Submission No 38

INQUIRY INTO PERSONAL INJURY COMPENSATION LEGISLATION

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Summary

Submission to the New South Wales Legislative Council Inquiry into Personal Injury Compensation Legislation

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EXECUTIVE SUMMARY

Like all financial services, insurance depends upon a high degree of certainty for its operations. Any factor that disrupts assumptions that are made today in the writing and pricing of products and policies ultimately feeds into increased caution in the decision-making of the business.

Uncertainty can manifest itself in higher prices charged to account for the risk-return on capital applied to the particular line of business. Alternatively, uncertainty may result in a loss of appetite by insurers to provide that type of insurance cover.

Changes to the law in NSW over recent years have provided a very reliable keel for what was an increasingly unattractive area of insurance: public liability.

In that short time premium rates have declined and the availability of cover increased considerably. This is now unarguable and has been the subject of independent robust ACCC scrutiny.

The complexity of the public liability field does not allow *Vero* to make quick judgments about the attribution of these positive movements to particular statutory or other initiatives. That is, we cannot advise the Committee with precision what proportion of premium reduction was caused by particular provisions in the amended law or other movements in insurance markets generally.

What is clear is that the decisions of the NSW Parliament have provided a sound basis on which the rationing of a scarce "compensation resource" can proceed in an orderly manner. To revert to a situation with fewer legislative boundaries would reintroduce uncertainty and escalate costs.

Companies such as *Vero* price premiums with a target return on capital in mind. Increased claims expenses arising from decisions of the community and Parliament will flow through to consumer costs. In that sense *Vero's* profit in the long run is relatively insensitive to legal changes, but the base price to consumers and the community is not.

Rather than accept a for-profit entity's analysis of legislative change, the Committee is encouraged to undertake comparisons of how liability insurance pricing and markets work with the NSW statutory insurance schemes: CTP and workers' compensation.

This submission provides particular comment on some of the claims or impressions about public liability insurance that are likely to be made in the course of the Inquiry. *Vero* is well placed to provide an assessment of the soundness of these claims.

INTRODUCTION

Vero welcomes the opportunity to provide a submission to the Committee.

This submission takes the form of several high level observations about:

- how insurance markets work
- how recent history has changed the dynamics of the market, and
- why the current debates are not straightforward for public policy makers to evaluate.

It also includes some observations exclusive to *Vero*'s experience of managing public liability matters over recent years.

This submission does not repeat the excellent statistical information and analysis provided in other reports such as those of the ACCC, the Productivity Commission and major accounting and actuarial firms.

Nor does this submission restate the structure and operation of public liability insurance in Australia over the past ten years. That is well summarised in several reports, particularly in the research report *Public Liability Claims Management* produced by the Productivity Commission.[i]

At the risk of being theoretical, *Vero* submits that the Committee's consideration of its terms of reference will be enhanced by understanding how public liability insurance has become such a volatile product and why it may remain so.

Through its own process of inquiry and reporting the Committee itself will contribute to the signals and opinions about our capacity as a community to sustain just and comprehensive compensation for the citizens of New South Wales.

Some authorities have suggested that "an increase in the number of claims by plaintiffs is a sign that we are progressing towards a more fair and just society"[ii]. In contrast, it is

not clear that we as a community would regard an increase in hospital admissions as a sign of a healthier society.

Vero contends that Parliaments, through the legislative changes over recent years, have responsibly asserted a community interest to ration a finite compensation resource within the public liability line of business.

As in compulsory third party motor vehicle accident (CTP) and workers' compensation insurance, the tension between capacity to pay and just compensation will be debated well into the next decade. Insurers, *Vero* amongst them, are now better placed than ever before to contribute to that debate on a sound empirical and policy basis.

WHO IS VERO?

Vero is a general insurer operating as part of the ASX listed Promina Group.

Vero:

- is part of a group whose general insurance businesses are collectively the third largest in Australia by gross written premium
- has over 1300 employees
- is a national company
- posted a net profit of $144m in 2004.
- had a gross written premium of over $1bn for the year ended 31 December 2004, of which 100% was written in Australia
- sells a range of insurance products including property, commercial motor, liability, marine and personal insurance through intermediaries, financial institutions, affinity groups and agents
- offers a range of fee for service products including workers' compensation services, claims management services, risk management services and registration and emergency support services through Secure Sentinel
- offers deposit and rent guarantees.

Vero's underwriting principles:

- **Pricing of risk:** Business is priced to meet return on capital targets
- **Risk selection and management:** Internal checks and controls are designed to ensure appropriate risk selection and management
- **Portfolio management:** Each distinct class of business is reviewed on a monthly basis and undergoes a bi-annual portfolio review.

The application of these principles is tailored to each of *Vero*'s businesses, territories and products.

