

The UK liability insurance market

**A follow-up to the OFT's 2003
market study**

June 2005

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CONTENTS

<i>Chapter</i>		<i>Page</i>
1	Outline of key findings	1
2	Introduction and background	6
3	Price developments	11
4	Initiatives to make insurance markets work better	25
5	After the event insurance	33
<i>Annexe</i>		
A	Glossary of terms	44

1 OUTLINE OF KEY FINDINGS

- 1.1 We first looked at the liability insurance markets¹ in 2003 against a background of concerns about substantial increases in premiums. The report of that study² concluded that the markets could work better and highlighted a number of measures which could be taken to improve matters. We said we would keep the markets under review. This follow-up study was announced on 3 December 2004. It looks at price developments, whether any businesses are finding it difficult to find cover, current costs and the impact of initiatives. It also includes a brief review of the after the event insurance (ATE) market.³

Are the liability insurance markets now working better?

Price developments

- 1.2 For our 2003 report, members of the Association of British Insurers (ABI) estimated that average rises in premiums in 2002 were about 50 per cent for employer's liability (EL), 30-40 per cent for public liability (PL) and 30-60 per cent for professional indemnity (PI) insurance. Comparable figures for 2004 were average premium rises of seven per cent for EL, and four per cent for PL and PI. These rises were still ahead of general inflation and do not take account of any changes in excesses or in the level of cover provided.
- 1.3 Stakeholders told us, and our survey confirmed, that in 2004 significantly fewer businesses were being denied renewal of cover by their insurer or denied cover by other insurers than in 2002; in the case of EL, the number of businesses denied cover fell by two thirds to just three per cent. Those sectors which were identified in our 2003 report

¹ Employer's liability, public and product liability and professional indemnity.

² Available at www.offt.gov.uk/Business/Market+studies/insurance.htm

³ After the event insurance is taken out once an injury has occurred and the individual has decided to pursue a claim against the liable party. Insurance cover can be purchased to cover the other party's or both parties' legal costs and disbursements.

as experiencing significant problems in getting cover, in terms of both availability and price, showed signs of improvements this time round. In addition, businesses more generally seem to have been more prepared in terms of budgeting for premiums in their own business plans.

Cost pressures

- 1.4 In our 2003 report we identified a number of upward pressures on the total cost of claims in recent years. Similar pressures are likely to persist. Over the long term, the cost of claims is likely to continue rising given, for example, the future cost pressures which we highlight below, suggesting that overall premiums will continue to fluctuate around a rising trend.
- 1.5 There have been no particular loss shocks since our previous study. Across all liability lines, profitability, defined in terms of the underwriting ratios,⁴ has improved from 105.8 per cent in 2001 to 88.2 per cent in 2003.
- 1.6 The legal costs pressures which we identified in our 2003 report, namely the cost of conditional fee arrangements⁵ (CFAs) and ATE, still exist, but more predictability seems to have been introduced. For example, fixed recoverable success fees⁶ for road traffic accidents (RTA) and EL accident claims were introduced in 2004. Capacity across the liability sector has expanded and insurers we spoke to claimed to have tightened their business models and cut unnecessary costs. However, possible future cost pressures include costs arising from the introduction of the new Individual Capital Adequacy Standards Framework which will result in higher capital loadings for liability insurers, the extension of the NHS Injury Costs Recovery Scheme to personal injury compensation cases,

⁴ The underwriting ratio compares costs (claims plus expenses) to premiums. Thus a ratio of under 100 indicates that premiums exceed costs (an underwriting profit) and over 100 indicates an underwriting loss.

⁵ 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 their solicitor's fees would not be payable by them.

⁶ A success fee can be charged by a solicitor under a CFA, uplifting their normal level of fees if they win to compensate them for those cases that they take on and lose and for which they receive no fee under the CFA.

and moves away from structured settlements to periodical payments (Courts Act 2003). Insurers were not able to point to any precise impacts at this stage.

Improved communication

1.7 It was encouraging to see that two-way communication has improved across the sector. The last year has seen a lot of work, often through working parties either led or attended by various government departments, aimed at finding ways to ease problems in the markets and make them work better. The initiatives which we identified in our 2003 report have now been in operation for over a year and seem to be providing benefits for all concerned. This included 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, eg: taking better account of good health and safety (H & S) practice.

Conclusion on liability insurance

1.8 There have been significant changes within these markets over the last year aimed at making them work better for all parties. Overall rises in liability premiums have been lower than in previous years, albeit still above general inflation. Variations around the average figures also appear to be lower than in previous years.

1.9 For many businesses the sharp increases in liability premiums experienced in recent years came as a considerable shock to their business plans and cash flow. These higher premiums have now been factored into budgets and, although a reduction to pre-2002 levels would be welcome to businesses, we found a general acceptance that this was unlikely to happen.

- 1.10 Lower premium increases in 2004 should not give rise to complacency. Much work is in hand, including the work of government departments and initiatives from the industry and, going forward, it is important that all sides remain committed to working together to take forward initiatives which have the aim of improving the way the markets work. It has to be recognised that these initiatives may not lead to short-term gains, but a continuing commitment to them should reap long term benefits.
- 1.11 Given the improvements to the markets there is no case for OFT to commit to undertaking a further review of this kind in the short to medium term. As in other sectors, we will continue to investigate and enforce relevant competition law as appropriate.

After the event insurance

- 1.12 During the course of our 2003 study liability insurers expressed concern about the impact of legal costs on liability premiums, particularly for EL. CFAs and ATE received particular mention. The evidence on legal costs at that time was inconclusive and in the light of the considerable amount of work already underway on CFAs, largely by the Department for Constitutional Affairs (DCA), we decided to confine our follow-up work to the ATE market. It became clear as our work progressed that ATE needs to be seen in the context of wider legal issues relevant to the cost of and access to justice, in particular its role in facilitating CFAs. We also learned that the Civil Justice Council (CJC) is proposing to carry out work on the issue later this year, which we did not wish to duplicate. We therefore have not explored the subject in great depth, although we have done sufficient work to form a picture of how the market operates.
- 1.13 We had hoped to be able to establish the validity of assertions that ATE premiums were contributing to the rise of liability premiums, both by increasing cost per claim and by increasing the number of claims. This has proved difficult. We have not been given access to disaggregated data to show the importance of ATE-related (or other) costs within

liability insurers' cost base.⁷ As to the numbers of claims brought, the contrary view has been put that the limited availability of ATE has constrained solicitors from taking forward cases which do not have a high chance of success as it would be difficult (or expensive) to get ATE cover for such cases. Overall it is not clear to what extent ATE is adding to either the numbers of claims brought, or to the cost of claims, compared to any alternative means of funding personal injury claims.

- 1.14 Not all personal injury claims are covered by ATE insurance. There are a number of inherent features of the ATE market which may pose problems. Those cases with either a very high or a very low probability of success are often not insured (the precise extent has proved difficult to quantify) which means that those which are insured may represent a narrow range of risk. ATE policies are normally purchased on the injury claimant's behalf by a Claims Management Company (CMC) or solicitor, with little or no shopping around. For that reason it is not clear that there is adequate downward pressure on premiums, other than from challenges by defendant liability insurers when costs are awarded against them.⁸ There are few insurers in this market and significant new entry by UK regulated insurers seems unlikely. For the consumer there are issues over transparency of ATE premiums which have to be seen in the wider context of an already complex transaction involving CFAs.
- 1.15 While the ATE market has some imperfections, ATE is essential for CFA arrangements to function. The CJC, in conjunction with the DCA, is intending to carry out work later this year to pinpoint the crucial issues with ATE and possible solutions. OFT will feed into that work.

⁷ Under the Access to Justice Act 1999 it has been possible to recover the cost of the ATE premium from the losing side since 2000.

⁸ ATE premiums, like other elements in the claimant's costs, can be challenged by the defendants.

2 INTRODUCTION AND BACKGROUND

What is liability insurance?

2.1 **Employer's liability** insurance is designed to cover the liability that might lie with an employer if an employee is injured in the course of employment. **Public liability** insurance covers businesses against claims by members of the public (ie: not employees) who suffer bodily injury or damage to their property through the negligent conduct of business activities. (**Product liability** insurance covers manufacturers and suppliers against claims by customers arising in connection with dangerous or defective goods. For the purposes of this report we have included product liability insurance alongside public liability). **Professional indemnity** insurance covers professional firms and individuals against claims for breach of their professional duty.

OFT's 2003 report

2.2 We published our first report into liability insurance on 3 June 2003. This was undertaken against the background of concerns about increases in premiums for liability insurance and found that premiums had indeed risen substantially in 2002:

- 50 per cent for EL
- 30 to 40 per cent for PL (also includes product liability insurance)
- 30 to 60 per cent for PI.

