lack of information on legal costs might be attributed to the fact that reforms have only recently taken place, it is

⁴⁵ Personal Injury Litigation 2002: The Compensation Culture Myth Exploded

not clear why better information on claims and claims costs is not available. As a result it has not been possible to quantify the relative importance of each of the factors highlighted in chapter 5 in terms of the rise in costs.

- 6.17 The sector would undoubtedly benefit from collating data that allow claims to be better forecast and show the differential impact between different classes of risk. Information on PI claims was particularly lacking. Ultimately this is a matter for the industry to consider, but the benefits of improving this information seem obvious.

ANNEXES

A GLOSSARY OF TERMS

Adverse selection	The likelihood that an insurer will attract business with a higher than average risk of making a claim.
ATE (After the Event insurance)	ATE insurance policies help to cover the cost of litigation once a dispute has arisen. ATE insurance is taken out once an injury has occurred and the individual has decided to pursue a claim against a liable party. It covers the cost of incurring costs in the event of an unsuccessful claim.
BTE (Before the Event insurance)	BTE insurance is taken out before an accident. It covers a claimant's expenses, such as solicitor's fees, the other side's expenses if the case is unsuccessful and any costs relating to the case. It is often found in motor and household insurance policies.
Capacity	The volume of business which an insurer is authorised to write. Capacity limits are defined by requirements to hold reserves in a set proportion to net premium income.
Claims ratio	The ratio of claims paid or accrued by an insurer to premiums earned, usually for a one year period. A ratio of 120 per cent means that claims exceeded premium income by 20 per cent.

Excess/deductible	An excess is defined as the amount of any loss that is not included in the cover provided (e.g. a loss falling below the excess is not a claim). A deductible on the other hand eats into the cover. This difference only really matters where there is an upper limit on the amount of cover such as reinstatements or an annual aggregate.
Expense ratio	The ratio of expenses to premium income.
Gross written premium	Premiums written in the year before deducting premiums ceded for re-insurance.
Gross earned premium	Gross premiums apportioned to the year in which the cover applies.
Hard phase	A hard phase in an insurance cycle is characterised by a shortage of capacity and steep increases in premiums. This leads to restrictions on the type of businesses covered or the amount of coverage that insurers are willing to provide.
Industrial Injuries Disablement Benefit (IIDB)	A state benefit scheme which covers disablement as a result of an accident at work or a number of work-related diseases. IIDB provides a safety net for employees suffering accident, injury or disease at work who choose not to pursue a claim and for cases where liability cannot be established (the employer may not longer be in business). The amount payable depends on how serious the disability is.
Loss ratio	The ratio of the losses to premiums usually expressed as a percentage.
Micro firm	A business with fewer than 10 employees.

Moral hazard	This is the risk that by giving insurance cover the insurer will bring about a change in behaviour which makes the undesirable event more likely to happen. The insured person might become less careful or even cause losses deliberately in order to get insurance money.
Net earned (written) premium	Premium retained by the insurer after re-insurance has been ceded.
SME	Small- and medium-sized enterprises were defined, for our survey, as businesses with between 10 and 249 employees.
Soft phase	A soft phase in an insurance cycle is characterised by an excess of capacity. This means premiums are low and increases are small. Increased competition leads to improved policies.
Underwriting	Setting one's name to an insurance policy for the purpose of becoming answerable for a designated loss or damage on consideration of receiving a premium per cent.

