



International Association for the
Study of Insurance Economics

Études et Dossiers

Extract from

Études et Dossiers No. 295

The 27th Liability Regimes Conference
“A European Perspective on
Global Developments”

27 – 29 October 2004
Rüschlikon Global Dialogue Centre, Zurich

April 2005

Working Paper Series of
The Geneva Association

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The Geneva Association Working Paper Series “Études et Dossiers” appear at irregular intervals about 10 - 12 times per year. Distribution is limited.

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Layout & Distribution: Valéria Kozakova & Bernadette Curty

The Economics of Liability Losses – Insuring a Moving Target

Thomas Holzheu


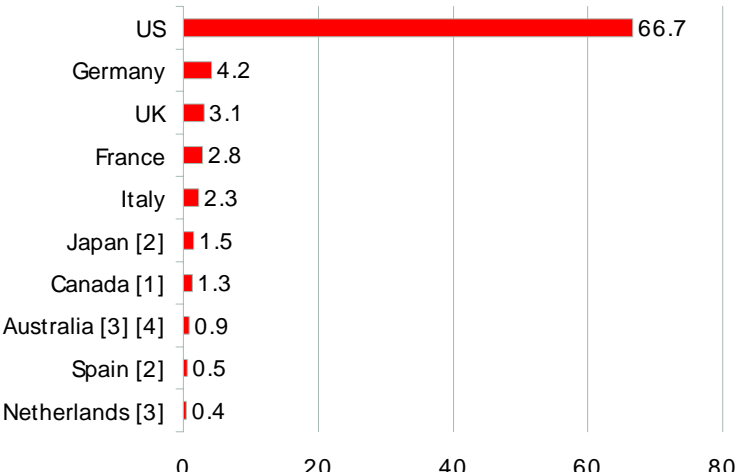
Swiss Re



Outline

1. Measuring the size of the tort system
2. Macro trends driving claims inflation
3. Dynamics in liability law
4. Coping with rising liability claims
5. Outlook

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Economics of liability losses
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<p>1. Measuring the size of the tort system</p>	<p style="text-align: right;">Swiss Re </p> <p>The US tort system is the most expensive in the world</p>
<p>sigma 6/2004 Economics of liability losses 28 October 2004 Slide 3</p>	<ul style="list-style-type: none"> ■ Of USD 84 billion of insured liability claims in 2002, USD 67 billion originated in the US. ■ Total tort costs are even bigger, because fees to lawyers of claimants and defendants are more than what victims get in terms of awards for damages. Tillinghast estimates tort costs at USD 233 billion or 2.2% of GDP in 2002. This cost ratio of 54% indicates a highly inefficient compensation system. ■ The deadweight loss (change in behavior to avoid tort costs) to the economy is estimated to be another USD 65 billion or 0.6% of GDP. ■ Medical malpractice, directors & officers, errors & omissions and employment practices liability have the fastest rising claims and the poorest results.

<p>1. Measuring the size of the tort system</p>	<p style="text-align: right;">Swiss Re </p> <p>The size of liability insurance claims</p>																						
<p><i>Commercial liability claims incurred, 2002</i></p> <p><i>10 countries USD 83.8 billion</i></p> <p>sigma 6/2004 Economics of liability losses 28 October 2004 Slide 4</p>	 <table border="1"> <thead> <tr> <th>Country</th> <th>Claims (USD billion)</th> </tr> </thead> <tbody> <tr> <td>US</td> <td>66.7</td> </tr> <tr> <td>Germany</td> <td>4.2</td> </tr> <tr> <td>UK</td> <td>3.1</td> </tr> <tr> <td>France</td> <td>2.8</td> </tr> <tr> <td>Italy</td> <td>2.3</td> </tr> <tr> <td>Japan [2]</td> <td>1.5</td> </tr> <tr> <td>Canada [1]</td> <td>1.3</td> </tr> <tr> <td>Australia [3] [4]</td> <td>0.9</td> </tr> <tr> <td>Spain [2]</td> <td>0.5</td> </tr> <tr> <td>Netherlands [3]</td> <td>0.4</td> </tr> </tbody> </table> <p>[1] net after reinsurance [2] claims paid [3] Motor incl. Hull, [4] 2001 [5] average loss ratio weighted by claims incurred Sources: National Insurance Supervisory Authorities</p>	Country	Claims (USD billion)	US	66.7	Germany	4.2	UK	3.1	France	2.8	Italy	2.3	Japan [2]	1.5	Canada [1]	1.3	Australia [3] [4]	0.9	Spain [2]	0.5	Netherlands [3]	0.4
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1. Measuring the size of the tort system