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

2.4 These increases followed several years of falling premiums. Between 1995 and 2000 liability premiums overall fell relative to prices by about 20 per cent (33 per cent for EL). In addition, liability insurers as a group had been making underwriting losses (ie: losses before investment revenues are included) for the last decade with underwriting ratios of 120 per cent.

Effect of premium increases on businesses

- 2.5 Our 2003 report did not find evidence that increases in premiums had led to businesses being unable to secure liability insurance at any price, and were consequently trading illegally or closing down.
- 2.6 Nevertheless, we recognised that certain types of business had suffered particular adverse effects as a result of premium increases. These included Independent Financial Advisers (IFAs) (who are required by Financial Services Authority (FSA) rules to have PI cover); Small and Medium-sized Enterprises (SMEs)⁹ (for whom increases in premiums are likely to have a proportionately more significant effect than larger businesses); businesses in 'high risk' sectors; businesses in Northern Ireland; and the voluntary sector.

Reasons for increases in premiums

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

Changes to costs incurred

- 2.8 The following possible sources of cost increases were suggested:
- expansion of liability – including new and uncertain types of liability, in particular 'long-tail'¹⁰ EL claims
 - loss shocks, such as those arising from the World Trade Centre and claims relating to asbestos
 - increases arising from changes in the legal system such as the introduction of CFAs and ATE, higher damages for individual claims and the Woolf reforms

⁹ For the purposes of the study, an SME was defined as a firm with between 10 and 249 employees.

¹⁰ The term 'long-tail claims' relates predominantly, but not exclusively, to occupational diseases. Such claims are characterised by long latency periods.

- lower investment returns, which reduced insurers' investment income (which can be used to offset underwriting losses) and increased the upfront cost of lump sum damages awards.

2.9 While each of these factors would have had an inflationary impact on premiums, we were not persuaded that they alone accounted for the large increases in premiums experienced in 2002. We therefore highlighted other factors that may have had an impact on premiums.

Changes in the competitive environment

2.10 For individual businesses seeking liability insurance, effective competition will depend, at least in part, on the number of insurers prepared to quote for their business. Those businesses presenting specialised risks found that an already limited choice had become further reduced and in some cases they had no choice at all. We also felt that the widespread practice of giving policyholders short renewal periods could restrict further the extent to which they could consider switching to alternative suppliers and reduce the level of competition. However we found no evidence of collusive agreements.

2.11 It was put to us that over the five years prior to our 2003 report, insurers had been competing in a way which was unsustainable and appeared to ignore the commercial realities of the business, with decisions seemingly based on short term growth rather than long term profitability. This argument was consistent with the reductions in real premiums and deteriorating underwriting ratios over the period described above.

2.12 Major insolvencies in the liability insurance sector following the earlier period of intense competition 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 appeared to have encouraged insurers to reconsider their underwriting practices, taking a more selective approach to the risks they were prepared to cover. Reductions in capacity led to a short term upward pressure on premiums and improvements in profitability. However, in a competitive market we

expected to see new capital provided in response to opportunities for profitable business.

Areas of improvement

2.13 The following points were highlighted in our report as methods for making the markets work better, some of which were already starting to be put into practice by insurers' bodies, trade associations and government. These included:

- 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, eg: taking better account of good H & S practice
- greater use of rehabilitation for those injured at work which should reduce damages claims.

Follow-up launched on 3 December 2004

2.14 In our 2003 report we committed to keeping the liability insurance markets under review. In particular, we stated that we would look again in late 2004 at the level of premiums, including whether proposed initiatives to make the market work better had led to positive change; and at the issue of legal costs to see whether there was any further work which OFT needed to undertake.

2.15 In examining whether the markets are now working better than in 2003 we committed to look at:

- price developments

- what current costs insurers are taking into account when pricing current policies
- what impact initiatives adopted by insurers are having across the liability insurance markets. These include longer renewal periods and improvements to risk management so that premiums more accurately reflect risk
- whether there are any business sectors that are finding it difficult to obtain cover
- whether ATE insurance premiums are contributing to the rise of liability insurance premiums. OFT aimed to gain an understanding of the structure of the market, how the product is sold to consumers, the level of premiums and how risks are assessed.

Who we consulted

2.16 For our follow-up study, views were sought from a wide variety of organisations including insurers, brokers, SMEs, trade associations, lawyers, voluntary organisations and other government departments. We would like to thank all those who contributed to the study.

2.17 We also conducted research similar to our 2003 business survey. This comprised a questionnaire 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 and made available on our website www.of.gov.uk. We wish to thank all those businesses who co-operated in this exercise. A summary of their responses is available on our website.

3 PRICE DEVELOPMENTS

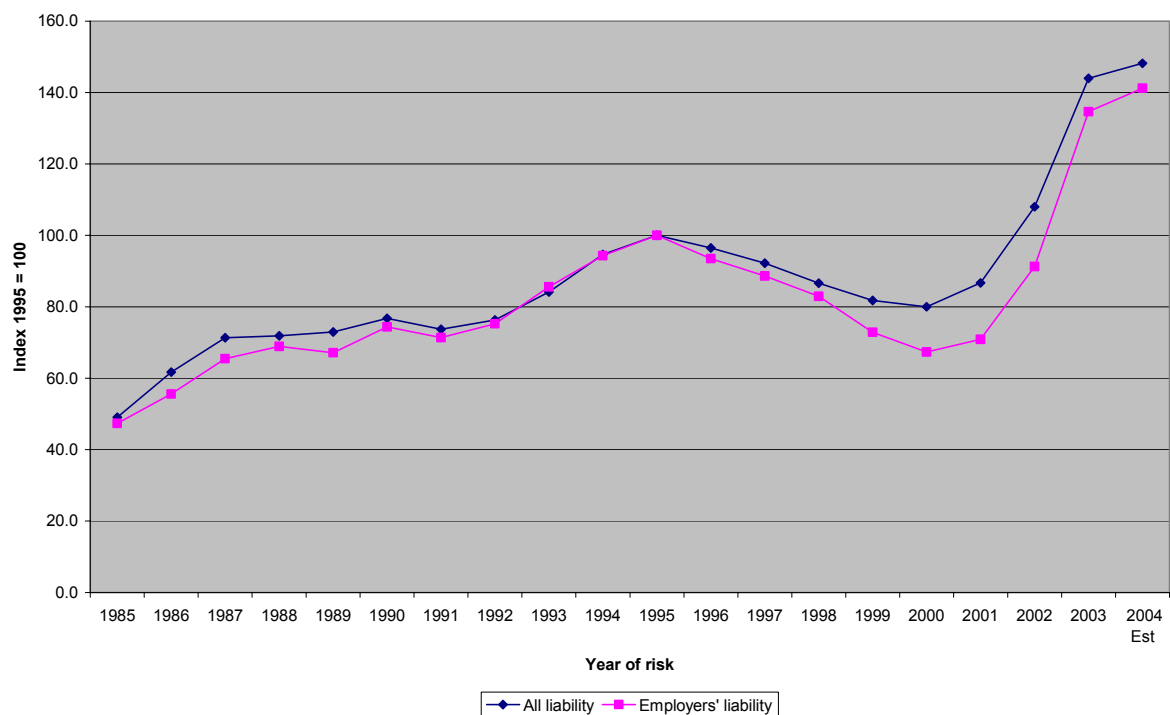
- 3.1 The ABI estimates that across all liability lines, premiums rose by an average of five per cent in 2004. Compared with 2002 which showed average rises of 50 per cent for EL, 30-40 per cent for PL and 30-60 per cent for PI, averages given by the ABI for 2004 suggest that there were lower than expected rises of seven per cent for EL, and four per cent for PL and PI.
- 3.2 ABI data collated from returns made to the FSA (previously to HM Treasury and to the Department of Trade and Industry (DTI)) cover business transacted both by its members and by Lloyd's. At the time of our 2003 report the most recent data available related to year of risk 2001. For this report we have been able to access data up to year of risk 2003. In each case we also had estimates of premium income made by the ABI's members for a further year.
- 3.3 For this report we have concentrated on three key items of data: premiums; claims paid; and the ratios of claims paid to premiums. Premium income and claims paid have been expressed at constant prices using the GDP price index. We have looked at all liability and EL separately (the latter because EL tends to be the least profitable line). We have not looked at lines of business in any greater detail. Similarly, these data are aggregated across all insurers. We have not looked at the performance of individual insurers. In order to give the historical context we have shown trends over a period going back to 1985.
- 3.4 Trends in premium income are a proxy for trends in the price of insurance.¹¹ The total level of premiums will tend to rise simply because

¹¹ The nature of insurance means that it is difficult to measure changes in prices over the industry as a whole, for particular sectors or even for the individual customers of insurance companies. The main measure available, the change in premium paid, conceals any changes in the nature and volume of the risk covered. For example it does not correct for differences in number of employees insured, changes in occupations or changes in excesses or deductibles. Our observations relate to premium increases. See *Cycles in Underwriting Profits for UK Insurers: Dynamic Panel Data Results*, Paul Fenn, University of Nottingham, Paper to 25th UK Insurance Economists' Conference 26th/27th March 2003
www.nottingham.ac.uk/business/cris/ukec/2003%20paul%20fenn%20paper.doc

the quantum of insurance cover purchased is increasing with the growth of the economy, so that more employees need EL cover, more production needs product liability cover or more professionals need PI cover. The breadth of cover purchased is also changing. Insured businesses may be taking a higher proportion of the risk on themselves through devices like higher excesses (charge-backs in the case of EL). Some risks previously covered may be excluded. For all these reasons trends in premiums do not fully represent trends in prices, but they are the nearest approximation.

