



Institute of Actuaries of Australia

Public Liability Tort Reform – Assessing the Impacts an Update

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Public Liability Tort Reform – Assessing the Impacts

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1. Aims and Conclusions

In October 2005, the IAA Tort Reform Working Group (TRWG) undertook an assessment the impact of the public liability tort reforms which occurred in 2002 and 2003. The TRWG report presented an assessment of the impact of the reforms from the perspectives of a variety of stakeholders in the insurance system and considered to what extent the reforms could be said to have met their objectives of improving the affordability and availability of public liability insurance.

In 2005, the TRWG concluded that –

- Consumers had seen a stabilisation of their premium rates in 2004 and a reduction in 2005 and in general issues of availability had eased considerably; issues for the Not-for-Profit sector remained since affordability issues in this sector were exacerbated by the manner of their funding.
- There had been a reduction in the number of bodily injury claims due to the general damages thresholds and this coupled with legal cost restrictions in some states had led to plaintiffs not pursuing valid claims for medical costs and economic loss.
- The liability class had returned to profitability for insurers and insurer appetite for this business had increased resulting in more competition, lower prices and better availability.
- Plaintiff lawyers expressed concern that the tort reforms had shifted the balance too much in favour of the insurers and that this was being used by the insurance industry to make “super” profits from this class.

The aim of the current Working Party was to update the assessment made in 2005 taking into account information which has emerged since then about the performance of the liability class in the post tort reform environment. We also conducted a survey of valuation actuaries to understand how these actuaries were dealing with the post tort reform claims environment in their liability valuations.

1.1 Context and Qualifications

While we are now four to five years post tort reform there remains considerable uncertainty in assessing insurer claims costs post tort reform. As well as the normal variability in the insurance process, for long tail classes such as public liability the time delay between personal injury claims occurring and being settled exacerbates the measurement issues.

It is also difficult to attribute changes to insurer claims costs between tort reform impacts and other changes to insurers’ portfolios such as changes to terms and conditions, underwriting standards and business mix. When considering total industry trends problems are compounded by a lack of meaningful long term industry data on liability claims costs.

Our assessment of the impact of the tort reforms has been made in this context. Particularly when looking at insurer claims costs we note that actual outcomes could vary considerably from the projections that we have made. In addition we would expect significant variation between different portfolios.

1.2 Conclusions

Our conclusions about stakeholder impacts at this point of time are as follows.

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Consumers

Consumers have now seen two years of price decreases as well as benefiting from extensions in policy terms and conditions and we expect that the competitive market will mean that price decreases will continue through 2007 and 2008. Different segments of the market will have experienced different price reductions and in general we would expect bigger proportionate reductions to have occurred for larger risks. We would expect prices to have fallen by an average of 20% between 2004 and 2006.

We are not become aware of any major availability problems.

Plaintiffs

There has been a significant drop in the number of court lodgements post tort reform suggesting that many injured people who were previously pursuing litigation are now not doing so. We note some cautions in interpreting these court figures.

We have also seen a large drop in personal injury insurance claims at least some of which is tort reform related. Information on the average size of personal injury claims suggests that part of the decrease in insurance claims post tort reform is due to lower value claims which would be assumed to be less serious in nature.

These observations would be consistent with the reforms to general damages which introduced thresholds and deductibles for this head of damage for less severe claims.

Plaintiff Lawyers

Concerns expressed by lawyers on the tort reforms include –

- whether tort reform was needed in an environment where the High Courts and appellate Courts were already reversing the previous trend of an ever expanding scope of liability
- the tort reforms were unsoundly based on anecdotal evidence about a litigation explosion which had not occurred in reality and concerns about the sustainability of the insurance system which proved to be misplaced
- the balance of the tort reforms swinging too much in favour of insurers/defendants leaving seriously injured people without recourse to fair compensation (including non economic loss)
- insurers not passing on the benefits of tort reforms to consumers and profiting to the detriment of injured people.

Insurers

Insurer profitability has improved dramatically since the 2000 underwriting year due to a combination of higher premiums, tighter underwriting standards, reduced policy terms and conditions and (from 2003) the impact of tort reform and possibly other favourable environmental factors on claims costs.

Pre tort reform, we have observed how changes to business mix, underwriting standards etc had a dramatic impact on personal injury and also property damage claims costs.

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We expect that insurer profitability for underwriting years 2003 to 2005 has exceeded “normal” Return on Capital expectations.

With the premium reductions that we have observed since 2004 coupled with extensions in policy terms and conditions, we expect that profitability is now reducing but should remain adequate through to the 2008 underwriting year. We demonstrate, however, how quickly that profitability can be eroded through a combination of higher than anticipated premium reductions and “unintended” coverage extensions.

Our assessment of past underwriting year profitability is inherently uncertain and if we revise our assessment of recent underwriting year loss ratios upwards by 10% (which could occur as post tort reform experience unfolds) then the picture for the 2008 underwriting year starts to look less rosy and profits for that year fall into inadequate territory.

Finally we point to the differences between underwriting year and accounting year profits and the inevitable lag that seems to occur before profitable (or unprofitable) underwriting year experience is reflected in accounting year profits/losses. This distorts the signals that are sent about price adequacy and contributes to the large swings in prices that we observe for this class.

1.3 Challenges for Actuaries

Our survey of valuation actuaries suggested that actuaries had generally been cautious about recognising apparent favourable post tort reform experience in liability valuations, particularly the decline in claim frequency which all respondents had observed.

By year end 2006 all actuaries were giving at least partial credibility to the post tort reform experience while one third were giving it full credibility. We expect that this would have led to prior year reserve releases for this class over the last few years.

If post tort reform experience does not produce any nasty “surprises” we would expect further reserve releases to emerge as actuaries continue to give more credibility to this experience.

2. Approach

As well as the October 2005 TRWG report and data the Working Party utilised a number of additional sources of information on the public liability market including –

- The JP Morgan/Deloitte general insurance survey for 2005 and 2006
- Presentations and discussions at various conferences on public liability and the tort reforms
- Court statistics on public liability writs as compiled by Professor Wright in the paper “Trends in Personal Injury Litigation: Before and After Ipp”
- APRA’s National Claims and Policy Database (NCPD) which includes data for the underwriting years 2003, 2004 and 2005
- premium, policy and claim data from a number of small to medium enterprise portfolios with claims data split between property damage and bodily injury claims where available; this data represents around 25% to 30% of the total Australian public liability insurance market
- a claims manager survey
- a survey of valuation actuaries.

We collated these various pieces of “evidence” in order to update the conclusions on the impacts of the tort reforms.

We acknowledge and thank the insurers who devoted time and resources to providing us with the additional information for this paper.