B MARKET SHARE TABLES

TABLE B.1

Table 84: Public & general liability market share by competitor, 1997- 2001		1997	1998	1999	2000	2001
1	Royal & SunAlliance	10.7%	11.9%	12.0%	13.4%	9.5%
2	New Hampshire	12.7%	11.8%	12.0%	12.9%	7.5%
3	Norwich Union	17.1%	15.8%	13.1%	10.6%	7.4%
4	Zurich FS	6.1%	5.0%	4.3%	5.2%	6.4%
5	St Paul	1.7%	1.7%	2.2%	3.4%	5.2%
6	AXA	7.2%	6.3%	6.5%	6.5%	4.8%
7	Underwriter	na	na	0.0%	1.0%	2.4%
8	XL Winterthur	1.9%	2.3%	2.1%	2.1%	2.2%
9	Allianz Cornhill	2.5%	2.3%	2.9%	2.3%	2.1%
10	NFU & Avon	1.8%	1.8%	1.8%	2.1%	1.6%
11	Groupama GAN	1.6%	1.5%	1.3%	1.6%	1.1%
12	NIG	0.6%	0.6%	1.0%	1.1%	1.1%
13	MMA	0.3%	0.3%	0.4%	0.7%	0.8%
14	Astrazeneca	0.8%	1.0%	1.0%	0.9%	0.7%
15	ICI	1.4%	1.2%	1.0%	0.9%	0.6%
16	Berks Hathaway	0.5%	0.5%	0.5%	0.7%	0.4%
17	Ecclesiastical	0.4%	0.4%	0.4%	0.5%	0.4%
18	CIS	0.7%	0.5%	0.4%	0.4%	0.3%
19	Tokio M&F	na	na	na	0.1%	0.2%
20	Electric Contr	0.2%	0.2%	0.2%	0.2%	0.2%
21	Aioi	0.0%	0.0%	0.1%	0.1%	0.2%
22	Fortis	0.2%	0.1%	0.1%	0.1%	0.1%
23	Iron Trades	1.0%	0.9%	0.8%	0.6%	0.1%
24	Sterling	0.1%	0.1%	0.1%	0.1%	0.1%
25	Stewart Title	0.0%	0.0%	0.1%	0.1%	0.1%
26	Yasuda Kasai	0.0%	0.0%	0.0%	0.0%	0.1%
27	CNA	0.0%	0.0%	0.0%	0.1%	0.1%
28	Harworth	0.1%	0.1%	0.1%	0.1%	0.1%
29	Gulf	0.0%	0.0%	0.0%	0.1%	0.1%
30	Ansvar	0.0%	0.1%	0.1%	0.1%	0.1%
31	Pearl	0.1%	0.1%	0.1%	0.2%	0.1%
	Total of above	70.1%	66.8%	64.4%	68.0%	55.8%
	Other	29.9%	33.2%	35.6%	32.0%	44.2%
	Total market	100.0%	100.0%	100.0%	100.0%	100.0%
	Note: Churchill Group					
	NIG	0.6%	0.6%	1.0%	1.1%	1.1%
	Pearl	0.1%	0.1%	0.1%	0.2%	0.1%
	Total	0.8%	0.7%	1.1%	1.2%	1.1%
	Source: Datamonitor analysis of SynThesys Non-Life database					
					DATAMONITOR	

Source: Datamonitor report 'UK Commercial General Insurance 2003'.

TABLE B.2

Table 81: Employers' liability market share by competitor, 1997- 2001						
		1997	1998	1999	2000	2001
1	Zurich FS	15.4%	16.3%	14.6%	15.6%	15.7%
2	Royal & SunAlliance	9.0%	10.6%	10.7%	10.7%	11.4%
3	Norwich Union	13.7%	16.1%	15.6%	13.7%	8.6%
4	AXA	8.1%	9.2%	7.5%	6.5%	4.8%
5	NFU & Avon	1.8%	2.0%	2.3%	3.0%	3.0%
6	St Paul	1.5%	1.5%	1.8%	2.5%	2.6%
7	Allianz Cornhill	2.2%	2.5%	2.3%	2.6%	2.5%
8	Iron Trades	5.6%	5.2%	6.3%	7.1%	2.0%
9	XL Winterthur	0.9%	1.7%	2.1%	2.3%	2.0%
10	Ecclesiastical	0.7%	0.8%	0.9%	1.3%	1.2%
11	Harworth	0.6%	0.8%	0.9%	0.8%	0.6%
12	CNA	0.0%	0.0%	0.0%	0.7%	0.4%
13	CIS	0.5%	0.4%	0.3%	0.3%	0.3%
14	Yasuda Kasai	0.0%	0.1%	0.1%	0.1%	0.2%
15	Pearl	0.1%	0.1%	0.1%	0.1%	0.2%
16	Folgate	na	na	na	0.0%	0.1%
17	Fortis	0.1%	0.2%	0.2%	0.0%	0.1%
18	Groupama GAN	0.5%	0.7%	0.7%	0.6%	0.1%
19	Congri&General	0.0%	0.0%	0.0%	0.1%	0.1%
	Total of above	60.6%	68.2%	66.3%	68.1%	55.9%
	Other	39.4%	31.8%	33.7%	31.9%	44.1%
	Total market	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Datamonitor analysis of SynThesys Non-Life database DATAMONITOR

