



Insurer profitability and the impact of tort reform

By Estelle Pearson

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INTRODUCTION

The 2004 year represented the best level of profitability measured for insurers for the last 25 years. The return on capital for the whole industry, as published by the insurance industry regulator APRA, was 23% compared with an average return on capital for the previous decade of 11%. A number of factors have contributed to this exceptional performance:

- a favourable economic environment;
- low rainfall, which affects motor vehicle accidents;
- strong pricing in commercial classes of business;
- tort law reform and its impact on personal injury claims;
- good investment markets; and
- an absence of major catastrophe events.

Never in the last 25 years have all of these elements coincided in the one year. While APRA has not yet published industry results by class of business, we expect that they will show strong performance across most if not all lines of business.

With such a diverse set of contributors and with good results across many classes of business, it is not valid to single out tort law reform as the sole or major contributor to the industry's current good profitability.

PREDICTIONS DIFFICULT

It is also difficult to predict what the results will look like for 2005. In 2004, insurers were predicting lower prices for some classes of business and increases in expenses, particularly regulatory and compliance costs, resulting in an overall reduction in the level of profit. The actual result will depend on the prices achieved in the market, the level of claims across all classes of business and the performance of investment markets. The former is cyclical while the latter

two are volatile. For example, the level of insurance claims in a year will depend on the weather, the absence or presence of any natural or man-made catastrophes and the trend in payments for personal injury claims.

The unpredictability of claims for personal injury classes such as public liability, compulsory third party (CTP) and workers' compensation exacerbates this situation. Insurers participating in these classes need to establish prices for policies being written today, but any claims for which will not be paid for a number of years. Insurers can only begin to really understand the likely claims outcome in around four or five years' time when a sufficient volume of claims have been finalised, and it will be a further four or five years before they know with any degree of certainty what the actual outcome has been. Until that time, the claims cost for business written in 2005 will be an estimate made by claims managers (of individual claims) and by actuaries looking at portfolio trends.

Having been caught in the past by such events, insurers are understandably wary about taking too optimistic a view of likely results early on. Prudent practice demands that insurers allow for the possibility of adverse experience when establishing provisions for outstanding claims in their accounts. Past experience has shown that precedent-setting events, such as court judgments, can cause the claim environment to deteriorate rapidly and unpredictably.

Also of importance is the fact that such events generally have a flow-on effect, not only to current year claims but also to outstanding claims from earlier years of business.

This makes it difficult to interpret published results since these will reflect not only the level of claims costs estimated for claims occurring in the current year, but also any

reevaluation of liabilities relating to previous years' claims. The profit declared in a year for a long-tail class of business may not, therefore, reflect the profitability of the business currently being written.

PUBLIC LIABILITY

The tort reform environment

Public liability tort reform took place in an environment where the average size of claims had been increasing at around 6% per annum above the rate of wage inflation throughout the 1990s, and probably for the two decades before that. There had also been a long-term judicial trend towards extension of standards of care, and judicial decision-making had been 'pro plaintiff'. At the same time, the insurance market for public liability business had been extremely competitive, and premiums had been falling since the mid-1990s. HIH was a significant player in this class of business and when that company collapsed in 2001 there are estimates that it had a 40% market share.

The coincidence of these two trends led to a severe adjustment in market prices in 2001 and 2002. The price adjustment corrected for years of under-pricing of this business by the insurance industry, and also reflected concerns about the uncertainty of risk exposures.

The tort reform which took place at this time was aimed at alleviating the problems of accessibility of cover for some of the most severely affected consumers and in improving affordability. Reforms were made to the level of compensation, including introducing thresholds for access to general damages.

Impact of tort reform

Tort reform has led to a significant drop in the number of claims because of the thresholds introduced for access to general damages – although the drop in claims is not as large as the fall in litigated matters. The drop in claims costs will be less than the drop in claims since it is the less serious claims that are impacted by the general damages thresholds. We also believe that tort reform has been a contributor to the more benign claims environment of the last couple of years. In these years, claims inflation has been much lower than recorded in previous years.

Of course, only a small proportion of post-tort reform claims have been finalised and hence the impact of the reforms on eventual claims costs for this period is not known with any degree of certainty.

