Response of The Association of British Insurers
to
The Department of Work and Pensions Review of
Employers’ Liability Insurance

February 2003
Contents

Executive Summary ................................................. Page 3
Response to the Review ........................................... Page 7
Appendices (following page 40) .................. following page 40
  1. Confidential letters from insurers about shareholders’ views of Employer’s Liability Insurance
  2. Notes on the German system of workplace compensation
  3. Notes on the Belgian system of workplace compensation
  4. Paper setting out a basis on which to separate accident/short tail diseases from long tail diseases
  5. Greenstreet Berman report “Workplace Compensation: Costs, Trends and Options for Change”
Executive Summary

Employers’ Liability Insurance – The Case For Fundamental Reform

The Department of Work and Pensions’ review of employers’ liability (EL) insurance provides the opportunity to consider fundamental reform of workplace compensation. This reform is now necessary to meet the complementary needs of all stakeholders.

Introduction

• No one benefits from the EL status quo. Claimants, employers, insurers and the public interest are all being short-changed;

• the problems of pricing premiums for unknown and unpredictable risks make employers’ liability insurance unsustainable in its current form, particularly because of the extreme difficulties caused by long-term occupational diseases;

• the pressure of legal changes and improving medical knowledge is adding to claims costs and therefore to premiums, and this will continue in future years;

• there are large frictional costs, particularly legal fees, which account for around 40% of total claims costs;

• rehabilitation suffers as a result;

• there is no clear link between premiums paid and health and safety best practice.

1. The problem of occupational diseases for employers’ liability insurance

Because of the long period that can elapse between the time when a disease is caused at work and when a claim is made (sometimes up to 40 years), the UK courts are often faced with critical dilemmas. Society rightly wants compensation to be awarded. The courts can only do this if fault is established. But, once they have done this (by defining what is known as the ‘date of knowledge’), their judgments create a retrospective burden for insurers that could not have been paid for through insurance premiums.

For instance, a legal judgement in 2001 extended the application of the 1931 Asbestos Regulations from firms making asbestos products to those that used asbestos products. This created decades of additional exposure for insurers.

Similarly, the Noise at Work Regulations passed in 1990 have been applied to cases dating as far back as 1963.

The free and competitive marketplace for EL insurance prevents insurers from pricing for these sorts of unknowable liabilities. Policyholders will protest if asked to pay for a liability that may never emerge. Insurers are ‘price takers’ and they have to offer competitive prices.
This pressure has led to many years of poor underwriting results for EL insurers. During the five years from 1997 to 2001, EL insurers made an underwriting loss (cost of claims paid minus value of premiums collected) of £761m.

2. **Recent problems in the EL market have increased difficulties for customers and insurers**

A number of factors have come together in the last eighteen months to exacerbate these long-term and systemic difficulties, leading to increased premiums for customers and a wider concern about the efficiency of the EL system.

   a) **Insurers are increasing prices because of the insurance cycle.**

   After a number of years of a ‘soft’ market of lower prices (exaggerated by the impact of the now insolvent Independent Insurance competing on price) the market has been hardening. Over the general insurance cycle, prices have to reflect exposure to risks. A perverse effect of EU and UK regulatory practice is that solvency requirements make it more difficult for insurers to accept new business at a time of rising prices.

   b) **Legal changes, particularly to personal injury law, are adding to claims inflation**

   - Greenstreet Berman has estimated for the ABI that inflation in the cost of personal injury claims is currently running at 15% per year.
   - The introduction of Conditional Fee Arrangements, with ‘after-the-event’ legal expenses insurance, has increased the cost of claims by 25-30%.
   - The cost of the average EL claim increased threefold between 1996 and 2002.

   c) **Other problems have added to the pressure on prices and effected the EL market**

   Reduced investment returns have removed an important source of income for EL insurers. And the recent falls in the stock market have reduced the value of capital within the industry.

   To counteract some of these pressures, the ABI is encouraging other trade associations to put together insurance schemes for their members, and looking for ways of giving credit to firms that meet minimum standards of health and safety performance.

3. **Medium-term prospects for EL insurance**
From our knowledge of individual insurers and the market for EL insurance, we expect to see further increases in premiums over the next 12 to 18 months. In part, this is because of further societal burdens that the system is being asked to carry.

- The Department of Health estimates that premiums will rise by around 8% because of proposals to recover the costs of NHS treatment for those injured at work;

- Experience elsewhere (e.g. from Denmark) suggests that the introduction of reviewable settlements in personal injury claims foreshadowed in the Courts Bill now before Parliament will add a further 3% to premiums.

Greenstreet Berman estimates that, under the most likely scenario, the cost of EL insurance will double as a percentage of payroll costs between today and 2015.

4. Options for reform

a) Separating long-tail occupational disease claims

Long tail diseases account for around 25% of all EL claims at the moment. We propose that these should be separated from other claims and compensated via new arrangements. While we also have proposals for smaller scale changes, this fundamental reform is essential.

There are at least three possible options for funding these claims:

- an employer-backed mutual fund;
- a fund financed by a levy on EL premiums;
- insuring these claims on a ‘claims made’ basis, not the existing ‘losses occurring’.

There will be other options, and each has advantages and disadvantages. There is a strong case for looking at a hybrid system which mixes ‘polluters pays’ and ‘pay as you go’ principles. The merits of each should be assessed according to clear criteria, so that a new system should:

- respect as far as possible the ‘polluter pays’ principle, so that employers whose practices cause occupational diseases pay for the claims;
- be financially sustainable;
- minimise any ‘boundary dispute’ between short and long-tail diseases;
- provide incentives for employers to improve their health and safety performance, and encourage research into the links between workplace practice and occupational disease;
- be institutionally simple.

b) Further proposals for incremental reform
Further reform is necessary to reduce the frictional costs of EL insurance and to encourage the wider use of rehabilitation, for example by setting up a high-level National Rehabilitation Committee.

Legal costs could be reduced by making it easier for claimants to enter their claims:
- possibly by using a tariff of compensation payable for specified conditions;
- by creating a cost-effective system for the arbitration of disputes;
- and by introducing fixed or predictable legal costs.

We also propose further investigation of the merits of moving to a system of no-fault compensation.
Response of The Association of British Insurers to
The Department of Work and Pensions
Review of Employers’ Liability Insurance

Introduction

(i) This report is the submission of the Association of British Insurers (ABI) to the review of the employers’ liability insurance system (EL) being led by the Department of Work and Pensions (DWP). ABI is the trade association representing 400 insurers which together account for 97% of the business of insurance companies in the UK. In addition to providing the majority of capacity for EL insurance in the UK, our members also provide all kinds of insurance in Britain and worldwide, including savings and pensions, life insurance, and motor, household and health insurance.

(ii) ABI very much welcomes the review, announced by the Chancellor of the Exchequer in his pre-Budget statement, as an opportunity to consider fundamental reform of workplace compensation in the UK. It also provides the opportunity to explain in depth why premiums for EL have risen so much over the last year and how the EL market operates. Over the last year ABI has worked extensively with other trade associations to explain the operation of the EL market and to consider ways which might help firms access the market.

(iii) About eighteen months ago ABI’s Liability Insurance Committee began its own review of EL. This review reached its conclusions before - and so uninfluenced by - the intensive media and political attention which was aroused in the summer by substantial increases to EL premiums. ABI’s Liability Insurance Committee concluded that fundamental reform of EL was necessary, because of the extreme difficulties caused by “long tail” occupational diseases. (“Long tail” refers to the decades - up to 40 years in extreme cases - which can elapse between exposure to harmful workplace practices or substances and the manifestation of the resultant occupational disease.

(iv) Another analogous description is diseases with long latency periods.) Progressively over the years legal changes combined with enhanced medical knowledge of the causal links between workplace conditions and occupational diseases have widened the scope of the conditions for which employers are liable. Under the EL system insurers bear the risk of changes to the law or improved medical knowledge which can arise in the many years between the setting of the insurance premium and occupational diseases manifesting themselves and being held to be compensatable by the courts. It is impossible for this risk to be assessed and priced.

(v) ABI’s Liability Insurance Committee concluded that without fundamental reform the EL system might not be sustainable. It also noted the large element of frictional costs in the EL system - legal fees make up about 40% of
total claims costs. The current EL system does not facilitate rehabilitation, on which the UK has an extremely poor record. Nor does it allow a clear linkage between current premiums and an employer’s current health and safety practices; this is because diseases claims arising from past years can heavily influence an employer’s current claims record. The Committee recognised that fundamental reform of EL could well have implications for the UK’s other system of workplace compensation, Industrial Injury Disablement Benefit (IIDB).