Source: Datamonitor report 'UK Commercial General Insurance 2003'.

TABLE B.3

Table 35: UK professional indemnity market share, 1997-2001						
% of premium income	1997	1998	1999	2000	2001	% change 2000-1
St Paul	1.2%	1.2%	2.2%	4.3%	11.5%	7.1%
R & SA	na	6.7%	7.6%	5.9%	8.9%	3.0%
New Hampshire	8.3%	7.5%	11.4%	12.3%	8.6%	-3.7%
Zurich FS	na	na	na	na	6.7%	6.7%
Norwich Union	12.5%	10.2%	7.3%	4.6%	5.5%	0.9%
MMA	0.2%	0.3%	0.5%	1.0%	1.9%	1.0%
Other	2.0%	3.5%	6.4%	0.2%	0.1%	-0.1%
Total of above	24.2%	29.4%	35.3%	28.3%	43.2%	14.9%
<i>Estimated total of Chubb and ACE</i>	15.1%	13.8%	14.8%	15.6%	15.8%	0.2%
Total company estimate	39.3%	43.1%	50.1%	43.9%	59.0%	15.2%
Lloyd's total	60.7%	56.9%	49.9%	56.1%	41.0%	-15.2%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	
Source: Datamonitor analysis of SynThesys Non-Life database, Xchanging Ins- sure Services, industry interviews						
						DATAMONITOR

Source: Datamonitor report 'UK Commercial Liability Insurance 2003'.

C A SNAPSHOT OF THE REGULATORY CONTEXT

FSA authorisation

- C.1 Under the Financial Services and Markets Act 2000 (FSMA) firms wishing to carry on insurance (or any other regulated activities for that matter) must be authorised by the FSA. Authorisation is granted only for the specified classes for which the applicant has applied. The classes of risk (i.e. types of insurance cover) have been defined in an EU Directive and are reflected in the UK legislation. The applicant for authorisation must satisfy a number of conditions, including 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 positions concerned). The applicant must also submit a business plan showing, amongst other things, that it has adequate financial resources to support the customer to which the authorisation relates. The FSA must ensure that the firm has adequate resources in relation to the specific regulated activity/ies which it seeks to carry on, or carries on. The applicant must also submit a business plan showing, amongst other things, that it has financial resources that are commensurate to the risks it will face and adequate to meet customer liabilities in the event of realistic adverse scenarios.
- C.2 In this context, adequacy of resources is not just about financial resources. The term 'resources' includes all financial resources, but also non-financial resources, the firm's means of managing its resources, capital, provisions against liabilities, holdings of or access to cash and other assets, and the existence within the firm of effective means by which to manage risks.
- C.3 When assessing whether a firm satisfies and will continue to satisfy threshold condition 4 (i.e. a threshold condition required for authorisation), therefore, the FSA takes into account, among other things, of the following:
- whether there are any indications that the firm may have difficulties, at the time when the application is granted or in future, in complying with any of the FSA's prudential rules
 - whether there are any implications for the adequacy of the firm's resources arising from the firm's history and/or proposed business plan

- whether there are any indications that the firm may not be able to meet its debts as they fall due
- whether the firm has put in place appropriate systems and controls, so that it is able to identify, measure and manage the likely risks that may arise from the activities it carries on
- whether the firm has satisfied itself that in the financial services area where it intends to conduct business, or where it carries on business: i) it has access to adequate capital to support the business, including losses which may be expected, in particular during the start-up period; ii) client money, deposits, custody assets and policyholders will not be placed at risk should the business fail.

