PRICEWATERHOUSECOOPERS

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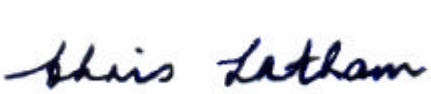
Report to the Insurance Issues Working Group of Heads of Treasuries

Actuarial assessment of the recommendations of the Ipp Report



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1 Introduction and summary of report

1.1 Introduction

This report has been prepared at the request of the Insurance Issues Working Group of Heads of Treasuries ("IIWG").

Throughout 2002 the IIWG has been working to assist government(s) in coordinating efforts to reform tort law as it affects personal injury claims. Coming out of the 30 May 2002 meeting of Ministers a review was commissioned, "Review of the Law of Negligence", chaired by The Hon David Ipp (referred to as "the Ipp report"). The Review was released on 2 October 2002 and comprises, inter alia, some 61 recommendations for change.

In response, the IIWG has been asked by Ministers to prepare an "Officials Report", and to obtain actuarial assistance.

The IIWG has asked PricewaterhouseCoopers Actuarial ("PwC Actuarial") to assess the potential financial implications of the Ipp recommendations. The terms of reference are included as Appendix A.

The majority of recommendations are not easily costed, either because suitable data is not collected or is collected in a form which is not amenable to statistical analysis. In many cases how the recommendations will work in practice is also unclear and it is not possible to pre-emptively determine how they will ultimately be applied.

Accordingly, we have been able to estimate the potential financial effect of a limited number of the recommendations only, as described in Section 3. For other recommendations we have provided largely qualitative comment on their possible effect.

In this context our report appears under the following sections:

Section	Content
3	Ipp as related to insurance classes Categorisation of Ipp recommendations
4	Data sources, description of general methodology and summary of key assumptions
5	Costing of quantifiable recommendations
6	Comments on main non-quantifiable recommendations
7	Discusses the question of permanence of the effect of the recommendations
8	Considers the potential impact on insurers' premiums
9	Comments on certain miscellaneous aspects

1.2 Summary of report

The calculations in this report are based upon data for the public liability class of insurance, although the results can be extended to medical indemnity. It has been assumed that the workers' compensation and CTP classes will not be subject to the Ipp recommendations.

We have divided the Ipp recommendations into the following categories:

Category	Description
A	Those expected to have a financial effect and which can be formally assessed.
B	Those expected to have a financial effect but which **cannot** be formally assessed.
C	Those of an essentially administrative nature.

We have estimated the potential financial effect of Category A changes.

The following table provides a summary of the results of our calculations, being the estimated impact on the underlying **gross incurred claims cost**.

Please note that:

- The estimated reductions are relative to the pre 30 June 2001 public liability environment;
- The reductions are in respect of the cost of claims occurring after the changes are implemented, ie: no retrospectivity is involved;
- The estimates are intended to be "central" in a statistical sense; and
- Claims cost is defined as the amount of damages paid to claimants plus associated legal costs. It does not include the other secondary costs of insurers, such as administration expenses and the cost of capital.

Notes	Recom	Proposal	Estimated savings
(3)	45	Reduced Legal Fees	10.1%
(1)	46	Tariff for General Damages	
	47&48	15% Threshold & Cap for General Damages	4.7%
	49&58	Cap on Damages for LOEC	0.6%
	50	Health Care Costs	0.7%
	51&52	Gratuitous care restrictions	0.8%
(2)	53	Future Economic Loss, discount rate	
	54	Interest to Judgement	2.7%
(2)	55&56	Death claims restrictions	
(2)	59&60	Collateral benefits, exemplary damages	
(1)	61	Indexation	
	Total		**19.6%**

Notes:

(1) Not measurable

(2) Expected to have nil or negligible effect

(3) Most of the legal cost savings is an indirect result of the General Damages Threshold

Therefore, we estimate that the net effect of all the proposed Category A changes will be to reduce claims cost of public liability claims by **14.7%.** This comprises an approximate **19.6%** reduction in personal injury claims cost, with **no** reduction in property damage claims cost.

