
GENERAL TRENDS & PROBLEMS IN LIABILITY INSURANCE

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I was genuinely pleased to receive the invitation to address you because it provides a rare opportunity to give the insurance industry's perspective on the general trends and problems in liability insurance.

Media coverage of the so-called "Liability Crisis" has not been of sufficient depth or detail to create a good understanding of the nature of the problem.

I propose to describe the way in which liability insurance has been impacted by the structure and characteristics of the insurance marketplace in Canada, by the world reinsurance market, by the Canadian judicial system and by the expectations of the society in which we live.

I will describe the causes of the current liability crisis, I'll explore the underlying philosophical issues and will review the options that we believe are open to society in deciding what kind of an injury reparation system is desirable and affordable.

I will conclude with a review of the system proposed by Dr. David Slater in the Report of the Ontario Task Force on Liability Insurance, the alternative system proposed by the Insurance Bureau of Canada and my assessment of the outlook for the future of the liability insurance marketplace.

Nature of Canadian insurance industry

To put this subject in perspective, it is necessary to have a basic understanding of the nature of the insurance industry in Canada and the forces at work in the marketplace.

Ours is an industry which periodically suffers from over-capitalization and surplus capacity and that was certainly the case from 1979 until 1985, the period we refer to as "the soft market".

During the soft market, competition drove down the premium levels, underwriting standards were weakened and loss prevention activity waned.

Competition flourishes in general insurance because it is a very fragmented industry in which there are roughly 300 companies competing, the largest of which has less than a 6 percent market share. (There is no dominant supplier, no price leader.)

There are few barriers to entry — practically anyone with \$5 million and what appears to be a reasonable business plan, can obtain a federal licence. Provincial requirements are less stringent.

The general insurance industry is supply driven — prices are very sensitive to the relationship between supply and demand, just like oil, wheat or pork bellies.

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It is an industry which is very cyclical — when supply exceeds demand, prices drop, profits evaporate, capital and surplus is depleted, supply shrinks, the market tightens, prices increase, profitability is restored, supply increases and the cycle starts all over again. We have just experienced the end of the eighth cycle of this century and are now in a “hard market” phase. In short, the marketplace conforms to an economist’s academic concept of “perfect competition”.

As a result of the competitive nature of the industry, profits are very thin. Return on shareholders’ equity has been rather unsatisfactory when compared to the generally-accepted target of 15 percent. In both 1984 and 1985, the return was just under 7 percent and the 13-year average was 9.78 percent.

Product priced before cost known

Apart from the competitive nature of general insurance, one of its formidable problems is that its product must be priced before its cost is known.

The best way I can describe this rather unique situation is to say that we have to use *yesterday’s* statistics to calculate *today’s* premiums out of which we must pay *tomorrow’s* claims.

This is a general outline of the property and casualty insurance business. Now, I would like to focus on liability insurance.

In contrast with the marketplace as a whole, the commercial liability insurance marketplace is relatively small with, perhaps, twenty companies being the major writers of this class of business.

There are relatively few underwriters and loss control engineers with the expertise that is needed to handle high-risk liability insurance. This narrow underwriting capability means that a tightening market impacts the high risk liability insurance business much more severely than the market as a whole.

Liability insurance is also negatively impacted by the problems insurers have experienced in recent years in forecasting future claims costs. They have fairly consistently found themselves under-reserved when claims eventually had to be paid.

The Ontario Task Force on Insurance estimated that claims reserves are currently deficient by close to one billion dollars, and we have no reason to disagree with that figure. The magnitude of that deficiency can be appreciated when one realizes that it represents one-sixth of the total capital base of the industry.

This inability to accurately predict ultimate claims costs presents a major problem to the actuary or underwriter charged

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with the responsibility for determining how much premium should be collected today to pay tomorrow's claims.

Another problem is that the Canadian liability insurance market is relatively small, producing only \$600 million a year in premium income. The high risk end of the market is even smaller.

More dependent on reinsurance

This does not create a very large pool out of which to pay substantial claims which means that the Canadian market is more dependent on the availability of reinsurance capacity in the international market than would be the case in, say, the United States.

In contrast, automobile insurance written by private enterprise insurers produces over four billion dollars in premiums, a much more substantial fund to withstand large claims.

