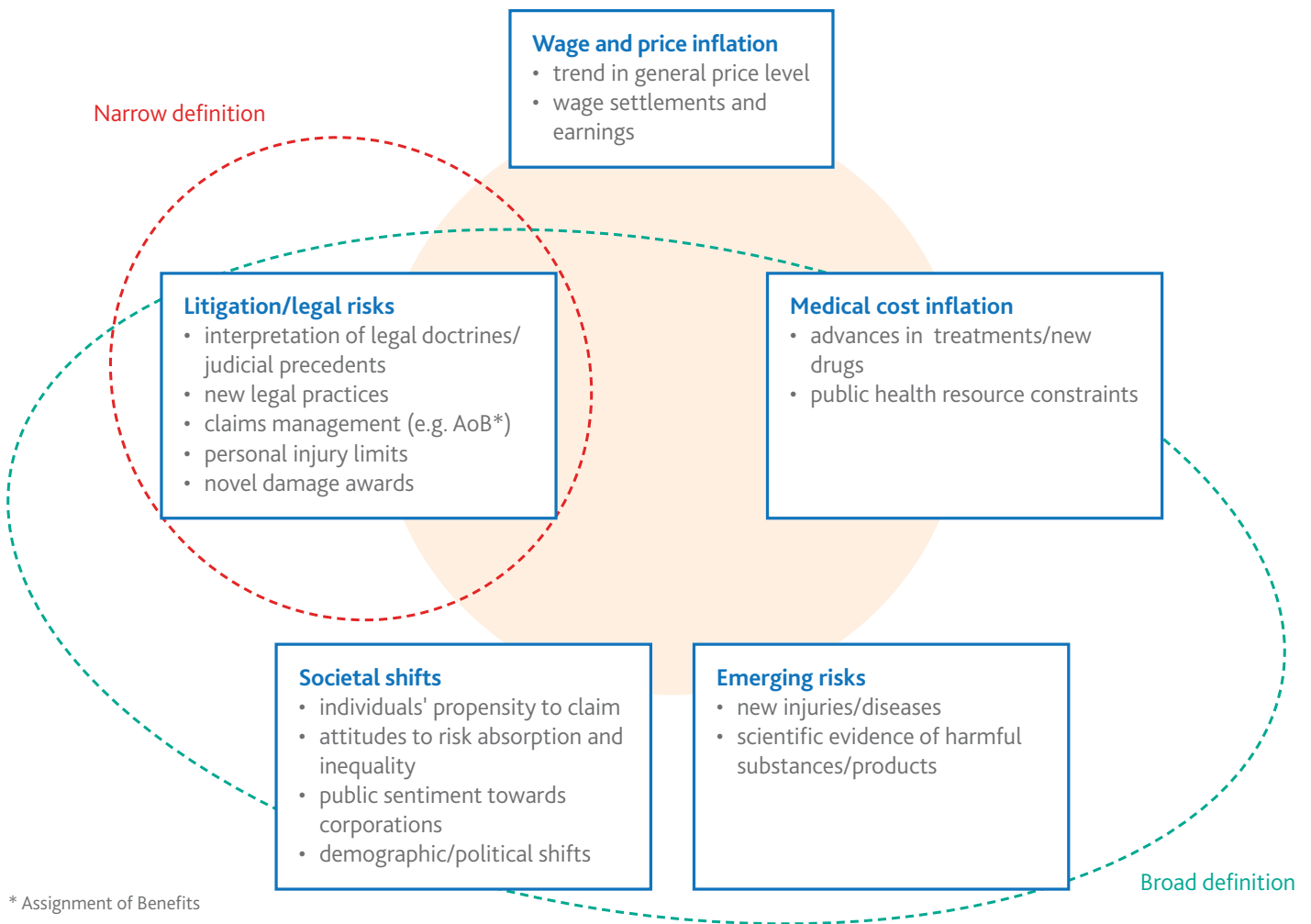


Darren Pain, The Geneva Association

## What is social inflation?

Social inflation is a term that is widely cited in insurance debates, but it is often ill-defined or at best only loosely explained. On a broad definition, social inflation refers to all ways in which insurers' claims costs rise over and above general economic inflation, including shifts in societal preferences over who is best placed to absorb risk. Insurance actuaries typically label such growth in claims costs 'superimposed inflation', and also separately include increases in claims handling costs and medical expenses to which insurers are often especially exposed. More narrowly defined, social inflation refers to legislative and litigation developments that impact insurers' legal liabilities and claims costs.