The background to these estimates is given in Section 5.

All other things being equal, these reductions in claims costs might translate into corresponding reductions in insurers' premiums of around **13½ %** on average. However there are a number of issues which insurers will consider in setting future premiums. These include, inter alia:

- Importantly, the adequacy or otherwise of current premiums;
- The form of implementation of the changes, and in particular the prospect of windfall gains relative to premium already written;
- The operation of the market, in particular the different views taken on future superimposed inflation; and
- The availability and cost of reinsurance protection.

These issues are discussed in Section 8. It is likely that a variety of responses will eventuate in practice.

These estimates are dependent on a **sliding** scale being introduced in conjunction with the 15% severity threshold for non-economic loss. The Ipp recommendations do not appear to incorporate such a scale. Without a sliding scale we believe the threshold will be quickly eroded together with any potential for significant cost savings. This is discussed in Section 5.4 where a number of alternative scenarios have been investigated. A key assumption is the extent to which small claims might be eliminated from the system, discouraged by the absence of general damages and the risk of paying their own legal costs.

These estimates are very uncertain and the eventual actual outcome of experience could be significantly different. We have tried to illustrate this uncertainty in Section 5.14.

These results are based, as far as possible, on Australia wide data. As such, they are generic and not necessarily applicable to the circumstances of any particular jurisdiction. Rather they are illustrative of the general cost saving which should be obtained from implementing the recommendations on a nationwide basis.

The lack of suitable data at a jurisdictional level, particularly for some of the smaller ones, would make credible specific jurisdictional costings difficult.

That said, approximately half of the savings generated is the indirect result of eliminating small claims via the general damages threshold reinforced by legal cost restrictions on small claims. This affect is likely to occur in all jurisdictions and is not likely to be particularly affected by debate over specifics of the data which should be used in the calculation. Regardless, it can be expected that significant cost savings should be achieved in each jurisdiction. The scenarios in Section 5.14 help describe the range of possible outcomes which may be possible.

These costings also assume that no jurisdiction has already made any reforms along the lines considered by the Ipp Report. In reality some jurisdictions have already implemented reforms over the last 12 months which are consistent with at least some of the Ipp Recommendations. In this situation, the cost savings referred to above will **not** be additional to savings from reforms already in place. This issue is discussed in Section 5.16.

In Section 6 we have included some general comments upon Category B changes. Although we have been unable to cost the effect of these recommendations, this should not be seen as diminishing their importance. It is quite plausible that these recommendations could result in claims cost reductions as significant as those of Category A. However, and unavoidably, their success or otherwise will be determined by legal drafting and judicial interpretation.

In Sections 7 and 9.5 we discuss the question of possible erosion of the effect of the recommendations.

Experience in other accident compensation systems indicates that, where the system remains in the legal environment, the immediate effect of changes is likely to be eroded. How quickly they are eroded and to what extent will vary according to the legal efficacy of the changes. However we cannot opine on legal efficacy, which will depend upon the detailed drafting of legislation.

In the circumstances as described it is important that claims experience in the system is continually monitored, and the need for further legislation considered if the initial changes lose their effectiveness. This requires comprehensive data.

In Section 9 we discuss some miscellaneous issues including:

- Lack of data
- The response of the insurance market
- The question of actuarial recognition.

2 Reliances and Limitations

This report has been produced for the IIWG and respective governments to consider the actuarial implications of the Ipp Report recommendations.

Costing savings from reforms is extremely difficult and relies in large part on subjective interpretation of the likely impact of the various reforms. There is obviously considerable uncertainty as to the ultimate success or otherwise of these reforms and thus **these costings are subject to a high degree of uncertainty.** There is a range of possible outcomes corresponding to more optimistic or pessimistic views compared to that presented in this report.

This report is prepared solely for IIWG and the Commonwealth, State and Territory Governments represented on IIWG. Other readers of this report should not rely on this report but should obtain their own advice.

