Chapter 2

Causes: insurance market issues

2.1 The causes of the insurance crisis are generally summarised as:

- international influences including the withdrawal of capacity and the increasing cost of reinsurance following the destruction of New York's World Trade Centre in terrorist attacks on September 11, 2001;
- the 'hardening' of the insurance market as, after a period of underpricing and poor profitability in the mid 1990s, insurers now focus on improving profitability rather than merely increasing market share; and
- the increasing cost of claims.

2.2 This chapter considers the international and domestic market influences, and some related matters: APRA's new prudential requirements and the effects of taxes on premiums. Chapters 3 and 4 consider the increasing number and cost of claims.

Global influences

2.3 Many submissions mentioned global influences as contributing to the present crisis—particularly the terrorist attacks on New York's World Trade Centre on September 11, 2001. The global insurance cycle was already hardening, but September 11 compounded the effect. Trowbridge Consulting observed:

> The direct insurance losses (likely to be over $A100 billion), the recognition of a major new risk factor, and greater caution throughout the business world have combined to further reduce the willingness to write business and further increase premium rates.[1]

2.4 The effects in Australia arise largely from the impact on the cost of reinsurance. Overseas reinsurers dominate the Australian reinsurance industry.[2] According to the Insurance Council of Australia:

> …the terrorist attack on September 11 was the biggest insurance loss in history and, of course, it resulted in reinsurers substantially increasing their rates to the insurance market. The average increase on liability classes or the long tail classes was probably somewhere between 30 and 50 per cent,

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1 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 11.

2 Australian Competition and Consumer Commission, *Insurance Industry Market Pricing Review—Release Draft*, March 2002, p. 67.

> which meant at least 10 to 15 per cent on top of premiums being charged to businesses and the public for insurance cover.[3]

2.5 APRA's summary was:

> …it is increasingly difficult post 11 September for direct insurers to obtain affordable reinsurance in the contracting international market. Reinsurance rates available to local insurers have recently risen on average by around 25%. Even before September 11, APRA statistics showed reinsurance expenses increased by 59% over the three year period to June 2001. While capital inflow into international reinsurance will over time moderate the rising costs, this will likely take years rather than months.[4]

2.6 A qualitative survey of insurers by JPMorgan in August 2001 found that insurers then predicted average public liability premium increases of 18 per cent in the year to June 2002. An update to February 2002 found predictions of 32 per cent, suggesting that 14 percentage points of increase could be attributed to the effects of September 11 and any other market changes in the interim.[5]

2.7 On the other hand, Trowbridge suggests that reinsurance costs are a relatively minor driver of public liability premiums:

> During the upward cycle, reinsurers have increased their rates by in the order of 25% although one insurer has reported a significantly greater increase. However, reinsurance programs for public liability are typically "excess of loss programs" and only pick up the top end of large claims (say over $2 million–$5 million depending upon insurers' capital levels). As such, they account for less than 10% of the direct insurers' premium in this class and hence the reinsurance rate increase has a marginal effect (25% of 10% or say 2–3%) on price for most insurers.[6]

2.8 JPMorgan's assessment is:

> …in the face of the large pay-outs from September 11, insurers had the resolve to reprice premium rates to an appropriate level. In our view, the industry's resolve to improve its risk/reward position has been the greatest driver of the increase in premium rates.[7]

2.9 The global and domestic investment cycle is also sometimes mentioned as contributing to the crisis. Insurers supplement their income by investing premiums.

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3 Mr R. Jones (Insurance Council of Australia), *Committee Hansard,,* 8 July 2002, p. 48.

4 Submission 127, Australian Prudential Regulation Authority, p. 2.

5 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 26.

6 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 38.

7 JPMorgan, *2002 Interim Insurance Survey*, February 2002, p. 3.

Investment returns are lower now than they were in the early 1990s. However Trowbridge suggests that this is not a significant factor:

> Most such funds obtained from premiums are invested by insurers in low risk fixed income securities. The average returns available on such investments have been between 5% and 5.5% since mid-1997, having been in the range 6.5% to 8.5% in the first half of the 1990's. This evidence indicates that changes in the rate of investment return should not have been a factor in premium rate changes in the last three years.[8]

2.10 Australia makes up less than two per cent of the world's insurance market and cannot expect to be quarantined from global changes.[9] However, in the Committee's view Australia can moderate their effects by developing a stable domestic insurance market. The Committee now turns to the domestic insurance market.

