TORT REFORM and INSURANCE PREMIUMS: another PERSPECTIVE

By Patrick Gallagher

Over the last 15 years, and especially since 2001, the twin sources of law in Australia – the courts and parliaments – have re-stated or reformed the law of tort in a manner that has generally been disadvantageous to claimants and their lawyers. This article aims to review the impact of tort law reform on one crucial stakeholder – insurers. »

TRIGGERS FOR REFORM

Much ink has been spilled and many forests felled in theorising the source of the judicial and political will behind these changes. My own view is the courts and parliaments of Australia were ultimately galvanised into action by the perception that the law of tort had failed to incorporate into its social equation the effect of *restitutio in integrum* on arguably the most significant stakeholder – society. The events of 9/11 and collapse of HIH were coincidental stimuli which hastened tort reform that was already in the wind.

THE ROLE OF PREMIUMS IN INSURERS' PROFITABILITY

Income from premiums is but one factor in determining an insurer's financial performance. Others are investment performance, severity and frequency of claims, catastrophic events, claims-handling costs, and risk diversification.

Risk diversification is particularly important to premium pricing, as the more diverse an insurer's risks, the more attractive it is to investors, leading to access to cheaper capital. Risk diversification is best achieved by underwriting the maximum number of varying risks.

As *KPMG's General Insurance Industry Survey 2004* reports:

> *'Contrary to popular belief, insurance companies seek to maximise underwriting profitability not by constantly increasing premiums, but by widening policyholder bases and therefore increasing their risk spread. Simply put, the better the (diversity), the lower the (cost) … Continually increasing premiums achieves the opposite result; premiums become unaffordable and policyholders cancel policies.'*[1]

The result of this dynamic is that insurers compete to write liability policies covering as many diversified risks as possible, all the while attempting to minimise exposure in areas that have historically had an unprofitable premium-to-claim cost-ratio. Liability policies, in particular public and product liability, and professional indemnity, have severely burnt insurers over the last 15 years, and it is perhaps understandable that the insurers are not presently rushing to grow their exposure (via lower premiums) in these areas.

Market forces must inevitably prevail. If tort reform does reduce the claim cost of public and product liability risks, capital should eventually flow in to underwrite those risks. However, the rate and extent to which capital will be attracted to those risks depends upon whether those risks can be priced with confidence, and whether the true claim costs can be predicted over time. Both variables are dependent on claims experience. Given that we are in the early days of post-tort reform claims, claims experience is currently very limited.

Having said this, perhaps we are already seeing early signs of premiums 'softening', with June 2004 policy renewals averaging only a 2% increase – a fall in real terms – according to the most recent *JP Morgan/Deloitte survey*.[2]

From the insurers' perspective, there is no collusion. There is no profit 'gouging'. There is no conspiracy to maintain artificially high premiums in liability insurance. Any such practice, apart from being corporate suicide in the current prudential environment, would be immediately apparent

There is no collusion. There is no 'profit-gouging'. There is no conspiracy to maintain artificially high premiums in liability insurance.

from the detailed data collected, interpreted and reported by the Australian Prudential Regulation Authority (APRA). The only substantial historical criticism that can be made of the regulation of insurers was a failure to detect that premiums were unsustainably low in the period 1994 to 1999.

Further, the industry is under close and continual scrutiny by the Australian Competition and Consumer Commission (ACCC). Its June 2004 publication, *'Public Liability and Professional Indemnity – Third Monitoring Report'*, stated:

> *'whilst costs associated with public liability insurance generally increased over the period (1997 to 2003), premiums did not.'*[3]

CURRENT LIABILITY INSURANCE COSTS

The recent reluctance of insurers to compete aggressively for business in liability insurance bears a direct and obvious relationship to the cost of such insurance for business and private consumers.

Experience with tort reform in the insurers' largest state market, NSW, would seem to vindicate their caution at rushing back into liability insurance. The non-economic loss (pain and suffering) thresholds imposed by the *Motor Accidents Act* 1988 were ineffective in reducing the quantity and cost of small claims until a 10% 'whole body impairment' threshold, compulsory administrative claims assessment, and severe costs restrictions for small claims were introduced a decade later.

As a result of the reduction in available compensation and costs, and the consequent reduction in numbers of claims, premiums (prudentially monitored and tied to claims cost by the NSW Motor Accidents Authority) have gradually receded from the peak of the late 1990s by approximately 25%. This experience tells us that tort reform can reduce premiums by an appreciable margin, but not overnight.