It is generally acknowledged that there is a sparcity of data available with respect to the cost and circumstances of public liability claims. This lack of data has restricted our ability to comment on the cost implications of adopting the Ipp Recommendations. In those cases where we have used data to undertake quantitative analysis users of this report must appreciate the considerable uncertainty associated with our answers.

This report was also prepared under certain time constraints, which has necessarily limited the amount of research which could be undertaken.

It is important to consider the various recommendations for reform as a complete package rather than in isolation.

The costings contained in this report are based solely on the recommendations included in the Ipp Report. They have been done prior to any drafting of any legislative bill. Changes made in any legislative process may considerably change the intent and outcome of the various reforms. In this case the calculations contained in this report will need to be reviewed.

Before this report is distributed to any further party outside government we require that our permission be asked in writing. Where permission is granted we require the report to be distributed in its entirety.

3 Context of this report

3.1 General background

The Ipp Report is a review of the law of negligence as it applies to claims for personal injury in Australia.

Claims for personal injury are usually associated with insurance, in the following classes:

- Workers' compensation
- Compulsory Third Party (CTP)
- Public liability
- Medical indemnity

Of these classes, workers' compensation and CTP are compulsory and are governed by state-based legislation. In all jurisdictions the legislation restricts, to varying degrees, the application of common law to claims for personal injuries.

The public liability and medical indemnity classes of insurance are *de facto* compulsory, in that for commercial organisations and doctors it is unlikely to be prudent to carry the risk of claim without the protection of insurance. Prior to 2001 these classes were not subject to State based legislation restricting the application of common law. In 2001 medical indemnity in NSW became regulated under the *Health Care Liability Act 2001*. During 2002 a number of states have introduced legislation restricting aspects of common law in public liability matters.

In the calculations which follow in this report we have essentially assumed that the Ipp recommendations will be applied to the public liability and medical indemnity classes only, with workers' compensation and CTP remaining under their current legislative framework.

Indeed the data used in the calculations is in respect of the public liability class only. However we have commented on the likely differences in effect between public liability and medical indemnity.

3.2 The Ipp Recommendations

A summary of the 61 recommendations appear in Appendix B.

From an actuarial point of view the recommendations can be divided into the following categories.

A: Those which are expected to have a direct financial effect and which can be formally assessed.

B: Those which are expected to have a financial effect but which cannot be formally assessed due to the reasons noted in Sections 1.1 and 9.1 of this report, and in our letter to Ms. Lorraine Allan – Commonwealth Treasury, dated 22 October 2002.

These can be divided into:

(i) those which are likely to restrict access to damages (and hence reduce numbers of claims);

(ii) those which are likely to affect the quantum of damages (ie. the average claim size); and

(iii) those which are likely to assist in preventing an "erosion" of the effect of other changes, (ie. assist in the permanence of the effect).

C: Those which are essentially administrative and cannot be said to have a direct financial effect.

In this context we have categorised the 61 recommendations as follows:

Category		Recommendations
A		45-56, 58-61
B	(i)	3, 4, 11, 24-26, 28, 29, 32, 34-35, 37, 39-43
	(ii)	10, 27, 30, 31, 36, 44
	(iii)	8, 14-15, 33, 38
C		All other

Formal assessment has been made for Category A recommendations only.

We have also offered some comments on those recommendations in B which we consider likely to have the most significant effect.

4 Data, methodology and assumptions

4.1 Data used

Other reports elsewhere have already commented on the sparsity of data available with respect to the cost of public liability claims. In particular, for this costing exercise, we require information about the composition of public liability personal injury settlements between the various heads of damage. Such data is not routinely collected by insurers.

Earlier this year PwC Actuarial provided advice on reforms proposed in New South Wales and Victoria. For the NSW advice, and after obtaining approval from our respective clients, we combined data sources with Trowbridge Consulting.

This data was a combination of that from:

- a number of licensed insurers, some of whom provided a sample of 60 claims.
- The NSW Treasury Managed Fund.
- Industry statistics for the NSW Motor Accident Scheme (from the Motor Accidents Authority).
- Industry statistics for the Queensland CTP Scheme (from the Motor Accidents Insurance Commission).
- United Medical Protection, provided to PwC for costing of the Health Care Liability Act 2001 (HCLA).