(vi) To answer the key question of whether EL is sustainable, it is essential to disentangle the many factors which have been at play in the insurance market over the last eighteen months or so. This allows one to distinguish between transient - though not necessarily unimportant - factors affecting the insurance market and the systemic problems which affect EL. To provide this analysis the report is divided into four main sections:

- **Section 1** explains the problems caused for EL insurers by long tail occupational diseases and the way the courts recognise these diseases as compensatable;

- **Section 2** explains what has happened to the insurance market generally and the EL market specifically over the last eighteen months or so, the reasons, and the impact these changes have had on premiums and the availability of cover;

- **Section 3** provides an analysis of what is likely to happen - as far as it is possible to predict this - to premiums and the availability of cover over the next two or three years. The analysis shows the continued likely fragility of the EL market;

- **Section 4** explains what reforms ABI believes are necessary to make the EL system sustainable and states that the key reform would be to separate the funding of long tail occupational diseases claims (which are likely to become uninsurable in the commercial market) from the funding of accident claims and short-tail disease claims. This section provides an analysis of the advantages and disadvantages of possible ways of separately funding long tail disease claims. Incremental reforms, to reduce the frictional costs (legal and other expenses) in EL claims and to increase the use of rehabilitation, also need to be pursued. They are not, however, a substitute for fundamental reform.
1.1 It is essential to understand why the insurance of long tail occupational disease claims presents such systemic problems for insurers in pricing EL risks and in reserving for claims. The Employers Liability (Compulsory Insurance) Act 1969 requires employers to obtain insurance cover for these claims.

1.2 The heart of the problem is the long latency periods which characterise occupational diseases: for example the average latency period for mesothelioma is 33 years. The characteristics of these diseases have posed an extremely difficult dilemma for the courts in the UK. The UK tort system operates on the basis that compensation is due if an employer has been negligent, i.e. the duty of care to the employee was breached. In disease claims, the duty of care is breached if, from the time the employer should reasonably have known of the link between certain workplace conditions and the disease, they did not take sufficient steps to protect their employees from it.

1.3 The time the employer should have known of the risk is referred to conventionally as the ‘date of knowledge’. The manner in which the courts have applied the date of knowledge test, in common law, has required employers and insurers to be liable for conditions which could not have been foreseen when the insurance was taken out and the premium assessed.

1.4 The nature of occupational diseases with long latency periods is such that under the UK’s tort system - which requires proof of negligence - any decision about compensation years later will bring about inequity somewhere. Either it lies with the claimants, with the result that they are denied compensation, or it lies with employers and their insurers who are held liable for conditions which were unknown and could not therefore have reasonably been prevented.

1.5 The courts have over the last generation progressively found unacceptable any outcome that results in no compensation being paid and have interpreted the law in a manner which entitles people to compensation. This dilemma with which the courts have had to grapple, and their attitude to where any inequity should lie, was stated most explicitly by Lord Bingham in his lead judgement in the recent *Fairchild* cases at paragraph 33 (emphasis added):

“The present appeals raise an obvious an inescapable clash of policy considerations … It can properly be said to be unjust to impose liability on a party who has not been shown, even on the balance of probabilities, to have caused the damage complained of. On the other hand, there is a strong policy argument in favour of compensating those who have suffered grave harm, at the expense of their employers who owed them a duty to protect them against that very harm and failed to do so, when the harm can only have been caused by breach of that duty and when science does not permit the victim accurately to attribute, as between several employers, the precise responsibility for the
harm he has suffered. I am of the opinion that such injustice as may be involved in imposing liability on a duty-breaking employer in these circumstances is heavily outweighed by the injustice of denying redress to a victim.”

1.6 The way the courts have interpreted the law so as to provide compensation has imposed a huge retrospective burden on employers and their insurers who in reality bear all the financial consequences of this retrospective liability. This liability is by its very nature unpredictable and therefore almost impossible for insurers to take account of in pricing and reserving. Two examples graphically illustrate the point:

- Until about 2001 the courts consistently upheld the view that the 1931 Asbestos Regulations applied only to firms making asbestos products and therefore did not apply to industries, such as shipbuilding, which used asbestos products. As recently as 1995 the Court of Appeal (in *Banks v Woodhall Duckham*) upheld this view but then in 2001 they changed their view (in *Shell Tankers v Jeromson*) and held that the Asbestos Regulations applied to firms which used asbestos products. Firms which had not complied with the regulations were therefore negligent and liable to compensate their employees for asbestos-related diseases which they had contracted. This meant that EL insurers were suddenly faced with many decades of negligent exposure from all the firms they had insured that had used asbestos products. Yet these policies had been written on the basis that the law held that the 1931 Asbestos Regulations applied only to firms making asbestos products.

- The first regulations to protect employees against potential deafness caused by noise at work were the 1990 Noise at Work Regulations. Yet the courts have held that the date of knowledge from employers, from which time they should have taken steps to protect employees, was 1963 because the then Department of Employment published a leaflet “Noise and the Worker” that year. The court reached its decision in spite of the leaflet having no legal status and imposing no requirements on employers. By holding that the date of knowledge was 1963 the courts created a period of 27 years of negligent exposure, during which no premium had been charged for the deafness risk.

1.7 Yet it could be argued that in some cases the preponderance of medical evidence begins over time to show a causal link between certain workplace conditions and a disease, before this is finally recognised by the courts. Should insurers not in these latter stages make allowance in the premiums and reserves they set for this potential liability? Similarly, if in the last thirty years or so a pattern has been established of the courts recognising diseases as compensatable in a manner which imposes a retrospective liability, should insurers not take account of this in their underwriting and reserving? The answer to both questions lies in the competitive nature of the insurance market, which does not allow for either problem.
1.8 For example, at present there seems to be no medical evidence showing a clear link between the use of mobile phones and brain damage. Suppose at some date in the future such a link was established and the courts held that all employees who had suffered brain damage in the intervening period were entitled to compensation.

1.9 It could be argued that the courts would not interpret the law in a way which imposed an unfair date of knowledge on employers and would also take account of private usage of mobile phones. Yet in his lead judgment in the recent *Fairchild* cases (which dealt with mesothelioma) Lord Bingham made it explicit that the courts would, as has become apparent over the last generation, be unlikely to interpret the law in a way that denied compensation to people with occupational diseases.

1.10 Should insurers therefore be pricing for the possibility that claims arising from the use of mobile phones at work may emerge in the future? Policyholders would argue vehemently that they should not be charged for a liability which may never emerge. Moreover a single insurer that tried to increase premiums to charge for this contingent liability would almost certainly be unable to charge these higher premiums in a competitive market.

1.11 A further constraint on insurers arises from the compulsory insurance legislation which means employers must take out insurance which does not include ‘prohibited conditions’. ‘Prohibited conditions’ may, for example, mean that if an employer did not insure against, say, asbestos related diseases he would be in breach of his duty to maintain proper insurance. For this reason standard EL insurance policies are designed to cover virtually all possible risks. The insurer therefore faces the choice of insuring an employer against all eventualities, or not insuring them at all.

1.12 The EL market, in common with the other insurance markets in the UK, is a free and highly competitive one. Business will tend to move to the insurers that are offering the lowest premiums. “Innocent” insurance capacity which under-prices known risks presents other insurers with a major quandary. From their actuarial analysis and understanding of risk knowledgeable insurers may consider that far higher premium rates should be charged but are unable, in the prevailing market, to charge premiums which properly reflect the risk. In effect they are price takers. They are unwilling to lose much of their EL portfolios because with the EL risks will go other more desirable types of business such as commercial property.

1.13 These systemic problems to which occupational diseases give rise, and the extremely poor underwriting results which result (which are detailed and graphically illustrated in *Table 1 below*), raise the question why insurers have continued to write EL, rather than withdrawing from the market?
## TABLE 1