EFFECT OF REFORMS ON QUANTITY OF CLAIMS

In NSW, the district court is the engine-room of the bulk of claims affected by tort law reform. The court deals primarily with damages claims based on negligence, although a percentage of the claims filed relate to property, commercial litigation, contract and other causes of action not directly affected by tort reform.

Raw claim numbers are telling – with 20,000 claims filed in 2001, 13,000 in 2002, and 8,000 in 2003. This

downward trend is continuing. Preliminary figures for 2004 suggest approximately 4,500 claims were filed in the Sydney Registry (which receives the vast bulk of claims) over the first ten months of the year, suggesting that filings have at best troughed, if not fallen further.

While the longer-term historical data tell a fuller story, revealing a spike in claims in the lead-up to the introduction of the *NSW Civil Liability Act* 2002, it seems reasonable to assume that the short- to medium-term impact of tort law reforms in NSW has been to halve the number of claims made in tort. This experience either has been, or will be, broadly replicated in other states. In Victoria, in the six months following the introduction of tort reform legislation, only 50 negligence claims have been brought.

It is well known that reforms to workers' compensation and motor accident schemes have, over the last 15 years, eroded the volume of work and therefore legal costs available to lawyers representing both sides in personal injury litigation. The most recent round of tort reforms has had, as the above court filing statistics demonstrate, a substantial impact on what work was left.

Many claims that would otherwise have remained viable despite tort reform, are now (in most states) subject to caps and thresholds as regards a claimant's recoverable legal costs. The Chief Justice of NSW, James Spigelman, recently commented that these caps, along with thresholds for general damages had 'made (smaller) claims virtually uneconomic from the point of view of the legal profession'.[4]

CRITICISM OF REFORMS AND CONCERN OVER LEVELS OF PREMIUMS

Given these circumstances, it is not entirely surprising that some disquiet has emerged over whether the right balance has been struck between the competing interests of the stakeholders in tort reform. There seems to be a view (not confined to plaintiff lawyers) that insurers are receiving liability premiums disproportionate to the likely cost of the risks that they are insuring. People are asking: 'If historically high premiums continue to be charged, why impose restrictive liability and damages regimes on claimants?', and, 'I have heard insurers are declaring huge profits; is that off the back of tort reforms?'

In recent months there has been a sharp increase in lobbying by lawyers' associations for a moratorium on further legislative tort reform, and a winding back of existing tort law schemes.

The Law Council of Australia (LCA) argues that the notion of eradicating 'trivial' liability claims is economically and morally flawed. Such claims, the Council points out, are invariably not trivial from the point of view of the claimant: '$5,000 might not seem much to some, but to the average worker with a family to support, it could mean the difference between sinking and swimming', argues Bob Gotterson QC, LCA President.[5]

The LCA further argues that thresholds on general damages for pain and suffering encourage a mentality that a certain amount of negligence is 'acceptable'.

Put more neutrally, the issue is whether society accepts that the consequences of negligence should be diluted to cure the perceived social and economic ill of high insurance premiums. This brings us back to the question of the extent to which 'trivial' claims are related to historically high premiums. The LCA says there is 'no evidence to suggest such claims caused the hike in insurance premiums or that their removal has or will result in a reduction in premiums.'

In many respects, the indignation of those lobbying against tort reform is understandable. The bare statistics indicate that insurers are currently doing well. *KPMG's General Insurance Industry Survey 2004* reported:

- total premiums across all facets of insurance increased by 12% in the 2003/4 financial year;
- underwriting profit (before tax) increased over 2003/4 by 428%; profits after tax increased from $916m to $2.5bn; and
- 'it is clear the industry currently enjoys unprecedented profitability and investor confidence'.[6]

Shane Fitzgerald, senior insurance analyst with JP Morgan, describes the 'exceptional performance' of the insurance industry over the last 12 months as the result of a 'perfect storm'. *J P Morgan's 2004 General Insurance Survey* concluded that the 'cumulative effect of rising premium rates, tightening policy terms and conditions, and a favourable claims environment, have combined to create a highly advantageous insurance environment'.[7] >>

Injured children, psych and mild brain cases, business owners: how do I empty the *too hard basket*?

Ah...Evidex.