C.4 In order to enable the FSA to make such an assessment, a firm is required to provide the regulator with:

- a well constructed business or strategy plan and, in the case of insurers, a detailed scheme of operations, showing, inter alia, the firm's assets and liabilities, its exposures to reinsurance and relevant risks, how the firm intends to ensure that it has enough financial resources to continue to meet customer liabilities in the event of realistic adverse scenarios, and the systems and controls in place to identify and manage risks
- appropriately analysed financial budget and projections which demonstrate that the firm expects to comply with the relevant financial resources requirement appropriate to its prudential category and that all financial and other resources of the firm are commensurate to the risks it will face.

Financial resources

C.5 As stated above, a firm is required to demonstrate that it has adequate financial resources to meet the financial resources requirements for its specific prudential category. In other words, a firm must maintain minimum levels of capital. These are determined by the FSA on the basis of the prudential category of the firm, international requirements and the particular risks underlying the business conducted by the firm in question. For insurers, this requirement means that the firm's solvency margin should not be less than that required by regulation.

- C.6 The solvency margin is the minimum amount of extra capital that an insurance provider must have to fall back on in unforeseen circumstances, for example higher than expected claims or unfavourable investment results. It is therefore a very important aspect of the financial position of an insurance company, not only from a prudential perspective, but also on consumer protection grounds. Increased solvency margins afford policyholders better protection against unexpected events.
- C.7 The current required margin of solvency for non-life insurers is the same for all the non-life classes of insurance, i.e. the required margin is the same for non-life insurers covering liability risks as it is for other classes of insurance although the risk underlying the different classes may vary significantly.
- C.8 The solvency margin requirement is expressed as the higher of two results:
- 16 per cent of the annual premiums written by the insurance undertaking, or
 - 23 per cent of the average annual claims costs incurred by the insurance undertaking,
- less (in each case) an allowance for reinsurance recoveries.
- C.9 The above represents the requirement originally laid down by EU First Non-Life Insurance Directive 73/239/EEC. Our understanding is that, in practice, the FSA will normally require a margin to be established which is well above the Directive requirement. The level will depend on the extent of the risks which the insurer is covering. In the case of the liability risks we are concerned with in this report, the FSA would tend to require a higher margin than for some other classes because of the unpredictability and long-tail nature of the risks in question.
- C.10 It should be noted that the existing rules for the calculation of the solvency margin requirement for insurance undertakings as set out in the European Directive have recently been revised.⁴⁶ As a result, the requirements for certain categories of non-life business with a particularly volatile risk profile, such as

⁴⁶ See Directive 2002/13/EC concerning the calculation of solvency margins for non-life insurance companies. This was adopted on 14 February 2002 as part of the current EU review of solvency margin requirements for both life and non-life insurance companies. The adoption of this Directive (and of another Directive concerning the solvency margin requirements of life insurance companies) marked the conclusion of the first stage of this review, known as 'Solvency 1'.

marine, aviation, and general liability are being increased by 50 per cent.⁴⁷ These requirements are to be transposed into national law by September 2003. While there are transitional provisions under which Member States can allow insurers more time to comply with the new requirements, we understand from the FSA that it is unlikely that it will allow such a transitional period, since, for the classes of insurance in question, UK insurers are already expected to have significantly higher solvency margins than those that will be required as a result of the recent EU review.