3.5 Figure 3.1 shows trends in inflation-adjusted premium income for all liability products and for EL separately. The sharp increases since 2000 need to be seen in the context of reductions of some 20 per cent from 1995 and the broad upward trend over the previous 10 years. For EL the fall from 1995 to 2000 was sharper at 33 per cent. The increases reported here for 2002 and 2003 were in line with those predicted by insurers for our 2003 report. The estimated figures shown for 2004 are based on a survey by the ABI of its members. Weighted increase in premium income across all lines of about five per cent in cash terms (seven per cent for EL) translate into a small real terms rise. A number of insurers reported that towards the end of 2004 and into 2005, and in response to competitive pressures, premium income was flat or even declining.

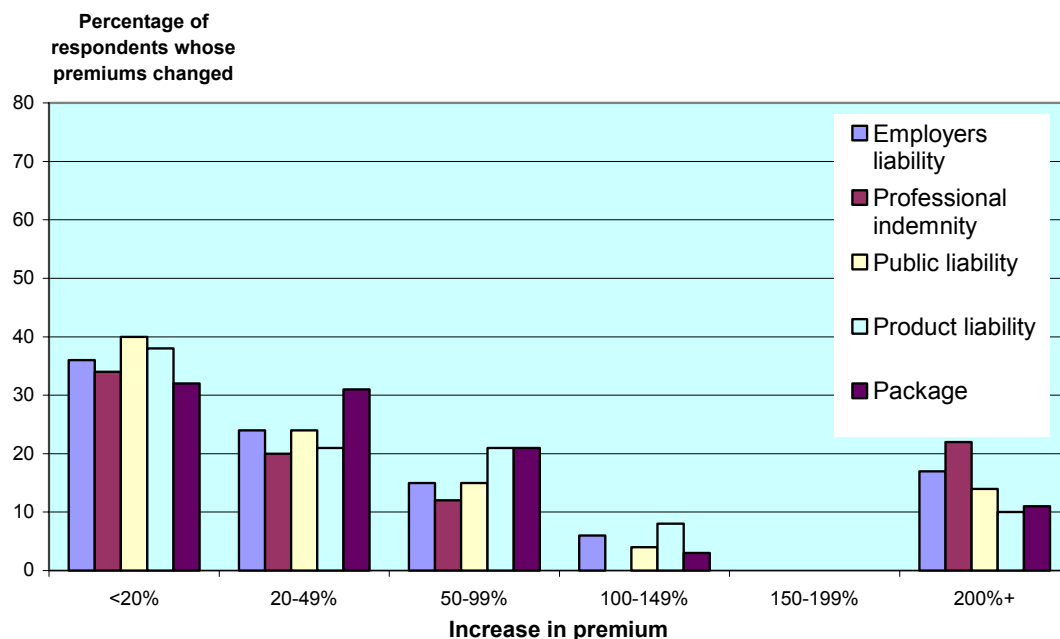
Figure 3.1: Trends in liability premiums (gross earned premiums adjusted for general inflation)



Source: ABI data

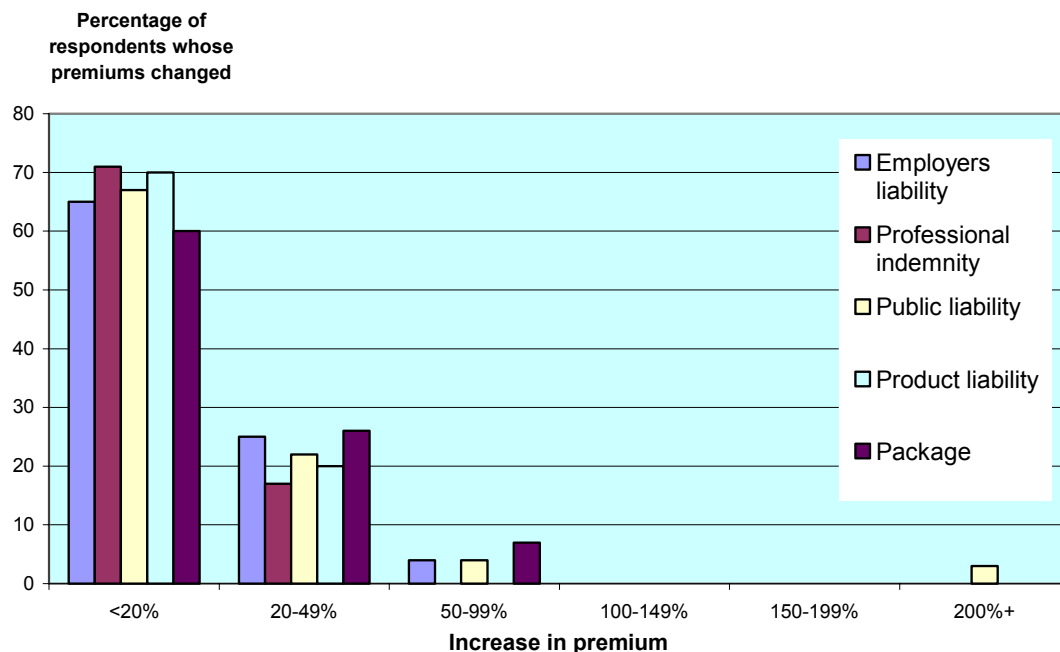
3.6 Figures 3.2 and 3.3 are drawn from OFT's survey data and show premium rises for 2002 and 2004. These charts illustrate the differences between the years, with businesses reporting not just lower increases, but a lower range of increases. For 2002 and depending on the sector, between 30 and 40 per cent of businesses surveyed reported increases below 20 per cent. For 2004, 60 to 70 per cent of businesses reported increases of below 20 per cent. Nevertheless, the 2004 rises were still ahead of general inflation and should be seen in the context of large rises over previous years.

Figure 3.2: Premium increases by business sector: 2002



Source: OFT business survey 2003

Figure 3.3: Premium increases by business sector: 2004



Source: OFT business survey 2005

- 3.7 Insurers have indicated that premium rises have been similar across all policyholders. OFT recognises, however, that there will be variations around the figures given above. A small number (single figures) of businesses from OFT's survey saw a decrease in their premiums. Only one sector, the equestrian sector, has been reported as experiencing significant rises in premiums. This has to be seen in the context of rises in the number and value of claims in that sector.

Excesses and deductibles

- 3.8 Neither from our surveys nor from insurers was it possible to gain more than an impression of changes in the level of insurance cover, including the effect of changes in excesses. Insurers told us that excess levels had stabilised (in a few cases they had dropped). OFT's survey showed that for 2004 around 21 per cent of businesses saw an increase in excess levels compared to 25 per cent in 2002, which is not a significant change. It is not clear whether this is at the instigation of the insurer or businesses seeking ways to reduce the cost of their premiums. Around eight per cent of respondents experienced a reduction in the level of cover in the last year. Neither our survey nor evidence provided by the ABI from its members gave any systematic analysis of the use of excesses or self insurance. To the extent that either has increased, overall premium increases will tend to understate the increase in the 'price' of insurance.

Are any business sectors finding it difficult to obtain cover?

- 3.9 The recent OFT survey revealed that very few businesses were being denied renewal in 2004 – at most three per cent depending on the type of insurance being purchased. Furthermore, these levels were significantly lower than when we first looked at the market. The number being denied new cover had also fallen; in the case of employer's liability, by two thirds to just three per cent.
- 3.10 At the time of OFT's first study a number of sectors (IFAs, businesses in Northern Ireland (NI), the voluntary sector, SMEs and 'high risk' business sectors) were reported as experiencing major problems of availability and

premium rises. Problems still exist in these sectors, but there have been signs of difficulties easing, particularly for IFAs, businesses in NI and the voluntary sector.