3. Background to the Tort Reforms

The background to the tort reforms was covered in more detail in the October 2005 TRWG report. In summary –

- The crisis in 2001/2002 was characterised by escalating premiums and lack of availability of cover for some market segments
- The crisis was caused by a combination of –
 - ▶ severe and swift rectification of prices by the insurance industry following years of loss-making premiums; this was exacerbated by external influences such as the September 11 attacks and subsequent insurance losses, the APRA stage 1 regulatory reforms and the failure of HIH
 - ▶ a long term upward trend in claim costs which had not been recognised in pricing decisions for almost a decade.

The tort reforms can be summarised into four broad categories –

- Targeted responses aimed at some of the groups hit hardest by the insurance crisis
- Compensation restrictions for personal injury claims
- Legal or resolution changes
- Codification of certain aspects of the law of negligence.

While each State Government implemented reforms, they did so in an inconsistent manner. The impacts of the tort reform will, therefore, be different in each state.

4. Consumers Perspectives

In this section we consider the impact of the tort reforms on consumers by reference to price. We show that after a period of significant price increases between 1999 and 2003, prices stabilised and have fallen between 2004 and 2006 by around 20%, although with significant variations depending on the type of business. We also believe that policy deductibles have reduced and terms and conditions have extended. We expect price reductions and coverage extensions to continue in 2007.

We have not become aware of any major availability problems.

The major driver of price reductions is the recognition of the improvement in the profitability of the liability class. The improved profitability is an outcome of the price increases between 1999 and 2003, restrictions in policy coverage, more selective underwriting and the impact of tort reform on claims costs. The recognition of liability as a profitable class has increased the competition for Australian public liability business which drives down prices.

4.1 Price Monitoring

The October 2005 TRWG report considered the changes in liability premiums up to 2004. For this update we have considered the results of the most recent JP Morgan/Deloitte survey, available data from APRA's National Claims and Policy Database (NCPD) as well as our analysis of the SME data collection specifically for this paper.

The 13th and 14th editions of the JP Morgan/Deloitte General Insurance Industry Survey were issued in November 2005 and December 2006 respectively. As in previous editions, the survey aims to provide an overview of the state and expectations of the Australian general insurance industry. The contributors to the survey account for over 85% of the total industry.

The table below summarises the survey outcomes for premium rate changes for liability business.

Table 4.1 – JP Morgan/Deloitte GI Survey – Public Liability Premium Rate Changes

Type of business	2006	2005
Corporate	-14%	-14%
Middle market	-11%	-9%
SME	-8%	-9%
All business	-10%	-11%

According to the most recent surveys, liability rates decreased rather significantly over 2005 (11%) and 2006 (10%) with the corporate market sustaining higher decreases than the SME market. When combined with the fact that over 30% of respondents reported a decrease in excesses and just over 20% an expansion in policy terms and conditions, real decreases in premium rates may have been higher than reported.

It should be noted that during the last two years, premium rates have decreased across all commercial insurance lines (with perhaps the exception of workers compensation which was reported to have had stable rates in 2005). Both the 2005 and 2006 surveys report on the fierce competition that existed in the commercial market over that time. This is particularly evident when premium rate reductions were similar across all market segments, not just at the corporate levels.

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Adding to competitive pressures is the indication by around half of the respondents that claims frequency for Public Liability was lower than they had factored into their pricing assumptions with the majority (64%) expecting the current favourable claims frequency to persist into 2007. This is not unexpected as the most cited industry issue in 2006 for this class involved the potential unwinding of Tort Reform.

Expectations by the respondents for 2007 are for further price reductions of around 5% with some stabilisation in 2008. However, we note that the 2005 respondents had expectations of price reductions of 6% in 2006 with the actual result being 10% and there is a long history of respondents' expectations understating price reductions in a softening market and understating price increases in a hardening market.

APRA's NCPD contains written premium figures for underwriting years 2003 through to 2005. The Level 1 report shows the following for liability business.

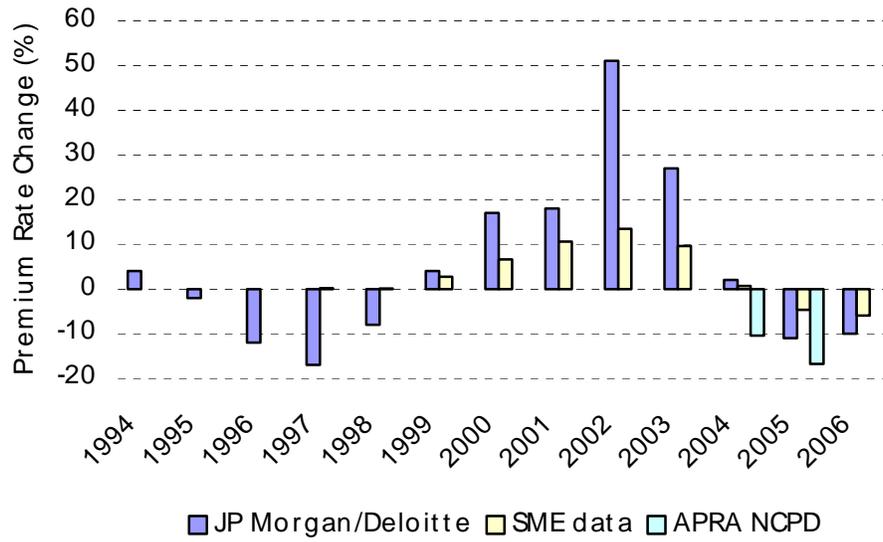
Table 4.2 – Premium and Policies from the NCPD

Underwriting year	Gross written premium	Policies written	Average written premium	Change
	\$m	'000	\$	
2003	1,713	1,722	994	
2004	1,743	1,882	926	-7%
2005	1,594	1,989	801	-13%

According to this data average written premium fell by 7% in 2004 and by 13% in 2005 suggesting higher premium rate decreases than the JP Morgan survey given that exposure measures such as turnover to which premium rates are applied could be assumed to increase by normal inflation. Of course, this assumes that average premium is an appropriate basis to measure rate changes and that this is not changing due to other impacts (e.g. business mix or policy recording practices).

The following graph shows the premium rate movements by year from three sources – JP Morgan/Deloitte, SME portfolios and APRA's NCPD. For the latter two sources we inflation adjusted the average premium in order to measure premium rate changes rather than premium changes due to growth in the underlying exposure.

Figure 4.1 – Summary of Premium Rate Changes



The various pieces of information on prices suggest that –

- premium rates have been falling since 2004
- the cumulative premium rate reduction between 2004 and 2006 varies from a 10% reduction from the SME portfolio data, a 20% reduction from the JP Morgan/Deloitte survey and over a 25% reduction from the NCPD information.