Components of tort costs

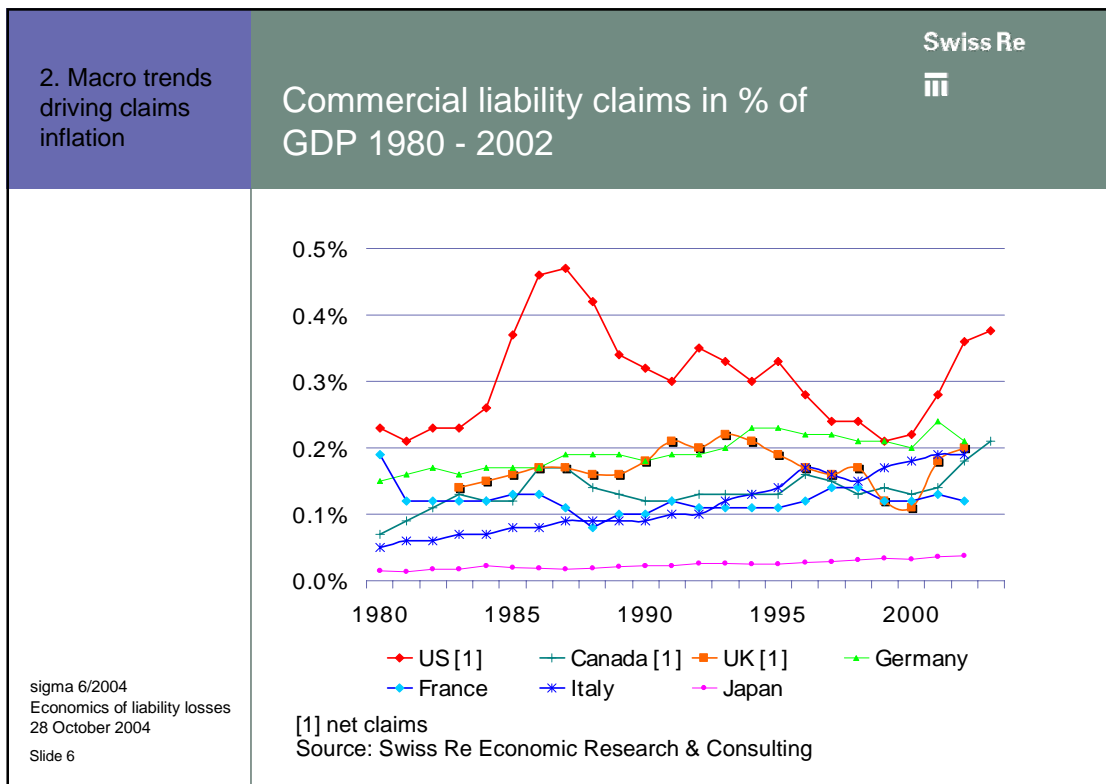
2002 data	USD billion	in % of		
		Tillinghast	CEA estimate	GDP
Awards for Economic Loss	51	} 46%	36%	1.0%
Awards for Non-Economic Loss	56			
Benchmark costs [1]	21	} 54%	42%	1.2%
Excess costs [2]	105			
Tillinghast estimate	233	100%	78%	2.2%
Deadweight loss [CEA]	65	28%	22%	0.6%
Total	298	128%	100%	2.8%

[1] it is assumed that administration, claimants' attorney and defense costs of 17% of awards are "efficient"

[2] Administration, claimants' attorney fees and defense costs in excess of benchmark costs

Sources: Tillinghast (2003), Council of Economic Advisers (2002), own calculations.