### Employers Liability Insurance

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Earned Premiums (£ 000)</th>
<th>Claims, Balance of each accident year (£ 000)</th>
<th>Estimated Commission and Expenses (£ 000)</th>
<th>Claims Ratio</th>
<th>Underwriting Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>223,612</td>
<td>329,690</td>
<td>41,551</td>
<td>147.4</td>
<td>166.0</td>
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<td>1986</td>
<td>270,712</td>
<td>371,263</td>
<td>50,303</td>
<td>137.1</td>
<td>155.7</td>
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<tr>
<td>1987</td>
<td>336,803</td>
<td>433,380</td>
<td>62,584</td>
<td>128.7</td>
<td>147.3</td>
</tr>
<tr>
<td>1988</td>
<td>379,278</td>
<td>534,221</td>
<td>70,477</td>
<td>140.9</td>
<td>159.4</td>
</tr>
<tr>
<td>1989</td>
<td>395,497</td>
<td>641,131</td>
<td>73,490</td>
<td>162.1</td>
<td>180.7</td>
</tr>
<tr>
<td>1990</td>
<td>472,660</td>
<td>711,878</td>
<td>87,829</td>
<td>150.6</td>
<td>169.2</td>
</tr>
<tr>
<td>1991</td>
<td>481,025</td>
<td>647,816</td>
<td>89,383</td>
<td>134.7</td>
<td>153.3</td>
</tr>
<tr>
<td>1992</td>
<td>523,815</td>
<td>598,229</td>
<td>97,334</td>
<td>114.2</td>
<td>132.8</td>
</tr>
<tr>
<td>1993</td>
<td>611,509</td>
<td>561,371</td>
<td>113,629</td>
<td>91.8</td>
<td>110.4</td>
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<td>1994</td>
<td>683,553</td>
<td>660,054</td>
<td>127,016</td>
<td>96.6</td>
<td>115.1</td>
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<td>1995</td>
<td>745,826</td>
<td>663,780</td>
<td>136,588</td>
<td>89.0</td>
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<td>1996</td>
<td>720,582</td>
<td>698,420</td>
<td>133,897</td>
<td>96.9</td>
<td>115.5</td>
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<tr>
<td>1997</td>
<td>700,740</td>
<td>737,079</td>
<td>130,210</td>
<td>105.2</td>
<td>123.8</td>
</tr>
<tr>
<td>1998</td>
<td>674,498</td>
<td>849,375</td>
<td>125,334</td>
<td>125.9</td>
<td>144.5</td>
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<tr>
<td>1999</td>
<td>605,523</td>
<td>822,308</td>
<td>112,517</td>
<td>135.8</td>
<td>154.4</td>
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<td>2000</td>
<td>566,104</td>
<td>789,798</td>
<td>105,192</td>
<td>139.5</td>
<td>158.1</td>
</tr>
<tr>
<td>2001</td>
<td>611,007</td>
<td>720,821</td>
<td>113,536</td>
<td>118.0</td>
<td>136.6</td>
</tr>
</tbody>
</table>

Source: Standard & Poors Thesys
Note: Based on accident year accounting (Form 31).

### Employers Liability Insurance Claims and Underwriting Ratios

![Graph showing Claims Ratio and Underwriting Ratio over years](image)

Source: Standard & Poors Thesys
Note: Based on accident year accounting.
1.14 In part this is because in the past the poor underwriting results shown in Table 1 were, to some extent, mitigated by the prevailing high interest rates. These allowed insurers to generate substantial interest income from the investment of premiums and claims reserves.

1.15 The other reason that major commercial insurers have continued to write such an unprofitable line of business is that it is compulsory for their policyholders. An insurer which ceased to offer EL would find that the more desirable parts of a policyholder’s account, such as their property insurance, would move to those insurers which continued to offer EL. Because of its lack of profitability it is unusual for an insurer to be prepared to write a firm’s EL without writing some of its other insurances as well.

1.16 Despite this (as will be seen in Section 3) it should not be assumed that commercial insurers will continue to tolerate the chronic unprofitability and huge retrospective liabilities inherent in EL. Despite the widespread consequences for their commercial business, some major insurers may decide to withdraw from the EL market or scale back their involvement massively.
Section 2 - The Insurance Market Over the Last Eighteen Months

2.0 Over the last eighteen months the market for commercial insurance risks has undergone a number of marked changes. These changes are the results of:

- the effects of the general insurance cycle on all classes of commercial insurance (liability, property, motor);
- the impact on all types of liability insurance (including motor) of changes to personal injury law made by the courts or by the Government over the last four years; these changes to the law have considerably increased the cost of personal injury claims and therefore necessitated increased liability premiums to fund the enhanced compensation; they have also imposed a substantial retrospective cost on liability insurers and their shareholders;
- problems which are specific to EL, including the continuing severe problems with occupational disease claims.

All these factors must be understood in order to have an appreciation of what has happened to the cost and availability of EL over the last twelve to eighteen months.

2.1 Factors affecting all commercial insurance

The insurance cycle

2.1.1 In common with other industries, general insurance is a cyclical business. The existence of the cycle, and that it is not inconsistent with an efficient and free market, was confirmed in the recent report by Professor Paul Fenn for the Treasury.

2.1.2 The cycle is typified by a relatively short “hard” phase of sharply increasing premium rates and improving profitability. This is then followed by a longer period of progressive “softening” of the market until it enters a period of loss (which can be substantial). At the bottom of the market shareholders of insurance companies demand action from management to restore profitability. The market then enters its hard phase.

2.1.3 In more detail these phases of the market cycle can be characterised as follows.

2.1.4 The Bottom of the Cycle - At this point most insurers are making losses, the magnitude of which varies according to how low premium rates have sunk, the insurer’s mix of business and its operating model. Some insurers, such as the UK branches or subsidiaries of overseas companies, may withdraw from the market entirely. Other insurers may withdraw from certain lines of business which appear to suffer from chronic lack of profitability or where they consider they lack competitive advantage. Insolvencies can occur in companies which have been especially weak at selecting and pricing risks. In
the current cycle two notable insolvencies have been Independent Insurance, which at the time of its insolvency had about 7% of the EL market, and Chester Street. Chester Street was a company in run-off (in other words no longer writing or renewing business) which had a portfolio almost exclusively composed of EL risks for heavy industry. The insolvency of Chester Street was entirely due to the under-pricing and under-reserving of EL risks; these were also a major factor in the insolvency of Independent. These insolvencies graphically illustrate the extreme difficulty of writing EL.

2.1.5 **The Hard Phase of the Cycle** - At the bottom of the market cycle shareholders demand action from management to restore profitability, so that a decent return on capital is earned, and to restore balance sheet strength. The regulator, the Financial Services Authority (FSA) has shared this view:

\[\text{“The FSA is not an economic regulator, and it is not for us to determine whether these premium rises are in all circumstances justified. But I would say that we believe it important for the long-term health of the industry, and its clients, that there is some strengthening of the industry’s capital base, and that is bound to require some increases in premium rates.”}\]

(Sir Howard Davies speaking at the Association of Insurance and Risk Managers in Industry and Commerce (AIRMIC) annual lecture in January 2002.)

2.1.6 The action taken to restore profitability results in marked increases in premium rates which more properly equate to true risk exposures, as shown by long run claims costs, plus a margin for profit. Insurers’ rigorous application of underwriting standards means there is little appetite for sub-standard risks with poor risk management. The capacity of the market is limited because:

- the capital base of insurers has been reduced by the losses they have sustained;
- some insurers have withdrawn from the market, or specific lines of business;
- insolvencies have occurred;
- and in the current cycle falls in the equity market have reduced insurers’ capital bases.

2.1.7 Ironically, the way EU law and UK regulatory practice has required solvency to be calculated, limits the capacity of insurers to accept business at a time of hardening rates. This is because the solvency margin required by regulators has typically been a percentage of premium: conventionally in the UK one third of written premiums (so insurers can use £1 of capital to support £3 of premium).

2.1.8 This has had a counter-intuitive effect. During the hard phase of the market insurers are able to write fewer risks (unless they receive a capital injection)
because the premiums they are charging have increased. So it follows that insurers are able to write less business when rates - and therefore likely profitability - are highest but more business when rates are lowest (and the possibility of insolvency greatest).

2.1.9 Partly because of this counter-intuitive effect the FSA is moving to a risk-based approach to regulation of insurers. As part of this approach the FSA will expect insurers to allocate capital according to the risks which specific lines of business present. The thrust of risk-based regulation is broadly in line with moves to economic capital management within the industry. Both are driven by the requirement to allocate capital efficiently against risk, and for that to be borne out in the price charged for general insurance.

2.1.10 While this change to regulatory practice is likely to mean certain lines of business, such as motor, require less capital to support them, it is likely to increase the amount of capital required to support EL. This will affect the pricing of EL, if the initial analysis of it is correct, because firms will be required to hold more capital against it and will be required to make a return on capital to shareholders.

2.1.11 The consequences of reductions in capacity in any free market - which the UK insurance market undoubtedly is - are that prices increase. Insurers remaining in the market are able to carry the premium increases which are necessary to restore profitability.

2.1.12 The Soft Phase - The softening of the market usually results from increases in the capital in the market and consequent increased competition. Capital is attracted into the market either because new entrants are attracted by the prevailing high premium rates and good profitability or because existing players increase their capital through rights issues or capital injections from parent companies. As the softening of the market continues, and premiums reduce, insurers’ profitability reduces until eventually many or most companies move into loss. This continues until the market reaches the bottom of the cycle.