- Worklife (vocational) Assessments with
- Statistical analysis of future employment
- Occupational Therapists' reports
- Forensic Accountants' reports
- Business valuations and profit analysis

"First secure victory. Then fight if you must."
-Sun Tzu, 300BC

PAYMENT ON RESOLUTION

EVIDEX

PERSONAL AND COMMERCIAL LITIGATION SUPPORT

Sydney (02) 9311 8900 Melbourne (03) 9604 8900 Brisbane (07) 3228 2900

However, the reality is that these figures and analyses are of limited utility in measuring the impact of tort reform on insurers' premiums and profits. The primary reason is simply that public liability portfolios represent just 7.8% of insurers' premiums.

The Insurance Council of Australia (ICA) points out that the ACCC price surveys show that the average liability claim cost rose 40% between 1997 and 2002. Even after the introduction of tort reform in many states, the average claim cost rose in 2003 by a further 17%. The ACCC's own analysis of public liability premiums over the same period concluded that these premiums did not increase.

In general terms, the Australian insurance industry has now experienced two years of recovery from unprecedented underwriting losses sustained in the decade leading up to 2002. Even excluding the $4bn underwriting losses sustained by HIH over this period, losses were staggering. Underwriting losses close to $1bn were sustained between 1998 and 2000, a period during which liability claims, according to APRA, increased by 60%, from 55,000 to 88,000.

It is also important to understand that, from an insurer's perspective, claims don't improve with age. Experience suggests that an insurer's reserve will need to double over the life of a seven year (or older) claim, meaning that the substantial number of pre-legislative tort reform claims on insurers books will continue to have a significant adverse impact on insurer's profitability over the remainder of this decade.

THE FUTURE OF TORT REFORM AND LIABILITY INSURANCE

Alan Mason, executive director of the ICA, has recently responded to the increased lobbying against tort reform by lawyers' organisations, and criticisms of perceived profiteering from the reforms. He says that the ICA 'can say with confidence that tort reform has had a positive effect on the market; price increases have moderated and availability (of insurance products for business and consumers) has increased'.[8]

Mason argues, however, that it is too early to predict the longer-term impact of the changes, citing the relative lack of judicial interpretation of the legislation, and the limitations period having yet to expire on most claims that post-date law reforms.[9]

Commentators on the performance of insurers, such as those already mentioned above (KPMG and Deloittes), further caution that the insurance market is cyclical, and that the currently favourable market conditions for insurers should not be expected to continue. Additionally, capital is now highly portable, so shareholders will increasingly shift their equity away from perceived risk. For these reasons, commentators argue that premiums will never return to the

N.E.W.S.
Nationwide Expert Witness Services

SERVICE COMMITMENT
We have established a fine reputation for timely and committed service. Our aim is to provide a resourceful & responsible service for our clients.

Quality provider of independent expert reports

AREAS OF AVAILABLE EXPERTISE IN 2004/2005 INCLUDE, BUT ARE NOT CONFINED TO:

- Acoustics & Energy in Buildings
- Air Quality & Dust Diseases
- Amusement Devices - Motorised Wheel Types
- Animal Behaviour
- Audio & Electronic Analysis
- Behavioural & Cognitive Psychology
- Biomechanics & Human Impact Injury Causation
- Building, Construction and Building Safety Standards
- Chemical & Process Engineering
- Civil, Geotechnical & Structural Engineering & Structural Collapse
- Community & Geriatric Medicine
- Computer System Engineering & Software Management
- Concrete Cancer
- Costume & Mascot Design
- DNA & Forensic Pathology
- Drugs & Alcohol
- Education & Sports Administration
- Electrical Engineering, Power Generation & Transmission Distribution
- Emergency Medicine & Trauma Resuscitation
- Environmental Engineering, Pollution Control & Oil Slicks
- Ergonomics, Manual Handing, Work Safety & Systems
- Explosives, Explosions & Combustion Engineering
- Fire Safety Engineering
- Forensic Linguistic Analysis & Language
- Food Science & Technology
- Ground & Ground Water Contamination
- Industrial & Furniture Design
- Marine Engineering, Maritime Military & Strategic Policy, Maritime Policy & Enforcement
- Mechanical & Automotive Engineering
- Melanoma & Skin Cancer
- Metallurgy & Stress Analysis
- Neurosciences
- Obstetrics & Gynaecology
- Occupational Therapy, Assistive Technology & Disabled Access
- Reflectivity, Lighting & Illumination
- Physical Functional & Vocational Assessment
- Plastic & Reconstructive Surgery
- Pre-hospital & Retrieval Medicine, Aero-medical Services
- Psychiatric & Neuropsychological Assessment
- Scientific Illustration & Digital Imaging
- Security & Risk Assessment
- Speech Pathology & Rehabilitation
- Speech & Lip Reading
- Sports Medicine & Occupational Medicine

Phone: (02) 9211 3299 Mobile: 0411 080 467 Email: morgana@nationwidexperts.com 135 Jones Street, Ultimo NSW 2007

How and when will the *'whole community'* be in a position to assess the impact of tort reform, and whether the *'proper balance'* has been struck?

levels experienced prior to 2000.