- 3.11 Independent Financial Advisers, for example, appear to have experienced more individual risk assessments by insurers (which have resulted in them securing cover) and increased capacity. Some (albeit a small number) have experienced premium decreases and a reduction in excess levels. The FSA is monitoring the impact on this sector of the Insurance Mediation Directive (IMD), which was implemented in January 2005 and places more demand on capacity by increasing the total level of indemnity. The FSA¹² indicates that Article 65 of the Markets in Financial Instruments Directive (MiFID) requires the European Commission to report to the European Parliament and Council on the continued appropriateness of the requirements for PI imposed on intermediaries under EU law. The FSA goes on to say that this could open the way to amendment of the PI requirements in the IMD and the MiFID. It is not clear that the current requirements in those directives are justified on a risk basis.
- 3.12 We have been made aware of a number of professions where obtaining PI has been problematic. As in the case of IFAs, such problems can arise in securing cover if insurers are uncertain about the extent of risk they are being asked to take on. For the most part these uncertainties are caused not by the insurance market as such but by concerns about the potential liabilities for (professional) negligence to which particular professions and their insurers are likely to be exposed.
- 3.13 Representatives of both actuaries and consulting engineers have raised concerns about the practice of joint and several liability, which is common within the business sectors in which they operate. This occurs where two or more people enter into an obligation such as a guarantee together. Joint and several liability means that the client, lender or creditor can recover the whole indebtedness from any one of them. They are then left to sort out their respective contributions between

¹² FSA International Regulatory Outlook 2005.

themselves. This potentially impacts on the terms on which these parties are insured.

- 3.14 One of the recommendations from the recent Morris Review of the actuarial profession¹³ was that the actuarial profession, the Association of Consulting Actuaries (ACA) and its membership should consider in more detail the use of proportionate liability clauses in contracts. This contractual approach, which could also be used in construction and engineering, would allow firms to negotiate terms other than joint and several liability.
- 3.15 Many of the positive changes which have taken place in these sectors have occurred because all parties have been working together to make the markets work better. Chapter 4 sets out some of the work which has taken place in these sectors and the impact it has had.
- 3.16 It must be recognised that some businesses will continue to pay higher premiums than others – premiums should reflect the risk – and insurers will continue to look carefully at what they see as high risk. As a result some sectors will continue to find a restricted number of insurers willing to take on their risk. As mentioned earlier, the equestrian sector has been identified as one which is experiencing problems at the present time. It is not clear whether this is a question of affordability, rather than availability.
- 3.17 Overall, businesses seem to have been more prepared for the premiums they face and have worked them into business plans. Going forward, unless the loss experience in a particular sector is very different from the average position, businesses are unlikely to see a return to pre-2002 premium levels, but experience will vary according to business sectors and differences in risk exposure. It is therefore the trends in the sectors in which they operate which are most important – improvements to H & S systems should result in improving claims trends within that sector.

¹³ The *Morris Review of the Actuarial Profession: Final Report* – March 2005 – HM Treasury on behalf of the Controller of Her Majesty's Stationery Office.

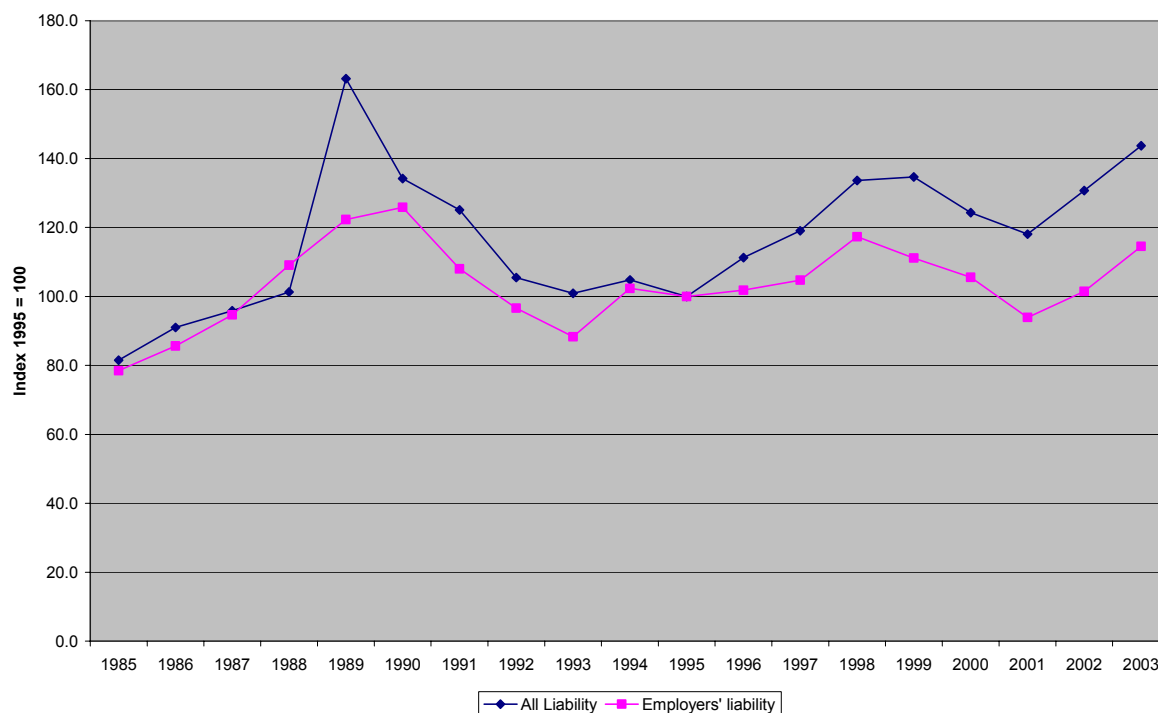
Cost pressures

3.18 Figure 3.4 shows trends in liability claims paid (including claimants' legal costs awarded against insurers) in respect of each year of risk and on a comparable basis to the premium income in Figure 3.1. Separate figures are shown for EL. In our 2003 report we identified a number of pressures on claims in recent years. It seems likely that broadly similar pressures are likely to persist in the foreseeable future. Again these data are industry aggregates and may not represent the claims experience of particular lines of business or business sectors. In the case of EL policies, while overall accident and injury claims have been falling in recent years (accident claims have declined by 15 per cent¹⁴) the cost of claims has been rising. Datamonitor¹⁵ indicates that between 1999 and 2003 EL claims costs have risen at an annual average of 17 per cent. Industry sources have suggested that 10 per cent claims inflation is a commonly used rule of thumb.

¹⁴ Note also that the number of PL claims has also fallen by 17 per cent in 2003/4 – Datamonitor *UK Personal Injury Litigation* 2004.

¹⁵ Datamonitor *UK Personal Injury Litigation* 2004.

Figure 3.4: Trends in liability claims (adjusted for general inflation)



Source: ABI data

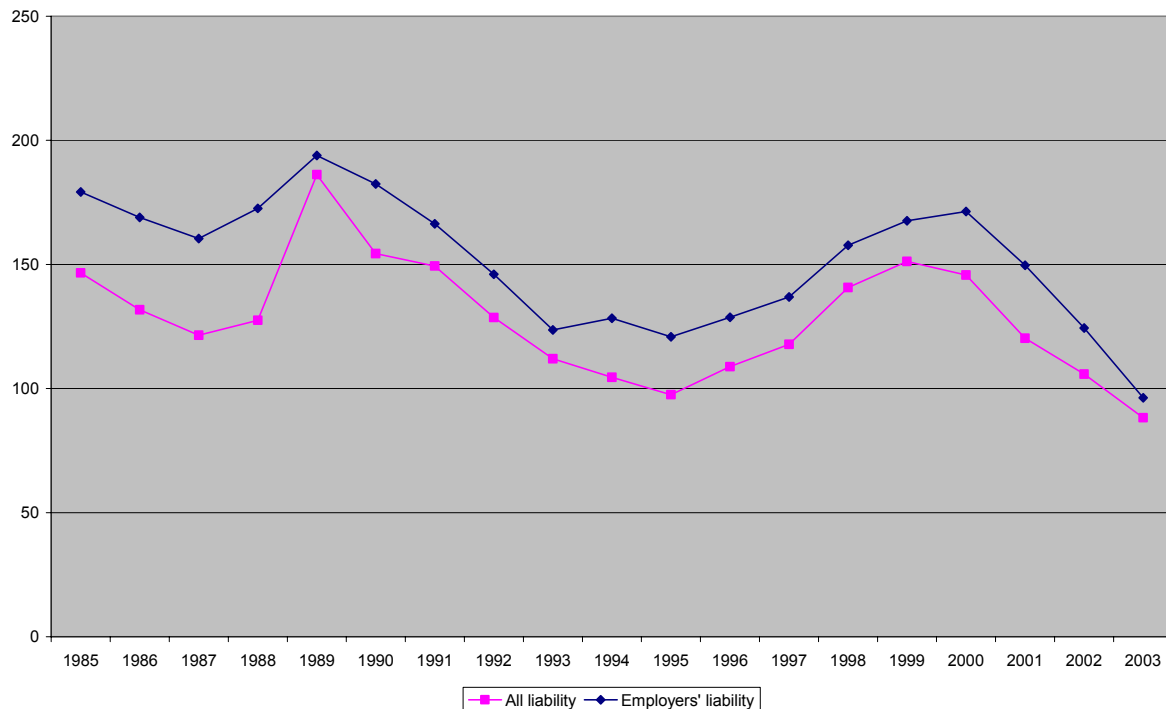
3.19 Figure 3.5 shows the combined effect of premiums and claims in terms of the aggregate underwriting result. The sharp deterioration in underwriting ratios around 1990 and subsequent recovery largely represents the adverse claims experience.¹⁶ By contrast the deterioration from 1995 to 2000 was the result of the reductions in premiums at the same time as claims continued on a broad upward trend. Premium increases since 2000 have allowed the ratios to improve to the extent that across all liability lines premium income is covering claims plus expenses for the first time since 1995.