The Current Cycle

2.1.13 Over the last eighteen months the general insurance market has been in the hard phase of the cycle; premiums for all commercial insurances - property, motor and liability - have increased markedly. Across all lines the market has hardened to a degree not seen in previous cycles. This has been caused by an unfortunate and unprecedented conjunction of events:

- a market which was already hardening following substantial losses; the extent of these underwriting losses can be clearly seen in table 2 which summarises the results of ABI members on commercial business over the period 1993 – 2001. See Table 2 below;
### TABLE 2 - COMMERCIAL PREMIUM AND UNDERWRITING RESULT (£m)

<table>
<thead>
<tr>
<th></th>
<th>MOTOR</th>
<th>PROPERTY</th>
<th>LIABILITY</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PREMIUM RESULT</td>
<td>PREMIUM RESULT</td>
<td>PREMIUM RESULT</td>
<td>PREMIUM RESULT</td>
</tr>
<tr>
<td>1993</td>
<td>1,725 (45)</td>
<td>2,122 66</td>
<td>1,480 (437)</td>
<td>5,327 (415)</td>
</tr>
<tr>
<td>1994</td>
<td>1,657 34</td>
<td>2,324 263</td>
<td>1,576 (363)</td>
<td>5,557 (66)</td>
</tr>
<tr>
<td>1995</td>
<td>1,544 (42)</td>
<td>2,164 183</td>
<td>1,543 (261)</td>
<td>5,251 (119)</td>
</tr>
<tr>
<td>1996</td>
<td>1,719 174</td>
<td>2,120 29</td>
<td>1,531 (190)</td>
<td>5,370 (335)</td>
</tr>
<tr>
<td>1997</td>
<td>1,691 (284)</td>
<td>2,110 0</td>
<td>1,555 (214)</td>
<td>5,356 (498)</td>
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<td>1998</td>
<td>1,842 (519)</td>
<td>2,114 (57)</td>
<td>1,599 (411)</td>
<td>5,556 (988)</td>
</tr>
<tr>
<td>1999</td>
<td>1,944 (430)</td>
<td>2,190 (203)</td>
<td>1,302 (237)</td>
<td>5,437 (870)</td>
</tr>
<tr>
<td>2000</td>
<td>2,194 (273)</td>
<td>2,304 (263)</td>
<td>1,257 (344)</td>
<td>5,755 (880)</td>
</tr>
<tr>
<td>2001</td>
<td>2,361 (37)</td>
<td>2,304 89</td>
<td>1,796 (566)</td>
<td>6,461 (514)</td>
</tr>
</tbody>
</table>

Commercial business is also written under the Accident and Health and Pecuniary Loss classes, but it is not possible to separate out the commercial business.

Source: ABI

The figures in the table underestimate the market losses because they do not include the losses of insolvent insurers such as Independent and Chester Street from the date of their insolvencies. Some estimate that Chester Street has about half the asbestos related claims in the EL market.

- The severe impact on the global reinsurance and insurance industry of the events in New York on September 11 2001. At an estimated $40 - $70 billion, the insurance loss was the largest ever from a single event. Much of this was borne by global reinsurers. Insurers rely on reinsurers to provide the capacity to insure large or specialist risk, or for risks where there could be an accumulation of losses in a single catastrophe. September 11 2001 caused a fundamental reappraisal by the global reinsurance industry of how it was prepared to deploy its capital, its preparedness to accept risk, and the pricing of risk;

- Extremely poor investment conditions characterised both by continued falls in equity markets and low interest rates. These investment conditions have had two effects on insurers:
  - The first is a reduction in the capital base of the market. This occurs because insurers tend to invest much of the long-term capital which supports their business - shareholders’ funds - in equities as these historically deliver the best long-term returns. However the fall in the equity markets over the last few years has substantially reduced the capital base of the industry and so its capacity to absorb business. Table 3 below shows the level of the FTSE over the last 6 years.
  - The second effect occurs because insurers have in the past tended to rely on interest income generated by the investment of premiums and claims reserves to offset underwriting losses. This offsetting effect has been especially important in the liability classes of insurance because of the extended period between receipt of premium and claims payment. However the continuing low interest rates have meant that...
insurers can no longer rely on interest income to more than offset underwriting losses; the imperative is now to set premiums at a level which will generate underwriting profits.

TABLE 3 - FTSE 100 Index
January 1997 to February 2003

Over the last year, February 2002 to February 2003, the FTSE 100 has fallen by 29%. It is down 47% since its peak in January 2000.
2.2 The Impact of Changes to Personal Injury Law on Liability Insurers

The Impact on Premiums

2.2.1 The cost of personal injury claims has for many years been rising at a rate well above retail prices or even wages inflation. The first International Underwriting Association (IUA) bodily injury study published in 1997 showed inflation in motor personal injury claims to be running at 13% pa between 1986 and 1995. Among the causes of this inflation has been the preparedness of the courts to allow a wider number of heads of claim in damages awards.

2.2.2 However the rate of inflation in personal injury claims has increased further over the last four or five years. This acceleration in the rate of personal injury inflation has been caused by the numerous changes to personal injury law introduced either by the higher courts or by the Government. Many of these changes result from implementation of the Law Commission’s recommendations for reforming damages for personal injury, which were published in the late 1990s. The consultants Greenstreet Berman, in their report for ABI “Workplace Compensation: Costs, Trends and Options for Change”, (see appendix 5 to this paper) estimate personal injury inflation has been running at 15% a year over the last three years.

2.2.3 ABI has consistently said in its responses to Government consultations on changes to personal injury law - for instance proposals to increase damages or to widen the category of eligible claimants - that it is for society to decide who should be compensated and for how much. However increased compensation has to be funded. The main method of funding claims is through commercial liability insurance (and through private insurances such as motor policies). The premiums paid by businesses (and consumers) are having to increase because the cost of personal injury claims is increasing so quickly.

2.2.4 In January 2002 Zurich Insurance published a booklet “Rate Increases Explained” which examined the effect on premiums of the various changes made to personal injury law (and general personal injury claims inflation and new types of claim). These are set out in Table 4 below.
TABLE 4 - Impact on Employers Liability Insurance Rates (Zurich Analysis)

<table>
<thead>
<tr>
<th>Legislation</th>
<th>Rate increase (%)</th>
<th>Average claims increase on affected cases (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate as applied to the Ogden Tables (1)</td>
<td>8</td>
<td>50</td>
</tr>
<tr>
<td>Conditional Fee Arrangements (CFAs)</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Law Commission reforms (2)</td>
<td>2-3</td>
<td>20</td>
</tr>
<tr>
<td>Civil Justice reforms (Woolf Report)</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Abolition of claims agreements (3)</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>Recovery of National Health Service Charges (4)</td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>

| Levies                                           |                   |                                               |
| Policyholders Protection Board (PPB) (5)         | 1                 |                                               |

| Claims                                           |                   |                                               |
| Personal injury claims inflation                 | 12                |                                               |
| New types of claims (6)                          | 5                 | 20                                            |

Notes:  
(1) Based on fall in discount rate from 4.5% to 2.5%.  
(2) Based only on “Pain and Suffering” reforms  
(3) Refers to the abolition of claims agreements between insurers and trade unions  
(4) Potential cost  
(5) Recent collapses include Chester Street Holdings and independent Insurance.  
(6) New types of claims include: Stress, violence, abuse, environmental tobacco smoke, sick building syndrome and acoustic shock.  

Source: Zurich Insurance

2.2.5 It is important to note that the Zurich booklet was published soon after the introduction of Conditional Fee Arrangements (CFAs) and therefore probably before their full effect on personal injury claims became apparent. Some insurers now consider that CFAs have increased the cost of personal injury claims by 25-30% (rather than the 8% set out in the Zurich booklet). This increase in costs is attributable to the success fees being charged by solicitors and the costs of “after the event” legal expenses insurance. In EL the increase in costs is particularly pronounced in small claims. In addition to the rise in the costs of existing claims, there is also evidence that more prevalent advertising of legal services has lead to an increase in the number of claims being pursued.

2.2.6 The cumulative impact of these particular changes to personal injury law - together with the compounding effects arising from their interaction on claims costs - combined with “background” legal inflation, has been to increase the cost of an average EL claim three-fold between 1996 and 2002. (Greenstreet Berman, based on claims data supplied by major EL insurers).

The Retrospective Impact

2.2.7 The various changes which have been made to personal injury law not only increase the cost of future claims. They have also had a retrospective impact on insurers’ claims reserves. This has occurred because the changes have not only applied to claims which arise after a certain date (such as implementation of the relevant legislation) but also have applied to claims that
have already occurred but are not settled (and will not be settled until after the change is made).

2.2.8 Insurers set aside reserves for two categories of claims:

- **Outstanding claims** - these are claims which have already been notified to insurers and are in the course of settlement; the period of settlement can be very short for small straightforward claims or several years for complicated cases involving severe personal injury. The delay does not occur because insurers deliberately prolong settlement; insurers realised many years ago that it is financially beneficial to settle claims as quickly as is feasible. Rather the delay occurs because it can take a long time for the condition of a severely injured person to stabilise and for a clear medical prognosis to emerge of their future quality of life and future medical needs. (During the period until the claim is settled insurers will generally make interim payments to the claimant.)