THE RECENT VERO EXPERIENCE OF CLAIMS

The *Vero* experience of claims over the past 2-3 years is affected to some extent by the reorganisation of its public liability portfolio in 2001/02. In 2001 *Vero*'s predecessor Royal Sun Alliance Insurance Australia Limited reduced its exposure to the then loss-making public liability business and withdrew from several segments, including high frequency accounts i.e. those clients with large numbers of small claims.

In general terms, however, the following observations apply.

1. The underwriting experience of *Vero* broadly parallels that outlined in the ACCC Fourth Monitoring Report on Public Liability[iii]. This observation applies to trends in profitability, premium reductions and claims experience.

2. There is a significant reduction in claim lodgements associated with small to medium enterprises.

3. The *Vero* underwritten scheme tailored to cover licensed clubs in NSW has recorded a significant reduction in claims, with no apparent reduction in the number or quality of risk mitigation activities by insureds other than a continual improvement and refinement of their existing risk management practices. Detailed risk analysis and prevention is a key element underpinning *Vero*'s support for this industry.

4. There is no appreciable impact of the overall reform package on larger or catastrophic claims yet discernable. This is because insufficient time has passed for relevant claims to have emerged, been settled or moved through the insurance process for adjudication in the courts.

5. Coincident with the changes in the law has been a corresponding increase in claims containing a psychiatric impairment component. This appears to be directed at augmenting the severity of injuries to achieve the threshold levels set in statute.

6. The industry practice of reaching commercial settlement of claims does not always allow an insurer or plaintiff to attribute directly to portions of a settlement to particular head of damage.

7. There is an indication that as with CTP prior to the 2002 reforms, the medical threshold to access non-economic loss is a matter for judgement and prone to be breached. As a consequence the certainty of retaining any benefits from these changes is arguable, given the history of CTP claims management prior to 2002. It is therefore premature to assess these claims cost reductions as enduring, and adjust premium accordingly.

8. Changes in the law have decreased the likelihood of general damages forming part of the award at the lower end of injury severity. *Vero* has noted an increasing number of plaintiffs dealing direct with the company (that is without legal representation) to secure payment of medical and like expenses and compensation for economic loss.

9. The procedural elements of the changes in law appear to have placed a greater onus on plaintiffs' solicitors. Our experience is that files and legal proceedings are more disciplined than previously and the system generally more efficient.

10. Contrary to some concerns expressed in the industry, there is no evidence of a rush of claims inside the three-year statute of limitation (20 March) attributable to the *Civil Liability Act* 2002 and the *Civil Liability Amendment (Personal Responsibility) Act* 2002.

11. Much of the claims management, data collection, compliance, audit, reporting and actuarial activities of the company have tightened considerably in recent years. In part this is due to external regulatory and compliance requirements, but is equally due to more refined business practices that come with industry growth and consolidation.

12. The socio-economic environment is a major and unpredictable factor in estimating claims expenses. The environment greatly affects the propensity of citizens to claim. If there is a general expectation that general damages are an entitlement or benefit to be pursued in the event of an incident, then claim rates escalate, regardless of merit of the claims. Similarly, claim rates have been documented to move with economic rises and falls. In other words, there is no natural or objective claim rate for these classes of liability. Many factors influence whether an insurer will be found to have accurately assessed the premium required to make payments and get a return on capital, whether or not incidents actually occur. On current estimation two-thirds of the identified reduction in claims expenses since 2002 relate to general damages. Any changes to community attitudes and claim behaviours that reverse this pattern will flow through to costs and premiums.

13. There has been a reduction in caseloads managed by claims officers in relevant areas of *Vero*, confirming the reduction in overall public liability case activity. The caseload reduction has been in the order of 10%.

14. *Vero* has, consistent with the rest of the industry, tightened its policy wordings, increased deductibles and used fewer manuscript policies.

15. The rigidity and certainty of the CTP system, which allowed for a rapid pass through of savings from the 2002 reforms, is not a feature of the current public liability system. The number of variables, the possibility of resurgent claims costs, the risk of legislative revision and judicial reinterpretation means that confidence will take a little longer to develop before all savings are locked into premiums.

COMPENSATION LAW

A justification for the tort law was eloquently set out by Justice Atkinson of the Queensland Supreme Court[iv].

First, it (a robust system of tortious liability) ensures compensation for the victim of negligence; secondly, it provides an incentive for safe behaviours by potential tortfeasors, reducing the overall loss to society from negligently inflicted harm; and, third, it allows the cost of negligently inflicted harm to be distributed amongst those who undertake risky activities, removing the financial burden from the person injured and fro the rest of society.

As the events of the last few years have shown, the above statement represents an ideal world which, if it ever did exist cannot be relied upon for the foreseeable future.

First, the system of liabilities does not ensure compensation for victims unless there stands behind a negligent party, a sound insurance policy backed by a solvent insurer or the State.