3.20 Since our previous report underwriting ratios have improved from 120.3 per cent in 2001 to 88.2 per cent in 2003 across all liability lines. Even for the less profitable EL, the underwriting ratio has improved from

¹⁶ This can be demonstrated by claims ratios (the ratio of claims paid or accrued by an insurer to premiums earned, usually for a one year period. A ratio of 20 per cent means that claims exceeded premium income by 20 per cent). Claims ratios for 1989 – 1991 were over 119 per cent, underwriting ratios ranged from 149 per cent to 186 per cent.

149.7 per cent to 96.3 per cent. These ratios will vary considerably across individual insurers and lines of business. Not surprisingly, the ABI reported a range of views from its members on whether recent premium increases had been sufficient to restore profitability to acceptable levels.

Figure 3.5: Underwriting ratios (claims plus expenses as a percentage of premiums)



Source: ABI data

Legal costs pressures

3.21 During our 2003 study, insurers expressed significant concern about the impact of legal costs on premiums, particularly on EL. The introduction of CFAs and ATE were said to be contributory factors to rising legal costs. Since 2000 both the CFA uplift and the ATE premium have been recoverable from the losing side, which more often than not is the liability insurer. In addition to raising legal costs, insurers argued that the availability of CFAs and ATE has resulted in an increase in the number of claims and the costs involved.

3.22 Insurers have indicated that legal costs pressures still exist, but more predictability seems to have been introduced. Following the introduction

of fixed recoverable success fees for RTA and EL accident claims in 2004, the CJC, with the support of the DCA, has facilitated a new agreement on fixed recoverable success fees for EL disease cases. DCA hopes to implement this agreement through new rules of court by October 2005. An agreement on public liability success fees is hoped for by the end of the year with implementation by April 2006. DCA plans to proceed with simplifying the regulation of CFAs and hopes to implement a simplified regime, which focuses regulatory controls on the Law Society, by October 2005.

Capacity to provide liability insurance

3.23 Capacity¹⁷ across the liability markets has expanded – mainly through existing players, but there have also been some new entrants, for example Aspen Insurance, Illium Insurance Group and Quinn Direct.

Changes to business models

3.24 Insurers stressed that they had looked harder at the management of their business, tightened risk models and cut unnecessary costs. This may have resulted, in part, from the outcome of the FSA's own review into these markets in 2003. That review resulted in a set of good practice indicators being circulated to all firms writing liability business at that time. These covered the following areas:

- development of good risk management practices
- survey a material proportion of the risks to audit risk management activity
- monitoring latencies and legal precedents
- giving reasonable notice to policyholders of rate increases

¹⁷ To renew existing policies or to write new business.

- clear communication with policyholders regarding reasons behind the changes
- efficient use of rehabilitation
- industry should look at claimant fraud
- control of legal expenses costs
- actuaries should be used to price large complex risks, where appropriate
- if actuaries are not used, robust controls must exist
- robust controls over outsourcing.

3.25 Many of the above had also been identified in our 2003 review and the Department of Work and Pension's (DWP) review of EL.¹⁸

3.26 The FSA has monitored the changes which these good practice indicators brought about using its risk assessment visits to those firms involved. This will continue to be the case.

Individual Capital Adequacy Standards Framework

3.27 A further impact on liability insurers' costs arises from the introduction of the new Individual Capital Adequacy Standards Framework – the new risk based capital framework now being used to set regulatory capital for firms. This framework aims to align the capital required more closely with the risks carried by the firms, and as liability business is obviously more risky than, say, motor insurance, it will incur higher capital loadings in general.

¹⁸ *Review of Employer's Liability Compulsory Insurance (ELCI) – First stage report – 3 June 2003* and *Review of Employer's Liability Compulsory Insurance – Second stage report – 4 December 2003*.

Possible future cost pressures

3.28 Possible future cost pressures include:

- the NHS Injury Costs Recovery Scheme¹⁹ – the extension of the scheme to personal injury compensation cases has recently been postponed until October 2006
- the update of the Ogden tables²⁰ to reflect higher life expectancy
- the impact of the recently implemented Courts Act 2003 on the volume and structure of periodical payments.²¹ The extent of this impact is still to be seen. Some uncertainties as to the eventual impact include:
 - the difficulty in assessing the ultimate cost of these payments due to uncertainty over mortality risk and future indexation allowances
 - an absence of suitable financial assets which match periodical payment liabilities
 - the effect of this additional uncertainty on regulatory capital requirements.

Future trends

3.29 It would be premature to speculate about the future path of premiums. Nevertheless, after allowing for the short term (cyclical) movements in premiums which have been observed in the past, the same pressures

¹⁹ This allows recovery of NHS hospital costs in all cases where personal injury compensation is paid, not just following road traffic accidents as happens now, but for example following accidents at work.

²⁰ Actuarial tables of life expectancy.

²¹ Instead of generally awarding lump sums, judges have the power to impose reviewable periodical payments on both the insurer and the claimant as the fairest method of compensation. It is open to the court to order that the parties seek variation of the payments in certain strictly defined circumstances. The change, which came into force on 1 April 2005, effectively removes the longevity risk and the investment risk from the claimant and places this with the insurer.

which contributed to the rising total cost of claims seem likely to have a broadly similar impact on the trend in premiums over the longer term. There are a number of initiatives designed to make the market work more effectively and, to the extent that these succeed, increases in the rate and cost of claims could be mitigated. These initiatives are described in the following chapter.

4 INITIATIVES TO MAKE INSURANCE MARKETS WORK BETTER

4.1 An exchange of information is key to insurance. One of the biggest criticisms raised with us during the first study was the poor communication between all parties in the chain. It was therefore encouraging to see that this is an area in which positive steps have been taken. A number of working parties have been established, often with a government lead, with the aim of ensuring a continual dialogue between policyholders, brokers and insurers in order to establish what the problems are and to try to find ways to ease or solve those problems.

The Department of Enterprise, Trade and Investment in Northern Ireland

4.2 Officials in the Department of Enterprise, Trade and Investment in Northern Ireland (DETINI) have monitored insurance costs over the past three years using a robust annual survey conducted by the NI Statistics Research Agency. Initial steep increases, averaging 49 per cent across all industry sectors, have started to reduce to levels in line with legal inflation.

4.3 As well as shadowing and implementing the recommendations of the DWP's Second Stage review of EL, DETINI, through its agencies Invest NI and Health and Safety Executive (NI), was able to introduce mentoring schemes and risk management advice for small businesses; it also employed H & S advisers to provide business friendly information to trade bodies and small firms. These actions were provided to help business reduce accidents and improve H & S management, and so increase the likelihood of obtaining insurance cover.

4.4 Communication between stakeholders was improved through the operation of an insurance working group which included the insurance industry and business sector representatives. Drawing on the skills of

members, DETINI was able to compile and publish a guide on purchasing insurance.²²

- 4.5 While the situation has eased, neither DETINI nor businesses in NI are complacent and continue to monitor insurance premiums.

The voluntary sector

- 4.6 In July 2002 the Home Office established the Insurance Cover Working Group (ICWG) to tackle difficulties being experienced with insurance cover in the voluntary and community sector (VCS). The ICWG commissioned a report to address the issues. This resulted in an agreed programme of action currently being delivered including, amongst other things:

- drawing together sources of practical advice and expertise in order to increase the capacity of the sector to deal with insurance issues – the ABI is intending to publish a guide on insurance and risk management for the VCS
- better practical arrangements for working with local government
- ongoing dialogue between the VCS, the insurance industry and government, facilitated by the Home Office.

- 4.7 The Home Office is currently leading on a programme to address risk and insurance issues in the VCS. This work is planned to be undertaken by Volunteering England.²³ The specific actions proposed include:

- commissioning research to build the evidence base
- creating a forum that ensures continued dialogue between key interested parties and which links to the wider DCA programme

²² Available in either electronic format from the DETINI website www.detini.gov.uk, or in paper copy from DETINI, Netherleigh, Massey Avenue, Belfast, BT4 2JP

²³ This is the national development agency for volunteering and the accountable body for the new ChangeUp Volunteering Hub.