5. Plaintiff Lawyers Perspectives

5.1 Background

One of the major groups in any fault-based personal injury compensation system is the plaintiff lawyers. They represent injured parties in deliberations with insurers as to the amount of compensation that is finally payable.

In this section we outline some of the views expressed by the legal profession on the issues surrounding tort reform during 2006.

5.2 Sources of Information

We have looked at the Law Council of Australia media releases and speeches from 2006 on the issue of tort reform as well as a paper prepared by Professor Wright for the Law Council of Australia in May 2006 titled “Trends in Personal injury litigation: Before and After “Ipp””. We also examined a paper written by Justice Terry Connolly of the Supreme Court of the ACT in 2006. Finally we looked at the material on the “Fair Go for Injured People” campaign being run in NSW by the NSW Bar Association, the Law Society of NSW, the Law Council of Australia and the Australian Lawyers Alliance. We have documented the concerns raised by the legal profession without assessing or commenting on the merits of the arguments raised.

5.3 Trend in Personal Injury Litigation: Before and After Ipp – Professor Wright

The paper prepared by Professor Wright for the Law Council of Australia examined trends in personal injury litigation excluding motor and workplace accidents in Australian state and territory courts over the period 1995 to 2005.

The conclusion of the analysis was that

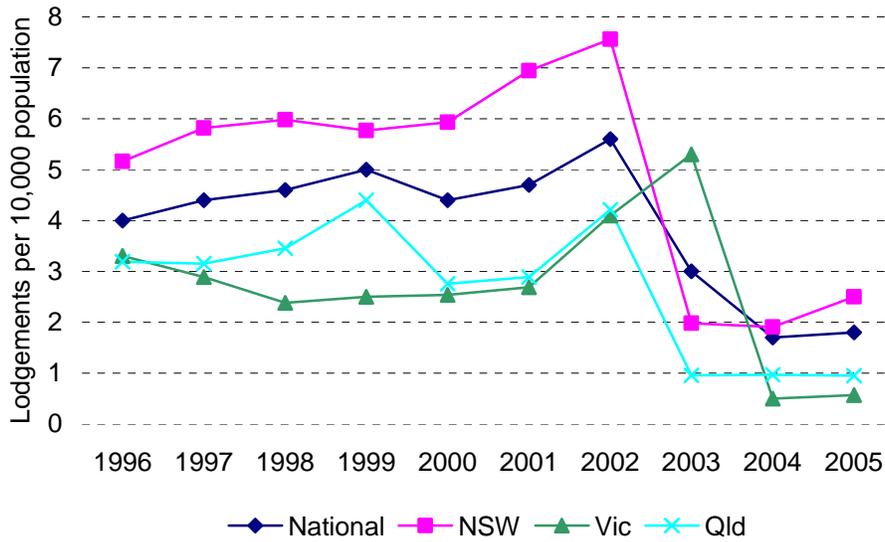
“contrary to widespread belief, litigation rates had not, generally, been increasing in the period leading to the Ipp Review. This finding provides no empirical foundation for the premises underlying tort law reform as a strategy for addressing the insurance crisis in 2002.”

And further

“The reforms introduced by the state and territory legislatures have caused a substantial decline in personal injury litigation rates in most jurisdictions. The ‘corrections’ in the three largest states, New South Wales, Queensland and Victoria have been particularly dramatic”

The following chart shows the numbers of court lodgements per 10,000 population for NSW, Victoria, Queensland and Nationally taken from Professor Wright’s paper.

Figure 5.1 – Court Lodgements per 10,000 Population



We have tried to establish a pre tort reform benchmark ignoring the “spikes” which occurred just before reforms were introduced and have measured the following –

- a 55% to 65% drop in court lodgements for NSW
- a 70% drop in court lodgements for Queensland
- an 80% drop in court lodgements for Victoria
- a 60% drop in court lodgements Nationally.

There was some increase in lodgements for NSW and Victoria in 2005.

There are a number of limitations to the data analysed in Professor Wright’s paper including –

- Reliance on the coding of matters to other personal injury rather than motor vehicle or workers compensation matters; Professor Wright notes that some features of the figures for the WA District Court for example suggest that this coding has not been reliable.
- Grouping of medical indemnity matters and occupiers liability matters – for many courts there is no distinction between these.
- Lack of full historic District Court records for NSW and the need to extrapolate this information from Sydney District Court records.
- Claim “spike” activity mainly associated with the introduction of tort reform (but not always) which makes it difficult to assess the pre tort reform level of court commencements.

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Professor Wright acknowledges these limitations. Professor Wright also acknowledges that not all liability claims lead to court proceedings and not all court commencements lead to substantial litigation. Further potential issues with the data are –

- the impact of the pre tort reform spike of court commencements on the post tort reform reporting patterns (i.e. the spike may have brought forward claim reports resulting in a low level of post tort reform reporting activity)
- the impact that delays in regulations governing court lodgements may have had on post tort reform reporting patterns (particularly in Victoria)
- public liability insurance covers both personal injury and property damage claims and the court statistics relate only to the personal injury component.

Because of this, caution is required in extrapolating the court statistics to draw conclusions on the impact of the tort reforms on public liability insurance claims.

5.4 Law Council of Australia

31 January 2006 – Tort Law Changes Hit Injured Australian Where it Hurts Most

“Referring to the (productivity) commission’s Review of Government Services report, Law Council President John North said “Tort law changes were an excessive reaction by governments. This report shows that the laws have prevented over 40 per cent of claimants from pursuing their common law rights. Since the laws were introduced there have been negligible reductions in premiums”

“What the report does not show is the real human cost of the [tort law] changes” Mr North said “Every year the number of people struggling to cope with injury, without compensation, continues to rise. Meanwhile, insurance companies are wallowing in profits made at the expense of those who can least afford it”

31 May 2006 – Tort Law Reforms Were Unnecessary, According to Law Council Report

This release refers to the report by Professor Wright.

“Law Council President elect – Tim Bugg said “This comprehensive national report shows, once and for all, that litigation rates were, generally, not rising exponentially in the lead up to the 2002 Ipp Report, and that there was no justification for the sweeping reforms to tort law”

“as the Law Council has feared for some time, these reforms have simply diminished the rights of injured Australians to claim compensation, rather than helped reduce insurance premiums”

Speech by Tim Bugg, President-elect of the Law Council of Australia, delivered at the Fiji Law Society 50th Anniversary Convention, 26-29 May 2006 – Negligence and damages – personal injury, property damage and pure economic loss

Conclusion of speech.