Second, the liability system may reinforce the adoption of appropriate risk management, but in modern society there are many other incentives. Some such as regulation and criminal penalties are of greater use and more enduring force.

Third, the extent to which the cost incurred by a negligent party can be distributed depends upon the existence of a pool of insureds, a contract of insurance, the level of excesses involved, the solvency of the insurer etc. As seen too often, many of these costs fall not to the pool of insureds but to the community at large through Government indemnification or financial support.

The most relevant example of this is the role government has played to support medical indemnity insurance, an area where private for profit interests have long exited the field.

In other words the last few years have probably changed forever many of the assumptions about the role that public liability insurance underwritten by the private sector represents.

Historically, it is difficult to imagine Governments withdrawing from its role in defining the boundaries of privately provided compensation mechanisms. This should not be taken as a surprising development. It has been a feature of statutory schemes in various States and the Commonwealth for decades.

The historical significance of statutory intervention in the allocation of compensation resources, funded by premiums, cannot be under estimated. Just as its introduction has probably added to stabilisation of the public liability market, attempts to weaken those interventions would probably destabilise private markets and lead to a withdrawal of supply or increased premium.

This is because liability insurance is an unusual financial service. The principal beneficiary of the product is a third party, the plaintiff. The forces acting on the provider of the product and the insured are mainly market driven (except in certain circumstances there is no compulsion on any of the parties to buy the product.)

PARLIAMENT'S ROLE AS SETTING THE FRAMEWORK FOR PUBLIC LIABILITY

Legislators bear a heavy burden when setting or changing the environment in which compensation and resources are distributed between members of the community. One objective of this submission is to explain, from one major insurers' perspective - *Vero*, why the task of resource allocation is so difficult and not amenable to quick-fix solutions.

On the one hand governments and Parliaments work to optimise the elements of an insurance system using the tools at their disposal – taxes, regulation and statute – while on the other, insurers have an equally complex matrix of economic considerations that have to be balanced to meet their competing requirements.

The Parliament has to balance a range of roles and stakeholder requirements including:

- consumers
- legal lobbies
- the judiciary
- the Government as an insured party
- the Government as insurer of last resort
- community groups
- employers, and
- unions.

Insurers too must balance the interests of many stakeholders:

- policyholders
- shareholders
- the community
- reinsurers
- Governments
- regulators
- staff
- claimants, and
- the judicial system.

Unfortunately for Government policymakers and the community, this complexity is not consistent with the natural drive or desire to identify simple answers to questions such as:

- What caused the insurance crisis in 2001?
- Was tort law reform necessary, what are the impacts and have any benefits been passed on to consumers?

As will be shown, the influences on the insurance economy are multifaceted. As a consequence simple analyses, responses and claims ought to be viewed with considerable scepticism.

The inherent complexity of public liability insurance as a product is compounded by two other factors that have hindered clear analysis. First, it is now agreed and well established that the data on which robust analysis could be founded has not existed in a consistent form until the last few years.[v] A consistent observation of many private and government reports is that the data available on the public liability class of business was, until 2003 or thereabouts, woefully inadequate to the task of describing industry-wide trends and informing policymakers. This failing has been overcome through the work of the APRA, Insurance Statistics Australia, individual companies and governments across Australia.

The consequence of this lack of data has been professional and public debate on tort law reform based on the best estimates of participants, or specially commissioned data analyses. This is not to say that these estimates were wrong or inadequate. Rather it highlights that going forward, legislators will have available data sets and analysis that were denied their predecessors.

The second factor that cannot be over-emphasised (and which has featured in many reports) is that public liability insurance is a "long-tail" line of business.[vi] This is not just a theoretical observation. As noted by the Productivity Commission in its report on Public Liability Claims Management:

> *Setting premiums for public liability insurance is very difficult because of its 'long-tailed' nature (claims costs occur over many years) and the wide range of risks it covers. Since the mid 1990's, public liability insurance has operated at a loss. The ACCC has recently assessed the outlook for return on capital for public liability insurance to be low.*

In practical terms, a company such as *Vero* is required to set and charge premiums today for a range of compensable incidents that may not emerge or be lodged for many years. Some claims may take up to 3000 days between lodgement and settlement. It is not until five or so years after the year in which premiums have been collected, that we are able to assess with any degree of certainty whether that underwriting year broke even or made a profit or loss.

There are many factors that can influence the difference or gap between the assumptions underpinning the premium price and the eventual financial result. These include:

- the frequency of claims increasing or decreasing
- fluctuations in the economy
- judicial precedents increasing or decreasing claim payments
- changes in the law affecting benefits, legal processes or costs
- administrative expenses, and
- reinsurance costs and the ability to recover claims.

A key objective of an insurance company is to assess the likelihood of change as realistically as possible and price that possible three to five year speculation into today's premium price.

The significant feature of the period 2001 to the present has been the large number of variables confronting insurers trying to price public liability premiums.

