Claims Inflation – does it exist, and, if so, how does it effect premium and profit?

- Paul Castellani   Eversheds LLP
- Robert Kastner   Syndicate 1218
Claims Inflation – the context

• “The modern liability environment brings with it a number of stereotypes, from individuals who treat a perceived tort by a major corporation as a **lucky lottery win**, to **ambulance-chasing lawyers** who help self-styled victims seek their fortunes. But beyond the stereotypes, liability is a serious issue for companies and one that cannot be ignored. To manage the risks involved effectively, businesses first need **accurate information** – on both **current issues** and likely **emerging trends**. But just as importantly, they need to put in place robust policies and process to anticipate and mitigate what is becoming a more prevalent and costly problem.”

1 Directors in the Dock – Lloyd’s 2008
Claims Inflation – an overview

- claims inflation – what it is and why important
- some statistics – are there more (and larger) claims than there used to be?
- if so, why?
- what are the commercial ramifications?
- how can claims inflation be mitigated?
Claims Inflation – what is it?

- Amount by which claims
  - increase in number (frequency)
  - increase in value (severity)
- Product of the two variables – expressed as an annual percentage

\[
\text{Increase in number} \times \text{Increase in value} = \text{Annual claims inflation}
\]
Claims Inflation – why important?

- Reserving
- Claims inflation
- Pricing
- Profitability
- Outwards reinsurance
Claims Inflation – a quiz

• Myth 1 – “compensation culture”
  – have court proceedings for BI claims increased or decreased since 1999?
    1999-1187
    2003-570
  – have court proceedings for “other negligence claims” increased or decreased since 1999?
    1999-373
    2003-128¹

¹ University of Warwick School of Law 2008
Myth 1 – Despite the evidence, is the myth true?

- number of litigated claims = crude measure of frequency; because
  - compulsory protocols
  - Regulatory forms of redress – FOS, SRA, Ombudsman
  - pre-action mediation
  - litigation less frequently used as a tool in rising economic market

- Better measure: 38% of companies seen an increase in number of claims

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Fourth UK Bodily Injury Awards Study

- claims were rising at a rate of 9.5% per annum
- larger claims probably growing at a faster rate than smaller claims
- Compounded, claims have risen 247.82% in a decade
- Claims Frequency increasing at 3% per annum
- Claims Severity increasing at 6% per annum
  - Claims over £2m – 12%
  - Claims over £5m – 30%
Myth 2 – People are now more likely to claim if something goes wrong?

- Third of companies seen an increase in litigation during recent “bull” market \(^1\)
- 90% of people agree that we are more likely to sue now than 5 years ago \(^2\)
- Situation can only deteriorate as economy worsens

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\(^1\) Lovells – The Shrinking World 2008
Myth 3 – are claims more expensive?

• Liability awards
  – Higher or lower?
• Costs (defence/claimants)
  – Higher or lower?
• 34% of companies seen increase in size of claims

1 Directors in the Dock – Lloyd’s 2008
Compensation Culture – the Biggest Myth of them all?

- What actually is Compensation Culture?
- Does one exist?
- Papers and politicians say “yes”
- Constitutional Affairs Committee says “no”
The Myths – What are their relevance to professional indemnity?

- PI is a liability account and affected by same trends
- Consumers – IFAs, solicitors, surveyors = “frontline professionals”
- Businesses – when feel economic pinch, review old advice
- Reduction in capital available for PI
Claims Inflation – why are there more claims?

- “compensation culture” (?)
- access to justice
  - CFA
  - third party funding
  - BTE
  - ATE
- economic factors – “transfer of risk” to insurers
- ‘laxity’ of quality in a bull market (?)
Claims Inflation – severity do claims cost more? Why?

- Professional Indemnity Claims – common heads of loss
  - loss of income
  - loss of profit/business interruption
  - property rights
  - cost of repair
  - bodily injury
- So, if any individual head of loss increases, so will severity of PI claims
- Legal costs and expenses
Claim Severity – an example

- Lender’s claim against a solicitor – 1990’s example – Colin Bishop

- Mortgage Advance £99,000
- Property £111,000
- LTV Ratio 89%
Claim Severity – an example

- Lender’s claim against a solicitor – 2008

- £300,000

- Property £300,000

- LTV Ratio 100% +

- ‘Sub-prime’ rate
- Self certification
- Fees
- Mortgage fraud
- Money laundering
So what rate of claims inflation applies?

- Should PI be greater than – BI?
  - EL?
  - PL?
  - Medmal?

- What rate should we apply?
  - 2.5%
  - 5%
  - 7.5%
  - 10%
  - 12.5%
What rates does the market apply? ¹

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¹ Institute of Actuaries Survey
Commercial Ramifications?

- **Reserving**
  - old claims – “step reserving”
  - re-analyse reserves for adequacy

- **Pricing**
  - in a logical world, more claims and higher value – higher premiums
  - in a real world, we are a market!
• Outwards Reinsurance
  – Adequacy of cover
  – Obligations to notify
  – Rates being charged

• Profitability
  – is book still profitable if 10% added to expected claim profile?

• 3\textsuperscript{rd} Party Supplier
  – claims strategy?
  – pay early pay less?
  – buy on quality, not on price
Mitigation – how can claims inflation be reduced? An **insurer’s** perspective

- only write good risks (!)
- do not chase premium (!)
- risk management – insistence not lip service
- deductibles
- early claim assessment
Mitigation – how can claims inflation be reduced? An insured’s perspective

- adequate scoping
- limitation of liability
- proportional liability
- clearly defined roles amongst professionals
- client selection
What does the future hold?

- **Frequency**
  - sub-prime – D&O liabilities
  - valuation claims
  - mortgage fraud
  - insolvency claims against accountants
- **Severity**
  - increase in house price inflation
  - increase in RPI
  - increase in PI awards (Ogden tables, structured settlements)
  - legal fees and expenses (CFA, ATE)
- Prediction – what will claims inflation be next year?