



# INSURANCE SUMMIT 2002

Speech for  
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### Introduction

It is a pleasure to be able to address you today. This conference is both timely and topical given the continuing high level of public debate centred on the insurance industry.

Over the last year there has been intense media focus resulting from public dissatisfaction over what some see as excessive increases in premiums, and limited availability of cover in relation to both public liability and professional indemnity insurance.

From small business, to community groups, local governments and the professions, many sectors of the community have been affected by escalating insurance premiums and, in some cases, have been unable to find cover. Many sectors appear to be especially frustrated because premium rises appear to be indiscriminate – taking little or no account of claims history.

Over the past twelve months, the Commission has received numerous complaints from the community about the size of premium increases. For example, two Victorian tourism operators indicated that they faced premium rises in the order of 980 per cent for this year. On average, Victorian tourism operators were faced with increases of 240 per cent in their public liability premiums for 2002-2003. Contract operators in rural areas claim to have faced premium rises in the order of 400 per cent to renew their public liability cover this year.

These and similar experiences have gained prominent, almost daily media attention. It is not surprising then, that there is a common perception that the insurance industry is in crisis. Having said this however, perspectives on the causes of, and extent of, the perceived crisis vary dramatically. There are also many and varied opinions on the most appropriate solutions to the current crisis.

I propose to use the time available to me today to:

- ? Outline the Commission's role in relation to the insurance industry;
- ? Comment a little on the insurance crisis and the possible responses;
- ? Summarise the Commission's findings in its March and September 2002 reports on insurance pricing – including our findings in relation to market conditions; and
- ? Outline the future role which the Government has set the Commission, in relation to insurance pricing.

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### The Commission's Role

Some of you may already be familiar with the role of the Australian Competition and Consumer Commission.

Its primary role is the enforcement of the *Trade Practices Act* across all sectors of Australian business – including the insurance sector. Within this context, the Commission has a variety of functions, ranging from enforcing the anti-competitive provisions of Part IV of the Act, to consumer protection under Part V. The main purpose of the *Trade Practices Act* is to promote competition and efficiency in markets and to protect consumers from unlawful anti-competitive conduct and unlawful market practices. Section 2 of the Act says that its object is to “*enhance the welfare of Australians*”.

Under the *Trade Practices Act*, two areas of Commission activity which are particularly relevant to recent developments in the insurance industry are:

- ? mergers and acquisitions; and
- ? authorisations (adjudications).

Under section 50 of the Act, the Commission can take court action to prevent mergers and acquisitions which may result in a substantial lessening of competition in an industry. It has been widely reported that the Commission is currently considering IAG's acquisition of Aviva's Australian insurance assets, CGU. The Commission has concluded its market inquiries and the submissions are currently being analysed. While there does not immediately appear to be worrying concentration of market share in the public liability and professional indemnity insurance sectors, concerns have been raised elsewhere.

This issue is being examined as I speak and the Commission expects to announce its decision shortly.

The authorisation provisions allow the Commission to authorise anti-competitive conduct in circumstances where it can be demonstrated that the likely public benefit from the proposed conduct will outweigh the anti-competitive detriment. The onus is on the applicant to satisfy the Commission that the public benefit test is satisfied.

The Commission is currently considering an application lodged by Allianz Australia, QBE Insurance and NRMA Insurance seeking authorisation of a co-insurance (or pooled selling) arrangement. The applicants have submitted that the co-insurance arrangement will provide non-profit organisations with improved access to public liability insurance. While the applicants have sought authorisation to enable the co-insurance product to be offered on a national basis, the applicants propose to initially only offer the co-insurance product to non-profit organisations that offer services predominantly in New South Wales. The applicants' stated reason for this is the

positive effect that the process of law reform being pursued by the NSW government is expected to have on claims.

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Again, the Commission expects to announce its decision in relation to the applicants' request for interim authorisation shortly.

Besides its powers under the *Trade Practices Act*, the Commission also has a role in relation to prices surveillance. This role can take two major forms, first it may be a formal declaration under the *Prices Surveillance Act*, or alternatively, it may be a price monitoring role. The *Prices Surveillance Act* enables the Commission, 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. Alternatively, the Treasurer can direct the Commission to monitor prices for a specific purpose.

There has been no declaration of insurance pricing under the *Prices Surveillance Act*. Instead, the Federal Government has asked the Commission to examine the impact of various law reforms on public liability and professional indemnity insurance premiums over the course of the next two years. This is a new and challenging task for the Commission, which I intend to discuss in more detail later in my presentation.

The Commission has also been asked by the Federal Government to take on a second monitoring role in relation to insurance, this time in relation to medical indemnity insurance. On 23 October 2002, the Prime Minister announced that the Commission would monitor medical indemnity insurance premiums to assess whether they are "*actuarially and commercially justified*". This Commission is currently developing its methodology and approach in relation to this work.

With respect to general insurance, the Commission has previously provided the Government with two reports on the insurance industry. The first report, the Insurance Industry Market Pricing Review – was released by the Commission in March of this year. At the Government's request, the Commission updated this Review in September.

In these Reviews, the Commission presented an assessment of the recent and ongoing performance of the general insurance industry by class of insurance, and noted some of the key drivers behind the current perceived crisis. The September Review also provided some preliminary views on some aspects of reforms currently being undertaken around Australia. This work is quite separate to our ongoing monitoring role. Again, I will speak about these Pricing Reviews in more detail later.

### **The Australian insurance crisis**

It has often been said lately, that liability insurance in Australia is in crisis. The insurance crisis is blamed for everything from the death of fun – to the death of Santa.

However, the extent of the crisis is, to my mind, unclear. On the one hand, liability losses are said to have "soared" to a disastrous \$500 million. On the other hand:

- ? the Commission's pricing review reports a positive outlook for the industry – with only professional indemnity; product & public liability; and travel insurance regarded as having a "low" profit outlook (where "low" is -5% to 10%); and

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? insurers themselves point to outstanding results. For example, in the half year to 30 June 2002, QBE reported record cash-flow and “a record insurance profit (before tax) up 27% to \$160,000,000”.<sup>1</sup>

So what is really happening? Whatever is happening, governments at both the State and Federal levels propose to respond with a series of law reforms intended to address the crisis. The proposed reforms are far-reaching. What is the nature of this crisis? What are its causes? What response is appropriate?

### *Historical Changes in Premiums and Costs*

I have sourced the following charts the Trowbridge Report to the Ministerial Meeting on 30 May 2002.

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<sup>1</sup> “*QBE Insurance Group Limited Results and Outlook for the Half Year Ended 30 June 2002*”  
28 August 2002.

Chart 1

Number and size of claims - Bodily injury and property damage liability claims - All Australia - 1993 to 2001

