# Public liability and professional indemnity insurance

Monitoring report

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# Contents

# Abbreviations

| | |
|---|---|
| ABS | Australian Bureau of Statistics |
| ACCC | Australian Competition and Consumer Commission |
| ACT | Australian Capital Territory |
| ANZSIC | Australian and New Zealand Standard Industrial Classification |
| APRA | Australian Prudential Regulation Authority |
| ASIC | Australian Securities and Investment Commission |
| AWE | average weekly earnings |
| CTP | compulsory third party |
| GDP | gross domestic product |
| GST | Goods and Services Tax |
| Insurance Act | *Insurance Act 1973* |
| ICA | Insurance Council of Australia |
| ISA | Insurance Statistics Australia |
| MDO | Medical Defence Organisation |
| the ministers | Commonwealth, state and territory ministers and the President of the Australian Local Government Association |
| NFPO | not for profit organisation |
| NSW | New South Wales |
| NT | Northern Territory |
| PC | Productivity Commission |
| PwC | PricewaterhouseCoopers Actuarial Pty Limited |
| Qld | Queensland |
| SA | South Australia |
| Tas | Tasmania |
| Vic | Victoria |
| WA | Western Australia |

# Glossary of terms

This glossary contains a brief description of common terms used in the insurance industry that appear in this report.

| Term | Meaning |
|---|---|
| agent | an insurance intermediary whose principal is an insurer |
| broker | an intermediary who places the risks of parties seeking insurance with insurers |
| brokerage expenses | commissions, brokerage and similar charges paid or payable by the insurer to agents or brokers |
| claims frequency | the rate of occurrence of claims, in this report, the number of claims as a percentage of the total number of policies written |
| claims payments | the payments that have been made on all claims at a particular date |
| combined ratio | the sum of the loss ratio and the expense ratio and shows the percentage of premium that is represented by the costs of writing the business, including the cost of incurred claims |
| cover limit | the maximum amount an insurer will pay under a policy |
| earned premium | the total amount of gross written premium that is 'earned' during the period, earned being that proportion of risk covered by the policy that has expired at the end of the reporting period. For example one year's premium may cover 12 months of risk, after 6 months has elapsed the insurer is said to have 'earned' 6 months worth of that premium. |
| excess | an amount of the loss that will be paid by the insured party before the insurer pays the claim |
| expected future payments | the insurer's liability for outstanding claims recognising the potential cost to the insurer of settling claims which it has incurred at the reporting date but which have not been settled (i.e. expected future payments in relation to unpaid reported claims, IBNRs, IBNERs and costs that the insurer expects to incur in settling those claims) |
| expense ratio | the percentage of gross written premium that is represented by the costs of writing the business, excluding claims costs |
| gross written premium | the total premiums underwritten by an insurer during the period, before the deduction of reinsurance expense |
| incident | an incident resulting in a loss which may develop into a claim against the insured |
| incident year | the year in which an incident occurs |
| incurred claims | the total number of claims for any one incident year which may result in a liability for the insurer, this would include claims paid and claims outstanding (including IBNRs and IBNERs) |

| | |
|---|---|
| incurred but not reported claims (IBNRs) | claims arising from incidents or losses which have taken place during the underwriting period but are expected to be reported to the insurer in subsequent periods |
| incurred but not enough reported (IBNERs) | a provision in an insurer's book that recognises that estimates for reported claims may be inadequate |
| long-tail classes | classes of business which have claims that can be reported over many years after writing the policy, such as employers' liability, public liability and professional indemnity |
| loss ratio | the percentage of earned premium that is represented by the cost of claims payments and expected future payments (including IBNRs and IBNERs) attributable to that earned premium |
| net combined ratio | the combined ratio net of reinsurance expenses and recoveries |
| net written premium | gross written premium less reinsurance expenses |
| personal injury or death claim | a claim relating to an incident that results in the injury or death of a third party individual |
| premium revenue | see 'earned premium' |
| property damage claim | a claim relating to an incident that results in the damage of third party property |
| reinsurance | the process by which an insurers cedes some of its premium underwritten in exchange for the reinsurer accepting some of the risk. Simply put, this is insurance for the insurers. |
| reinsurance expenses | the amount of premium ceded to reinsurers for reinsurance during a period |
| report | the notification to the insurer of an incident or loss that may develop into a claim against the insured |
| report year | the year in which an insurer is notified of an incident or loss that may develop into a claim against the insured |
| settlement | when parties to a claim, agree to finalise the claim or a court gives a verdict, the claim is said to have been settled |
| settlement year | the year in which a claim is settled |
| superimposed inflation | the rate of inflation of claims costs by reason of factors other than economic/investment factors, for example court awards, legislative amendments etc |
| underwriting expenses | costs attributable to the underwriting of specific classes of insurance |
| underwriting year | the year in which a policy was issued or renewed |
| unearned premium | premium received before the balance date but which relates to risks after that date |

# Summary

## Background

Many consumers have expressed concern about the size of recent increases in public liability and professional indemnity premiums. Cases of insurance premiums doubling within a relatively short time are not uncommon. In some cases, consumers have found insurance unattainable at any price.

In 2002 Commonwealth, state and territory governments responded to this concern by establishing a framework for reform. The reforms agreed to by governments up until 31 December 2002 related to changes to how tort law applied. They focused mainly on minimising personal injury claims costs by implementing caps and thresholds on court-awarded settlements, provisions for structured settlements, changes to negligence laws and minimising legal costs.

Governments expect the insurance industry to deliver affordable insurance products to the community as a result of these reforms.

## The ACCC's monitoring role

This is the first of four monitoring reports to be produced by the Australian Competition and Consumer Commission (the ACCC) over the next two years.

In July 2002 the Federal Government asked the ACCC to monitor costs and premiums in public liability and professional indemnity insurance to assess the extent to which insurance companies are passing on to consumers the benefits of insurance reforms.

To do this, the ACCC asked several major insurers in the public liability and professional indemnity insurance sectors to provide quantitative and qualitative information on costs and premiums in their insurance business. This report monitors costs and premiums of insurers up until 31 December 2002 which was the latest data available to the ACCC.

This report also outlines insurers' expectations about movements in costs and premiums in 2003 and in the longer term. To some extent, these expectations incorporate insurers' views about the likely impact of government reforms, at least in the short term. Future reports will examine the actual outcomes for costs and premiums beyond 1 January 2003 when this data is available. Therefore, this report should be viewed as a base against which future monitoring outcomes can be compared.

## Defining public liability and professional indemnity insurance

Public liability and professional indemnity insurance are separate classes of insurance within the general insurance framework.

- *Public liability* insurance protects individuals, businesses or organisations against the financial risk of being found liable to a third party for death or injury, loss or damage of property or 'pure economic' loss resulting from negligence by the insured.
- *Professional indemnity* insurance indemnifies professional people—accountants, architects, lawyers and others—for their legal liability to their clients and others relying on their advice and/or services. It provides indemnity cover if a client suffers a loss, either material, financial or physical that is directly attributed to negligent acts of the professional.

# Findings on costs and premiums in public liability insurance

Insurers consider several factors when setting public liability and professional indemnity premiums. They include direct costs to the insurer of providing insurance, such as paying out and administering claims, and other costs related to buying reinsurance. Premiums set by insurers are also likely to reflect their corporate objectives, such as achieving profit and business growth targets. However, claims costs are the major contributor to premiums charged by insurers.

The ACCC found that, in real terms, the costs of providing public liability insurance have increased over the past five years. Insurers have charged higher premiums in the past two years.

- **Claims costs**, which are the largest component of the premium charged by insurers, increased between 1997 and 2002.
  - Compared to the number of policies, in 2002 fewer claims were reported to insurers than in previous years. At the same time, the average size of claims increased. In 1997 the average size of claims settled was $10 237 (adjusted to 2002 dollars). By 2002 it had grown to $17 906 (a 75 per cent increase).
  - The time taken for claims to be settled has generally grown. In 1998 21 per cent of total claims settled took between three and five years of the incident occurring. In 2002 this had risen to 34 per cent. The longer it takes for a claim to be settled, the greater likelihood that the claim will be more expensive to settle.
  - There were increases in costs across all settlement size bands, although the largest occurred in claims settled for amounts between $50 001 and $500 000 (medium cost claims).
  - Insurers generally considered that recent increases in the number and size of claims were due to an increasingly litigious society, court precedents/higher awards and a higher frequency of bodily injury claims (i.e. the number of bodily injury claims as a proportion of the number of policies written).
  - Data analysed by the ACCC shows that the higher frequency of bodily injury claims is very recent, only evident in 2002. Between 1998 and 2001, the number and size of personal injury claims as proportions of total claims were stable.
- **Average premiums** (adjusted to 2002 dollars) in *public liability* were stable for the three years up to 2000, before increasing on average by 19 per cent in 2001 and then by an average of 44 per cent in 2002.
  - Insurers generally perceive the recent rise in premiums to be linked to increases in claims costs and changes in conditions associated with the insurance cycle, such as stricter risk assessment of policyholders and previous poor underwriting returns.
  - The ACCC's analysis supports insurers' assertions that claims costs have risen. Work conducted by the ACCC in March and September 2002 indicated that insurers in the public liability class have previously incurred substantial losses. This is commented on later in this section.
  - Insurers did not perceive unpredictable historic shocks, such as the liquidation of HIH or the 11 September 2001 terrorist attacks, when considered in isolation, to be major drivers of recent premium increases. This suggests that the impact of these one-off events may already have been absorbed by the industry.

## Findings on costs and premiums in professional indemnity insurance

The ACCC found that costs associated with providing professional indemnity insurance have also increased over the past five years, leading to higher premiums being charged by insurers.

- **Claims costs** increased between 1997 and 2002.
  - Compared to the number of policies, the number of claims reported to insurers remained unchanged over the period, except for a small decrease in 2002. At the same time, the average size of claims increased, from $6 399 (adjusted to 2002 dollars) in 1997 to $18 885 in 2002 (a 195 per cent increase). The 2002 settlement figure is affected by one very large claim settled during that year.
  - Increases in the average size of claims settlements appears to have been driven by increases in the size of claims settled for more than $500 000 (high cost claims).
  - Insurers considered that recent increases in the number and size of claims were due to court precedents/higher awards and an increasingly litigious society.
- **Average premiums** (adjusted to 2002 dollars) in *professional indemnity* decreased by about 21 per cent between 1997 and 1999. Since then, they have risen by around 125 per cent between 1999 and 2002.
  - Insurers generally perceive that the recent premium increases have been caused mainly by stricter risk assessment of policyholders by insurers, larger claims payouts and previous poor underwriting returns.
  - Insurers' perceptions of increasing claims costs are supported by the analysis above. As with public liability insurance, the ACCC's work in March and September 2002 showed that insurers in the professional indemnity sector had incurred substantial losses in the past. This is commented on further below.

## Findings on the financial performance of public liability and professional indemnity insurance

The overall financial performance of insurance companies is determined by many factors, including underwriting performance, cost structures, and investment returns on both technical provisions and shareholder funds.

The ACCC has been specifically asked to monitor the impact of reforms on costs and premiums on policies issued in Australia for two individual classes of insurance—public liability and professional indemnity. It considered the underwriting performance of several insurers in these classes of insurance by comparing past and expected costs in current dollar values to premium income, without allowing for the effect of future claims inflation, or for expected investment income between the time of receiving premiums and the time of paying out claims.

In long-tail classes of insurance such as these, insurers typically earn substantial income on premiums invested before paying out claims—however claims costs also tend to rise with inflation, so these two effects work in opposite directions. The ACCC's analysis of the financial performance of insurers does not include an assessment of the difference between future inflation and investment returns, or changes in the overall capital position of insurers.

The public liability and professional indemnity classes are among several that have performed poorly in recent years. The ACCC examined this in detail in two insurance market pricing reviews in March 2002 and September 2002.

After conducting analysis for this report the ACCC estimates that the underwriting performance of these two insurance classes has improved in 2002. It examined changes in the 'net combined ratio' for insurers between 2001 and 2002 for each insurance class. A net combined loss ratio shows whether the sum of all costs (claims costs and expenses) to an insurer is greater or less than premiums. For example, if the net combined ratio is greater than 100 per cent, an insurer will be making a loss on its underwriting business; if the ratio is less than 100 per cent an insurer will be making a profit on its underwriting business. Because of how the ACCC has measured loss ratios, there may also be a further profit item due to the gap between investment returns and inflation from receipt of premiums to payment of claims. However, this is likely to be offset by the fact that claims handing expenses are not included in the net combined ratio.

- For *public liability* insurance, the ACCC estimates the net combined ratio has decreased from 121 per cent in 2001 to an expected 96 per cent in 2002. Thus insurers are expected to make a small underwriting profit in the public liability class on premiums earned in 2002.
- For *professional indemnity* insurance, the ACCC estimates the net combined ratio has decreased from 114 per cent in 2001 to an expected 85 per cent in 2002. Thus insurers are expected to make an underwriting profit in the professional indemnity class in 2002.

Although these statistics were based on aggregated data from a limited number of insurers, they do indicate expected improvements in the underwriting performance of insurers for 2002 and a turnaround from previous years when insurers have typically incurred underwriting losses in long-tail classes of insurance. Again, this does not take into account changes in investment returns which are important in determining the overall financial performance and capital position of insurers. It should also be noted that the loss ratios for 2002 at this stage of measurement incorporate mostly insurers' assessments of **expected** future claim payments—these are quite uncertain and the true profit or loss will only be known once all future payments have been made against premium income earned in these years.

## Findings on the expected impact of reforms on costs and premiums in public liability and professional indemnity insurance

For its first monitoring report, the ACCC's assessment of the extent to which insurance companies are passing on to consumers the benefits of reforms was based on insurers' pricing **expectations** for public liability and/or professional indemnity premiums in 2003 and in future years. This report cannot comment on actual premiums charged in 2003 due to lags in the availability of data. However, when data becomes available, future reports will assess the impact of reforms on actual premiums charged by insurers.

### *Public liability insurance*

All insurers expected premiums to rise in 2003, irrespective of the implementation of government reforms in 2002.

- In the absence of reform, most insurers expected premiums to increase at a national level between 11 and 20 per cent in 2003.
- The size of the expected savings in claims costs in 2003 arising from reforms differed across insurers and jurisdictions but are not considered large (on average around 5 per cent).
  - Insurers expected this to translate into lower premium increases in 2003, with insurers lowering their expectations by around 3 per cent on average. Some insurers quantified the expected impact of enacted government reforms in particular jurisdictions, with the results showing that reduced rates of premium increases are expected in NSW, Qld, Vic, the ACT and possibly SA. The ACCC will monitor the impact of reforms in remaining states (WA, NT and Tas) in future reports as additional reforms become implemented.
- Some insurers thought it was too early to quantify the impact of government reforms on premiums in 2003 in the absence of reliable data that would indicate claims costs are being contained as a result of reform.

Insurers regard the longer-term impact of government reforms on premiums as uncertain. Reasons cited by insurers related to an absence at this stage of observed trends in claims experience resulting from reforms and the impact of other factors that may influence premiums over time.

### *Professional indemnity insurance*

All insurers expected premiums to rise in 2003, irrespective of the implementation of government reforms in 2002.

- In the absence of reform, most insurers expected premiums to increase between 11 and 20 per cent in 2003.
- No adjustments were expected to be made to premiums by insurers in 2003 as a result of tort law reforms implemented by governments in 2002.
  - Reasons cited by insurers varied. Some insurers thought that no cost savings would apply to professional indemnity premiums in 2003 because the reforms in 2002 targeted personal injury claims, which are a small percentage of professional indemnity claims for insurers with a low percentage of medical malpractice business within their insurance portfolio. Other insurers commented that it was too early to tell or very difficult to estimate the impact on premiums at this stage.

Based on responses received by the ACCC, government reforms dealing with personal injury claims were not expected to have a material impact on professional indemnity premiums in the long-term.

## Conclusion

With public liability insurance, there is evidence that some insurers expect government reforms to reduce claims costs and have correspondingly adjusted expected premiums in 2003 downwards. These changes will moderate premium increases in 2003 rather than redress the premium increases of previous years. Other insurers do not appear to be factoring cost savings arising from reforms into the premium pricing for 2003. Uncertainty about the short and long-term impacts of recent reforms on claims costs is a consideration in the insurers' approaches to factoring in the effect of reforms.

Insurers do not expect recent government reforms that target lower claims costs for personal injury to materially affect professional indemnity costs and premiums because such claims are only a small proportion of claims within this class. Reforms considered by ministers in early 2003 focus directly on professional indemnity insurance. The extent to which these reforms are implemented and in turn impact on costs and premiums in the professional indemnity class may be considered in future monitoring reports.

The ACCC considers that it is too early to say in this report the extent to which reforms have lowered insurers' costs and if these cost savings have been passed on to consumers. This will be assessed in future reports when data on actual outcomes becomes available.

# 1 Introduction

## 1.1 Background

During 2002 Commonwealth, state and territory governments established a framework for reform in response to the perceived crisis of rising premiums and reduced availability of public liability and professional indemnity insurance. As part of this framework, a role for the ACCC was created to monitor particular aspects of these reforms.

The reform initiatives agreed to by governments were designed to satisfy one or more of the following objectives:

- cost reduction
- cost containment
- increasing certainty and predictability of costs of claims for insurers which was considered to be critical in containing premium increases in the short to medium term
- managing community expectations about personal responsibility and risk.[1]

Commonwealth, state and territory ministers and the President of the Australian Local Government Association (the ministers) agreed to changes to the application of tort law, the use of structured settlements, legal system reforms, data collection and risk management strategies.

This report is the first of four ACCC reports to the Federal Government on monitoring costs and premiums in public liability and professional indemnity insurance.

## 1.2 Ministerial request

At the 30 May 2002 ministerial meeting on public liability insurance, all participating ministers unanimously agreed to an ongoing role for the ACCC in monitoring the insurance market. They agreed that the ACCC's role was crucial to monitoring the progress of reforms designed to address the problems of rising public liability and general insurance premiums. They also agreed that the ACCC would monitor market developments and premium prices and that the Commonwealth would review the ACCC's involvement (including more formal processes) if it becomes clear that cost savings are being made but not passed through to consumers.[2]

On 5 July 2002 the Parliamentary Secretary to the Treasurer, Senator the Hon Ian Campbell, asked the ACCC to monitor costs and premiums in the public liability and professional indemnity sectors of the insurance market on a six monthly basis over the next two years. He asked the ACCC to give consideration to the impact on insurance premiums of measures taken by governments to reduce and contain legal and claims costs and to improve the data available to insurers to evaluate and price risk. He also asked the ACCC to assess to the extent possible, the impact on premiums made by these measures. The Parliamentary Secretary also indicated that this ongoing work would contribute to a greater understanding of market developments and premium pricing in long-tail classes of insurance.[3] The ACCC's role was not a direction under the *Prices Surveillance Act 1983*.[4]

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1 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique ministerial meeting on public liability, press release, 30 May 2002, p. 2.)

2 ibid., p.1.

3 Public liability and professional indemnity insurance are typically referred to as long-tail classes of insurance. This is because many years may pass between the period for which cover was provided and the date at which claims arising from incidents during that period are finally settled. This is discussed more fully in section 4.1.

4 The *Prices Surveillance Act 1983* enables the ACCC, where the government declares products or services, to formally monitor prices with the objectives of promoting competitive pricing wherever possible and restraining price rises in markets where competition is less than effective.

## 1.3 Previous insurance reports by the ACCC

In March and September 2002 the ACCC released two market pricing reviews on the general insurance industry.

The March 2002 market pricing review examined the state of the general insurance market specifically regarding the influence of the international insurance market, the major lines of HIH's business and links to profitability of those lines, the cost drivers of each class of insurance, as well as profitability of the general insurance industry by class and overall.

The ACCC was subsequently requested to update this analysis by the Parliamentary Secretary as an outcome of the 27 March 2002 ministerial meeting on public liability insurance. The September 2002 market pricing review, as well as updating market performance and premium information, analysed the public liability and professional indemnity insurance sectors and examined the impact of the events that 11 September 2001 and the liquidation of the HIH Group had on the performance of the general insurance industry.

The ACCC's price monitoring reports will not be directly comparable to these previous reports because of differences in purpose and scope.

## 1.4 Scope of the monitoring report

The Parliamentary Secretary's request indicated that the ACCC would not be expected to form a view about the adequacy or appropriateness of reform measures, as this is a matter for state and territory governments.

The scope of the ACCC's monitoring analysis relates to public liability and professional indemnity insurance written in Australia. Consumers seeking insurance cover in Australia can also go offshore to access cover from insurers located in overseas countries. Insurance business written outside of Australia is not included in the scope of the ACCC's monitoring framework.

In Australia, public liability insurance is usually provided to household consumers as part of their home and contents insurance policies. However, the stand alone public liability insurance policies provided to individuals and organisations for commercial purposes often raise problems of affordability and availability. The public liability component of home and contents policies is relatively small and has not demonstrated substantial premium increases. It is only the commercial public liability policies that are relevant to the ACCC's monitoring exercise. Also, in most industries and especially for smaller businesses, public liability and products liability insurance have been sold as a combined product with a single premium.[5] Therefore, discussion about public liability insurance in this report, including data, refers to public and products liability combined, except where otherwise indicated.

Within professional indemnity insurance, there is a sub-class relating to medical malpractice. Before 1 July 2003 Medical Defence Organisations (MDOs) were not governed by the Australian Prudential Regulation Authority (APRA) but were responsible for underwriting malpractice for doctors and specialists. Under the Federal Government's new medical indemnity framework, MDOs can no longer offer medical malpractice insurance to doctors and specialists from 1 July 2003. Instead, only an insurer authorised by APRA can offer such insurance to doctors and specialists. The ACCC has excluded from this report medical malpractice insurance policies written previously by MDOs because

[5] Trowbridge Consulting, *Public Liability Insurance, analysis for meeting of ministers on 27 March 2002*, March 2002, p. 2.

this form of indemnity insurance is part of a separate ACCC monitoring program. Some general insurers provide medical malpractice to hospital and ancillary staff, such as midwives, nurses and other medical staff, as part of their professional indemnity business and this is included in the scope of this report.

## 1.5 Approach to monitoring

In late 2002 the ACCC approached a number of general insurers that were identified as major participants in the public liability and professional indemnity insurance markets in Australia and requested information on their cost and premium structures. The ACCC asked nine insurers to participate in its monitoring program. All were asked to provide information about their public liability insurance business. The nine major insurers' premium revenue represented 68 per cent of the public (and product) liability class of insurance, as measured by APRA statistics for the year ending 30 June 2002.[6] Seven of them were also asked to supply information about their professional indemnity insurance business. Their premium revenue represented 58 per cent of the professional indemnity class, as measured by APRA statistics for the year ending 30 June 2002.[7] Insurers that participated in the ACCC's monitoring program are listed in appendix A.

The ACCC asked insurers to provide historical data about policies, premiums and costs as well as qualitative information about their price setting arrangements, cost drivers and how they expected reforms to affect costs, premium levels and profit margins for 2003 and in the longer term.

This first monitoring report covers the period ending 31 December 2002 which means that information provided by insurers was current at 31 December 2002. It also means that the ACCC focused on those reforms that were announced and implemented by Commonwealth, state and territory governments up to 31 December 2002. Other reforms that were announced but not implemented by respective governments before 31 December 2002 fall outside the scope of this first report. These additional reforms, once implemented, will be included in subsequent reports.

Before 31 December 2002 respective governments agreed on a range of reform measures to deal with the insurance situation. By October 2002 most progress had been made in tort law reform. This report therefore concentrates on monitoring the impact of these particular reforms on costs and premiums. To the extent that they can be assessed, other reforms will be included in future reports. The ACCC acknowledges that, in some cases, a short time period may have elapsed between the enactment of certain tort law reforms by respective governments and the end of the ACCC's monitoring period (31 December 2002).

When preparing this first report, the ACCC engaged a consultant, PricewaterhouseCoopers Actuarial Pty Limited (PwC) to provide technical actuarial assistance as required.

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6 It should be noted that an APRA reporting year reports on all insurance companies' data whose balance dates fell within that reporting year. For example, the APRA report year 'year ending 30 June 2002' will incorporate insurance companies' data whose balance dates were anywhere between 1 July 2001 and 30 June 2002. Also some insurers may have changed their balance date during this period and this may mean that during the transition to the new balance date, the length of reporting period may have become longer or shorter than the standard 12-month period.

7 This excludes medical malpractice premium revenue written by captive insurers of MDOs.

## 1.6 Qualifications

The extent of the ACCC's monitoring analysis largely reflects the degree to which data was provided to the ACCC by insurers. Insurers did not provide all the quantitative and qualitative information asked for. In their responses to the ACCC's monitoring survey, insurers gave reasons why certain information was not provided—in many cases, this was due to insurers' reporting systems not capturing this information.

The information provided by insurers is presented in this report at an aggregated level. The ACCC recognises that insurance companies do not operate in a uniform manner. Each company has its own profit targets, capital structure, distribution channels, policy terms and conditions, target markets and objectives. Where necessary, the ACCC qualifies certain aspects of its analysis throughout the report.

## 1.7 Report outline

The report contains 9 chapters and 7 appendixes.

Chapter 2 outlines the reform process by Commonwealth, state and territory governments in public liability and professional indemnity insurance and identifies those reforms that were implemented up to 31 December 2002. Further details on these reforms plus information on other reforms that were announced but not implemented before 31 December 2002 are in appendix B.

Chapter 3 briefly outlines the structure of the general insurance industry in Australia. Appendix C provides an overview of the regulatory arrangements that apply to general insurance business conducted in Australia.

Chapter 4 identifies the main features of the public liability and professional indemnity insurance sectors. It also examines the market structure of each sector.

Chapter 5 examines trends in costs of public liability insurance between the years ending 31 December 1997 and 31 December 2002 based on data provided by insurers as part of the ACCC's monitoring program. It also examines the relative importance of cost drivers. An outline of the ACCC's information request to insurers and related issues is in appendix D.

Chapter 6 examines trends in premiums, policies and the financial performance of insurers in the public liability class for the period between the years ending 31 December 1997 and 31 December 2002. It also identifies the reasons for recent premium increases based on information provided by insurers as part of the ACCC's monitoring program. An outline of factors that determine an insurer's overall financial performance is in appendix E. Pricing aspects of the insurance cycle are discussed in appendix F.

Chapter 7 examines trends in costs and associated cost drivers in professional indemnity insurance based on data provided by insurers.

Chapter 8 examines trends in premiums, policies and the financial performance of insurers in the professional indemnity insurance class.

Chapter 9 outlines the methodology adopted by the ACCC in its monitoring program to assess the impact of reforms on costs and premiums in public liability and professional indemnity insurance. It also provides a summary of insurers' expectations for premium rate increases in 2003 and in the longer term and the extent to which cost savings are being passed on to consumers. Appendix G presents a summary of insurers' responses relating to insurance buying/pooling arrangements that were also covered in the ACCC's monitoring program.

# 2 Reforms to address the insurance 'crisis'

Commonwealth, state and territory governments participated in several joint ministerial meetings during 2002 and agreed to a series of reforms to address the perceived problems of affordability and availability of public liability insurance. The reforms included changes to the application of tort law, the use of structured settlements, legal system reforms, data collection and risk management strategies.

In October 2002 most progress had been made in tort law reform. This report therefore concentrates on monitoring the impact of these particular reforms—those announced and implemented by Commonwealth, state and territory governments up to 31 December 2002—on costs and premiums. This section identifies those reforms that were implemented before then.

The ACCC determined that other reforms that were announced but not implemented before 31 December 2002 fell outside the scope of this first report. For completeness, these reforms are listed in appendix B.

## 2.1 Background

To understand the recent reform process undertaken by Commonwealth, state and territory governments, it is important to discuss briefly the nature of public liability and professional indemnity insurance in the context of the common law system.

Public liability and professional indemnity insurance are forms of liability insurance.[8] Liability insurance refers to a type of insurance where the insurer undertakes to indemnify the insured in relation to losses incurred as a result of the insured becoming liable to a third party. Therefore, public liability and professional indemnity insurance provide protection for those who would otherwise have had to pay damages or compensation arising from a breach of their duty. This could cover liabilities arising from a breach of duty imposed by common law, contract or legislation.

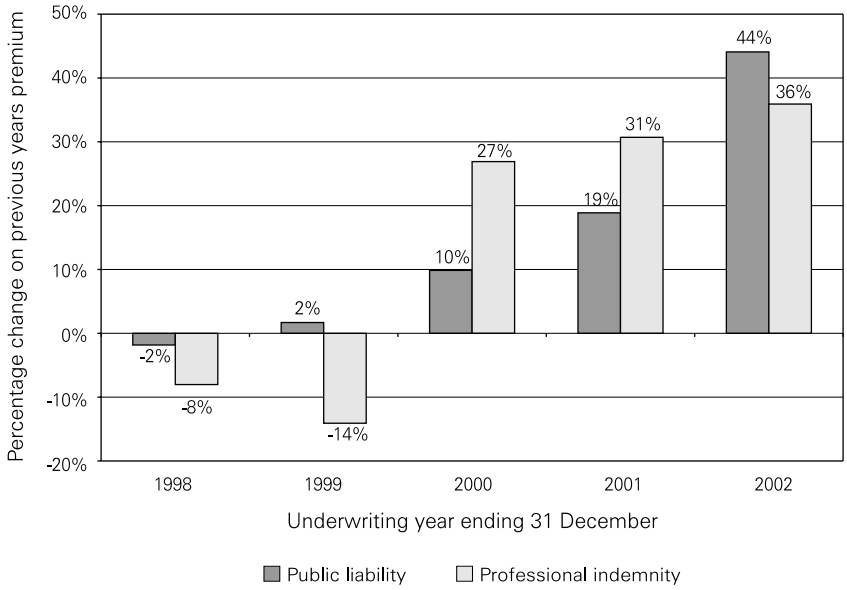
Depending on the type of duty, compensation may be based on the common law principles of tort. A tort is a wrong involving a breach of a duty, such as the duty of care under the law of negligence but does not include a criminal wrong. The law of torts aims to restore the person who suffered from the breach of duty to the position he or she was in before the tort was committed—this is known as restitution. Therefore, if a wrong (tort) is found to be committed on one party by another (the tortfeasor) then the tortfeasor is considered to be liable and is considered liable and is required to make restitution for damage suffered.

## 2.2 Recent premium increases

Following a decade of relative stability, public liability and professional indemnity insurance premiums began to rise in 2000 and 2001, followed by further increases in 2002. These are shown in chart 2.1.

[8] The nature of public liability and professional indemnity insurance is discussed in detail in section 4.

**Chart 2.1 Percentage change in average premium on previous year's premium in real terms—1998 to 2002—public liability and professional indemnity**




Source: Derived by ACCC from responses provided by seven insurers for public liability and six insurers for professional indemnity. Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

Data given to the ACCC by insurers shows that average premium rates for public liability and professional indemnity insurance increased by 10 per cent and by 27 per cent respectively in 2000. Further increases of 19 per cent and 31 per cent followed in 2001. In 2002 public liability premiums rose by 44 per cent and professional indemnity premiums by 36 per cent.

There has been considerable speculation that a series of unusual events had contributed to these increases—such as the HIH collapse in March 2001, the terrorist attacks on 11 September 2001, as well as issues associated with the past poor financial performance of particular classes within the insurance industry and rising claims costs. Stakeholders deemed the public liability and professional indemnity sectors to be in 'crisis'.

## 2.3 Ministerial meetings

Commonwealth, state and territory ministers and the President of the Australian Local Government Association (the ministers) held several meetings in 2002 to address the problems of rising premiums and reduced availability of public liability insurance. The ministers agreed that many of the issues were complex and cross-jurisdictional and required collective action from governments and industry in the immediate term. They also acknowledged that the problems being confronted in the public liability area were not unique and were also evident in other insurance classes.

The first ministerial meeting was held on 27 March 2002, in which ministers received an expert report identifying the major factors behind rising premiums and reduced availability of public liability insurance. They were:

- changing community attitudes to litigation
- change in the courts' view of what constitutes negligence

- increased compensation payments for bodily injury claims
- past under-pricing and poor profitability of the insurance industry
- the collapse of HIH, a major player in the public liability market
- a decision by insurance companies to be more selective about the risks that they cover.[9]

At the meeting ministers noted that several jurisdictions had already taken action including facilitating group insurance for not-for-profit organisations, tort law reform and development of risk management guidelines. Ministers agreed to legislative changes relating to the use of structured settlements for personal injury compensation and also agreed to examine at their next meeting proposals for reform in claims cost reduction, waivers of personal risk, the role of the insurance industry, data collection and risk management procedures.[10]

The second ministerial meeting was held on 30 May 2002 when ministers outlined the various initiatives that had begun, particularly in the areas of tort law reform, facilitating pooling and group insurance for not-for-profit organisations and the development of risk management guidelines.[11] Ministers also agreed that the role of the ACCC was crucial in monitoring the impact of the reforms on premiums. Ministers identified that unpredictability in the interpretation of the law of negligence was a factor in driving up premiums and agreed to appoint an expert three-member panel to examine the law of negligence.[12]

Ministers received the panel's findings, the Review of the Law of Negligence, at their third meeting on 2 October 2002.[13] The review recommended several changes to the law to strike a balance between the interests of injured persons and the wider community. They included options for limiting liability and the quantum of awards for damages in certain circumstances. Some recommendations involved proposed amendments to the *Trade Practices Act 1974*. The ministers agreed in principle to developing nationally consistent legislation for provisions relating to liability for personal injury or death resulting from negligence.

At the fourth meeting on 15 November 2002 they agreed to a package of reforms implementing key recommendations of the review. They agreed that key recommendations that go to establishing liability should be implemented on a nationally consistent basis. Each jurisdiction agreed to introduce the necessary legislation as a priority.[14]

## 2.4 Commonwealth, state and territory tort law reforms as at 31 December 2002

This section summarises the tort law reform measures which were considered at the four ministerial meetings in 2002 and subsequently implemented by Commonwealth, state and territory governments before 31 December 2002.

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9 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique—ministerial meeting on public liability, press release, 27 March 2002.

10 ibid.

11 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique—ministerial meeting on public liability, press release, 30 May 2002.

12 This review would later become known as the Ipp Review of the Law of Negligence.

13 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique—ministerial meeting on public liability, press release, 2 October 2002.

14 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique—ministerial meeting on public liability, press release, 15 November 2002.

This information is presented in table 2.1 which identifies the major initiatives implemented by respective governments as at 31 December 2002. A more detailed summary is in appendix B.[15]

## Table 2.1 Major reforms implemented by governments-as at 31 December 2002

| Major reforms implemented by each jurisdiction | C'wlth | NSW | VIC | QLD | SA | ACT | NT |
|---|---|---|---|---|---|---|---|
| Cap on damages for non-economic loss (e.g. pain and suffering) | | ✔ $350 000 indexed to AWE | ✔ $371 380 indexed to CPI | | ✔ $241 500 indexed to CPI | | |
| Minimum threshold of impairment to access damages for non-economic loss | | ✔ 15% of a most extreme case | | | ✔ 7 days or $2 750 medical expenses | | |
| Cap on damages for economic loss (e.g. loss of past and/or future income) | | ✔ 3 times rate of AWE. Discount rate (5%) on lump sums | ✔ 3 times rate of AWE. Discount rate (5%) on lump sums | ✔ 3 times rate of AWE. | ✔ $2.2m for loss of earning capacity. Discount rate (5%) on lump sums | ✔ 3 times rate of AWE. | |
| Limitation period for personal injury cases | | ✔ | ✔ | ✔ | | | |
| No award for exemplary or punitive damages | | ✔ | | ✔ | | | |
| Cap on award of legal costs | | ✔ 20% or $10 000 for personal injury damages <$100 000 | | ✔ Nil for claims <$30 000; $2 500 for claims <$50 000 | | ✔ Nil for claims <$50 000; 20% or $10 000 for personal injury cases <$100 000 | |
| Waivers for risky activities | ✔ | ✔ | ✔ | | ✔ | | ✔ |
| Provision for contributory negligence | ✔ | ✔ | ✔ | | ✔ | ✔ | |
| Protection for volunteers or 'good Samaritans' | | ✔ | ✔ | ✔ | ✔ | ✔ | |
| Provision for structured settlements | ✔ | ✔ | ✔ | ✔ | ✔ | ✔ | |
| Regret not admission of guilt | | ✔ | ✔ | ✔ | ✔ | | |
| Provisions for quick resolution of claims | | | | ✔ | | ✔ | |
| Restrictions on unmeritorious claims | | ✔ | | | | ✔ | |

Source: various Commonwealth, state and territory acts of parliaments.

[15] For completeness, a summary of other tort law reform initiatives that were announced but were not implemented as at 31 December 2002 are also presented in appendix B. Introduction of private members bills into Commonwealth, state press release, 30 May 2002.

## 2.5 Expected impact of reforms and future direction of premiums

The 30 May 2002 joint ministerial communiqué noted that Commonwealth, state and territory governments had met with the Insurance Council of Australia (ICA), the insurance industry's peak representative body, and chief executives of several major insurers and made it clear that the insurance industry is expected to deliver affordable public liability products to the community on the basis of the reform packages being implemented.[16]

After considering the recommendations of the Review of the Law of Negligence on 2 October 2002, ministers requested actuarial advice assessing the impacts of the proposed national reforms to negligence law on the affordability and availability of public liability insurance. PwC prepared this report and it was presented to the joint ministerial meeting on 15 November 2002. The report indicated that:

- the estimated net effect of those reforms that could be formally assessed was a reduction in public liability claims costs of 14.7 per cent
  - this comprised an approximate 19.6 per cent reduction in personal injury claims costs, with no reduction in property damage claims costs
- all other things being equal, these reductions in claims costs might translate into corresponding reductions in insurers' premiums of about 13.5 per cent on average.[17]

PwC also noted that the estimated reductions were relative to the pre-30 June 2001 public liability environment and that the reductions related to the cost of claims occurring after the changes were implemented (i.e. no retrospective application of legislation is involved). The report also noted that the estimated cost savings assumed no jurisdiction had already made any reforms along the lines considered by the Ipp Report.