- **Incurred but not reported (IBNR) claims** - these are claims which have not yet been notified to insurers but which insurers know from past experience have already been incurred and are likely to materialise in the future. Occupational disease claims, where there can be a time lag of up to forty years between the employee being exposed to harmful workplace conditions and the manifestation of the resultant disease, are the paradigm of IBNR claims. Despite the best efforts of actuaries, estimating the number and cost of unreported future claims, and therefore setting the proper level of IBNR reserves to hold, is extraordinarily difficult for all the reasons explained in Section 1.

2.2.9 Changes to the law which widen or increase compensation, and which do not apply purely prospectively, mean that insurers’ claims reserves (both for outstanding and IBNR claims) are no longer sufficient to meet the expected future cost of those claims. The reserves have therefore to be increased. This is a direct hit to the balance sheets of liability insurers. The increase in reserves has to be funded by insurers’ shareholders, usually by a reduction in the profits earned elsewhere in the company.

2.2.10 This retrospective impact has affected all liability insurance which covers personal injury: EL, public and products liability, and motor liability. The effects on the various classes differ but overall the retrospective cost to the industry of the various changes to personal injury law over the last four or five years has been estimated by insurers to be £1.1 billion.

2.2.11 In the same way that ABI has said it is for society to decide future levels of compensation, we have also consistently argued that change to the law which has a retrospective effect is inequitable because it is in effect changing the rules (of law) after the insurance policy was underwritten and priced. This is not only inequitable, but it further reduces the capital available in the industry to support business and prejudices the views of shareholders who, not unnaturally, are averse to legal changes which have this retrospective effect.
2.3 Problems specific to EL & the EL Market Over the Last Year

2.3.1 The interaction of all the factors set out above - the problems of occupational disease, personal injury inflation and reduced investment income – have caused the severe and systemic lack of underwriting profitability of EL shown by the underwriting results given in Table 1 above. Such losses were clearly unsustainable. The corrective action which has been taken by insurers has resulted in a dramatic change in the EL market over the last year. This section of the report explains what these changes have been and their effect on premiums and the availability of cover.

2.3.2 One question which arises is why, given that the problems of occupational diseases have resulted in losses for many years, corrective action has only been taken over the last twelve months or so? A major part of the answer to this question is the effect that Independent Insurance had on the EL market.

2.3.3 In the last few years, before it became insolvent in 2000, Independent’s EL account and share of the market grew rapidly from 3% in 1997 to 7% in 1999. Other EL insurers maintain that this growth came because Independent was severely under-pricing risks - a contention that the company’s insolvency supports. Independent’s under-pricing and drag on the EL market prevented other insurers from obtaining more realistic premiums.

2.3.4 It should be noted that solvent, prudent insurers suffer twice from the under pricing of companies such as Independent which subsequently become insolvent. Not only have they been deprived of premium income by under-pricing but also, due to the insolvency, they pay an increased levy to the Financial Services Compensation Scheme. This is because claims on the insolvent company’s EL portfolio (and on other classes of insurance which are protected) are funded by all solvent, prudent insurers through the levies they pay to FSCS.

2.3.5 With the insolvency of Independent and the demand from shareholders to restore profitability across all lines of commercial insurance, insurers began to increase premiums. The extent to which they have hardened has been the result of the unprecedented conjunction of events noted previously. The consequence has been a major and very rapid adjustment in the EL market, though by late 2001 a number of insurers were signalling the need for premium increases and publishing material which explained why. There have been two main consequences of this market adjustment:

- **Premium increases** - Across all types of risks the average increase in premiums has been about 50%. However in higher risk sectors such as the construction trades and foundries the increases have been much higher - increases between 300% and 500% being not exceptional (but not widespread). Two related criticisms were levelled at insurers. One was that insurers did not seem to pay due regard to a firm’s current health and safety practices in setting premiums. The other was that insurers did
not seem to differentiate between the specific risk individual small firms present but rather to “book rate” them. The answers to these criticisms are straightforward. As to the first, a firm’s claims experience is partly determined by current health and safety practices and their impact on accident rates and partly by disease claims from past years. Insurers have to take both into account in setting premiums. As to the second, insurers do have to “book rate” small firms (i.e. aggregate the claims experience across similar firms) as a starting point for setting premiums. This is because the claims experiences of individual firms are not statistically significant. However, risk features of individual businesses are taken into account in determining the final premium.

- **Availability of cover** – There has been considerable comment in the media and from some trade associations that firms, especially in high-risk sectors, have been unable to obtain any EL cover. This commentary often seems to have been based on anecdote rather than objective evidence. As far as ABI is able to determine there has not been a widespread problem for firms that have a reasonable degree of compliance with health and safety in obtaining quotations for cover. In a number of cases these quotations have been markedly more expensive than previously, but nevertheless EL cover has been available. Indeed some insurance companies have made sure that they provide renewal terms to all existing policyholders which show reasonable compliance with health and safety requirements. This practice has not been universal because some insurers have made strategic decisions to cease writing insurance for certain types of business - eg motor, property or liability for large risks. Some employers may have decided to break the law and not buy insurance; how many firms have taken this decision is difficult to know.

2.3.6 It is undoubtedly true that insurers have become much more selective, especially about new risks they take on, and that with the reduction in market capacity brokers needed to have high levels of expertise to access all possible insurance markets (including Lloyd’s), advise employers about risk management, and present the risks in a favourable light. Provincial brokers without any particular expertise in EL have found it difficult to access all markets, especially specialist insurers in the London Market, and particularly for smaller firms in high risk sectors. ABI has suggested that one way for these firms to better access all insurance markets would be for their trade associations, with the help of specialist brokers, to put together insurance schemes for their members. Such schemes would potentially provide insurers with a better spread of risk, a greater volume of premium and reduced transactional costs.

2.3.7 ABI is currently working with other trade associations which require their members to meet certain minimum standards of health and safety to see what credit can be given for this by insurers when underwriting risks. This work is continuing. It remains to be seen whether the trade association schemes set sufficiently high standards for insurers and whether compliance with the requirements of the schemes are rigorously policed. The DTI also recently announced that members of TRADESMEN – the Government’s anti-cowboy
builder initiative quality mark - will be able to enjoy a 20% discount on public and employers’ liability insurance premiums.
Section 3 - The EL Market Over the Medium Term

3.1 The attempt to answer the question as to whether EL is sustainable, for insurers and for employers, is at the heart of this DWP review. It is essential therefore to try and analyse the factors which will be at play in the EL market over the medium term - the next two or three years.

Future Premium Trends

3.2 Competition law of course forbids insurers from discussing jointly what their future underwriting and pricing policy will be. The ABI secretariat has therefore had bilateral discussions with a number of the major EL insurers. From these discussions it seems clear that the premium increases which have been imposed over the last year will not be sufficient to restore insurers’ EL accounts to profitability (to the extent insurers can ever know that they have priced long tail disease exposures correctly). A further large increase in premiums will be required over the next twelve months, though it will probably be smaller than that seen over the last year.

3.3 One of the main reasons why further premium increases will be necessary is that there are a number of new external factors which will either increase the cost of claims or increase the proportion of capital required by the FSA to support EL. (It is important to distinguish increases in the proportion of existing capital required to support EL from absolute increases in the amount of capital available in the whole market for EL.) Increasing the proportion of capital to support EL will further limit the capacity of the market and push up the premiums needed to earn the required return on capital. The various factors which are currently foreseeable include:

- **recovery of the costs NHS hospitals incur in treating people injured at work** - the Department of Health estimates that this will increase EL premiums by about 8%;

- **introduction of reviewable periodical payments in personal injury claims** - the Courts Bill, which is currently before the House of Lords, will enable personal injury claims settlements to be reopened in specific circumstances. The circumstances presently envisaged in which a case could be reviewed are narrowly defined. However the Bill does give the Government the power to introduce reviewability in other circumstances. The progressive widening of the law in favour of claimants which has occurred over the last decade or more, and the retrospective effect of that widening, will naturally make insurers cautious about the potential impact of reviewability. In particular the degree of uncertainty for actuaries in trying to project future claims costs - and therefore where future premiums must be set - will increase. They will tend to make cautious assumptions about the future impact of reviewability. Evidence collected by ABI from Denmark, where reviewability has prevailed since the mid 1980’s indicates that EL premiums would need to rise by at least 3% just to account for the narrow form of reviewability. (The evidence is not strictly comparable as it
relates to motor personal injury claims; nevertheless it is strongly indicative.)