- developing a strategy to communicate with the wider VCS and the public in particular, to allay fears and show that the issues are being addressed
- developing resources to provide access to guidance, examples of good practice, details of key contacts, details of the work programme etc
- working with governing bodies, umbrella bodies and the ABI to explore the possibility of introducing a scheme equivalent to Making the Market Work (see 4.14 below for details of the scheme)
- encouraging and supporting the development and spread of good practice within the sector
- developing training materials and packages where necessary to address specific gaps, making links to existing schemes where possible.

Legal costs

4.8 As already mentioned, there are a number of initiatives aimed at easing legal costs pressures, including fixed recoverable success fees for disease cases. Other initiatives are being developed as part of a programme of work to tackle perceptions of a compensation culture and to improve the compensation system. A Ministerial Steering Group has been set up, led by the DCA, to coordinate and direct this work, with the support of an Action Group of expert stakeholders working on specific initiatives. This will include work to discourage and resist invalid claims and to improve the system for those with valid claims by providing fair compensation in a more timely, proportionate and cost-effective way. A particular strand of work will look at ways of making processes in low value claims more proportionate and cost-effective.

FSA guide for IFAs

4.9 The FSA has worked with industry practitioners from the PI market and IFA trade bodies to produce a Guide which aims to give IFAs a greater insight into the PI market, including the process of obtaining cover. It

also gives IFAs information on how to improve their systems and present their risk more effectively to insurers. It can be found at:
www.fsa.gov.uk

Equestrian sector

- 4.10 As mentioned earlier, particular problems are currently being experienced in the equestrian sector. In response to these problems, the British Horse Society, the Association of British Riding Schools and the ABI are working together to help riding establishments improve the quality of their record keeping and risk management in order to defend claims more effectively. They will monitor a sample of establishments to see whether better record keeping produces valuable results. The ABI has indicated that any resulting reductions in claims costs are anticipated to flow into future premium rates.
- 4.11 A number of initiatives were also highlighted during our first study aimed at making the markets work better. These have now been in operation for over a year.

Statement of Good Practice on (21 day) renewals

- 4.12 Following concerns about short renewal notice periods, the ABI and the British Insurance Brokers' Association (BIBA) published a Statement of Good Practice which came into effect on 1 November 2003. This states that liability insurers will provide at least 21 days notice of their renewal terms. Although we received anecdotal evidence that smaller insurers did not follow the Statement of Good Practice, on the whole our evidence suggests that it is being complied with. Indeed some insurers indicated that they use long renewals as a means of obtaining competitive advantage.
- 4.13 There was no sign that increased renewal periods had increased switching between insurers, but given the importance of understanding the risk, it is perhaps not surprising that businesses see benefits to remaining with their existing insurer. Businesses may be more likely to consider switching if they feel that relationship to be under strain, for

example, if large and unexpected increases in premiums or excesses or reductions in cover are proposed.

The ABI's 'Making the Market Work' scheme

- 4.14 The ABI's 'Making the Market Work' scheme (MMW), which was launched in September 2003, gives more focus to H & S practices. It sets out criteria of H & S risk management activity against which trade associations are invited to benchmark themselves. MMW was intended to improve access to the liability insurance market and to complement the steps insurers are taking to promote and recognise good H & S practices.²⁴ Insurers say that it was designed as a communication mechanism to facilitate the transfer of information between employers, trade associations and insurers. Since MMW started, twelve trade associations from a number of sectors, many of which would be considered 'high risk', have completed the assessment process. A review of MMW by the ABI has indicated that it has led to increased recognition by insurers of good risk management and is helping firms with a commitment to good H & S improve their access to the insurance market.
- 4.15 There was some concern from the businesses OFT surveyed that MMW was not delivering what they expected, ie: lower premiums. Some businesses may have had unrealistic expectations of the impact that membership of MMW was likely to have on their individual premiums in the short term. It was unrealistic to expect to see an overnight reduction in premium. Moreover, MMW's role lies in improving access to the markets for high risk sectors that might otherwise struggle. The ABI has indicated that all insurers have mechanisms to reward good risk management, but it is important that they receive good information on H & S practices. Gains from an initiative of this kind are likely to be long term as claims records in individual sectors improve as a result of better H & S systems.

²⁴ ABI report *Making the Market Work – Making a difference*.

Health and Safety Performance Indicator for SMEs

- 4.16 Following a recommendation in DWP's Review of EL, the Health and Safety Executive (HSE) has developed an H & S Performance Indicator²⁵ (the Indicator) for SMEs. A key aim of the Indicator is to help insurers and brokers identify good H & S performers – in the DWP Review they said they had no practicable means of doing so. In turn this enables insurers and brokers to recognise good performers when insurance terms are set. In developing the Indicator HSE worked closely with key stakeholders including DWP, the Small Business Service, ABI, BIBA and the Federation of Small Businesses. Hosted by DTI's Small Business Service, it was launched in January 2005 and can be found at: www.hspi.info-exchange.com
- 4.17 The HSE is now encouraging the ABI and BIBA to get their members to use it.
- 4.18 The HSE is currently developing a Corporate H & S Performance Index for use by both large public and private organisations.

Rehabilitation

- 4.19 In our earlier report increasing rehabilitation²⁶ was cited as a means of helping to reduce costs in the system. Claimants who are successfully rehabilitated are likely to be able to live more independently and have an increased chance of securing employment. This would mean that defendants, or rather their insurers, would pay less in compensation so both sides would benefit. The programme of work referred to at

²⁵ The Indicator is a self-assessment tool, which is free to use. Businesses complete the Indicator anonymously but they can choose to share the results with others, eg: their broker or trade association. It is generic and applies to all SMEs across the wide range of activities undertaken. It works by asking a series of questions on a) incident frequency, and b) key hazards that HSE developers found most SMEs encounter, eg: manual handling, noise. By May 2005 over 1000 businesses had completed the Indicator with businesses in the manufacturing and engineering sector the largest users, followed by construction.

²⁶ Rehabilitation restores an injured person to as productive and independent a lifestyle as possible through the use of medical, functional and vocational interventions.

paragraph 4.8 above will also draw together the various strands of work across government on rehabilitation in order to promote earlier and fuller recovery through access to earlier and better rehabilitation.

- 4.20 In October 2004 DWP published *Building Capacity for Work: A UK Framework for Vocational Rehabilitation* (the Framework), which contains a series of recommendations and next steps. The Framework highlighted that there is a big commitment to support vocational rehabilitation externally but a weak evidence base to help government advise on a new approach in this area. To address the gaps in the evidence base, work has begun in DWP to set up the Research Working Group recommended as a next step in the Framework. Membership of the group will be drawn from relevant stakeholders from the insurance sector, the legal profession, trade unions, employer organisations, other government departments as well as academics and research organisations.
- 4.21 An important piece of research that is already underway to improve the evidence in this area is the Job Retention and Rehabilitation Pilot (JRRP). JRRP is being sponsored jointly by DWP and Department of Health with support from the HSE, Welsh Assembly and Scottish Executive. The aim of JRRP is to examine the barriers preventing people from a healthy return to work after sick absence and try to find ways of overcoming them. The evaluation will be completed at the end of the year. In the meantime DWP has published, *Job Retention and Rehabilitation Pilot: Employers' management of sickness absence*,²⁷ to develop a better understanding of what employers in JRRP areas do to manage absence, and what services they currently provide to absent employees to help them return to work.
- 4.22 It is difficult to determine with any precision the impact these various initiatives are having across the markets, but there are numerous examples where better two-way communication between insurers, brokers and customers has helped ease problems. None of the initiatives

²⁷ By Nice, K and Thornton, P (2004 DWP Research Report No 227), copies are available at www.dwp.gov.uk/asd/

in place is likely to have a dramatic effect on the markets in the short term, but they are likely to have long-term positive benefits. By improving information/communication and H & S systems and trying to find ways to reduce costs the markets should work better. This should reduce the likelihood of another big swing in premiums. But it is important that there is a commitment from all sides to take forward initiatives which have the aim of improving the way in which the markets operate and for businesses to be able to demonstrate good H & S records.

Conclusion

- 4.23 There have been significant changes within these markets over the last year aimed at making them work better for all parties. Lower than expected price rises are only one part of an improving picture. The primary change has been an improvement in communication and a continued commitment from all sides to seeking ways to make the markets work better. Most businesses are unlikely to see premiums drop to the unsustainable pre-2002 levels, but they should be better prepared for changes and able to find ways to improve claims trends within their sectors and present these better to insurers. Insurers in turn need to ensure that they make good use of all data available, rewarding good risk management.
- 4.24 The recent increases in premiums appear to have improved the financial performance of liability insurance to the extent that new capacity has been provided by existing insurers and some new entrants. A range of initiatives has been taken with a view to making the markets function more efficiently in the longer term. Problems will continue to arise from time to time in relation to particular business sectors and particular lines of insurance. This review has shown that for the most part these are solved or mitigated by discussions between the businesses concerned and their insurers (including their respective trade associations) and involving where necessary those who set the legislative or regulatory framework. Given the improvements to the markets there is no case for OFT to commit to undertake a further review of this kind. As in other sectors, we will continue to investigate and enforce relevant competition law as appropriate.