“The Australian experience holds many lessons for countries considering statutory reform of tort law. Good reason for the reform of tort law to the extent seen in Australia must be clearly shown. The reforms which have occurred have robbed many seriously injured people of the right to seek fair compensation

from the wrongdoer. In the meantime, perhaps the most vocal proponent of legislated tort reform, the insurance industry, has experienced considerable financial gain.”

5.5 Other Legal Commentary

Justice Terry Connolly, Supreme Court of the ACT paper “Where does the tort debate leave us? Views from the bench” delivered at the 15th annual insurance law congress in Sydney, 26-28 July 2006.

Some key points from that paper include –

- The tort reforms recommended by the Ipp panel were largely made on the basis of anecdotal evidence about affordability, availability, levels of damages, insurance costs or profitability.
- The assumption of an unsustainable insurance industry that drove much of the 2002 debate may prove to be mistaken.
- The tort reform debate in Australia has avoided an entrenched partisan debate unlike the US, which is a positive.
- The ACT Government did not impose a regime of caps and thresholds yet CTP premiums remain competitive with NSW.
- The report by Professor Wright debunks the myth that Australia had been experiencing a litigation explosion in the period leading up to Ipp.
- Even before the insurance crisis the High Court and appellate courts in the various states had intervened to reverse the long term trend in favour of an ever-widening scope of liability –
 - ▶ Professor Harold Luntz “Editorial Comment: Round up of Cases in the High Court of Australia in 2003” observed that in 2002-2003 only 30% of High Court decisions relating to personal injury could be considered pro plaintiff whereas in 1987-1999, 80% of decisions were pro plaintiff.
- Key decisions noted include –
 - ▶ *Ghantous v Hawkesbury Council*, 2001 (pedestrian who slipped and fell on an obvious and visible pavement irregularity failed to recover damages).
 - ▶ *Woods v Multi-Sport Holdings Pty Ltd*, 2002 (plaintiff injured eye from a ball deflection during a game of indoor cricket, trial judge rejected a claim that there was a duty of care to warn players of a risk of injury).
 - ▶ *Vairy v Wyong Shire Council*, 2006 and *Mulligan v Coffs Harbour City Council*, 2006 (no failure to warn a swimmer about hazards of diving).
 - ▶ *Cole v South Tweed Heads Rugby League Club*, 2004 and *Desmond v Cullen*, 2001 (a person who drinks to the point where they take dangerous actions cannot recover against the person who sold them the liquor).
 - ▶ *Reynolds v Katoomba RSL*, 2002 (no duty of care owed by gaming establishment in allowing patrons to gamble beyond their means).

- ▶ Agar v Hyde, 2000 (no duty of care owed by rugby union governing body to a player who sustained injuries playing a rugby union game).

5.6 The Fair Go for Injured People Campaign in NSW

The campaign highlights the right to compensation for non economic loss for those people injured due to the negligence of others. The campaign points out the complexities and inconsistencies in injury compensation in NSW and the barriers to access to fair compensation particularly compensation for non economic loss.

The campaign vision is for a uniform system of compensation across NSW with the compensation for individuals determined by independent judges not bureaucrats, politicians or insurers and the elimination of AMA whole person impairment type thresholds for access to non economic loss. In general the campaign appears to target the workers compensation and CTP benefit regimes (which have WPI thresholds for access to non economic loss) however there is some ambiguity in certain statements.

“The profitability of both Workers Compensation and the Motor Accidents Schemes indicated that it was now time to relax the harsh and arbitrary thresholds that determine whether a person’s injury is severe enough to warrant compensation”, 28 September 2006

“sweeping changes to workers compensation, motor accidents and civil liability legislation in 1999-2002 were driven by panic over rising insurance premiums and unavailability of insurance. “”Insurers have been the sole beneficiaries of massive reductions in personal injury payments to those injured through no fault of their own””, 9 June 2006

“The changes to motor accident compensation, workers’ compensation and public liability claims went too far. It’s as though the most important people – the injured – were forgotten when the laws were being debated”, extract from letter to local MP from the Bar Association of NSW website

6. Insurer Perspectives

We have considered the insurer perspective in terms of the impact of tort reform on insurance claim costs and on profitability.

From the information we have examined, we believe that –

- tort reform has contributed to a significant drop in claim frequency for insurers, possibly of the order of 40% for personal injury claims and 20% to 30% for all claims; the analysis we have undertaken indicates the significant impact that portfolio mix and policy terms and conditions can also have on claim frequency
- average claim size for personal injury claims has increased as claim frequency has decreased which would be consistent with tort reform having a bigger impact on the damages for less serious claims; overall average claim size has been relatively flat due to the increasing contribution of property damage claims to total claims costs
- cost per policy has fallen in real terms for both personal injury claims and all claims; tort reform may have reduced costs per policy by around 25%
- we would expect very different results from different types of portfolio due to the impact of portfolio mix and policy terms and conditions on outcomes
- profitability has been very strong since the 2002 underwriting year due to a combination of premium rate increases and cost per policy reductions; the liability class has outperformed RoC expectations for more recent underwriting years following a long period of inadequate performance; liability business is now viewed as the most profitable class underwritten by many insurers
- we predict that liability business profits will decline but remain adequate for the next couple of underwriting years despite our expectation of a continuation of premium rate reductions; however we demonstrate how rapidly profitability can be eroded
- because of the lag in recognising profitable or unprofitable performance it is possible (and even likely) that the market will remain competitive for liability business after premium rates become inadequate.

6.1 Claim Cost Impacts

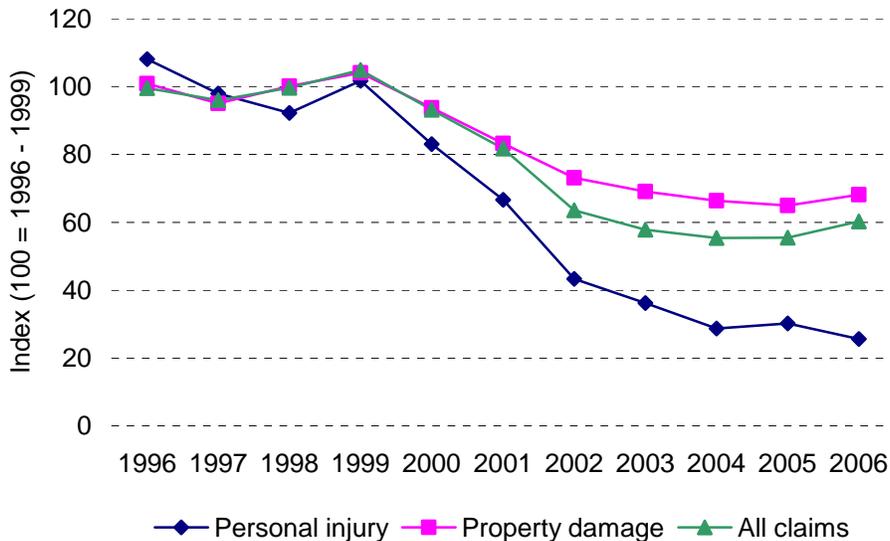
We have examined the impact of the tort reforms on the number or frequency of claims, the average size of claims and cost per policy using the SME portfolio data.