The PwC report contained several qualifying statements. PwC commented that the majority of the Ipp Report's recommendations were not easily costed, either because suitable data is not collected or is collected in a form which is not amenable to statistical analysis. It also commented that, in many cases, how the recommendations would work in practice was unclear and it was not possible to pre-emptively determine how they will ultimately be applied.[18] PwC noted that its estimated cost savings were very uncertain and the actual outcome of experience could be significantly different. They also added that the results were based on Australia-wide data, and therefore were generic and did not necessarily apply to the circumstances of any particular jurisdiction.[19]

The ACCC is also aware that two state governments had previously commissioned separate actuarial studies about the expected impact of proposed reforms on public liability insurance premiums. Only the NSW Government publicly released its study.

Before the Civil Liability Bill 2002 was introduced into the NSW Parliament on 28 May 2002, the NSW Government commissioned PwC to estimate the potential financial effect of those changes on the quantum of damages, claims costs and the consequential effects on premiums charged by insurers for public liability insurance. The report, released on 28 May 2002, concluded that:

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16 The Minister for Revenue, Senator the Hon Helen Coonan, joint communique—ministerial meeting on public liability, press release, 30 May 2002.

17 PricewaterhouseCoopers Actuarial Pty Limited, *Report to the Insurance Issues Working Group of Heads of Treasuries-Actuarial Assessment of the Recommendations of the Ipp Report*, 7 November 2002, p. 3.

18 ibid, p. 2.

19 ibid, p. 4.

- the estimated net effect of those reforms that could be formally assessed was a reduction in public liability claims costs of 14.0 per cent
  - This comprised an approximate 17.5 per cent reduction in personal injury claims costs, with no reduction in property damage claims cost
- all other things being equal, these reductions in claims costs might translate into corresponding reductions in insurers' premiums of around 12.0 per cent on average.[20]

On 22 October 2002 the Senate Economics References Committee released its report into public liability and professional indemnity insurance in which it handed down 15 recommendations[21]. The report examined, through a Senate inquiry, the costs of such insurance, reasons for the increase in premiums, and the schemes, arrangements or reforms that may reduce the cost of insurance. A total of 166 submissions were made to the inquiry from parties, including government agencies, community organisations, sporting organisations and professional associations. In evidence to the committee, the ICA was asked to comment on what benefits to premiums could be expected from the reforms passed by the NSW Government at that time. Mr Raymond Jones, President of the ICA, commented that:

> The ICA does not have an opinion on that per se, because we do not talk about pricing issues on behalf of our member companies...Member companies, through their actuarial departments, are working on the number at the moment...There is a belief that in many cases, this will not reduce premiums—it will slow them down, but it will not reduce them. There is not a collective industry viewpoint on this, because every one of the member companies of the Insurance Council has a very different pricing strategy and policy. They are the ones that have to take responsibility. (Committee Hansard, 8 August 2002, p. E50, E51).

The *2002 General Insurance Industry Survey* conducted by JP Morgan and Deloitte Touche Tohmatsu was released on 5 December 2002. It surveyed a number of underwriters, brokers and reinsurers to canvass their views on the future direction of premiums in various classes of general insurance. The survey reported that:

- for public liability, premium increases of 23 per cent and 13 per cent are expected in 2003 and 2004 respectively
- in professional indemnity, premium increases of 27 per cent and 13 per cent are expected in 2003 and 2004 respectively.[22]

The report also commented that:

> ... it is important to note that we are not able to ascertain whether the forecast rate increases for Public & Product Liability and Professional Indemnity insurance include any consideration of Justice David Ipp's negligence reforms. The reforms include proposals to significantly change negligence definitions, putting caps and thresholds on the level of damages and to change the legal system in terms of fees payable to lawyers...From the insurance industry's perspective profitability needs to be restored to the [public and product liability] class, and this should be achieved on the back of the premium rate increases being put through, combined with the various tort reforms and legislative changes. (JP Morgan Survey, p. 5, 35)

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20 PricewaterhouseCoopers Actuarial Pty Limited, *Report to the NSW Treasury on Tort Law Reforms in Public Liability Insurance*, 28 May 2002, p. 3.

21 Recommendation 11 of the Senate report in which the Committee recommended that the Trade Practices Act be amended to allow the ACCC to take enforcement action that any savings or benefits that accrue directly or indirectly from legislative reforms being implemented throughout Australia to minimise insurance premiums are passed on by the insurance companies to consumers. This is similar to the Private Member's bill, *Trade Practices Amendment (Public Liability Insurance) Bill 2002* introduced into Federal Parliament on 23 September 2002 by Senator Conroy which proposed amendments to the *Trade Practices Act 1974* to give the ACCC powers to deal with any price exploitation arising from changes in the law in relation to public liability.

22 JP Morgan and Deloitte Touche Tohmatsu, *2002 General Insurance Industry Survey*, 5 December 2002, p. 15.

On 3 April 2003 Mr Raymond Jones, President of the ICA, addressed the Victorian Branch of the Insurance Council saying:

> ...despite calls from some politicians for immediate reductions in premiums, the reform process was far from over, with only one jurisdiction, NSW having completed its commitment to legislative amendments ...We also acknowledge the desire of governments and the community to see immediate impacts on the price and availability of cover. However, they need to remember that the reform process is far from complete and it is premature to believe that there will be a significant reduction in claims costs until that it is achieved. (ICA media release, p. 1)

In July 2002 the Federal Government asked the Productivity Commission (PC) to undertake a research study into Australian insurers' claims management practices in the public liability class of insurance and benchmark them against world's best practice.[23] The PC's report was released on 23 January 2003. Among other things, it examined how compatible insurers' current claims management practices are with the passage of cost savings associated with the insurance reforms to consumers. On this issue, the PC concluded that:

> There is nothing inherent in insurers' claims management practices, or the environment in which they are undertaken, which would prevent the benefits of other measures taken, or planned, by governments to improve the availability and affordability of public liability insurance from being passed onto consumers. (Productivity Commission, p. XII)

## 2.6 Conclusion

Commonwealth, state and territory governments participated in a series of ministerial meetings during 2002 to address the perceived problems in the affordability and availability of public liability and professional indemnity insurance. The ACCC's monitoring program for this first report has concentrated on the tort law aspects of the reform agenda, and in particular, those reforms that were implemented up to 31 December 2002.

Results of independent actuarial analysis about the expected impact of proposed reforms on public liability claims costs and premiums indicated that, other things being equal, cost savings and corresponding reductions in premiums were expected. However, no time frame by which these savings may be expected to eventuate was provided. Insurance industry representatives expect these reforms to slow the increase of premiums, rather than reduce them. Governments expect savings to result from these reforms and they also expect insurers to pass these savings on to consumers in the form of more affordable insurance premiums.

[23] Productivity Commission, *Public liability claims management-research report*, December 2002, p. v.

# 3 Insurance market overview

## 3.1 The general insurance industry in Australia

There are many classes of general insurance. Public liability and professional indemnity insurance are two classes within the broader general insurance industry. This section presents a brief overview of the general insurance industry in Australia, with a more detailed analysis of public liability and professional indemnity insurance in section 4.

Statistics used in this section have been derived from data available from APRA. Although the ACCC's monitoring period for this first report is up until 31 December 2002, the data in this section relates to the year ending 30 June 2002, as it was the latest available from APRA at the time this report was prepared.

## 3.2 Insurance defined

Insurance provides protection against the unfortunate consequences of future events, by transferring the possible risk of loss from a person or organisation (the insured) to the insurer. In order to gain this benefit, the insured pays the insurer a sum of money known as a premium (the cost of insurance cover).[24]

According to APRA, general insurance in Australia comprises 15 classes of insurance business, excluding life and health insurance. These are:

- fire and industrial special risks
- houseowners/householders
- compulsory third party (CTP) motor vehicle
- commercial motor vehicle
- domestic motor vehicle
- marine and aviation
- professional indemnity
- product and public liability
- employers' liability
- mortgage
- consumer credit
- travel
- other accident
- other
- inward treaty.[25]

Chart 3.1 shows the comparative size of each class of insurance business by measuring the percentage of premium revenue earned in each for the year ending 30 June 2002.

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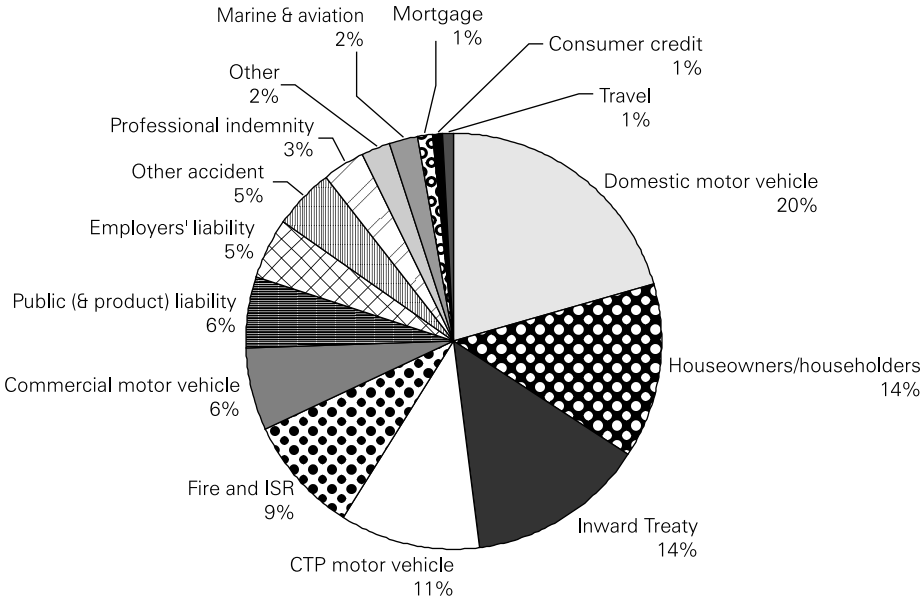
24 ICA, *Background Paper No 7 to the HIH Royal Commission, A Profile of the General Insurance Industry*, November 2001, p. 3.

25 An examination of the performance of each of these classes was presented in the ACCC's insurance industry market pricing reviews in March and September 2002.

**Chart 3.1 Premium revenue by class of business—year ending 30 June 2002**




Source: APRA, *Selected statistics on the general insurance industry*, June 2002, table 6.

The above premium revenue represents the total amount of gross written premium that is 'earned' during the period, earned being that proportion of risk covered by the policy that has expired at the end of the reporting period. For example, one year's premium may cover 12 months of risk, after six months has elapsed, the insurer is said to have 'earned' six months' worth of that premium.

The chart illustrates that the domestic motor vehicle class is the largest class of business, representing 20 per cent of total general insurance premiums. Public liability (including product liability) and professional indemnity insurance represent 6 per cent and 3 per cent respectively.[26]

The comparative size of each class of insurance has remained fairly constant, with the APRA statistics between 1998 and 2002 showing relatively little movement in these percentages over this time.

## 3.3 Major industry participants

There are several types of participants in the general insurance industry in Australia. The major types include:

- Direct insurers—The premiums paid by policyholders to insurance companies are pooled to meet any insurance claims. In the event of a claim arising, the insurance company is responsible for meeting the cost of the claim under the agreement it entered into with the policyholder.

[26] The APRA statistics combine public and product liability insurance into the one class of insurance as policies are usually sold as a combined product. This is discussed further in section 4.

- Brokers—Insurance is often sourced through intermediaries known as brokers whose role is to advise clients on insurance needs and obtain the best terms and conditions (including price). More than 80 per cent of business customers and about 15 per cent of domestic consumers arrange their insurance contracts using the services of a broker.[27]
- Agents—In some cases the intermediary may be an agent, who acts for one or more insurers.
- Reinsurers—Insurers buy reinsurance protection against individual or cumulative large losses that they may incur. For example, with liability cover of $10 million, an insurer's own risk retention may be $2 million, with any claim above this amount covered by reinsurance. Reinsurers charge insurers a premium for that cover.[28]

Consumers seeking insurance cover in Australia can also go offshore to access cover from insurers located in overseas countries. The actual rate of offshore insurance bought by Australian customers is unknown.[29]

## 3.4 Regulatory arrangements

APRA is the regulatory body responsible for overseeing the activities of insurance companies which issue general insurance policies. Private sector insurers operating in Australia must be authorised to supply general insurance under the *Insurance Act 1973*. They must also be incorporated entities under the *Corporations Act 1989*.

APRA administers the Insurance Act, which imposes several conditions on authorised insurers. Significant reforms to the Insurance Act were implemented in mid-2002 to strengthen the prudential regulation of general insurers. The new standards, introduced on 1 July 2002, include requirements to:

- comply with APRA's new liability valuation standard, which mandates actuarial advice and a risk margin
- possess a **minimum** level of capital of $5 million, which is calculated for each insurer based on their insurance, investment and concentration risks. The new capital requirements result in higher levels of minimum capital being held than previously for many insurers[30]
- have risk management systems, including pricing and underwriting control mechanisms.[31]

All insurers must meet these standards and requirements in order to enter and remain in the insurance industry. The Insurance Act also sets out requirements for firms seeking to exit the industry, with guidelines for the assignment of liabilities, transfers and amalgamations, and winding up.

Foreign insurers with no direct presence in Australia can also offer insurance in Australia without becoming authorised insurers under the APRA framework by offering their products through Australian licensed brokers. The conduct of brokers, however, is regulated by APRA under the *Insurers (Agents and Brokers) Act 1984*.

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27 Insurance Council of Australia, *Background Paper No. 7-A Profile of the General Insurance Industry* , November 2001, p. 5.

28 Trowbridge Consulting, *Public Liability Insurance, analysis for meeting of ministers on 27 March 2002*, March 2002, p. 4.

29 In evidence to the Senate inquiry into public liability and professional indemnity insurance in 2002, the ICA commented that 40 per cent of the insurance market is conducted offshore. See committee transcript, 8 August 2002, p. 62.

30 APRA website, prudential reform of the general insurance industry http://www.apra.gov.au/general/general-insurance-reforms.cfm#risk

31 ibid.

Further detail on the regulatory arrangements of the general insurance industry is in appendix C.

## 3.5 Industry structure

There were 153 private sector insurers authorised to conduct general insurance business as at 30 June 2002.[32] This compares with 156 in the previous financial year. This shows some degree of rationalisation in the general insurance industry during this period and, more broadly, continues the long-term downward trend in the number of insurers in the Australian market since the mid-1970s.[33]

Table 3.1 shows a breakdown of the number and type of insurers active in the general insurance industry as at 30 June 2001 and as at 30 June 2002. In addition to private sector insurers, there are also public sector insurers that write general insurance business.[34] The remainder of the ACCC's industry analysis relates to the private sector.

**Table 3.1 Number of insurers by type—2001 and 2002**

| Type of insurer | As at 30 June 2001 | As at 30 June 2002 |
|---|---|---|
| Direct underwriter | 102 | 98 |
| Mortgage insurer | 17 | 15 |
| Captive[35] | 5 | 6 |
| Reinsurer | 28 | 30 |
| s. 37 exempt insurers[36] | 4 | 4 |
| Total private sector | 156 | 153 |
| Total public sector | 15 | 15 |

Source: APRA, *Selected statistics on the general insurance industry* as at 30 June 2001 and 30 June 2002.

Table 3.2 lists the top 20 conglomerates (i.e. groups of companies) in the general insurance industry and these are ranked according to the amount of premium revenue earned by each conglomerate in the year ending 30 June 2002.

32 APRA, *Selected statistics on the general insurance industry-year ending June 2002* , June 2002, p. 1.

33 ACCC, *Second insurance industry market pricing review*, September 2002, p. 7.

34 Public sector insurers write general insurance business such as workers compensation scheme at the federal level (Comcare) and in Victoria, New South Wales, South Australia and Queensland; transport accident schemes in Victoria, Tasmania and South Australia; and specialist insurers Victorian Managed Insurance Authority, Joint Coal Board, Export Finance and Insurance Corporation.

35 Captive insurers are companies, within a group of related companies, performing the function of insurer to that group.

36 Section 37 exempt insurers specialise in writing business for associations, e.g. the NSW Bar Association. Many of these insurers are members of insurance or banking groups.

## Table 3.2 Major private sector insurers—year ending 30 June 2002

| Private sector insurer | Premium revenue[37] ($'000) |
|---|---|
| Insurance Australia Group Limited | 3 733 491 |
| Royal & Sun Alliance Insurance Australia | 2 374 589 |
| Suncorp Metway Ltd | 2 155 340 |
| CGU Insurance Limited[38] | 1 696 431 |
| Allianz Australia Limited | 1 421 293 |
| QBE Insurance Limited | 1 310 547 |
| Munich Reinsurance Company | 926 560 |
| Zurich Australian Insurance Limited | 640 807 |
| Swiss Reinsurance Company | 589 823 |
| ING Group NV | 455 789 |
| Lumley General Insurance Limited | 405 653 |
| Gerling | 392 499 |
| AIG Group | 306 575 |
| General & Cologne Reinsurance Australasia Ltd | 282 358 |
| Hannover Re | 255 772 |
| GE Group | 200 973 |
| Wesfarmers Federation Insurance Limited | 199 904 |
| ACE Insurance Limited | 178 466 |
| AMP General Insurance Limited | 166 656 |
| Elders Insurance Limited | 149 073 |
| **Top 20** | **17 842 599** |
| **Industry total—private sector** | **20 503 470** |

Source: APRA *Selected statistics on the general insurance industry year ending June 2002*—tables 1a and 14b.

The table shows that the top 20 conglomerates earned about 87 per cent of all general insurance premiums, and the top 4 earned about 49 per cent of all premiums.[39]

In terms of industry structure, foreign insurers have increased their marketing of services in Australia and have attracted increasing levels of business following the collapse of the HIH group of companies and the withdrawal of low price insurance for some high risk insurance lines.[40]

The ACCC conducted a detailed analysis of the structure and operation of the Australian general insurance industry in its March and September 2002 pricing reviews. The September 2002 report, in particular, examined the level of concentration in the general insurance industry. Using the Herfindahl-Hirschman Index, the ACCC found that, while there had been an increase in concentration in the general insurance industry since 1997, a substantial degree of competition remains.[41]

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37 Premium revenue for these conglomerates includes premium revenue earned by reinsurers within the conglomerate.

38 Since these statistics were published, CGU Insurance Limited was transferred to the Insurance Australia Group on 2 January 2003. See CGU Insurance website.

39 These figures are not directly comparable with those included in the ACCC's March 2002 report. The premium revenue data for the total private sector industry shown in table 3.2 represents total premium revenue derived from general insurance business inside Australia. This is different to the analysis in the ACCC's March 2002 report which used premium revenue data for the total private sector industry that was derived from general insurance business conducted both inside and outside Australia.

40 ACCC, *Second insurance industry market pricing review*, September 2002, p. 8.

41 ACCC, *Second insurance industry pricing review*, September 2002, p. 5. The Herfindahl-Hirschman index (HHI) shows the degree to which an industry is dominated by a small number of large firms. The index is calculated by taking the sum of the squares of the market shares of each firm in the industry. The higher the figure, the more concentrated the market.

## 3.6 Barriers to entry and exit

Barriers to entry and exit refer to factors that prevent market forces from eroding an industry's excess profits over time. With low barriers to entry and exit, new entrants will be attracted into a market where existing firms are earning excess profits or have inflated costs. In this way, competitive pressure is maintained on incumbent firms to operate efficiently.

The ACCC's September 2002 pricing review commented that entry into the general insurance industry requires insurers to:

- gain knowledge of their targeted market segments
- enter at a level sufficient to claim the necessary economies of scale
- attract necessary capital
- establish distribution channels
- obtain staff with the skills to write the business.

The ACCC did not comment on whether these factors constituted high or low barriers to entry in the insurance industry. However, in its draft determination of 28 April 2003 for the joint venture arrangement between Allianz, QBE Insurance and NRMA Insurance Limited to collectively supply public liability insurance to eligible not-for-profit organisations, the ACCC commented on barriers to entry in the public liability insurance class. It noted that the nature of public liability insurance makes it difficult for insurers to determine adequate provisions for insurance claims and, more generally, manage risk. Therefore, new entry into this particular class may be impeded. The ACCC noted the findings of the Senate 2002 review of public liability and professional indemnity insurance, that the marketplace should have access to industry-wide data so that it can better assess risk and premium pricing, and that a well informed market is far better equipped to anticipate shifts, to adjust to trends in the market and to plan future strategies (ACCC, 2003, p. 32).

In January 2003 the PC released its report on claims management practices and examined various barriers to entry and exit in both the general insurance industry and the public liability insurance class which were not dissimilar to the factors listed above. It concluded that:

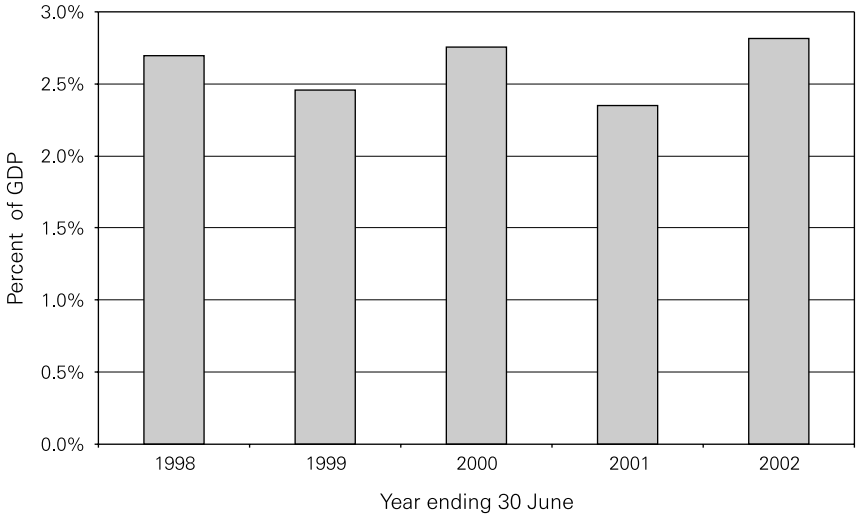
> Overall, the [Productivity] Commission considers that the public liability insurance market in Australia remains competitive, with low barriers to entry and exit. The recent behaviour of firms is consistent with the current environment they are operating in—low or negative profitability in the public liability insurance market has required a tightening of policy conditions and increased premiums. (December 2002, p. 49)

## 3.7 Trends in insurance premiums

Chart 3.2 examines the contribution of general insurance to the Australian economy by showing the value of gross written premium as a percentage of GDP between 1998 and 2002.[42] Gross written premium is defined as the total premiums underwritten by an insurer during the period, before the deduction of reinsurance expenses.

[42] Gross written premium has been used for this comparison as it is more comparable to GDP. Premium revenue is used elsewhere in this section as it is the main basis for measurement for premiums.

**Chart 3.2 Gross written premium as a percentage of gross domestic product—1998 to 2002**




Sources: APRA, *Selected statistics on the general insurance industry*, table 6. ABS, 5206.0 Australian National Accounts: National Income, Expenditure and Product.

The chart shows that insurance premiums as a percentage of GDP remained relatively constant between 1998 and 2002, increasing marginally from around 2.7 per cent in 1998, to just over 2.8 per cent in 2002. The reduction in 2001 is directly attributable to the exclusion of the HIH Group from APRA statistics.

The historical performance of the general insurance industry was examined in detail in the ACCC's March and September 2002 insurance industry market pricing reviews. The March 2002 report examined changes in standard performance measures, including premium revenue, underwriting profits/losses, investment revenue and returns on equity between 1993 and 2001. It showed that:

- the insurance industry incurred underwriting losses (that is, claims and underwriting expenses exceeded premium revenue), with the size of such losses increasing in most years since 1992–93
- the industry has therefore had to rely on investment income and/or the running down of capital reserves to maintain profits[43]
- low returns on equity have been experienced by some of the 15 classes of insurance over that nine-year period. Some classes (including public liability and professional indemnity) have experienced 'very low' returns on capital, while other classes have experienced 'high' or 'very high' returns.[44]

[43] In long-tail classes of insurance such as public liability and professional indemnity insurance, insurers typically earn substantial income on premiums invested before paying out claims—however claims costs also tend to rise with inflation, so these two effects work in opposite directions.

[44] The March and September 2002 ACCC reports provided a summary on the performance and outlook for each class of business. A 'very low' rating indicated that the return on capital investment may be an unsustainable level suggesting intervention to either increase premiums (perhaps selectively) or exit from the market. 'High' and 'very high' ratings were defined as returns on capital of 20 per cent to 50 per cent and in excess of 50 per cent respectively.

The September 2002 report gave an updated market analysis, noting that the performance of the general insurance industry in recent years was affected by two large and unusual events. The first of these was the liquidation of the HIH Group of companies in March 2001. The second event was the terrorist attacks in the United States on 11 September 2001. The report indicated that the general insurance industry as a whole performed extremely poorly in the 2001–02 financial year. It also experienced the highest underwriting losses ever recorded in Australia. However, the report also indicated that the short-term outlook for the industry was much more positive, with large and sustained premium increases over the past three years restoring most classes of the general insurance industry to profitable levels.[45]

The remainder of this report focuses on the public liability and professional indemnity classes of insurance.

[45] ACCC, *Second insurance industry market pricing review*, September 2002, p. vi.

# 4 Features of the public liability and professional indemnity insurance sectors

## 4.1 Liability insurance

Liability for personal injury or property damage can arise in various contexts, including in the workplace, for a matter covered by a contract, or as a result of a motor vehicle or other accident. Various types of liability insurance are available to reduce the exposure of organisations and individuals to such risks. Within the general insurance industry, the five main types of liability insurance are:

- motor vehicle third party
- workers' compensation
- public liability
- products liability
- professional indemnity.

These categories of liability insurance are distinguished from first party cover, which may cover similar risks but which will be for the benefit of the person insured. For example, accident and disability policies may cover persons who also have claims against persons liable for the injury done.

Motor vehicle third party and workers' compensation liability insurance are typically referred to as 'statutory schemes' because insurance is made compulsory by state-based legislation and the statutes define many aspects of the schemes including benefit entitlements and how insurance claims are handled.[46] In contrast, the remaining three types of liability insurance are generally considered voluntary, as there is virtually no specific legislation governing how claims are dealt with and how compensation is determined. However, the exceptions to this are discussed later in sections 4.2.1 and 4.3.1.

Liability insurance is often referred to as 'long-tail' insurance, as many years may pass between the period for which cover was provided and the date when claims arising from incidents during that period are finally settled. The delay may occur because, for example, injured people may wait until their injury stabilises before making a claim. Once it receives a claim, the insurance firm will typically investigate it, negotiate with the client and either settle or seek an outcome through the legal system.[47] In contrast, most claims for damage to motor vehicles or homes tend to be made in the year in which cover is provided, with final settlement usually occurring soon after the claim is lodged.

The remaining part of this section focuses specifically on the public liability and professional indemnity classes. The accompanying data was sourced from APRA for the year ending 30 June 2002 (the latest data available when this report was prepared).

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46 Trowbridge Consulting, *Public Liability Insurance, analysis for meeting of ministers on 27 March 2002*, March 2002, p. i.

47 Productivity Commission, *Public Liability Claims Management Research Report*, December 2002, p. 13.

## 4.2 Public liability insurance

### 4.2.1 What is public liability insurance?

Public liability insurance protects individuals, businesses or organisations against the financial risk of being found liable to a third party for death or injury, loss or damage of property or 'pure economic' loss resulting from negligence by the insured.[48]

This protection may relate to a particular location, to the use of movable property, or to the activities of a group or individual. Because the policy is intended to cover the unexpected, most are limited by exclusion, rather than attempting to specify the perils which are covered. The exclusions are the perils for which the insured would normally be expected to have more specific insurance. Known hazardous activities may also be excluded, as are criminal actions by the insured.[49]

For household consumers, public liability insurance tends to be part of their home and contents insurance policies. Stand-alone public liability insurance policies are provided to individuals and organisations for commercial purposes. These commercial policies are the focus of the ACCC's monitoring exercise. In most industries, and especially for smaller businesses, public liability and products liability have been sold as a combined product with a single premium. Therefore, statistics are usually only available for public and products liability combined.[50]

The nature of public liability insurance is an important consideration in this discussion about premium setting arrangements. There are several major features of public liability insurance policies.

#### *Voluntary insurance*

Public liability insurance is considered a voluntary form of insurance although there are several exceptions, such as certain public events and facilities, where a licensing authority may require public liability insurance. Many organisations that operate on a voluntary basis, typically with the support of local councils, are also required to hold public liability insurance. This protects the supporting body (the council) from any call on its own public liability insurance.[51] Since 1997 contracts issued by governments to businesses for government work have required businesses to take out public liability insurance. Such insurance is effectively compulsory, although not mandated by legislation.[52]

#### *Long-tail insurance*

Public liability insurance is considered a form of long-tail insurance. Depending on the statues of limitations which vary between each state and territory, claims can be made for some years after an accident, even if the policy has expired. For example, the ICA commented that:

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48 ibid., p. 9.

49 Institute of Actuaries of Australia, *Submission to the Public Liability Forum*, March 2002, p. 4.

50 Trowbridge Consulting, *Public Liability Insurance, analysis for meeting of ministers on 27 March 2002*, March 2002, p. 2.

51 Institute of Actuaries of Australia, *Submission to the Public Liability Forum*, March 2002, p. 4.

52 ACCC, *Second insurance industry market pricing review*, September 2002, p. 44.

> If a child of one year of age in NSW was injured, legal action could be commenced some 25 years after a policy has expired. There is no need to commence legal action until the child achieved majority at 18 years of age when the Statute of Limitations of 3 years applies. A further extension of 5 years may also be granted. (ICA, Public Liability Submission to Ministerial Forum, March 2002, p. 10)

This long-tail characteristic is cited as one of the reasons why insurers may experience difficulty in accurately estimating future claims costs, and in turn setting appropriate premiums. The ICA commented that:

> This creates uncertainty for liability insurers who may pay a claim in future years based on a premium charged years before. The type and amount of claim may have increased substantially based not only on inflation, but also on the current developments. (ICA Submission, March 2002, p. 10)

Trowbridge also noted that:

> It takes three to five years before a reasonable accurate estimate can be made of the cost of claims for a given year of insurance. (2002a, p. 3)

With respect to pricing, the PC found that:

> 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 1990s, public liability insurance has operated at a loss. (2002, p. 14)

### *Unpredictable risks*

Public liability risks may vary from a largely predictable number of, for example, 'frequency' events (such as 'slip and fall' accidents in a supermarket) to the highly unpredictable, such as claims arising from a major accident. This is cited as a further reason for insurers experiencing problems in accurately estimating future claims costs. The Institute of Actuaries commented that:

> There is a long history of substantial losses by insurers writing various forms of liability insurance. In some cases, there is an issue of incompetent (or even no) underwriting, but mostly it reflects the extreme difficulty of assessing the probable cost of public liability risks. Despite a long history of such things, insurers continue to be surprised by the new and inventive ways in which people can injure themselves and others, and to be caught by the extent to which acceptable standards change over time. (2002, p. 11)

### *Claims-occurring policies*

The main types of claims against public liability policies are for personal injury (both physical and psychological) and property damage, with some claims encompassing both. Section 5 contains a detailed discussion about the type of claims and size of costs. Policies are typically written on a 'claims-occurring' basis. A policy covers claims for incidents which occur during the policy period, regardless of when the claim is reported.

## 4.2.2 Industry structure

### *Industry participants*

APRA provided the ACCC with unpublished data for the year ending 30 June 2002 which indicated that there were 47 direct insurers active in the public liability class during this period.

These statistics also showed that the top ten insurers earned about 66 per cent of total premium revenue for the whole public (and product) liability class of insurance in Australia, with the top four earning about 36 per cent. The 10 companies are listed below:

- ACE Insurance Limited
- Allianz Australia Insurance Limited
- CGU Insurance Limited
- Gerling Australia Insurance Company Pty Limited
- GIO General Insurance Limited
- Mercantile Mutual Insurance (Australia) Limited
- QBE Insurance (Australia) Limited
- Royal & Sun Alliance Insurance Australia Limited
- Suncorp Metway Insurance Limited[53]
- Zurich Australia Insurance Limited.

The industry shares of these companies ranged between 3 per cent and 12 per cent of premium revenue. The remaining 34 per cent was spread among 37 insurers with each having industry shares of less than 3 per cent. Since 1999 these insurers have grown in importance in the public liability insurance sector. The ACCC's September 2002 report examined, among other things, the level of concentration in the public liability insurance sector. Using the Herfindahl-Hirschman Index, it found that there had been a substantial decrease in concentration since 1997.[54]

Since 30 June 2002 several insurers announced changes to their corporate structures which are likely to affect this market analysis. Although no up-to-date data is available, the following changes should be noted:

- On 25 November 2002 QBE Insurance (Australia) Limited announced that a letter had been signed to purchase the right to renew Gerling Australia's general insurance portfolio.[55]
- On 2 January 2003 the CGU Insurance Group of companies, including CGU Insurance Limited and New Zealand Insurance Limited, was transferred to the Insurance Australia Group from its UK-based parent company, Aviva plc, for $1.86 billion.[56]
- On 3 February 2003 Royal & SunAlliance was restructured to form the Promina Group and was floated on the Australian Stock Exchange on 12 May 2003.[57]

### *Premium revenue*

Chart 4.1 shows the value of premium revenue for public liability insurance in real terms for each of the years ending 30 June between 1998 and 2002.

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53 APRA statistics as at 30 June 2002 record GIO and Suncorp Metway as two separate insurance companies. In a press release, 'Suncorp Metway Settles GIO Acquisition' of 28 September 2001, Suncorp Metway announced it had acquired the GIO general insurance business and brand name. Data supplied to the ACCC as part of the monitoring program included statistical history of three of its companies – GIO, AMP and Suncorp Metway.

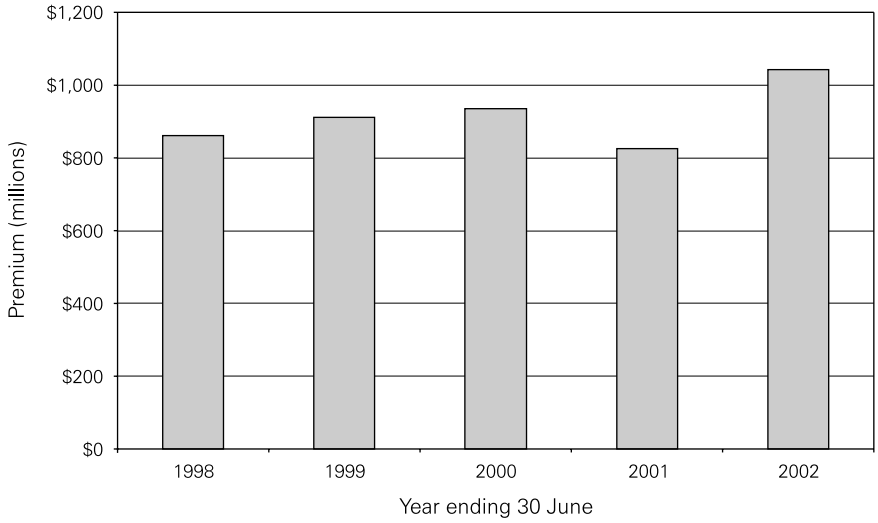
54 ACCC, *Second insurance industry market pricing review*, September 2002, p. 46.

55 http://www.qbe.com.au/group/press_releases/2002/group_pr_2002_nov25.html.

56 IAG Press release, 'Insurance Australia confirms CGU and NZI transfer of ownership', 2 January 2003.

57 Promina Press release, 'Promina Final Institutional Price Set At A$1.80 Per Share, Allocation Details Released', 12 May 2003.

**Chart 4.1 Premium revenue—real terms—public liability—1998 to 2002**



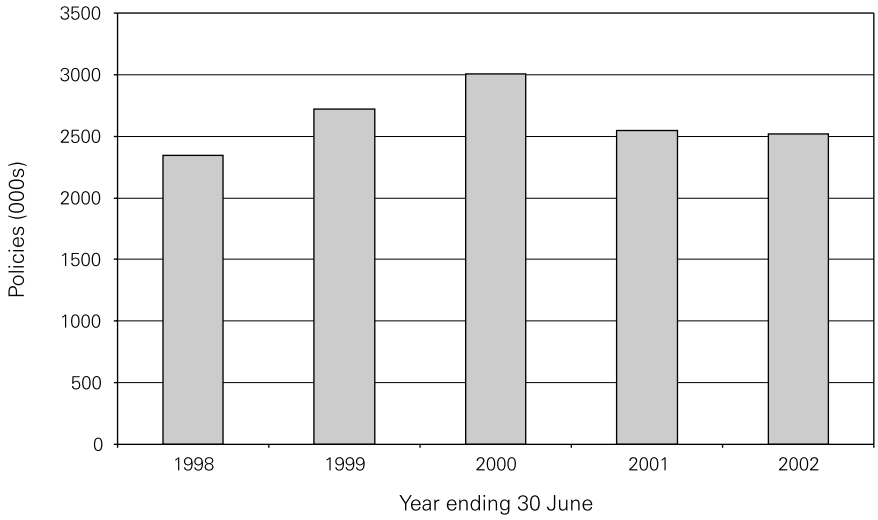

Source: APRA, *Selected statistics on the general insurance industry*, table 6.
Data adjusted using average weekly earnings index to 31 December 2002 values.