The hardening insurance market

2.11 The insurance business is by nature cyclical.[10] During a 'soft' market capital flows into the market. Insurers compete on price to gain market share, even at the expense of profitability. The competitive pressure is more intense where customers can and do move quickly from one insurer to another depending on price. This is the case with the commercial classes of insurance, including public liability and professional indemnity.

2.12 In this highly competitive market, falling prices may lead to an unsustainable level of unprofitability—which happened in the case of public liability and professional indemnity insurance during the mid to late 1990s.[11] According to the Insurance Council of Australia, 'Public liability insurance losses across the industry have been very large…'

> The APRA statistics show that for the period 1998–2000 gross premiums were approximately $2.5 billion, whilst claims, also gross incurred, were $3.5 billion. In addition, if you add the expenses to the industry for public liability insurance, which was another $600 million, it results in an underwriting loss of $1.6 billion for public liability insurance over that

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8 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 38.

9 See Background Paper no. 1, *A Profile of the General Insurance Industry,* prepared by the Insurance Council of Australia for the HIH Commission, November 2001, p. 6.

10 For most of the ideas in this section the Committee acknowledges submission 152, Department of the Treasury; Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, pp. 9ff; JPMorgan, *2002 Interim Insurance Survey*, February 2002.

11 By contrast, the domestic classes—householders and domestic motor—have shown relatively stable premiums and profit margins over the last nine years. JPMorgan, *2002 Interim Insurance Survey*, February 2002, p. 4.

> three-year period…The professional indemnity side has also been very unprofitable for a number of years.[12]

2.13 When the industry's profits decline to such a level of unsustainable unprofitability, capital is withdrawn from the market and prices rise again.

2.14 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, had 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.

2.15 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. The long tail refers to the fact that (by contrast with most other types of insurance) claims on liability insurance can be made many years after the premium is paid. This is particularly so for personal injury claims. 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.

2.16 The problem is not new: predicting future costs is a large part of the business of insurers. In large part, the accuracy of the prediction depends on:

- the volume of similar business: a greater volume allows more reliable prediction;[13] and
- the trend in claim costs: a more stable trend allows more reliable prediction.

2.17 Liability insurance, compared with other classes, suffers on both counts. The pools of similar risks are often small (enlarging the database to enable better calculation of risk is a major purpose of the proposed industry-wide data sharing discussed in chapter 5). As well, claim costs have increased in recent years faster than expected. According to Insurance Australia Group, 'with the benefit of hindsight, it is now clear that a number of insurers seriously under-estimated the growth rate in claims costs for much of the 1990s…'

> …a policy written today is not priced on the basis of the current cost of claims but on an estimate of claims costs when claims under that policy will, on average, be paid out…Under-pricing (and potentially over-pricing) occurs when these estimates prove to be seriously inaccurate.

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12 Mr R. Jones (Insurance Council of Australia), *Committee Hansard,* 8 July 2002, pp. 45-6.

13 This a matter of the mathematics of probability. The greater the number of events, the more accurately the outcome of a group of events can be predicted. In one trial of tossing a coin, we cannot predict the outcome. In 1,000 trials of tossing a coin, we can predict with confidence that the outcome will be heads close to 500 times.

> With the benefit of hindsight, it is now clear that a number of insurers seriously under-estimated the growth rate in claims costs for much of the 1990s. The impact on profitability for some was masked, for a time, by buoyant but unsustainable investment profits…Today's premiums reflect the market's adjustment to that reality and some expectation that this trend will continue to impact on claims going forward. [14]

2.18 The longer the tail, the harder it is to predict future claim costs. The problem is worse where the size of claims, as well as the number of claims, is less predictable. This is particularly the case for personal injury claims, which vary enormously. For example, the Insurance Council of Australia cited the following example:

> One of our member companies collected £300 for an insurance policy for workers compensation back in the sixties. Asbestos is now a very real problem, and they have reserved 20 $1 million claims against that £300 premium. So long tail classes have some sting.[15]