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2. Macro trends driving claims inflation

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Liability claims grow faster than GDP in all industrialised countries

- Insured liability claims have grown 1.2 (France) to 2.2 (Japan) times faster than GDP. In the US this elasticity is 1.5.
- Health expenditures had a similar fast expansion.
- The growth of liability claims does not correlate closely with any economic indicator.
- It must be explained by the expansion of the legal base for liability claims: expanded liability rules, extended number of responsible parties, increased compensations and reduced grounds for exemption.

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2. Macro trends driving claims inflation

Swiss Re

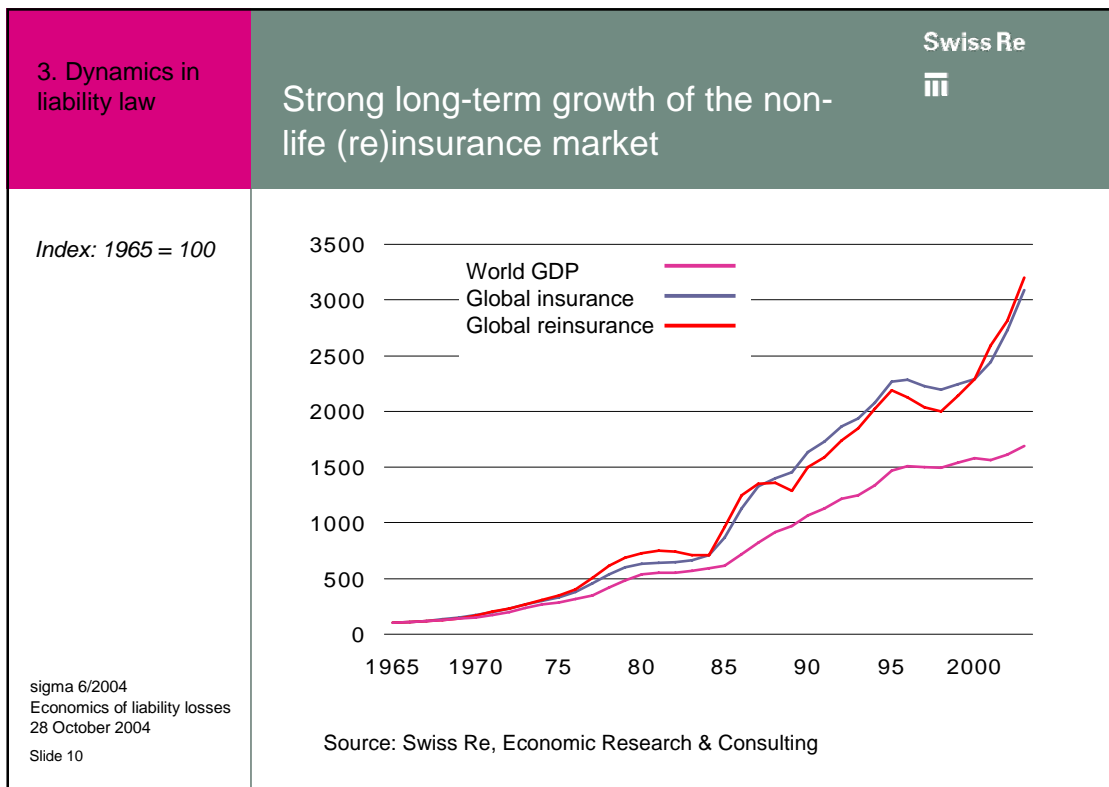
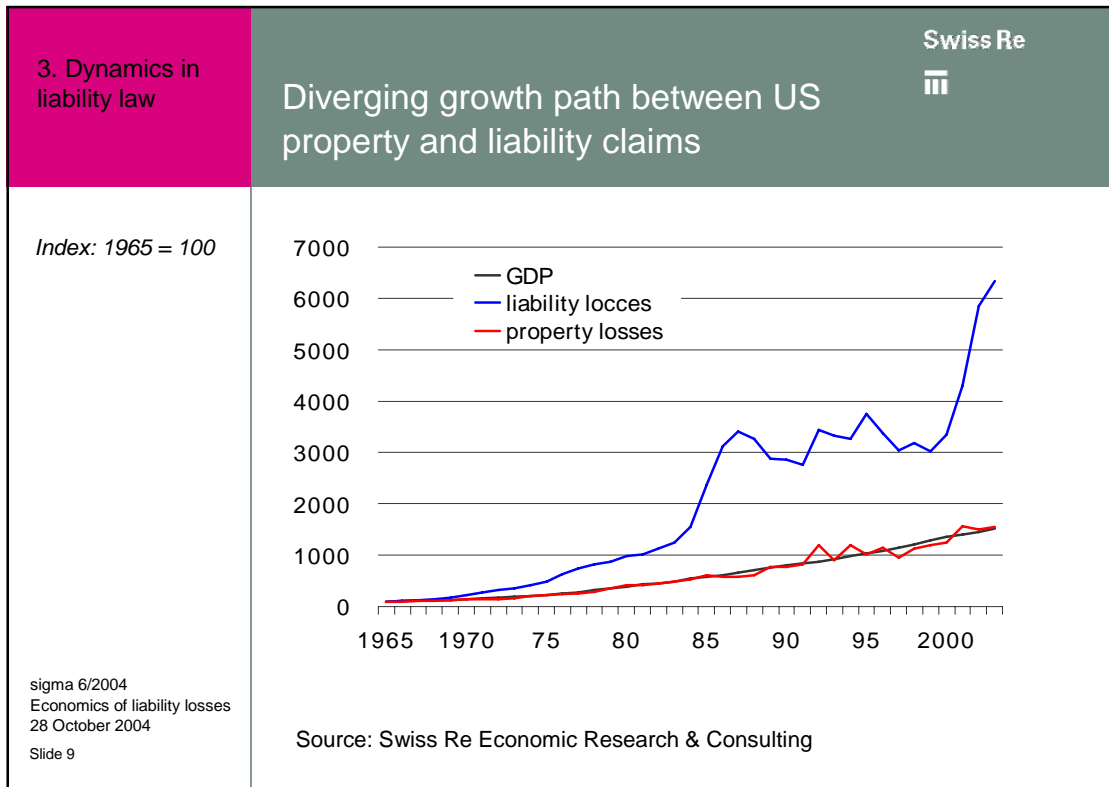
Long-term growth trends of general liability claims in major markets