Figure 1: A stylised typology of social inflation



\* Assignment of Benefits

Source: The Geneva Association

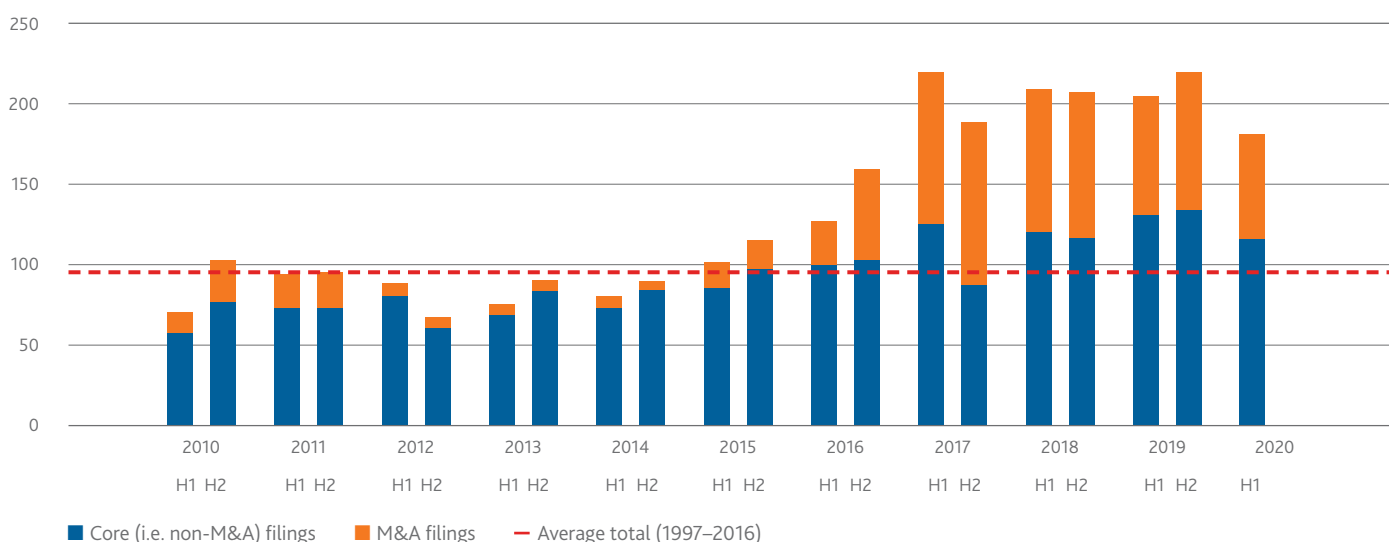
Social inflation is not a new phenomenon. It tends to occur in bouts or waves and respond to changes in the liability landscape. Earlier episodes occurred most notably in the 1980s and 1990s/2000s, especially for product and professional liability as well as medical malpractice insurance. Moves towards no-fault liability, pursuit of claims against defendants with deep pockets, under the doctrine of joint and several liability, and the emergence of environmental hazards such as asbestos, greatly expanded liability of companies and their insurers.

To the extent that insurers set premiums to cover expected increases in claims costs and hold capital to absorb unexpected losses, temporary bouts of social inflation that quickly subside, though unwelcome, should be manageable. Much more problematic for insurers is when outsized claims represent an enduring shift to a sharply higher trend in claims growth that far outstrips estimates assumed when policies were originated. Such persistent social inflation that goes unrecognised for years can lead to chronic under-reserving and under-pricing, especially since liability lines are often long-tail in nature and large claims may come to light only slowly.