5 AFTER THE EVENT INSURANCE

What is after the event insurance?

- 5.1 ATE insurance is taken out once an injury has occurred and the individual has decided to pursue a claim against another party. It covers the claimant in the event that they lose their case and are required to pay the costs of the other side. It is usually (though not always) sold alongside a CFA. As with any insurance, policies vary in what they cover but they may include: opponents' lawyers' fees; disbursements such as expert witness fees, court fees, and travel expenses; and the cost of the insurance premium. It is possible to purchase policies which cover both sides' costs, but it is more common to purchase policies covering only the other side's costs.
- 5.2 Under the Access to Justice Act 1999 it has been possible to recover the cost of the ATE premium from the losing side²⁸ since 2000. This led to the growth of ATE.

Why is OFT looking at ATE?

- 5.3 During the course of our 2003 study liability insurers expressed concern about the impact of legal costs on liability premiums, particularly for EL. CFAs and ATE insurance were included within these costs. The evidence on legal costs at the time of the 2003 study was inconclusive, and as a result we indicated that we would look again at the subject following the publication of the report to see whether any further research was required on our part.
- 5.4 We found that much work was already underway on CFAs, largely by the DCA. It therefore seemed sensible for OFT to focus its research on ATE as liability insurers had indicated that ATE insurance raised their costs, both by increasing the number of claims and the costs of dealing with them.

²⁸ Usually the liability insurer.

- 5.5 In December 2004 Citizens Advice published a report entitled, *No win, no fee, no chance*.²⁹ That report raised concerns about the sale of ATE and consumer credit loans used to pay for it. While much of the evidence for that report seems to date from before 2000, since when the market has undergone significant changes, it highlights the role of ATE in personal injury cases (which are predominantly against EL and PL insurers) and raises questions about how well the market is working.
- 5.6 It became clear as our work progressed that ATE needs to be seen in the context of wider legal issues relevant to the cost of and access to justice, in particular its role in facilitating CFAs. We also learned that the Civil Justice Council (CJC) is proposing to carry out work on the issue later this year, which we did not wish to duplicate. We therefore have not explored the subject in great depth, although we have done sufficient work to form a picture of how the market operates.
- 5.7 We did not focus on ATE for situations outside the personal injury cases relevant to EL and PL – there is a market for ATE in commercial cases.

Structure of the ATE market

- 5.8 ATE is part of a wider market for legal expenses insurance (LEI), the remainder being before the event insurance (BTE).³⁰ Mintel (2004),³¹ using information from ABI, estimate that ATE comprises about 29 per cent of UK LEI, or some £110 million in 2003. This figure does not include business written in the UK by insurers based and regulated outside the UK. Nor does it include organisations such as trade unions which self-insure EL claims.

²⁹ Citizens Advice – *No Win, no fee, no chance* - CAB evidence on the challenges facing access to injury compensation December 2004.

³⁰ Before the Event 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. Limited coverage of some BTE policies may restrict the use of BTE in funding liability claims.

³¹ Mintel *Legal Expenses Insurance 2004*.

- 5.9 There are only a small number of insurers writing ATE policies. Around half are thought to be offshore players, ie: not UK-regulated. Examples of UK-regulated ATE insurers who are also writing BTE insurance include DAS, Allianz Cornhill and Brit Insurance. Offshore insurers include Isle of Man Insurance Company and Red Sands (Gibraltar). As Datamonitor³² indicates, there is no longer ATE insurance capacity within the Lloyd's market. Goshawk, Catlin and Atrium have been the most notable withdrawals. NIG is the most significant FSA-registered insurer to exit. However, it has been suggested that there is still spare capacity in the market. The insurers we spoke to suggested that new entry was most likely to come from offshore - primarily, they say, because offshore regulators tend to have less stringent capital requirements than in the UK.
- 5.10 As indicated above, the ATE market only really grew from 2000 when it became possible to recover the cost of the premium from the losing side. It is still maturing, although at least one insurer felt that it had peaked in volume - the number of claims/cases coming through the system has slowed down (see paragraph 3.19 above).
- 5.11 With the data available to us we have not been able to assess the premium to claims performance of ATE insurance. One subjective test of profitability is the tendency of firms to exit the market or willingness of new firms to enter it. Problems in relation to two claims management companies, The Accident Group (TAG) and Claims Direct³³ have prompted exit on the part of Lloyd's syndicates. UK-based ATE insurers told us that, as there were still claims outstanding against some of the early policies they had written, they were still unclear about the long term viability of ATE and for that reason were not keen to increase their exposure.
- 5.12 There have been a number of significant changes in recent years, the most notable being the demise of TAG and Claims Direct. Both were said to have contributed to the controversy surrounding the so-called

³² Datamonitor- *Personal Injury Litigation 2004*.

³³ Ceased trading in 2003 and 2002 respectively.

compensation culture in the UK and the negative publicity which has since followed. The role of claims management companies within the personal injury sector has been subject to much criticism. In a speech on 22 March 2005,³⁴ the Secretary of State for Constitutional Affairs indicated that the claims management sector will be brought under statutory regulation when the DCA legislates to implement reforms to the legal services market. Since then, the DCA has said that it plans to accelerate this process and intends to bring forward the primary legislation required to introduce regulation in the proposed Compensation Bill announced in the recent Queen's speech. The DCA will continue to work with the Law Society, FSA, Claims Standards Council and others on what additional measures can be taken prior to the introduction of new statutory regulation to ensure that the current regulatory net is as effective as possible in safeguarding consumer interests.

How the product is sold

- 5.13 Although the policyholder for ATE is the consumer who is making a liability claim, in reality the solicitor who is pursuing the claim on the consumer's behalf is also a major beneficiary of the policy. It is in the solicitor's interest for insurance to be in place to cover the risk that, if the claim does not succeed, costs may be awarded against their client who may not be able to pay the full amount. It is the solicitor, not the client, who decides whether to insure the case.
- 5.14 The consumer (as claimant in a liability action) does not deal with the ATE insurer direct. The choice of ATE provider is made by the solicitor or CMC. While there may be alternative channels or indeed alternative

³⁴ Lord Falconer of Thoroton, Constitutional Affairs Secretary and Lord Chancellor speech at the Legal Services Reform Conference, London - 21 March 2005.

classification of these channels,³⁵ the ATE product appears to be primarily sold through the following routes:

- through CMCs, following which the case is passed to a panel of solicitors (who will be charged a referral fee by the CMC for obtaining the case), with ATE purchased through the CMC already in place
- through solicitors purchasing direct from an insurer or authorised intermediary. Solicitors often become part of networks accessed via referral organisations such as National Accident Helpline, InjuryLawyers4U and Accident Line. Many of these referral organisations provide ATE (through an insurer). Depending on the organisation, solicitors may or may not be bound to use the ATE product offered by the referral organisation
- for a limited number of high value, high level of indemnity, cases solicitors will go through specialist ATE intermediaries or (traditional) brokers who will place the risk direct with an insurer.

5.15 We found little evidence of solicitors or CMCs shopping around, except for difficult cases where the case required additional cover, where the case had progressed further than expected without cover, or where the likelihood of winning was finely balanced. The reasons for the lack of shopping around are twofold. First, ATE cover is simply one (small) part of the case. For many simple cases the costs of the solicitor spending time shopping around may well outweigh the savings made. Secondly, as with liability insurance, solicitors find it beneficial to establish a good working relationship with an ATE insurer, based on their track record of handling personal injury cases, in order to be able to secure ATE cover. In many instances the solicitor is given delegated authority to offer ATE

³⁵ Note that trade unions play a significant role in personal injury cases, introducing claimants either direct to solicitors who work on Collective Conditional Fee Arrangements or on a CFA basis with the union either insuring the risk or self-insuring it. Many test cases will proceed with union backing. The role of trade unions was outside the scope of this report and is not explored further.

cover on standard terms once agreement on a CFA is in place. Some ATE insurers pay commission to solicitors.

Consumer credit loans

- 5.16 Concerns have been expressed, for example by Citizens Advice, that consumers are often sold expensive consumer credit loans in order to pay for the ATE premium. While it has not been possible to explore this point fully, the insurers and lawyers we spoke to indicated that this is becoming increasingly less common. Instead, many insurers defer the ATE premium until the case is concluded, with some most waiving the premium if the claim is unsuccessful. Some solicitors fund the ATE premium themselves, recouping it from the client upon completion of the case. While some insurers do ask for credit agreements to be signed to cover a deferred premium (even where no interest is charged), this seems to be simply a cautious approach to avoid any possible problems about the enforcement of the contract. Problems which arose at the time of TAG and Claims Direct have been cited as reasons why suppliers of consumer credit loans are no longer very attracted to the ATE sector.
- 5.17 Where a loan is offered the consumer does not appear to be given much choice of funder. The loan is often provided as part of the package alongside the ATE.