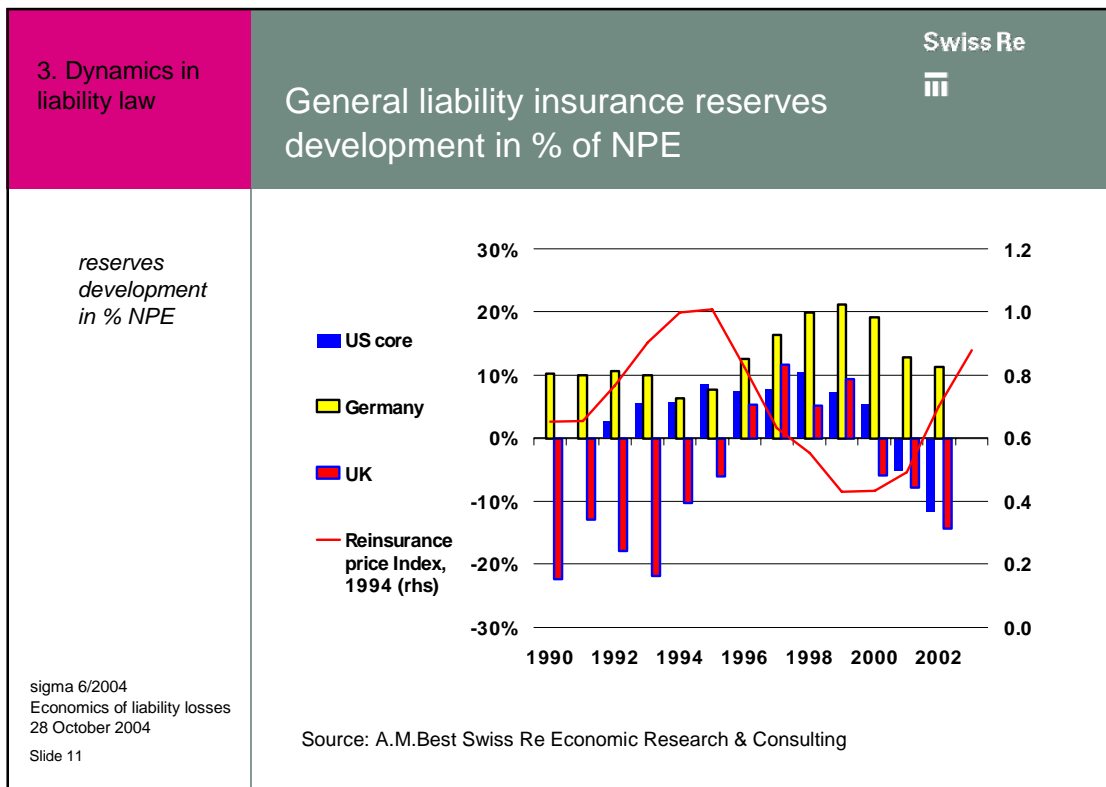
	US [1]	Canada [1]	UK [1]	Germany	France	Italy	Japan [2]
Period	1955 - 03	1975 - 02	1983 - 02	1971 - 02	1971 - 02	1970 - 02	1970 - 02
Compound annual growth rate							
- Liability claims	10.6%	11.3%	8.8%	7.4%	9.4%	15.9%	13.8%
- Nominal GDP	7.1%	7.3%	6.7%	5.2%	8.0%	11.6%	6.1%
- Health expenditures	10.2%	9.4%	8.7%	7.4%	10.2%	na	8.3%
Elasticity [3] of liability claims versus:							
- Nominal GDP	1.51	1.55	1.31	1.43	1.17	1.38	2.24
- Health expenditures	1.04	1.19	1.02	1.01	0.93	na	1.66