In 1998 the value of premium revenue in real terms was approximately $861 million. By 2002 the value of premium revenue was about $1 043 million, indicating an increase of 21 per cent over the five-year period. The lower figure in 2001 largely reflects the exclusion of HIH from the APRA statistics for that year.

### *Number of policies*

Chart 4.2 shows the total number of public liability insurance policies in force as at 30 June for each year between 1998 and 2002.

**Chart 4.2 Total number of policies in force—public liability—1998 to 2002**



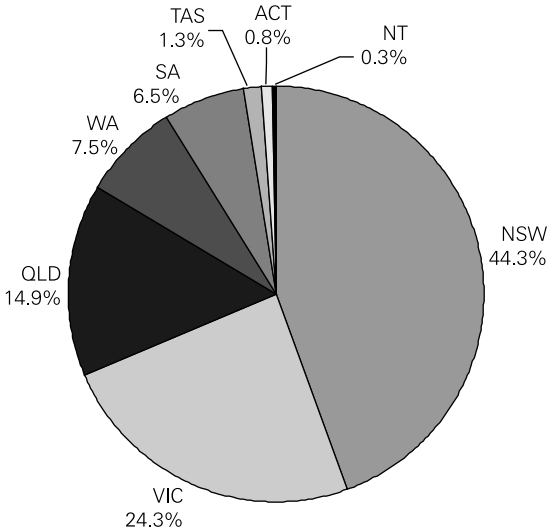

Source: APRA, *Selected statistics on the general insurance industry*, table 6.

At 30 June 1998 there were about 2.3 million policies in force—this figure had climbed to just over 3 million by 30 June 2000. Since then, the number of policies in force has fallen, with the result in 2001 being partly explained by the exclusion of HIH from the APRA statistics. As at 30 June 2002 there were about 2.5 million policies in force.

### *Distribution of premium revenue by state and territory*

Chart 4.3 shows the percentage of total premium revenue underwritten by all insurers for public liability on a state by state basis in the year ending 30 June 2002.

**Chart 4.3 Proportion of premium revenue by state or territory—public liability—year ending 30 June 2002**




Source: APRA, *Selected statistics on the general insurance industry*, June 2002, table 10.

The largest share of premium revenue was written in NSW (44.3 per cent), followed by Vic (24.3 per cent) and Qld (14.9 per cent). The smallest share of premium revenue was written in the NT (0.3 per cent). An analysis of the APRA statistics between 1998 and 2002 indicates that these state and territory shares have remained relatively stable during that time, suggesting that NSW is the largest sector on a geographical basis. This is consistent with state-based population trends and the likelihood that a higher proportion of businesses taking out public liability insurance have their headquarters in NSW.[58]

[58] APRA Form GRF 420 'Premium Revenue by State and Territory of Australia' provides instructions to insurers for reporting premium revenue data and indicates that premium revenue in Australia should be reported according to where the risk is located.

## 4.3 Professional indemnity insurance

### 4.3.1 What is professional indemnity insurance?

Professional indemnity insurance indemnifies professional people—accountants, architects, lawyers and others—for their legal liability to their clients and others relying on their advice and/or services. It provides indemnity cover in the event that a client suffers a loss, either material, financial or physical which is directly attributed to negligent acts of the professional. This liability principally arises from negligent breach of contract but may arise in simple negligence or under statute (under the Trade Practices Act for example). Malpractice insurance is another name for professional indemnity but this title has generally been reserved for the medical professions.[59]

The nature of professional indemnity claims differs according to the profession being indemnified. Accountants, lawyers, investment advisers and valuers, for example, are usually sued for economic loss occurring as a result of advice provided. Claims against architects and engineers often relate to some physical damage leading to economic loss. Personal injury may also be involved.[60]

#### *Voluntary insurance*

Similar to public liability insurance, professional indemnity insurance is also considered to be a voluntary form of insurance with several exceptions. Although no specific legislation governs how claims are dealt with or how compensation is determined, some professions are required by legislation to hold professional indemnity insurance in some states and territories and/or nationally. The main professions that are required to hold such insurance are the legal profession, insurance brokers and medical practitioners. The Australian Council of Professions claim that about 95 per cent of professionals have professional indemnity insurance.[61]

Professional indemnity insurance may also be a requirement for membership of a professional body. For instance, although accountants are not required by law to hold professional indemnity insurance, the Institute of Chartered Accountants in Australia requires its members to hold professional indemnity insurance to a specified level.[62]

In recent years, while it has not been compulsory for many professional groups to hold professional indemnity insurance, the requirements by government agencies to hold indemnity cover has led to an increase in cover. Government contracts specifying the need for insurance cover gained prominence in the mid-1990s and notably coincided with substantial outsourcing of government contracts to the private sector.[63] Again, while it may not be compulsory to hold professional indemnity insurance, it has become a requirement for those professionals tendering for government work.

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59 Insurance Council of Australia, *Submission to Ministerial Forum, Addressing the Issues in Professional Indemnity Insurance*, March 2002, p. 1.

60 ibid.

61 Australian Council of Professions Ltd, *Submission to Senate Economics References Committee*, May 2002, p. 4.

62 Institute of Chartered Accountants website, http://www.icaa.org.au

63 ACCC, *Second insurance industry market pricing review*, September 2002, p. 50.

### *Claims-made policies*

Professional indemnity is usually written on a 'claims-made' basis. This means that an insurer indemnifies the insured against claims that are notified in the policy year and which occurred during that year. In some cases, retrospective cover may be offered by insurers in addition to the policy which means that the policy would then cover claims notified in the year of cover that may arise from incidents that occurred before the inception of the policy.

This contrasts with public liability insurance which, as outlined in section 4.2.1, is usually written on a claims-occurring basis.

## 4.3.2 Industry structure

### *Industry participants*

APRA's unpublished data for the ACCC for the year ending 30 June 2002, indicated that 29 direct insurers were active in the professional indemnity insurance sector during this period.

These statistics also showed that the top 10 insurers earned about 77 per cent of total premium revenue for the professional indemnity class of insurance in Australia, with the top four earning about 48 per cent. These companies are listed below:

- Allianz Australia Insurance Limited
- American Home Assurance Company
- American Re-insurance Company
- Australasian Medical Insurance Limited
- CGU Insurance Limited
- Chubb Insurance Company of Australia Limited
- Gerling Australia Insurance Company Pty Limited
- Liberty Mutual Insurance Company
- QBE Insurance (Australia) Limited
- Royal & Sun Alliance Insurance Australia Limited.

The size of the industry shares ranged between 3 per cent and 18 per cent. The remaining 23 per cent of the premium revenue earned in the professional indemnity insurance class comprised 19 insurers, each having shares of less than 3 per cent. The ACCC's September 2002 report examined, among other things, the level of concentration in the professional indemnity insurance class using the Herfindahl-Hirschman Index and noted that concentration levels had fallen consistently from 1998 to 2000 and then rose substantially from 2000 to 2001, though the industry was still far from being considered highly concentrated.[64]

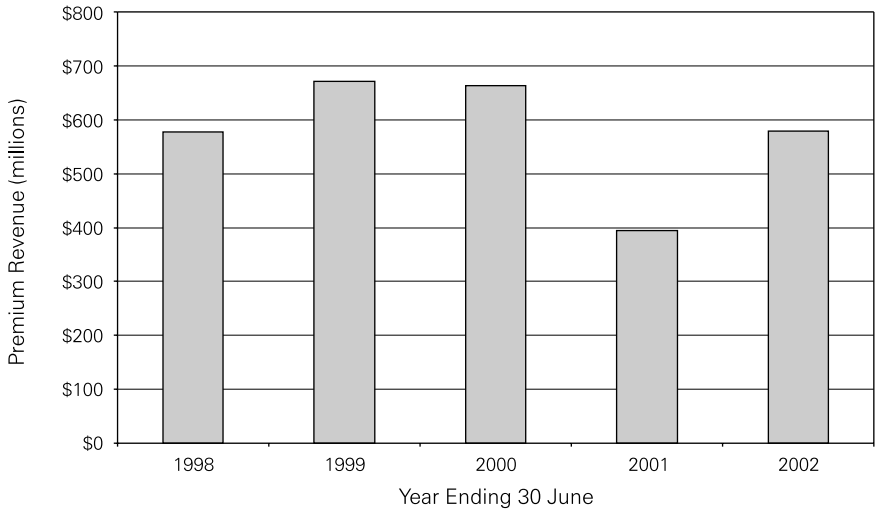
Consistent with the discussion in section 4.2.2, these industry shares are likely to have been affected by corporate restructures that have occurred since 30 June 2002.

[64] ACCC, *Second insurance industry market pricing review*, September 2002, p. 48.

### *Premium revenue*

Chart 4.4 shows the value of premium revenue for professional indemnity in real terms for each of the years ending 30 June between 1998 and 2002.

**Chart 4.4 Premium revenue—real terms—professional indemnity—1998 to 2002**



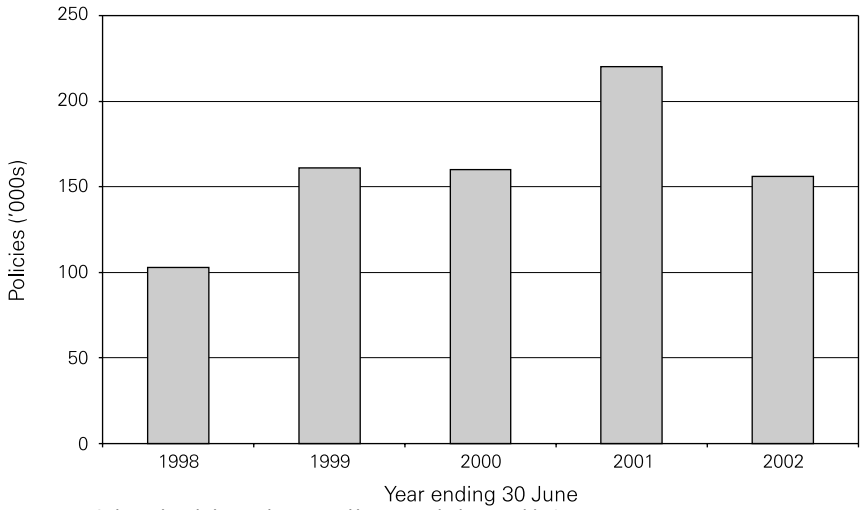

Source: APRA, *Selected statistics on the general insurance industry*, table 6.
Data adjusted using average weekly earnings to 31 December 2002 dollars.

In 1998 the value of premium revenue in real terms was about $577 million. By 2002 it had risen to about $579 million. The lower figure in 2001 largely reflects the exclusion of HIH from the APRA statistics for that year.

### *Number of policies*

Chart 4.5 shows the total number of professional indemnity insurance policies in force as at 30 June for each year between 1998 and 2002.

**Chart 4.5 Total number of policies in force—professional indemnity—1998 to 2002**



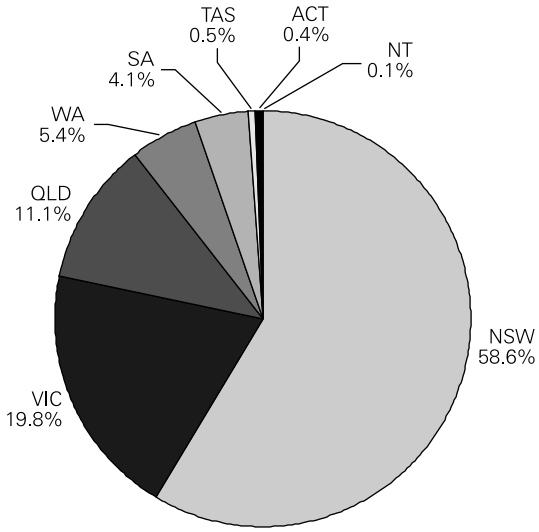

Source: APRA, *Selected statistics on the general insurance industry*, table 6.

At 30 June 1998, approximately 103 000 policies were in force—this figure had grown to 220 000 by 30 June 2001. The number of policies in force as at 30 June 2002 was 156 000.

### *Distribution of premium revenue by state and territory*

Chart 4.6 shows the percentage of total premium revenue underwritten by all insurers for professional indemnity on a state by state basis in the year ending 30 June 2002.

**Chart 4.6 Proportion of premium revenue by state or territory—professional indemnity—year ending 30 June 2002**




Source: APRA, *Selected statistics on the general insurance industry*, June 2002, table 10.

By far the largest share of premium revenue was written in NSW (58.6 per cent). This was followed by Vic (19.8 per cent) and Qld (11.1 per cent). The smallest share of premium revenue was written in the NT (0.1 per cent). An analysis of the APRA statistics between 1998 and 2002 indicates that these state and territory shares changed over this period, although NSW has remained the largest sector geographically. Similar to public liability insurance, this is consistent with state-based population trends and the likelihood that a higher proportion of businesses taking out professional indemnity have their headquarters in NSW.[65]

## 4.4 Conclusion

Public liability and professional indemnity classes of insurance are forms of liability insurance. Although providing such insurance is not required by statute, in many cases, cover is considered a necessary requirement. Their inherent characteristics, in particular, their 'long tail' and the unpredictability of large claims occurring are likely to add to the complexity of insurers' pricing decisions. A brief industry analysis shows that there are several insurers in both the public liability and professional indemnity classes in Australia, with the top 10 insurers in each class representing a significant portion of the industry. NSW is where the largest share of premium revenue for these two classes of insurance is written.

[65] APRA Form GRF 420 'Premium Revenue by State and Territory of Australia' provides instructions to insurers for the reporting of premium revenue data and indicates that premium revenue in Australia is to be reported according to where the risk is located.

# 5 Costs of public liability insurance

## 5.1 Introduction

The Federal Government asked the ACCC monitor costs and premiums in public liability insurance and professional indemnity insurance. To do this, the ACCC requested a range of quantitative and qualitative information from several insurers included in its monitoring program.[66]

This section first outlines the ACCC's monitoring methodology. It then presents the ACCC's findings about trends in costs of public liability insurance between the years ending 31 December 1997 and 31 December 2002.[67] Insurers' responses about the relative importance of perceived cost drivers are also presented.

Section 6 examines trends in premiums and policies and the financial performance across a similar period. It also summarises information from insurers about the way in which they determine overall premiums rates and the types of factors they consider in their ratings process when assessing the level of risk of insureds.

Section 7 and 8 examines costs and premiums relating to professional indemnity insurance.

## 5.2 Factors that influence premiums

Insurers consider several factors in setting public liability and professional indemnity premiums. They include costs to the insurer of providing insurance, such as paying out and administering claims, and other costs such as reinsurance. Premiums set by insurers are also likely to reflect their corporate objectives, such as achieving profit targets and business growth.[68] Claims costs appear to be the major component of the premiums charged by insurers. This is discussed below.

### 5.2.1 Costs of public liability insurance

The ACCC's September 2002 pricing review examined the costs associated with providing public liability insurance. Public liability claims typically fall into two main categories—personal injury (both physical and psychological) and property damage. Property damage claims tend to be higher in number, but are generally lower in cost.[69] Costs associated with property damage claims usually include loss of profit and other consequential losses.

In its submission to the March 2002 Public Liability Forum, the Institute of Actuaries outlined the breakdown of personal injury claims. The main elements of compensation considered in the settlement of a claim are referred to as heads of damage, and include:

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66 Nine insurers were included in the ACCC's monitoring program for public liability insurance, seven of which were also surveyed in relation to their professional indemnity insurance business. The nine insurers represented 68 per cent of the total premium revenue for the public (and products) liability insurance class for the year ending 30 June 2002. Of these nine, seven were also asked to give the ACCC information about their line of professional indemnity insurance business. The seven insurers represented 58 per cent of the total premium revenue for the professional indemnity insurance class year ending 30 June 2002. The insurers included in the ACCC's monitoring program are listed in appendix A.

67 Details about the ACCC's data request are in appendix D. Information about the reporting basis adopted by the ACCC in examining different data sets is also discussed in that appendix.

68 The ACCC's September 2002 pricing review outlined in detail the issues insurers are likely to address when setting pricing and the factors that influence final premiums (see pp. 58–72).

69 ACCC *Second insurance industry pricing review*, September 2002, p. 44.

- economic loss—this includes past loss of income (before settlement of a claim) and loss of future earning capacity
- treatment and care—this includes the cost of medical treatment, hospital care, prosthetic and other aids, rehabilitation, home modification, domestic and live-in help and fund management
- non-economic loss—this includes costs for pain and suffering, loss of use of limbs, bereavement
- exemplary damages
- plaintiff legal costs awarded against the defendant (p. 5).

The Institute also identified several secondary costs associated with providing public liability insurance, which they estimated typically added from 30 per cent to 50 per cent to the risk premium for liability policies. They relate to costs incurred by insurers from meeting damages awarded as well as costs incurred when they defend each case, such as the costs associated with case assessment, expert reports, investigation, defendant legal costs and claim administration, as well as general administration, policy distribution (including issuing of policies, commission and other fees), policy taxes and duties, and profit margins.[70]

The ACCC asked insurers to identify the cost components of premiums written in the year ending 31 December 2002. Table 5.1 summarises responses from seven insurers. The percentage of premium **charged** by the insurers for each cost category is presented as an average estimate based on the responses across these insurers.

### Table 5.1 Components of premium—public liability

| Components | Percentage of premium charged by insurer (%) |
|---|---|
| Discounted claims costs | 47 |
| Claims handling expenses | 5 |
| Underwriting expenses | 24 |
| Cost of reinsurance | 13 |
| Profit margin | 11 |
| **Total premium** | **100** |

Source: Derived by ACCC from responses provided by seven insurers.
This table represents the premium charged by the insurer and does not include statutory third party collections, such as stamp duty and the Goods and Services Tax (GST).

The table shows that the largest component of premium charged by insurers (on average, 47 per cent) relates to the cost of claims (which are inflated and discounted). Claims handling expenses (around 5 per cent of premiums) are those attributed to the settlement of claims, such as legal expenses and claims assessors' fees. These two categories combined show that direct claims costs account for just over half of the premium charged by insurers.

Underwriting expenses (on average, 24 per cent) are incurred by insurers in writing their book of business. They typically include commissions and fees paid to brokers and agents by insurers because many policies are distributed exclusively through these intermediaries.

Most insurers typically cede some of their premium to reinsurers to manage the risks inherent in their insurance portfolio (see section 3.3) and the cost of this reinsurance reflects around 13 per cent, on average, of the premium charged by insurers.

[70] Institute of Actuaries of Australia, *Submission to the Public Liability Forum*, March 2002, p. 5.

The remaining component is the insurer's indicative profit margin—which is estimated to be, on average, around 11 per cent of premiums.

## 5.3 Monitoring methodology

As the cost of providing insurance represents a substantial part of the premiums charged by insurers, the ACCC examined trends in the major cost components, that is, claims costs and expenses, as part of its monitoring program. It also looked at trends in premiums and polices. This information was also used to examine the recent financial 'underwriting performance' of insurers in each insurance class.

The ACCC used several indicators to examine costs and premiums and these are identified below.

### 5.3.1 Claims

- *Claims frequency*—this shows the number of claims reported in the same year as incident expressed as a proportion of the total number of policies for the corresponding underwriting years.[71] Claims frequency gives an indication of whether insurers are receiving more or fewer claims reported in the same year as incident for the same number of policies over time. To enable analysis of recent incident years, claims reported in years subsequent to the incident have been excluded.
- *Average size of claims*—this shows the average size of settled claims in real terms[72], that is the total amount of settlement costs divided by the total number of claims settled in any one year inflated to 31 December 2002 values. It shows whether the average size of claims in real terms has increased over time.
  - *The time taken to reach settlement*- this shows the proportion of all claims settled in a year that were settled within two years of incident, between three and five years of incident or more than five years after incident. As larger claims typically take longer to settle, the time taken to reach settlement is an indicator of whether more large claims are being settled.
  - *The mix of claims settled*- for public liability insurance it is also important to examine the types of claims settled, as those which are for personal injury and death are typically larger than those for property damage. Therefore, the ACCC examined three indicators:
    - *The proportion by settlement number of the two types of claims*- whether the proportion of personal injury and death claims settlements had increased over the period
    - *The proportion by settlement costs of the two types of claims*- whether the proportion of settlement costs attributable to personal injury and death claims had increased over the period

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71 The incident year data are not directly comparable with the underwriting year data. This is overcome by converting underwriting year data to an incident year basis by taking the incident year B and comparing it to the average of underwriting year A and underwriting year B. This is because one underwriting year may incur incidents across two years depending on when the policy is written (i.e. a policy written on 1 July year A effectively covers incidents occurring in the second half of year A and the first half of year B).

72 Using the average weekly earning index (AWE) published by the Australian Bureau of Statistics (ABS) (catalogue number 6302.0). The AWE has been used throughout this analysis to convert nominal dollars into real dollars for data on premiums and claims. AWE is considered an appropriate measure of claims inflation as claims costs for this class of insurance generally increase at a level above prices (and average wages is used as a proxy for this). AWE is also considered an appropriate measure for adjusting premiums given that claims costs are a large component of premiums charged by insurers.

- *The average size of personal injury and death claims settlements and the average size of property damage claims settlements in real terms*[73]- the trend in average size of each of these claim types over time.

- *The distribution of settlement numbers and costs between settlement size bands*- the change in the distribution of settlements across various size bands and whether specific size bands are leading to changes in the average settlement size or whether the change can be attributed to all size bands.

### 5.3.2 Expenses

The ACCC examined trends in major categories of expenses—brokerage, reinsurance and underwriting expenses- by comparing them to gross written premium, that is, shown as a proportion of gross written premium. This indicates how much each of these expenses represents of written premium and whether this has changed over time. The expenses are compared with the gross written premium because the premium written in any one year will be used to pay for all costs of acquiring, writing and servicing insurance business.

### 5.3.3 Premiums and policies

To examine trends in premiums and policies, the ACCC used one main indicator, the *average premium*. The average premium is based on the total gross written premium written in one underwriting year, divided by the number of policies for that year, in real terms.[74] This indicates the average premium that was paid across the period by policyholders.

### 5.3.4 Underwriting performance

The overall financial performance of the insurance companies is determined by their underwriting and investment activities. However, the ACCC's monitoring role relates specifically to monitoring costs and premiums, rather than investment activities, and therefore it focused on the underwriting performance of insurers.[75] This was examined using a number of ratios:[76]

- *Loss ratio*- this is calculated as the total amount of claims costs paid or payable (including expected future claims costs) on all incurred claims[77] in current dollar values (i.e. before inflating or discounting) as a proportion of earned premium. This ratio shows the proportion of premiums that claims costs represent.

- *Expense ratio*- this is calculated as the sum of brokerage expenses and underwriting expenses, as a proportion of gross written premium. It shows the proportion of premiums that these expenses represent.

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73 Using the average weekly earning index (AWE) published by the Australian Bureau of Statistics (ABS) (catalogue number 6302.0).

74 ibid.

75 An outline of factors that determine an insurer's overall financial performance is in appendix E.

76 These ratios, excluding the reinsurance ratio, are calculated both gross and net of reinsurance expenses and recoveries. As reinsurance effectively passes off a portion of risk from the insurer to the reinsurer, examining the net ratios indicates the direct performance that the insurer expects to achieve. Calculating the ratios net of reinsurance means deducting the reinsurance expense from premiums, and also deducting reinsurance recoveries from the claims payments.

77 The total number of claims incurred for any one incident year which may result in a liability for the insurer, this would included claims paid and claims outstanding (including IBNRs and IBNERs).

- *Reinsurance ratio*- this is calculated as reinsurance expenses as a proportion of gross written premium. As with the expense ratio, it shows the proportion of premiums that the reinsurance expense represents.
- *Combined ratio* = the loss ratio + the expense ratio + the reinsurance ratio. This ratio shows whether the sum of all costs (claims costs and expenses) is greater or less than premiums.[78] For example, if the combined ratio is greater than 100 per cent, then insurers will be making a loss. If the ratio is less than 100 per cent, then insurers will be making a profit. Because of the way in which the ACCC has measured loss ratios, there may also be a further profit item if investment returns exceed inflation over the time from receipt of premiums to payment of claims.

## 5.4 Trends in public liability claims

### 5.4.1 Claims reports and claims frequency

Chart 5.1 examines the number of claims reported to insurers within the same year as the incident occurred (reported within the same year as incident)[79], and the frequency of claims reported within the same year as incident over the incident year period 1998 to 2002.[80]

This chart shows that the number of claims reported within the same year as incident increased (by 3 per cent) from 16 978 to 17 439 between 1998 and 1999. However, between 1999 and 2002 the number of claims reported within the same year as incident declined to below 1998 levels with 11 430 claims reported within the same year as incident by 2002.

The chart shows that the trend in claims frequency of those reported within the same year as incident decreased between 1998 and 2002, from 2.4 per cent in 1998 to 1.5 per cent in 2002.[81]

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78 The loss ratio is calculated using earned premium, while the expense ratio and the reinsurance ratio are calculated using written premium, so there is a small timing inconsistency in adding them together for the combined ratio—however this is not considered material to the ACCC's conclusions.

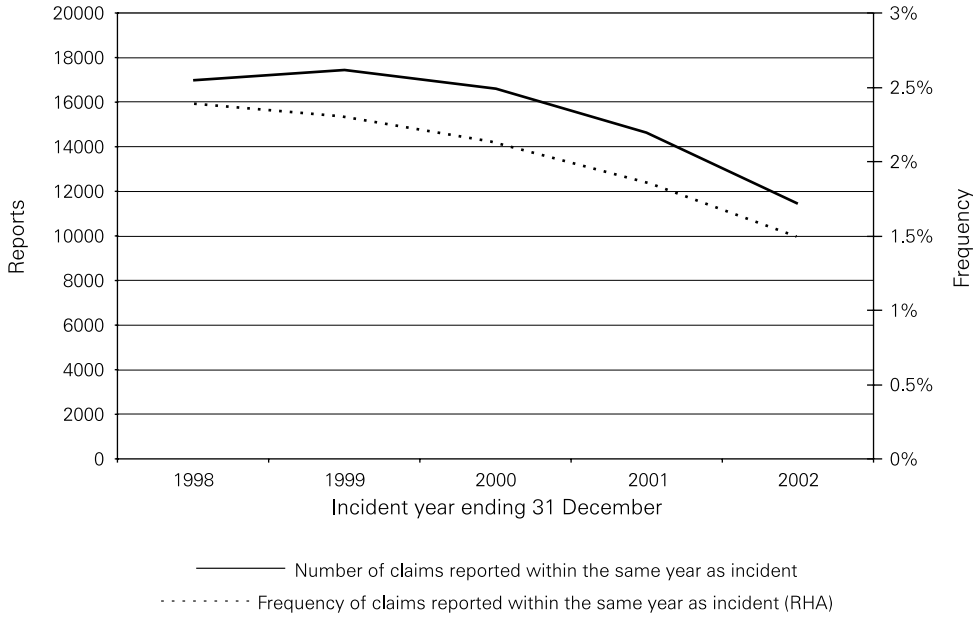
79 To indicate what proportion of claims reported within the same year as incident represents of total claims incurred, the ACCC examined a sample of data provided by five insurers for the five-year period. It showed that the number of claims reported within the same year as incident represents on average 66 per cent of total claims incurred in that incident year with this figure remaining relatively constant over the period and across the five insurers.

80 The ACCC attempted to construct an analysis of the number of incurred claims and the claims frequency but was unable to do so reliably due to only a limited number of selected insurers providing reliable IBNR estimates. Thereforethe analysis was constructed on claims arising within the same year as incident. The results of the analysis on thelimited sample of five insurers showed broadly similar trends in terms of claims frequency as that shown in chart 5.1 with a declining trend from 1998 to 2002. The trend in the number of incurred claims over the period, however, differed from the trend in the number of claims reported within the same year as incident. The number of incurred claims increased between 1998 and 2000 and this was followed by steep decreases in 2001 and 2002.

81 A similar declining trend in claims frequency was also noted in the March 2002 Trowbridge report (p. 13) in which they analysed claims frequency per $100 000 premium for ISA contributors (based on data provided by insurers who were members of the ISA). The report noted that the overall frequency of claims has been fairly flat, with some reduction in 1999 and 2000. However, the report noted that the decline in claims frequency may not be a favourable trend because:

- the mix of claims seemed to be changing, with reductions in property damage claims but increases in bodily injury claims
- the introduction of excesses (and higher levels of excess) in recent years may account for the lower claim numbers. Even a small excess can eliminate many claims by number, without making a big impact on the total cost of claims
- changes in the number and business mix of the ISA members distort the observed trend.

**Chart 5.1 Total number of claims reported within the same year as incident and frequency of claims reported within the same year as incident—public liability—1998 to 2002**




Source: Derived by ACCC from responses provided by seven insurers.

A declining claims frequency however may not indicate a more favourable claims experience for insurers. There may be several possible causes. For instance changes in an insurer's portfolio may influence claims frequency. If an insurer typically underwrote policies that had a large number of small claims, then shifted to underwriting policies that had a small number of large claims, then this would lead to a decline in the claims frequency but not necessarily a reduction in claims costs.

A breakdown of claims frequency by jurisdiction is in appendix D.

*In summary:*

*Nationally, the frequency of claims reported within the same year as incident decreased between 1997 and 2002.*

## 5.4.2 Average size of claims settled[82]

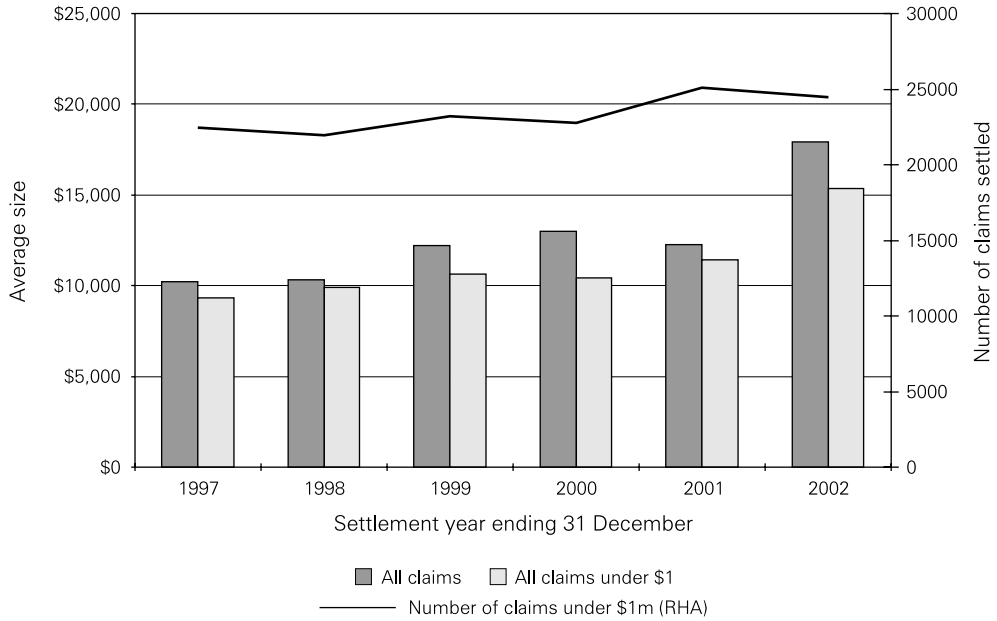
It is also important to assess how the size of claims has changed over time. This is because a lower number of claims will not necessarily result in lower claims costs for an insurer if the average size of those claims is increasing.

[82] The claims data used in this section is reported by settlement year, whereas the claims frequency analysis in section 5.4.1 has been reported by incident year. Therefore, the analyses of these two sections are not directly comparable. This issue of different reporting bases is explained fully in appendix D.

Chart 5.2 shows the average size of all claims settled[83] each year in Australia[84] in real terms. It also shows the average size of claims settled for less than $1 million[85] in real terms.

Both measures were calculated by taking the total claims settlement costs by settlement year divided by the total number of claims settled by settlement year. The number of claims settled for less than $1 million is also shown on the right hand axis (RHA) to give an indication of the sample size (i.e. number of claims used to determine the average).

**Chart 5.2 Average size of claims for all claims settled and all claims settled under $1 million—real terms—number of claims settled under $1 million—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by seven insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

The chart indicates that:

- The average size of claims settled increased between 1997 to 2002, from $10 237 to $17 906 (a 75 per cent increase). Between 1997 and 2001 the trend steadily grew, notwithstanding a marginal decrease in 2001. In 2002 the average size of claims increased significantly—by 46 per cent.[86]

83 Includes claims settled in and out of court.

84 The ACCC understands that settlement costs may not be indicative of the amounts paid in any one year because claims settled in one year may not be paid until following years and also partial payments may be made over several years. Therefore, the average size of settlements indicates the finalised cost of claims incurred by insurers and not the amounts they may pay out in any one year.

85 Using this measure removes the large one-off claims that may significantly influence the average.

86 The May 2002 Trowbridge report found similar results, albeit with a trend one year sooner than is indicated by chart 5.2. The report found that between 1997 and 2000 the average size of claims for all Australia increased steadily, however in 2001 there was a sharp increase. Chart 5.2 above shows that the average size of claims increased steadily over the period 1997 to 2001 and only began to increase sharply in 2002. This difference may be due to different samples of insurers by the ACCC and Trowbridge, however, it does not diminish the results of either analysis as both show similar overall trends. The trend observed in the ACCC's *Second Insurance Industry Market Pricing Review* of September 2002 showed some difference with an increasing average size of claims between 1997 and 1999 before becoming more stable in 2000 and 2001. Again, the differences in the trends may be explained by the different data sets requested or different samples of insurers.

- A similar trend occurred in the average size of claims settled for claims under $1 million. They steady increased between 1997 and 2001 (despite a marginal decrease in 2000) from $9 340 to $11 433. In 2002 the average increased sharply to $15 342.
- The number of claims settled under $1 million between 1997 and 2002 increased from 22 484 to 24 482 (up by 9 per cent), although there was not a consistent upward trend.

A further breakdown of the average size of claims is in appendix D.

*In summary:*

*The average size of claims settled nationally steadily increased between 1997 and 2001, followed by a significant increase in 2002. This trend was generally observed for all claims settled and for all claims settled for under $1 million.*

### 5.4.3 Increasing average claim sizes—detailed analysis

Section 5.4.2 showed that the average size of claims in real terms steadily grew between 1997 and 2001, with a sharp increase between 2001 and 2002.

This section identifies causes for the increase. The ACCC found that:

- While most claims were settled within two years of incident, the number of claims with longer settlement periods increased in more recent years. The ACCC understands these claims are usually larger compared to those claims settled more quickly.
- There was a shift towards a greater proportion of personal injury and death claims and a greater total cost of these claims between 2001 and 2002. This led to an increase in the average size of settlements, as these types of claims are typically larger than property damage claims and this may have been one factor leading to the sharp increase in the average cost of all claims in 2002.
- The number of claims settled for amounts above $50 000 increased, possibly due to some degree of bracket creep that may have occurred over the period.[87]
    - Claims within size bands above $50 000 represent a higher proportion of total claims settlement costs in more recent years. The bands that showed the greatest increase, both in terms of costs and number of claims, were between $50 000 and $500 000.

*In summary:*

*There was a trend towards larger settlements between 1997 and 2002.*

*While the number of claims and proportion of total costs represented by high cost claims (claims greater than $500 000) both increased over the period, most of the increase came from those claims settled for amounts greater than $50 000 but less than $500 000.*

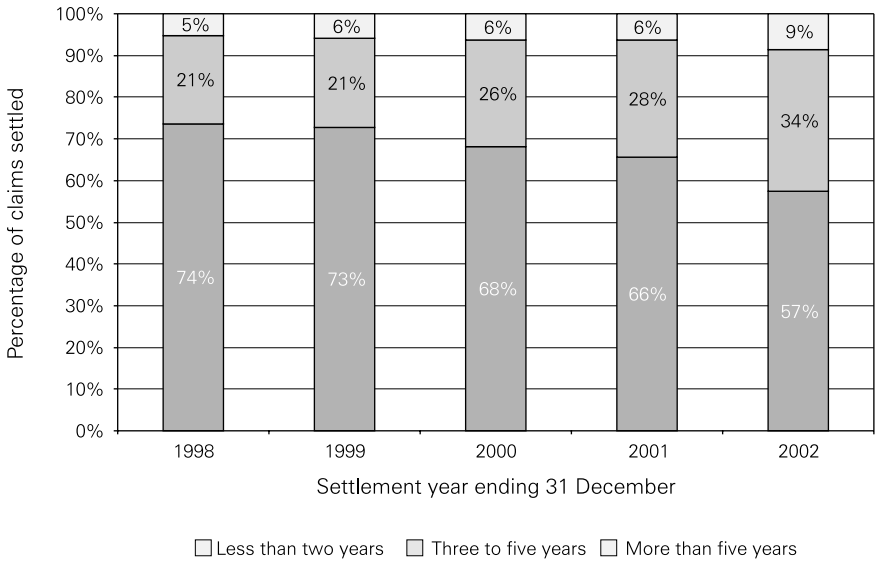
[87] Bracket creep occurs where plaintiffs who would typically sue for certain types of claims in one band are now suing for the same claims in a higher band. For example, a 'slip and fall' case may have typically been awarded $40 000, however, over time this may have increased to $60 000 meaning that this type of incident has moved up a bracket.

### 5.4.3.1 Period between year of incident and settlement year

The ACCC examined the time between when an incident occurred and when a claim arising from that incident was settled to determine if there was a greater proportion of 'old' incidents in more recent settlement years. For example, an incident may occur in 1994 but may not be settled until 1999, meaning that five years have elapsed between the incident and settlement. The ACCC understands that smaller cost claims are typically settled quickly, whereas larger claims tend towards longer settlement periods.

Chart 5.3 shows the proportions of claims settled in settlement years 1998 to 2002 for claims where the time between incident and settlement was (a) less than two years; (b) three to five years; and (c) more than five years.