- C.11 It is important to note that it is likely that further changes to these solvency requirements will be made. Discussions and consultation on the nature and scale of such changes are already taking place both in the UK and at EU level, in the context of the so-called 'Solvency II project'.⁴⁸ Essentially, the main thrust of these reviews is to design a regime under which solvency requirements are better matched to the true risks encountered by an insurance company.
- C.12 The rationale for this is that, as shown earlier, under the existing EU and UK rules, the solvency margin has typically been calculated by reference to premium, not risk measures. This has had two major implications. Firstly, the current system provides no basis on which either firms or regulators can distinguish actual capital relative to the capital required by the risks that the insurer is facing. Secondly, there appears to be little or no incentive for non-life insurers to exercise good risk management.
- C.13 Furthermore, the current system has the counter-intuitive effect that a decline in premium income will generate a lower solvency requirement, just when the profitability of an insurer may be under strain. Importantly, this also affects the capacity of insurers to accept business at a time of hardening rates. Conventionally, in the UK, the solvency margin required is one third of written premiums. Therefore, insurers need use £1 of capital to support £3 of premium. It follows that insurers are able to write less business (unless they receive more

⁴⁷ Article 16a, (3) and (4), Directive 2002/13/EC.

⁴⁸ Solvency II follows on from the first stage of the EU review of solvency margins which was completed by the adoption of Directive 2002/13/EC. This is a wider ranging exercise that will consider the overall financial position of an insurance firm, hence the rules governing the assets and liabilities of insurance undertakings; the matching of assets to liabilities; reinsurance arrangements; and the implications of accounting and actuarial policies. In view of the wide scope of the project and the complexity of the issue, Solvency 2 is not likely to be implemented before 2007 at the earliest. However, the European Commission is expected to publish a paper setting out proposals on the direction that this work should take in the near future.

capital) when premiums (and hence likely profitability) are highest but more business when rates are lowest.

Lloyd's

- C.14 At this stage, it should be noted that while the FSA imposes a solvency requirement on Lloyd's equivalent to the FSA's requirement for general insurance companies, and Lloyd's is largely subject to the same prudential rules as commercial general insurers, the Society of Lloyd's has its own internal process for setting capital requirements for its members. In setting these, the Society uses a risk-based model which expresses capital requirements in relation to the level of premium that a member plans to write in a certain year. The implication of this is that in a given year each member will be able to underwrite only the amount of business, i.e. the volume of premiums, for which it received approval when its capital requirements were set. So, should this capacity be absorbed early on in that year, that member will not be able to underwrite any more business the year after.
- C.15 On this point, it may be worth adding that under current rules, there are no restrictions on equity investment. There are, however, admissibility limits for certain assets. For unlisted equities issued by an issuer and its connected companies exposures are limited to one per cent of the general business amount. For listed equities, there is a limit of 2.5per cent of the general business amount in respect of the issuer and its connected companies.

Technical provisions

- C.16 In addition to complying with the required solvency margins, insurers are required by regulation to set up technical provisions to cover their liabilities to policyholders.
- C.17 For general insurance business, the technical provisions include the following:
- outstanding claims provisions
 - unearned premiums provisions
 - unexpired risk provisions, and, where applicable,
 - equalisation provisions.

These, however, do not apply to liability insurance.

- C.18 The key purpose of these provisions is to ensure that a firm retains assets of a value sufficient to meet expected liabilities, i.e. at least the expected ultimate cost of claims and related expenses. They also help protect against risk from inherent uncertainty in the timing, but not necessarily the amount, of policyholder claims.
- C.19 It is required that the amount of technical provisions is at all times sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen.
- C.20 As regards the determination of the amount of liabilities of an insurer, this must be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurers.⁴⁹
- C.21 It should be noted that while there are no regulatory limits on the amount of provisions that can be established, there are tax implications for over-reserving. The Inland Revenue 'penalises' firms which have set provisions that have proved with hindsight to be more than required, by demanding interest on the tax that has been deferred. For this purpose, provisions must be discounted and there are rules governing the rate of discount.

Matching of assets and liabilities

- C.22 An insurance firm is required to identify the assets available to meet its liabilities. Where, however, a firm carries on both long-term insurance business and general insurance business, the assets in respect of each business should be separately identified.
- C.23 More specifically, a firm must ensure that the assets identified are sufficient in amount, and of appropriate nature, term, safety and yields to ensure that their value is at least equal to the amount of its liabilities; and that this would continue to be the case even after making a prudent allowance for possible future fluctuations in asset values. To this end, a firm should identify the extent

⁴⁹ Paragraphs 5.2 onwards of the FSA Interim Prudential Sourcebook for Insurers ('IPRU (INS)). See also the insurance accounts rules that are set out in Schedule 9A to the Companies Act 1985, and the Statement of Recommended Practice ('SORP') on Accounting for Insurance

to which it is exposed to: volatility in equity markets and, within these markets, particular sectors (e.g. telecoms, energy, etc.); markets in other types of securities; real estate markets; and markets in other types of asset.