[1] net of reinsurance [2] claims paid [3] % increase in liability claims when nominal GDP or health expenditures increase by 1%

Source: Swiss Re Economic Research & Consulting

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3. Dynamics in liability law

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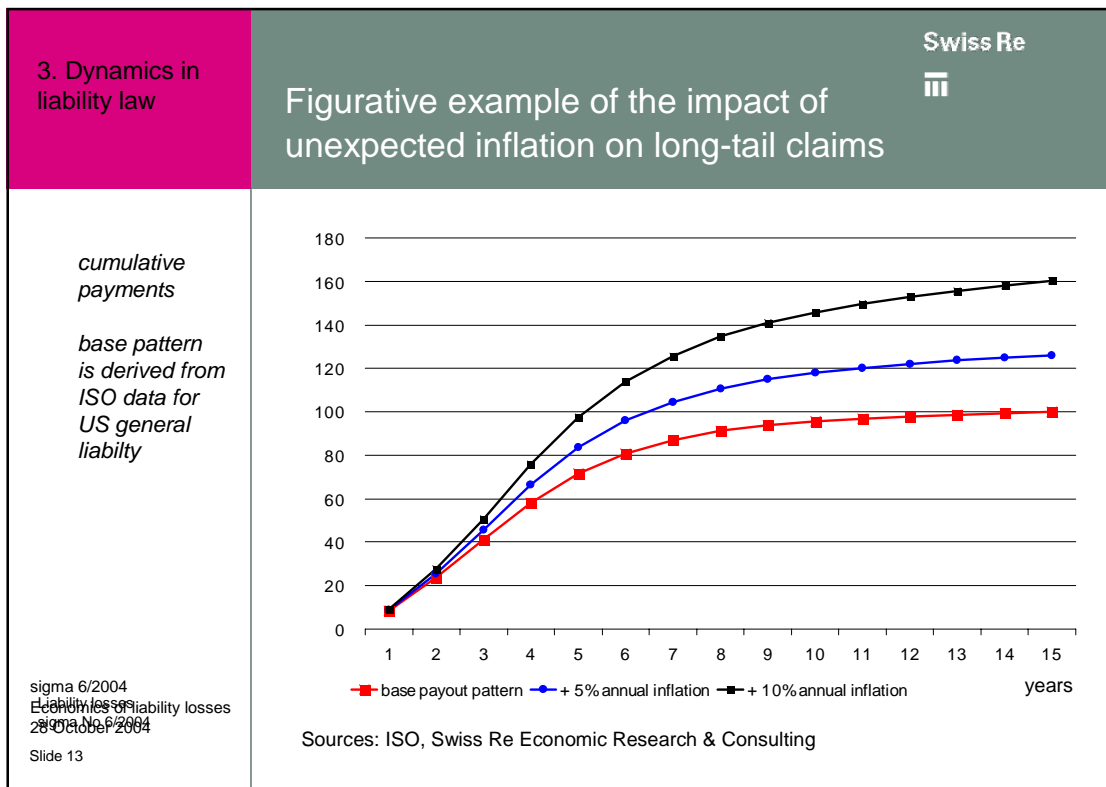
Short-term vs. long-term liability claims growth

Annual average general liability claims growth			
	US	UK	Germany