Ghost policies

- 5.18 Certain market participants believe that 'ghost policies' are a feature of the ATE insurance market – though we are not aware of any hard evidence that this is the case. Ghost policies are said to occur when a solicitor approaches an ATE underwriter for a policy on the understanding that they will never make a claim on it. The underwriter returns the favour by charging a low premium for a policy. The insurer is effectively guaranteeing that the defendant insurer's costs will still be met in the event of the solicitor's insolvency. We are aware of claims

that this allows the solicitor to charge the client more for the premium than it actually cost, allowing the solicitor to make a profit.³⁶

- 5.19 Although the issue of ghost policies was raised on a number of occasions during our research, we had we did not come across any actual policies and none of the stakeholders consulted had entered into such a contract. Anecdotal evidence suggested that they are used primarily by offshore insurers. We were therefore unable to establish whether or not ghost policies exist and, if they do exist, the extent to which they are used or what they might mean for the market or the consumer. If such products do exist we think it would be important to ensure that consumers are made fully aware of the products they are purchasing, the supplier of those products and the true cost.
- 5.20 The DCA has indicated in its consultation paper, *Making Simple CFAs a Reality*,³⁷ that in conjunction with the CJC it will be exploring the issue of ghost policies as part of its proposed work on ATE.

Assessing the insurance risk and setting the level of premiums

- 5.21 Underwriters told us that they needed at least five years of data to get a complete picture of operating in the ATE market. It could take several years from the date of the policy before the value of any claim against that policy became known. A number of insurers were already selling BTE before moving into the ATE market. This gave them knowledge (of claims at least) on which to draw. Nevertheless, several insurers said they were cautious about their total exposure to ATE. In common with other insurance products, a lack of data on how to price risks could either deter new entry or lead to under-pricing of risks and subsequent exit, even insolvency.
- 5.22 Insurers say that they will not take on a case unless it has a 'reasonable' - at least a 51 per cent - chance of winning. For cover that

³⁶ *Litigation Funding* April 2005.

³⁷ *Making Simple CFAs a Reality* – A summary of responses to the consultation paper *Simplifying Conditional Fee Agreements and Proposal for Reform* – June 2004 (Consultation No CP 22/04).

is provided under solicitors' delegated authority a figure nearer 70 per cent is likely to be needed before ATE is provided. It is possible to purchase policies for more difficult cases - though at significant cost. A potential precedent-setting case could be unable to proceed because of a failure to obtain ATE. This is clearly a commercial decision for the insurer, but it raises access to justice issues, ie: it may be influenced by solicitors' cash flow – can they afford to take on a case without ATE? This is an issue for the DCA.

- 5.23 The cost of an ATE policy will depend on potential exposure to costs, including the complexity of the case and whether it is likely to get to court. An 'average' premium cost for a fast track personal injury case (ie: those worth above £1000 but below £5000) is around £350 for RTA cases and £650 - £900 for whole case cover for non-RTA cases. The level of cover tends to be fairly standard at £100,000 and, we are told will, in the majority of cases, be sufficient to cover costs. Top-ups are available at extra cost.
- 5.24 We are aware that a substantial number of personal injury claims, the so called 'straightforward' cases where the solicitor is confident that they have a high chance of winning (usually RTA rather than liability cases) are not insured. Datamonitor was told that maybe as many as two-thirds of fast track cases were probably not insured by ATE cover. If correct, those cases which are insured may represent a narrow range of risk. Some insurers try to ensure a mix of risks by requiring solicitors to insure all of their cases, often at an early stage, as part of their contract with the firm; but it is not clear if these strategies succeed. One insurer we spoke to saw non-insurance of low risk cases as the main alternative to the use of ATE and thus the main competitive constraint on them.
- 5.25 If the solicitor's assessment of the case proves to be wrong, there may be opportunities to purchase or increase cover as the case progresses. That said, the more complicated a case becomes, and the later ATE is purchased, the more expensive it becomes; this will add to the overall costs of the claim.
- 5.26 It is difficult to say with confidence how many risks are not insured or whether this might influence the cost of ATE premiums. Solicitors should

be free to insure cases with as many ATE providers as they wish and the fact that a solicitor does not insure all of their cases with one provider does not automatically mean that some cases are uninsured. The CJC may wish to consider as part of its future work the way in which different risks are priced and the impact this may have on access to ATE and access to justice through the courts.

5.27 It is not clear if ATE premiums (or other costs) fixed by the courts (as a result of costs awards) have been set at levels which reflect the long term cost of underwriting the risks covered. ATE insurers have indicated that premiums have settled at a level which generally reflects the costs involved. Nevertheless, there are a number of inherent features of the ATE market which may pose problems:

- downward pressure on premiums seems to come mainly from defendant insurers who will challenge (litigate) if a premium is thought to be too high (the Claims Direct case is an example of this)
- defendant liability insurers argue that there is a lack of transparency – they are told only that a policy exists, not what it covers, the type of policy or the burning costs.³⁸ However, this information could reveal the strength of the case
- influence of the courts – decisions given on 'reasonableness of premiums' can set broad figures for the market.
- there is a suggestion that ATE insurers compete on service rather than price
- solicitors do not shop around. Rather they aim to establish a track record with a particular ATE insurer in order to secure cover and obtain a delegated underwriting authority for the majority of straightforward cases

³⁸ Ratio of excess losses to premium income.

- since it takes up to 10 years before all claims against a year of risk are paid, it is difficult for ATE insurers to know if premiums are adequate or if business is profitable. For the present, existing UK legal expenses insurers appear unwilling to increase their exposure to ATE
- there is some pressure on premiums from new entrants – but they may lack the information necessary to set premiums.

Conclusion

- 5.28 It is not clear to what extent ATE in itself is adding to either the numbers of claims brought, or to the cost of claims that the liability insurers would be called upon to pay under alternative means of funding.
- 5.29 It is difficult to look at the ATE market without considering the wider legal context of alternative means of securing access to justice. The effective customer for ATE is the solicitor or CMC, not the claimant in a personal injury case. Both are in a position to influence the cost and the choice of insurer (albeit they are limited by the number of insurers supplying the product), but it is not clear that this happens in a way that maximises the benefits to end customers. The solicitor or CMC has an interest in ensuring that the cover provided by ATE is commensurate with the conduct of the case. The consumer relies on their advice. Issues about transparency for the consumer go wider than just the ATE policy.
- 5.30 The main downward pressure on premiums appears to come from defendant insurers and `costs' awards. While we would not wish to underestimate the effect of this, it is not clear if premiums set by the courts are at levels which reflect the long-term cost of underwriting the risks covered.
- 5.31 The CJC, in conjunction with the DCA, is intending to carry out work later this year on the subject of ATE, with the aim of considering what further work and action may be needed to help ensure there is a transparent and sustainable ATE market that works in the interests of the consumer, but also to ensure that the costs payable by losing

defendants are reasonable and proportionate. The CJC intends to hold a forum of all the main interested parties to pinpoint the crucial issues with ATE and possible solutions. OFT will feed into that work.

ANNEXE

A GLOSSARY OF TERMS

ATE (After the Event insurance)

After the event insurance is taken out once an injury has occurred and the individual has decided to pursue a claim against the liable party. Insurance cover can be purchased to cover the other party's or both parties' legal costs and disbursements.

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.

Burning costs

Ratio of excess losses to premium income.

Capacity

The volume of business that 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.

Conditional Fee Arrangements (CFAs)

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 their solicitor fees would not be payable by them.

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.

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.

Loss ratio

The ratio of the losses to premiums usually expressed as a percentage.

Net earned (written) premium

Premium retained by the insurer after reinsurance has been ceded.

Ogden tables

Actuarial tables of life expectancy.

Periodical payments

Instead of generally awarding lump sums, judges have the power to impose reviewable periodical payments on both the insurer and the claimant as the fairest method of compensation. It is open to the court to order that the parties seek variation of the payments in certain strictly defined circumstances. The change effectively removes the longevity risk and the investment risk from the claimant and places this with the insurer and came into force 1 April 2005.

Rehabilitation

Rehabilitation restores an injured person to as productive and independent a lifestyle as possible through the use of medical, functional and vocational interventions.

Small and medium-sized enterprise (SME)

Small and medium-sized enterprises were defined, for our survey, as businesses with between 10 and 249 employees.

Success fees

A success fee can be charged by a solicitor under a CFA, uplifting their normal level of fees if they win to compensate them for those cases that they take on and lose and for which they receive no fee under the CFA.

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.

Underwriting ratio

The underwriting ratio compares costs (claims plus expenses) to premiums. Thus a ratio of under 100 indicates that premiums exceed costs (an underwriting profit) and over 100 indicates an underwriting loss.