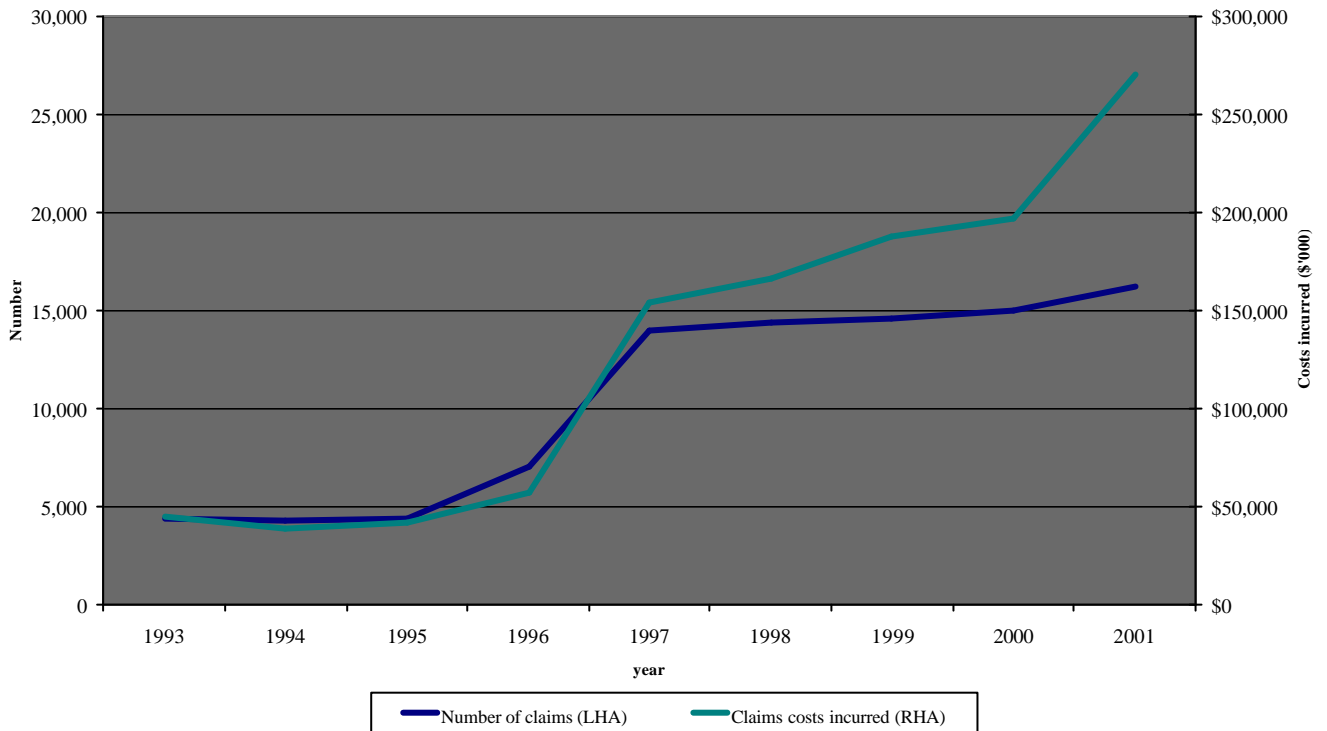


Chart 1 shows increasing numbers of claims, and increasing size of claims from 1995 onwards for combined bodily injury and property damage claims. While the number of claims appears to have levelled out recently, the cost of these claims is still steadily increasing.

## Chart 2

Average claims cost - Bodily injury liability claims and property damage liability claims - All Australia - 1993 to 2001

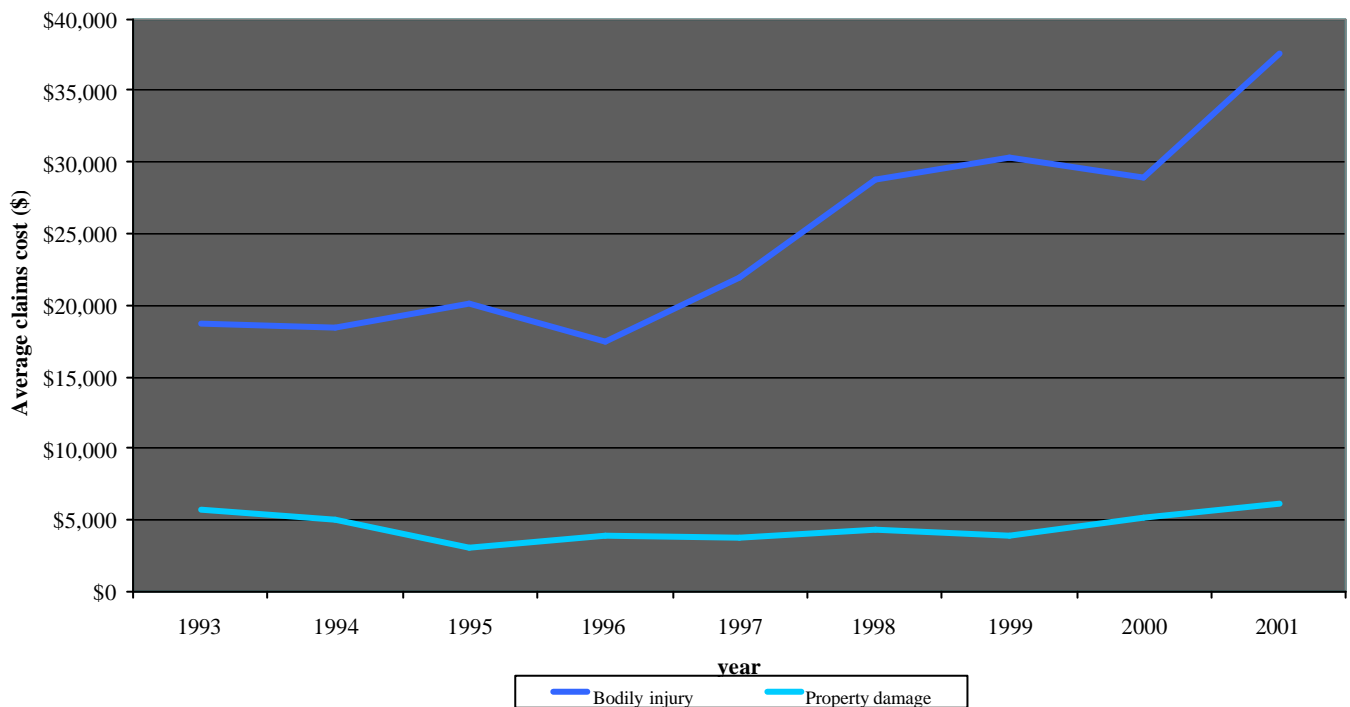


Chart 2 shows the average claim sizes for bodily injury, and property damage into two distinct trends. This shows us that the size of property damage claims has remained largely unchanged, and that the substantial increases in bodily injury claim sizes have been driving recent increases in overall claims costs.

Chart 3

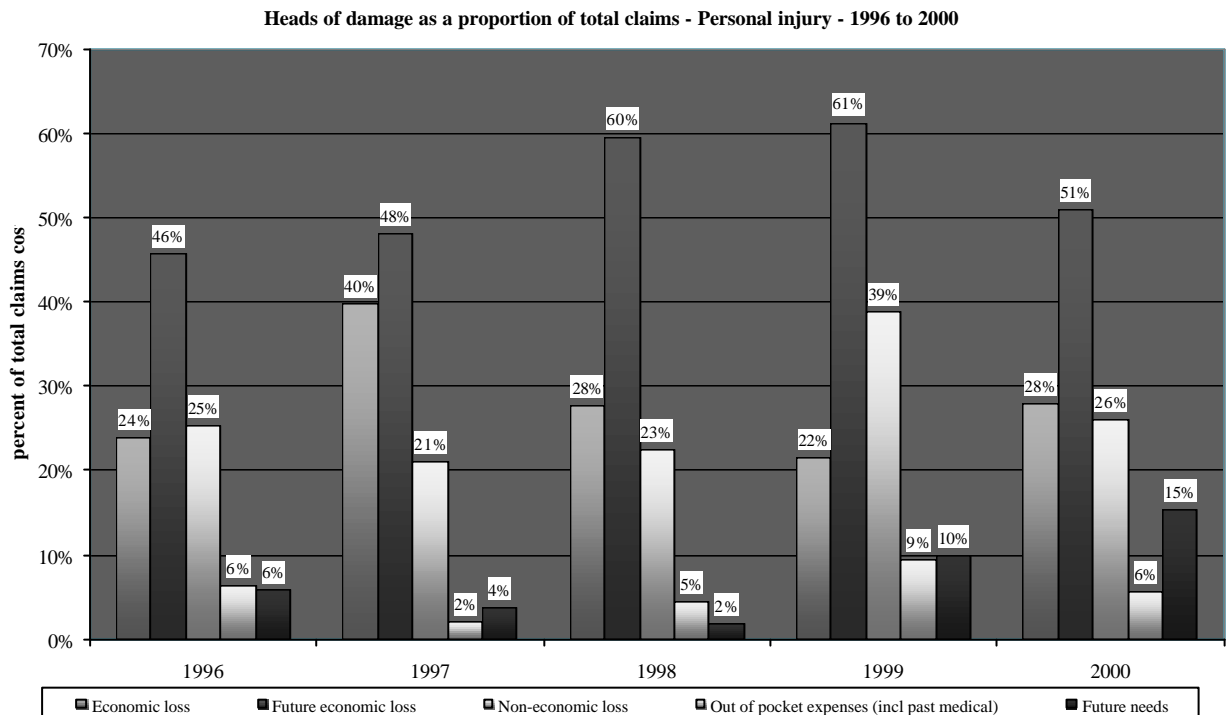


Chart 3 breaks down personal injury claims into the various heads of damage in order to assess the drivers behind recent increases in claims costs. As this chart shows, proportions of each head of damage have remained roughly the same, with two exceptions. “Future economic loss” and “future needs” appear to be trending upwards in importance in claim pay-outs.