Measuring the impact of tort reform changes on claims costs is always difficult for long tail classes because of the time that it takes from a claim occurring to being settled. Difficulties are often compounded by a slowing down of finalisation levels post tort reform as plaintiffs and their representatives and insurers become familiar with the new environment. This can lead to a “honeymoon” effect, with the benefits of tort reform appearing greatest in the periods immediately following implementation but being unwound somewhat with the passage of more time.

6.2 Claim Frequency

The SME data that we analysed contained both personal injury and property damage claims with some insurers able to split the data between these two claim types. We projected claim numbers to ultimate amounts and expressed the resulting frequency relative to the frequency applying in the period 1996 to 1999. The graph below shows the results for each of personal injury, property damage and all claims. Note that here the total is for all insurers who provided claims data not the total for those insurers who split the claims data between personal injury and property damage.

Figure 6.1 – Accident Year Claim Frequency – SME (100 = 1996-1999)



Claim frequency started to fall in 2000, well before the tort reforms. For these insurers, by 2001 claim frequency had already fallen by over 30% for personal injury claims and by 20% for property damage and across all claims. Claim frequency in the post tort reform period then fell by a further –

- 50% - 60% for personal injury claims
- 20% for property damage claims
- 30% for total claims.

Clearly factors other than tort reform caused the drop in claim frequency prior to 2002 and the drop in property damage frequency after 2002. Factors that would have impacted include higher deductibles, restrictions in coverage and changes in portfolio mix. It is therefore not possible to be definitive about the contribution of tort reform to the 50% - 60% drop in personal injury claim frequency post tort reform. Tort reform is clearly a major factor but we do not believe is the only contributor to this reduction.

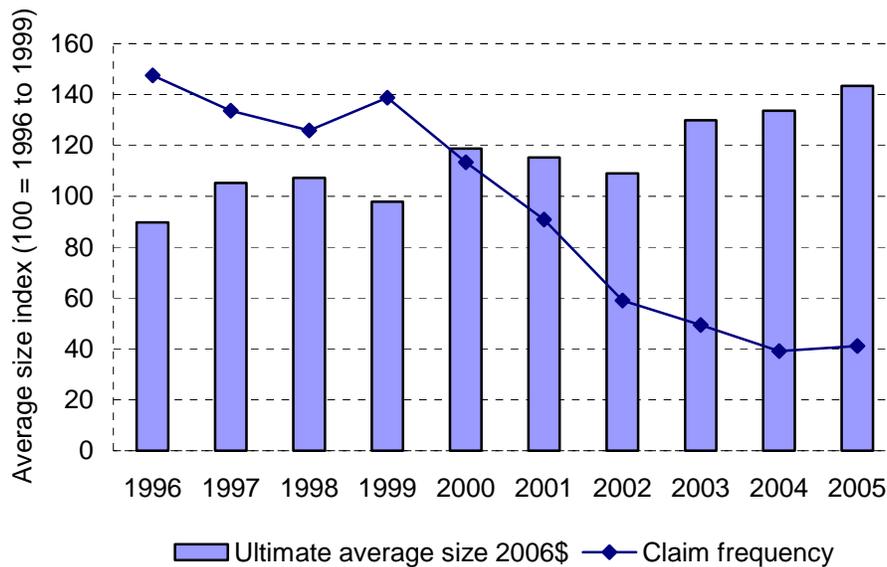
We would expect significant variation in frequency changes for individual portfolios depending on the type of business written and the jurisdictional exposures as well as changes to the specific portfolio composition and policy terms and conditions (including deductibles).

6.3 Average Claim Size

The impact of the tort reforms on the size of claims is complex. To the extent that the reduction in claim frequency is due to the elimination of “smaller” claims, then average size might be expected to increase. The extent of any increase will vary, however, depending on the jurisdiction. For example, in Victoria where there is a threshold for access to general damages (5% WPI) but no change to the assessment of GDs once this threshold is met there will be a different impact than in NSW, where the GD sliding scale approach impacts claims with a pre tort reform GD entitlement of over \$137,000.

Because of the delay between accident occurrence and settlement it will be some years before the average claim size impact can be measured with certainty. The graph below shows the projected ultimate average claim size for the SME portfolios for personal injury claims. Clearly there is considerable uncertainty in these projections and they rely on the appropriateness of applying historic development patterns to post tort reform experience. The projection for 2006 is considered too uncertain to be included. The chart also shows the claim frequency for personal injury claims over the same period.

Figure 6.2 – Personal Injury Ultimate Average Claim Size (2006 \$s) vs Frequency - SME

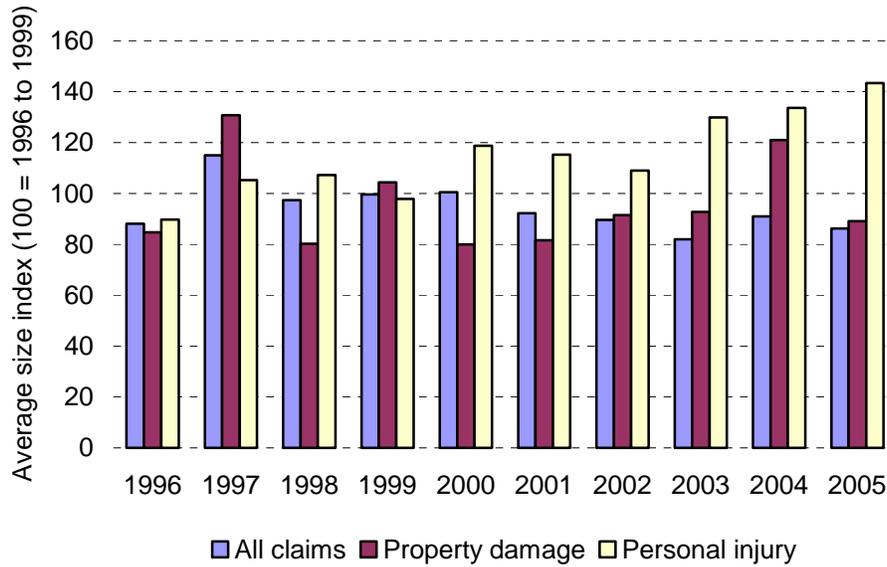


The chart indicates that when claim frequency started to drop in 2000 and 2001 average claim size increased by around 20%. It increased further post tort reform as claim frequency fell further – the average size for 2005 is around 40% higher than the pre tort reform size.