1960–2002 [1]	10.9%	8.8%	8.7%
2001–2002	32.3%	27.2%	5.2%
2001–2002 adjusted for reserve additions [2]	14.7%	12.9%	12.5%
Implied growth from long-run elasticity for 2001–2002	8.3%	6.2%	2.9%

[1] UK: 1984–2002
 [2] excluding extraordinary and cyclical reserve changes

Sources: National Insurance Supervisory Authorities, Synthesis Non-Life


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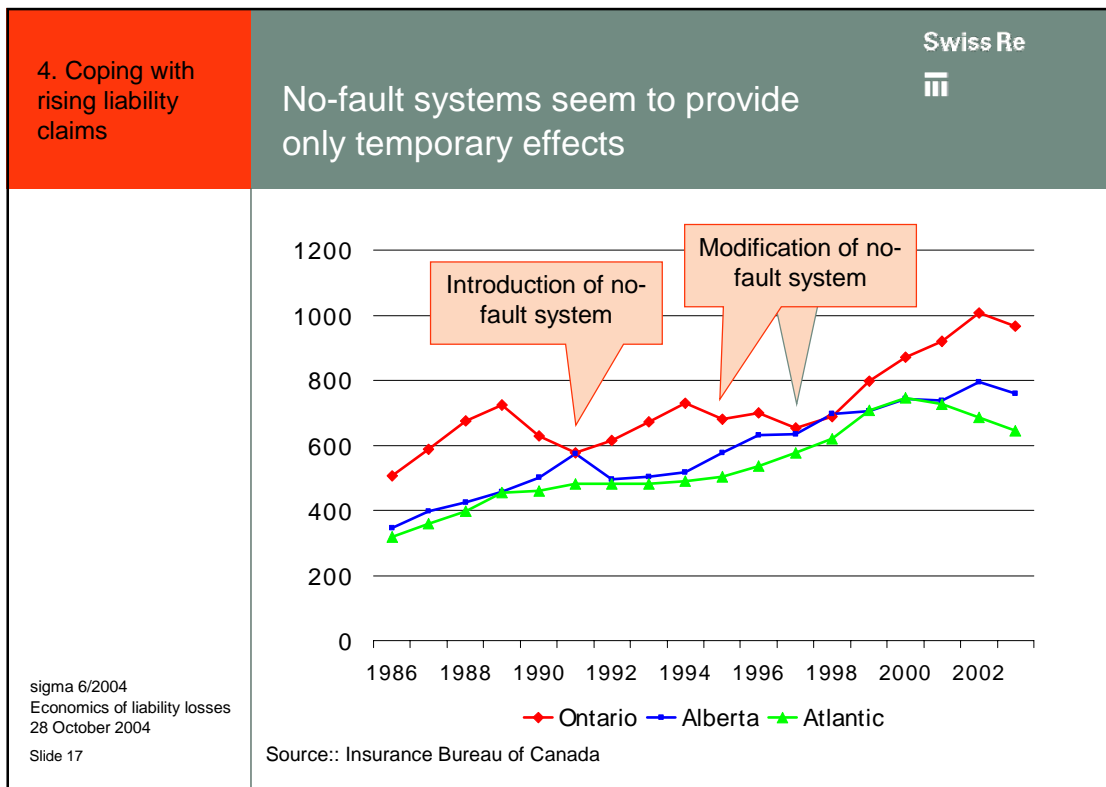
4. Coping with rising liability claims