This observation raises some initial doubts about the view that ‘court generosity’ is a key driver in the increase in claims. It is arguable that future economic loss payments are less discretionary than other damages components, such as non-economic loss payments (ie pain and suffering) and less closely linked to “generosity.

Views vary considerably when it comes to naming the alleged drivers behind the current insurance crisis in Australia. The insurance industry tends to focus on external factors such as the litigiousness of society, legal practices and global events. Lawyers, perhaps not surprisingly, disagree and focus more attention on the insurance industry’s own conduct.

Are the crisis and the reform program proposed as a solution unique to Australia? Although it may be small consolation, it is instructive to note other countries have experienced or are currently experiencing similar problems in insurance. It may be instructive to examine the way they have addressed their crises.

? In the USA, there has been no Federal tort reform response to the liability insurance crisis of the 1980’s. There was some State law reform but it was by no means “uniform” in approach or extent. The single most important state reform (in terms of impact on verdicts) has been the abolition of punitive damages in some



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jurisdictions. But some other measures, similar to measures now proposed in Australia such as:

- capping of awards for non-economic damages;
- the abolition or limitation of joint and several liability; and
- waivers for inherent risk;

were also taken. Despite these reforms, premium levels, especially from medical malpractice, are currently at a perceived crisis point in the US. *The Florida Times-Union* on 18 March 2001 reported that the average premium for nursing homes rose by 109% from 1999 to 2000, and for one home, have risen from \$37,000 to \$1.5 million from 1993 to 2001.

Premiums for liability insurance for medical malpractice have increased markedly in the last few years, especially for specialists. *American Medical News* reported on 3 December 2001 that the average premium paid by orthopaedic surgeons in Philadelphia two years prior was \$65,000 US – by 2001, it had doubled to an average of \$130,000.

As in Australia, there is disagreement as to the cause of increasing premiums. Some of the identified factors, such as low investment returns and underpricing, have also been suggested as causes of the Australian situation.

- ? Canada also experienced a public liability insurance crisis during the 1980s. Canadian jurisdictions did not pursue comprehensive tort law reform in response. The only major change appears to have been the introduction of contractual waivers.

The Supreme Court of Canada had already capped damages awards for non-economic loss. This cap, adjusted for inflation, now equates to approximately \$270,000 (CA). Converted into Australian dollars at the current exchange rate, this would be equivalent to a cap of around \$315,000 for non-economic loss.

One Canadian response of interest is the move that took place towards pooled buying arrangements—especially for municipal authorities. This type of response has also been suggested for Australian organisations.

Otherwise, the crisis appears to have passed.

- ? The UK is currently experiencing a crisis displaying very similar characteristics to that faced in Australia.

A study published by the International Underwriters Association in 1999 entitled the *Second Bodily Injury Study*, gives some insight into claim trends in the UK over the last 15 years, showing that they have been steadily increasing.

Notable changes to the law in recent years include the Woolf Reforms introduced in April 1999. These reforms were designed to improve the handling cases and stem what was seen to be a rising culture of litigation.

Notwithstanding these procedural reforms, however, the Daily Telegraph reports that public liability premiums for some organisations have been rising by up to 600%, and on average have risen by between 300% and 450%. Rates for professional indemnity had also risen by around 50% on average.

The Association of British Insurers (ABI) has said that rates have risen for all liability products due to underpricing in recent years.

It is unclear whether the British Government will respond to the UK crisis with comprehensive tort law reform. My own dealings with the Office of Fair Trading there lead me to think that such law reform is unlikely. Moreover, the treasury has made it clear that there should be clear evidence of market failure before the Government will intervene

Given the nature of the Australian crisis, governments have been under enormous pressure to find a fix. Two key issues requiring urgent political attention have been the price and availability of cover, for both public liability and professional indemnity.

Those organisations most vulnerable appear to be not-for-profit groups, community groups, adventure tourism operators and other special interest or high risk categories. However, many professional groups also say they are suffering and that the services they provide are in jeopardy as a result. If these groups perform vital services to the community and require insurance to provide those services, assistance of some form may be necessary.

The decision facing governments in the current crisis is not whether to act, but in which way to act. Four Ministerial Meetings have been held in order to attempt to arrive at a nationally consistent approach to reform to address the perceived crisis. These meetings have called for and considered a number of reports on the current insurance situation.

In the lead up to the first two Ministerial Meetings, Trowbridge Consulting was engaged to prepare two major reports. The first, for the Ministerial Meeting held on 27 March 2002, analysed the depth and extent of the current crisis, its drivers and general market performance. The second, for the Ministerial Meeting on 30 May 2002, canvassed a number of proposals for reform.

As a result of continued concern at all levels of government, a number of reviews have been commissioned by the Government to assist policymakers with reform. Notable examples include the Review of the Law of Negligence chaired by Justice Ipp (the "Negligence Review") and the Commission's March and September 2002 Pricing Reviews. As I flagged earlier, the Senate Economic References Committee conducted an inquiry into public liability and professional indemnity insurance earlier this year.

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### Reviews

I would like to begin with a number of observations in relation to the Negligence Review.

Underpinning this Review was an assumption that awards of damages for personal injury had become unsustainable and unaffordable. I think it is fair to say that the focus of the Review was on ways in which such damages awards could be reduced.

Awards of damages for personal injury are currently available under or by reason of the *Trade Practices Act*, for example:

- ? The Act implies a statutory warranty into service contracts that the service provided will be provided with due skill and care. If the services are not provided with due skill and care, and you are injured as a result, you are entitled to sue for damages. The Act also provides that this warranty cannot be excluded.
- ? The Act also prohibits misleading or deceptive conduct. If, as a result of misleading or deceptive conduct, you are injured, you are entitled to sue for damages.

Because of the availability of such damages, one issue the Negligence Review considered was whether the Act should be amended to reduce or eliminate such rights, either:

- ? by allowing people to waive the implied warranty of due care and skill;
- ? by reducing the damages that people could claim, for personal injury; or
- ? by abolishing the right to sue to personal injury damages resulting from a breach of the Act.

I will return to the proposals for reform coming out of the review in more detail later. At this stage, it suffices to say that the Commission is concerned about reforms that water down consumer rights and shift the risk of activities from the person best placed to judge and control those risks to the person most poorly placed to judge and control those risks.

The Commission made two submissions to the Negligence Review. The first submission was provided in August 2002; the second submission was presented in September. Its first submission dealt predominantly with the proposal to allow consumers to waive their right to “due care and skill” in the case of risky recreational services. But the second submission was far more broad-ranging, and recorded the Commission’s view on the “least harmful” of the reform options being considered. The Commission also noted that, there was no evidence that awards of personal injury damages under the *Trade Practices Act* have caused or contributed to the current insurance problems. The fact that the Act itself is not the cause of the current crisis is one reason for exercising caution with respect to any reform of the *Trade Practices Act*.

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### The Commission's Insurance Industry Market Pricing Reviews

I would now like to comment in some detail on the Commission's March and September Insurance Industry Market Pricing Reviews.

In its March 2002 Insurance Industry Market Pricing Review, the Commission examined a range of data provided by Australia Prudential Regulation Authority ("APRA") and sought information directly from a number of larger general insurers. The findings of the March Review were updated in the September Review.

Broadly, these Reviews assessed:

- ? Profitability – industry profitability was assessed by class of insurance;
- ? Class performance – the reviews covered the financial performance of all classes, and the September report examined the crisis areas of public liability and professional indemnity in greater detail;
- ? Cost drivers – the Commission outlined key cost drivers behind the current premium increases; and
- ? Options for reform – the September Review outlined some of the options for addressing the problems, including some considered views on reform proposals.