### Recent escalation in litigation and claims

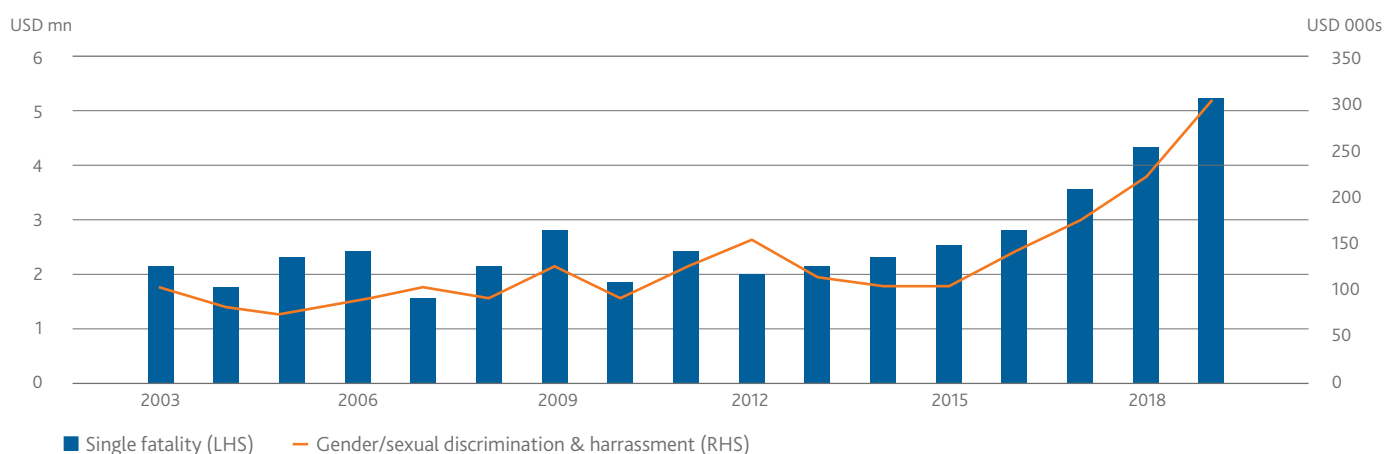
There are signs that social inflation has emerged again as a disruptive issue. The number of claims pursued through the U.S. courts has risen sharply over the past few years, especially class actions. According to one study, between 2017 and 2019, securities class actions across U.S. federal and state courts were more than double the average number in the previous five years (Figure 2).

**Figure 2: Number of securities class actions in the U.S.**



Source: Cornerstone Research

**Figure 3: Median value of award in the U.S. for selected case features, by disposition date**



Source: Advisen

As well as a pick-up in civil litigation activity, the level of compensation awarded has increased. A review of U.S. cases reported to VerdictSearch shows that the number of verdicts of USD 20 million or more in 2019 has risen more than 300% from the annual average between 2001 and 2010. Since 2015, the median award for a case involving a single fatality has more than doubled; for a case involving sexual harassment, it has tripled (Figure 3). As a result, U.S. insurers' claims across a number of key liability lines accelerated rapidly over the past five years, growing at a rate well in excess of consumer price inflation.

Though largely a recent U.S. issue, evidence of social inflation is present in some other countries too, at least for selected types of cases. Litigation in a number of European countries has expanded the categories of compensation – so-called 'heads of damages' – available to a victim of tort. Beyond personal injury cases, securities class actions have surged in Australia, with ever-larger sums awarded to plaintiffs leading to significant directors' and officers' liability (D&O) insurance claims.

### What are the underlying drivers?

Social inflation reflects a complex set of interacting socio-economic, institutional and behavioural factors that change over time. Many factors are most pronounced in the U.S. where adversarial legal procedures often combine with a litigious culture to promote lawsuits and high jury awards/settlements, including large punitive damages. But some resonate more widely, suggesting potential international sources of social inflation, at least for certain types of cases.