For this report we have derived data from all Australia in the same form as that used for NSW. In doing so we have used the summaries included in the report by Trowbridge Consulting *Public Liability Insurance. Analysis for Meeting of Ministers 27 March 2002,* and checked if for internal consistency with the NSW data.

In our view the assumptions drawn from these data sources are a realistic representation of the distribution of public liability personal injury settlements by number, total settlements and heads of damages. As such, they form a reasonable basis for the calculations appearing in this report.

However, because of the data issues we caution against unrealistic expectations from any analyses undertaken. Any conclusion will, unavoidably, be subject to a high degree of uncertainty and the final outcomes from tort law changes could vary within a significant range.

4.2 General Methodology

The general approach to the calculations has been as follows:

- Determine the proportion of public liability claims costs which are in respect of personal injury claims;
- Derive a distribution of personal injury claims by size band. As certain changes will not impact claims of different sizes uniformly we have undertaken the calculations separately by claim size band;
- Determine which heads of damage will be impacted by each proposed change;
- Estimate the effect of the proposed change on that head of damage; and
- Aggregate the result to determine the impact on total claim cost.

It is important to note that the aggregate effect is **not** necessarily the simple sum of the effect of each individual change. In the aggregation of the results we have assumed that **all** of the proposed changes will be introduced simultaneously, and allowed for the potential inter-reactions between the individual changes.

4.3 Key Assumptions

The main assumptions we have relied upon in our calculations are summarised below:

4.3.1 Heads of damage proportions

The assumed distribution of heads of damage and claims cost is as follows:

Claim size band	General damages	Past economic	Future economic	Plaintiff legal	Defendant legal	LTC	Medical	Other	Total
50,000	39%	3%	2%	10%	38%	2%	3%	3%	100%
100,000	37%	8%	5%	13%	25%	5%	6%	1%	100%
200,000	32%	12%	10%	15%	18%	7%	5%	1%	100%
500,000	25%	10%	24%	10%	15%	10%	5%	1%	100%
750,000	22%	10%	27%	8%	12%	15%	5%	1%	100%
1,000,000	18%	9%	26%	7%	10%	24%	5%	1%	100%
1,500,000	12%	8%	24%	6%	9%	35%	5%	1%	100%
2,000,000	10%	7%	22%	5%	8%	42%	5%	1%	100%
3,000,000	9%	6%	18%	5%	8%	48%	5%	1%	100%
4,000,000	8%	6%	14%	5%	8%	53%	5%	1%	100%
5,000,000	7%	6%	10%	4%	8%	59%	5%	1%	100%
7,000,000	6%	6%	10%	4%	8%	60%	5%	1%	100%
weighted average	38%	4%	3%	11%	35%	3%	4%	3%	100%

The limited data available is not sufficient to allow any specific assumptions regarding split by heads of damage to be derived for aggregated Australian data.

These assumptions are from NSW analyses.

4.3.2 Claim Number & Claims Cost Distribution

The assumed distribution of claim numbers and claims cost, for all Australia, is as follows:

Upper band	Distribution of claims	Average Cost	Proportion of claims cost
50,000	80.7%	11,000	25.2%
100,000	12.7%	55,000	19.8%
200,000	4.3%	140,000	17.1%
500,000	1.7%	350,000	16.9%
750,000	0.3%	630,000	5.4%
1,000,000	0.2%	892,500	3.8%
1,500,000	0.0%	1,312,500	1.1%
2,000,000	0.0%	1,837,500	1.0%
3,000,000	0.0%	2,625,000	1.5%
4,000,000	0.0%	3,675,000	2.1%
5,000,000	0.0%	4,725,000	2.7%
7,000,000	0.0%	6,300,000	3.6%
Total	100%	35,289	100%

The distribution of claim numbers and claim cost will vary significantly from state to state, with potential implications for the distributions by heads of damage. We have commented on this aspect in Section 5.14.