Since tort reform was introduced, we have seen prices for public liability business reduce. The Australian Competition and Consumer Commission's (ACCC) public liability monitoring report showed a 4% drop in prices in 2004, and we believe that prices are likely to have fallen again in 2005. This is based on our discussions with underwriters and supported by a recent National Insurance Brokers Association (NIBA) survey of members, which reported that 33% of respondents replied that prices had fallen by 10% to 19% for liability business at June.

These lower prices can be attributed both to insurers reflecting the impact of tort reform and to a greater level of

competition in the market. There is no doubt that the combination of higher prices (compared to mid-90s) and tort reform have acted to make the Australian public liability market a more attractive proposition for insurers, both locally and internationally.

Insurer profitability

We do not yet understand the impact of tort reform on the profitability of the personal injury classes. We believe that when industry figures are published they will show that this class has returned to profitability following many years of losses. However, it is difficult to know to what extent this profitability improvement has already been factored into the lower prices.

NSW CTP

Impact of tort reform

Tort reform in NSW CTP took place in 1999. Access to general damages was changed from a court-determined assessment to a medical assessment equal to 10% whole-person impairment. In addition, major changes were made to the way in which claims were settled. One of the objectives of the NSW reforms was to reduce claims costs by reducing general damages for less severe injuries and thus reduce premiums which, prior to 1999, had been much higher than in other Australian jurisdictions. >>

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Tort reform had a dramatic impact – since 1999 the frequency of NSW CTP claims has dropped by 45%, and the cost of claims (based on payments and case estimates) by 25%. The drop in claims costs is less than the drop in frequency because it has largely been small value claims that have disappeared. The weather has also played a part in the reducing claims cost, with a lower level of road accident casualties in the period since 1999 due to low rainfall.

But we still do not know with certainty what the impact of tort reform on claims costs has been. Even for the oldest post-tort reform accident year, although numerically 88% of claims have been finalised, the remaining 12% of claims represent 50% of the total claims cost.

The NSW tort reforms were reflected immediately in premium reductions by insurers. Using figures published by the Motor Accident Authority (MAA), the NSW CTP regulator, just prior to tort reform in 1999 the average premium charged was \$419. In the 12 months to December 2000 this had dropped to \$340 and in the 12 months to December 2004 it was \$334. Some insurers have been advertising lower prices recently, and figures for 2005 may show a further premium reduction.

Insurer profitability

There have been no published figures on industry profitability in NSW CTP since 2002. We would expect, however, that profitability has been good, given the ability of

the industry to maintain or reduce prices over a four-year period, and the competitiveness for market share. Prices are regulated in the NSW CTP system insofar as insurers have to file their intended premium rates and pricing basis to the MAA annually. This places restrictions on the profit margin which can be included in premiums – we understand that the average profit margin currently represents around 8.5% of the premium amount.

CONCLUSION

After considering the available evidence, we conclude that tort reform has been just one factor in the good insurance industry profits for 2004. The good result has been achieved across most classes of business including motor, householders and commercial property. Premium income for non-personal injury classes which are not impacted by tort reform accounts for around 80% of total industry premiums.

Restrictions on access to general damages introduced by tort reform have led to a large reduction in the number of claims, but since the thresholds are targeted at less serious injuries, the reduction in claims cost is less than the reduction in claim numbers.

Premiums have reduced for classes of business affected by tort reform. There are no industry figures on premium rates for public liability; however, the ACCC monitoring report in 2004 measured a 4% premium reduction. For NSW CTP, prices dropped by 19% following the 1999 tort reforms and have continued to reduce slightly over the subsequent four years. We expect further reductions are likely for both classes in 2005.

The price reductions are due to two factors – allowance for the impact of tort reform and increased competition, driven by the increased certainty about claims costs and the therefore increased attractiveness of the market to insurers post-tort reform.

It has been suggested that the high industry profitability should make it feasible for tort reform to be wound back without any flow-on impact to prices. We do not agree with this conclusion.

It is not feasible for profits made on non-personal injury classes to be used to 'subsidise' the personal injury classes, since this would be inequitable and also impractical, given that not all insurers participate in all classes of business. For personal injury classes there is uncertainty about claims costs and the impact of tort reform on claims costs.

To the extent that the current tort reform is reflected in prices (and some insurers have announced specific tort reform-related price reductions) any wind-back would be reflected in higher prices. In addition, if a wind-back of tort reform signalled a return to the difficult, high-inflation environment that was a feature of the 1990s for personal injury classes, then the level of competition for business would also be likely to reduce, putting more upward pressure on premium rates. ■

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