**Chart 5.3 Proportion of claims settled by settlement time period bands—public liability—1998 to 2002**




Source: Derived by ACCC from responses provided by seven insurers.

The chart shows that:

- The proportion of claims settled **within two years** of incident decreased between 1998 and 2002. In 1998, 74 per cent of all claims settled were for incidents occurring within two years of settlement, by 2002 this had decreased to 57 per cent
- Conversely, the proportion of claims settled **between three to five years** of the incident occurring increased from 21 per cent in 1998 to 34 per cent in 2002
- The proportion of claims settled **more than five years** after incident remained relatively constant at 5 to 6 per cent between 1998 and 2001 before increasing to 9 per cent in 2002.

*In summary:*

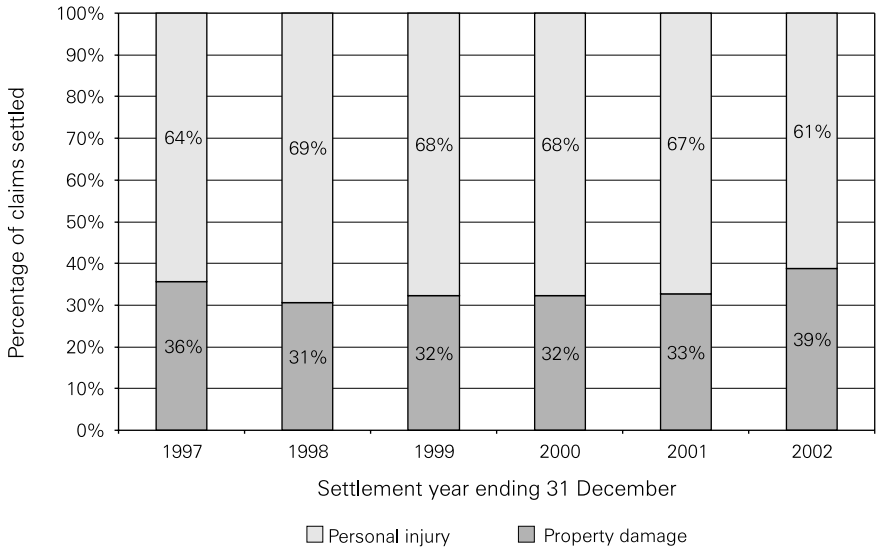
*The proportion of claims settled that were 'old' incidents (that is claims settled more than two years after incident) increased between 1998 and 2002. This would suggest that, assuming there is a direct correlation between the length of settlement and the cost of settlement, there was an increase in the number of higher cost claims over the period.*

### 5.4.3.2 Types of claims—property damage versus personal injury and death claims

The ACCC examined the number of claims and related costs attributed to personal injury and death claims and property damage claims.[88]

Chart 5.4 shows the proportion of the total **number of claims** settled between 1997 and 2002 that were personal injury and death claims and those that were property damage claims.

**Chart 5.4 Proportion of total claims settled that are property damage settlements or personal injury and death settlements—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by five insurers.

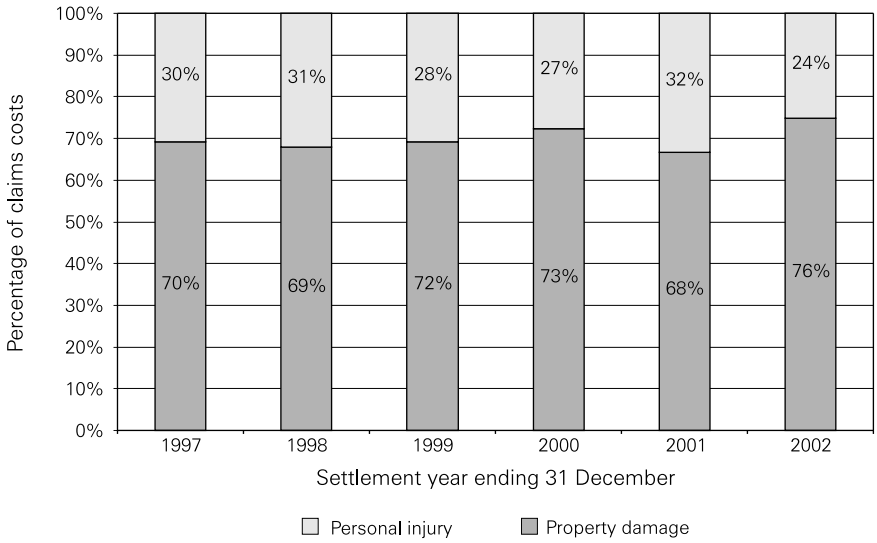
This chart shows that there was a greater number of property damage claims than personal injury and death claims between 1997 and 2002. Over the period, the percentage of total claims settled which were property damage claims ranged between 61 per cent and 69 per cent. The percentage of settlements relating to personal injury and death ranged between 31 per cent and 39 per cent.

In 2002 the number of personal injury and death claims increased as a proportion of all claims from 33 per cent in 2001 to 39 per cent.

Chart 5.5 shows the proportions of the total **costs of claims** settled between 1997 and 2002 that were property damage claims and personal injury and death claims.

[88] Not all the insurers included in the ACCC's monitoring program provided this information as some indicated it was not produced in their reporting systems. Other insurers provided some of the information for part of the time period specified by the ACCC. It should be noted that the analysis in chart 5.2 was based on data provided by seven insurers, while analysis in this section is based on data from five insurers. For consistency the ACCC analysed data provided by the five insurers in the context of chart 5.2 and found that the general trend was the same compared with the analysis of the seven insurers. This suggests that the analyses are broadly comparable.

**Chart 5.5 Proportion of total claims settlement costs that are property damage settlements or personal injury and death settlements—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by five insurers.

The chart shows that personal injury and death claims represented a significantly larger portion of settlement costs than property damage claims across the period. Between 1997 and 2002 the proportion of settlement costs comprising personal injury and death claims ranged between 68 per cent and 76 per cent. The proportion of settlement costs comprising property damage claims ranged between 24 per cent and 32 per cent.

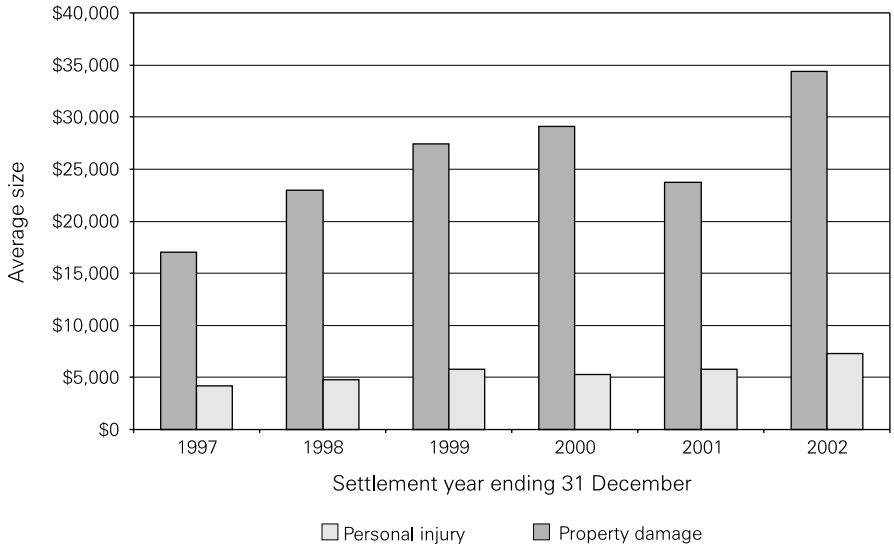
*In summary:*

*Compared to property damage claims, personal injury and death claims are lower in number but higher in cost.*

There was a substantial change to the proportion of total costs represented by personal injury and death claims in 2002 compared to the previous four years, with the proportion increasing from 68 per cent in 2001 to 76 per cent in 2002. However, while this is notable and may be reflected in changes to the average size of claims in 2002, it is not known whether this will develop into a trend.

Chart 5.6 shows in real terms the average size of settled claims for personal injury and death claims and the average size for property damage claims over the period 1997 to 2002.

**Chart 5.6 Average size of settled claims—real terms—personal injury and death and property damage claims—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by five insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

Chart 5.6 shows that the average size of personal injury and death claims is significantly higher than for property damage claims.

The average size of personal injury and death claims increased from $16 635 in 1997 to $33 616 in 2002, reflecting an increase of 102 per cent. In 2001 the average size of personal injury and death claims decreased.

The average size of property damage claims increased from $3 891 in 1997 to $6 708 in 2002, up 72 per cent.[89]

*In summary:*

*This analysis shows that while the number of property damage claims exceeded those for personal injury, it is personal injury and death claims that represent a relatively greater proportion of costs. However it should be noted that the average size of both personal injury and death claims and property damage claims increased between 1997 and 2002.*

*This suggests that the increase in the number and costs of personal injury and death claims may be influencing the average size of all claims settled over the period.*

Following the analysis in section 5.4.3.1, it is possible to examine the number of years between incident and settlement for property damage claims and personal injury claims for the five insurers.

Table 5.2 shows the proportions of claims settled in 1998 to 2002 for claims settled within two years of incident, between three and five years after incident and more than five years between incident and settlement for property damage claims and personal injury and death claims.

[89] This is consistent with the findings in the March 2002 Trowbridge report which also concluded that property damage claims make up the majority of all settled claims by number and have low average costs while bodily injury claims make up most of the cost, because they have a much greater size (p. 12).

**Table 5.2 Proportion of claims settled by settlement time period bands—year ending 31 December—public liability—1998 to 2002**

| Personal injury claims | Within two years | Between three and five years | More than five years |
|---|---|---|---|
| 1998 | 43% | 45% | 12% |
| 1999 | 39% | 46% | 15% |
| 2000 | 41% | 45% | 14% |
| 2001 | 37% | 49% | 14% |
| 2002 | 31% | 51% | 18% |
| **Property damage claims** | **Within two years** | **Between three and five years** | **More than five years** |
| 1998 | 88% | 11% | 1% |
| 1999 | 87% | 11% | 2% |
| 2000 | 84% | 14% | 2% |
| 2001 | 83% | 15% | 2% |
| 2002 | 77% | 20% | 3% |

Source: Derived by ACCC from responses provided by five insurers.

The table shows that most property damage claims are settled within two years of incident. However, most personal injury and death claims take more than two years to settle from the time of incident.

However, the time taken to settle for both types of claims has increased. In 1998, 88 per cent of property damage claims were settled within two years, however, this decreased to 77 per cent by 2002. Similarly personal injury and death claims settled within two years of incident decreased from 43 per cent in 1998 to 31 per cent in 2002.[90]

*In summary:*

*The number of claims that were 'old' incidents increased between 1998 and 2002. This occurred in both personal injury and death and property damage claims.*

### 5.4.3.3 Claims distribution by claims settlement size bands

In assessing the changes in the average size of claims settled, it is also important to examine the number of claims by band size and the proportion of total claims costs represented by claims within these bands.[91] [92]

Table 5.3 shows the number of claims settled within specified settlement band sizes for the settlement years 1997 to 2002.

[90] It should also be noted that the March 2002 Trowbridge Report suggested that most property damage claims are finalised within two years of incident, while personal injury and death claims are typically not finalised until three to six years after incident (see p. 12).

[91] The bands nominated by the ACCC were: Less than $50 000; $50 001 to $100 000; $100 001 to $200 000; $200 001 to $500 000; $500 001 to $750 000; $750 001 to $1 000 000; $1 000 001 to $1 500 000; $1 500 001 to $2 000 000; $2 000 001 to $3 000 000; $3 000 001 to $4 000 000; $4 000 001 to $5 000 000; $5 000 001 to $7 000 000; and above $7 000 001.

[92] A common argument for increases in claims costs is that the size and number of 'high cost claims' has increased, leading to increased pressure on premiums. Data on size bands can be analysed to see if the number of claims is increasing across all size bands or if the number of claims is getting higher in the higher bands—that is if there is any bracket creep. This may be due to several reasons such as higher court awards, the ability to sue for other damages or court precedents. The information collected from insurers by the ACCC on size bands was on a nominal basis and as such some small degree of bracket creep would be expected in line with inflation.

**Table 5.3 Numbers of claims settled by settlement size bands—settlement year ending 31 December—public liability—1997 to 2002**

**Number of claims settled**
(Numbers in brackets represent percentage of total claims numbers)

| Upper Limit | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | % increase between 1997 and 2002 |
|---|---|---|---|---|---|---|---|
| **$50 000 or less** | 21 775 (97%) | 21 185 (97%) | 22 284 (96%) | 21 767 (96%) | 23 837 (95%) | 22 650 (93%) | **4% (-4%)** |
| **$50 001 to $100 000** | 437 (2%) | 475 (2%) | 577 (2%) | 581 (2%) | 699 (3%) | 1 007 (4%) | **130% (112%)** |
| **$100 001 to $200 000** | 171 (1%) | 198 (1%) | 212 (1%) | 267 (1%) | 343 (1%) | 507 (2%) | **196% (172%)** |
| **$200 001 to $500 000** | 86 (0%) | 98 (0%) | 135 (1%) | 119 (1%) | 164 (1%) | 268 (1%) | **212% (186%)** |
| **$500 001 or more** | 25 (0%) | 19 (0%) | 40 (0%) | 37 (0%) | 46 (0%) | 74 (0%) | **196% (172%)** |
| **Total** | **22 494** | **21 975** | **23 248** | **22 771** | **25 089** | **24 506** | **9%** |

Source: Derived by ACCC from responses provided by seven insurers.

The table indicates that the total number of claims settled increased from 22 494 in 1997 to 24 506 in 2002—an increase of 9 per cent. In terms of the individual size bands:

- The proportion of total claims **numbers** that are represented by the size bands *more than $50 000* has increased from 3 per cent in 1997 to 8 per cent in 2002. Although not shown in the table above, the ACCC also examined the size of settlements costs in each band and found that the proportion of total settlement **costs** represented by these bands has actually increased from 55 per cent to 73 per cent over the same period.
- The table also shows that the **number** of claims settled within the size band *$50 000 or less* increased only marginally compared to the increase in total claims. However, although not shown in the table above, the proportion of total claims settlement **costs** represented by this band actually decreased over the period from 45 per cent in 1997 to 27 per cent in 2002.
- Claims in the bands *$50 001 to $100 000, $100 001 to $200 000* and *$200 001 to $500 000* showed increasing trends in terms of **numbers** of claims settlements. In terms of total settlement **costs** by size bands, these four bands generally showed an increasing trend over the period. Claims between $50 001 and $500 000 represented 41 per cent of total claims settlement costs in 1997 which increased to 51 per cent in 2002.
- The **number** of settlements for amounts *$500 001 or more* has also increased. Overall, claims settled in this size band grew by 196 per cent. However, due to the low chance of claims of this size occurring, the number is sporadic and has not shown a consistent upward trend. Similarly the proportion of claims **costs** represented by this band increased between 1997 and 2002, however, again the proportion of total costs is sporadic and does not show a clear trend.

*In summary:*

*The total number and cost of claims has increased over the period, with most of these increases coming from the settlements above $50 000. While high cost claims (claims settled for amounts greater than $500 000) have grown in number and costs over the period, the major increase in costs and numbers appears to be in medium cost claims (claims settled for amounts between $50 001 and $500 000).*

*This may be due to some degree of bracket creep occurring between 1997 and 2002.*

## 5.5 Cost drivers

Insurers included in the ACCC's monitoring program were presented with a list of possible factors that might explain the increase in the number and size of public liability claims over recent years. This section examines these perceived cost drivers.

Insurers were asked to rank a number of possible factors in order of importance. If an insurer considered the stated cost driver to have had no impact on premiums, insurers were asked to exclude it from their ranking.

Table 5.4 summarises insurers' responses about the perceived cost drivers in public liability claims. It shows, for each cost driver, the number of insurers which rated it the most important as well as the total number of responses from insurers. The relative importance of each cost factor across all insurers is also shown by presenting an index for each cost driver which the ACCC calculated as an average of the individual insurers' rankings indicated by insurers, weighted by the number of responses for that cost driver. This index is indicative only of the relative importance of cost factors across insurers. This means that the higher the index, the more important the cost driver was considered across all insurers, and conversely, the lower the index, the less important it was considered to be.

**Table 5.4 Summary of insurers' responses—drivers in the number and size of claims over recent years—public liability**

| Cost driver | Number of insurers that ranked the cost driver as most important | Number of insurers that ranked cost driver as second most important | Total number of responses | Index of relative importance of cost driver (1 = most important; 0 = least important) |
|---|---|---|---|---|
| Increasing litigious society | 4 | 2 | 8 | 0.62 |
| Court precedents/higher awards | 3 | 3 | 8 | 0.57 |
| Higher bodily injury claims frequency | 1 | 2 | 4 | 0.24 |
| Increased use of 'no-win no-fee' by lawyers | 0 | 0 | 7 | 0.20 |
| Other | 1 | 0 | 3 | 0.19 |
| Increased advertising of personal injury legal services | 0 | 0 | 6 | 0.17 |
| Higher non-bodily injury claims frequency | 0 | 1 | 3 | 0.09 |
| Stricter risk assessment of policyholders | 0 | 0 | 1 | 0.02 |

Source: ACCC monitoring questionnaire, 31 December 2002. Nine insurers in sample.

The table shows that the major driver in the number and size of claims over recent years was considered to be an increasingly litigious society, with eight insurers considering it important, of which four ranked it the most important factor and a further two ranking it the second most important. The index for this driver was the highest (0.62) compared to the indexes calculated in relation to the other factors. Court precedents/higher awards were considered to be the second most important driver of claims across insurers, with eight insurers considering it important, of which three ranked it the most important factor and a further three ranking it the second most important (index = 0.57). This was followed by higher bodily injury claims frequency with four insurers ranking it as important in driving the number and cost of public liability claims (index 0.24). The data analysed by the ACCC in section 5.4.3.2 shows that both the number and size of personal injury claims as a proportion of total claims remained relatively constant between 1998 and 2001, with personal injury claims increasing in terms of number and average costs in 2002.

*In summary:*

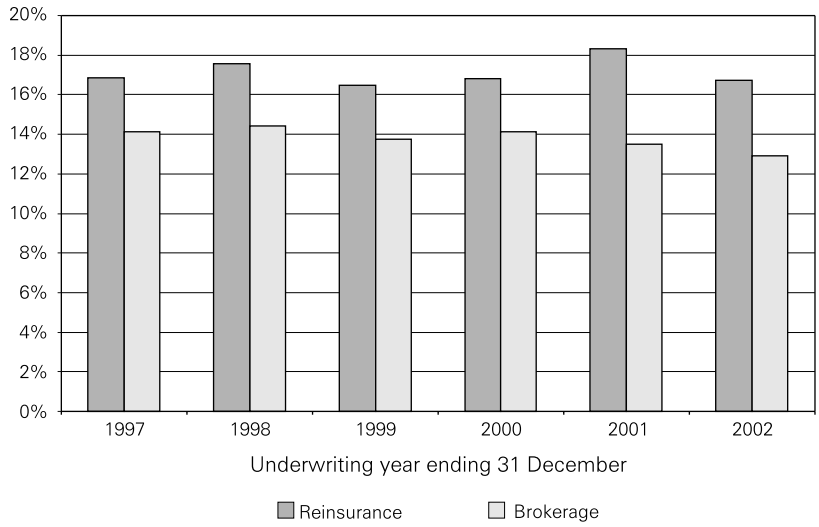
*Generally, insurers considered that recent increases in the number and size of* ***public liability*** *claims were due to an increasingly litigious society, court precedents/higher awards and a higher bodily injury claims frequency.*

## 5.6 Trends in expenses

This section examines the other cost components of public liability insurance by examining trends in reinsurance, brokerage and underwriting expenses based on data provided by insurers to the ACCC.

Chart 5.7 shows reinsurance and brokerage expenses as a proportion of gross written premium over the period 1997 to 2002.[93]

**Chart 5.7 Reinsurance expense and brokerage expense as a proportion of gross written premium—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by six insurers.

The chart shows that reinsurance expenses as a proportion of gross written premium remained fairly constant over the period. This suggests that as reinsurance costs have increased, premiums have increased as a consequence and/or as more premium is written, the same proportion of this is ceded in reinsurance.[94]

Brokerage expenses as a proportion of gross written premium also remained fairly constant over the period, although there was some decline in 2001 and 2002.[95]

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93 The expenses are compared with the gross written premium due to the fact that the premium written in any one year will be used to pay for all costs of acquiring, writing and servicing insurance business.

94 While reinsurance costs have remained relatively stable compared to gross written premium, this does not take into account changes in the amount of cover being received for the reinsurance. For example the amounts of cover or excess may have changed over time meaning that insurers are getting more or less value for money.

95 The ACCC understands that brokerage expenses are typically a fixed percentage of premium written and generally range from 15 to 20 per cent. However, as insurance policies can also be issued directly to the insured the amount of brokerage paid in any one year will not equal exactly the fixed percentage.

Most of the insurers did not provide historical data on underwriting expenses to a sufficient level of detail. This means that the ACCC could not conduct similar trend analysis on underwriting expenses. However, a few insurers provided partial data for the period 2001 and 2002. This showed that underwriting expenses as a proportion of gross written premium for six insurers represented 13 per cent in 2001 decreasing to 9 per cent in 2002. The underwriting expense data provided by three insurers showed a decreasing historical trend is broadly evident across the period.

*In summary:*

*Brokerage and reinsurance expenses increased in line with increases in gross written premium over the period 1997 to 2002.*

*There is also evidence to suggest that underwriting expenses decreased as a proportion of gross written premium between 2001 and 2002, the declining trend in underwriting expenses was observed in a smaller sample of insurers historically from 1997 to 2002.*

## 5.7 Conclusion

Based on data provided by insurers with respect to **public liability insurance**, the ACCC found that over the period year ending 31 December 1997 to year ending 31 December 2002:

- The frequency of claims reported within the same year as the incident decreased between 1998 and 2002.
  - This means that, compared to the number of policies, in 2002 fewer claims were reported in the same year as the incident than in 1998.
- At the same time, the average size of claims settled increased with steep increases occurring in 2002.
- The increase is mainly due to a general trend towards larger settlements over the period.
  - The majority of increases in both cost and the number of claims has occurred in those settled for amounts greater than $50 000 but less than $500 000.
- Insurers generally considered that recent increases in the number and size of claims were due to an increasingly litigious society, court precedents/higher awards and a higher bodily injury claims frequency.
  - Data analysed by the ACCC shows that a higher bodily injury claims frequency is a more recent occurrence, evident in 2002. Between 1998 and 2001 the number and size of personal injury claims as a proportion of total claims were stable.
- Other costs, namely, brokerage and reinsurance increased in line with recent increases in gross written premium. Underwriting expenses decreased despite this increase in premium.

# 6 Premiums, policies and financial performance in public liability insurance

## 6.1 Introduction

Section 5 examined trends in the costs of public liability insurance between the years ending 31 December 1997 and 31 December 2002.

This section examines trends in premiums and policies and the financial performance of the public liability insurance class during the same period.

It examines insurers' reasons for raising premiums recently. It also assesses how insurers determine overall premium rates and the types of factors they consider when assessing the level of risk of insureds. In addition, it examines how much non-price factors have changed in recent years, such as excess amounts, cover limits and exclusions of policies.

The ACCC's monitoring methodology was outlined in section 5.3.

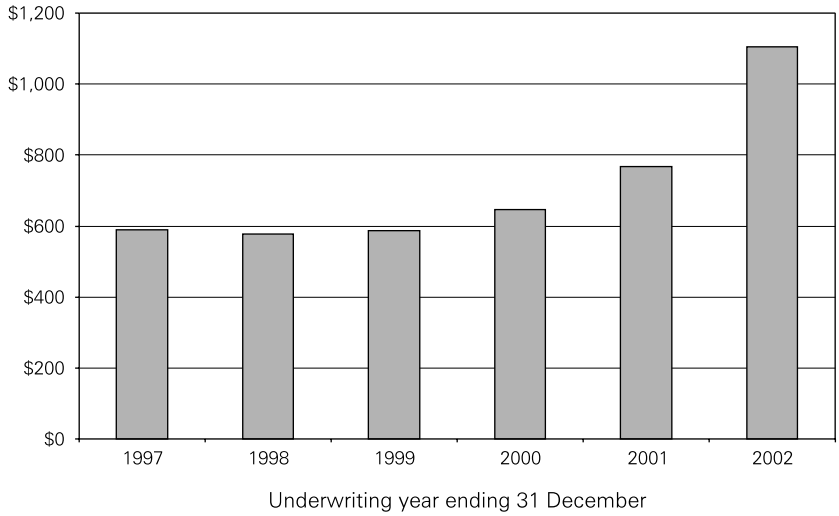
## 6.2 Trends in premiums and policies[96]

This section examines trends in premiums and polices between 1997 and 2002, in particular how the average premium demonstrates the change in premiums charged by insurers over the period. However, it may also reflect changes in the insurers' portfolios. The average premium will not exactly reflect changes in the premiums paid by all consumers.

### 6.2.1 Changes in average premium

Chart 6.1 shows the average premium in real terms from 1997 to 2002. Average premium is derived by dividing the gross written premium by the number of policies in force.

**Chart 6.1 Average premium—real terms—public liability—1997 to 2002**



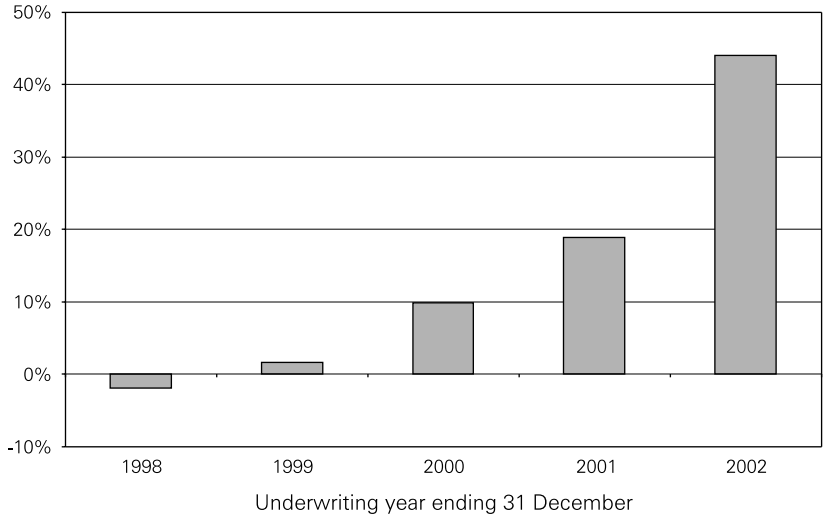

Source: Derived by ACCC from responses provided by seven insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

[96] The premium analysis may not be directly comparable to the claims trend analysis. This is because premium and policy data was collected on an underwriting year basis while claims data was typically collected on an incident year and settlement year basis. Therefore, information contained in section 6.2 below may not correspond directly with the information in section 5.4.

This chart shows the average premium in real terms was stable at about $585 from 1997 to 1999. From 1999 they increased substantially, to $1105 in 2002.

The increase is illustrated again in chart 6.2 by showing the percentage change in average annual premium in real terms between 1998 and 2002.

**Chart 6.2 Percentage change in average premium on previous year's premium—real terms—public liability—1998 to 2002**




Source: Derived by ACCC from responses provided by seven insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

This chart indicates that the percentage change in average premium between 1997 and 1999 was relatively small. However, from 1999 average premiums in real terms started to rise, with an increase of 10 per cent in 2000, 19 per cent in 2001 and 44 per cent in 2002.

## 6.2.2 Changes in average premium by state and territory

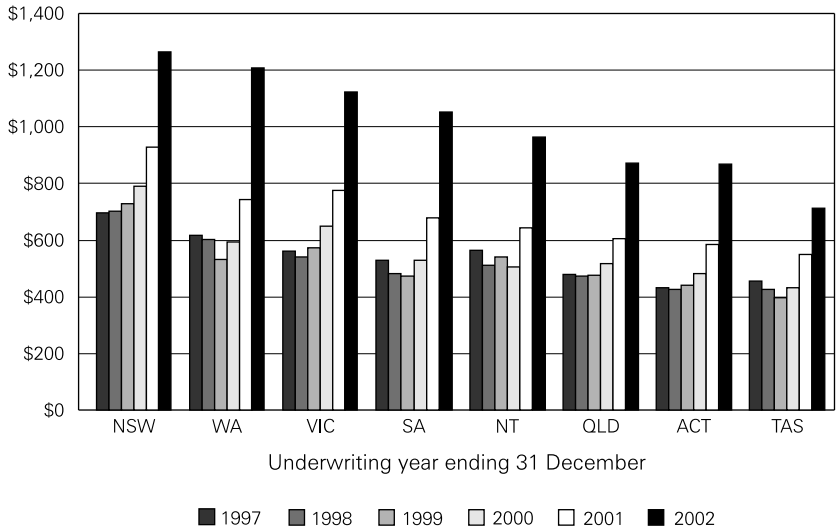
Chart 6.3 shows the average premium in real terms, on a state and territory basis, from 1997 to 2002.

Chart 6.3 shows that NSW consistently had the highest average premium during that period. The lowest was in the ACT from 1997 to 1998, and then in Tasmania from 1999 to 2002.

Generally, premiums in all states and territories showed a similar trend in average premiums across the period with either small increases or marginal decreases in average premium between 1997 and 2000, followed by an increase in 2001 and then a further steep increase in 2002.

WA may have a higher average premium than other states due to the policy mix that selected insurers write in that state. For example, some insurers may write large commercial policies for mining in WA.

**Chart 6.3 Average premium by state and territory—real terms—public liability—1997 to 2002**




Source: Derived by ACCC from responses provided by seven insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

*In summary:*

*The average premium nationally remained stable between 1997 and 1999. Between 2000 and 2002 it increased, followed by a significant increase in 2002.*

*This trend occurred in all states and territories, however, some states showed a declining trend between 1997 and 1999 before rising again between 2000 and 2002.*

## 6.3 Reasons for recent premium increases

This section examines the specific reasons by insurers for the recent premium increases between the years ending 31 December 2001 and 31 December 2002.

Insurers were asked to rank a list of possible reasons for recent premium increases in order of importance. If insurers considered that the stated reason had no impact on premiums, they were asked to exclude it from their ranking. Their responses would necessarily incorporate some level of subjective judgment, and in some cases, there could be some degree of overlap between the reasons nominated. Despite these limitations, the responses broadly indicate the reasons for recent premium increases claimed by the insurers who write policies for this type of insurance.

Table 6.1 summarises insurers' reasons behind recent premium increases for public liability insurance. It shows, for each reason, the number of insurers which rated it the most important as well as the total number of responses from insurers. The relative importance of each reason across all insurers is also shown by presenting an index—the higher the index, the more important the reason was considered across all insurers, and conversely, the lower the index, the less important it was considered to be.[97]

[97] The index was calculated on the same basis as that described in section 5.5 and is indicative only of the relative importance of reasons across all insurers.

**Table 6.1 Summary of insurers' responses—reasons for recent premium increases—public liability**

| Reason | Number of insurers that ranked reason as most important | Number of insurers that ranked reason as second most important | Total number of responses | Index of relative importance of reason (1 = most important; 0 = least important) |
|---|---|---|---|---|
| Larger claims payouts | 2 | 5 | 8 | 0.54 |
| Poor underwriting returns | 3 | 0 | 6 | 0.41 |
| Stricter risk assessment of policyholders | 2 | 1 | 6 | 0.32 |
| Increased cost of reinsurance | 1 | 1 | 7 | 0.29 |
| A higher claims frequency | 0 | 1 | 5 | 0.19 |
| Poor investment returns | 0 | 0 | 7 | 0.18 |
| Other | 1 | 0 | 3 | 0.16 |
| Change in APRA prudential standards | 0 | 0 | 5 | 0.09 |
| Reduced number of competitors in the market | 0 | 0 | 3 | 0.04 |
| Increased claims management /administration cost | 0 | 0 | 1 | 0.03 |
| Increased uncertainty | 0 | 0 | 2 | 0.02 |
| Liquidation of HIH | 0 | 0 | 2 | 0.02 |
| Reduced availability of capital /capacity following September 11 | 0 | 0 | 2 | 0.02 |
| Recoupment of past losses | 0 | 0 | 1 | 0.02 |

Source: ACCC monitoring questionnaire, 31 December 2002. Nine insurers in sample.

The table shows that insurers considered larger claims payouts were the most important reason for increases in premiums in 2002, with seven insurers ranking it either the most or second most important reason. The ACCC's analysis of public liability claims data provided by insurers supports the incidence of increasing claims costs in 2002 (see section 5.4.2). The index for this reason (0.54) was the highest compared to those calculated for other reasons.

The second most important was poor underwriting returns, with six insurers ranking it important, three of which considered it the most important reason (index = 0.41). This was followed by stricter risk assessment of policyholders, with six insurers regarding it as important in explaining recent premium increases, and two insurers regarding it as the most important reason (index 0.32).

Interestingly, issues such as the liquidation of HIH, reduced availability of capital following the September 11 2001 terrorist attacks and recoupment of past losses were regarded as the least important by all insurers. This may mean that these events were short-term external shocks that have since been absorbed by the industry. However, other reasons nominated by the ACCC in its monitoring questionnaire may have incorporated some elements of these factors. Therefore insurers may have decided it less appropriate to consider these particular factors in isolation.

*In summary:*

*Insurers reported that recent increases in* ***public liability insurance*** *premiums have primarily been caused by larger claims payouts, poor underwriting returns and stricter risk assessment of policyholders by insurers. Insurers regarded factors associated with the liquidation of HIH, reduced availability of capital following the September 11 2001 terrorist attacks and recoupment of past losses as the least important reasons for recent premium increases. This may mean that these events were short-term external shocks that have since been absorbed by the industry.*

## 6.4 Pricing methods

Insurers were asked to identify, from a list of pricing methods, which best described their current method in setting overall premiums for public liability insurance policies. They included:

- market rate pricing—this is market share oriented. It is based on observing the prices that competitors (the market) charge and then deciding on a price that conforms to the market, without specific regard to how profitable this market rate is.
- target pricing—this is cost oriented. It is based on a decision to charge rates which are expected to make a chosen level of profit.
- cost plus pricing—this is also cost oriented. The approach determines the expected cost of claims and adds a percentage to cover administrative expenses and a profit margin.
- demand adjusted pricing—this is demand oriented and is consistent with maximising profits. The price charged is what customers will pay for the product according to what they think it is worth, regardless of the costs of claims and administration or the insurer's need for profit. Under this method, prices will be low if demand is low relative to supply and will be high if demand is high.
- other—insurers were asked to specify other pricing methods not covered in the list above that they considered important.

Insurers were asked to rank these pricing methods, with '1' being the most important. If insurers did not use one of the methods the ACCC instructed them not to include it in the rankings.

Table 6.2 presents a summary of insurers' responses. The table shows, for each pricing method listed above, how many insurers rated it the most important as well as the total number of responses from insurers (that is, the count of the number of insurers that ranked the method somewhere between 1 (most important) and a maximum of 5 (least important)). The ACCC then calculated the relative importance of each pricing method across all insurers using an index—the higher the index, the more important the reason was considered across all insurers, and conversely, the lower the index, the less important it was considered to be.[98]

[98] The index was calculated on the same basis as that described in section 5.5 and is indicative only of the relative importance of pricing methods across all insurers.

**Table 6.2 Summary of insurers' responses—pricing methods—public liability**

| | Market rate pricing | Target pricing | Cost plus pricing | Demand adjusted pricing | Other method identified by insurers |
|---|---|---|---|---|---|
| **Number of insurers that ranked pricing method as most important** | 0 | 6 | 2 | 0 | 1 |
| **Total number of insurers that ranked pricing method at all** | 2 | 7 | 4 | 3 | 1 |
| **Index of relative importance of each pricing method (1 = most important) (0 = least important)** | 0.09 | 0.72 | 0.33 | 0.14 | 0.11 |

Source: ACCC monitoring questionnaire, 31 December 2002 NB. Nine insurers in sample.

The table shows that most insurers included more than one pricing method in their responses, suggesting that insurers do not adopt a single pricing method but are likely to consider several methods, albeit to varying degrees, when setting overall premiums for public liability insurance products. It also shows that target pricing was the most important, with six out of nine insurers rating it the most important. The index for this pricing method was 0.72, which was the highest. This was followed by cost plus pricing, with two insurers indicating it was the most important pricing method. One insurer ranked the 'Other' category the most important—its own price method involved each public liability risk being individually risk underwritten. Market rate pricing was considered the least important among insurers with an index figure of 0.09.

Insurers were also asked whether or not they thought the relative importance of these pricing approaches had changed over the last two years. Eight of the nine indicated they had not changed their rankings during that time.

The ACCC asked insurers how often they had changed their overall premium rates over the last two years. Seven indicated that they changed overall rates every 12 months. The remaining insurers indicated that either each risk was individually underwritten or rates were changed irregularly over the last two years bearing in mind a range of factors.

Insurers were then asked whether they intended to review overall premium rates more often in the future. Four insurers said they did not intend to review rates more often. Three indicated they would (between three and six months). The impact of legislative reform was cited as a reason for more frequent reviews of rates. The remaining two insurers did not respond on this issue, or did not respond directly, stating only that each risk was individually assessed.

The ACCC also asked insurers whether they used different pricing methods for new policies compared to renewal policies. Eight said they did not apply different pricing methods. The remaining insurer indicated that it did, offering discounts on renewal policies to particular market sectors in certain circumstances.[99]

[99] Discounts were not offered to insureds with a poor claims history or where the insured is exposed to unusual or high hazards.