Both the March and September Reviews used the same methodology to arrive at measures of profitability. The Reviews were constructed with the assistance of Taylor Fry Consulting Actuaries.

The September 2002 Review found that while the insurance industry performed poorly for the 2001-02 financial year, the outlook for the industry is generally more positive than it was at the time of the March Review. Large and sustained increases in premiums over the past three years had returned most classes to profitability.

Table A shows the profitability updates contained in the September 2002 Review.

I should explain the terminology used.

“Very low” indicates that the return on capital invested may be at an unsuitable level suggesting intervention to either increase premiums (perhaps selectively) or exit from the market.

“Low” indicates that return on are in the range of -5 to +10 per cent. These returns generally do not provide a margin above returns on risk free investments to compensate for the risk involved in insurance.

“Moderate” indicates returns on capital are being achieved in the range of 10 per cent to 20 per cent. This is significantly higher than the industry has achieved overall over the last eight years.

“High” and “Very High” refers to returns on capital of 20 per cent to 50 per cent and in excess of 50 per cent respectively.

**Table A**

<b>Class of Business</b>	<b>Overall</b>	<b>Recent</b>	<b>Outlook</b>
Fire and Industrial Special Risks	Low	Low	High
Houseowners/Householders	Moderate	High	Moderate
CTP Motor Vehicle	Moderate	High	Very High
Commercial Motor Vehicle	Low	High	High
Domestic Motor Vehicle	Low	High	High
Marine and Aviation	High	High	Very High
Professional Indemnity	Low	Very Low	Low
Product and Public Liability	Very Low	Very Low	Low
Employers' Liability	Very Low	Moderate	Moderate
Mortgage	Very High	Very High	Very High
Consumer Credit	High	Very High	Very High
Travel	Very Low	Very Low	Low
Other Accident	Moderate	High	Moderate
Other	Low	Very Low	Unclear
Inward Treaty	Low	Moderate	Unclear
<b>Overall</b>	<b>Low</b>	<b>Moderate</b>	<b>Moderate/High</b>

This table contrasts with the March Review in that almost all classes of business, general insurance is generating returns equivalent to, or in excess, of ‘moderate’. Four classes are expected to experience ‘very high’ returns.

That being said, the September Review found that three sectors were still experiencing ‘very low returns’, namely travel, professional indemnity, and public and product liability insurance. These latter two classes are those most widely perceived to be in crisis, and therefore it is appropriate to examine the findings of the Commission’s Reviews in relation to these two areas in more detail.

### **Professional Indemnity**

The professional indemnity class of insurance is one of the smaller classes of insurance. It represents 3% of gross written premium, less than 1% of policies written, yet accounts for 7% of the total general insurance industry’s outstanding claims provision. The disproportionately large provision for professional indemnity reflects the high uncertainty of loss in this class, which is characterised by infrequent but potentially extremely large losses.

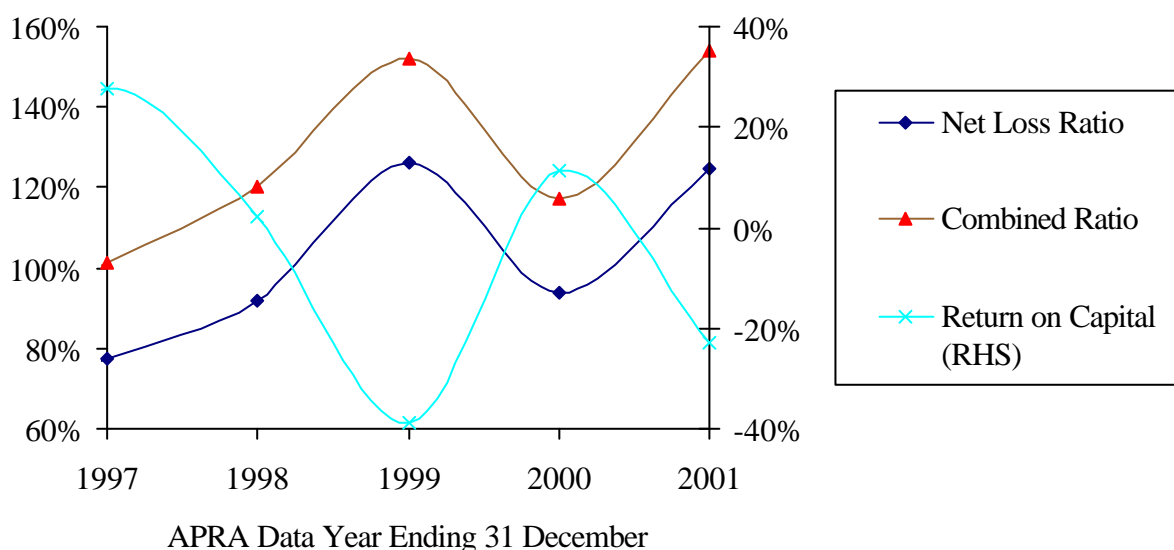
There are three aspects of the findings of the Commission’s Reviews in relation to this class which I will now cover in greater detail: profitability; policies and settlements; and competition.

## *Profitability*

As can be seen in Figure 1, loss ratios, while erratic, have generally been increasing. The spikes in the loss ratio again are caused by infrequent, but substantial losses on individual claims. The principle cause of the increase appears however to have been the increases in provisions for outstanding claims. The return on capital in this class has correspondingly been erratic, ranging from over 20% in 1997, to approximately -40% in 1999.

The Commission’s March 2002 review estimated that premiums may have to increase by around 20% to restore this class to ‘low’ profitability (-5% to 10%) – and given the average increase over 2001-02 was 24%, this class of insurance is expected to have returned to profit in 2002.

**Figure 1**



The potential for unprofitable years to occur as a result of the nature of claims in this class will not be diminished by a return to general profitability. The recent Senate Economics References Committee report reviewing public liability and professional indemnity, contained recommendations relating to the capping of liability of certain professionals. These reforms would limit the ability of plaintiffs to recover economic damages caused to them by the professions, and mirror existing legislation in NSW and WA.

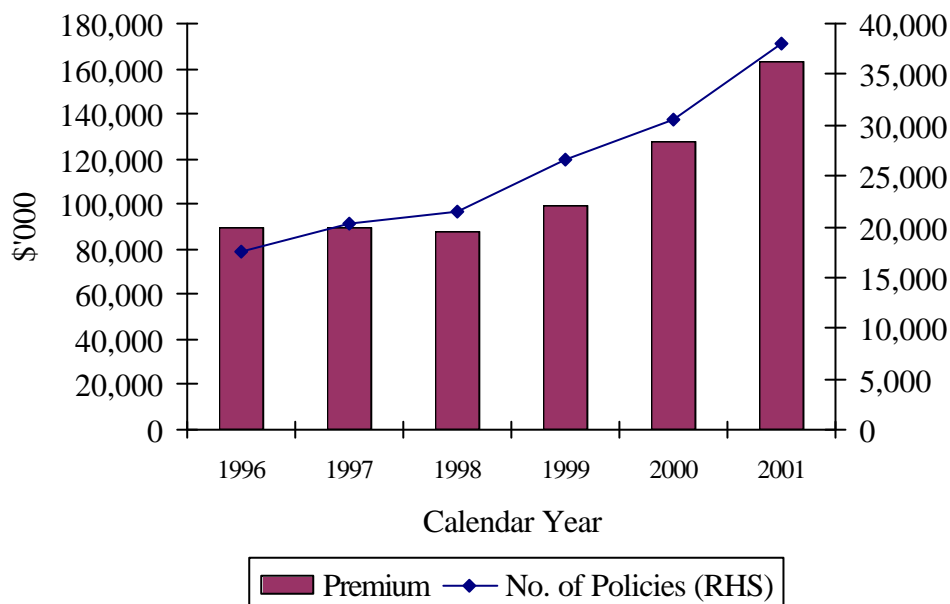
While these reforms would return some measure of predictability to claim payouts, and therefore loss ratios in this class, it is not clear why other measures – such as improved

data collection, and risk management are not more appropriate policy tools for addressing the problems of this class.

## *Policies and Settlements*

Ten of the insurers sampled by the Commission wrote in this class, representing 54% of the total written premium for 2001 as measured by APRA.