This period is aberrant because of the large number and type of factors influencing the market:

1. disruption to the supply of public liability product through the collapse of HIH
2. disruption to the pricing of product because of the negligent behaviour of HIH
3. an accumulation of underwriting losses due to claims payments significantly in excess of estimates implicit in premiums collected to superimposed inflation of a high and unsustainable nature, and
4. disruption to reinsurance and capital markets due to the events of September 11.

These factors are well set out in the research paper prepared by the Federal Parliament Research Service[vii].

In response to the unprofitable nature of public liability insurance and the uncertainties surrounding its future, *Vero*'s predecessor, Royal and Sun Alliance Insurance Australia

Limited took a decision to withdraw from many sections of the liability market, most particularly the so-called "high frequency" accounts.

This was a commercial recognition that for the foreseeable future none of the five elements listed above was likely to be moderated in a manner that would bring sustainable profitability back into this business line. *Vero* has not significantly moved from this position.

Tort law reform is significant to a company such as ours. It represents an attempt to influence or control at least some of the maverick factors that makes public liability an inherently risky line of business to write, in particular, so-called superimposed inflation.

Consistent with this observation is the view that like many insurance companies, our appetite to re-enter segments of the public liability market or to allocate more capital to this line of business will depend upon actual emerging claims experience.

For Parliamentarians, the community and insurers, this is one of the dilemmas of public liability. It is an uncertain line of business to manage and measure over any three to five plus year period. As a consequence, it is more difficult for a company to reallocate capital and re-enter or expand its market than it was to exit during times of significant loss.

For the Committee's purposes these are relevant considerations because:

- it is too early to make an objective or conclusive assessment of the NSW tort law reform
- any ill-considered amendment to those reforms will interfere with the ongoing evaluation of the original changes, and
- any un-costed amendments will add to the degree of uncertainty that insurers will have to factor into their assessment of the market, premium pricing and appetite, for involvement in this line of business.

The Parliament's role in establishing a framework for pricing certainty is a key element in how the public liability market develops in New South Wales and Australia in years to come.

OTHER SOURCES OF ANALYSIS

STATUTORY INSURANCE CLASSES

The Committee should not simply rely on the observations of a private insurer to test the impact of changes in pricing long-tail products.

Statutory insurers providing CTP and workers' compensation insurance are confronted by the same dilemma as private insurers in managing long-tail schemes.

In their case, the accusation cannot be levelled that reforms have been engineered to improve profitability. They are statutory agencies and the impacts of change go almost directly to their bottom line. It would be possible, therefore, for the Committee to test the propositions about pricing long-tail liability products in a not-for-profit environment. This would elucidate the key role played by statutory certainty in pricing, managing and sustaining long-tail insurance classes.

Of course, in the case of the statutory classes, an adverse precedent set by judicial determination or a claims trend adverse to the interests of the State can be readily rectified through amending legislation.

In this case the State plays the multiple roles of insurer, reinsurer, rule setter and shareholder. The *Motor Accidents Compensation Act* 1999 was a response to community concerns about the escalating cost of CTP premiums. These changes occurred without an accompanying debate about "tort law reform". Rather, the adjustment of the law to match the community's capacity and preparedness to pay was relatively straightforward, and based on sound economics.

These reforms have taken some years to work through the system. There is now good evidence that the assumption on which they were based was correct, that a more disciplined claims cost and processes environment has translated to a containment of premiums.

While we as a community appear to accept the nexus between claims expenses and premiums for statutory classes of insurance, there is ongoing debate about the

equivalent connection in the provision of private insurance, especially in public liability insurance. Why is this?

Two recent observations by leading judges highlight how there are many interpretations of how premiums and liabilities relate to one another.

First, Justice Michael Kirby recently noted that:

> *While in Australia we roll back the entitlements of those who suffer damage in the name of personal responsibility, we have to be careful that we do not reject just claims and reduce unfairly the mutual sharing of risks in cases where things go seriously wrong.*
>
> *These are important questions for the insurance industry. It will not thrive if it becomes known, or suspected, that high premiums are paid when its liability is significantly and consistently reduced. The sharing of risks is the essential brilliant idea of insurance*[viii].

Our responses are:

1. *Vero* shares a concern that we not reject the just claims and rely on Parliaments and the courts to set the framework in which the compensation balance is reasonably struck.

2. The mutual sharing of risks in cases where things go seriously wrong is only capable of being achieved where insurance of some form is available to the injured person. The availability of cover is as much an economic question as a legal one.

3. It is not clear why these questions are exclusively for the insurance industry to own or resolve.

4. The mandatory provision of public liability products is not a requirement of being an authorised insurer of Australia. One way of avoiding the opprobrium of recent public debates on liability insurance is, therefore, to exit the market.