2.19 To compensate for this extra risk, JPMorgan suggests that to achieve a reasonable rate of return on capital the profit margin on premiums would need to be 2–3% for short-tail classes and 5–8% on long-tail classes.[16]

2.20 Mr P. McCarthy, in a paper quoted in Trowbridge's March 2002 report, suggested that the causes of underprovisioning for future claims have been poor data and inadequate access to levels of detail; limitations of actuarial models and science; management pressure on actuaries; inadequate understanding of the business by actuaries; an underlying environment that leads to increases in personal injury claims; manipulation of case estimates by insurers; poor corporate governance; and characteristics of public liability business, especially the variety and the types of risks.[17]

2.21 Where supply of capital is tight and insurers have become more risk-averse, as at present, the more unpredictable classes will have most difficulty finding affordable insurance or, sometimes, any insurance.

> Today's premiums….also reflect a shortage of global capital, particularly since the events of 11 September 2001, and a preference to allocate the available capital to under-write less volatile, and therefore less risky, products.[18]
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> At a time when your attitude to risk is maybe more averse, you tend to avoid those areas where, 99 times out of 100 or 999 times of 1,000, you do not

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14 Submission 143, Insurance Australia Group, pp. 2-3.

15 Mr R. Jones (Insurance Council of Australia), *Committee Hansard,* 8 July 2002, p. 47.

16 JPMorgan, *2002 Interim Insurance Survey*, February 2002, p. 5.

17 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 37.

18 Submission 143, Insurance Australia Group, p. 3.

> have a problem, but the one problem you have will cost you $X million. You tend to go for those where you have maybe a few more incidents but each one will cost you less because you can predict them more.[19]

> Unless there is predictability in pricing and claims development then companies are not particularly keen to play.[20]

2.22 As suggested from paragraph 1.58, the relative unpredictability of claims in the public liability and professional indemnity lines is probably a significant cause of the enormous variation in premium increases which submissions reported.

2.23 The Insurance Australia Group suggested that 'a sustainable solution therefore requires a concerted effort by all stakeholders to embed much greater certainty and stability to the underlying cost drivers of long tail insurance classes.'[21]

Other issues

New prudential standards

2.24 The new prudential standards for general insurers are sometimes mentioned as a possible contributor to increased premiums. The standards came into force on 1 July 2002. The minimum capital requirement is increased from $2 million to $5 million. Above the $5m floor, the capital requirement is risk based. Insurers writing liability lines need more capital to meet the greater uncertainty they face—due to the potential time lag between premium and claim—than insurers writing property business.[22]

2.25 The Insurance Council of Australia claimed that the more rigorous standards 'will increase the costs for insurers and that increased cost could be reflected in premiums'.[23] The Law Council of Australia suggested that 'if the federal government wanted to do something to attract insurers into the market then they could relax the capital prudential requirements that have been imposed by APRA from 1 July…'

> We are told that they are a disincentive to new insurers coming into or back to the market and to insurers writing more business.[24]

2.26 Trowbridge commented: 'These changes are not a primary driver of the increase in public liability rates, although they reinforce the more conservative attitude to risk of insurers and a greater focus on profitability.'[25]

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19 Mr D. West (Royal and SunAlliance), *Committee Hansard,* 9 July 2002, p. 355-6.

20 Mr R. Jones (Insurance Council of Australia), *Committee Hansard,* 8 July 2002, p. 47.

21 Submission 143, Insurance Australia Group, p. 3.

22 APRA, *Australia's World Class Insurance Reforms Come into Effect*, media release 28 June 2002.

23 Submission 67, Insurance Council of Australia, attachment 1, *Public Liability Submission to Ministerial Forum,* March 2002p. 5.