- C.24 In addition, under the new regulatory regime being developed by the FSA, senior management (of all financial services firms) will be held responsible for assessing properly their own firms' resource requirements and for addressing their risk management and systems and controls weaknesses.
- C.25 In parallel with the above, the FSA (as well as other European financial services regulators) is working at strengthening its supervision tools and procedures. The new supervisory review process will not only consist of a number of quantitative ratios and indicators, but will also cover qualitative aspects that influence the risk-standing of an undertaking (management, competitive situation, systems and controls, etc). To this end, greater focus is being placed on developing early warning indicators and reference scenarios for stress tests, as well as on documentation of risk management processes. The supervisory review process will also include an analysis of an insurance undertaking's longer-term development, with a view to assessing its financial position on an ongoing basis.
- C.26 These changes should encourage insurers to take risk management more seriously and to adopt a longer-term view of profit-making. This, in turn, should contribute to reducing the risk that insurers may be caught unprepared by weak market conditions or other unexpected events that may significantly destabilise their financial position. Also, it should help minimise the risk that policyholder expectations or liabilities are not adequately taken into account by an insurer when determining its business and investment strategy.
- C.27 But these changes will come at a cost. Insurers are likely to require more capital to support the higher risk lines of their business, which includes liability insurance, and face increased regulatory costs. As a result, premiums are likely to rise and insurers' underwriting practices are likely to be stricter than in the past, so much so that certain risks may be considered 'uninsurable' or insurable only at a high price unless it can be demonstrated that serious and constant work is being done in order to mitigate and/or control such a risk. This latter point is reflected throughout the findings of this report.

Business issued in 1998 by ABI. This provides important guidance as to how UK generally accepted accounting practice (UK GAAP) should be applied to insurance business.

D PROFESSIONAL INDEMNITY INSURANCE AND INDEPENDENT FINANCIAL ADVISERS

- D.1 Under existing financial services regulation, PI is compulsory for Independent Financial Advisers (IFAs). The FSA regulates over 4,000 IFAs.⁵⁰ If an IFA does not have compliant PI cover, it breaches FSA's prudential rules and one of the threshold conditions for authorisation, namely threshold condition 4, which requires a firm to have adequate resources.
- D.2 Without adequate resources, a firm may not be able to meet claims that are made against it. As a result, it could ultimately face insolvency. The PI requirement represents, therefore, an important element of investor protection and also a prudential measure to mitigate the risks that a firm may face as a result of advising on investments.
- D.3 The FSA's rules on PI are set out in Chapter 13 of the Interim Prudential Sourcebook for Investment Businesses ('IPRU (INV)'). Under these rules, a personal investment firm, i.e. IFA, is required 'to effect and maintain at all times adequate professional indemnity insurance cover for all the business activities which it carries on, or for which it is responsible.' The rules also specify how firms may affect and maintain adequate cover and what requirements should be incorporated within that cover.
- D.4 As a result of the implementation of the Insurance Mediation Directive ('IMD')⁵¹ in the UK, the FSA is proposing to extend the requirement to hold PI to insurance and mortgage intermediaries. While some of these are already subject to such a requirement by their self-regulatory body (i.e. GISC), the FSA indicates that there may still be a large number of intermediaries who would need to secure cover for the first time.

⁵⁰ FSA press release, 'FSA acts on professional indemnity insurance concerns', FSA/PN/106/2002, 29 October 2002.

⁵¹ The Insurance Mediation Directive sets European standards for the regulation of insurance intermediaries. It addresses issues such as: registration of insurance intermediaries, professional requirements, availability of redress, disclosure of information to the customer, claims handling, etc.