*In summary:*

*Most insurers included in the ACCC's monitoring program have applied target pricing and cost-plus pricing as major components of their pricing methodology for* ***public liability insurance*** *over the last two years. Both methods use expected costs rather than market shares or demand factors as the basis for setting premiums.*

*Most insurers changed their overall premium rates over the last 12 months. Around half the insurers do not intend to review rates more often in the future, while some insurers are intending to review rates more often (in the range of 3 to 6 months).*

*Most insurers indicated that they apply the same pricing method to new policies and renewal policies.*

## 6.5 Risk assessment in pricing

This section examines why risk is an important determinant of insurance premiums and how insurers assess the risk of an insured.

To ensure that there are enough funds to meet the cost of possible claims, insurers are required to assess the risk of a claim arising and its possible cost when setting premiums. Risk is determined by numerous factors such as the likelihood of an event occurring, its time and severity. The insurer derives these estimates based on past experience and predictions of future trends for groups or events with similar risk characteristics. The premiums reflect the insurer's assessment of the degree of risk for the policy.

When an insurance policy is issued, the risk that the policyholder will be required to make a payment is effectively transferred to the insurer. The ACCC's September 2002 pricing review noted that there were three types of risk that an insurer bears, including:

- insurance risk—the possibility that the actual value of premiums collected may be lower and claims liabilities will be greater than expected
- investment risk—the risk of adverse movements in the value of the insurer's assets and/or off-balance sheet exposures
- concentration risk—representing the largest loss to which an insurer is exposed (p. 5).

The way in which the insurer manages this risk is important. APRA's establishing minimum capital requirements is one way in which insurers must manage their risk.

To minimise its exposure to large, unpredictable risks, an insurer may seek to 'offload' this risk to another insurer. This is known as reinsurance. The insurer pays the reinsurer a premium and this cost is also factored into premiums. The cost of reinsurance is largely determined by the international markets and varies over time. The Institute of Actuaries, in its submission to the public liability forum in March 2002, noted that:

> In the wake of the 11th September 2001 attacks on the US, reinsurers have acted to exclude terrorism and substantially increase rates. The rates increases represent a significant acceleration of a trend which was previously apparent, as a combined result of heavy catastrophe claims and the hardening phase of the reinsurance market cycle. Some reinsurers have withdrawn from the market and most have become more restrictive in what they will accept at normal. It should be noted that reinsurance rates are more strongly affected by global events than by the Australian market, which is small in global terms. (March 2002, p. 14)

### *Risk assessment in public liability insurance*

As part of its monitoring program, the ACCC presented a list of possible factors that insurers are likely to consider in their risk assessment of insureds when writing public liability policies. It asked insurers to rank these factors (i.e. 'high', 'medium', 'low' or 'not applicable') when setting individual premium rates. The factors were:

- the type of industry in which the insured operates
- the amount of turnover of the insured
- the size of floor space of the insured's business premises
- the number of employees in the insured's business
- state (NSW, VIC etc.) in which the insured's head office is based
- postcode in which the insured's business is located
- past claims experience specific to the insured
- other (insurers were asked to specify other factors they considered relevant).

Table 6.3 presents a summary of the insurers' responses about public liability insurance.

**Table 6.3 Summary of insurers' responses—rating factors—public liability**

| | High importance | Medium importance | Low importance | Not applicable | Total number of insurers that responded |
|---|---|---|---|---|---|
| **Industry** | 9 | - | - | - | 9 |
| **Past claims experience specific to the insured** | 7 | 1 | 1 | - | 9 |
| **Turnover** | 6 | 3 | - | - | 9 |
| **Floor space** | 1 | 2 | 3 | 3 | 9 |
| **Number of employees** | 1 | 4 | 3 | 1 | 9 |
| **State (e.g. NSW, VIC)** | - | 5 | 2 | 2 | 9 |
| **Postcode** | - | 2 | 2 | 5 | 9 |
| **Other** | 2 | 4 | - | - | 6 |

Source: ACCC monitoring questionnaire, 31 December 2002. Nine insurers in sample.

The table shows that:

- industry was the most common factor considered highly important, with all nine insurers ranking this factor of 'high importance'
- past claims experience was the second most common category considered highly important, with seven of the nine insurers rating this factor of 'high importance'
- turnover was the third most common factor considered highly important, with six of the nine insurers rating this factor of 'high importance'
- there was a variety of responses about the factors for floor space and number of employees with responses ranging from 'not applicable' to of 'high importance'
- no insurer considered the state in which the insured was located to be of 'high importance'
- 'postcode' was the least important factor, with seven of the nine insurers ranking it either of 'low importance' or 'not applicable'

- six of the nine insurers indicated that other factors were considered important, and these included contractual arrangements of the insured, indemnity levels, risk management attitudes, volume of shopper traffic, rental income and asset values.

For those factors ranked highly important, the ACCC asked insurers to provide further information about how they were rated. Given the nature and extent to which insurers responded on this point, it is possible to make only limited comments about the 'industry' factor. Each insurer used a different process to assess the industry factor. Four said that they used the ANZSIC classification system to establish particular industry groupings, although the level at which they applied this system varied across insurers. Another three said that they formed 'hazard bands' to classify industries into different levels of perceived risk, although they did not specify how these bands were derived. Another insurer used the ISA classification system. The remaining insurer indicated that the risk of insureds were individually determined.

The ACCC also asked insurers whether they had changed their premium relativities between different risk classes over the last two years. Four of the nine insurers indicated that they had changed their premium relativities between the different risk classes within the last 12 months. The remaining five indicated that they changed these relativities irregularly, with three saying that the relativities had not been changed in the last two years. Two thirds of the insurers said that they did not intend to review these premium relativities more often in the future.

*In summary:*

*When setting **public liability insurance** premiums, insurers' assessments of the level of risk of insureds is determined by a range of factors, with industry type, past claims experience specific to the insured and turnover of the insured considered the most important. Most insurers changed their premium relativities between different risk classes over the last two years.*

## 6.6 Terms and conditions of policies

Insurers can compete on terms and conditions of policies as well as price. It was therefore important that the ACCC's monitoring program also examine the nature of public liability and professional indemnity policies offered by selected insurers to see whether insurers had recently changed the terms and conditions of policies. For example, when considering the effect of price movements over time, it is important to assess whether the underlying product remains fairly constant. Otherwise, prices in one period will not be comparable with prices in another.

Factors examined by the ACCC related to:

- whether or not insurers offered a standard policy in the year to 31 December 2002, and the percentage of its insurance business which was written under the standard policy during that period
- changes in cover limits between 31 December 2001 and 31 December 2002[100]
- changes in excesses between 31 December 2001 and 31 December 2002.[101]

[100] Cover limits are limits set by the insurer on the quantum of compensation it will pay in the event of a claim or series of claims arising within the period of insurance. There are 'minimum' and 'maximum' cover limits. The maximum cover limit is the maximum amount of compensation that will be paid by the insurer—the portion of any claims above this limit falls back to the insured.

[101] An excess, set by the insurer or selected by the insured, is the amount of the claim that the insured is required to pay if a claim arises within the period of insurance. The excess is also referred to as a deductible because the amount is deducted from the amount of the claim paid to the insured by the insured.

### *Standard policies*

Eight of the nine insurers offered a standard policy for public liability insurance in the year ending 31 December 2002. The remaining insurer did not offer a standard policy, underwriting each risk individually.

Of those eight insurers, six indicated that more than 75 per cent of their book of business in public liability for the year ending 31 December 2002 was written under the standard policy. Two insurers indicated that 50–75 per cent was written under their standard policy.

Of the eight offering a standard policy, six offered the standard policy to all sectors in which they wrote business. Two indicated that the standard policy did not apply to all sectors.

### *Cover limits*

The ACCC asked insurers to specify the minimum and maximum cover limits on standard policies written in the years ending 31 December 2001 and 31 December 2002. The minimum cover limits on standard policies ranged from $1 million to $5 million across insurers, with the most common minimum cover limits being $2 million and $5 million. Between 2001 and 2002 none of the selected insurers had changed their minimum cover limits between these periods.

The maximum cover limits on standard policies ranged from $20 million to $100 million across insurers, with the most common maximum cover limit being $50 million. Between 2001 and 2002, none had changed their maximum cover limits between these periods.

### *Excesses*

The ACCC also asked insurers to specify the minimum and maximum levels of excess for standard policies written in the years ending 31 December 2001 and 31 December 2002. The minimum levels of excess on standard policies ranged across insurers, with some reporting no minimum excess and others reporting a minimum excess of $500, the most common being $250. Between 2001 and 2002, none of the selected insurers changed the minimum excess levels. A wide variety of responses were given about the specification of the maximum levels of excess. Three insurers did not offer a set maximum level of excess under their standard policies, but set the excess through negotiations between the insurer and the insured. The remaining insurers offered a maximum excess of $20 000, $500 000 and $1 million. Between 2001 and 2002, no insurers had changed the maximum excess levels on standard policies.

### *Exclusions*

The ACCC also asked insurers what major exclusions were specified in standard policies written in the year ending 31 December 2001 and if any new exclusions were specified in policies written in the year ending 31 December 2002. Of the eight insurers offering standard policies, all indicated that they had added acts of terrorism to the list of exclusions during 2002.[102] Four of the eight insurers had added ‘electronic risk’, referring to internet operations and computer viruses.

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[102] The Federal Government introduced the *Terrorism Insurance Bill 2002* into Parliament on 12 December 2002. It was passed in the Senate on 16 June 2003. The Bill renders terrorism exclusion clauses in insurance contracts ineffective for loss or liabilities arising from a declared terrorist incident. The Bill also provides for the Government to establish a statutory authority, the Australian Reinsurance Pool Corporation, to provide reinsurance to insurers for declared terrorist incidents.

*In summary:*

*During the 12 months up to 31 December 2002, the standard* ***public liability insurance*** *product, had not changed significantly in terms of the excesses and cover limits. However, all insurers offering standard policies during this period did specify additional exclusions.*

## 6.7 Trends in financial performance

The ACCC examined the underwriting performance of insurers to determine how the classes performed financially. The ACCC used a number of ratios commonly used in the insurance industry to determine how classes are performing.

### 6.7.1 Ratios

The ratios used by the ACCC can be calculated both gross and net of reinsurance expenses and recoveries.

The ACCC examined gross ratios because reinsurance coverage (and level of recovery) may change substantially from one year to the next which may mean that an insurer's net ratio could fluctuate from year to year. The gross loss ratio is free of this problem, showing the insurer's performance before reinsurance recoveries. Net ratios are examined because, even though reinsurance recoveries may fluctuate from year to year based on the coverage and level of recovery, the net ratio shows the financial performance experienced by the insurer directly, and therefore is more representative of the costs that it will pay and the premium it will retain.

The ACCC examined underwriting performance in terms of the loss ratio, the expense ratio, the reinsurance ratio and the combined ratio. These terms were defined in section 5.3. Most insurers did not provide all necessary data sets for the ACCC to reliably construct all ratios for the entire period from 1997 to 2002. The ACCC has instead calculated the ratios for 2001 and 2002 based on data provided by seven insurers.

The following ratios are constructed on an aggregate basis, and therefore represent total ratios for all seven insurers.

#### 6.7.1.1 Loss ratio

The loss ratio can be calculated gross or net of reinsurance costs and recoveries. The gross loss ratio is calculated by taking claims payments by incident year (past payments inflated into 31 December 2002 dollars using average weekly earnings, plus expected future payments in 31 December 2002 dollars on an uninflated and undiscounted basis) and dividing it by earned premium, inflated to 31 December 2002 dollars by AWE.

The net loss ratio effectively takes reinsurance and other recoveries out of the claims payments and takes the outwards reinsurance expenses away from the earned premium.

Because the calculation of the loss ratios by incident year takes into account both past claims payments and expected future payments (payments which will be made on claims that the insurer has incurred at the reporting date but which have not yet been settled) these ratios are still largely uncertain. This is because the expected future payments are based on an actuarial estimate of not only unfinalised reported claims costs, but also incurred but not yet reported (IBNRs) claims costs. Therefore this estimate may change as experience emerges, and this can either result in the loss ratios becoming more or less favourable for the insurers.

Table 6.4 shows the gross and net loss ratios for 2001 and 2002.

**Table 6.4 Gross loss ratio and net loss ratio—year ending 31 December—public liability—2001 and 2002**

| | Gross loss ratio | Net loss ratio |
|---|---|---|
| **2001** | 84% | 89% |
| **2002** | 66% | 68% |

Source: Derived by ACCC from responses provided by seven insurers.

The table shows that the gross and net loss ratios decreased between 2001 and 2002. This effectively means that for every dollar of premium earned in 2002, the seven insurers were paying on average $0.66 in claims alone, or if reinsurance was taken into account, $0.68 in claims. This represented an improvement in financial performance in 2002 compared with 2001.

The ACCC examined data for previous years although this was a smaller sample size and therefore less reliable. Data from three insurers showed that between 1997 and 1998, the gross and net loss ratios increased and were at relatively high levels. In 1999 the loss ratios dropped marginally then steadily decreased over the next three years to similar levels shown in table 6.4. These trends may be indicative of the industry for this class of insurance.

### 6.7.1.2 Expense ratio

The expense ratio can again be calculated gross or net of reinsurance expenses. The gross expense ratio is calculated as taking the underwriting and brokerage expenses by underwriting year and dividing it by the gross written premium by underwriting year. The net expense ratio takes the underwriting and brokerage expenses and dividing it by the net written premium (the net written premium is the gross written premium less reinsurance expenses).

Table 6.5 shows the gross and the net expense ratio for 2001 and 2002.

**Table 6.5 Gross expense ratio and net expense ratio—year ending 31 December—public liability—2001 and 2002**

| | Gross expense ratio | Net expense ratio |
|---|---|---|
| 2001 | **28%** | **32%** |
| 2002 | **25%** | **28%** |

Source: Derived by ACCC from responses provided by seven insurers.

The table shows that the gross and net expense ratio decreased marginally between 2001 and 2002.

Longer time period data from three insurers shows the expense ratios were similar to the ratios of the seven insurers in 2001 and 2002, albeit slightly lower. The expense ratios for the three insurers decreased steadily between 1997 and 2002 (except in 1999 when it increased marginally).

Section 5.6 noted that the ratio of underwriting expenses to premiums decreased for these insurers over the period, at a faster rate than that of the brokerage expenses ratio. This suggests that the primary driver behind decreases in the expense ratio was underwriting expenses rather than brokerage expenses.

### 6.7.1.3 Reinsurance ratio

The reinsurance ratio is calculated as reinsurance expenses by underwriting year divided by gross written premium by underwriting year. Reinsurance is calculated as a separate ratio because reinsurance is a different type of expense to underwriting and brokerage in that it is somewhat discretionary, and because it is a major component of the expenses.

Table 6.6 shows the reinsurance ratio for 2001 and 2002.

**Table 6.6 Reinsurance ratio—year ending 31 December—public liability—2001 and 2002**

| | Gross reinsurance ratio |
|---|---|
| **2001** | 13% |
| **2002** | 12% |

Source: Derived by ACCC from responses provided by seven insurers.

The table shows that the reinsurance ratio decreased marginally between 2001 and 2002.

This is consistent with chart 5.7 which showed that reinsurance expenses as a proportion of gross written premium remained relatively constant from 2001 to 2002.

### 6.7.1.4 Combined ratio

The gross combined ratio is calculated by adding together the gross loss ratio, the gross expense ratio and the reinsurance ratio. The net combined ratio is the sum of the net loss ratio and the net expense ratio.

Table 6.7 shows the gross and net combined ratios for 2001 and 2002.

**Table 6.7 Gross combined ratio and net combined ratio—year ending 31 December—public liability—2001 and 2002**

| | Gross combined ratio | Net combined ratio |
|---|---|---|
| **2001** | 125% | 121% |
| **2002** | 103% | 96% |

Source: Derived by ACCC from responses provided by seven insurers.

This table shows that the gross and net combined ratios decreased between 2001 (125 per cent and 121 per cent respectively) and 2002 (103 per cent and 96 per cent respectively). This was consistent with that observed by the ACCC in the seven insurers' individual combined ratios.

These indicators suggest that the financial performance of insurers improved in 2002 compared with 2001.

If the combined ratio is greater than 100 per cent then an insurer will be losing money while conversely if the combined ratio is less than 100 per cent an insurer will be making a profit. It should be noted than by writing insurance, an insurer is putting their capital "at risk", and would therefore normally expect a return on that capital, i.e. a profit margin. The required profit margin for different classes of business depends on the riskiness of that class, and hence the capital "at risk" from underwriting that class. However, it is not uncommon for combined ratios to exceed 100 per cent for some classes of insurance and these may still be profitable after investment income is taken into account.[103] It should also

[103] ACCC, *Insurance industry market pricing review*, March 2002, p. 20.

be noted that the combined ratio calculated above does not take into account claim handling expenses. These expenses range in size depending on the insurer's book of business and the insurer's size, but may typically be around 3–5 per cent of premium.

The longer time period data provided by three insurers shows similar trends to that for the seven insurers for 2001 and 2002, although the combined ratios for the three insurers is slightly lower. Historically for these insurers the combined ratios were substantially higher than 100 per cent, however between 1998 and 2002 they have been slowly decreasing.

*In summary:*

*The gross combined ratio and the net combined ratio decreased between 2001 and 2002. The source of the decrease was a fall in the loss ratios and to a lesser degree a fall in the expense ratios (due to falling underwriting expenses).*

*This indicates improved underwriting performance by insurers in the public liability insurance class.*

*It should be noted that this analysis does not take account of differences between inflation and investment returns from receipt of premium to payment of claims.*

## 6.8 Conclusion

Based on data provided by insurers with respect to **public liability insurance** in section 5 and section 6, the ACCC found that over the period year ending 31 December 1997 to year ending 31 December 2002:

- The frequency of claims reported within the same year as the incident decreased between 1998 and 2002.
  - This means that, compared to the number of policies, in 2002 there were fewer claims reported in the same year as the incident than in 1998.
- Despite this, the average size of claims settled increased with steep increases occurring in 2002.
- The increase is mainly due to a general trend towards larger settlements over the period.
  - Most increases in both cost and the number of claims have occurred in claims that were settled for amounts greater than $50 000 but less than $500 000.
- Insurers generally considered that recent increases in the number and size of claims were due to an increasingly litigious society, court precedents/higher awards and a higher frequency of bodily injury claims.
- Other costs, such as brokerage and reinsurance, increased in line with recent increases in gross written premium. Underwriting expenses decreased despite this increase in premium.
- The average premium remained relatively constant from 1997 to 2000 and increased in 2001 and then increased substantially in 2002.
  - Insurers perceive the recent premium increases to be associated with increases in claims costs and changes in conditions associated with the insurance cycle, namely stricter risk assessment of policyholders and previous poor underwriting returns.
  - In recent years, insurers have favoured a cost oriented pricing approach. The calculation of risk by insurers is also an important determinant in premiums they charge.

- Although the premiums set by insurers have increased in recent years, the terms and conditions associated with providing standard public liability and professional indemnity policies have remained substantially unchanged in the last 12 months. Most insurers have, however, incorporated additional exclusions, with terrorism cover being the most common.
- The combined ratio, that is expenses (including claims costs) compared to total premiums, decreased between 2001 and 2002 indicating improved underwriting performance. However, it should be noted that the loss ratio is uncertain as it incorporates estimates of future claim payments.

# 7 Costs of professional indemnity insurance

## 7.1 Introduction

This section examines costs of professional indemnity insurance between the years ending 31 December 1997 and 31 December 2002 based on information provided by insurers as part of the ACCC's monitoring program.[104]

The ACCC also examined the relative importance of perceived cost drivers based on information provided by insurers.

The ACCC adopted a similar methodology for examining costs in professional indemnity insurance as it did for public liability insurance. This was outlined in section 5.3.

Section 8 examines trends in premiums, policies and underwriting performance of the professional indemnity insurance class.

## 7.2 Costs of professional indemnity insurance

The ACCC asked insurers to identify the cost components of professional indemnity premiums written in the year ending 31 December 2002. Table 7.1 provides an estimated break down of professional indemnity premiums based on responses from four insurers. The percentage of premium **charged** by insurers for each cost category is presented as an average estimate based on the responses of insurers.

**Table 7.1 Components of premium—professional indemnity**

| Component | Percentage of premium charged by insurer (%) |
|---|---|
| Discounted claims costs | 45 |
| Claims handling expenses | 2 |
| Underwriting expenses | 21 |
| Cost of reinsurance | 19 |
| Profit margin | 13 |
| **Total premium** | **100** |

Source: Derived by ACCC from responses provided by four insurers.
This table represents the premium charged by the insurer and does not include statutory third party collections, such as stamp duty and the GST.

This table shows that the largest cost component relates to the cost of claims, representing, on average, 45 per cent of the insurance premium charged by insurers. Claims handling expenses were estimated to represent, on average, about 2 per cent of the premium charged by the insurer.

[104] Seven insurers were asked to give the ACCC information about their professional indemnity insurance business. The seven insurers represented 58 per cent of the total premium revenue for the professional indemnity insurance class year ending 30 June 2002. One of the seven insurers monitored by the ACCC for professional indemnity insurance intended to exit the professional indemnity industry after 31 December 2002. This insurer provided historical data on its professional indemnity business but declined to submit a response to questions asked by the ACCC in its professional indemnity questionnaire.

The HIH group of companies was a large player in the professional indemnity class of insurance and acknowledges that this would have had some impact on the business strategies of insurers included in the ACCC's monitoring program. This should be kept in mind when reading this section. The ACCC's September 2002 *Second Insurance Industry Pricing Review* examined the impact of the exit of HIH from the insurance market.

Expenses associated with the underwriting of the policies and the administration of claims that arise against the policies are estimated to represent, on average, around 21 per cent of the insurance premium charged. Reinsurance costs associated with the policies are estimated to represent a further 19 per cent, on average.

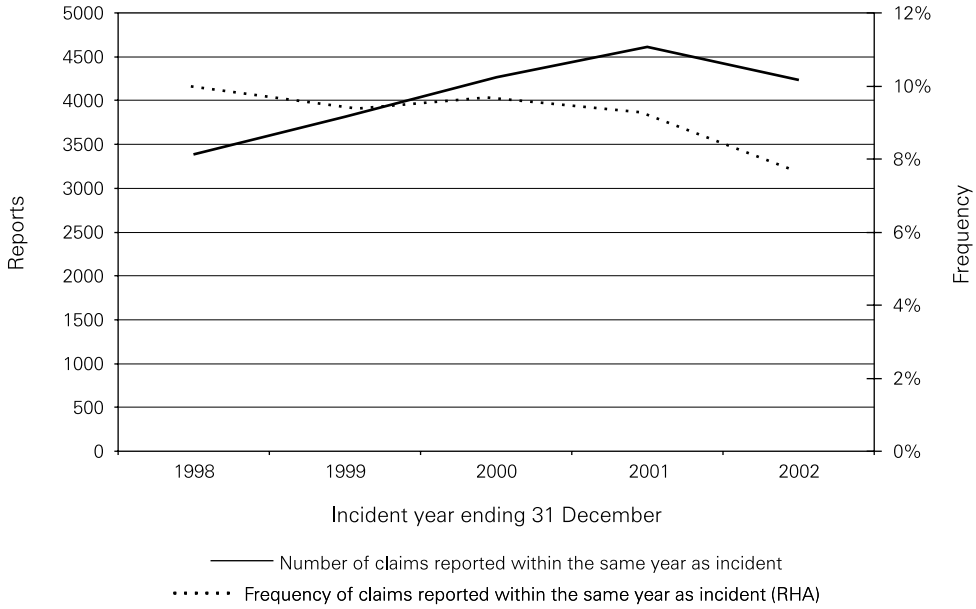
The remaining component of the premium charged by insurers reflects the insurer's profit margin, which was estimated to be, on average, around 13 per cent of premiums.

# 7.3 Trends in professional indemnity claims[105]

## 7.3.1 Claims reports and claims frequency

Chart 7.1 shows the numbers of claims reported within the same year as incident and the frequency of claims reported within the same year as incident over the incident year period 1998 to 2002. The number of claims and the claims frequency was calculated the same way as for chart 5.1 in section 5.

**Chart 7.1 Total number of claims reported within the same year as incident and frequency of claims reported within the same year as incident—professional indemnity—1998 to 2002**




Source: Derived by ACCC from responses provided by six insurers.

The chart shows that the number of claims reported within the same year as incident increased from 3 388 to 4 616 between 1998 and 2001 (an increase of 36 per cent). However, between 2001 and 2002 the number of claims reported within the same year as incident decreased to 4 240 (a decrease of 8 per cent).

[105] Most professional indemnity insurance is written on a *claims made* basis rather than a *claims incurred* basis. Under claims made type cover, insurance policies cover claims that are notified in the year of cover and which have occurred within the period of insurance (unless there is retrospective cover). This effectively means that in most cases the year of incident is also the year of report, as the insured will notify the insurer of potential claims that occur within a period of insurance. Therefore, when incident year is referred to in section 7, it generally will also be referring to the report year also.

The chart also shows that the trend in claims frequency of claims reported within the same year as incident fluctuated around 11 per cent between 1998 and 2001. However, in 2002 the frequency decreased to 9 per cent.

A breakdown of claims frequency by jurisdiction is in appendix D.

*In summary:*

*While the number of claims reported within the same year as incident increased between 1998 and 2001, the frequency with which claims were reported compared to the number of policies that were issued in any one year has remained relatively constant.*

*Both the number of claims reported within the same year as incident and the frequency of claims decreased in 2002.*

### 7.3.2 Average size of claims settled[106]

It is also important to assess the extent to which the size of claims has changed over time. This is because fewer claims will not necessarily result in lower claims costs for an insurer if the average size of those claims is increasing.

Chart 7.2 shows the average size of all claims settled[107] each year in Australia[108] in real terms. It also shows the average size of claims settled for less than $1 million[109] in real terms. The number of claims settled for less than $1 million is also shown on the right hand axis (RHA) of the chart to give an indication of the sample size (i.e. the number of claims used to determine the average). Both measures were calculated using the same methodology for chart 5.2 in section 5.

The chart shows that:

- The average size of claims settled almost tripled between 1997 to 2002, from $6 399 to $18 885 (an increase of 195 per cent). A steadily increasing trend was evident between 1997 and 2001 (notwithstanding a marginal decrease in 2001).
  - In 2002 the average size of claims settled increased substantially. One insurer incurred a claim of significant size in 2002 which increased the average size—if this claim was excluded, the average size of claims settled in 2002 would be $14 494.
- A similar trend occurred in the average size of claims settled for claims under $1 million. There was a steady increase over the period, with the average increasing from $5 347 in 1997 to $10 987 in 2002 (an increase of 105 per cent over the period).
- The difference between the average size of all claims settled and the average size of claims settled under $1 million has grown between 1997 and 2002 (a difference of $1 052 in 1997 increasing to $7 898). This suggests that claims above $1 million are a major factor in the increasing average size of all claims settled.

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106 The claims data used in this section is reported by settlement year, whereas the claims frequency analysis in section 7.3.1 has been reported by incident year. Therefore analyses of these two sections are not directly comparable. The issue of different reporting bases is explained fully in appendix D.

107 Includes claims settled in and out of court.

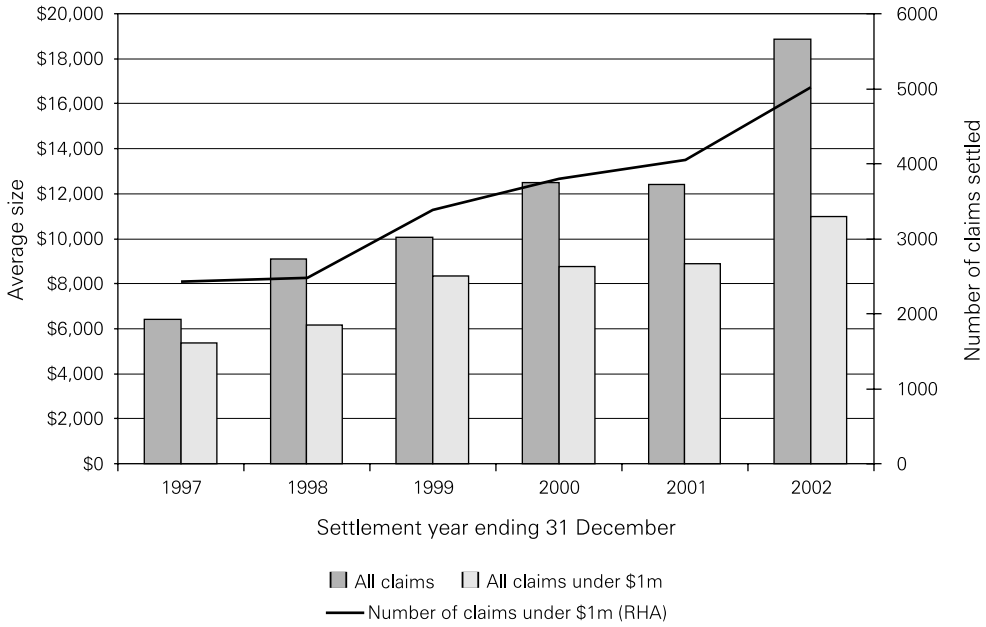
107 The ACCC understands that settlement costs may not be indicative of the amounts paid in any one year because claims settled in one year may not be paid until following years and also partial payments may be made over several years. Therefore the average size of settlements indicates the finalised cost of claims incurred by insurers and not the amounts they may pay out in any one year.

109 Using this measure takes out the large one-off claims that may significantly influence the average.

- The number of claims settled under $1 million increased between 1997 and 2002, from 2 432 to 5 024 (an increase of 107 per cent over the period). This rise in claims settlements is broadly consistent with the rise in the number of policies.

A further breakdown of the average size of claims is in appendix D.

**Chart 7.2 Average size of claims for all claims settled and all claims settled under $1 million—real terms—number of claims settled under $1 million—professional indemnity—1997 to 2002**




Source: Derived by ACCC from responses provided by six insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

*In summary:*

*The average size of claims generally increased between 1997 and 2002. This increase appears to be driven mainly by claims settled for amounts greater than $1 million.*

## 7.3.3 Increasing average claims sizes—detailed analysis

Section 7.3.2 showed that the average size of settled claims steadily increased in real terms between 1997 and 2002. This section identifies causes for the increase in the average size of claims between 1997 and 2002.

- Most claims have been settled within two years of incident, and this trend has not changed significantly in recent years.
  - The ACCC understands that claims which are settled quickly are usually for a lower amount. This suggests that there has not been a major increase in the proportion of the **number** of high cost claims (claims settled for amounts greater than $500 000) when compared to increases in the total number of claims in recent years—shown in table 7.2.
- However, when the total **cost** of claims settled is examined over the size bands, higher cost claims represented a higher proportion of costs in more recent years.

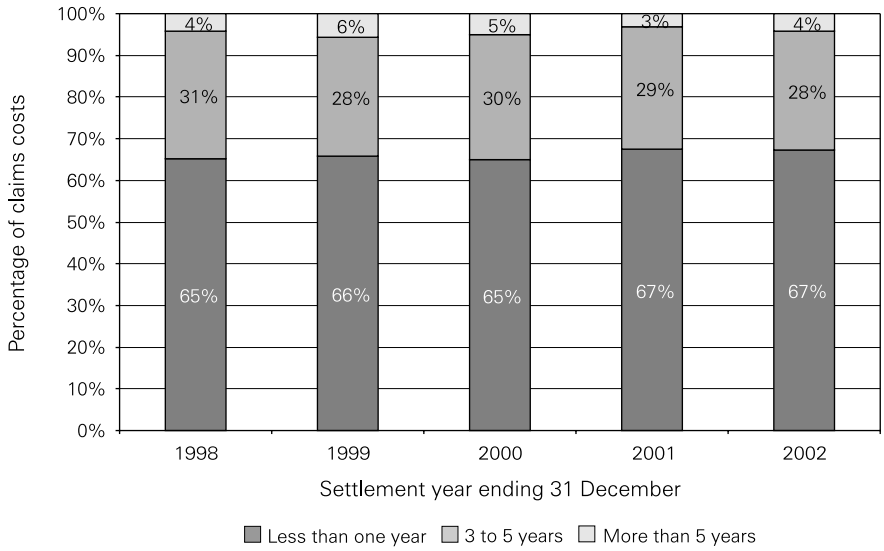
*In summary:*

*In professional indemnity insurance, the increase in the average size of claims settled over the period is the result of the increasing* ***cost*** *of high cost claims (claims settled for amounts greater than $500 000), rather than an increasing proportion of these claims.*

### 7.3.3.1 Period between year of incident and settlement year

Similar to the analysis conducted on the public liability class of insurance in section 5.4.3.1 chart 7.3 shows the proportions of claims settled in the settlement years 1998 to 2002 for claims where the time between incident and settlement was (a) less than two years; (b) three to five years; and (c) more than five years.

**Chart 7.3 Proportion of claims settled by settlement time period bands—professional indemnity—1998 to 2002**




Source: Derived by ACCC from responses provided by six insurers.

The chart shows that:

- the proportion of claims settled **within two years** of incident remained relatively constant between 1998 and 2002, ranging from 65 per cent (in 1998 and 2000) to 67 per cent (in 2001 and 2002)
- the proportion of claims settled **between three and five years** remained steady over the period, ranging from 28 per cent (in 1999 and 2002) to 31 per cent (in 1998)
- claims settled **more than five years** after incident ranged from 3 per cent in 2001 to 6 per cent in 1999.

*In summary:*

*The proportion of claims settled that were 'old' incidents (that is claims settled more than two years after incident) has remained constant over the period. This would tend to suggest that, assuming there is a direct correlation between the length of settlement and the cost of settlement, the* ***number*** *of high cost claims is not rising by a greater amount than that for the total number of claims.*

### 7.3.3.2 Claims distribution by claims settlement size bands

In assessing the changes in the average size of claims settled, it is also important to examine the number of claims by band size and the proportion of total claims costs represented by claims within these bands.[110]

Table 7.2 shows the number of claims settled within specified settlement band sizes for the settlement years from 1997 to 2002.

**Table 7.2 Numbers of claims settled by settlement size bands—settlement year ending 31 December—professional indemnity—1997 to 2002**

**Number of claims settled**
(Numbers in brackets represent proportion of total claims numbers)

| Upper limit | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | % increase between 1997 and 2002 |
|---|---|---|---|---|---|---|---|
| **$50 000 or less** | 2 168 (89%) | 2 271 (92%) | 3 181 (94%) | 3 622 (95%) | 3 873 (96%) | 4 781 (95%) | **121% (7%)** |
| **$50 001 to $100 000** | 244 (10%) | 173 (7%) | 151 (4%) | 109 (3%) | 102 (2%) | 100 (2%) | **-59% (-80%)** |
| **$100 001 to $200 000** | 7 (1%) | 24 (1%) | 21 (1%) | 32 (1%) | 38 (1%) | 81 (2%) | **1057% (459%)** |
| **$200 001 to $500 000** | 10 (0%) | 9 (0%) | 22 (1%) | 37 (1%) | 26 (1%) | 46 (1%) | **360% (122%)** |
| **$500 001 or more** | 4 (0%) | 5 (0%) | 10 (0%) | 11 (0%) | 14 (0%) | 24 (1%) | **500% (190%)** |
| **Total** | **2 433** | **2 482** | **3 385** | **3 811** | **4 053** | **5 032** | **107%** |

Source: Derived by ACCC from responses provided by six insurers.

This table shows that the total number of claims settled more than doubled over the period, increasing from 2 433 in 1997 to 5 032 in 2002, representing an increase of 107 per cent. Throughout the period, the total number of claims settled has shown a consistent upward trend.[111]

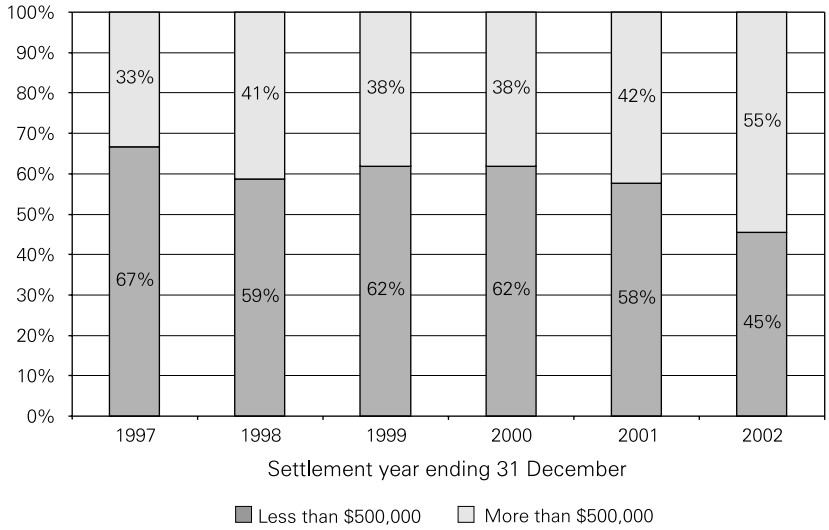
The table shows that the number of claims settled increased between 1997 and 2002 in all of the specified bands with the exception of the '$50 001 to $100 000 band'. However the size of the increases within a particular band varied.

While the number of claims settled across all size bands generally increased, this does not necessarily explain why the average cost of claims has increased. To gain a better understanding of why the average cost of claims increased, the ACCC examined the proportion of total claims costs attributable to aggregated size bands. This is shown in chart 7.4.

[110] Again, the information collected from insurers on size bands was on a nominal basis and as such some degree of bracket creep would be expected in line with inflation.

[111] However, it should also be noted that the total number of policies has also risen over the period, while conducted on an incident year basis this was shown in section 7.3.1 in the claims frequency analysis.

**Chart 7.4 Proportion of total settlement cost—claims settled for amounts under $500 000 and claims settled for amounts above $500 000—professional indemnity—1997 to 2002**[112]




Source: Derived by ACCC from responses provided by six insurers.