5. Fortunately the processes of various Governments, the ACCC and APRA have moved to ensure that suspicions about insurers profiteering from liability reductions are now capable of being tested over time. The implication that reduced liabilities are not likely to find their way into reduced premiums or that insurers have some unconstrained discretion in this respect is challenged by another commentator on the liability situation.

A significant thinker on public liability issues is Justice J J Spigelman, Chief Justice of the NSW Supreme Court. His comments on the nexus between liability costs and premium accords with the *Vero* experience.

> *I have expressed the view both in judgements and extra judicially, that the judiciary cannot be indifferent to the economic consequences of its decisions. Insurance premiums for liability policies can be regarded in substance, a form of taxation (sometimes compulsory but ubiquitous even when voluntary) imposed by the judiciary as an arm of the state. For many years there was a seemingly inexorable increase in that form of taxation by judicial decision in Australia.*
>
> *Whether by way of increases in insurance premium or by way of a call on taxpayers' funds it became widely accepted at all levels of government and in the community generally that the existing tort system had become economically unsustainable. The particular focus was the sudden escalation of premiums. Insurance premiums are the result of a multiplicity of factors, however, the costs of claims sets the basic structural parameters within which other forces operate. Those costs have increased considerably over recent decades.*[ix]

In the case of statutory classes, judicial decisions or changes to the law endorsed by Parliaments translate almost directly to the Government's own financial position. As Justice Spigelman notes:

> *It is quite clear that governments have a very real financial interest in the operations of the tort system.*[x]

In the case of private insurers, the route is more circuitous but is no less similar in effect.

In theory, favourable liability movements could give rise to financial advantage, even super-profits for insurers. In the case of statutory insurers the not-for-profit structure, Parliamentary scrutiny and pressure for a compulsorily insured consumer base limits this possibility (not to mention the political impacts of deficits and unfunded liabilities). This structure is reinforced though the existence of statutory price controls.

In the private sector the critical question for the Committee and other inquiries of its type is: "What are the economic mechanisms preventing an insurance company arrogating to itself the benefits of changes in the liability environment that have been sanctioned by the community through the Parliament?"

In the absence of price controls on public liability premiums it is reasonable for the community to satisfy itself that any benefits for containing claims expenses (brought about though the application of the State's powers) have contributed either to the availability or affordability of the product.

In addition to the standing references of the ACCC to oversee competitive behaviour, several specific mechanisms exist to test the efficiency of public liability insurance markets.

The most significant mechanism to prevent insurers enriching themselves as a result of tort law changes is the operation of an open market. An open and competitive market will prevent any insurer capturing and holding the benefits of tort reform. This observation holds true for other elements in the structure of premiums – efficiency in claims management is only a comparative advantage while competitors lack this skill.

Vero concurs with the findings of the Productivity Commission which noted that:

> *Competition in the supply of public liability insurance provides incentives for insurers to make their claims management practices, and other facets of their business, efficient and cost effective.*[xi]

A more recent and detailed explanation of premium movements is provided in the 2004 General Insurance Industry Summary commissioned by KPMG[xii]. A copy of the executive summary is attached for the Committee's information.

Although the KPMG summary does not separate out the public liability business line, its general themes are relevant to the Committee's consideration of what constitutes "cost effective" insurance.

"Cost effectiveness" is not just about premiums being low. It is about the ability of the market to supply to the greatest number of exposed individuals and businesses, the most robust and sustainable cover at an affordable price.

Tort law reform is but one contributor to the complex framework setting public liability premiums. Within the operation of the market *Vero* agrees with the KPMG analysis – one objective is to the price within the "stewardship responsibility zone", outside of which is a clear warning: [xiii]

> *Inadequate premium levels are potentially as harmful to an insurer as excessive premiums*

TREASURY MANAGED FUNDS

A considerable amount of public attention has focused on the behaviour of private insurers and their willingness to pass cost savings on to consumers through lower premiums. Regrettably the debate has been conducted in a charged atmosphere frequently assuming that private insurers alone are the beneficiaries of legislative change.

Though the precise impact is difficult to discern from published information, it is clear that the NSW Treasury Managed Fund is sufficiently certain of the economic benefits of legislative changes that its financial statements reflect positive movements[xiv].

These benefits ought to translate directly to NSW taxpayers through a reduced call on premiums paid by departments and agencies, a reducing aggregate liability of the Fund or a mix of the two.

In either case, the community of NSW through its extensive responsibilities for the business risk of public bodies and health services is a major beneficiary of legal changes.

Though the precise details of these benefits are not known to *Vero* they might form the basis of useful benchmarking opportunities to access the extent to which premiums in a not-for-profit, but tort affected environment have moderated.

MEDICAL INDEMNITY INSURANCE

Vero does not write medical indemnity policies. An analysis of medical indemnity insurance and tort law reform is instructive This is because a large number of personal injury awards (particularly at the high or catastrophic end) in NSW are made pursuant to medical indemnity policies held by public and private practitioners.