E SUMMARY OF BUSINESS SURVEY

- E.1 A questionnaire was issued to SMEs from a variety of business sectors: manufacturing, construction, health and wholesale. This questionnaire was also distributed via a number of trade associations, including AIFA, and was made available on our website. Contributions were received from 475 independent businesses and we wish to thank all those businesses who co-operated in this exercise.
- E.2 Nearly three-quarters of respondents reported a change in their liability premium in 2002. The rise in premiums was greatest for those buying employers liability, public liability and their insurance in package form. For these types of insurance, around 40 per cent of respondents observed increases of 20 per cent or more.
- E.3 Around 10 per cent of respondents with each type of insurance were denied renewal of cover by their insurer in 2002, while similar proportions were denied cover by other insurers. This is approximately twice the rate for 2001.
- E.4 Thirty per cent of respondents tried to move brokers in 2002, compared with about 15 per cent in 2001. Of those who tried to move brokers, over half found it difficult or very difficult to move. Many firms commented on the small (and diminishing) number of businesses willing to deal with their types of business.

Respondents

- E.5 Over half of businesses in this survey are micro firms employing less than 10 people. Only 5 per cent of firms (i.e. only 20 respondents) have 250 or more employees. The survey was not aimed at large firms and the small number of responses from this group means that their results are subject to a wide margin of error.
- E.6 Around a quarter of respondents were manufacturing sector and 29 per cent were construction firms. Most of the companies who responded are well established - over 60 per cent have been operating for 20 years or more.

Purchasing

- E.7 Nearly all respondents said they had EL and PL. Twenty-two per cent had PI and 40 per cent had PR. There was considerable variation between sectors: 91 per cent of health businesses had PI with few doing so in any of the other sectors.

Around two thirds of manufacturing firms and wholesalers had PR. The proportion was below 25 per cent in the other sectors surveyed. Eighty-five per cent of respondents purchased both EL and PL. Eight per cent of businesses purchased all four types of cover.

- E.8 Just under half of respondents have changed insurers once or twice in the last five years. The average number of changes is 1.1. Large firms seem to change insurers more frequently than smaller ones: the average number of insurers for micro firms, SMEs and large firms is 0.9, 1.3 and 1.5 respectively. The manufacturing sector saw the greatest turnover in insurers.
- E.9 Around 70 per cent of respondents buy their liability in a package. Small firms are more likely to buy their insurance in this way (77 per cent of respondents) than SMEs (62 per cent) and large firms (20 per cent). Seventy per cent of respondents were quoted the overall price when buying insurance as part of a package rather than the price of individual components and over 90 per cent of businesses buy insurance through a broker.
- E.10 Around 12 per cent of respondents had difficulty in obtaining liability cover during the last two years. There was little variation between the different types of cover being purchased. Roughly half of all firms received advice on how to reduce premiums from their brokers while 15 per cent did so from their insurers. This indicates the lack of direct contact that many business have with their insurers. SMEs were more likely to receive advice from both brokers and insurers than micro firms.
- E.11 Around 30 per cent of respondents tried to move brokers in 2002, compared with about 15 per cent in 2001. The large variation between the two years is almost entirely due to micro firms: 25 per cent tried to move broker in 2002 while only eight per cent did in 2001. Of those who tried to move brokers, over half found it difficult or very difficult to move. SMEs (58 per cent) found it more difficult to move than micro businesses (49 per cent). Of those who commented on why it was difficult to move, the vast majority could not easily find affordable quotes or, in some cases, anyone to quote at all. Many firms commented on the small number of insurers willing to deal with their types of business.
- E.12 In the instances where respondents gave two sets of quotes and cover, there was substantial variation in the quotes given for the same level of cover. The differences between the smallest and biggest ranged from four per cent to 325