The chart shows that, in 1997 most total settlement costs were represented by claims under $500 000 (67 per cent). Except in 1999 and 2000 this proportion declined, with such claims representing 45 per cent of total claims costs in 2002.

*In summary:*

*Generally the number of claims has been increasing across all size bands (with the exception of those settled between $50 001 and $100 000). However the proportion of costs attributed to high cost claims (claims settled for amounts greater than $500 000) has increased over the period from 33 per cent in 1997 to 55 per cent in 2002.*

*This would suggest that while high cost claims have not increased proportionally by number, they have increased proportionally by cost.*

## 7.4 Cost drivers

Insurers included in the ACCC's monitoring program for professional indemnity insurance were presented with a list of possible factors that might explain the increase in the number and size of professional indemnity claims over recent years. Insurers were asked to rank these factors and table 7.3 presents a summary of their responses. The index was calculated using the same methodology as in table 5.4 in section 5.5.

[112] Due to the large number of size bands, chart 7.4 aggregates these bands into claims above and below $500 000 to identify trends. As noted in chart 7.2 the total settlement costs include one large claim in 2002 and this is likely to have influenced the proportion of total claims costs represented by claims settled for amounts greater than $500 000. The ACCC did not exclude this claim from its data analysis as it represented a substantial cost to that particular insurer.

**Table 7.3 Summary of insurers' responses—drivers in the number and size of claims over recent years—professional indemnity**

| Cost driver | Number of insurers that ranked cost driver as most important | Number of insurers that ranked cost driver as second most important | Total number of responses | Index of relative importance of cost driver (1 = most important; 0 = least important) |
|---|---|---|---|---|
| Court precedents/higher awards | 3 | 2 | 6 | 0.72 |
| Increasingly litigious society | 2 | 1 | 6 | 0.56 |
| Stricter risk assessment of policyholders | 1 | 1 | 4 | 0.36 |
| Increased exposure on policies | 1 | 1 | 4 | 0.35 |
| Other | 1 | 1 | 2 | 0.25 |
| Increasing advertising on legal services | 0 | 0 | 3 | 0.12 |

Source: ACCC monitoring questionnaire, 31 December 2002. Six insurers in sample.

The table shows that insurers considered the major driver in the number and size of claims over recent years was court precedents/higher awards, with six insurers considering it important, of which three ranked it the most important factor and a further two ranking it the second most important. The index for this driver was the highest (0.72) compared to the indexes calculated for the other factors. Insurers considered an increasingly litigious society as the second most important driver of claims, with six considering it important, of which two ranked it the most important factor and a further one insurer ranking it the second most important factor (index = 0.56).

*In summary:*

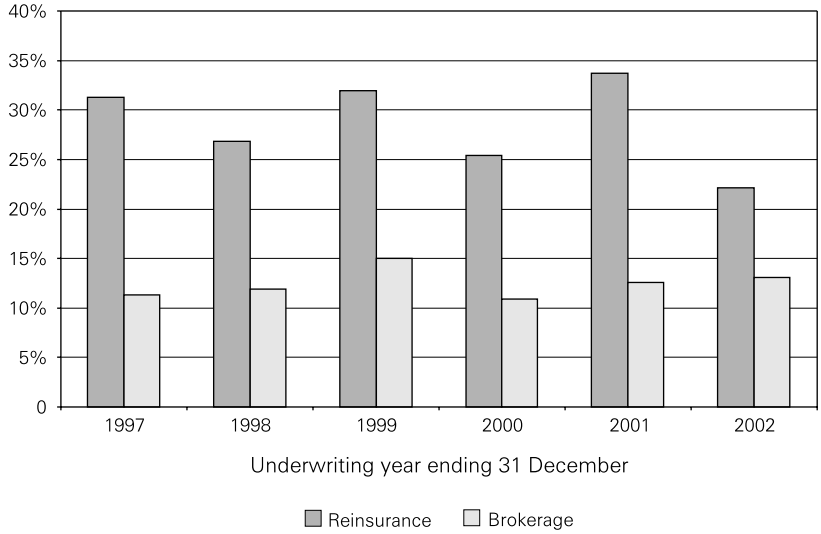
*Generally, insurers considered that recent increases in the number and size of* ***professional indemnity*** *claims were due to court precedents/higher awards and an increasingly litigious society.*

## 7.5 Trends in expenses

This section examines the other cost components of professional indemnity insurance by examining trends in reinsurance, brokerage and underwriting expenses based on data from insurers.

Chart 7.5 shows reinsurance and brokerage expenses as a proportion of gross written premium from 1997 to 2002.

**Chart 7.5 Reinsurance expense and brokerage expense as a proportion of gross written premium—professional indemnity—1997 to 2002**



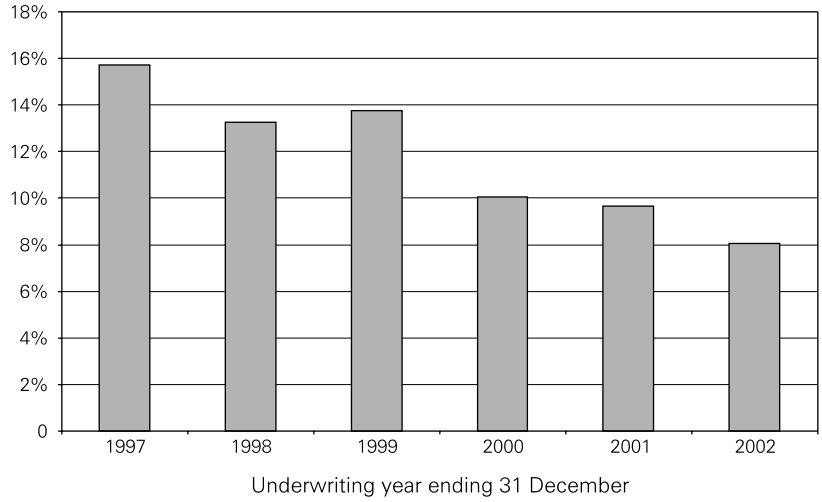

Source: Derived by ACCC from responses provided by six insurers.

The chart indicates that reinsurance expenses as a proportion of gross written premium fluctuated over the period.[113]

Brokerage expenses as a proportion of gross written premium also fluctuated, albeit to a lesser extent.

Chart 7.6 shows the trend in underwriting expenses as a proportion of gross written premium from 1997 to 2002.

**Chart 7.6 Underwriting expenses as a proportion of gross written premium—professional indemnity—1997 to 2002**




Source: Derived by ACCC from responses provided by five insurers.

[113] It should be noted that reinsurance as a proportion of gross written premium examined the cost to the insurer but does not examine any changes being made to the reinsurance cover in terms of excess or cover limits.

The chart shows that, unlike reinsurance and brokerage expenses, the trend in underwriting expenses as a proportion of gross written premium decreased between 1997 and 2002.

There was a similar trend for the public liability class of insurance where underwriting expenses decreased as a proportion of gross written premium based on a smaller sample of insurers.

*In summary:*

*Reinsurance and brokerage expenses as a proportion of gross written premium fluctuated between 1997 and 2002. However, underwriting expenses as a proportion of gross written premium generally decreased over the same period.*

## 7.6 Conclusion

Based on analysis of data provided by insurers with respect to **professional indemnity insurance**, the ACCC found that over the period year ending 31 December 1997 to year ending 31 December 2002:

- The number of claims reported within the same year as incident increased. However, the frequency of these claims per policy issued in any one year remained unchanged, with the exception of a decrease in 2002.
- The average size of claims settled increased on a national basis.
- The increase is mainly due to a general trend towards larger settlements between 1997 and 2002.
  - This has been largely due an increase in the **costs** attributable to higher cost claims (claims settled for amounts greater than $500 000), rather than an increase in the **number** of these higher cost claims.
- Insurers generally considered that recent increases in the number and size of claims were due to court precedents/higher awards and an increasingly litigious society.
- Other costs, namely reinsurance and brokerage expenses as proportions of gross written premium varied across the period. Underwriting expenses decreased as a proportion of premium.

# 8 Premiums, policies and financial performance in professional indemnity insurance

## 8.1 Introduction

Section 7 examined trends in the costs of professional indemnity insurance between the years ending 31 December 1997 and 31 December 2002.

This section examines trends in premiums, policies and the financial performance of the professional indemnity insurance class across this same period.

It examines reasons why insurers raised premiums recently. It also assesses how insurers determine overall premium rates and the types of factors they consider when assessing the level of risk of the insured. The extent to which non-price factors of policies, such as excess amounts, cover limits and exclusions, have changed in recent years is also examined.

The monitoring methodology adopted by the ACCC was outlined in section 5.3.

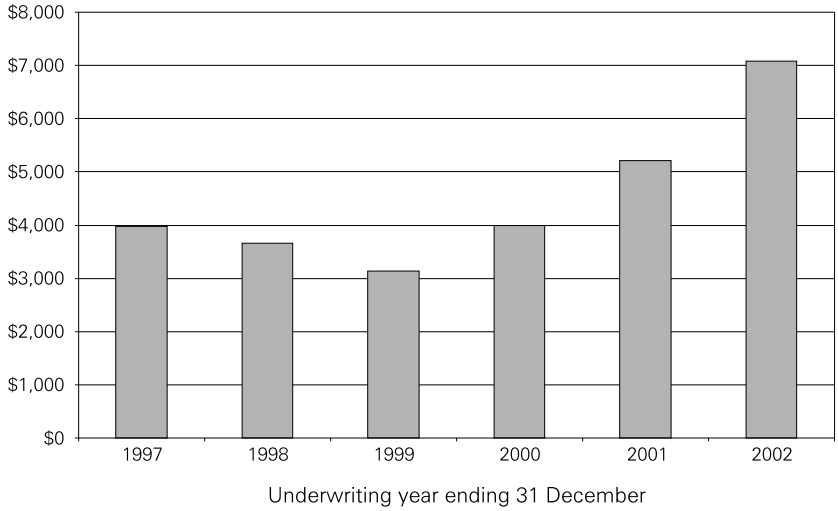
## 8.2 Trends in premiums and policies[114]

This section examines the trends in premiums and polices between 1997 and 2002. In this section the ACCC examines the average premium as an indicator. This demonstrates how the premiums charged by insurers have changed over the period. However, it may also reflect changes in the insurers' portfolios. The average premium will not be exactly indicative of changes in the premiums paid by all consumers.

### 8.2.1 Changes in average premium

Chart 8.1 shows the average premium in real terms between 1997 and 2002. Average premium is derived by dividing gross written premium by the number of policies in force.

**Chart 8.1 Average premium—real terms—professional indemnity—1997 to 2002**




Source: Derived by ACCC from responses provided by six insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

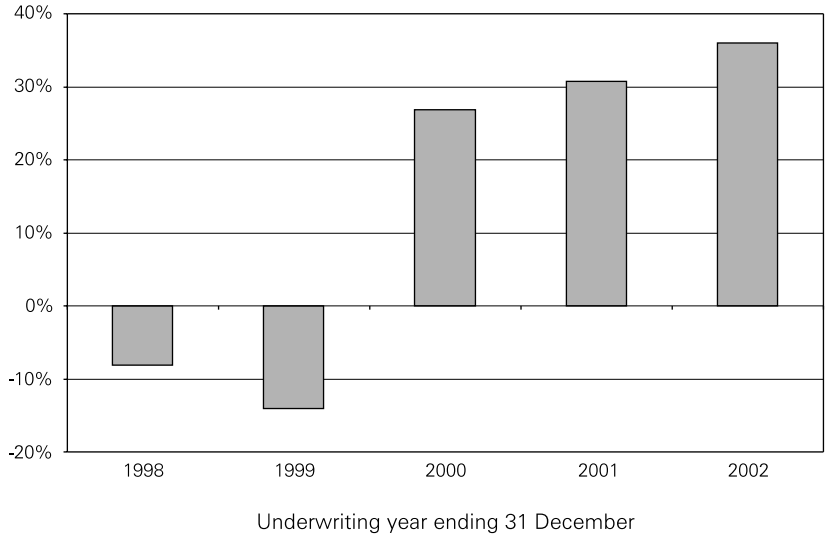
[114] The premium analysis, similar to that in section 6 on public liability insurance, may not be directly comparable to the claims trend analysis. This is because premium and policy data was collected on an underwriting year basis while claims data was typically collected on an incident year and settlement year basis. Therefore, information contained in section 8.2 below may not correspond with the information in section 7.3.

The chart above shows that, between 1997 and 1999, the average premium in real terms decreased from $3980 to $3144 (a decrease of 21 per cent).

Between 1999 and 2002 the average premium in real terms increased consistently, reaching $7086 in 2002 (an increase of 125 per cent).

The increase in average premiums is illustrated again in chart 8.2 by showing the percentage change in annual average premium in real terms between 1998 and 2002.

**Chart 8.2 Percentage change in average premium on previous year's premium—real terms—professional indemnity—1998 to 2002**




Source: Derived by ACCC from responses provided by six insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

This chart indicates that the percentage change in average premium between 1997 and 1999 declined. Since 1999 average premiums in real terms increased, with an increase of 27 per cent in 2000, 31 per cent in 2001 and 36 per cent in 2002.

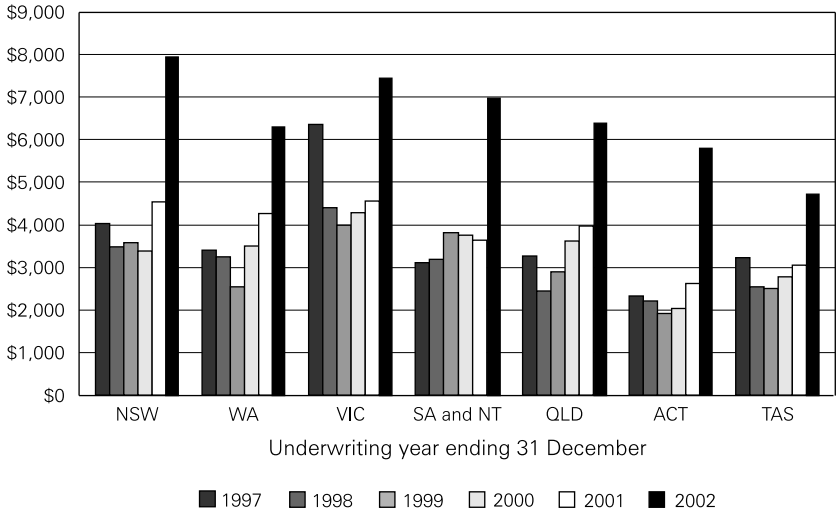
## 8.2.2 Changes in average premium by state and territory

Chart 8.3 shows the average premium in real terms, on a state and territory basis, over the period 1997 to 2002.

Chart 8.3 shows that:

- Premiums in all states and territories showed a similar trend in average premium across the period, with some decrease in the first three years followed by an increase in the last three years, with the increase in 2002 being relatively sharp.
- The combined average premium for SA and NT showed a different trend with the average increasing between 1997 and 1999, followed by marginal decreases in 2000 and 2001, followed by a sharp increase in 2002.

**Chart 8.3 Average premium by state and territory—real terms—professional indemnity—1997 to 2002**




Source: Derived by ACCC from responses provided by five insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.
Due to the way in which data was provided by some insurers, the data for South Australia and the Northern Territory have been combined.

Chart 8.3 also shows that across the period WA had the highest average premium, except in NSW in 2002. The lowest average premium was in Queensland from 1997 to 2001, and then in Tasmania for 2002.

*In summary:*

*Average premiums decreased between 1997 and 1999 and have increased since. This trend was broadly evident all in states and territories.*

## 8.3 Reasons for recent premium increases

Similar to that for public liability insurance analysed in section 6.3, insurers included in the ACCC's monitoring program for professional indemnity insurance were asked to rank a list of possible causes of premium increases for professional indemnity insurance between the years ending 31 December 2001 and 31 December 2002. A summary of insurers' responses is in table 8.1.[115]

[115] The index was calculated using the same methodology as in table 5.4 in section 5.5.

**Table 8.1 Summary of insurers' responses—reasons for recent premium increases—professional indemnity**

| Reasons | Number of insurers that ranked reason as most important | Number of insurers that ranked reason as second most important | Total number of responses | Index of relative of importance of reason (1 = most important 0 = least important) |
|---|---|---|---|---|
| Stricter risk assessment of policyholders | 2 | 0 | 5 | 0.47 |
| Larger claims payouts | 1 | 3 | 5 | 0.45 |
| Poor underwriting returns | 2 | 0 | 3 | 0.35 |
| Increased exposure on policies | 0 | 2 | 5 | 0.27 |
| Increased cost of reinsurance | 0 | 1 | 4 | 0.19 |
| A higher claims frequency | 1 | 0 | 2 | 0.18 |
| Other | 1 | 0 | 2 | 0.18 |
| Poor investment returns | 0 | 0 | 4 | 0.13 |
| Increased uncertainty | 0 | 0 | 3 | 0.11 |
| Increased claims management /administration costs | 0 | 0 | 3 | 0.10 |
| Reduced availability of capital/capacity following September 11 | 0 | 0 | 1 | 0.06 |
| Change in APRA prudential standards | 0 | 0 | 2 | 0.04 |
| Liquidation of HIH | 0 | 0 | 1 | 0.02 |
| Recoupment of past losses | 0 | 0 | 1 | 0.02 |
| Reduced number of competitors in the market | 0 | 0 | 1 | 0.01 |

Source: ACCC monitoring questionnaire, 31 December 2002. Six insurers in sample.

The table shows that insurers believed stricter risk assessment of policyholders was the most important reason for increases in premiums in 2002, with five insurers ranking it as important, and two of these ranking it the most important reason. The index for this reason was the highest (0.47) compared to the indexes calculated for the other reasons. Larger claims payouts were considered the second most important reason, with five insurers regarding it as important, including one regarding it as most important and three others regarding it as the second most important factor contributing to recent premium increases (index = 0.45).

Poor underwriting returns was considered the next most important factor, with two of the three responses finding it the most important factor contributing to premium increases in 2002 (index 0.35). These findings are all consistent with a hardening of the insurance cycle. Issues such as the liquidation of HIH, recoupment of past losses and reduced number of competitors in the market (which is also associated with the exit of HIH from the insurance industry) were considered by insurers to be the least important factors for explaining recent increases in professional indemnity insurance premiums. However, other reasons nominated in the ACCC's monitoring questionnaire may have incorporated some elements of the impacts associated with these factors. It is possible, therefore, that insurers believe it less appropriate to consider these particular factors in isolation.

*In summary:*

*Recent increases in **professional indemnity insurance** premiums have primarily been caused by stricter risk assessment of policyholders by insurers, larger claims payouts and poor underwriting returns. Similar to public liability insurance, Insurers regarded factors associated with the liquidation of HIH, reduced availability of capital following the September 11 2001 terrorist attacks and recoupment of past losses among the least important reasons for recent premium increases.*

## 8.4 Pricing methods

Insurers were asked which, from a list of pricing methods, best described their current method in setting overall premiums for professional indemnity insurance policies. Table 8.2 presents a summary of their responses.[116]

**Table 8.2 Summary of insurers' responses—pricing methods—professional indemnity**

| | Market rate pricing | Target pricing | Cost plus pricing | Demand adjusted pricing | Other method identified by insurers |
|---|---|---|---|---|---|
| **Number of insurers that ranked pricing method as most important** | 0 | 2 | 1 | 0 | 3 |
| **Total number of insurers that ranked pricing method at all** | 3 | 5 | 4 | 3 | 3 |
| **Index of relative importance of each pricing method (1 = most important) (0 = least important)** | 0.13 | 0.53 | 0.42 | 0.17 | 0.50 |

Source: ACCC monitoring questionnaire, 31 December 2002. Six insurers in sample.
See section 6.4 for a description of the pricing methods.

The table shows that, similar to public liability insurance, most insurers that write professional indemnity insurance do not adopt a single pricing method but are likely to consider several, albeit to varying degrees, when setting overall premiums. It also shows that target pricing was the most important pricing method, with two out of five insurers rating it the most important. The index for this pricing method was 0.53 which was the highest compared to other methods. This was closely followed by three insurers ranking the 'other' category as the most important pricing method. Responses included two insurers indicating that each risk was individually underwritten and/or based on exposure, with another insurer saying that it sets rates based on its claims experience by class of business. Another insurer believed that cost plus pricing was the most important pricing method. Market rate pricing was considered the least important pricing method across insurers, with an index of 0.13.

The ACCC asked insurers how often they had changed their overall premium rates over the last two years. Three indicated that they changed overall rates every 12 months. The remaining three insurers indicated that they changed overall rates on a different basis, with some risks being individually assessed and often amended, or changes to overall premium rates varying by class of business.

[116] The index was calculated using the same methodology as in table 5.4 in section 5.5.

Insurers were then asked whether or not they intended to review overall premium rates more often in the future. Five indicated that they did not intend to do so, while one insurer intended to review rates every six months in the future.

The ACCC also asked insurers whether they used different pricing methods for new policies compared to renewal policies. Five indicated that they did not while the remaining insurer indicated that it did use a different method, adjusting its rates on renewal policies down in certain circumstances, and applying a no claim discount, which ranged in percentage terms, for certain policyholders.

*In summary:*

*Most insurers included in the ACCC's monitoring program focused their pricing method for* ***professional indemnity insurance*** *over the last two years on target pricing rather than trying to increase their relative market shares. However, unlike the pricing of public liability insurance, other pricing methods are also considered highly important by insurers. These other pricing methods tend to involve some insurers undertaking individual pricing assessments of insureds.*

*The frequency of overall rate changes varied across insurers with half indicating that they changed overall premium rates every 12 months, while the remaining insurers indicated that individual premiums were amended when required. Most of the insurers do not intend to review rates more often in the future.*

*Most insurers indicated that they apply the same pricing method to new policies and renewal policies.*

## 8.5 Risk assessment in pricing

Similar to public liability insurance, the ACCC presented a list of possible factors that insurers are likely to consider in their risk assessment of insureds when writing professional indemnity policies. It asked insurers to rank these factors according to their level of importance (i.e. 'high', 'medium', 'low' or 'not applicable') when setting individual premium rates. This time, the rating factors listed were:

- the type of profession in which the insured practices
- the amount of turnover of the insured
- the number of employees in the insured's business
- state (NSW, VIC etc) in which the insured's head office is based
- past claims experience specific to the insured
- other (insurers were asked to specify other factors they considered relevant).

Table 8.3 summarises the insurers' responses.

**Table 8.3 Summary of insurers' responses—rating factors—professional indemnity**

| | High importance | Medium importance | Low importance | Not applicable | Total number of insurers that responded |
|---|---|---|---|---|---|
| **Profession** | 6 | - | - | - | 6 |
| **Turnover** | 5 | 1 | - | - | 6 |
| **Past claims experience specific to the insured** | 5 | - | - | - | 6 |
| **Number of employees** | 1 | 2 | 3 | - | 6 |
| **State (e.g. NSW, VIC)** | - | 2 | 2 | 2 | 6 |
| **Other** | 3 | 1 | - | - | 4 |

Source: ACCC monitoring questionnaire, 31 December 2002. Six insurers in sample.

The table shows that:

- profession was the most common factor considered highly important, with all six insurers ranking this factor of 'high importance'
- turnover was the second most common category considered highly important, with five of the six insurers rating this factor of 'high importance'
- past claims experience was the third most common factor considered highly important, with five insurers rating this factor of 'high importance'
- there was a variety of responses in relation to the importance of the number of employees in which responses ranged between 'of high importance' to of 'low importance'
- the state in which the insured is located was the least important factor, with four of the six insurers ranking it either of 'low importance' or 'not applicable'
- four insurers indicated that other factors were important, including risk management of the insured, the ability to provide claim disclosures, corporate governance quality and exposure.

For those factors ranked highly important, the ACCC asked insurers to provide further information about how they rated those factors. The level of information from insurers varied, with some providing a list of their relativity rates and others commenting that the relativities varied. Few insurers commented on the turnover factor or the past claims experience factor.

The ACCC also asked insurers whether or not it had changed its premium relativities between different risk classes over the last two years. Only two said they had changed them within the last 12 months with the remaining four saying they changed these relativities on a different basis. The responses included risks being individually underwritten and relativities being constantly under review.

Insurers were divided on whether they intended to review these premium relativities more often in the future, with three indicating that they would not and the remaining three indicating that they would.

*In summary:*

*When setting **professional indemnity** premiums, insurers' assessments of the level of risk of insureds is determined by several factors, with profession type, turnover and past claims experience specific to the insured considered by insurers as the most important factors. The frequency by which insurers adjusted premium relativities between different risk classes over the last two years has varied across insurers.*

## 8.6 Terms and conditions of policies

The ACCC asked insurers in its monitoring program for professional indemnity insurance about the type of policy they offered—that is, whether or not they offered a standard policy, the minimum and maximum cover limits and excesses and the types of exclusions specified on those policies.

### *Standard policies*

Of the six insurers that responded to the ACCC's monitoring questionnaire, all offered a standard policy for professional indemnity insurance in the year ending 31 December 2002.

Of the six that offered a standard policy, five indicated that more than 75 per cent of their book of business in professional indemnity for the year ending 31 December 2002 was written under the standard policy. The remaining insurer did not quantify the percentage of its business written under the standard policy.

Of the six insurers that offered a standard policy, five offered the standard policy to all sectors in which they wrote business. The remaining insurer indicated that the standard policy was not available to all sectors as it had more than one standard policy.

### *Cover limits*

The ACCC asked insurers to specify the minimum and maximum cover limits on standard policies written in the years ending 31 December 2001 and 31 December 2002. The minimum cover limits on standard policies varied across insurers, with some indicating that they did not specify a minimum cover limits, while others said that the minimum cover was $0.5 million. Between 2001 and 2002, one insurer had changed its minimum cover limits, raising it from $0.5 million in 2001 to $1 million in 2002.

The maximum cover limits on standard policies varied across insurers, from $20 million to $100 million. One insurer said that it did not set a maximum cover limit. Between 2001 and 2002 two insurers changed their maximum cover limits, one decreasing its cover limit from $20 million to $10 million, and another decreasing it from $60 million in 2001 to $40 million in 2002.

### *Excesses*

The ACCC also asked insurers to specify the minimum and maximum levels of excess for standard policies written in the years ending 31 December 2001 and 31 December 2002. The minimum levels of excess on standard policies varied, with some insurers reporting no minimum excess and others reporting a minimum excess as a percentage of their fee income—from 0.25 per cent up to 0.1 per cent.[117] Between 2001 and 2002 one insurer increased the minimum excess from 0.25 per cent to 0.5 per cent of fee income.

Three insurers did not answer this question about the maximum excess. One insurer indicated that there was no set maximum level of excess. The remaining insurers indicated a maximum excess of $250 000 and $500 000 respectively. Between 2001 and 2002 no insurers had changed the maximum excess levels on standard policies.

[117] The ACCC understands that premium rates and excesses for professional indemnity insurance are usually quoted as a percentage of fee income of the professional being insured.

*Exclusions*

The ACCC also asked insurers to specify what major exclusions were specified in standard policies written in the year ending 31 December 2001 and to identify any new exclusions. Of the six insurers that offered standard policies, four indicated that they had added new exclusions between 2001 and 2002. They varied across insurers, with three of the four insurers saying that they had added terrorism to their list of exclusions. Other exclusions related to breach of duty, electronic data recognition, radioactivity and assumption of liability.

*In summary:*

*During the 12 months up to 31 December 2002, the nature of the standard* ***professional indemnity insurance*** *product, in terms of the excesses and cover limits, had not changed substantially. However, most insurers offering standard policies during this period did specify additional exclusions.*

## 8.7 Trends in financial performance

Similar to the analysis in section 6.7 the ACCC examined the underwriting performance of the professional indemnity class of insurance using several ratios.

### 8.7.1 Ratios

The ACCC examined underwriting performance in terms of the loss ratio, the expense ratio, the reinsurance ratio and the combined ratio. These terms were defined in section 5.3. Most insurers did not provide enough data for the ACCC to reliably construct all ratios for the entire period from 1997 to 2002. The ACCC has instead calculated the ratios for 2001 and 2002 based on data provided by six insurers.

The following ratios are constructed on an aggregate basis, and therefore represent the total ratio for all six insurers.

#### 8.7.1.1 Loss ratio

Table 8.4 shows the gross loss ratio and the net loss ratio.[118]

**Table 8.4 Gross loss ratio and net loss ratio—year ending 31 December—professional indemnity—2001 and 2002**

| | Gross loss ratio | Net loss ratio |
|---|---|---|
| **2001** | 74% | 78% |
| **2002** | 54% | 56% |

Source: Derived by ACCC from responses provided by six insurers.

The table shows that that the gross and net loss ratios decreased between 2001 and 2002. This effectively means that for every dollar of premium written in 2002, insurers will be paying on average $0.54 in claims alone, or, if reinsurance is taken into account, $0.56.

[118] Because the calculation of the loss ratios by incident year takes into account both past claims payments and expected future payments (payments which will be made on claims that the insurer has incurred at the reporting date but which have not yet been settled) these ratios are still uncertain. This is because the expected future payments is based on an actuarial estimate of not only unfinalised reported claims costs, but also incurred but not yet reported (IBNRs) claims costs. Therefore this estimate may change as experience emerges, and this can either result in the loss ratios becoming more or less favourable for the insurers.

The ACCC examined data for earlier years provided by three insurers which shows that the gross loss ratio increased between 1997 and 1998 followed by small decreases in 1999 and 2000. In 2001 there was a substantial decrease in the gross loss ratio followed by another major decrease in 2002.

#### 8.7.1.2 Expense ratio

Table 8.5 shows the gross expense ratio and the net expense ratio for 2001 and 2002.

**Table 8.5 Gross expense ratio and net expense ratio—year ending 31 December—professional indemnity—2001 and 2002**

| | Gross expense ratio | Net expense ratio |
|---|---|---|
| **2001** | 25% | 36% |
| **2002** | 23% | 27% |

Source: Derived by ACCC from responses provided by six insurers.

The table shows that the gross expense ratio decreased marginally between 2001 and 2002. The net expense ratio decreased more substantially over the same period.

#### 8.7.1.3 Reinsurance ratio

Table 8.6 shows the reinsurance ratio for 2001 and 2002.

**Table 8.6 Reinsurance ratio—year ending 31 December—professional indemnity—2001 and 2002**

| | Reinsurance ratio |
|---|---|
| **2001** | 31% |
| **2002** | 21% |

Source: Derived by ACCC from responses provided by six insurers.

The table shows that the reinsurance ratio decreased significantly between 2001 and 2002.

This is consistent with chart 7.5 which, while based on different insurers, showed that reinsurance expenses as a proportion of gross written premium decreased between 2001 and 2002.

#### 8.7.1.4 Combined ratio

Table 8.7 shows the gross combined ratio and the net combined ratio for 2001 and 2002.

**Table 8.7 Gross combined ratio and net combined ratio—year ending 31 December—professional indemnity—2001 and 2002**

| | Gross combined ratio | Net combined ratio |
|---|---|---|
| **2001** | 129% | 114% |
| **2002** | 99% | 85% |

Source: Derived by ACCC from responses provided by six insurers.

The table shows that the gross combined ratio decreased from 129 per cent in 2001 to 99 per cent in 2002. The net combined ratio also decreased—from 114 per cent to 85 per cent over the same period. These combined ratios suggest that insurers are moving towards more favourable levels of financial performance.

Section 5.3 noted that if a combined ratio is greater than 100 per cent then an insurer will be losing money. It should also be noted that the combined ratio does not take into account inflation, discounting, claims handling expenses of the insurer.

The historical trends observed in the data provided by three insurers for the combined ratio suggests that, for the five years from 1997 to 2001, the combined ratio was much greater than 100. However, the trend from 1999 to 2002 was a declining one, suggesting that these insurers were moving towards some degree of profitability in more recent years.[119]

*In summary:*

*The gross combined ratio and the net combined ratio decreased between 2001 and 2002. This was due to a fall in the loss ratios. Both the gross and the net combined ratio indicate improved financial performance.*

*However, it should be noted that this does not take account of inflation or discounting of claims costs, or claims handling expenses of insurers.*

## 8.8 Conclusion

Based on the data analysis provided by insurers with respect to **professional indemnity insurance** in sections 7 and 8 the ACCC found that over the period year ending 31 December 1997 to year ending 31 December 2002:

- The number of claims reported within the same year as incident increased. However, the frequency of these claims per policy issued in any one year remained unchanged, with the exception of a decrease in 2002.
- The average size of claims settled increased nationally.
- The increase is mainly due to a general trend towards larger settlements from 1997 to 2002.
  - This has been largely due an increase in the **costs** attributable to higher cost claims (claims settled for amounts greater than $500 000), rather than an increase in the **number** of these higher cost claims.
- Insurers generally considered that recent increases in the number and size of claims were due to court precedents/higher awards and an increasingly litigious society.
- Other costs, namely the change in reinsurance expenses, varied across the period while brokerage expenses remained relatively constant. Underwriting expenses decreased despite this increase in premium.
- The average premium decreased between 1997 and 1999 by 21 per cent, but has increased since then by 125 per cent between 2000 and 2002.
  - Insurers considered that the recent premium increases have primarily been caused by stricter risk assessment of policyholders by insurers, larger claims payouts and previous poor underwriting returns.
  - In recent years, insurers have favoured a cost oriented pricing approach. Insurers' calculation of risk is important in determining premiums.
- Although premiums have increased in recent years, the terms and conditions of the standard product, in terms of the excesses and cover limits, has not changed greatly. However, most insurers offering standard policies during this period did specify additional exclusions.
- The combined ratio, that is expenses (including claims costs) compared to total premiums, decreased between 2001 and 2002 indicating improved underwriting performance.

[119] These observations are consistent with the trend noted in the ACCC's September 2002 *Insurance Industry Market Pricing Review* which stated that this class was expected to return to profit in 2002 (p. 23).

# 9 Impact of government reforms on public liability and professional indemnity insurance costs and premiums

## 9.1 Introduction

The Federal Government asked the ACCC to monitor premiums in public liability and professional indemnity insurance to assess the impact on premiums of measures taken by governments to:

- reduce and contain legal and claims costs
- improve the data available to insurers to evaluate and price risk.

Governments have previously indicated that they expect there to be savings from these reforms and also expect insurers to pass these savings on to consumers in the form of more affordable insurance premiums (see section 2).

The ACCC asked insurers included in its monitoring program questions about their pricing expectations for public liability and/or professional indemnity insurance premiums in 2003 and in future years. This section summarises insurers' responses.

In addition to pursuing tort law reform, ministers agreed on 27 March 2002 that state and territory governments would encourage group-buying arrangements where appropriate. Therefore, as part of its monitoring program, the ACCC also asked insurers about group buying/insurance pooling arrangements. A summary of insurers' responses to these issues is in appendix G.

## 9.2 The ACCC's monitoring program

The ACCC asked insurers for particular information to help it identify the expected impact of government reforms. The ACCC took a 'with and without reform' approach, asking insurers what their expected costs and premiums for 2003 and in the longer-term are with the governments' reforms, and without those reforms. By comparing the two sets of responses, the ACCC intended to isolate the expected impact of reforms from other cost factors. Its methodology is detailed below.

### 9.2.1 Monitoring methodology

The ACCC asked insurers to provide the following information about their public liability and/or professional indemnity insurance business:

*Expected short term impact on premiums 'without reform'*

- The expected percentage change in overall premium rates for public liability and professional indemnity insurance over the next 12 months (up to the end of 31 December (2003) **without** recent and proposed government reforms of the insurance industry.
  - Insurers were asked to provide this expected percentage change on a national basis and also as a breakdown for each state and territory.

### *Expected short term impact on premiums 'with reform'*

- The expected changes in premiums and costs between 31 December 2002 and 31 December 2003. The ACCC specified five cost components of premiums including discounted claims costs (allowing for inflationary costs), underwriting expenses, claims handling expenses, cost of reinsurance and a profit margin. The greatest impact of reforms is likely to be on containing claims costs. Using these components, insurers were asked to quantify the following:
  - the proportion that each component represented of the total value of gross written premium charged by an insurer in the year ending **31 December 2002**
  - the proportion that each component represents of the total value of gross written premium that an insurer expects to charge in the year ending **31 December 2003**, *without* Commonwealth and state reforms
  - the proportion that each component represents of the total value of gross written premium that an insurer expects to charge in the year ending **31 December 2003**, *with* Commonwealth and state reforms.

The ACCC asked insurers for this information for each state and territory in which reforms had already taken place (NSW, QLD, VIC, ACT and SA).[120] They were also asked to describe the method and assumptions they had used in assessing the 'without reform' and 'with reform' impact on premiums, including explanation for each different component of premiums.[121]

### *Expected longer term impact of reforms on premiums*

The ACCC asked insurers whether the impact they had specified for each state and territory would continue to be the impact of government reforms on premiums in the longer-term (e.g. over the next three to five years) for that particular state. Insurers were asked for information to support their answer.

### *General comments*

The degree of detail with which insurers responded to the questions varied considerably. Some insurers noted that they had experienced difficulty with this aspect of the ACCC's monitoring questionnaire, despite the ACCC piloting its questionnaire with a sample of insurers during its draft stage and modifying it to address some of their concerns. Although the ACCC could still draw conclusions based on the information they provided, it intends to review this part of its monitoring questionnaire to better align insurers' responses with requirements of subsequent reports.

Other insurers stated that their responses should be considered notional because actual outcomes with respect to premium increases in 2003 could differ from expectations. This was generally because other factors could influence premiums, as well as the possibility that legislation could operate in a manner that was unforeseen or unintended.