So much for the nature of the insurance market. Now let's look at the reasons for the liability crisis. The primary cause of the liability crisis in Canada is the rapid deterioration in the Canadian claims experience.

In the five years ending 1985, claims costs mushroomed from \$184 million to \$602 million, an increase of 227 percent which is five times greater than the rate of economic inflation. (43 percent) In contrast, during the same period of time, competition held growth in premium income to only 94 percent.

Based on figures for the first six months of 1986, we forecast another 20 percent increase in liability claims costs this year, so they are still increasing five times faster than inflation.

For the past twelve months we have been witnessing the closing of the gap between income and outgo by means of substantial premium increases. Even though investment income was very healthy throughout this period, outgo for liability insurance claims and expenses exceeded income from both premiums and investment income by \$350 million. This financial drain threatened the solvency of the weaker insurance companies.

The second largest carrier of liability insurance went to the wall and was rescued from bankruptcy by a new owner who promptly took it out of the high risk liability insurance business which had precipitated its near demise. Another major insurer of high risk business did go broke — flat broke!!

While all of this was taking place in the domestic insurance market, the same or worse was happening in the world market, influenced mainly by events in the United States where the civil justice system is regarded by many observers as out of control.

“A common misconception is that the dramatic decline in interest rates had an adverse impact on investment income and reduced the funds available to pay claims. This is simply not supported by the facts.”

As a result, there has been a near collapse of the market for high risk liability insurance business in North America. European and Asian reinsurers have withdrawn in bewilderment at the unpredictability of the system and dismay at the magnitude of their losses.

Unfortunately, Canada has been tarred with the same brush as the United States, in spite of the fact that our judicial system is not yet interpreting negligence as broadly as in the U.S.A.

Devastating shakeout

Quite apart from the reluctance of international reinsurers to handle North American liability risks, there has been a devastating shakeout in the reinsurance business because of disastrous claims experience.

Many new reinsurers who entered the business during the last ten years and who created a worldwide glut of reinsurance capacity, have since gone broke. Reports emanating from the world reinsurance community indicate that the number of reinsurers active in the marketplace shrank from over 4,000 to under 800 and capacity dropped by 65 percent, with some estimates running as high as 75 percent.

This sharp reduction in reinsurance capacity had a particularly heavy impact on the Canadian marketplace because its relatively small size makes it more heavily dependent on reinsurance for higher levels of coverage.

Essentially, then, the liability insurance crisis is the result of a rapid escalation of claims costs which outpaced income from both premiums and investments and caused a severe shakeout in both domestic and foreign markets.

This shakeout manifested itself in reduced capacity, tight market conditions, large premium increases, restrictions on the extent of coverage and the total exclusion of risks which had become so unpredictable that they were virtually uninsurable.

Having identified mushrooming claims costs as the basic cause of the crisis, I would like to dwell for a moment on what did *not* cause it.

A common misconception is that the dramatic decline in interest rates had an adverse impact on investment income and reduced the funds available to pay claims. This is simply not supported by the facts.

Figures gathered by Statistics Canada show that investment income has been running at an all-time high, both in absolute dollar terms and relative to premium income.

The rate of return of invested assets has not changed very much over the past five years and certainly does not indicate that investment income has suffered. It is currently running

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at 8.3 percent, right in the middle of the five-year range of 8.1 percent to 8.5 percent.

Real interest rates higher now

What needs to be borne in mind is that it is the *real* interest rate — the difference between inflation and the nominal rate — that counts. And real rates are slightly higher now than they were when the nominal rate was double its current level. Clearly, the liability crisis was precipitated by rising claims costs, *not* falling interest rates.

The most obvious question to arise from the information I have provided so far is: what caused the explosion of claims costs?

The perception of the insurance industry is that the underlying cause is what we have come to know as “*social inflation*”.

Social inflation is the result of the cumulative impact of a series of changes in legislation, court practices, judicial interpretations and a pronounced shift in society’s expectations.

Social inflation results from the fact that our society has become more litigious — we are suing each other more readily. We seem to be unwilling to suffer any injury or inconvenience without feeling that we are entitled to be compensated by someone. We are holding all “professionals” to a much higher standard of performance than in the past.

We appear to be seeking a risk-free environment but we have now come face to face with the question: Can we afford it?

Social inflation results from the fact that courts have expanded the tort system by moving away from the traditional fault-based system of liability.