- **the implementation of Law Commission reports** – several reports on damages issued by the Law Commission have yet to be implemented. These include proposals to increase payments in fatal accidents and liability for psychiatric illness. Their implementation will have an inflationary effect on EL claims costs and hence premiums.

- **the impact of risk-based regulation by the FSA** - as mentioned earlier the FSA is progressively moving to risk-based regulation. This will have important consequences for the amount of capital insurers are required to deploy to support specific lines of business. Generally the more unpredictable the pattern of claims for a line of business and the more unprofitable it is - and therefore the greater the risk to solvency - the more capital will be required. The FSA is not prescribing how capital should be deployed, but rather requiring insurers to develop models to analyse the predictability and profitability of specific lines of business. Some firms are already using these economic capital models to allocate capital to their various lines of business; others will progressively move in this direction over the next year or two. What seems clear is that under this risk-based approach the amount of capital insurers are required to deploy to support certain lines of business - such as motor - may diminish from that conventionally required. By contrast the capital required to support EL is likely to increase: one firm of strategic consultants estimate it could increase to **two or three times** that of the conventional solvency margin.

3.4 There do not appear to be any countervailing trends which will dampen down these effects on claims costs.

3.5 Without fundamental reform the systemic problem of occupational diseases and the way the courts determine the date of knowledge will remain.

3.6 Reference has already been made in Section 1 to the explicit statement of Lord Bingham in the recent Fairchild cases that the higher courts will seek to interpret the law in a way which ensures claimants with occupational diseases will obtain compensation.

3.7 It is important to understand the effect that these trends, without fundamental reform, will have on the cost of EL. Greenstreet Berman were asked by ABI to analyse the current cost of workplace injury for the UK as a whole and the consequent costs of compensation. They were also asked to look at the current trends affecting the cost of EL claims and assess what affect these trends, were they to continue, would have on the future cost of EL.

3.8 Greenstreet Berman concluded that the current cost or workplace injury and ill-health in 2001 was about £7 billion shared in the following way:

<table>
<thead>
<tr>
<th>Employers</th>
<th>£2.35 bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employers' liability ins.</td>
<td>£1.3 bn</td>
</tr>
</tbody>
</table>
State £1.8 bn
Individuals £1.3 bn

3.9 They also concluded that average EL costs as a percentage of employers’ wage roll were: 0.8% (mode) or 0.25% (weighted mean taking account of how premiums vary by size of firm). The costs for firms in high risk sectors are many times higher than these averages.

3.10 Greenstreet Berman’s conclusions about future costs are neatly summarised in table 5 below.
The graphs show the projected cost of EL to 2015 in two ways - as a percentage of the total costs of workplace compensation in the UK and as a percentage of national payroll. They show these projected future costs under three scenarios:

- 5% annual inflation in claims costs;
• 10% annual inflation in claims costs; Greenstreet Berman believe this to be the most likely scenario as it matches the long term trend in inflation in EL claims;

• 15% annual inflation; this has been the trend rate of inflation in EL claims over the last three years.

3.12 Under the most likely scenario of 10% claims inflation, Greenstreet Berman (whose report is attached to this submission as appendix 5) project that:

• The EL system will be bearing the majority of the cost of workplace compensation in the UK, rising from its current proportion of about 25% to nearly 60% by 2015;

• EL will account for about 2.0% (mode) and 0.6% (weighted average) of employers’ payroll by 2015. This is more than double the current level. The percentage of wage roll costs will of course be much higher for firms in high risk sectors.

3.13 Greenstreet Berman consider that the 15% annual inflation in the cost of average EL claims experienced over the last three years is unlikely to continue. Their reason for believing this is that the impact on claims costs of the many reforms to personal injury law detailed earlier is unlikely to be replicated. However the recent increases in the rate of inflation and the retrospective impact of the changes to the law have made the extremely uncertain future of EL claims costs even more uncertain. Actuaries now have to grapple with uncertainty about which trend line to use for personal injury inflation as well as uncertainties about what causal links will be established in the years to come between exposure to workplace conditions and occupational diseases. The more uncertainty there is the more difficult it is to set premiums with any degree of confidence; this is not an appealing message to insurers’ shareholders.

Market Capacity

3.14 The capacity of the EL market over the next two or three years - and the consequent impact this will have on levels of premiums - will be caused by the interplay between two factors. One is whether new capital enters the market. The other is how much capital existing players deploy to support EL and whether any of them decide to withdraw from the market.

3.15 It is possible that as EL premiums continue to rise new capital may be attracted into the market. It is difficult to judge the extent to which this may happen, but a number of factors suggest that it is unlikely to result in a pronounced expansion of capacity:

• premium rates are high and profitability reasonable in most classes of general insurance, none of which suffer from the systemic problems long tail occupational diseases cause EL insurers; it would therefore seem that new capital will be attracted to other lines of business than EL.
• the market for EL is relatively consolidated, with five insurers, all major multinationals, writing 70% of business; and new capital deployed in the market is unlikely to match the capital these insurers commit to support EL and therefore unlikely to have a major impact on market capacity.

3.16 The other factor which will determine market capacity is the amount of capital which existing insurers deploy to support EL. At appendix 1 to this report are several statements from most of the leading EL insurers about how their shareholders view EL. (These statements are confidential.) They show that at best insurers will commit the minimum amount of capital necessary to support EL, because it is compulsory for their business customers to have the insurance; at worst insurers are having to justify to sceptical shareholders or head offices why they should continue writing EL.

3.17 What is clear is that if one of the major insurers did decide to stop writing EL the impact on market capacity would be immense - far greater than the problems which employers have experienced over the last year. It is likely that many employers would be unable to obtain cover and premiums for firms which could find cover would increase hugely.

3.18 The extent to which existing EL insurers review their continued participation in the market will, of course, be heavily influenced by this Government review of EL. The prospect of fundamental reform, which would lead to a more sustainable market, would encourage existing insurers to stay in the market and would almost certainly attract new capital into the market.
Section 4 - Options for Reform

4.1 The fundamental need to separate funding for long tail occupational disease claims

4.1.1 ABI believes fundamental reform of EL is necessary if it is to prove sustainable in the future; incremental change will not achieve this sustainability. While accidents and short tail diseases can be funded through the commercial insurance market, there is a fundamental need for a new way of funding occupational disease claims. For the reasons explained in this report it is impossible to predict accurately the future cost of long tail occupational disease claims; this means that the new way of funding occupational diseases has to be, at least in part, a pay-as-you-go system (rather than the present accruals-based system).

4.1.2 At the same time incremental reform to reduce the legal and other costs associated with EL claims and to improve the use of rehabilitation should be pursued. However they are no substitute for fundamental reform.

4.1.3 A number of different methods for funding long tail occupational disease claims have been suggested. They include:

- an employer-backed mutual fund;
- a fund financed by a levy on EL premiums;
- insuring long tail occupational disease claims on a “claims made” basis (rather than the present “losses occurring” basis).
- Some form of tax-based arrangement.

The first two options are essentially variants of the same idea but with different organisational and administrative arrangements. The first option – an arrangement funded wholly by taxes – is not discussed further in the paper, but should be fully considered in future work by the Department.

4.1.4 How each of these options would work, with their respective advantages and disadvantages, are set out below. However it should be noted that in the short time available to prepare this response to the DWP consultation it has not been possible to explore all the implications of these options. There may also be other options.

4.1.5 One extremely important benefit of making this separation of funding would be that EL premiums would be linked much more closely than at present to an employer’s current health and safety practices. There would be a much more direct financial incentive than exists at present for employers to invest in improving health and safety. The link would be more direct because currently an employer’s claims record can be heavily influenced by disease claims which occurred many years in the past, but are only now manifesting themselves.
4.1.6 In 2001 the claims incurred by EL insurers were £639 million. Of this a rough estimate is that about 25% relates to long tail diseases. This gives an order of magnitude – about £150m – to the claims which would pass through the new separate non-insurance mechanism. (This of course assumes that the cost and pattern of future occupational disease claims are similar to today’s; this will not be the reality.) In considering options for reform ABI has, as far as time has allowed, looked at alternative systems of funding which other countries operate. In particular the German and Belgian systems have been studied. These countries’ systems are of interest because in Germany industrial sector funds (Berufsgenossenschaafen or BGs) are responsible for the funding, in the relevant industrial sector, of all workplace compensation as well as for prevention and rehabilitation. And in Belgium (as in Portugal and Denmark) there are separate systems to fund workplace accidents and occupational diseases.

4.1.7 Notes on the German and Belgian systems are attached as appendices 2 & 3 to this report. ABI is indebted to Munich Reinsurance for arranging contact with the compensation bodies in both Germany and Belgium.

4.2 Policy objectives

4.2.1 Before considering the options for new systems of funding long tail diseases it is worth setting out some of the policy objectives against which they should be tested.