Figure 2 shows the number of policies written, and the premium collected by the selected insurers for the years 1996 to 2001.



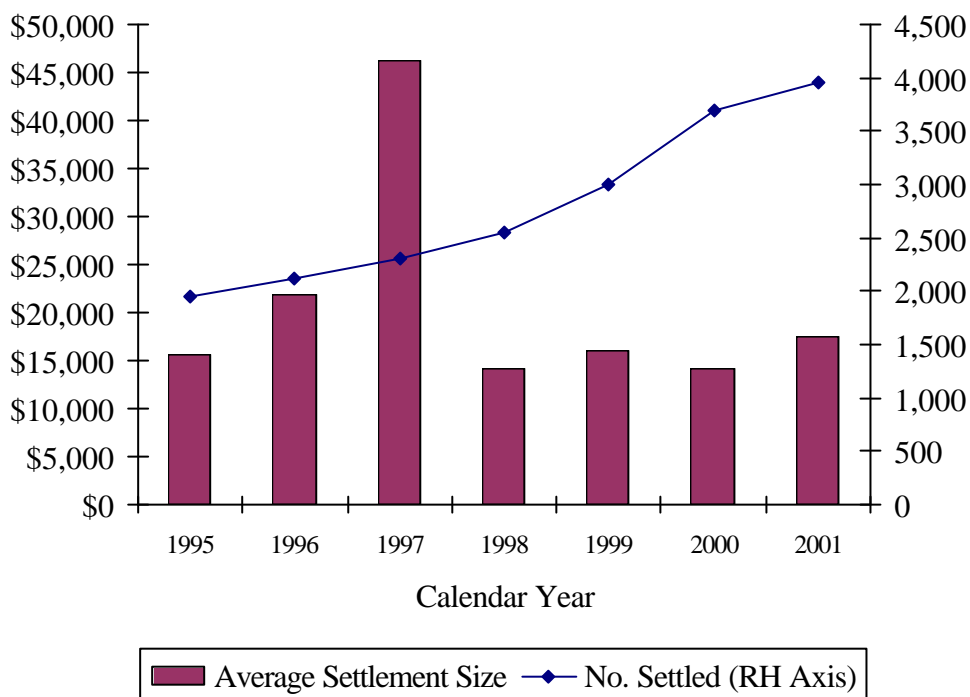
**Figure 2**

The number of policies written has grown steadily. A key driver of this has been the requirement by the public sector for consultancies to have adequate cover.

Premium increases have been quite significant in the last two years, and this trend is set to continue. The lack of premium increases through 1996 to 1999 contributed to the deterioration in the return on capital for this class during this period.

Figure 3 shows the settlement experience for the selected insurers in this class.

**Figure 3**



The number of settlements has steadily increased through this period, however the majority of this increase can largely be attributed to the increasing number of policies written in this class. With the notable exception of 1997, the average settlement size has remained reasonably constant.

Insurers have indicated a major driver for increasing premiums has been the substantial increases in outstanding claims provisions. This has been attributed to the uncertainty surrounding claim frequency and size, as well as an allowance for poor corporate performance in recent years.

Outstanding claims provisions rose nearly 30% in 2001 to \$1 billion, which drove the poor return on capital result shown earlier despite a return to reasonable profitability for 2001.

**Competition**

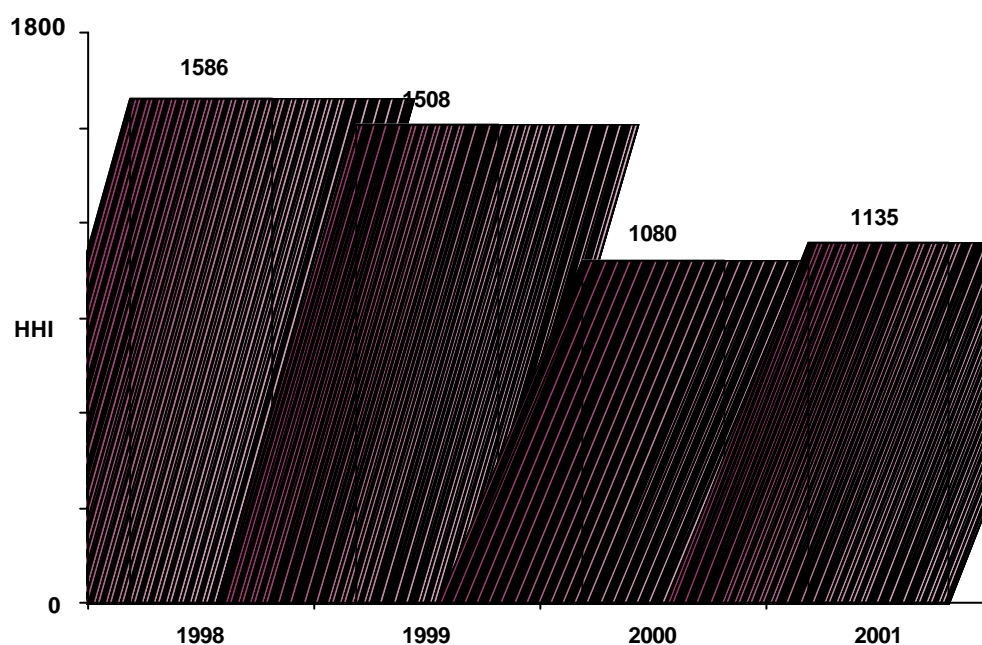
Moving on to competition within the professional indemnity class, Figure 4 shows the Herfindahl-Hirschman index, or HHI, of the professional indemnity market from 1998 to 2001. For those you, who like me, are not economists, I am told that the HHI is a measure of industry concentration. Concentration is a tool that economists use to assess market structure. Generally speaking, the more concentrated a market is, the less likely it is that participants in the market will behave in a competitive manner.



In the US, an industry with an HHI above 1800 is considered highly concentrated. The potential for adverse competitive consequences is more likely above this level than below, although under the US merger guidelines, the potential for adverse competitive consequences still exists for any concentration above 1000.

As you can see, this index has been reasonably high in the past, although not high enough to cross the 'concentrated' threshold of 1800. The index is currently shown trending upwards, even without the recent push for consolidation through mergers and acquisitions in the industry being reflected.

**Figure 4**



### **Public and Product Liability**

Public liability and product liability insurance are generally bundled together by insurers, hence the referral to both in this class of business. The recent crisis is perceived to be occurring in public liability, and I shall therefore restrict the majority of comments accordingly. However the data I shall present will necessarily incorporate both public and product liability due to the difficulties in disaggregating the data for public liability alone.

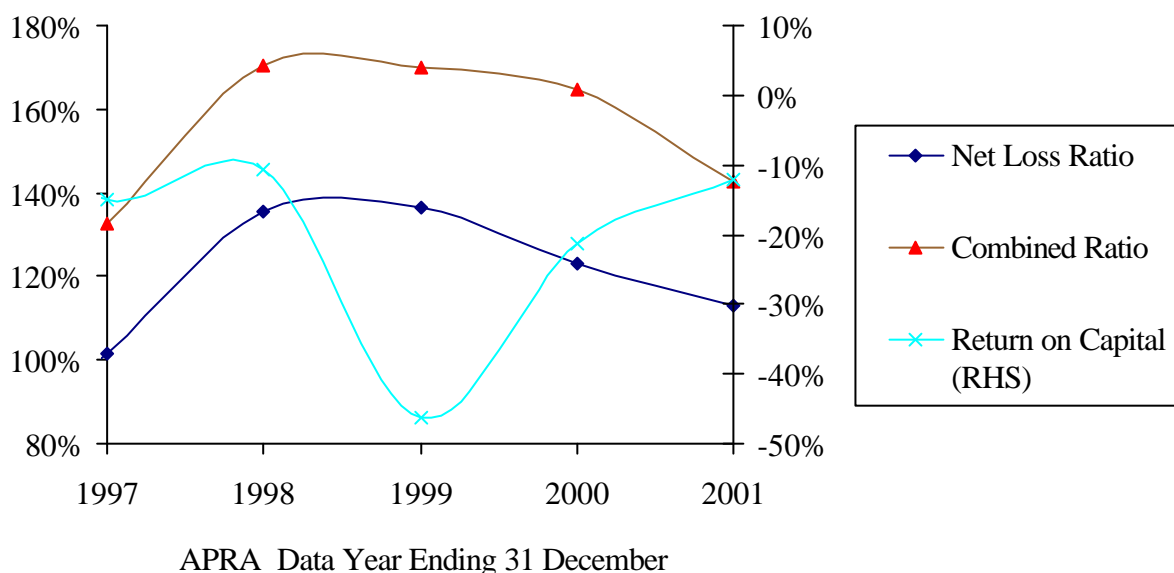
Public and Product Liability premiums represents 5% of total gross written premium, and 6% of policies written. One of the most notable aspects of this class was that the number of policies written in this class more than doubled from 1.1 million in 1999/00 to 2.59 million in 2000/01. The September review noted that this number had subsequently declined to around 2.44 million during 2001.