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[120] The ACCC sent its information request to insurers on 7 November 2002. The information request listed the states—NSW, QLD, VIC and the ACT—in which reforms had already taken place as at 6 November 2002. The information request also specified the acts of legislation that were enacted in the various jurisdictions as at that date. On 16 January 2003 the ACCC sent to insurers an updated information request which identified additional reforms that were implemented by jurisdictions between 7 November and 31 December 2002. As part of this update, insurers were asked to assess the impact of reforms in SA that were enacted as at 31 December 2002. The ACCC's future monitoring reports will include an examination of the impact of tort law reforms in other jurisdictions after reforms are enacted in those jurisdictions.

[121] The ACCC presented two 'example' tables to assist insurers in presenting this information, although insurers were not required to provide information using this format.

However, some insurers did provide detailed responses to this part of the questionnaire. Because some of this information was specific to those insurers, much of the detail was unable to be published in this report. The ACCC examined this information and it is reported on in general terms in this section.

The variation in insurers' responses prevented the ACCC summarising the information across insurers on an industry-wide basis. The results are instead presented as a summary of 'like' responses from insurers where most appropriate.

## 9.3 Expected impact of government reforms on public liability insurance

This section summarises the expected impact of government reforms on public liability insurance premiums in the short term—for the year ended 31 December 2003—based on insurers' responses to the ACCC's questionnaire. The actual impact of reforms over this period will be assessed in subsequent reports when data on actual outcomes is available.

The expected impact of government reforms on costs and premiums in the longer term is also examined.

### 9.3.1 Expected short term impact on premiums 'without reform'

Insurers were asked to specify how they expected overall premiums to change over the next 12 months (up to the end of 31 December 2003) **without** recent and proposed government reforms.

Table 9.1 summarises the responses provided by insurers. The information is presented on a national basis and for each state and territory.

**Table 9.1 Summary of insurers' responses—overall expected changes in premiums in 2003 'without reform'—public liability**

| | Expected premium increases within the specified band in the year ending 31 December 2003—without recent and proposed government reforms—number of insurers that responded | | | | | | | Total number of of responses |
|---|---|---|---|---|---|---|---|---|
| | Percentage bands | | | | | | | |
| **Jurisdiction** | **1-5%** | **6-10%** | **11-20%** | **21-50%** | **51-75%** | **76-100%** | **101%+** | |
| National | - | 2 | 4 | 2 | - | - | - | 8 |
| NSW | - | 1 | 3 | 2 | - | - | - | 6 |
| VIC | 1 | 1 | 2 | 2 | - | - | - | 6 |
| QLD | - | 2 | 2 | 2 | - | - | - | 6 |
| WA | - | 2 | 2 | 2 | - | - | - | 6 |
| SA | - | 2 | 2 | 2 | - | - | - | 6 |
| TAS | 1 | 1 | 2 | 2 | - | - | - | 6 |
| ACT | - | 1 | 3 | 2 | - | - | - | 6 |
| NT | - | 1 | 2 | 2 | - | - | - | 5 |

Source: ACCC monitoring questionnaire, 31 December 2002. Based on responses from eight insurers.

All insurers expect premiums to increase in 2003 irrespective of reforms. However, the table shows some variation in insurers' expectations about increases in premiums for 2003 **without** recent and proposed government reforms.

- At a **national** level, insurers expected premiums in 2003 to increase in the bands between 6 and 50 per cent on their 2002 levels, although most expected premium increases between 11 and 20 per cent.
  - Four insurers expected premiums to increase between 11 and 20 per cent.
  - Another two insurers expected premiums to increase between 21 and 50 per cent, with one insurer's expectations on the 'lower side' of this range.
  - The remaining two insurers expected premiums to increase between 6 and 10 per cent.
- At the **state** level, six insurers quantified expected changes in premiums without recent and proposed government reforms.[122]
  - The range of responses from insurers were similar to insurers' expectations for premium changes at the national level, with four insurers indicating that premiums were expected to increase by less than 20 per cent without recent and proposed reforms.
  - Most responses from insurers expected that the quantum of premium increase would be the same across the states and territories. Only one insurer expected the size of the premium to differ across the states and territories, with premium increases expected to be relatively higher in NSW and the ACT and relatively lower in Victoria and Tasmania. The insurer did not comment on why the size of the premium increase was expected to differ in this way.

*In summary:*

*Insurers' expectations about price increases in public liability insurance premiums in 2003 varied in the absence of recent and proposed government reforms. However, at a national level, most insurers expected premiums to increase between 11 and 20 per cent in 2003. There was less agreement among insurers about the size of expected premium increases in 2003 across individual states and territories, although most expectations were still less than 20 per cent.*

## 9.3.2 Expected short term impact on premiums 'with reform'

The extent to which insurers completed this part of the ACCC's monitoring questionnaire and the manner in which pricing information was presented varied widely across insurers.

### *Responses at a national level*

Two insurers indicated that they adopted Australia-wide pricing strategies. The relative importance of various cost drivers to these insurers varied. However, both identified claims as a major factor expected to drive premium increases in 2003 in the absence of government reform.

[122] Two of the eight insurers did not specify changes at this level as they had earlier indicated that their pricing strategies were conducted Australia-wide. The reason for constructing premium rates on a national basis related to problems associated with making rate assumptions based on relatively small pools of state data. It was indicated in part that future analysis of public liability portfolios would try to recognise variables at the state/territory level and to the extent allowed by the data available, reflect those variables in the rating structures.

- Only one of these insurers estimated the expected increase in premiums in 2003 'with reform'. For that insurer, the size of expected premiums was around 3 per cent lower than would be expected in the absence of reform. That insurer expected reforms to lower the rate of increases in all five cost components. However over half of the anticipated cost savings were in lower expected claims costs and reinsurance costs.
- The second insurer did not quantify the expected premium increase in 2003 'with reform'. It did not consider it possible at this early stage to reliably predict the impact of legislative reforms. The insurer indicated that the effect of recent legislative reforms would be reflected in future pricing, as those effects became apparent.

### *Responses at the state and territory level*

Three insurers provided responses about expected changes in premiums for 2003 at the state and territory level. These responses are summarised in table 9.2.

**Table 9.2 Summary of insurers' responses—expected changes in claims costs, other expenses and premiums in 2003—'without reform' and 'with reform'—public liability ***

| | Expected increase in claims costs in 2003 above 2002 levels | | Expected increase in other costs ** in 2003 above 2002 levels | | Expected increase in premiums in 2003 above 2002 levels | |
|---|---|---|---|---|---|---|
| | 'without reform' % | **'with reform' %** | 'without reform' % | **'with reform' %** | 'without reform' % | **'with reform' %** |
| **NSW** | 9–12 | **0–5** | 6–17 | **4–17** | 8–12 | **2–9** |
| **VIC** | 9–10 | **2–8** | 5–17 | **5–17** | 7–12 | **6–9** |
| **QLD** | 9–10 | **-2–8** | 5–17 | **3–17** | 7–12 | **1–10** |
| **ACT** | 9–10 | **7–10** | 5–17 | **5–17** | 7–12 | **7–11** |
| **SA** | 9–10 | **6–8** | 14–17 | **12–17** | 11–12 | **9–10** |

Source: ACCC monitoring questionnaire, 31 December 2002.
* Insurers that provided estimates of overall premium changes but not compositional changes are excluded from this table. This table is based on information provided by three insurers (two insurers in the case of SA). Results indicate the range of expectations of insurers.
** This includes expected increases in underwriting, claims handling and reinsurance costs. These components are not listed separately as not all insurers provided their expectations for each individual component.

Insurers who responded at the state and territory level anticipated rises between 7 and 12 per cent in 2003 in the absence of government reforms. Neither of the insurers who anticipated higher rises (within 21–50% band) identified in table 9.1 responded to this question.

The table shows that:

- For **NSW, VIC, QLD** and the **ACT**, insurers indicated that:
  - '**without reform'**, premiums would be expected to increase in 2003 above 2002 levels, with expectations ranging between 7 and 12 per cent. This premium increase was expected to be driven by:
    - increased claims costs (accounting for around half of the premium charged by insurers—see section 5) which were expected to increase between 9 and 12 per cent in 2003

- other costs (including underwriting, claims handling and reinsurance expenses) which were expected to increase between 5 and 17 per cent in 2003.

- '**with reform**', premiums were still expected to increase in 2003 above 2002 levels. However, the reforms were expected to lead to lower anticipated premium in creases in 2003 compared to their expectations 'without reform' which were outlined above.
  - Insurers' expectations for premium increases in 2003 ranged between 1 and 11 per cent above 2002 levels, which were lower than their expectations for premium increases in 2003 'without reform'.
    - This was largely because insurers adjusted downwards their expectations for increased claims costs in 2003. Insurers' expectations for increases in other costs in 2003 were largely unchanged as a result of reforms. This suggests that insurers expected the reforms to have the greatest impact on claims costs compared to other types of costs.
  - For **NSW,** insurers indicated premiums were still expected to increase in 2003 above 2002 levels, with expectations ranging between 2 and 9 per cent. 'With reform', claims costs were expected to increase by no more than 5 per cent in 2003 above 2002 levels. This was lower than their expectations for increased claims costs (between 9 and 12 per cent) 'without reform'.
  - For **VIC**, insurers indicated that premiums were still expected to increase in 2003 above 2002 levels, with expectations ranging between 6 and 9 per cent. 'With reform', claims costs were expected to increase between 2 and 8 per cent in 2003 above 2002 levels. This was lower than their expectations for increased claims costs (between 9 and 10 per cent) 'without reform'.
  - For **QLD**, insurers indicated that premiums were still expected to increase in 2003 above 2002 levels, with expectations ranging between 1 and 10 per cent. 'With reform', claims costs were expected to increase by less than 8 per cent in 2003 above 2002 levels. One insurer expected that claims costs would decrease in absolute levels between 2002 and 2003 as a result of reforms. This was lower than insurers' expectations for increased claims costs (between 9 and 10 per cent) 'without reform'.
  - For the **ACT**, insurers indicated that premiums were still expected to increase in 2003 above 2002 levels, with expectations ranging between 7 and 11 per cent, marginally less than the expected increase without reform. 'With reform', claims costs were expected to increase between 7 and 10 per cent in 2003 above 2002 levels. This was marginally lower than the expectations for increased claims costs (between 9 and 10 per cent) 'without reform'.

For **SA**, only two insurers provided expectations. The responses suggested that 'with reform', premiums would be expected to increase in 2003 above 2002 levels, by around 9 or 10 per cent. 'With reform', claims costs were expected to increase by around 6 to 8 per cent, which was lower than expectations for increased claims costs 'without reform'. The extent to which this generally reflects the expectations of other insurers is unknown.

The insurers adopted different methods and assumptions quantifying the expected impact of reforms on premiums in 2003, although the size of the difference between the expected premium increase in 2003 'with reform' and the expected premium increase in 2003 'without reform' were generally consistent across insurers. The insurers constructed their assumptions using several sources of information, such as public reports, with some insurers indicating they had used the report by PwC, *Actuarial Assessment of the Recommendations of the Ipp Report*, and another report by PwC, *Report to the NSW*

*Treasury on Tort Law Reforms in Public Liability Insurance*, as well as the Trowbridge report. Insurers also indicated that part of their methodology in estimating expected claims cost reductions was based on internal analysis of a sample of their own claims data.

The analysis has so far outlined the pricing expectations of four insurers that quantified the impact of reforms on premiums and costs in 2003. However, as one of those insurers responded at a national level and the remaining three insurers at a state/territory level, it is difficult to ascertain the overall expected impact of reforms on premiums in 2003.

The ACCC has therefore attempted to present a broad, indicative estimate of insurers' expectations of the impact of reforms by analysing the information from the four insurers. By doing this, the ACCC estimated that across the four insurers, on a national basis:

- '**without reform**', insurers expected premiums to increase by an average of about 12 per cent in 2003 on 2002 levels. This was largely driven by:
  - expected increases in costs associated with underwriting, claims handling and reinsurance expenses of around 16 per cent on average in 2003 on 2002 levels
  - expected increases in claims costs of around 12 per cent on average in 2003 on 2002 levels.[123]
- '**with reform**', premiums were still expected to increase in 2003 above 2002 levels. However, reforms were expected to lead to lower anticipated premium increases in 2003 compared to their expectations 'without reform' outlined above.
  - '**with reform**' insurers expected premiums to increase by an average of around 9 per cent in 2003 on 2002 levels.[124] This was largely driven by:
    - expected increases in costs associated with underwriting, claims handling and reinsurance expenses of around 14 per cent on average in 2003 on 2002 levels
    - expected increases in claims costs of around 6 per cent on average in 2003 on 2002 levels.

Comparing both sets of insurers' expectations for costs and premiums in 2003 (i.e. comparing insurers' expectations for 2003 'with reform' with expectations in 2003 'without reform'), the ACCC found that:

- the effect of government reforms was expected by insurers to lower claims costs in 2003 by around 5 per cent on average, and lower other costs by around 1 per cent on average.[125]
  - This was expected to lead to a corresponding expected reduction in premiums of around 3 per cent on average in 2003.[126]

It is important to note when considering these aggregated estimates that they are based on expectations of the four insurers that quantified the impact of reforms on premiums in 2003.

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123 This estimate is the average of responses provided by the four insurers which has been weighted based on the proportion of premium written by state and territory and the relative size of the insurer in terms of the amount of gross written premium of all four insurers included in the average.

124 This is the average of responses provided by the four insurers which has been weighted based on the proportion of premium written by state and territory and the relative size of the insurer in terms of the amount of gross written premium of all four insurers included in the average. For the states where insurers provided a 'with reform' response (NSW, Qld, Vic, ACT and SA), the ACCC weighted these answers; where insurers were not asked to provide a 'with reform' response (Tas, NT and WA), the ACCC assumed that premiums would rise by the average amount estimated 'without reform' by each insurer and weighted this by each state.

125 The 5 per cent on average decrease in claims costs is the percentage difference between the expected level of claims costs with reforms and the expected level of claims costs without reform in 2003 (put another way, this change represents a decrease of 6 percentage points). This method was used for other costs.

126 The 3 per cent on average decrease in premiums is the percentage difference between the expected level of premium with reforms and the expected level of premium without reforms in 2003 (put another way, this change also represents a decrease of 3 percentage points).

*Other responses*

Other responses that did not quantify the expected impact of government reforms on insurance premiums in 2003 are presented below.

- One insurer indicated it was too early to quantify the impact of reforms on premiums.
- Another insurer reviewed a sample of claims data in the states in which it had exposure to quantify the impact of recent legislative reforms. The insurer said that its studies were broadly consistent with the analysis from the Ipp report and supported the hypothesis that claims costs would reduce. It also commented that its approach would be to base premium rates on its own past claims experience and wait for clear and sustained evidence of the legislative reforms through its own data. It also indicated that it had not explicitly allowed for the impact of the legislative reforms in premium rates at this stage but would monitor the situation.
- Another insurer indicated that legislative reform would have minimal impact on its business as it had focused its liability business away from personal injury policies in recent years.
- The remaining insurer indicated that due to its underwriting approach, it had assessed recent government reforms and concluded that they would have very little impact on its business.

*In summary:*

*This analysis indicates that all insurers expected premiums to increase in 2003, irrespective of the implementation of government reforms in 2002.*

*Different approaches have been adopted by insurers with respect to factoring the impact of government reforms into premiums for 2003.*

*Some insurers expect to make some allowances for the impact of reforms by lowering the size of premium increases in 2003 on the basis of lower expected increases in claims costs. The anticipated savings in claims costs in 2003 were estimated to be on average around 5 per cent. This would correspond to an overall premium reduction of about 3 per cent in 2003 when comparing insurers' expectations for premiums increases in 2003 'with reform' to those 'without reform'. However, insurers qualified these expected reductions.*

*Other insurers did not expect to adjust premiums for 2003 in response to government reforms. Reasons given include the mix of insurance business underwritten by some insurers, and in other cases, some insurers consider it too early to quantify the impact of government reforms in the absence of reliable claims experience data that would indicate claims costs were constrained as a result of reform.*

### 9.3.3 Expected longer term impact of reforms on premiums

The ACCC asked insurers whether the impact they had specified for each state and territory would continue to be the impact of government reforms on premiums in the longer-term (e.g. over the next three to five years) for that particular state.

Five insurers responded to this particular issue about the expected longer term impact of reforms.

- Three insurers said the expected short-term impact of reforms on premiums and costs would not continue over the longer term. Reasons cited by insurers included the existence of superimposed inflation (that is, the tendency for court-awarded payments to increase faster than economic inflation) and the effects of other countervailing factors that will impact on claims outcomes in future years. Some insurers cited the experience of legislative changes in other classes of insurance (such as CTP), in which

they indicated that past legislative changes have not eliminated such underlying inflationary trends. Other factors cited were the attitude of community and courts, which were considered to be less specific and quantifiable.

- The remaining two insurers commented that the expected longer-term impact of government reforms on premiums was uncertain. Reasons given related to uncertainty in how courts and plaintiff lawyers may interpret and apply legislative changes over time, and the absence of reliable observed trends in claims experience.

Several insurers indicated to the ACCC that they would continue to monitor claims outcomes to determine the actual emerging impact of legislative reforms over time.

*In summary:*

*Insurers generally regarded the longer-term impact of government reforms on premiums as uncertain. Reasons cited by insurers related to an absence at this stage of observed trends in claims experience resulting from reforms and the impact of other countervailing factors that may influence premiums over time.*

## 9.4 Expected impact of government reforms on professional indemnity insurance

This section summarises insurers' responses to the ACCC's monitoring program about the expected impact of government reforms on professional indemnity premiums. Of the seven insurers monitored by the ACCC for professional indemnity insurance, one did not respond to the ACCC's questionnaire (this was discussed in section 7). The extent to which the six remaining insurers responded to each question is identified in the relevant sections below.

### 9.4.1 Expected short term impact on premiums 'without reform'

Insurers specified how they expected overall premiums to change over the next 12 months (up to the end of 31 December 2003) **without** recent and proposed government reforms of the insurance industry.

Table 9.3 shows the number of insurers that identified expected premium increases with recent and proposed government reforms, on a national basis, and for each state and territory.

**Table 9.3 Summary of insurers' responses—overall expected changes in premiums in 2003 'without reform'—professional indemnity**

| | Expected premium increases within the specified band in the year ending 31 December 2003—without recent and proposed government reforms—number of insurers that responded | | | | | | | Total number of responses |
|---|---|---|---|---|---|---|---|---|
| | Percentage bands | | | | | | | |
| **Jurisdiction** | **1-5%** | **6-10%** | **11-20%** | **21-50%** | **51-75%** | **76-100%** | **101%+** | |
| National | - | 1 | 4 | 2 | - | - | - | 6* |
| NSW | - | - | 3 | 1 | - | - | - | 4 |
| VIC | - | - | 3 | 1 | - | - | - | 4 |
| QLD | - | - | 2 | 1 | - | - | - | 4** |
| WA | - | - | 3 | 1 | - | - | - | 4 |
| SA | - | - | 3 | 1 | - | - | - | 4 |
| TAS | - | - | 3 | 1 | - | - | - | 4 |
| ACT | - | - | 3 | 1 | - | - | - | 4 |
| NT | - | - | 2 | 1 | - | - | - | 3 |

Source: ACCC monitoring questionnaire
* One insurer specified two ranges in its response.
** One insurer specified a decrease of 1-5%.

The table shows some variation in insurers' expectations about increases in premiums for 2003 **without** recent and proposed government reforms. Of the six insurers that responded to the ACCC's monitoring questionnaire:[127]

- At a **national** level, insurers expect premiums in 2003 to increase in the bands between 6 and 50 per cent on their 2002 levels, with four of the seven responses showing an expected increase between 11 per cent and 20 per cent.
  - One insurer, who expected premiums to increase between 21 and 50 per cent, indicated that its expectations were on the 'lower side' of this range.
- At the **state** level, four insurers quantified expected changes in premiums at the state level without recent and proposed government reforms.
  - The range of responses from insurers was broadly similar to insurers' expectations for premium changes at the national level, with most insurers indicating that premiums were expected to increase between 11 and 20 per cent.
  - Most insurers expected that the quantum of premium increase would be the same across the states and territories. Only one insurer expected it to differ across the states and territories, with a slight decrease in premiums in Queensland. The insurer did not comment further on why premiums were expected to differ across jurisdictions in this way.

*In summary:*

*Insurers' expectations varied about price increases in professional indemnity insurance premiums in 2003 in the absence of recent and proposed government reforms. However, most expected rate increases to be between 11 and 20 per cent. This applied at a national level and for most of the states and territories.*

[127] The seventh insurer included in the ACCC's monitoring program for professional indemnity insurance did not provide a response on the questionnaire.

### 9.4.2 Expected short term impact on premiums 'with reform'

The extent to which insurers completed this part of the ACCC's monitoring questionnaire and the manner in which pricing information was presented varied widely across insurers.

Only two insurers quantified the expected premium increase in 2003 'with reform'.

- There was considerable variation in the relative importance of various cost drivers to these insurers. One insurer attributed the overall expected premium increase 'without reform' to a higher profit margin and increased reinsurance costs. The other insurer attributed most of the expected increase in 2003 to higher claims costs.
- Both responses indicated no change to their expected premium increases in 2003 as a result of government reforms. Reasons cited related to reforms enacted by governments to contain costs to insurers for personal injury claims would have little if any impact as personal injury claims comprised a small percentage of total claims costs for their professional indemnity business.

The remaining four insurers did not quantify the expected increase in premiums in 2003 'with reform'. Reasons cited by insurers included it being too early to tell or very difficult to estimate at this stage the impact on premiums. Others referred to the limited short-term impact reforms may have on some insurers, given that some insurers may target particular professions and risk that have low claims frequency and loss ratios.

*In summary:*

*This analysis suggests that no adjustments were expected to be made to professional indemnity premiums in 2003 as a result of tort law reforms enacted by governments in 2002.*

*Reasons cited by insurers varied. Some insurers considered that no cost savings would apply to professional indemnity premiums in 2003 as the reforms enacted by governments in 2002 targeted personal injury claims, which comprise a small percentage of their professional indemnity claims. Other insurers commented that it was too early to tell or very difficult to estimate at this stage the impact of government reforms on premiums.*

### 9.4.3 Expected longer term impact of reforms on premiums

The ACCC asked insurers whether the expected short-term impact would continue to be the impact of government reforms on premiums in the longer term (e.g. over the next three to five years) for that particular state. Two insurers responded to this question. They estimated there would be no change to their expected premium increases in 2003 as a result of reform and there would be no effect in the longer term. The reasons given were consistent with their previous responses where they considered that personal injury reforms would have no material impact on their professional indemnity insurance premiums now or in the future. However, one insurer noted that, although this would not be reflected in their current portfolio of business, savings in claims may be expected to accrue in the areas of medical malpractice and those professions directly involved with bodily injury claims.

*In summary:*

*Based on a limited number of responses from insurers, the reforms implemented by governments dealing with personal injury claims are not expected to have a material impact on professional indemnity premiums in the long term.*

## 9.5 Conclusion

The role of the ACCC was to assess the extent to which insurers had factored the impact of recent government reforms into public liability and professional indemnity premiums. In this first monitoring report, the ACCC based its assessment on the expectations of insurers at the end of 2002.

With public liability insurance, the ACCC found that the extent to which recent government reforms were expected to be factored into premiums in 2003 varied across insurers. Some insurers indicated that they expected some cost savings to materialise in 2003—on average, four insurers anticipated claims cost savings of around 5 per cent—and these were expected to be reflected in lower premium increases in 2003 when comparing insurers' expectations for premium increases in 2003 'with reform' to expectations 'without reform'. These insurers correspondingly adjusted expected premium increases down by around 3 per cent on average in 2003 due to expected claims cost savings. Other insurers indicated that it was too early to adjust premiums until the benefits of reforms, mainly in terms of lower claims outcomes, became evident in claims experience data.

With professional indemnity insurance, the ACCC found that insurers did not expect to adjust premiums in 2003. Insurers said that the government reforms enacted during the monitoring period related mainly to personal injury which was unlikely to have any material impact on professional indemnity or that they considered it too early to quantify the impact.

# Appendixes

# A Insurers that participated in the ACCC's monitoring program

This appendix outlines the insurers that participated in the ACCC's monitoring program to prepare this first report.

The insurers are listed below in alphabetical order:

- ACE Insurance Limited
- Allianz Australia Insurance Limited
- CGU Insurance Limited
- Chubb Insurance Company of Australia Limited
- QBE Insurance (Australia) Limited
- QBE Mercantile Mutual Limited
- Royal & Sun Alliance Insurance Australia Limited
- Suncorp Metway Insurance Limited[128]
- Zurich Australia Insurance Limited.

All nine insurers were included in the ACCC's monitoring program of public liability insurance. Their premium revenue represented 68 per cent of the public (and product) liability class of insurance, as measured by APRA statistics for the year ending 30 June 2002.

Seven of the nine insurers were included in the ACCC's monitoring program of professional indemnity insurance.[129] Their premium revenue represented 58 per cent of the professional indemnity insurance class, as measured by APRA statistics for the year ending 30 June 2002.[130]

The ACCC acknowledges that all insurers responded to varying degrees to the ACCC's information request, although there was no statutory requirement for them to comply. Information about the ACCC's data request is in appendix D.

[128] Data supplied by Suncorp Metway Insurance Limited to the ACCC included statistical history of three of its companies—GIO, AMP and Suncorp Metway.

[129] Two of the nine companies (Allianz and QBE Mercantile Mutual) were not included in the ACCC's monitoring program of professional indemnity insurance.

[130] This excludes medical malpractice premium revenue written by captive insurers of MDOs.

# B Tort law reforms as at 31 December 2002

## B.1 Introduction

This appendix outlines the tort law reforms announced by respective governments up to 31 December 2002. It is presented on the following basis:

- initiatives announced by governments during 2002 that **were implemented** as at 31 December 2002.
  - These reforms were the focus of the ACCC's monitoring exercise for this report.
- initiatives announced by governments during 2002 that **were not implemented** as at 31 December 2002.
  - These reforms fall outside the scope of this first report. However, once implemented they will be included in future reports by the ACCC.

## B.2 Initiatives announced by governments during 2002 that were implemented as at 31 December 2002

### B.2.1 Commonwealth Government

The *Taxation Laws Amendment (Structured Settlements and Structured Orders) Act 2002* was introduced into the Federal Parliament on 6 June 2002 and commenced on 19 December 2002.

The Act amends the *Income Tax Assessment Act 1997* to encourage the use of structured settlements for personal injury compensation, by providing an income tax exemption for annuities and deferred lump sum paid as compensation for seriously injured persons. The income tax exemptions are available for such payments if the necessary eligibility criteria are met. Structured settlements involve periodic payments for life.

The *Trade Practices Amendment (Liability for Recreational Services) Act 2002* was introduced into Federal Parliament on 27 June 2002 and began on 19 December 2002. The Act amends the *Trade Practices Act 1974* so that individuals can waive their contractual rights to sue when undertaking risky recreational activities. It allows people to voluntarily waive their right to sue, and is designed to achieve a balance between protecting consumers and allowing them to take responsibility for themselves.

### B.2.2 New South Wales

The *Civil Liability Act 2002* was introduced into the NSW Parliament on 28 May 2002 and has been in force retrospectively since 20 March 2002. The main provisions of the Act relate to implementing caps on damages and thresholds for personal injury damages claims. They include:

- fixing the maximum amount of damages for non-economic loss (general damages) that may be awarded at $350 000 (indexed to AWE)
- establishing a 15 per cent threshold of impairment for non-economic damages according to a sliding scale
- fixing the maximum amount of loss for damages for past or future economic loss at three times the rate of AWE for NSW

- requiring the claimant to prove realistic future earnings
- requiring lump sum damages for future economic loss to be discounted by 5 per cent (or as per Regulations)
- no interest awarded on damages for non-economic loss or gratuitous attendant care services
- allowing damages claims under the *Compensation to Relatives Act 1987* to be reduced to incorporate contributory negligence of the deceased person
- no exemplary or punitive damages
- limits on recovery for gratuitous attendant care
- limits on legal cost claims to the greater of 20 per cent of damages or $10 000 in small claims
- new requirements on lawyers and penalties to apply for unmeritorious claims and defences
- allowing costs to be awarded on an indemnity basis if incurred after the failure to accept an offer of compromise.

The *Civil Liability Amendment (Personal Responsibility) Act 2002* was introduced into Parliament on 23 October 2002. It was assented on 28 November 2002.[131] The Act deals with the following matters:

- allows waivers and voluntary assumption of risk (subject to amendments of *Trade Practices Act 1974*)
- provides for peer acceptance defence in connection with civil liability of professionals in tort or contract
- provides that no civil liability arises for a failure to take reasonable care in respect of a risk, or to warn of a risk, that a reasonable person would consider to be an inherent obvious risk
- protects volunteers and 'good Samaritans' who act in good faith from liability
- facilitates structured settlements
- ensures that saying 'sorry' does not represent an admission of guilt
- limits claims for nervous shock
- limitations on damages for injuries suffered by a person while intoxicated
- proportionate liability for claims involving economic loss in property damage in non-personal injury activities
- limited liability for injury or death or damage to property resulting from self-defence or arising from criminal conduct
- new limitation periods for personal injury cases.

[131] Schedules 1 [1], 1 [4], commenced on 10 January 2003.

### B.2.3 Victoria

The *Wrongs and Other Acts (Public Liability Insurance Reform) Act 2002* was introduced into the Victorian Parliament on 12 September 2002 and began, in part, on 23 October 2002.[132] The Act covers the following matters:

- caps on loss of earnings at three times AWE
- cap on non-economic loss at $371 380 indexed to the Consumer Price Index (CPI)
- sets a discount rate of 5 per cent with adjustments from time to time to reflect actual real investment returns
- provides for structured settlements
- allows people who partake in risky activities to waive their right to sue
- in determining whether a plaintiff has established a breach of the duty of care owed by a defendant, requiring courts to take account of the fact that a plaintiff may have been affected by alcohol or drugs or was engaged in a criminal activity
- protection from liability for good Samaritans and volunteers
- ensures saying sorry does not represent an admission of liability
- protects food donors from liability where they have donated food to charities in good faith
- requires insurers to account clearly for the collection and remission to the fire brigades of amounts the insurers collect from insurance policy as 'fire services levies'
- the appointment of a special Insurance Commissioner to the Essential Services Commission, with responsibility for collecting insurance data to ensure transparency and fairness in the pricing of premiums.

The *Limitation of Actions Amendment Act 2002* was introduced in Parliament on 16 October 2002, and commenced on 4 November 2002. It amends the *Limitations of Actions Act 1958* to limit further the period within which certain actions for damages for personal injuries can be brought from six to three years after injury except for adult disabilities, which remains at after six years, and except for minors.

### B.2.4 Queensland

The *Personal Injuries Proceedings Act 2002* was introduced into the Qld Parliament on 30 June 2002 and began retrospectively from 18 June 2002. This Act provides:

- procedures for speedy resolution of claims for damages for personal injury
- a requirement for the mandatory early notification of claims following an injury or the appearance of symptoms
- a requirement for the mandatory exchange of information (including medical reports) to facilitate early settlement and avoid costly litigation
- restrictions on legal advertising including the banning of 'no win no fee' advertising
- limits the amount of legal costs that can be awarded in specified circumstances—no legal costs being payable for claims under $30 000 and a maximum $2 500 in costs begin payable for claims between $30 000 and $50 000

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[132] Sections 8 and 11 and Part 5 of the Act are scheduled to commence, subject to amendments to the *Trade Practices Act 1974* and the *Fair Trading Act 1999.*

- allows expressions of regret by defendants
- limits compensation economic loss to three times AWE
- excludes jury trials in personal injury claims
- courts cannot award exemplary, punitive or aggravated damages
- provides for a court to make a consent order for a structured settlement
- liability does not attach to a person rendering first aid or other assistance to person in distress in an emergency.

The *Personal Injuries Proceedings Amendment Act 2002* was introduced into Parliament on 30 July 2002 and began on 29 August 2002, except sections 4 and 8 of the Act which commenced on 18 June 2002. The Act provides transitional provisions for the *Personal Injuries Proceedings Act 2002*.

### B.2.5 South Australia

The *Statutes Amendment (Structured Settlements) Act 2002* was introduced into the South Australian Parliament on 12 September 2002 and commenced from 1 December 2002. It allows for damages orders for personal injury to award structured settlements.

The *Recreational Services (Limitation of Liability) Act 2002* was introduced on 5 September 2002 and began, in part, on 1 December 2002 and then fully on 19 December 2002. It allows for duty of care to be modified by a registered code for providers of high-risk recreational activities. It also provides that after two years the South Australian Economics and Finance Committee must investigate and report to the Parliament on how the Act affects the availability and cost of insurance for providers of recreational services.

The *Wrongs (Liability and Assessment of Damages) Amendment Act 2002* was introduced on 14 August 2002 and began on 1 December 2002. The main features of the Act include:

- placing caps on general damages for pain and suffering to $241 500 indexed to the CPI
- placing thresholds (7 days impairment or $2 750 in medical expenses) for general damages payments and using a regulated scale of damages related to severity of injury
- placing caps on payments for loss of earnings capacity to $2.2 million
- reducing damages where the injured party was intoxicated and this contributed to the accident
- excluding award of damages for injuries suffered by a person engaged in a criminal activity
- providing protection for ‘good Samaritans’
- strengthening the protection to volunteers
- allowing that saying sorry may not mean an admission of liability.

### B.2.6 Australian Capital Territory

The *Civil Law (Wrongs) Act 2002* was introduced into the ACT Legislative Assembly on 20 August 2002 and was scheduled to come into effect on various dates between 10 October 2002 and 1 July 2003.[133] The Act allows for the following:

- the provision of structured settlements
- courts can determine liability separate from an order of damages
- limit on damages for loss of earning equivalent to three times the rate or AWE
- protection of volunteers and 'good Samitarans' from liability, including bushfire volunteers
- establishing new presumptions in regard to contributory negligence
- replacing common law rules regarding standard of care an occupier of premises must show to people entering the premises in relation to any dangers to them
- no legal costs in personal injury cases where the award is $50 000 or less, and maximum costs allowed for legal services are the greater of $10 000 or 20 per cent
- prohibiting lawyers from prosecuting civil claim where there are no reasonable prospects of success
- establishing a regime for neutral evaluation of cases to resolve disputes more quickly and cheaply
- requiring insurers to report their annual returns for ACT.

### B.2.7 Northern Territory

The *Consumer Affairs and Fair Trading Amendment Act (No 2) 2002* was introduced into the NT Legislative Assembly on 20 August 2002 and began, in part, on 1 December 2002. The Act removes a statutory impediment to the self-assumption of risk by people undertaking risky recreational activities.

As at 31 December 2002, the remaining state governments of WA and Tasmania were at varying stages of the tort law reform process.

## B.3 Initiatives announced by governments during 2002 that were not implemented as at 31 December 2002

### B.3.1 Commonwealth

The *Commonwealth Volunteers Protection Act 2002* was introduced into Federal Parliament on 23 October 2002 and was assented on 24 February 2003. The Act protects people who perform voluntary work for the Commonwealth or a Commonwealth authority from civil liability for acts or omissions by such volunteers, done in good faith when performing that work.

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133 Sections 1 and 2 of the Act began on 10 October 2002 (LA section 75 (1)) [good Samaritans, volunteers, effect of death on action, wrongdoers]. Part t 7.1 commences on 1 July 2003 [limitation of liability of innkeepers]. Part 11.1 began on 30 April 2003 [neutral evaluation of liability]. Ch 10 of the Act began on 1 January 2003 [limitation of legal costs]. The remainder of the Act began on 1 November 2002 [wrongful or omission causing death, injury from mental or nervous shock, damages, defamation, trespass, mitigation of strict liability except inkeepers, misrepresentation, miscellaneous].

### B.3.2 Victoria

The Personal Injuries Procedures Bill 2002 was introduced into the Victorian Parliament on 30 October 2002 but lapsed once Parliament dissolved on 5 November 2002 after the announcement of the Victorian state election. The Bill is designed to provide pre-litigation procedures, to facilitate the early settlement of claims for damages for death or injury and to discourage the commencement of proceedings without full preparation for resolution of the claim.

### B.3.3 Queensland

On 11 March 2003 the Queensland Government introduced the Civil Liability Bill 2003 into state Parliament and it passed Parliament on 3 April 2003. It proposes fundamental changes to the law of negligence and will further facilitate the ongoing affordability of insurance through caps and thresholds on damages for personal injury claims. The Bill is based on the Ipp Report recommendations and complements Queensland's earlier reforms.

### B.3.4 Western Australia

The *Civil Liability Act 2002* was introduced by the Western Australian Government into Parliament on 14 August 2002 and began from 1 January 2003. It provides for:

- a cap on damages for economic loss of three times average weekly earnings
- structured settlements
- a threshold for damages for non-economic loss, indexed, of $12 000
- a threshold of $5 000 and a cap on damages for gratuitous care to AWE in Western Australia
- restrictions on advertising by lawyers of personal injury services.

The *Volunteers (Protection from Liability) Act 2002* was introduced on 19 June 2002 and was scheduled to begin on 1 January 2003. It protects volunteers from incurring civil liability when doing voluntary community work. It also provides that community organisations that organise the volunteers' work may incur the civil liability from which volunteers are protected when doing that work.

### B.3.5 Tasmania

The *Civil Liability Act 2002* was introduced into the Tasmanian Parliament on 1 October 2002, and was scheduled to commence on 1 January 2003. It provides for:

- restricting the level of damages for those injured where the use of recreational drugs, including alcohol, has contributed to the injury
- restricting people from being able to claim damages if injured while engaging in criminal activities
- using structured settlements
- ensuring that saying sorry is not an admission of liability.