The stakeholders in tort law remain the same: claimants and their lawyers, insurers and their lawyers, courts, and governments. The largest stakeholder is society as a whole, which comprises:

- members of the general public, who bear (directly or indirectly) the cost of liability insurance, and who perceive the cost of insurance to have reached a point where the rights of claimants to sue for compensation need to be compromised to maintain a sustainable balance; and
- future claimants whose rights have been compromised by tort reform.

No one in the first category can predict whether they will one day become a member of the second class. Whether tort reform is stabilised, increased or wound back will depend largely on whether and when society perceives a correct balance to have been struck between the rights of each group. Australian insurers understand this, the ICA's Alan Mason having said as much in an *Australian Financial Review* opinion piece on 29 October 2004, which he concluded by saying:

> *'But in the end, the question for the whole community to decide is this – what is the proper balance between fair and reasonable compensation for injured people and the community's ability to pay for that compensation through affordable premiums.'*

This begs the final question – how, and when, will the 'whole community' be in a position to assess the impact of tort reform, be confident that liability premiums have stabilised, and be in a position to assess whether the 'proper balance' has been struck?

Perhaps the answer will be supplied in large part through the National Claims and Policies Database (NCPB) currently being compiled by APRA. Contribution of a wide-ranging scope of policy, premium and claims data by Australian insurers is compulsory. Data covering three six-monthly reporting periods of January 2003 to June 2004 will be collected in early 2005. APRA estimates that the 'first set of reports will be available in 'early 2005'. Thereafter the data will be collected, and reported on, at six-monthly intervals.

Given the detail of the data required, it seems likely that the relationship between compensation and premiums will become increasingly clear over the next two to three years, with each new round of reports showing trends and developments. The NCPB is likely to emerge as the prime tool in measuring whether the 'proper balance' has been struck. ■

Notes: **1** KPMG: *General Insurance Industry Survey 2004*, September 2004, p32. http://www.kpmg.com.au/Portals/0/2004_GenInsuranceExec_Summ.pdf **2** JP Morgan/Deloitte: *General Insurance Industry Survey 2004*, October 2004. http://www.deloitte.com/dtt/cda/doc/content/2004%20General%20Insurance%20Industry%20Survey%20Summary.pdf **3** ACCC, *Public Liability and Professional Indemnity – Third Monitoring Report*, June 2004, Executive Summary, pxii. http://www.accc.gov.au/content/index/phtml/itemId/530860/fromItemId/3737 **4** http://www.agd.nsw.gov.au/sc/sc.nsf/pages/spigelman_140904 **5** Bob Gotterson QC, Law Council of Australia President, LCA Media Release, October 2004. **6** http://www.deloitte.com/dtt/cda/doc/content/2004%20General%20Insurance%20Industry%20Survey%20Summary.pdf **7** http://www.deloitte.com/dtt/press_release/0,1014,sid%253D5527%2526cid%253D64211,00.html **8** *Australian Financial Review*, 29 October 2004. **9** http://www.ica.com.au/corpaffairs/mediareleases.nsf/c94e71bde9284239ca2569f2000f8b99$FILE/102204tortresponse.pdf

Patrick Gallagher *is a senior associate with law firm, Phillips Fox, which has a substantial insurance litigation practice.*
PHONE *(02) 9286 8094* **EMAIL** *patrick.gallagher@phillipsfox.com*

How do I figure the changing costs of care for a young parent with acquired brain injury? I'll need a *team* of experts.

Ah...Evidex.

- Worklife (vocational) Assessments with
- Statistical analysis of future employment
- Occupational Therapists' reports
- Forensic Accountants' reports
- Business valuations and profit analysis

"First secure victory. Then fight if you must."
-Sun Tzu, 300BC

PAYMENT ON RESOLUTION

EVIDEX
PERSONAL AND COMMERCIAL LITIGATION SUPPORT
Sydney (02) 9311 8900 Melbourne (03) 9604 8900 Brisbane (07) 3228 2900