The value in examining this area of insurance is that it is overwhelmingly provided by not-for-profit mutual organisations. The well-documented experience of medical practitioners unable to afford the premiums derived from non-profit funding models emphasises the reality of the problem facing the Australian community.

Even a cursory examination of the medical indemnity insurance industry, which was subject to the same cost pressure as general insurance, demonstrates that without some significant intervention claims costs and superimposed inflation would have driven premiums up and practitioners out of business. It is for this reason that the Federal Government intervened with its extensive funding support scheme for Australian doctors. The intervention was not driven by pressure for increased profits by mutual insurers, but by the reality of an extreme affordability gap. This was compounded in the case of NSW by a dramatic availability gap with temporary withdrawal of UMP.

GENERAL ISSUES FOR CONSIDERATION

THE RIGHT TO SUE

Regrettably, much of the debate about tort law reform is conducted by some as though the "right" to sue for damages has been denied through recent changes in the law.

The history of statutory insurance schemes, such as CTP and workers' compensation, is one of constant revision of the benefits that the Parliament has determined ought to be made available under various circumstances. Similarly, the common law effectively provides for movements in the benefit regime attached to various classes of insurance to be increased or decreased as social conditions change and precedents are established. The best analysis of the highly constrained nature of common law rights is provided by Chief Justice Spigelman.[xv]

In the case of statutory classes of insurance the frequent modification of the entitlement 'rights' at any time is assessed by governments, and Parliaments having regard to the costs or relief in premiums that will flow.

In the case of compulsory statutory schemes the relationship between entitlements and premiums is almost a direct one. Apart from administrative efficiencies and enhanced risk management that can be achieved by an authority, there are few other tensions in the scheme. Being compulsory products with policy terms defined in statute, the authorities managing these products are not able to opt out of a segment of the market, increase excesses, reduce exposure to risky clients or use any of the other management techniques in the private sector. The implicit or explicit sovereign guarantee standing behind these State sponsored schemes also means that the volatility of international reinsurance markets is not generally a feature of their pricing. This observation does not, of course, hold for those with privatised schemes that area subject to international reinsurance volatility.

In respect of adverse legal precedents or decisions it is not unusual for the State, the ultimate bearer of the cost of adverse decisions, to amend the law from time to time to clarify the nature of our entitlement or to reinstate a position that was thought to exist prior to the act of judicial interpretation that created an alternative view of the world.

AFFORDABILITY AND AVAILABILITY

The Committee's information sheet in support of the terms of reference implies some scepticism as to whether businesses in NSW were adversely affected by significant premium increases. Although *Vero* has no data to confirm this, it is our contention that the rapid escalation of premiums in the period 2002 to 2004 were well beyond the capacity of businesses to bear. This was particularly obvious at the smaller end of the market where the opportunity to raise revenue and prices was constrained.

More importantly, the Committee's attention is drawn to the well documented reduction in availability of cover for many community and small business organisations.

Vero made a conscious decision prior to 2003 to withdraw from the so-called "frequency claims" end of the market i.e. businesses with a likelihood of having many low value claims. This preceded the collapse of HIH which had a significant, if not majority, coverage of this market segment for public liability policies.

Vero identified the troublesome nature of the low-end of the public liability line of business some years ago. On current evidence it appears sufficiently unattractive for us to return to that market other than in targeted markets such as manufacturing where a strong risk management emphasis mitigates the exposures for clients, *Vero* and the public. In other words, *Vero*'s response to this line of insurance remains cautious despite the tort law reforms that are, in some quarters, alleged to be producing excessive profits.

Why do we write any public liability insurance at all? Some clients have enviable risk management programs and an established relationship that makes the writing of the product more certain. Many of our clients require portfolio cover that takes into account the full range of their exposure.

Some liability risks are capable of being costed and claims defended in a manner that brings certainty to the pricing equation. These tend to be the more significant risks facing businesses that *Vero* has come to understand very well.

RISK SPREADING

In 2001-02 we were confronted, for the first time in many decades the essentially voluntary nature of privately secured liability insurance. As indicated above, there are two sides to the recent insurance crisis: the affordability and availability of insurance.

Many commentators naively assume that the private insurance market either must or naturally does provide cover for all risks to which members of the community are exposed. This is not true.

In many areas, citizens fall upon State welfare for relief or compensation where the circumstances of an incident do not provide for private redress.

The process of risk selection by insurers i.e. choosing ones customers according to their riskiness, is an increasingly common feature of contemporary liability insurance management. A primary obligation of an insurer is to ensure that the claims lodged by insured parties can be paid, and that extremely risky members who have not contributed in direct proportion to their risk exposure do not deplete the premium pool. The more certain the characteristics and claims patterns of insureds, the more attractive that business becomes for an insurer.

Many of the tort law changes have the potential to bring into the mainstream groups of insureds who threatened the viability of risk spreading. In the case of risky recreational activities, for example, changes in law may prove to bring the insurers' exposure back into a normal range and allow for risk spreading.