The original object of the tort system was to hold parties responsible for the harm they bring to others through their careless acts.

However, the perception of insurers is that we are gradually drifting from a requirement to show that negligence caused the harm done to others, to the requirement to show mere *involvement* in the harm done. There are times when the issue appears to be not “Who is negligent” but “Who can pay?”

This emphasis on *involvement* rather than *negligence* significantly expands the scope of liability insurance and creates uncertainty about the potential cost of claims.

Uncertainty is heightened by the fact that some judges are more liberal than others in their interpretation of negligence. Ontario appears to be the “hot spot”.

Under these circumstances, the underwriter or actuary finds

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it extremely difficult to strike a premium level that he can be reasonably certain will be sufficient to cover future losses (and the funding of future losses is precisely what the property and casualty insurance business is all about).

Drifting toward compensation system

Dr. Slater, author of the Report of the Ontario Task Force on Insurance, agrees that the courts are drifting toward a compensation system. He describes the situation this way:

"The current crisis arose because of the conjuncture of the end of a soft market cycle with the accumulative impact of long-term structural changes arising from *increased public focus on compensation, greater exposure to risk and heightened consumer expectations*. The pressure to compensate, particularly in the personal injury area, has resulted in a virtual explosion in liability and liability litigation. The law of negligence is being judicially expanded and extended to new areas of activity and injury."

He goes on to say:

"Courts are certainly at the forefront of these changes but, the driving force behind these changes, and in large part the cause of the 'crisis', is the very existence of liability insurance. The phenomenon of modern liability insurance has played a major role in transforming tort and in creating a judicial environment that is becoming increasingly uncertain and unpredictable."

Not "California of the North"

Dr. Slater also observes that there is every indication that although Ontario is decidedly not a "California of the North" as some have suggested, it may become so in the foreseeable future — not so much in the escalation of the size of awards but rather in the continuing expansion and extension of liability.

I find myself in basic agreement with Dr. Slater's analysis with one notable exception. While I do not find it an unreasonable suggestion that the very availability of insurance has been a *permissive* factor in social inflation, I do find it hard to accept the idea that liability insurance has been a *causative* factor or, as Dr. Slater puts it: "the driving force".

Surely, the driving force lies within society itself, in its ethics, its values, its expectations! The question is: do the courts *reflect* society's values and expectations or do they *create* them?

Some observers contend that the courts cannot be criticized for expanding the concept of negligence and compensating injured parties regardless of fault on the grounds that the courts are merely reflecting the values of a society that seeks a risk-free environment.

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Other observers contend that it is the courts which have taken the *lead* in creating the expectation that a risk-free environment can be achieved.

Certainly, most of what has appeared in print on this subject has been authored by professors of law or members of the judiciary who have criticized the tort system for its failure to compensate those who cannot attribute their injuries to someone else's negligence (Justices Linden and Krever).

Society's resources not limitless

These writers argue, among other things, that tort losses should fall on the person who can most easily absorb them (Justices Linden and Laskin). However, I believe that we are now in the process of discovering that there is a need to return to a more economic approach to injury reparation because it is society as a whole which ends up bearing the cost and we are beginning to realize that the resources of society are *not* limitless and cannot sustain the high cost of the existing system.

In the final analysis, it may not matter whether the courts reflect society's values or whether they create society's expectations.

What does matter is that we do a better job of determining:

1. What kind of an injury reparation system society wants, and;
2. What society considers an acceptable cost.

Only then can we design a system that would deliver the product in the most cost-effective way. So the challenge to us as a society is to strike the right balance between what is *socially desirable* and what is *economically affordable*.

If society decides that it wants to compensate victims without regard for the question of responsibility for their injury, then I suggest that there is a much more cost-effective way to do it than through the tort system.

To use the tort system as a transfer mechanism with only superficial regard for actual liability is to be guilty of the utmost extravagance because the tort system is a terribly inefficient way to move money.

The second challenge is to come up with the most *cost-effective* delivery system. In doing so, we must be cognizant of society's desire to reduce the cost. In recent years, society has learned an important lesson.

Dr. Slater puts it this way:

“As in most activities, there is no ‘free lunch’ in insurance.

As the public demands higher compensation and as the risks associated with modern life escalate in degree and uncertainty, the insurance industry must respond by charging higher premiums.”