24 Mr A. Abbott (Law Council of Australia), *Committee Hansard,* 8 August 2002, p. 269.

2.27 In general, though, the new standards were not a major concern in evidence, and others who mentioned them approved them for their primary purpose of improving the stability of the industry.[26]

2.28 APRA does not believe that the new prudential requirements are a significant element in the insurance crisis:

> It is true that companies writing long-tail liability insurance are facing relatively higher regulatory capital requirements (because of the greater uncertainty involved in this business) than are companies writing predominantly short-tail property insurance, and that some smaller companies are facing a risk-adjusted capital requirement beyond their current resources. By and large, however, the industry overall has sufficient capital to meet the new requirements. And in particular, the major providers of these liability business classes are among the largest (eight or so) insurance groups in the Australian market, and are well placed to meet the new standards.[27]

2.29 The Committee expects that the new prudential standards will affect premiums to some degree. However, it accepts the new standards as a necessary precaution in strengthening the solvency of insurance companies.

Taxes and stamp duty

2.30 State stamp duty on public liability and professional indemnity premiums varies among the states from 8 per cent to 11.5 per cent. Stamp duty is levied on the GST-inclusive premium.[28]

2.31 A number of submissions complained that the increasing premiums have caused a windfall in stamp duty receipts for the states and territories. Others complained about the 'tax on tax' effect of levying stamp duty on the GST-inclusive premium.[29] Some suggested that the states and territories should remit or discount stamp duty for a period as a contribution to ameliorating the crisis.[30] New South, Wales, Queensland, Tasmania and the Australian Capital Territory have made concessions or plan to do so.[31]

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25 Trowbridge Consulting, *Public Liability Insurance—analysis for meeting of ministers 27 March 2002*, March 2002, p. 11.

26 For example, submission 23, Local Government and Shires Association of NSW, p. 5.

27 Submission 127, Australian Prudential Regulation Authority, p. 2.

28 Australian Competition and Consumer Commission, *Insurance Industry Market Pricing Review—Release Draft*, March 2002, pp. 59ff.

29 For example, submission 123, National Farmers Federation, p. 7.

30 For example, submission 90, Australian Chamber of Commerce and Industry, p. 6; submission 115, Australian Business Ltd, p. 5.

31 Hon. M. Egan MLC, New South Wales Budget Speech, 4 June 2002, p. 21; Hon. T. Mackenroth MP, Appropriation Bill 2002 [Queensland], Second Reading Speech, 18 June

Comment

2.32 Some submitters who wished to talk down the extent of the present crisis have analysed the insurance cycle in this way: 'Insurance buyers have had bargain prices for several years—they cannot expect it to last forever.' For example, APRA said:

> Australian policyholders have been getting a free ride in the form of unduly cheap premiums for a number of years and they now need to accept that this was an aberration that may never recur.[32]

2.33 The Committee agrees that insurance companies cannot be expected to continue offering unprofitable prices. However in the Committee's view such comments miss the point. The essence of the present crisis is the way so many people have been harmed by the extreme volatility of the insurance cycle. The community groups and small businesses who are the chief victims are not sophisticated insurance buyers. It is unrealistic to expect them to set aside funds during the good years to pay for the bad ones. It is probably unrealistic to expect that they would even notice that the good years were good. They are now being hit by huge increases which they are ill-placed to cope with. Their problems rebound in the form of bad press for insurers. The volatility of the cycle is bad for insurance buyers and bad for the public credit of insurers. It should be in everyone's interest to moderate the effects of the cycle. Governments should take an active responsibility in helping to do this.

2002, p. 17; Hon. D. Crean MLC, 2002-2003 Budget Speech [Tasmania], 23 May 2002, p. 9. Hon. T. Quinlan, Deputy Chief Minister of the ACT, media release 15 July 2002.

32 Dr D. Roberts (Australian Prudential Regulation Authority), *Committee Hansard,*, 9 July 2002, pp. 132-3.

Part II

High Premiums—causes and solutions

The recent increases in both public liability and professional indemnity insurance have had and will continue to have a dramatic impact on small business, community and sporting organisations, individuals and local councils. While the increases in public liability and professional indemnity insurance have affected the profitability of small business, they have also resulted in many community and sporting organisations being forced to reduce the level of services they provide or, in many cases, to cease operations altogether, due to their inability to obtain any affordable, or sometimes any, insurance cover.

This section of the report builds on the analysis contained in Part I where the report looked at the global insurance industry and the cyclical nature of the domestic market. Part II narrows the focus to analyse the more specific and immediate causes of premium rises.

The two following chapters deal with;

- the rise in the number of claims and
- the increase in the amount of awards or settlements.