As has been stated on several occasions, the effectiveness of these changes on the practice of insurance will take five plus years to emerge.

GENERAL DAMAGES

One claim made in the course of debate on tort law changes was that restricting general damages for minor injuries was unfair to unemployed persons. The argument suggested that damages for pain and suffering went some way to providing support to persons who otherwise had no claim against the "economic loss" head of damage.

It is not known if, or when the courts or Parliament endorsed the use of insurances to provide general economic relief. In effect the operation of this principle generally would have successful claimants not only reinstated to their original economic state but significantly improved.

One of the benefits of the discussion on entitlements under public liability insurance contracts, has been to draw attention to the drift in the manner in which compensation has been interpreted and paid.

It remains open to Parliament to determine statutorily that benefits ought to be payable on the same basis to all people regardless of their employment status. But this should only be done once costings have been provided and a decision made as to where the economic burden of such an initiative should fall. Were there community views that insurance ought to provide an additional benefit to persons without an actual claim for economic loss, then the costs associated should in our view come from community resources as part of a general welfare program.

In a policy sense, insurers would most likely be indifferent to a statutory direction to treat all claimants in the same manner. The inevitable consequence is that the costs associated would be translated into premiums in the event that payment remained a responsibility of the insurer.

WRITS ISSUED, CLAIMS LODGED AND TRENDS

Throughout the public liability debate there has been a significant confusion between statistics on:

1. writs issued in the courts
2. claim lodgements, and
3. solicitor derived data.

A significant measure of claims activity could be derived from the files maintained by plaintiff law firms – the number of files opened, legal fees charged in party–solicitor agreements, claim inquiries not pursued etc.

Regrettably data in category 3 is not available to assist authorities assess the impacts of changes to the law. Writs issued are an indicator of court related activity not insurance activity overall. We concur with the ACCC interpretation of the extreme drop-off of writs issued in 2004 compared to 2003:

> *The claimants in both the States (NSW & Vic) rushed to file claims preceding the introduction of reform … it is possible that the significant fall in the number of filings post-reforms may be partly the result of claimants waiting to see the effect of reforms. The*

> *net effect of reforms on the number of claims filed will only become clear over the next few years (emphasis added).*[xvi]

Using these statistics it may be possible, though not credible, to claim that changes to the law have all but eliminated claims for personal injury.

So far as *Vero* is concerned, our actuarial estimates of claims lodgements will take at least two more years to be sound enough for pricing decisions. That is, not until 2007 would we expect to have a clear impression of the behaviour of claims and writs of incidents that occurred in 2002.

UNDER OR NON-INSURANCE

At some point enterprises may choose to opt out of insurance, self-insure or take up insurance products of an untested quality i.e. not written under Australian law or provided by an APRA authorised insurer. The risk to citizens in these circumstances is that in the even of an incident they may have no or little prospect of recovery.

This is a consequence of the voluntary nature of most liability insurance arrangements. Other than where required by statute or by a businesses' financier, the holding of sound insurance on which reliance can be placed remains an optional feature of business operations. This is certainly not a desirable or prudent position from an insurers' perspective. Nor is it desirable from a community perspective where a reasonable policy objective is that all negligent acts have standing behind them an adequate compensation mechanism to support the plaintiff.

A similar risk to consumers arises in the case of deductibles and excesses. One negative impact of the insurance crisis has been the tendency of insureds to reduce their potential premium outlays by bearing higher excesses than previously. At the lower end of the claims scale, and in the absence of tort reform, many of these low-end claims would have been directed individuals or businesses for resolution outside the normal insurance contract framework. In other words, had the tort environment not changed, or if it reverts to previous settings, there is a risk that consumers will find themselves engaged in complex civil litigation with individual businesses claiming small below excess damages.

The preferable and balancing position is one along the line adopted by many Australian State Governments. That is, some containment of general damages but the retention of

an injured party's entitlement for payment of medical expenses and economic loss in the event of lower scale or impermanent impairments.

RISK MANAGEMENT

It may be claimed that restricting access to general damages at the lower end of injury severity will absolve insureds and insurers of their obligation to manage risks in their environment.

Vero attaches significant weight to risk management and has a strong preference for historical risk-managed lines of business such as manufacturing. This was the case prior to the reforms and will remain the case in the future.

It is not possible for an underwriter in the general insurance industry or an insured to tailor risk management interventions according to the levels and types of compensation affected by tort law reform.

There is no demonstrable reduction in risk management activities by *Vero*'s insureds, who have in the past had significant, now below threshold, claims. Nor is there evidence that caps on various categories of payments at the higher end of claims have translated in any way to looser risk management behaviours.