“The uncertainty and unpredictability that bedevil the current system are the absolute nemesis of the insurance underwriter and actuary because insurance is a business of taking calculated risks, not gambling.”

If it has done nothing else, the liability crisis has driven home to the public the fact that the courts do not dispense the insurance companies' money, they dispense the insurance-buying public's premiums and the cost of those premiums is built into every product and service we buy.

Costs too high

The message society is delivering with great clarity is that the cost has gotten too high. Essentially, the problem is that we are trying to run a compensation system within the framework of the tort system and we have ended up with a hybrid system which is the worst of both worlds because its results are unpredictable and its cost is high.

To remedy the situation, the choices are three:

1. Revert to a strict application of tort law under which only the victims of negligence are compensated, or;
2. Switch to a no-fault or no-tort approach which compensates all victims on a first party basis, or;
3. Attempt to achieve a blend of the two concepts which is more orderly and more predictable than the present system *and would result in a net reduction in claims costs.*

It doesn't much matter to insurers which system is chosen as long as the rules of the game are clear. It must be possible to clearly measure and quantify the degree of risk and it must be possible to predict with reasonable certainty the future claims costs that flow from the system.

Dr. Slater describes the problem this way:

“At the time of the sale of the insurance contract, the potential liability assumed by the insurers is in the future and is therefore necessarily indeterminate.

The magnitude of the risk assumed by the insurer depends on the degree to which the probability of the occurrence of the potential liability being insured against can be accurately predicted.

These risks are, of course, exacerbated when insurers cannot forecast the nature of the anticipated potential liabilities.”

The uncertainty and unpredictability that bedevil the current system are the absolute nemesis of the insurance underwriter and actuary because insurance is a business of taking *calculated* risks, not taking gambles.

Insurance is the law of averages and the law of large numbers at work. Risks which cannot be quantified, measured and predicted with reasonable certainty are virtually uninsurable.

The conclusion reached by the Ontario Task Force is that the liability crisis “reflects major technological, social, legal and economic changes that have so fundamentally affected the risk

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environment and the insurance market that it is no longer possible for the current cost and capacity problem to be overcome within the parameters of the existing system.

“The solution to the liability crisis is a fundamentally different approach to accident compensation.”

The Task Force recommended that automobile insurance be changed to a no-tort compensation system which would eventually be extended to general liability and become a universal personal injury compensation program.

Dr. Slater makes a very powerful and logical argument for his recommendation but it remains to be seen what will happen in the political decision-making process.

Loud voices express opposing views

I do not envy the politicians — they are faced with a difficult choice. It is not at all clear what society wants and there are some loud voices expressing opposing views. Not even the legal and judicial fraternity is in agreement.

On one hand, the Advocates' Society has made it clear that it will vigorously oppose the elimination of tort because they believe that to do so would deny full compensation of injured people. On the other hand, for the reasons mentioned earlier, some members of the judiciary and some professors of law advocate a no-tort compensation approach.

Dr. Slater has made it clear that the reparation system should be decided by society as a whole, not by lawyers.

While the no-tort approach has many attractions for both insurers and consumers, it also has its drawbacks. From an insurer's point of view, such coverage is an underwriter's and actuary's dream because it is quantifiable and predictable.

It would also reduce administrative costs and would enable insurers to deal with claimants as “customers” not as “adversaries”. The impact that this could have on customer satisfaction and public goodwill is immeasurable.

On the negative side, customer relations would be damaged if no-tort is not what the customer wants.

From a consumer's point of view, the attraction of the no-tort proposal is that it substitutes certainty for uncertainty. Compensation is paid regardless of fault, the exact extent of the benefits payable is known in advance and claims can be handled expeditiously.

Offends sense of fairness

The no-tort approach is also a step toward the so-called “risk-free environment”. But some consumers have negative attitudes to no-tort because it offends their sense of fairness and justice to

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think that negligent parties cannot be held liable for injuries they cause. They are concerned that the removal of a sense of personal responsibility for one's acts may result in less careful behavior.

It is notable that the Canadian Bar Association of Ontario's submission to the provincial government states that the shift to no-tort for automobile bodily injury claims in the province of Quebec was followed by a 17 percent increase in accident frequency.

For its part, the insurance industry does not feel that it should tell society what kind of an injury reparation system it should have. Our job is to respond with an efficient insurance system.