The following chart shows the overall average claim size and property damage average claim size by accident year.

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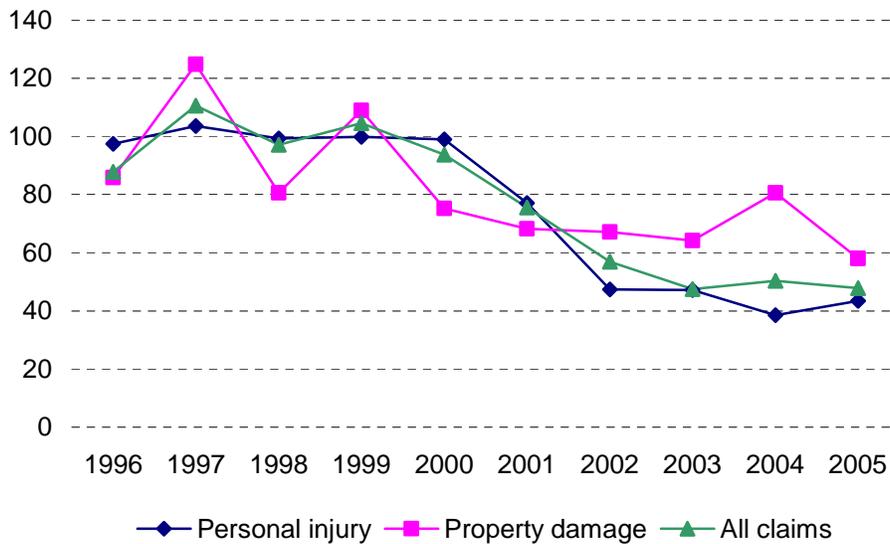
Figure 6.3 – Total, PD and PI Ultimate Average Claim Size (2006 \$) - SME



At an overall level, average claim size has decreased in real terms by about 10% post 1999. This is because property damage claims, which have a much lower average claim size than personal injury claims, now comprise a much higher proportion of the total claims costs.

Combining the claim frequency and claim size information we examined the cost per policy (CPP) impact on the SME portfolios. The following chart shows the CPP for each of personal injury, property damage and for all claims relative to the pre tort reform “base” level measured as the average of 1996 to 1999.

Figure 6.4– Accident Year CPP (2006 \$) – SME (1996 – 1999 = 100)



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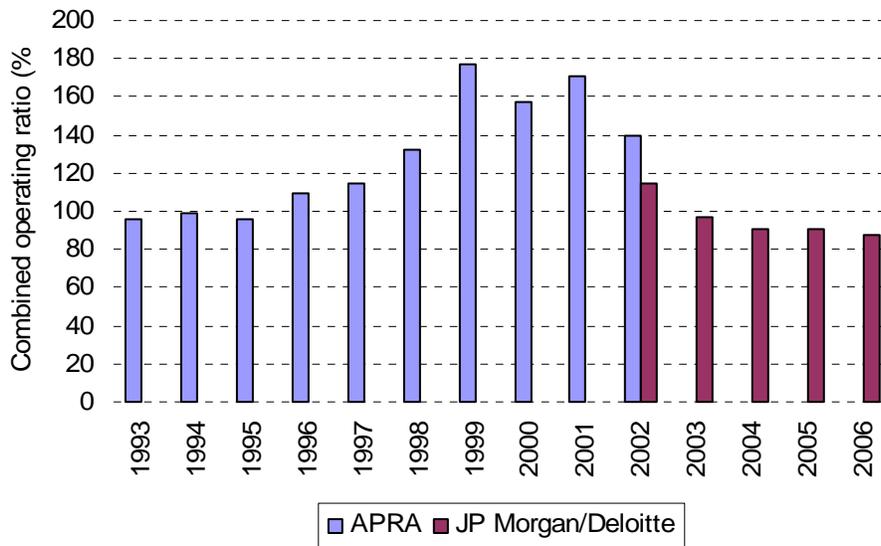
The chart indicates that for these portfolios the CPP for property damage fell by around 30% in the period 2000 to 2005 compared with the “base” level. The personal injury CPP for the period 2002 to 2005 is around 45% of the base level but had already dropped to 80% of the base level in 2001 (prior to the tort reform). Overall the CPP has halved in real terms with half of this reduction occurring prior to the introduction of the tort reforms.

6.4 Profits

Past Profits – Accounting Year

As detailed in the October 2005 TRWG report, profitability proved evasive for this class from 1996 to 2002 (significantly so for the period 1998 to 2002). Since that time it would appear that profitability has returned. The graph below shows the industry combined operating ratios (loss ratio plus expense ratio) for the period 1993 to 2006. The earlier years’ data is taken from APRA statistics and the latter from the JP Morgan/Deloitte surveys. (HIH is excluded for the 2001 statistic and therefore results for that year will be understated.) Note that these figures are for accounting years and include the impact of reserve increases and decreases.

Figure 6.5 – Accounting Year Combined Operating Ratio – “Industry”



The impact of prior year reserve releases on more recent years’ results is unclear. We would expect that initial caution about the impact of tort reform and other portfolio changes may have led to subsequent redundancy in prior year reserves.

Past Profits – Underwriting Year

It is clearly more relevant to examine profitability on an underwriting year basis or at least an accident year basis rather than an accounting year basis. In order to do this we have made a projection of underwriting year loss ratios using three sources of information –

- Insurance Statistics Australia (ISA) public and products liability aggregate data which was collected on an accident year basis up until 2000.

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- NCPD database of underwriting year losses.
- SME portfolio information on an accident year basis.