Again, I will now briefly review the findings in this class in relation to: profitability; policies and settlements; and competition.

## *Profitability*

Figure 5 shows the loss ratios and return on capital in this class for the years 1997 to 2001.

**Figure 5**



As can be seen, loss ratios for public and product liability have been extremely high in recent years, peaking at around 135% in 1999. These extremely high loss ratios throughout this period were contributed to by the behaviour of the industry itself, not solely or predominantly arising from an increasingly adverse litigious environment.

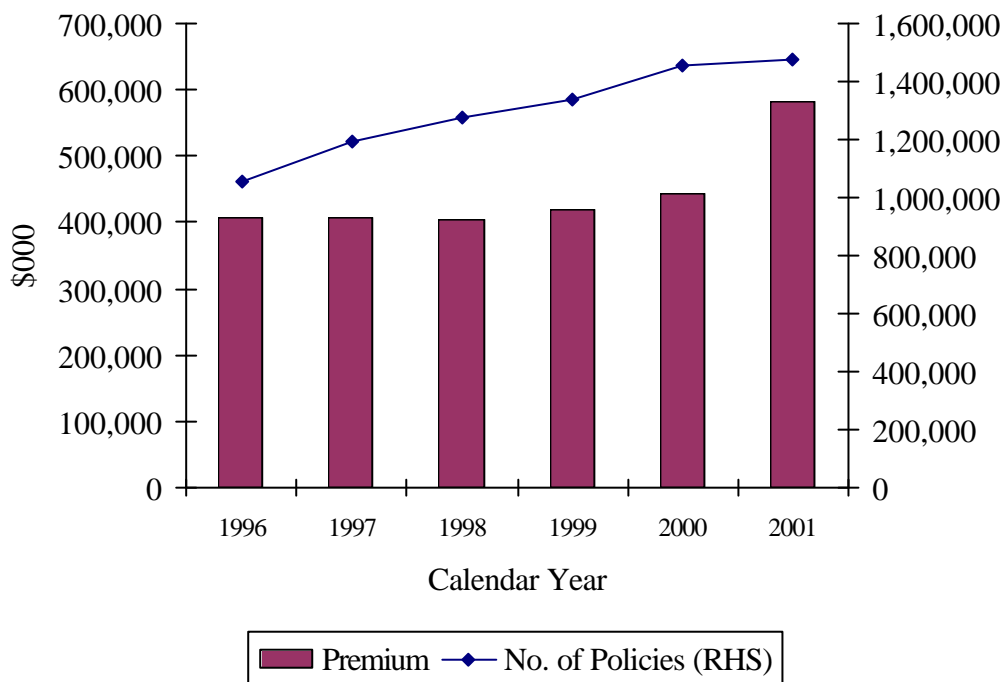
Competition in this class was fierce during the period from 1993 onwards. Emphasis was placed on obtaining market share in this class, rather than pricing premiums on a cost-based methodology.

More recently, the industry has begun to return to cost-based pricing, and loss ratios have subsequently begun to decline, down to 113% in 2001. Profitability, while beginning to show signs of recovery in this class, is still considered by the Commission to be 'very low' (<-5%), however it is expected to recover to 'low' profitability in the future.

*Policies and Settlements*

The insurers surveyed by the Commission wrote 63% of the total premium for public and product liability in 2001. Their premium income and number of policies is shown in Figure 6.

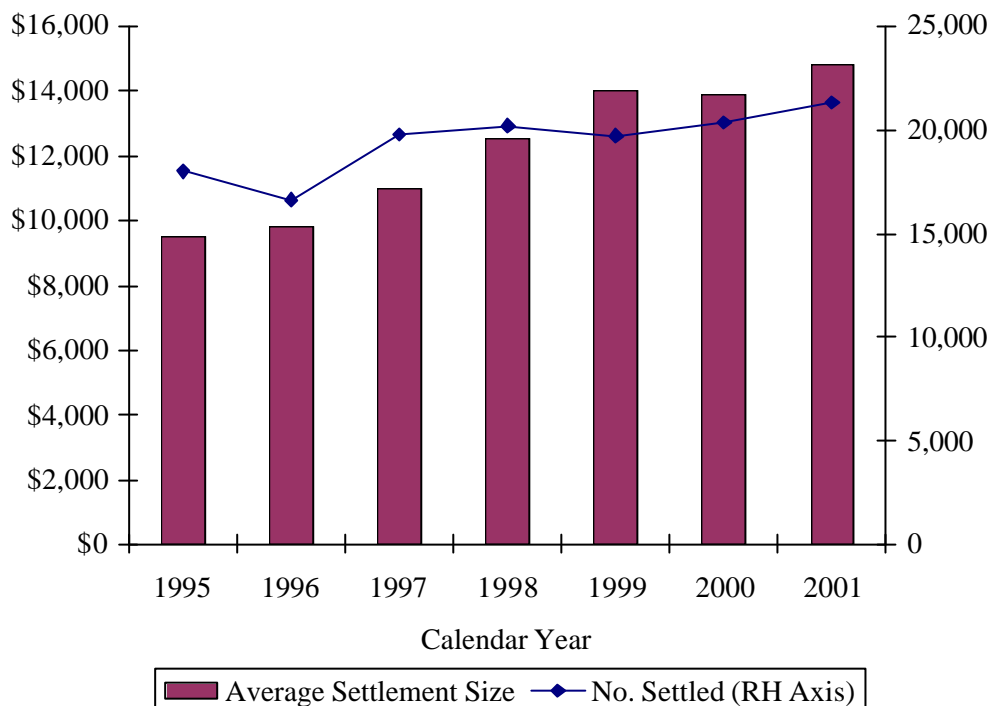
**Figure 6**



This chart shows a steady increase in the number of policies being written, but no corresponding increase in total premium until 1999. This supports the contention that strong competition in the industry was keeping premiums low through this period.

Figure 7 shows the settlement experience of the selected insurers during the same period.

Figure 7



This chart tends to refute claims currently being made that an explosion in claims is driving the current crisis, as the rate of increase in claims is lower than that of policies, therefore the number of claims per policy is currently trending downwards.

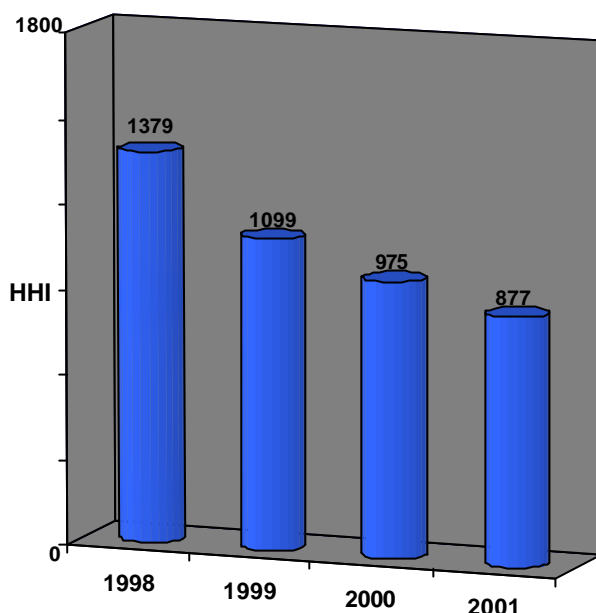
It should also be noted that the average size of claims has been increasing across this period. With no corresponding increase in premium revenue, as demonstrated in the previous chart, substantial pressure is now being placed on premiums to rise to compensate insurers for their past underwriting losses.