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Actions needed to curb rising liability costs
- Political solutions are necessary to bring US liability claims back to a reasonable level. Unfortunately the European Commission tends to expand liability in its legislation.
 - The move to non-fault insurance reduces litigation expenses in the short term (see car insurance in Ontario). In the long term claims tend to raise again, because behavioural changes (moral hazard and fraud) become more critical.
 - The insurance industry must better understand, monitor, and price for escalating liability claims costs. If a peril grows too uncertain and its limits cannot be well defined by contract design and wording, insurers should cease writing cover.
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<p>4. Coping with rising liability claims</p>	<p style="text-align: right;">Swiss Re </p> <h2 style="text-align: center;">Tort Reform Agenda in the US</h2>
	<p>Most reforms have taken place on the state level. The effect of such piecemeal reforms will remain limited, unless all states pass certain key reforms (avoidance via forum shopping).</p> <ul style="list-style-type: none"> ■ Caps on punitive damages and non-economic damages. ■ Limiting the venue shopping ■ Restricting joint and several liability ■ Eliminating the collateral source rule, ■ Reforming contingency fees (e.g. sliding scales) <p style="text-align: center;">Tort reform on Federal level? → elections</p>
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<p>4. Coping with rising liability claims</p>	<p style="text-align: right;">Swiss Re </p> <h2 style="text-align: center;">In Europe, precisely the opposite political objective may be observed</h2>
	<p>Rather than seeking to limit the scope of tort liability, the European Commission is pursuing a policy of expansion.</p> <ul style="list-style-type: none"> ■ Environmental Liability Directive [introduces a polluter-pays-all regime for environmental impairment]. ■ Insurance Agents and Brokers Directive [requires brokers to purchase professional indemnity insurance or any other comparable guarantee against liability claims arising from professional negligence]. ■ Accession of ten new members has expanded the scope of the tort system to these countries
<p>sigma 6/2004 Economics of liability losses 28 October 2004 Slide 16</p>	



4. Coping with rising liability claims

Swiss Re

The reality of limits of insurability:
How to underwrite a moving target?
-
- Exclusions & segmentation in separate covers allows for better risk u/w and reduces adverse selection
 - Claims made trigger shifts some risk of old u/w years from insurer to policyholder
 - Index clause reduces inflation risk associated with long tail risks
 - (Annual) aggregate limits, significant deductibles
 - ART solutions: substitute risk transfer with risk financing
 - Avoid what remains uninsurable
 - Claims management: active litigation and commutation of claims
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<p>6. Outlook</p>	<p>Swiss Re </p> <p>Outlook</p>
<p>sigma 6/2004 Economics of liability losses 28 October 2004 Slide 19</p>	<ul style="list-style-type: none">■ Legacy problems → Asbestos legislation■ Traditional risks → Federal tort reform → More liability via Brussels■ New emerging risks → Silicosis → Toxic Mold → Electromagnetic fields → Nanotechnology → Genetic Engineering → Obesity