4.2.2 The first objective is that as far as possible the systems should try to satisfy the “polluter pays” principle: those employers whose employment practices have caused a disease should as far as possible pay the claims. To date employers have not paid the full cost of diseases they have caused. The costs of treatment by the NHS of ill employees (or indeed those injured in accidents) have not been recovered from employers. Also insurers have, through the losses they have sustained on their EL accounts, subsidised employers. It could be argued that employees have in part paid for this subsidy through the premiums they have paid on other, more profitable, types of commercial insurance. This contention would, at best, be only partially true. Businesses which have paid large commercial property insurance premiums - for instance property companies - have little EL exposure and their EL premiums will have been commensurately low. Also insurers will have subsidised losses on their EL accounts from profits generated on personal insurances or even, if they are a composite insurer, from their life insurance businesses.

4.2.3 The second objective is that any new system should be established on a basis which is financially sustainable.

4.2.4 As there is not necessarily a clear-cut distinction between accidents/short tail diseases and long tail diseases, “boundary disputes” about which funding ‘pot’ conditions fall into, should be minimised. This is the third objective.
4.2.5 Ideally a **fourth objective** would be that there should be incentives for employers to improve health and safety as regards occupational diseases. One the one hand it is difficult to see how such incentives could be provided. The characteristic of such diseases is that causal links between workplace practices and the disease only emerge in the future so that there can be no present knowledge of how workplace practices should be changed, or how this could be linked to financial incentives. On the other hand there is no coherent system in the UK - unlike in Germany - for funding research into the links between workplace practices and occupational diseases. Knowledge of the causal links between workplace exposures and occupational disease tends to emerge piecemeal from medical researchers and lawyers. A more systematic and properly funded system of carrying out such research - and then feeding the findings of such research into prevention and risk management at as early a stage as possible - could potentially lead to significant reductions in the incidence of occupational diseases in the UK and consequent reductions in the cost of compensation.

4.2.6 The **last objective** is that any new funding system should be institutionally simple and, as far as possible, operate through and with existing infrastructures and organisations.

4.3 **Models for separating the funding of long tail occupational disease claims**

4.3.1 The key issue facing any occupational disease fund, whether financed through levies on EL premiums or financed directly from employers, would be how to secure the greatest equity in financing so that the arrangement was sustainable. The issues to be addressed would be which firms pay, how much cross subsidy between firms and across different “generations” of firms is acceptable, and whether there is any role for the taxpayer.

4.3.2 Paying for long tail occupational disease claims can only be financed in one of three ways:

- it can in theory be done on an **accruals basis**, but the experience of EL insurers has shown that this is not viable;
- it can be done on a **pure pay-as-you-go basis**; this would not conflict with the polluter pays principle if firms never went out of business because they would simply pay their due share of the cost of claims as they materialised. However firms do go out of business and a pure pay-as-you-go system would maximise the degree of cross subsidy across generations of firms;
- this suggests that a **hybrid system**, which operates partly on an accruals basis and partly on a pay-as-you-go system, might be the most equitable and sustainable system, if it can be proved to be workable.

**A hybrid system**

4.3.3 The **first element of a hybrid system** would be a year-on-year levy - effectively a “premium”- paid into the fund based on the best objective
assessment at the time of the exposures the firm presents. The key question
would be whether a methodology could be established to do this which would
command support across the broad range of industry and commerce. (This
may be a task that consultants could be asked to address.) Insurers’
experience shows that the original estimates of future long tail disease
exposures will almost certainly turn out not to be correct - usually being too
low.

4.3.4 Therefore, as diseases begin to manifest themselves and assessments can
be made of the adequacy or not of the cash held within the fund (plus the
interest accrued over many years) top up payments might need to be made
(the second element of the system). As far as possible these payments
would be raised from the firms whose workplace practices had given rise to
the claims. However for firms which had gone out of business no further
payments could be raised so there would have to be a element of cross-
subsidy from other firms.

4.3.5 One option would be to limit cross-subsidy to firms within the same industrial
or commercial sector. At one level this would be appealing as it would prevent
for example the IT industry from paying for claims in the steel industry.
However it could potentially cause another problem which the German BGs
have grappled with.

4.3.6 There are about 35 BGs in Germany organised by industrial sector. When a
specific sector is in decline it can also be the case that a large number of
occupational disease claims are emerging - shipbuilding would be an obvious
example - so that a very large claims cost will fall on the few firms remaining
in the sector, effectively bankrupting them. This problem has been solved by
cross-subsidy between BGs, which has had to be negotiated whenever a
particular industry sector BG has run into financial difficulty. In the light of this
a single fund covering all industry and commerce but with pre-agreed
protocols for cross- subsidy across sectors might be a better option for the
UK.

4.3.7 The pay-as-you-go option for financing the fund would no doubt be attractive
to be the current generation of employers. It is probably axiomatic that a
move to a new system of funding long tail diseases would only apply
prospectively – ie to claims which occur (are caused) from the time the
change is effected. The fund would not take on any of the liabilities assumed
by insurers on policies already issued and for which employers have already
paid premiums. Yet it is unlikely that a “prospective” fund would in its early
years have to pay many, or indeed any, claims because of the time which
elapses between exposure to the disease and the disease manifesting itself.
The effect of this would be that the current generation of employers would not
be paying anything towards the cost of funding the diseases their work
practices cause. There would be no element of the EL premium which would
be covering these exposures because they now rested with the fund and the
fund would not have claims to pay. This is another extremely strong
argument for all stakeholders to invest time and effort in seeing whether the
hybrid method can be made to work.
4.3.8 If it is not possible to agree a methodology which will allow some cross subsidy, consideration should be given, in the interests of making the system sustainable, as to whether in certain prescribed circumstances some funding could not come from the taxpayer - for instance for claims from companies which no longer existed.

**A fund financed by a levy on EL premiums**

4.3.9 In terms of administrative simplicity a fund where the money to pay claims was collected by a specific levy on EL insurance premiums would have advantages over a system where the money was collected by an industry body. All employers are required by law to have EL; they are not required to belong to an industry body or trade association though many do. If the fund were financed by a levy on insurance premiums insurers would be acting as collecting agents for the fund, as they are for Insurance Premium Tax. Insurers would completely oppose the fund being financed directly from insurance premiums (as opposed to a separate levy on them) because they would then be bearing the risk.

4.3.10 A fund would need a structure of governance which ensured that all the stakeholders felt their interests were represented and that the fund operated in a manner which was fair to the various categories of funders and to those receiving compensation.

4.3.11 As well as its core role in providing compensation the fund could, if it was felt appropriate, take on the role of co-ordinating and funding primary research into the links between workplace practices and long tail occupational diseases. As has been mentioned, no body in the UK has this responsibility presently. Though there would be costs associated with this there could be substantial benefits in establishing causal links between long tail diseases and accidents at an earlier stage than at present, reflecting this in health and safety practice, and in reducing the incidence of occupational disease in the UK.

**Insuring long tail disease claims on a ‘claims made’ basis**

4.3.12 The Employers’ Liability (Compulsory Insurance) Act 1969 effectively stipulates that EL policies must provide cover on a ‘losses occurring’ (accruals) basis. As has been noted, this ensures that once the employer has paid the premium all the risk of future legal changes and improvements in medical knowledge are passed to the insurer. The Third Parties (Rights Against Insurers) Act 1930 also ensures that even if the policyholder (the employer) becomes insolvent and is wound up an injured or ill employee can exercise the insolvent policyholder’s right against the insurer and make a claim under the EL policy.

4.3.13 ‘Claims made’ policies respond to claims quite differently from ‘losses occurring’ policies. These policies respond to claims according to when they are first made against the policyholder; it is not relevant whether the claim
occurred many years in the past. They essentially operate on a pay-as-you-go basis: premiums reflect current claims.

4.3.14 The advantage of this option is that it satisfies the polluter pays principle. The premiums paid by the employer (so long as it is still in business) would directly reflect the cost of disease claims to which their previous employment practices had given rise. The cost of premiums to cover the exposures would be subject to the competitive pressures operating in the insurance market. Whilst this would have advantages it would leave employers exposed if capacity in the insurance market - for whatever reason - were to reduce markedly.

4.3.15 Because this option would be delivered through an existing infrastructure - that of the insurance industry - it measures up quite well against the test of institutional simplicity, with the exception of the need to create an Employers’ Liability Insurance Bureau (ELIB), mentioned below.

4.3.16 ‘Claims made’ policies require the policyholder to notify the insurer about claims as soon as they are first intimated (disputes can arise about when the policyholder first knew or ought to have known that a claim might be made against them). In practice this would mean that when an employer first became aware that claims might be made against them for a newly recognised occupational disease, they would potentially notify the insurer of hundreds or thousands of claims - anyone in their past workforce who might have contracted the disease.