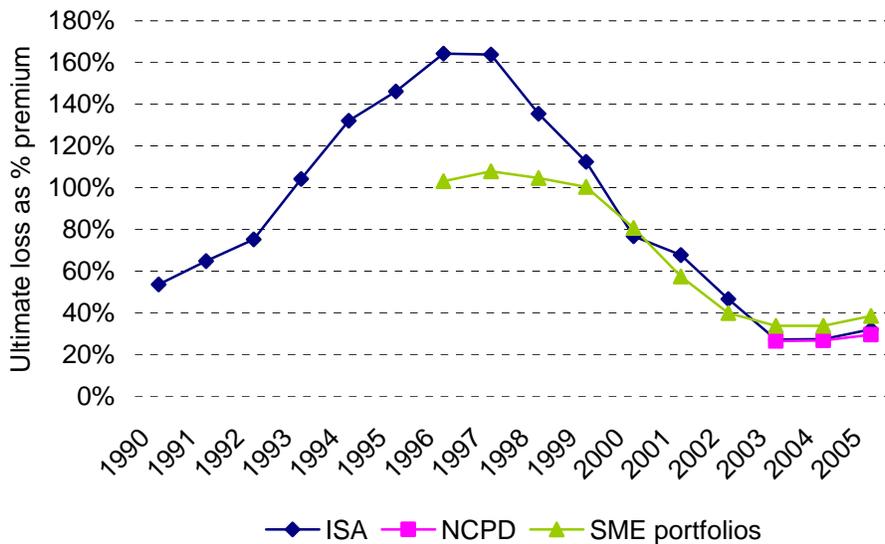
The process we used was as follows –

- Estimate underwriting year loss ratios for the period 1990 to 2000 from the ISA accident year data and extrapolate those loss ratios forward allowing for –
 - ▶ Premium rate changes as contained in the JP Morgan/Deloitte surveys
 - ▶ Superimposed inflation of 4% per annum
 - ▶ 30% reduction in claims costs from a combination of tort reform, higher deductibles, restrictions in coverage and more selective underwriting.
- Project underwriting year loss ratios for the period 2003 to 2005 from the NCPD using “benchmark” loss development patterns.
- Estimate underwriting year loss ratios from the SME portfolio data which is on an accident year basis.

It is important to note the uncertainty of these projected loss ratios since we are applying pre tort reform incurred cost development factors to the post tort reform experience. There is some concern that post tort reform development experience may be slower than pre tort reform as the “new” environment begins to be tested and that larger claims may emerge.

The following chart shows the results of these three sets of projections and extrapolations.

Figure 6.6 – Underwriting Year Loss Ratios



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This analysis indicates high underwriting year loss ratios in the period 1993 to 1999 although with much better performance from the SME portfolios compared with the ISA portfolios. All three projections suggest loss ratios of the order of 30% to 35% in the period 2003 to 2005 following the combination of –

- Premium rate increases
- Underwriting and policy and condition changes
- Tort reform.

There are a number of additional items needed in order to examine underwriting year profitability and we have made the following assumptions –

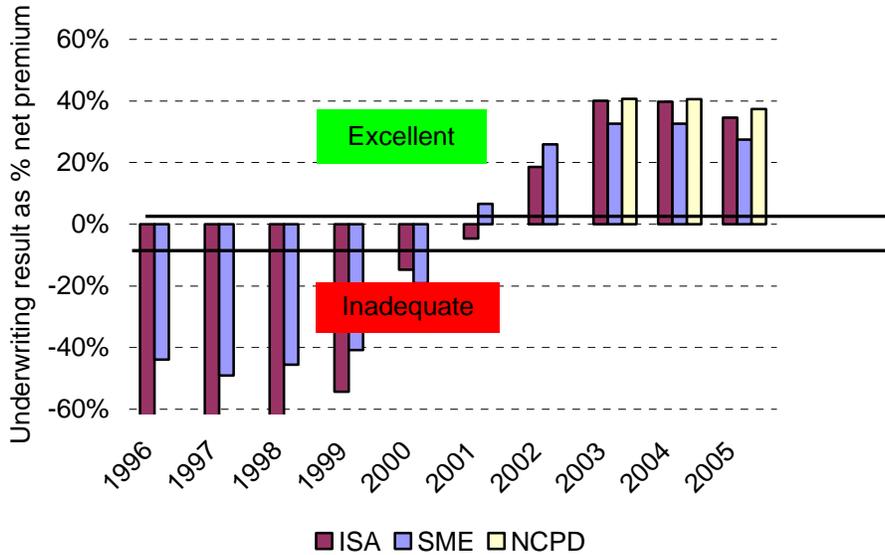
- Reinsurance cost – 5%
- Expenses – 30% net premium (from APRA and JP Morgan/Deloitte figures) plus 5% of claims costs
- Underwriting year undiscounted loss ratio – as projected above
- Underwriting year result = 100% - U/W yr loss ratio – R/I cost – Expenses.

The following chart shows the resulting underwriting year result expressed as a % of net premium. We have estimated the level of underwriting result required to produce an adequate return on capital (RoC) assuming further –

- “stable” state single year calculation basis
- average payment duration 4 years
- undiscounted loss = discounted loss + risk margin
- RoC target between 12% and 17% (after tax)
- capital = 80% net premium
- risk free rate = 6%, capital investment return 8%
- tax rate 30%.

The solid lines indicate the boundaries for the underwriting result producing an adequate RoC. We estimate that an underwriting result of over 2%, i.e. undiscounted combined operating ratio of under 98%, will produce an above expectations or “excellent” RoC. An underwriting result of lower than -8%, i.e. undiscounted combined operating ratio of over 108% of premium, will produce a below expectation or “inadequate” RoC.

Figure 6.7 – Underwriting Year Result



The 1996 to 2000 underwriting years produced inadequate RoCs. The 2002 to 2005 underwriting years have exceeded RoC expectations and produced excellent results.

Future Profits - Underwriting Year

We have made an assessment of future underwriting year profitability assuming a base case of –

- 2004 underwriting year gross loss ratio 30%
- Reinsurance cost and expense rate assumptions as above
- Premium rate reductions of 10% per annum
- Superimposed inflation of 4% per annum.

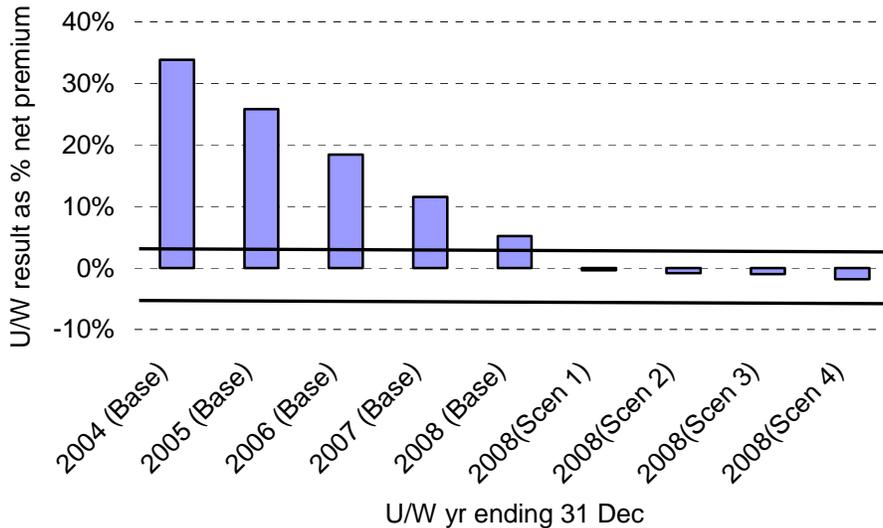
The chart below shows the projected underwriting result on these “base case” assumptions. We have then tested the sensitivity of these results to the following alternative scenarios –

- Scenario 1 - claim cost deterioration of 15% (above and beyond expected SI) due to a combination of reduction in underwriting standards, extension of policy terms and conditions and/or erosion of tort reform impact.
- Scenario 2 - Superimposed inflation of 8% per annum.