The reason for this is simply that the nexus between ultimate payment levels, and the obligation of insureds is not established. A dangerous surface will be fenced off by a site manager regardless of his or her assessment of whether the injuries arising from an incident on the site would likely be above or below threshold, or involve gratuitous care or otherwise.

PROFIT

There have been strong and repeated claims that tort law reforms were introduced to assist insurers generally and specifically increase their profits.

Regrettably most of this analysis fails to appreciate:

1. the manner in which insurance companies establish their prices and hence profits, and

2. the significant separation of business lines for costing, pricing and reporting purposes that has occurred in recent years.

There is no obligation on an insurer to subsidise an underperforming business line (i.e. poor loss ratio, poor return on capital). Many of the claims about recent insurance company profits assume:

1. that the above average aggregate profits are derived in whole or in part from business lines associated with personal injury claims

2. that if personal injury lines achieve a break-even point, the profits of other insurance lines should somehow be redirected to reinstate benefits affected by tort law reform, or

3. that if cross subsidisation is not practicable then insurers should raise premiums and extend cover in a manner that has no socially disruptive effects.

RESPONSES TO ANY PROPOSED CHANGES IN THE LAW

The Committee is likely to receive submissions calling for the reversal of all or some of the tort law changes introduced since 1999 (or 2002 in the case of non-statutory classes). It is reasonable, therefore, to provide advice on how in reality any such initiatives may be perceived or factored in to pricing. There are two distinct areas where Parliament and responsible bodies should take evidence in the event that any adjustments to the law are proposed.

The first centres on the intangible factors such as the perception of overseas markets and the reinsurers. Anecdotal evidence suggests that the Australian liability market is perceived more favourably by reinsurers following the attempt to codify the common law, more strictly defined the boundaries of benefits and disciplined legal processes. This more favourable climate has most likely contributed to a greater availability of capital in the Australian market than previously.

It is suggested that the Committee take evidence on this point in the event that submissions are made to revert to past statutory practices. As the majority of reinsurance and capital support for the Australian liability market is sourced from overseas, the economic impact of change is best assessed through direct inquiry of those sources, such as Lloyds.

Vero contends that though difficult to quantify, a reversal of initiatives taken since 2002 (for civil liability in NSW) would have a strong, negative impact on liability markets. This would reflect the risk aversion of reinsurance and the fact that the current initiatives are in their infancy. Caution is likely to drive suppliers of capital to be more conservative, and lead to a more restricted or more expensive supply of capital.

The second tangible factors relate to the emerging claims impacts of the tort law changes. *Vero* and other companies are just beginning to factor claims payment and claims management savings into premium prices. These savings predominantly relate to the high frequency and low value claims. Reinstatement of these into the cost mix would lead to a prompt upward premium adjustment.

Insofar as the impacts of the more complex changes to the law affecting high value claims, *Vero* has insufficient experience to speculate about the impacts of any changes to the law. In theory, we anticipate a positive outcome and therefore a revision to past practice would be expected to be at some cost to premium payers.

NOTES

[i] Productivity Commission, 2002, *Public Liability Claims Management*, December, Chapter 2.

[ii] Justice Atkinson, *Tort Law Reform in Australia*: Speech to the Australian Plaintiff Lawyers Association Queensland State conference, 7 February 2003, Hyatt Regency, Sanctuary Cove, page 3.

[iii] ACCC (Australian Competition and Consumer Commission), 2005, *Public Liability and Professional Indemnity Insurance – Fourth Monitoring report*, January

[iv] Justice Atkinson, *Tort Law Reform in Australia*: Speech to the Australian Plaintiff Lawyers Association Queensland State conference, 7 February 2003, Hyatt Regency, Sanctuary Cove, page 6.

[v] Trowbridge (Trowbridge Consulting Ltd), 2002, *Public Liability Insurance : Analysis for Meeting of Ministers,* 27 March 2002, page 40.

[vi] Productivity Commission, 2002, *Public Liability Claims Management*, December, page 14.

[vii] Kehl, D 2002, *Liability Insurance Premium Increases: Causes and Possible Government Responses*, Current Issues brief, Economics, Commerce and Industrial Relations Group, Department of the Parliamentary Library, Canberra, 19 March.

[viii] Justice Michael Kirby, 2005, Speech: *Annual Review of Insurance and Reinsurance Law,* 23 February

[ix] Justice J J Spigelman, 2004, *Tort Law Reform in Australia – Address to the London Market at Lloyd's,* 16 June, page 4

[x] Ibid, page 7

[xi] Productivity Commission, 2002, *Public Liability Claims Management*, December, page 49.

[xii] KPMG, 2004, *General Insurance Industry Survey 2004*, Executive Summary

[xiii] Ibid, page 6

[xiv] NSW Government, 2004, *Crown Entity Annual Report 2003-04*

[xv] Justice Spigelman 2002 *Negligence: The Last Outpost of the Welfare State*, April, pages 5&6.

[xvi] ACCC, 2005, page 44