4.3.17 This kind of blanket notification is quite different to how the current ‘losses occurring’ policy operates. As most long tail occupational diseases are caused by exposure over many years, rather than at a specific point in time, the current practice in the insurance industry is for each insurer on risk over the period of exposure to contribute their share of the claim based on proportionate time on risk. Nor does the employer have to take the precaution of notifying all the possible claims because the policy will automatically pick these up.

4.3.18 The effect of this (i.e. switching to ‘claims made’) is that insurers writing long tail occupational diseases would face the prospect of a catastrophic flood of claims in a single year of a magnitude which does not exist with losses occurring policies. Insurers could limit their catastrophic exposure by imposing limits on the maximum they would payout on the policy; an amount in excess of this would however fall back on the employer. Alternatively they might be able to pass some of this exposure to reinsurers. But it was noted in Section 2 that the events of September 11 2001 have caused a fundamental reappraisal by the global reinsurance industry about the risks it accepts. No discussions have been held with reinsurers to see what appetite they would have for reinsuring long tail occupational diseases written on a ‘claims made’ basis. This should be a next step.

4.3.19 Another difficulty of ‘claims made’ policies is that if a policyholder is unable to obtain insurance - perhaps because insurers are concerned about the large
numbers of claims which they think are about to materialise - then the policyholder has no protection against claims from the past.

4.3.20 Similarly a claimant has no protection under a claims made policy if their employer has gone out of business and been wound up. There is a potential solution to this problem, which is to create an ELIB (akin to the Motor Insurers’ Bureau) to pay compensation to claimants whose employer has gone out of business. If an ELIB were to be established, insurers would insist (a) that it formed only part of a broader range of reforms to the EL system and (b) that it were funded by an explicit levy on EL premiums, rather than from within the premium itself (as is the case with the MIB). The existence of an ELIB might also raise concerns about the moral hazard it created to avoid insuring.

4.4 Practical Issues of Separation

4.4.1 Insurers consider that both accidents and short tail disease claims - ones in which diseases manifest themselves quite soon after exposure - can readily be insured within the commercial insurance market. This is because insurers can tell relatively quickly whether the premiums they have charged are adequate or not and then adjust their future premiums to reflect the emerging level of risk.

4.4.2 There are a number of possible ways to separate accidents/short tail diseases from long tail diseases. What is clearly desirable is that there should be the minimum number of disputes about which funding ‘pot’ a disease falls into - is it short tail or long tail? ABI’s Liability Insurance Committee has considered this matter in some detail and is currently of the view that the most clear cut method of separation would be to use a temporal criterion.

4.4.3 For example, diseases which manifested themselves within 5 years of exposure would be short tail diseases and be paid by insurers; diseases where the period to manifestation was longer would be compensated by one of the alternative funding methods set out above for long tail diseases. The period of 5 years is only given for illustration - the period could be 10 years. The great benefit of using a temporal criterion, rather than the other possible methods of separation, is that it is clear-cut.

4.4.4 A detailed paper setting out some of the options for separation is included at appendix 4 of this report.

4.4.5 The obvious next step is for there to be a more rigorous exploration of the feasibility and implications of these funding options and any others which may emerge. It is essential that when fundamental change is made there are no unforeseen consequences. The best way to carry forward this work might be through a working party chaired by DWP. The working party could comprise other Government departments and agencies and key non-governmental stakeholders.

4.5 Options for Incremental reform
4.5.1 This report has pointed out the UK’s extremely poor record on rehabilitation and the high level of legal and other frictional costs which arise in EL claims - especially small claims where these costs can account for 90% of the total claim payment. In both these areas a concerted effort to bring about reform would benefit most stakeholders and if successful could result in material reductions in claims costs. Reduced claims costs would, other things being equal, be reflected in lower EL premiums.

**Rehabilitation**

4.5.2 From an extremely low base the insurance industry has, over the last few years, made significant progress in establishing procedures for the vocational rehabilitation of people injured at work or in motor accidents. Most major insurers now have such procedures and there is an emerging private sector market of healthcare providers who can deliver the necessary rehabilitation services. One of the main landmarks was the publication in 1999 of *The Code of Best Practice on Rehabilitation Early Intervention and Medical Treatment in Personal Injury Claims*, an updated version of which will be re-launched in March 2003 as *The Rehabilitation Code* at a seminar marking the publication of the IUA/ABI 3rd Bodily Injury Awards Study.

4.5.3 However the number of people so rehabilitated each year is still small - in the low thousands - and the effort has tended to be concentrated on severely injured people because theirs are the most expensive claims. It is widely recognised that large aggregate savings could accrue for all parties if rehabilitation could be provided to the mass of people with small injuries such as back pain.

4.5.4 At the recent ABI/TUC conference on rehabilitation, held on 28 January 2003, a sense of frustration was evident. There was an eagerness to take steps which would see mass rehabilitation in the UK. The two main barriers seemed to be a cultural one - unfamiliarity and perhaps mistrust of rehabilitation among the wider stakeholder communities - and the lack of a national infrastructure to provide rehabilitation.

4.5.5 At the seminar, Owen Tudor - Senior Health & Safety Officer of the TUC and a Health & Safety Commissioner - suggested that a National Rehabilitation Committee be set up. The committee could be comprised of senior representatives from the various stakeholders and ideally be chaired by the Minister for Work. ABI wholeheartedly supports this proposal. It seems the best way to bring about the step-change in the UK’s record on rehabilitation which all believe is necessary.

**Legal costs**

4.5.6 This report has already pointed out that legal and associated expenses make up 40% of the total cost of EL claims. Yet the reality is that for the vast majority of EL claims - well over 90% - there are no serious disputes about the liability of the employer. In effect the UK EL system is close to being a "no-
fault” system, but with the attributes processes and associated costs of a tort system.

4.5.7 Because there are few disputes about liability, especially on small claims, claimants’ solicitors are arguably advising their clients mainly on matters of quantum rather than liability law. What has become obvious from ABI’s investigations of other countries’ compensation systems is that in any system, claims settlement requires three functions to be performed:

- there must be a route for claimants to enter a claim into the system; in Belgium, which is highly unionised, this function is performed by unions;
- there must be a method of ensuring that the compensation paid to the claimant is fair and comparable to the compensation people with similar conditions have received. This equity can be obtained by the use of a tariff of compensation payable for specific conditions. In the UK, claimants’ representatives and insurers know from judicial guidelines and custom the upper and lower levels of compensation which a condition attracts, with the exact amount eventually paid being settled by negotiation;
- there must be a system of adjudication for settling any disputes about entitlement to compensation and the amount of compensation payable; in the UK, the courts perform this function whereas in Germany it is performed by tribunals.

4.5.8 What seems clear is that the functions that claimants’ representatives are performing, especially on small EL claims, are to provide a route for claimants to make a claim and to negotiate the amount of the claim. (By contrast this is not the case on medical negligence cases where the claimant’s representative has to advise on liability and establish that there was negligence.) The question is whether the costs associated with the performance of these functions are proportionate?

4.5.9 Serious consideration should therefore be given to the introduction of a fixed legal costs regime, at least for small EL claims. An analogous scheme has recently (December 2002) been developed for small motor injury claims under the auspices of the Civil Justice Council and ABI believes that this example could be replicated for small EL claims as a way of managing the comparatively high legal costs which they attract (40%). The predictability of costs under such a scheme is in the interests of all stakeholders as it will promote early settlement of genuine claims and minimise frictional costs.

No-fault

4.5.10 The workplace compensation systems of most developed countries are no-fault-based rather than tort-based. No-fault systems do seem to have much greater levels of rehabilitation than the UK, primarily because there is not the adversarial claims culture associated with the tort system. Also, legal expenses in countries such as Germany appear to be a fraction of those in the UK; this is not the case with the workers’ compensation system in the USA, which even though no-fault, is highly litigious.
4.5.11 For a host of reasons - interaction with the benefit and healthcare systems, levels of compensation, scope of the systems etc - it is difficult to make comparisons between the overall cost of different countries’ systems of workplace compensation. Nevertheless there are indications that no-fault systems result in a higher cost to the economy than the UK’s tort system, probably because more people make claims. It would therefore be a big step for the UK to consider a move to a no-fault system. Insurers would be concerned if such a step were considered without the fullest possible analysis of the implications.

4.5.12 To ensure that if such a move were ever considered it would be based on some understanding of the costs, ABI has commissioned Greenstreet Berman and Callund Consulting to undertake some economic modelling. The modelling will investigate how a no-fault system (under various configurations) would compare with the costs of workplace compensation in the UK (EL, IIDB and other relevant benefits such as Incapacity Benefit).

Association of British Insurers
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