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- Scenario 3 - 2004 underwriting year loss ratio actually 35% (note that this is equivalent to an extra 15% of development in our earlier loss projections).
- Premium rate reduction of 12.5% per annum.

Figure 6.8 – Projected Underwriting Year Profit



Under the “base case” assumptions the underwriting year result reduces dramatically due to the combination of the premium rate reductions and claim cost increases. However, by the 2008 underwriting year, we predict that the business will still be producing healthy results. Under each of the alternative scenarios considered the 2008 year result falls further but remains in the “adequate” range.

The scenarios required to move the 2008 year result from adequate to inadequate are as follows –

- claim cost deterioration of 35% or more
- superimposed inflation of 12% per annum or more
- 2004 underwriting year loss ratio of 40% or more
- premium rate reductions of 15% per annum.

A combination of these scenarios, such as recognition that the 2004 underwriting year loss ratio is actually higher than projected coupled with some claim cost deterioration due to more relaxed policy terms and conditions will also push outcomes into the inadequate territory.

It is also interesting to consider that changes to portfolio composition, underwriting standards and policy terms and conditions led to a quite rapid 25% improvement in the cost per policy for the SME portfolios examined in the period 1999 to 2001. Presumably this improvement could be equally rapidly lost.

Underwriting Year Versus Accounting Year Profits

Liability business was very profitable from 2002 but its ranking as a profitable class by insurers in the JP Morgan/Deloitte survey on a scale of 1 (most profitable) to 9 (least profitable) was –

- 9 in the 2002 survey
- 7 in the 2003 survey
- 4 in the 2004 survey
- 3 in the 2005 survey
- 1 in the 2006 survey.

While this ranking may also say something about other classes of business, we note that liability business was producing extremely healthy profits on an underwriting year basis for four years before it was ranked in the top 3 profitable classes.

We believe that this is indicative of the inevitable lag in recognising how profitable (or not) a long tail class of business is, particularly when changes in claims experience are occurring. Once favourable (or unfavourable) experience is recognised there is a geared impact on accounting profitability as the new view impacts both the measurement of the profitability of past underwriting years as well as the profitability of the current underwriting year.

This can lead to an over reaction in prices both upwards and downwards since the normal feedback mechanism of profit/loss recognition into the need to decrease/increase prices has had a 3 to 4 year time delay.

7. Challenges for the Actuary

In this section we present the results of our survey of a number of actuaries involved in reserving for liability business.

The portfolios valued by these actuaries included corporate and SME business and were reasonably uniformly spread across jurisdictions. There was a huge variety of insured deductibles for corporate business of as much as \$500,000 per claim. For the SME portfolios deductibles ranged from \$250 to \$1000. The following summarises the responses to the survey questions on the effects of tort reform.

1. What, if any, change has there been in the type of business written post tort reform?

Several respondents noted the increase in competition post tort reform having an impact on strategy.

2. How have premium rates changed over the post tort reform period?

Premium rate changes ranged from 10% per annum reductions for SME to 20% to 30% per annum reductions for large risks. Some respondents noted that rate reductions had been targeted at specific occupations rather than across the board decreases.

3. Has tort reform had an impact on the speed of claim reporting?

Majority view appears to be that there has not been any change in the speed of claim reporting post tort reform. However, some respondents had observed a speeding up.

4. Has tort reform had an impact on the frequency of small and large claims?

Most respondents agreed that there had been a reduction in the frequency of small claims post tort reform. Large claim frequency had either stayed the same or reduced slightly. Some respondents attributed some of the claim frequency changes to changes in business mix.

5. Has tort reform had an impact on the size of claims?

Responses were very mixed with some actuaries noting an increase in average claim size and some actuaries a decrease in average claim size!

6. What differences in frequency and claim size exist between States?

This was not examined by all actuaries due to the size/nature of portfolios. Where it was examined in general NSW was rated as having a higher average claim size than other states. Otherwise responses were quite inconsistent.

7. Has tort reform had any specific effects on industry segments?

Most respondents had not examined this or had not completed their investigation. One respondent noted that the reforms had clearly had a very significant impact on claim frequent segments with significant personal injury exposure.

8. How are you dealing with changes in claim frequency in your valuation?

All actuaries (who used average payment x number models) had allowed for the reduction in claim frequency in their valuations albeit gradually. Some actuaries were still being cautious about the low frequency being exhibited for the most recent years and adding a loading to the observed level.

9. How are you dealing with changes in claim size in your valuation?

Most actuaries (who used average payment x number models) were now allowing for the observed “post tort reform” average claim size in their valuations. In some cases this led to a lower average claim size being adopted and in others a higher average size. Some actuaries were assuming average claim sizes will rise for more recent accident years due to the reduced frequency of small claims.

10. How are you dealing with changes to superimposed inflation in your valuation?

Most actuaries making an explicit superimposed inflation assumption had not changed this assumption post tort reform although some noted that there had not been much evidence of superimposed inflation in recent years. Other actuaries noted the difficulty of understanding the contribution of superimposed inflation as opposed to tort reform or business mix changes on emerging average claim size (where this was observed to be increasing).

11. Have you made any changes to your reserving methodology post tort reform?

In general actuaries had not made changes to their valuation methodologies post tort reform although in some cases they had had to adapt their application to deal with the change in claims experience observed. A number of respondents were using pricing and premium rate information to establish ‘a priori’ estimates that reflected changes to pricing adequacy. One respondent was making an explicit adjustment to the central estimate to allow for the impact of a potential wind back of tort reform.

12. How much credibility is given to post tort reform experience?

Two thirds of respondents were giving partial credibility to post tort reform experience. The remaining third were giving significant credibility to the experience. It appeared as if the level of credibility given to the post tort reform experience had increased in 2006 and prior to this some actuaries were giving little weight to this experience.

13. Over what time period do you think it reasonable to give full credibility to the post tort reform experience?

Responses varied from 3 years to 6 years post accident. This means that full credibility would be given to the experience of the 2003 accident year – the first post tort reform year - by 2008 for all respondents.