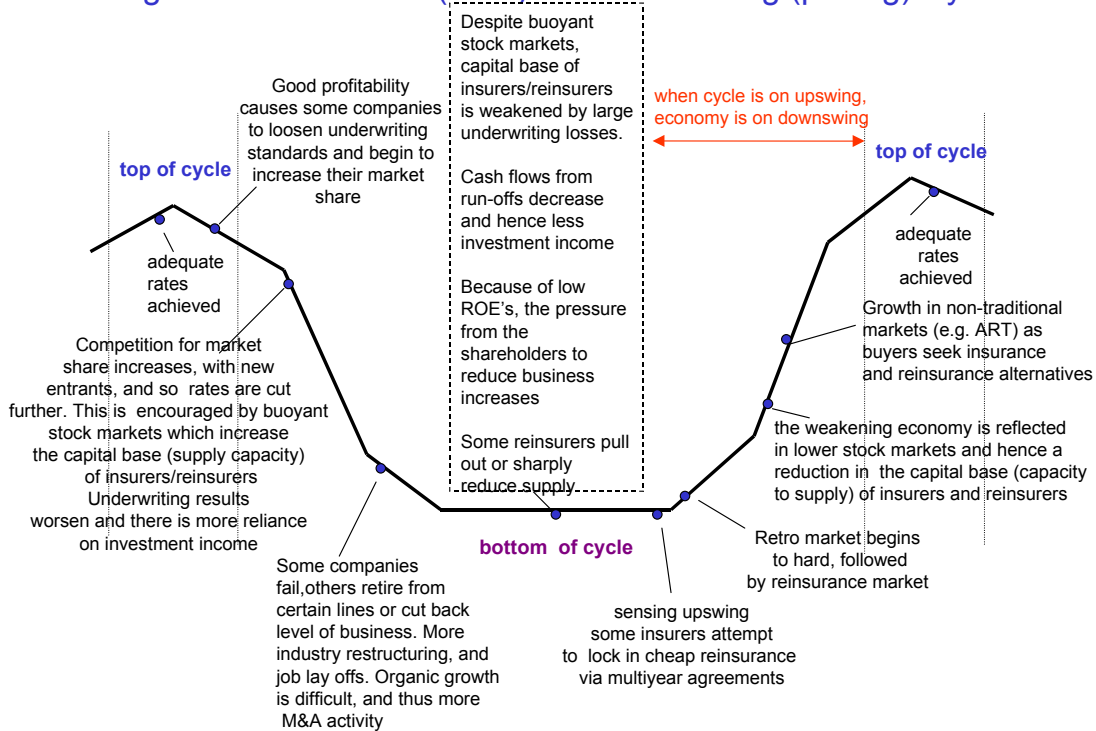
per cent increases. About nine per cent of respondents with each type of insurance were denied renewal of cover by their insurer in 2002. This is over twice the rate for 2001. Around 10 per cent were denied cover by other insurers, again approximately twice as many as in 2001.

- E.13 Twelve per cent of respondents experienced a reduction in the level of cover in 2002 (five per cent in 2001). About 25 per cent of businesses saw an increase in their excess (12 per cent in 2001). Of those who were denied cover, around a half were given reasons why. Fifty-two companies commented on the reasons with 19 reporting that their insurer was withdrawing from their market.
- E.14 Seventy-two per cent of respondents said their premiums changed in 2002. SMEs seem to have fared worse: the premiums changed for 79 per cent of these businesses but only 65 per cent of micro firms. The increase in premiums was greatest for those buying EL, PL and their insurance in package form. For these types of insurance, around 40 per cent of respondents observed increases of 20 per cent or more. For PI and PR, the increases in premiums were much smaller (with 20 per cent recording increases of 20 per cent or more).
- E.15 The terms of payment changed for 10 per cent of respondents. The most quoted change was a move from monthly terms to one annual payment. However, there were also a few instances of the reverse being true.
- E.16 On average, seven per cent of turnover is accounted for by the total liability insurance premium (although nine of the 250 businesses responding gave a figure of 100 per cent). Premiums account for a greater proportion of SMEs' turnover (nine per cent) than micro firms (five per cent).

F THE INSURANCE CYCLE

TABLE F.1

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



Source: Swiss Re (Canada), with additions by Gerry Dickinson