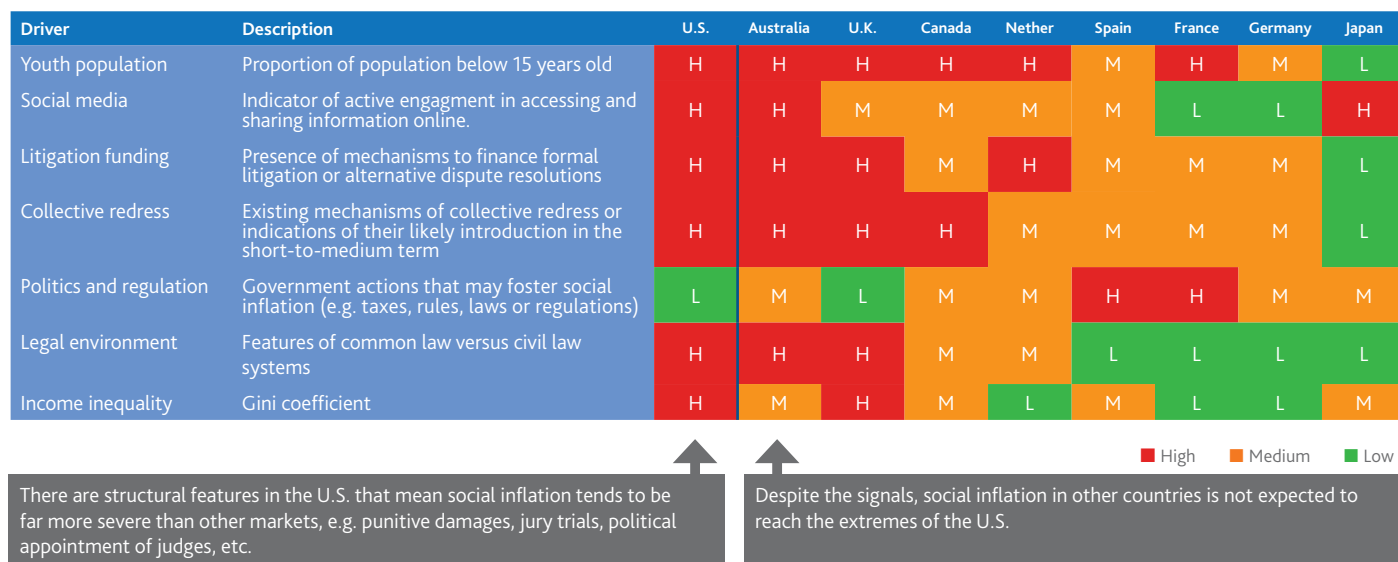
There are signs in some jurisdictions of a recent judicial backlash against ongoing tort reform. For instance, of the 32 U.S. states that have reformed punitive damages, four had reforms struck down as unconstitutional and have not enacted additional reforms. Compared with earlier episodes, however, it is not obvious that changes in judicial protocols and reinterpretations of legal doctrines can explain the recent pick up in compensation awards, at least so far. More generally, the perceptions of companies' senior attorneys and executives of the litigation environment have improved over recent years despite the pick-up in jury verdicts. Outside of the U.S., legislative changes have also worked to curb frivolous or abusive litigation and limit damages, at least for personal injury cases.

Instead, the key recent drivers for social inflation reflect:

- Aggressive strategies of plaintiffs' attorneys who have strengthened their activities throughout the litigation process from client acquisition, pre-trial discovery and evidence gathering right through to tactics at the trial itself.
- The development of third-party litigation funding and collective redress mechanisms in a number of jurisdictions, which are changing the economics of litigation and the appetite and ability of claimants to file lawsuits.
- Shifts in judge/public attitudes, on the back of growing recognition of social and income inequalities, about who should bear risk and the appropriate duty of care that firms and institutions should extend to individuals.

Many of these developments pre-date the COVID-19 pandemic situation. But the pandemic could ultimately work to accelerate and/or amplify the underlying drivers to make the claims landscape even more challenging for insurers. This includes possibly expanding the scope of liability standards as well as further hardening anti-corporate public sentiment.

**Figure 4: Subjective assessment of social inflation risks across selected countries**



Source: Swiss Re using publicly available indicators from, for example, the OECD and Statista

Figure 4 provides an informal assessment of the potential scope for social inflation to spread to other major developed insurance markets, using recent U.S. drivers as a benchmark. Australia and the U.K. stand out as having large numbers of high-risk factors that could foster social inflation, although probably not to the

degree seen in the U.S. The threat is more nuanced in medium-rated countries with a more neutral mix of signals. At the other end of the spectrum, Japan currently appears less susceptible to heightened litigation and social inflation.

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## How can re/insurers respond?

Insurers need to continue to engage actively in the public policy debate to promote changes in the legislative framework that further level the playing field between plaintiff and defendant in order to ensure fairness and financial practicality in settlement awards. In particular, increased transparency and the exchange of information relevant to the calculation of damages, as well as initiatives to curb exorbitant legal fees or at least ensure they are proportionate, would be welcome.

However, on its own, further tort reform it is unlikely to be enough. Likewise, relying on a continued upswing in the underwriting pricing cycle to boost insurers' results still leaves them vulnerable to a further deterioration in the social inflation outlook, which for long-tail lines can have a leveraged effect on required reserves.

The report therefore makes the case for three additional areas of focus for insurers:

- **Enhanced defence case management:** Deploying data analytics and predictive modelling to help decide, for example, whether to litigate or settle claims, evaluate potential fraud, and assess which firms and even which lawyers to use before a specific judge or court.
- **Better exposure modelling:** Compared with property lines, casualty underwriting is typically guided less by formal models and relies largely on expert judgement. There is scope to change that through the greater use of, for example, forward-looking scenarios and counterfactual analysis.
- **Product innovation:** Insurers should move beyond typical product strategies that look to adapt exclusionary language or amend policy triggers to embrace more radical innovations, such as parametric solutions and eventually, perhaps to transfer some peak liability risks to capital markets.