If the industry's pricing behaviour is a key driver of the current crisis, it suggests that the current situation is simply an upswing in the cyclical behaviour of the insurance market. This raises doubts about the need for reforms that restrict consumers' access to appropriate compensation. Reforms aimed at improving the risk management and prudential behaviour of insurers may be more appropriate.

### Competition

Figure 8 shows the HHI of the public and product liability for 1998 to 2001. The strong competitive push for market share through the late 1990s helped contribute to the higher HHI index in 1998. With the return to cost-based pricing, the HHI has steadily declined, presumably as smaller players with less reserves are being attracted back into the market by the return to profitability.

Figure 8



These increasing competitive pressures should constrain the ability of the market to price in order to recoup past losses, however the current cyclical upswing indicates that the market is focusing on restoring profitability to this class. The signals the market is currently sending to insurers support continued premium rises, and it may not be until profitability is fully restored that competitive constraints will again act to rein in premiums.

### Responses to the Commission’s Pricing Reviews

The Commission has received feedback on its Reviews from a variety of sources. Governments, both Federal and State, have welcomed both Reviews.

The ICA also strongly welcomed the findings of the March 2002 Review. However, on the release of the September Review, the ICA criticised some aspects of the Reviews methodology and findings, despite the fact that the conclusions of the review were founded upon the same methodology that the ICA had earlier approved of.

The Commission has considered the concerns raised by the ICA. We consider that the issues raised do not alter the general findings of the September Review. In particular, the Commission stands by its conclusion that the insurance industry is returning to profitability.

This is consistent with public statements made by some insurers that I referred to at the start of my presentation.

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### **Do the Pricing Reviews support reform?**

Public liability and professional indemnity insurance have been characterised in the past by poor data collection, which is compounding the current problem. Insurers and Governments have recognised this issue, and reforms aimed at correcting this are vital. Many of the issues relating to unavailability of cover could potentially be resolved by the improvement of data collection by insurers, to enable them to more appropriately assess and price risk.

If rising premiums result in rapid increases in profits and an inflow of new capital, this would tend to suggest the crisis has arisen as a result of the substantial deterioration in capital due to the sustained under-pricing of the late 1990s.

A return to profitability will attract new capital into the market, which should alleviate the availability issues currently facing many businesses as capacity will be increasing. In other words, the market will correct itself and there is little justification for long term government intervention.

If this is the case, the current reform process should be undertaken cautiously, as the crisis may merely be a short-run phenomenon. The Commission formed the view that competitive forces are reasonably strong in both classes of concern. Once the market has adjusted, premiums and availability may well return to competitive levels.

If however increases in profits and capital inflow are not observed as a result of rising premiums, this would tend to indicate the factors driving the crisis are more long-term and pervasive. If the risks associated with these classes have indeed increased substantially in recent years, there may well be a case for limiting liability, or creating special arrangements protecting the more vulnerable and valuable community groups and professions.

At this stage, little concrete evidence has been advanced to indicate that this is the case.

The Commission's September Review also acknowledged the difficulties faced by insurers in these two classes, especially the problems of moral hazard, adverse selection, and the fat and long tails associated with these classes.

Capital market imperfections faced by insurers have compounded the problems faced by insurers in the aftermath of the HIH collapse and September 11. These events resulted in a substantial and instantaneous decrease in capital.

Resupplying capital from the external capital market can be expensive and problematic. Insurers, faced with constrained capacity, have restricted supply and raised prices, in order to rebuild financial capital.

This adjustment process may take some considerable length of time. The Commission considers that recent premium rises have been necessary for both the public liability and professional indemnity, and future rises may be necessary to return profitability to sustainable levels. Just as the problems the insurance industry now finds itself in have

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developed over an extended period of time a period of time may be needed to resolve these problems.

### **The proposals for reform**

The Commission acknowledges that there are various proposals for reforms that are currently being considered by Governments around Australia. However, the timing and coverage of these reforms has so far differed between jurisdictions.

Tort law reform proposals have been placed high on the reform agenda. In-principle agreements on reform have arisen from a series of Ministerial Meetings held between State and Federal ministers throughout this year. Several jurisdictions have already enacted reforms, while others are in the process of drafting and introducing reforms for their jurisdictions.

Broadly, these reforms all include one or more of the following elements, among others:

- ? Capping of compensation pay-outs;
- ? Self-assumption of risk;
- ? Structured settlements;
- ? Restrictions on legal costs;
- ? Moving to proportional liability from joint and several liability;
- ? Minimum claim amount thresholds; and
- ? Protection of volunteers and 'good Samaritans' from litigation.

Reforms along these lines are currently progressing in all jurisdictions in Australia. Reforms have been enacted in NSW, Victoria, Queensland and the ACT, with reforms currently at various stages in all other jurisdictions. I note, however, that the reforms are not consistent across the States.

In addition, the Commonwealth has introduced legislation to amend the taxation laws to encourage structured settlements, and is currently proposing to alter the *Trade Practices Act* to allow for waiving of liability in relation to recreational activities.

In its two submissions to the Negligence Review the Commission set out its concerns that amending the *Trade Practices Act* in this way will result in the risks of recreational and other activities being inappropriately allocated to consumers.

In the Commission's view, law reform should be driven by policy which has the potential to promote the welfare of all Australians. In the case of negligence and *Trade Practices Act* law reform, that policy should be focussed on reducing the number of accidents and the costs of the resulting injuries. As a general rule, potential liability is best placed on the person best able to avoid the accident most easily and cheaply in the first place. This is both sensible and fair.

In addition, the Commission sees no case for excluding particular community organisations or professional groups from the operation of the Act or other liability laws. It sees as inappropriate proposals to amend the Act such that only the Commission could bring actions claiming damages for personal injury and death (on behalf of others) under the Act and expressed grave concern about any reform of the product liability regime in Part VA of the Act and relaxing the norms of commercial conduct specified in Parts IVA and V generally. The Commission can conceive of no circumstance in which it is or should be acceptable for a supplier to mislead or deceive consumers or to behave unconscionably.

Governments have clearly indicated that they expect there to be cost savings as a result of these reforms. On 7 November 2002, a report to the Insurance Issues Working Group of Heads of Treasuries by Pricewaterhouse Coopers predicted that comprehensive law reform would result in a drop in insurance premiums exceeding 13.5%.

Industry stakeholders, such as the ICA, have publicly stated that they do not believe the current package of tort law reform will necessarily result in premium reductions, or increases in availability. The president of the ICA, Raymond Jones stated to the Senate Inquiry in August that, in relation to tort law reform:

*“It is certainly a move in the right direction, but by no means is it going to mean an instant reduction in the cost of public liability”*

and that:

*“there is a belief that in many cases this will not reduce premiums – it will slow them down, but it will not reduce them”.*

Even if premium rises are only held back by 13.5% and not actually reduced, that is still a saving that most people would welcome. However, it should be noted that a 13.5% saving will probably not assist those people and businesses who say they have been hit by premium rises exceeding 100% or 1,000%. Nor will it make insurers insure unacceptable risks.

A one off 13.5% increase in premium, while unwanted, is a cost most businesses can bear. If that will be the one-off saving which results from law reform, what will be the cost?

The Commission believes that in the main, the recommendations for tort reform appear to result in restricted consumers' rights. The purpose of damage awards is to restore a victim to the position they would ordinarily have been in without the accident. To restrict compensation effectively forces victims to subsidise the reduction in premiums for those who caused them harm. Not only is this an inequitable outcome, it also shifts part of the burden of care for victims from the insured to the public health system, as victims may not receive enough compensation to ensure their ongoing care.

Given that the causes and extent of the current crisis are yet to be fully realised, such restrictions to consumers' rights without appropriate justification is of concern to the



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Commission. If a rise in tort claims is not responsible for the current problems, then there will be little or no benefits from reform – but the cost to society may be very great indeed.

In any case, it seems to me that there are some options which could improve the performance of the troubled classes of insurance that should be explored in preference to reforms that cut back on consumer rights.