### B.3.6 Northern Territory

The Personal Injuries (Liabilities and Damages) Bill 2002, the *Personal Injuries (Liabilities and Damages) (Consequential Amendments) Act 2002* and the Legal Practitioners Amendment (Costs and Advertising) Bill 2002 were introduced into the NT Legislative Assembly on 17 October 2002. The first two Bills provide for a range of proposed measures including:

- past and future loss of earnings capped at a maximum of three times AWE
- threshold for non economic loss of 5 per cent scaling of awards up to an indexed cap of $350 000
- no damages for those engaged in criminal activity and limited liability for contributory negligence
- protection of good Samaritans
- the use of structure settlements
- saying sorry not an admission of liability.

The remaining bill is intended to limit legal fees in 'no win no fee' cases and propose limits on touting for business by legal representatives.

A discussion draft of the Personal Injuries (Civil Claims) Bill 2002 was released by the NT Government in October 2002. It proposed changes to court procedures and legal practitioners' operations, faster claims processing with compulsory conferencing, and limits on recovery of legal costs where court damages are less than earlier settlement offers.

# C Regulatory arrangements

This appendix briefly describes the regulatory arrangements associated with providing insurance in Australia.

## C.1 The role of the Australian Competition and Consumer Commission

The ACCC seeks to improve competition and efficiency in markets, foster adherence to fair trading practices in well informed markets, promote competitive pricing wherever possible and restrain price rises in markets where competition is less than effective. It is particularly concerned to foster a fair and competitive operating environment for small business.

It is an independent statutory authority. Its formation in 1995 was an important step in implementing the national competition policy reform program agreed to by the Council of Australian Governments.

The ACCC is responsible for administering the *Trade Practices Act 1974* (TPA) and the *Prices Surveillance Act 1983* (PSA). The PSA enables the ACCC, where the government declares products or services, to examine prices with the objectives of promoting competitive pricing wherever possible and restraining price rises in markets where competition is less than effective. Inquiries into products under the PSA require a direction from the Parliamentary Secretary to the Treasurer.

## C.2 Role of the Australian Securities and Investments Commission[134]

The Australian Securities and Investments Commission (ASIC) is an independent Commonwealth government body established by the *Australian Securities and Investments Commission Act 1989*. It began on 1 January 1991 as the Australian Securities Commission, to administer the Corporations Law. It replaced the National Companies and Securities Commission (NCSC) and the Corporate Affairs offices of the states and territories. In July 1998 it received new consumer protection responsibilities and its current name.

ASIC is one of three Commonwealth government bodies, along with APRA and the Australian Taxation Office, that regulate financial services. Its responsibilities encompass protecting investors, superannuants, depositors and insurance policy holders, and regulating and enforcing laws that promote honesty and fairness in financial markets, products and services and in Australian companies.

The consumer protection responsibilities of ASIC that are particularly relevant to general insurance regulation include:

- consumer disclosure requirements including disclosure of terms and conditions (including exclusions), disclosure of premiums and other fees, disclosure of risks, and the disclosure of complaints handling arrangements. This includes disclosure in the paper-based form or on the web or through telephone sales
- dispute resolution procedures
- oversight and approval of the operation of codes of conduct and the operation of the Insurance Enquiries and Complaints Scheme

[134] ACCC, *Insurance industry market pricing review*, March 2002, appendix A.2.

- the conduct of sales representatives, including their disclosure obligations and training requirements. This includes telesales staff as well as brokers and agents.

ASIC's consumer protection capacity has been further enhanced with the recently passed Financial Services Reform legislation which sets out new consumer protection requirements for both disclosure and conduct in the financial services sector, including the insurance industry.

## C.3 Role of the Australian Prudential Regulation Authority

The Australian Prudential Regulation Authority (APRA) was established on 1 July 1998. It is responsible for the prudential regulation of banks, life insurers, general insurers, superannuation funds, building societies, credit unions and friendly societies.

Before its formation, the Insurance & Superannuation Commission (ISC) undertook prudential supervision of the general insurance sector. The Federal Government established the Financial System Inquiry in 1996, chaired by Mr Stan Wallis. In its final report, released in March 1997, the Wallis Inquiry recommended, among other things, a reorganisation of the regulatory agencies overseeing the financial sector. This included establishing a single prudential supervisor governing deposit-takers, insurance companies and superannuation funds. APRA's establishment required the integration of supervisory resources from the Reserve Bank of Australia, the ISC and seven state-based organisations.[135]

APRA seeks to meet its prudential and market supervision objectives in relation to the insurance sector by:

- monitoring the solvency and operational activities of general insurers
- providing policy advice to the government on general insurance issues
- promoting improved industry standards
- maintaining close contact with the insurance industry about issues affecting the industry and policyholders.

APRA administers the following legislation, which is directly relevant to the insurance industry:

- *Australian Prudential Regulation Authority Act 1998*
- *Insurance Act 1973*
- *Insurance Acquisitions and Takeovers Act 1991*
- *Financial Institutions Supervisory Levies Collection Act 1998*
- *General Insurance Supervisory Levy Imposition Act 1998.*

[135] APRA, *Submission to the HIH Royal Commission, Future policy directions for the regulation and prudential supervision of the general insurance industry*, September 2002, p. 4.

## C.4 Role of the Insurance Enquiries and Complaints Scheme[136]

The General Insurance Enquiries and Complaints Scheme is a national scheme developed by the ICA to handle inquiries and complaints and to resolve claims disputes which come within the terms of reference of the scheme.

It began operations in December 1993 and is approved by the Australian Securities and Investments Commission (ASIC) in accordance with ASIC Policy Statement 139 'Approval of external complaints resolution schemes'.

The scheme operates on two-tier system. At the first level consumer consultants provide advice for inquiries and assistance in encouraging resolution of complaints by promoting conciliation between claimants and insurance companies.

If a claims dispute falling within the scope of the scheme's terms of reference remains unresolved following an insurer's internal dispute resolution process or review, it can be referred to the second tier of the scheme. At this tier a panel, referee or adjudicator offers claimants an impartial and authoritative alternative to litigation. An adjudicator can make binding determinations on participating insurers for amounts not exceeding $3000 and by a panel or referee for amounts not exceeding $120 000. A panel or referee may also make recommendations, for an amount greater than $120 000 but not exceeding $290 000.

Claimants are not bound by any panel, referee or adjudicator determination and retain their rights to legal action or other forms of redress if they are dissatisfied with a determination.

These dispute-handling arrangements are essentially for the benefit of claimants who are natural persons, not corporations. This restriction is intended to exclude large commercial concerns, which are likely to have the resources to pursue disputes by other means. Small business organisations may refer disputes to the scheme.

The scheme also allows consumers, who are natural persons and who are seeking to make a claim for motor vehicle property damage against an insured or against a person to whom a policy of insurance extends, to have access. The claim is limited to an amount not exceeding $3000.

All participating insurers sign an agreement signifying their compliance with the terms of reference, including the procedures to be followed to resolve disputes within the periods set down in the terms of reference. The agreement also means that insurers undertake to comply with the binding determinations of an adjudicator for amounts not exceeding $3000 and of a panel or referee to the $120 000 limit outlined above.

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36 ACCC, *Insurance industry market pricing review*, March 2002, appendix A.4.

# D The ACCC's data request to insurers

This appendix identifies several issues associated with the ACCC's data request to selected insurers.

## D.1 Data sources

Before its monitoring work, the ACCC was aware that some data on public liability insurance already existed. Some insurers who are members of the Insurance Statistics Australia (ISA) group provide data to that body. Also, all authorised insurers are required to provide particular data to APRA as part of their prudential reporting requirements.

In developing its monitoring methodology, the ACCC noted that a large part of its information requirements would not be available from these two sources. Previous public reports, such as the March and May 2002 Trowbridge reports and the Senate Economics References Committee Report in October 2002, noted that there has been a history of poor data collection in the public liability insurance industry.

The ACCC therefore considered it appropriate to approach the insurance industry directly for information about costs and premiums. The insurers included in the ACCC's monitoring program are listed in appendix A.

## D.2 Data sets

The following information was requested from insurers for the public liability and professional indemnity classes:

- Premiums:
  - a range of premium data, such as gross written premium for new and renewed policies, the earned premium and the unearned premium reserve, as well as reinsurance, underwriting and brokerage costs
- Policies:
  - Data on the number of new and renewed policies and additional data on the number of policies by the insureds' level of turnover for public (and product) liability insurance
- Claims:[137]
  - *Public (and product) liability*- detailed data on claims broken down into personal injury and death claims and property damage claims. This included specific data on payments, provisions, types, numbers, size and breakdowns of claims (including by heads of damage).
  - *Professional indemnity*- Detailed data on claims, including specific data on payments, provisions, numbers, size and breakdowns of claims (including the proportion of damages paid to internal claims costs).

The ACCC requested most information from insurers for the period 31 December 1993 to 31 December 2002. In some cases data covering the entire period was unavailable. In other cases insurers considered data for earlier years was unreliable. As a result the ACCC conducted most of its analysis for the period from 31 December 1997 to 31 December 2002. The ACCC notes that, with respect to public liability data, one insurer only provided data for

[137] A description of the cost components of public liability claims is in section 5.2.

2001 and 2002 and was therefore excluded from the **historical** analysis included in sections 5, 6, 7 and 8.

The ACCC has relied on the information provided by insurers to be accurate in undertaking its analysis. Insurers have assured the ACCC to this effect.

## D.3 Reporting basis

Analysis conducted within sections 5, 6, 7 and 8 is done on a variety of reporting bases, by incident year, by settlement year and by underwriting year (these terms are defined in the glossary). These are not necessarily directly comparable which may be best illustrated using the following example where each recording year is done on a calendar year basis (i.e. year ending 31 December).

- Assume that a company takes out a 12-month public liability policy on 1 July 2002. That policy is issued by the insurer in **underwriting year 2002** (that is the year that the policy is issued or renewed).
- The policy covers the insured for incidents (or accidents) that occur anytime between 1 July 2002 and 30 June 2003.
- Further assume that an incident occurs on 30 June 2003.
- The insurer however, may not become aware that this incident has occurred until several years later.
- Assume that the insured notifies the insurer of the incident on 30 June 2005, the insurers will record the incident as having occurred in **incident year 2003**. Despite this, the insurer will record this incident in **report year 2005** (the year in which the insurer becomes aware of the incident).
- It may take several more years before the reported claim arising from this incident is settled. In this example, assume that the claims are settled on 30 June 2008. Therefore the claim will be recorded by the insurer as being settled in **settlement year 2008**.

The above example illustrates the difficulty facing insurers in accurately pricing long-tail risks for each underwriting year.

Also, as can be seen above, premium written in one year cannot be directly compared to claims reported or claims settled in that same year. Where possible the ACCC has attempted to report premiums, claims and expenses consistently, however, some sections may not be directly comparable and this should be kept in mind when reading sections 5, 6, 7 and 8.

## D.4 Data received by the ACCC

While the ACCC received enough information from insurers to perform its monitoring analysis, it requested some data sets that were not supplied by some or all insurers. Therefore the extent of the ACCC's analysis was affected by the degree to which insurers provided the information requested.

In some cases, insurers did not provide a complete set of data. They either did not provide data for the entire time period requested or did not provide specific data sets at all. The main reasons they gave for being unable to provide all of the data was that whole data sets or at the least historical data, was unavailable, incomplete or unreliable. In some cases, insurers indicated that this was due to acquisitions and mergers, or the changeover of data collection systems.

In some cases where information was not available, insurers provided supplementary data to assist the ACCC in its analysis. Generally, they outlined differences in the data sets.

Specific examples of information requested by the ACCC that insurers could not provide include:

*Public liability insurance*

- Data on personal injury and death claims broken down into the heads of damage cost components was requested. The ACCC consulted with several selected insurers before finalising its data request in late 2002, at which time several insurers indicated that they had not kept this information historically. The ACCC then decided to request heads of damage data for a sample of claims. However, insurers typically still could not provide this information because either they did not record the information at all, did not record the information in categories which met the ACCC's definitions, or they did not record the information in an accessible format.
  - Some insurers provided limited information, however the data sets were not consistent across insurers. Therefore, the ACCC was unable to draw any meaningful conclusions from it.
- The ACCC requested data on policy numbers by policy holder turnover levels to help it identify the book of business the various insurers held and therefore whether they catered to particular areas of the market. Insurers indicated that they could not provide reliable data for the full set of their policies.

*Professional indemnity insurance*

- A breakdown of claims (including the proportion of damages paid to internal claims costs) was requested. Some insurers provided partial information, however the data sets provided were not consistent with the ACCC's initial request, nor were they consistent across insurers. Therefore, the ACCC was unable to draw any meaningful conclusions from it.

## D.5 Detailed data analysis—public liability insurance

This section presents more detailed information on several aspects of the ACCC's monitoring analysis contained in section 5.

### D.5.1 Claims frequency by jurisdiction

Chart 5.1 in section 5 examined the number of claims reported to insurers within the same year as incident and the frequency of those claims over the incident period between 1998 and 2002. It was based on data provided by seven insurers.

Table D.1 examines the frequency of claims reported within the same year as incident by jurisdiction. The analysis was conducted using the same methodology and using the same insurers shown in chart 5.1.

**Table D.1 Frequency of claims reported within the same year as incident by jurisdiction—national, all states and territories—public liability insurance—1998 to 2002**

| | Claims frequency by jurisdiction—year ending 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | National | NSW | VIC | QLD | SA | WA | TAS | NT | ACT |
| **1998** | 2.4% | 2.4% | 2.3% | 2.2% | 2.3% | 2.7% | 2.7% | 2.7% | 2.7% |
| **1999** | 2.3% | 2.2% | 2.5% | 2.3% | 2.3% | 2.4% | 2.4% | 2.3% | 1.8% |
| **2000** | 2.1% | 2.0% | 2.1% | 2.1% | 2.0% | 2.6% | 2.2% | 2.2% | 2.0% |
| **2001** | 1.9% | 1.7% | 1.8% | 1.9% | 2.0% | 2.5% | 2.0% | 2.0% | 1.1% |
| **2002** | 1.5% | 1.3% | 1.4% | 1.8% | 1.6% | 1.9% | 1.5% | 1.3% | 1.3% |

Source: Derived by ACCC from responses provided by seven insurers.

The table shows that, generally, all states and territories experienced a decreasing trend in the frequency of claims reported within the same year as incident. However, the progression of this trend differed between jurisdictions:

- The frequency in NSW showed a consistent downward trend, however, this was steeper than the national trend.[138]
- The frequency in Vic increased in 1999 and decreased in following years.
- The frequency in WA started from higher than national levels and decreased between 1998 and 1999 before increasing marginally in 2000. The frequency continued to decrease to 2002; however, it was still higher than that observed nationally.
- The frequency in the ACT decreased between 1998 and 2002; however this was not a consistent trend across the period with slight increases in the frequency occurring in 2000 and 2002.

### D.5.2 Average size of claims settled by jurisdiction

Chart 5.2 in section 5 sets out the average size of all claims settled each year in Australia between 1997 and 2002.

The ACCC also examined trends in the distribution of settlements costs across the states and territories. Based on the data provided by insurers, the ACCC considered the absolute numbers of settlements in some jurisdictions to be too low to enable it to construct meaningful trends in all states and territories. Reliable historical trend analysis was only possible for NSW, Vic, Qld, SA and WA.

Table D.2 shows the average size of all claims and those under $1 million settled in real terms for each jurisdiction. It also shows the average size of claims settled on a national basis which includes all states and territories.

[138] The number of claims reported within the same year as incident in NSW represented around 31 per cent of the national total, indicating that NSW may have been driving the national average.

## Table D.2 Average size of claims for all claims settled and all claims settled under $1m—real terms—national, NSW, Vic, Qld, SA and WA—public liability—1997 to 2002

**Average size of all claims settled in real terms—year ending 31 December**

| | National | NSW | VIC | QLD | SA | WA |
|---|---|---|---|---|---|---|
| **1997** | **10 237** | 11 434 | 11 934 | 8 234 | 9 315 | 6 782 |
| **1998** | **10 346** | 13 723 | 9 010 | 8 607 | 6 859 | 8 522 |
| **1999** | **12 186** | 16 706 | 10 312 | 10 935 | 7 515 | 9 230 |
| **2000** | **12 979** | 14 650 | 12 808 | 15 469 | 8 547 | 7 354 |
| **2001** | **12 256** | 16 954 | 10 685 | 9 788 | 9 644 | 8 065 |
| **2002** | **17 906** | 26 688 | 15 130 | 12 807 | 11 780 | 10 771 |
| **% change b/w 1997 and 2002** | **75%** | 133% | 27% | 56% | 26% | 59% |
| **Ave annual % change —1997 to 2002** | **13%** | 21% | 8% | 13% | 6% | 11% |

**Average size of all claims settled under $1 million in real terms—year ending 31 December**

| | National | NSW | VIC | QLD | SA | WA |
|---|---|---|---|---|---|---|
| **1997** | **9 340** | 11 017 | 9 516 | 7 239 | 9 315 | 6 782 |
| **1998** | **9 886** | 12 612 | 8 775 | 8 607 | 6 859 | 8 522 |
| **1999** | **10 628** | 14 637 | 8 909 | 8 955 | 7 515 | 8 032 |
| **2000** | **10 430** | 13 487 | 9 343 | 9 747 | 6 074 | 7 354 |
| **2001** | **11 433** | 14 993 | 10 169 | 9 788 | 8 948 | 8 065 |
| **2002** | **15 342** | 20 696 | 14 690 | 11 812 | 9 238 | 10 771 |
| **% change b/w 1997 and 2002** | **64%** | 88% | 54% | 63% | -1% | 59% |
| **Ave annual % change —1997 to 2002** | **11%** | 14% | 10% | 11% | 3% | 11% |

Source: Derived by ACCC from responses provided by seven insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

The table shows that:

- NSW and Vic were the only states that broadly showed trends similar to national trends
- Qld, SA and WA did not show any meaningful trends in the average size of claims settled.

## D.6 Detailed data analysis—professional indemnity insurance

This section presents more detailed information on several aspects of the ACCC's monitoring analysis contained in section 7.

### D.6.1 Claims frequency by jurisdiction

Table D.3 shows the frequency of claims reported within the same year as incident by jurisdiction.[139] Because of the small number of claims reported in SA, WA, Tasmania and the territories these jurisdictions have been excluded from the analysis. The national claims frequency in the table, however, includes data for all states and territories.

**Table D.3 Frequency of claims reported within the same year as incident by jurisdiction—national, NSW, Vic and Qld—professional indemnity insurance—1998 to 2002**

| | Claims frequency by jurisdiction | | | |
|---|---|---|---|---|
| | National | NSW | VIC | QLD |
| 1998 | 10% | 10% | 16% | 7% |
| 1999 | 10% | 9% | 11% | 8% |
| 2000 | 9% | 9% | 9% | 10% |
| 2001 | 8% | 9% | 9% | 7% |
| 2002 | 7% | 8% | 7% | 7% |

Source: Derived by ACCC from responses provided by five insurers

The table shows that generally NSW, Vic and Qld experienced a downward trend in the frequency of claims reported within the same year as incident over the period. However, the progression of this trend differed per state:

- The claims frequency in NSW showed a similar trend to the national trend.
- The claims frequency in Victoria showed a consistent downward trend, however, it decreased from higher levels than that observed nationally in 1998 and by 2002 showed the same level of frequency to the national trend.
- The claims frequency in Qld rose between 1998 and 2000, but decreased to 1998 levels in 2001. It remained stable in 2002.

### D.6.2 Average size of claims settled by jurisdiction

Chart 7.2 examined the average size of all claims settled in Australia between 1997 and 2002. The ACCC also examined state trends.

Based on the data provided by insurers, the ACCC considered the absolute numbers of settlements in some states to be too low to enable it to conduct reliable analysis in all states and territories. Reliable historical trend analysis is therefore only possible for NSW, Vic and Qld.

Table D.4 shows the average size of all claims and those settled under $1 million in real terms for these jurisdictions. It also shows the average size of claims settled on a national basis which includes all states and territories.

[139] It should be noted that table D.2 above is based on five insurers, while chart 7.1 is based on six insurers.

**Table D.4 Average size of claims for all claims settled and all claims settled under $1m—real terms—national, NSW, Vic and Qld—professional indemnity—1997 to 2002**

| Average size of claims settled in constant dollars—year ending 31 December | | | | |
|---|---|---|---|---|
| | **National** | **NSW** | **VIC** | **QLD** |
| **1997** | **$6,399** | $7,195 | $6,264 | $5,453 |
| **1998** | **$9,098** | $7,679 | $12,408 | $5,822 |
| **1999** | **$10,072** | $15,197 | $7,668 | $7,253 |
| **2000** | **$12,501** | $16,602 | $12,551 | $10,526 |
| **2001** | **$12,395** | $17,355 | $15,253 | $6,275 |
| **2002** | **$18,885** | $22,372 | $24,593 | $8,914 |
| **% change b/w 1997 and 2002** | 195% | 211% | 293% | 63% |
| **Ave annual % change —1997 to 2002** | 26% | 29% | 41% | 16% |

| Average size of claims settled under $1 million in constant dollars—year ending 31 December | | | | |
|---|---|---|---|---|
| | **National** | **NSW** | **VIC** | **QLD** |
| **1997** | **$5,347** | $7,195 | $4,611 | $5,453 |
| **1998** | **$6,180** | $6,449 | $6,411 | $5,822 |
| **1999** | **$8,331** | $11,016 | $7,668 | $7,253 |
| **2000** | **$8,778** | $9,422 | $8,754 | $10,526 |
| **2001** | **$8,896** | $11,009 | $10,413 | $6,275 |
| **2002** | **$10,987** | $11,709 | $13,837 | $8,914 |
| **% change b/w 1997 and 2002** | 105% | 63% | 200% | 63% |
| **Ave annual % change —1997 to 2002** | 16% | 14% | 25% | 16% |

Source: Derived by ACCC from responses provided by six insurers.
Data is shown in real terms adjusted to 31 December 2002 values using the AWE index.

The table shows that the average size of all claims settled in NSW and Vic appear to be driving the average size of claims on a national basis.

# E Factors that determine an insurer's financial performance

## E.1 Financial performance

The overall financial performance of an insurer depends on several factors including underwriting performance, investment returns and general expenses.

Underwriting performance, which the Commission assessed,[140] measures the amount of premium revenue compared to the sum of all related costs, that is past and expected claims costs, brokerage and underwriting expenses, net of reinsurance expenses and returns. Insurers can incur underwriting losses or profits depending on how ultimate claim costs and expenses compare to those estimated when the premium was collected—obviously, the longer the gap between writing premium and settling claims, the large will be the uncertainty regarding underwriting performance.

However, it should be noted that underwriting performance can be measured in a number of ways, for example:

- on an accounting or financial reporting year basis, whereby all costs incurred in a year (including changes in estimates of outstanding claims for prior years, and claim payments made in that year) are compared to premium revenue in that year; or
- on an underwriting year basis, whereby cumulated past claim payments and estimated future payment and expenses relating to policies written in each year, are compared to the premium written in that year; or
- on an incident year basis, whereby cumulated past claim payments and estimated future payments and expenses relating to incidents that occurred in each year, are compared to premium earned in that year.

A further complication in assessing underwriting performance is that premiums collected are invested to earn returns for the insurer prior to that money being needed to pay claims. Assessment of underwriting performance usually allows for the expected return on invested technical provisions by discounting future claim payments. Before discounting, future claim payments are usually inflated to the amounts expected to be paid in future years. In the ACCC's analysis, claims costs have been expressed in current values, without allowing for future inflation or discounting—this removes the distorting effect of different inflation or discount rates between insurers or over time.

As well as underwriting performance, the financial performance of an insurer will depend on actual investment returns compared to those expected on technical provisions, plus returns on capital/shareholder funds. Actual expenses will also influence financial performance.

[140] The ACCC's monitoring role for this report related specifically to monitoring the impact of reforms on costs and premiums in public liability and professional indemnity insurance. The ACCC therefore considered financial performance in terms of 'underwriting performance' only.

## E.2 The need for capital

Insurers hold capital to cover the risk that actual future claims costs and expenses arising from their insurance operations will differ from those expected when premiums were collected. This capital increases the chance that there will be sufficient funds available to meet policyholder obligations. APRA specifies a Minimum Capital Requirement (MCR) which insurers must meet. However, insurers typically hold capital above the MCR requirement. The higher the capital the greater the probability that there will be sufficient funds to pay all claims. If premiums turn out to be insufficient to pay claims, capital will need to be drawn upon by the insurer to meet such costs.

In return for putting their capital 'at risk', insurers expect to earn a return on that capital (the profit margin).

# F The insurance cycle

This appendix discusses the possible causes of the insurance cycle and the extent to which insurers are able to learn from the cycle in attempting to set accurate premiums.

## F.1 Background

The Trowbridge and Senate Committee reports noted that movements in the insurance cycle were also a contributing factor to recent increases in premiums. The Trowbridge report, for example, noted that:

> Insurance markets are renowned for their cyclical nature, with extended periods (say three to five years) of stable or reducing premium rates, followed by a shorter period (usually two or three years) of rapidly increasing premiums. (Trowbridge Consulting, March 2002, p. 4)

The Senate Committee report noted that:

> The insurance business is by nature cyclical. During a 'soft' market capital flows into the market. Insurers compete on price to gain market share, even at the expense of profitability…This is the case with the commercial classes on insurance, including public liability and professional indemnity. (October 2002, p. 31)

*The insurance cycle is likely to operate in the following manner:*

- *'soft' markets-at this stage of the cycle, insurers have access to relatively large volumes of capital at cheap rates. The insurer seeks to increase the number of policies it underwrites even at the expense of profitability. There is a degree of price competition among insurers. Under these conditions, insurance is considered a 'buyers' market'. As prices move down and the volume of policies increases, insurers are likely to incur significant financial losses in underwriting such policies.*
- *'hard' markets-at this stage of the cycle, conditions are usually described as a 'sellers' market' in which insurers now seek improved profitability and a move away from the underwriting losses that were incurred during the soft market. Capital is also withdrawn from the market and insurers may adjust their risk selection process. As a result, premiums payable for some activities and/or industries rise. Additionally, there may be temporary shortages in supply of insurance. However, rising profits are likely to attract new entry into the market. This will tend to put downward pressure on premiums and improve availability; the market will begin to 'soften' again.*

The Trowbridge March 2002 report noted that the public liability insurance industry in Australia was generally considered to be in the 'soft' market stage during the mid 1990s and to be 'hardening' in the late 1990s:[141]

> During the mid to late 1990s public liability was very competitive and premium rates reduced steadily. By about 1998, insurers were recognising losses from public liability … by June 2000 the market cycle had bottomed and rates began to rise. (Trowbridge, March 2002, p.10)

The Senate Economics Reference Committee further noted in its October 2002 report that:

> Globally, most classes of insurance have been hardening over the last two years, but in Australia the position was exacerbated by the collapse of HIH in March 2001. HIH, a major player in public liability and professional indemnity insurance, has been a driver of price competition, and removal of HIH allows remaining insurers more easily to increase prices. However, the market was hardening even before the collapse of HIH. (October 2002, p. 32)

[141] An overview of the cyclical nature of the insurance cycle was presented in the March 2002 Trowbridge report (see p.9).

## F.2 Possible causes of the insurance cycle

It is useful to consider from an economic perspective, the extent to which insurers are able to learn from past experience over previous cycles to 'smooth out' the severity of financial losses that are incurred in a soft market and the subsequent recoupment of these losses through excessive profit taking in a hard market.

A study by Lamm-Tennant & Weiss examined some explanations put forward by other academic authors about the behaviour of insurers in the context of the insurance cycle. The study noted that there were two broad schools of economic thought.[142]

- The first is founded on the premise that insurance markets operate irrationally and/or are characterised by market imperfections. Irrational behaviour in the form of erroneous estimates—whether deliberate or naïve—about claims losses or future investment income under this argument is highlighted as a considerable destabilising force. Irrational behaviour of this kind is especially problematic in the liability classes of insurance, as these are typically long-tailed, and therefore predictions of losses and future investment income impact relatively more heavily on the underwriting results of insurers over time. Market imperfections in the form of impediments to capital flows also contribute to the cycle under this school of thought and it is argued lead to prolonged lag periods of excess and inadequate capital supply, thereby exacerbating the cyclical nature of underwriting.
- The second school of thought is centred on the belief that insurance markets are in fact characterised by rational, rather than irrational, behaviour, as well as institutional intervention. This school suggests that the insurance market cycles are caused by external events and market characteristics outside the direct control of insurers. Exogenous shocks such as catastrophes, unexpected changes in claims costs or loss distributions over time, changes in the regulatory framework, and uncertainties about the general market environment, all prompt reactionary behaviour by market participants. This school argues that market participants respond to the pricing information available to them in ways which are rational, but the considerable time lags associated with many aspects of long-tail insurance markets will cause premiums and profits to move in cycles which appear irrational.[143] These lags are primarily those associated with:
    - data collection—the delay in collecting data for any relevant financial period means that in general this data cannot be used for setting the next period's premiums
    - policy renewal—premiums cover set time periods—as information becomes available indicating the need for premium changes, these cannot be effectively implemented until policies come due for renewal.

The existence of such lags in the second school of thought contributes towards the outcome that rationally acting insurers create irrational cycles in the market. This latter argument would appear broadly consistent with that put forward by Trowbridge which noted that:

> Premiums are established by insurers with the intention of making a profit, but premiums must be set before the cost of the product (particular the claims cost) is known. This need to set the price without knowing the cost of the product make the insurance business unusual; it introduces the potential for an insurer to unwittingly take business at a loss and is one reason for the market cycles. (March 2002, p. 29)

[142] Lamm-Tennant, J & Weiss, M, 1997, p.416.

[143] ibid, p. 418.

The Senate Committee report also noted that:

> The 'long tail nature of liability insurance exacerbates the cycle because it increases the risk of insurers under- or over-estimating the premiums needed to reach a target profit level…Insurers, in effect, must sell their product some years before they know how much the product will ultimately cost them. Today's prices must make provision for future costs. (October 2002, p. 32)

## F.3 Understanding the cycle

Although there appears to be a general acceptance that the insurance cycle exists, the ACCC's March 2002 pricing review noted that limited research is available to verify the existence or nature of cycles in Australian classes of general insurance.[144]

Given that the insurance cycle is considered to be a cause of recent premium increases, it follows that a better understanding of the insurance cycle by insurers is likely to lead to more accurate premiums. The ability of insurers to understand the insurance cycle depends on their ability to accurately predict claims costs. It is generally regarded that, currently, the ability of insurers to accurately predict claims costs is constrained by a lack of reliable claims data. Trowbridge noted that:

> Overall, it seems fair to conclude that the insurance industry in Australia has done a poor job in collecting and analysing data for public liability. This begins at the individual policy level, and flows through to the portfolio analysis where insurers have traditionally:
>
> - not sought detailed information on the classification of risk or the quantification of exposure for each policy
> - not coded and stored accurately on computer systems the information they do obtain
> - not analysed and used the information they do have to assist in premium setting (although changes have/are occurring in this regard in recent years
> - not had a comprehensive industry-wide system to make relevant information available across the industry (noting that many insurers have elected not to join the ISA) (March 2002, p. 40)

Similar concerns were also raised by the Institute of Actuaries in its submission to the March 2002 Public Liability Forum, commenting that:

> Because there is insufficient data, it is difficult for insurers and their actuaries to set appropriate rates for individual risks, and to set aside appropriate claim reserves. This has been a major contributor to recent inadequate premium rates, and increased the level of risk capital required to support public liability underwriting. It also makes it very difficult to reliably estimate the effect of any proposed changes in the Tort system. (March 2002, p. 14)

The Trowbridge report noted many insurers have realised that they need to take a more scientific approach to public liability and are very reluctant to enter some segments of the market because they have no data on which to base premium rates.[145]

APRA and the Insurance Statistics of Australia (ISA) collect some general industry information but this has been either inadequate or unreliable. APRA publishes selected statistics on the general insurance industry on its website as a by-product of its regulatory role in general insurance. The data has the following limitations:

- the data collected by APRA is based on an insurer's financial reporting date which differs across the industry. For example, insurer A may report to APRA on a financial year ending 30 June 2002 while insurer B may report on a calendar year ending 31 December 2002. APRA however, classes both these reporting dates as 2002 even though they are not directly comparable reporting periods.

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144 ACCC, *Insurance industry market pricing review*, March 2002, p. 37.

145 Trowbridge Consulting, *Public Liability Insurance, analysis for meeting of ministers on 27 March 2002*, 26 March 2002, p. 40.

- APRA bundles public liability insurance with product liability insurance meaning that it is not possible to determine trends in either class on an individual basis.
- Claims data for public liability is considered to be unreliable.

APRA's submission to the Senate Committee Inquiry noted that:

> We would note that there are presently some serious data gaps in the publicly available information on premium trends, which we understand the Insurance Council of Australia is addressing. We would certainly caution against drawing conclusions from APRA's own public liability and professional indemnity data over the past year or so (or any other short-term period) because of the inevitable attendant statistical quirks. (October 2002, p. 3)

The ISA is a private non-profit company that manages insurance data on behalf of the ICA and its insurer members. This system is an attempt to improve the quality and amount of data that exists on the insurance industry, although it is also subject to limitations:

- the data is provided by insurer members, and the membership makeup regularly changes meaning that historically the results may not be comparable. If the membership in one year is specifically geared towards domestic lines[146] of insurance, but the following year the membership shifts more towards commercial lines[147] then this will bias some of the statistics.
- not all insurers are members and therefore the statistics gathered may not be representative of the whole industry.[148]

The ACCC notes that ministers agreed at the 30 May 2002 ministerial meeting that the lack of comprehensive data on claims significantly constrained the appropriate pricing of premiums by the insurance industry and the Commonwealth would use the *Financial Sector (Collection of Data) Act* 2001 to require all authorised insurers operating in Australia to submit public liability claims data to APRA for analysis and publication.

## F.4 Expectations about current movements in the cycle

Given the lack of reliable information at the moment, it is not surprising that few public reports have attempted to predict how long these perceived hard market conditions may be expected to last. However, the JP Morgan general insurance industry survey indicated that:

> Survey respondents have confirmed the existence of a cycle and has also given an indication of its expected duration … The overwhelming majority believed that the cycle would last for a minimum of 18 months, and on average would last for another 2-3 years…The industry is in agreement with us, firstly by forecasting a continuation of increased premium rates and secondly by their views on the duration of the insurance cycle … We believe the high returns generated by these businesses in 2004 will attract new capital and thus the increased competition represents the turning point of the cycle. (December 2002. p. 6, 8)

The earlier discussion of the insurance cycle indicated that insurers may adjust their risk selection processes as the conditions in the insurance market are said to 'soften' and 'harden'. This suggests that the level and type of risk that the insurer is willing to bear as a result of it issuing a policy may change according to changes in conditions associated with the insurance cycle and this is likely to influence premiums.

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146 Domestic lines refers to insurance for individuals an families, for example motor vehicle, personal property and home and contents insurance.

147 Commercial lines refers to insurance for businesses, professionals, and commercial establishments, for example, commercial motor fleet, construction, theft and liability policies.

148 The October 2002 Senate Economics References Committee noted in evidence from the ICA that it promotes the collection of data from everyone in the industry through the work of the ISA. The ICA noted that collection of information, however is voluntary and represents around 22 per cent of the market (see Committee report p.78).

# G Insurance buying/pooling arrangements

This appendix provides information obtained by the ACCC from insurers included in its monitoring program for marketing of insurance buying/pooling arrangements.

## G.1 Background

In addition to pursuing tort law reform, ministers agreed on 27 March 2002 that state governments would encourage group buying arrangements where appropriate. Therefore, as part of its monitoring program, the ACCC also asked insurers questions relating to group buying/insurance pooling arrangements.[149]

A group buying arrangement is where members of an industry, profession or other group or association combine to buy more favourable insurance terms and conditions. For insurers, this group of like risks enables better understanding of the nature of the risk and improved ability to predict claims costs and hence set premiums. In addition, savings in administration costs may also be achieved.

An insurance pooling arrangement is where members of an industry, professional or other group or association combine to pool funds to retain a higher level of risk within the pool and insure excessive risk with an underwriter.

The ACCC asked questions about whether or not insurers underwrote group buying/ insurance pooling arrangements as at 31 December 2002 and whether such arrangements would be marketed in the next 12 months.

Of the insurers that responded to this part of the questionnaire, none participated in insurance pooling arrangements as at 31 December 2002. Therefore, the remainder of this section summarises insurers' responses about group buying arrangements.

## G.2 Group buying arrangements—public liability insurance

Three of the nine insurers offered insurance to insureds that participated in particular group buying arrangements. The market sectors covered were different across the three insurers, with the market sectors including not-for- profit organisations, tourism and leisure industries, community care organisations, couriers, taxis and the trucking industry. The availability of these schemes varied across states and territories.

The extent to which recent government reforms influenced insurers' decisions to market these schemes differed according to each insurer, with one indicating that government reforms had directly influenced its decision as it considered the reforms in a particular state to be effective. Another insurer indicated it had marketed a particular scheme at the request of a particular state government. The remaining insurer indicated the government reforms had no impact on its decision to market these schemes.

Comments from several insurers that did not participate in these schemes as at 31 December 2002 indicated that they had no plans to market insurance to group buying arrangements in the next 12 months.

[149] An evaluation of insurance schemes that aggregate buyers and aggregate sellers was presented in the ACCC's September 2002 Pricing Review (see pages 91–95).

## G.3 Group buying arrangements—professional indemnity insurance

Three of the seven insurers offered insurance to insureds that participated in particular group buying arrangements. The market sectors covered by most of the insurers were similar and included architects, churches, computer consultants, councils, dentists, draft persons, engineers, financial advisors, not-for-profit organisations, physiotherapists, radiographers and travel agents. The insurers indicated that recent government reforms had not influenced their decisions to market these schemes.

Comments from several insurers that did not participate in these schemes as at 31 December 2002 indicated that they had no plans to market insurance to group buying arrangements in the next 12 months.