However, at the request of the Ontario government, the industry, through its trade association, the Insurance Bureau of Canada, has suggested a solution, which is a compromise between tort and no-tort.

This *proposed system* enhances the first party benefits payable to injured persons but still retains the right to sue in the event of death or serious permanent injury and economic loss above the limits of first party coverage.

The proposed program provides unlimited medical and rehabilitation expense, significantly higher death benefits and a much improved income replacement coverage which is designed to replace after-tax income up to \$600. per week.

Studies performed by our actuarial department indicate that had the proposed plan been in place in Ontario in 1985, it would have reduced automobile third party liability and accident benefits claims costs for private passenger vehicles by 250 million dollars or approximately 26 percent.

Unfortunately, this claims cost reduction would not translate into a comparable premium reduction because current premium levels are inadequate by about 20 percent, but it would at least contain the cost to consumers.

The downside risk in the industry's proposal is that the retention of tort will cause plaintiff's lawyers to look for more innovative approaches to injury settlements which, of course, would defeat the objective of achieving a net reduction in claims costs. (i.e. verbal threshold is eroded).

From frying pan into fire?

If that happens, premiums will continue to climb faster than society thinks they should and the whole issue of tort reform will go from the frying pan into the fire.

But, on balance, the industry proposal is a good one because it gives society time to carefully consider the social, philo-

“The bottom line is that the availability of a market for high risk business is very much dependent on tort reform.”

sophical and economic issues and to decide what kind of an injury reparation system is desired.

While the no-tort and modified no-tort proposals for automobile insurance would provide better compensation to more people at lower cost than the present system, no such solution is readily available in the general liability field.

Dr. Slater recommended that his no-tort proposal be extended *eventually* into general liability but, for a variety of reasons, the concept is more difficult to apply to that field.

Therefore, the Insurance Bureau of Canada has recommended a series of interim reforms to the tort system which it believes are *imperative* if a measure of stability is to return to the general liability marketplace.

These proposals include:

- Abolition of pre-judgement interest on general damages;
- Increased use of structured settlements;
- Abolition of the gross-up in non-structured cases;
- The use of arbitrators instead of judges to resolve some disputes;
- Elimination of over-compensation where collateral benefits exist, and;
- Modifications to the Ontario Family Law Reform Act to limit the circumstances under which claims can be lodged for loss of care, companionship and guidance.

Only time will tell whether these changes will be implemented, whether they will have the desired impact on social inflation and, therefore on the availability and cost of insurance. And that brings me to the outlook for the future.

Outlook for future

Let's deal first with availability. The corrective measures already introduced by insurers, particularly the heavy premium increases, will restore profitability to the business, bolster capitalization and create additional capacity.

However, underwriters will be reluctant to use that additional capacity for those risks which present the greatest amount of unpredictability and uncertainty.

Dr. Slater pinpointed the problem accurately when he said:

“The present tort insurance system, although run by a well-intentioned and compassionate judiciary, remains riddled with uncertainty and unpredictability . . . so much so that many commentators have described tort litigation as a ‘lottery’.”

The bottom line is that the availability of a market for high risk business is very much dependent on tort reform.

“The underlying cause is social inflation which is a societal problem, not an insurance problem.”

Worst is over

On the subject of the cost of liability insurance, I feel quite safe in saying that the worst of the premium increases is over because the gap between income and outgo is closing fast.

Future increases will be more moderate and, in fact, will reflect the rate of social inflation. There may even be some premium reductions as competition heats up *but* the market will *not* return to the hyper-competitive state that prevailed prior to the current crunch.

In fact, I expect a period of marketplace stability unprecedented in this quarter century.

The abundance of cheap reinsurance which so profoundly destabilized the market has disappeared forever.

The tighter solvency regulations being implemented by the federal government, particularly those relating to the actuarial certification of claims and premium reserves, will prevent a recurrence of the irresponsible competition that was so debilitating to the industry.

In conclusion, I would like to observe that it was really encouraging to see that Dr. Slater made no recommendation for a quick solution to the liability crisis for the simple reason that there isn't one.

The underlying cause is social inflation which is a societal problem, not an insurance problem.

Determining the kind of injury reparation system that society wants *and can afford* will not be an easy task, but the results will be more satisfactory if *all* of the stakeholders accept a share of the responsibility for getting the job done.



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