### ***Risk management through information collection***

As I have discussed earlier, data collection in both public liability and professional indemnity has long been inadequate. Very little information has been collected by insurers when it comes to risk management, particularly in relation to heads of damage of claims, industry risk, or other rating variables.

The lack of information has been reflected in industry-wide aggregate data, as apart from APRA data requirements, little information has been collected on an industry basis.

Reforms to encourage improved collection of data, and management of risk, will be of benefit to all participants in the insurance market. Availability should improve for those areas which are proven to be of low risk, and insurers will be better able to price appropriately and provision against future losses more accurately.

Insurers have openly recognised the need for improved data collection in relation to these areas. Insurers, through the ICA, appointed Insurance Statistics Australia in September 2002 to compile public liability data and report on various trends to APRA. This data initiative is aimed at providing more up-to-date and comprehensive data to State and Federal governments to assist in the reform process.

The ongoing monitoring work of the Commission, as well as significant changes to APRA's role, should assist the insurance industry in this regard. APRA's reform proposals took effect on July 1 2002, and involve upgraded, risk-based capital adequacy requirements, and improved risk management. In order to fulfil their requirements under these and other reforms, insurers will need to improve their internal data collection methods in order to be able to adequately and appropriately manage their risk, which should benefit both insurers and insured in the longer run.

The Commonwealth has agreed to use the Financial Sector (Collection of Data) Act 2001 and require all authorised insurers operating in Australia to submit claims data to the Australian Prudential Regulation Authority (APRA) for analysis and publication.

The Productivity Commission has also been asked to conduct a study into the claims management practices of Australian public liability insurers, and benchmark these against world's best practice. This should contribute significantly towards improving the claims management culture of Australian public liability insurers, and the Commission looks forward to incorporating the insights gained from this report into its ongoing monitoring work.

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As mentioned earlier, a proposal which already exists in NSW and WA is improved risk management for professional indemnity via professional standards legislation. This legislation requires professional associations to commit to compulsory indemnity insurance, risk management programs and complaints and discipline procedures, in return for limitation of their liability in service provision.

This kind of proposal would certainly improve risk management, both on the part of the insured and the insurer. Similar concerns exist with this kind of legislation as do with tort law reform however. Limitation of liability is granted in return for improved risk management and operational procedures.

The need to limit liability however implies that, in a free situation, claims against that association would exceed this limit. Again, limitation of liability restricts the payment of appropriate compensation to victims, penalising those victims to the benefit of the insured.

### *Aggregation of buyers*

Many of the benefits which flow from professional standards legislation could equally be achieved via aggregation of buyers of insurance.

Group purchasing of insurance will tend to decrease transaction costs for insurers, and promotes risk management on the part of the insured parties.

Aggregated buyers will tend to impose internal discipline within the group on each other in order to achieve the best possible premium outcome.

Submissions to the Senate Inquiry noted several successful arrangements in this regard.

### *Aggregation of sellers*

The aggregation of sellers, or pooling arrangements, is an idea which is currently gaining momentum. As outlined earlier, the Commission has recently received an application seeking authorisation of a public liability co-insurance arrangement from – Allianz Australia, QBE Insurance and NRMA Insurance.

The applicants have claimed that, as a result of the proposed co-insurance arrangement, public liability insurance will be available to certain types of non-profit organisations that had previously been unable to obtain cover.

### *Government assistance*

A range of proposals and schemes are currently being brought into operation in various jurisdictions to assist the groups identified as being most vulnerable in the current crisis.

These schemes include:

- ? Government run group insurance schemes;

- ? Risk management and advisory services for these groups; and
- ? Reductions in stamp duty payable by these groups.

These kinds of schemes have a particularly important place if the crisis is determined to be only a short run phenomenon which requires short-run solutions while the market re-establishes itself.

Once the market has returned to some measure of equilibrium, the return of capacity and availability should enable these measures to be phased out as the private sector will again be able to write in a sustainable fashion for these groups.

### **The state of the market and competition going forward**

As the Commission Pricing Reviews have shown, profitability has been returning to the general insurance industry as a whole.

In some sectors, profitability is extremely high. In others, such as the areas of primary concern – public liability and professional indemnity - profitability is still very low but is in the process of being restored to sustainable levels.

Solutions to the current insurance situation must be balanced between the need for appropriate Government action to secure the outcomes we expect as a society, and the need to manage the costs of doing so. The aim is to arrive at an outcome which gets the settings right to ensure the market works more effectively.

The Commission supports improved competition in the insurance industry. While capacity is relatively constrained in public liability and professional indemnity at this stage, returning profitability is likely to attract new entrants to these markets.

Suggestions have been made that the Commission should be given the power to control the price of premiums in public liability and professional indemnity. Although there is a role for price control in some instances, the Commission does not think that such controls are likely to be useful in addressing the current problems. While the Commission may be able to restrain prices, it cannot force insurers to write unprofitable business. Such controls would likely be counter-productive in improving availability. It may be that better outcomes will be achieved by allowing the market to determine its own prices.

### **The ongoing role of the Commission**

As I previously mentioned, the Commission has been given a new role in relation to public liability and professional indemnity insurance. The Commission's role in monitoring the impact of the reforms was foreshadowed in the 30 May 2002 Joint Communique.

In July of this year, Senator the Hon Ian Campbell, Parliamentary Secretary to the Treasurer, requested that the Commission monitor costs and premiums in the public liability and professional indemnity sectors of the insurance market on a six monthly

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basis over the next two years. Within that context, the Commission was asked to give consideration to the impact on insurance premiums resulting from measures taken by governments to reduce and contain legal and claim costs and to improve the data available to insurers to evaluate and price risk. To the extent possible, the Commission's future monitoring reports will assess the impact made by these measures.

Consistent with this request, the Commission intends to provide four reports to the Federal Government in six monthly intervals over the next two years, with its first monitoring report due in mid 2003.

The Commonwealth also signalled in the Communique that it would review the Commission's involvement, including more formal processes, if it becomes clear that cost savings are being realised but not passed onto consumers.

In order to perform this task, the Commission will need to seek information directly from the insurance industry. Earlier this month, the Commission sent an information request to the larger providers of public liability and professional indemnity insurance asking them detailed questions about cost allocations, pricing methodology, and in particular their expectations about the impact of government reforms. These insurers will be asked to provide information in six monthly intervals over the next two years.

So far, the Commission is extremely pleased with the level of cooperation that insurers have provided in relation to this exercise. The information requested by the Commission comes at a difficult time for insurers, who are currently under pressure for data and other information from other regulators such as APRA, and peak bodies such as the ICA. The Commission has worked with the industry to seek to minimise the burden on insurers by coordinating where possible the information we are requesting with other bodies, however the Commission does have its own specific needs and must fulfil these in order to produce the first of its monitoring reports next year.

As I commented earlier, the Commission has also been given a new responsibility in relation to medical indemnity insurance. On 23 October 2002, the Prime Minister announced, as part of the Government's medical indemnity reform package, that the Commission will monitor medical indemnity premiums to assess whether premiums are actuarially and commercially justified.

The drivers behind the crisis in medical indemnity are somewhat different to that of the rest of professional indemnity, and public liability. The proposed solutions to the crisis also vary as a consequence.

The package of reforms recently announced by the Government reflects this. The collapse of UMP, the underfunding of IBNRs by MDOs, the increasing cost of premiums for high risk practitioners, are all factors which the Government has attempted to address.

While the more general tort law reforms currently proposed and/or being enacted will certainly have some impact on this area, they are somewhat peripheral to the problems facing the medical profession.

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The monitoring work of the Commission in this area will necessarily be substantially different to that being undertaken in relation to public liability, and other professional indemnity.

### **Concluding remarks**

I thank you all for your attention. My presentation has been a lengthy one – reflecting the Commission’s many current roles on insurance issues

Forums such as this are very useful. They serve to increase the level of public awareness and debate in what is a very important area for all Australians. Finding appropriate solutions to the current crisis will be challenging and will require public and private stakeholders to work together. It is important work and in this work, an appropriate balance must be struck between the interests of those likely to be affected by the “solutions”.