4.3.3 Personal injury as a proportion of public liability claim cost

The Trowbridge report indicates that roughly 75% of the cost of public liability claims, for all Australia, relates to personal injury claims, and 25% to property damage claims.

We note that:

- The proportions vary between insurers, particularly for smaller, more specialised portfolios; and
- The cost of personal injury claims is a more significant proportion in NSW (80:20) than in other States, where the ratio of personal injury to property claim cost is closer to 60:40.

We have made sensitivity calculations using alternative assumptions.

4.3.4 Average duration to settlement

Based on the various data sources available to use we have adopted the following assumptions for the average duration from date of injury to settlement (in years) for claims of various sizes:

Claim size band	Average Term to Settlement
50,000	3.0
100,000	4.0
200,000	5.0
500,000	6.0
750,000	7.0
1,000,000	8.0
1,500,000	8.0
2,000,000	8.0
3,000,000	8.0
4,000,000	8.0
5,000,000	8.0
7,000,000	8.0

5 Estimated effect on claims costs

5.1 Preliminary comments

This section gives the results of our calculations of the effect of Category A recommendations (refer Section 3.2) on claims cost.

The calculations are in respect of the cost of claims *occurring after the changes are implemented*. In particular, there is no allowance for any retrospective effect on claims which occurred prior to the date of change.

The question of retrospectivity is discussed in the Section on insurer premiums (Section 8).

The recommendations are first costed assuming that all existing cla ims will remain in the system (Sections 5.2 to 5.12), but be reduced according to the recommendations.

Subsequently in Section 5.13, and when aggregating the effects, we have considered the likelihood of claims being eliminated from the system due to the disincentives created by the recommendations.

Finally, it should be noted that the calculations indicate the estimated change in cost from the claims environment *prior to any changes made by after 30 June 2001*. The effect of these changes is discussed in Section 5.16.

5.2 Recommendation 45: Legal costs

The changes proposed are the same as those passed in the Queensland *Personal Injuries Proceedings Act 2002*, namely;

- No order that the defendant pay the plaintiff's legal costs may be made in any case where the award of damages is less than $30,000; and
- In any case where the award of damages is between $30,000 and $50,000, the plaintiff may recover from the defendant no more than $2,500 on account of legal costs.

The Ipp report makes the following comments;

"… proposals for limiting the number and cost of personal injury claims worth less than $50,000 offer a good prospect of promoting objectives of the Terms of Reference …"

Comments are as follows;

- The changes will only directly affect small claims (claims under $50,000). These comprise 80% by number and 25% by cost;
- The recommendation refers to recovery of plaintiff costs **only,** with no recovery of defendants costs; and
- Most of these small claims might be expected to be eliminated by the introduction of the general damages threshold (recommendation 47). This is the major cause of the saving in legal costs, and is dealt with later in Section 5.13.

Cost savings from legal fee restrictions

The following table shows our estimated savings in legal and investigation costs arising from restrictions in the amount of plaintiff legal costs. At this stage we have **not** assumed any cultural change reducing claim numbers, which should result from the combined influence of the general damages threshold plus reduced legal costs:

Table 3 : Impact of changes on Legal Costs

			Plaintiff	Defendant	Plaintiff Legal Costs		Defendant Legal Costs	
Upper band	Average size	Distribution of claims	Legal Proportion	Legal Proportion *	Current Plaintiff	Proposed Plaintiff	Current Defendant	Proposed Defendant
50,000	11,000	80.72%	10.0%	38.0%	1,100	200	4,180	4,180
100,000	55,000	12.70%	13.0%	25.0%	7,150	7,150	13,750	13,750
200,000	140,000	4.30%	15.0%	18.0%	21,000	21,000	25,200	25,200
500,000	350,000	1.70%	10.0%	15.0%	35,000	35,000	52,500	52,500
750,000	630,000	0.30%	8.0%	12.0%	50,400	50,400	75,600	75,600
1,000,000	892,500	0.15%	7.0%	10.0%	62,475	62,475	89,250	89,250
1,500,000	1,312,500	0.03%	6.0%	9.0%	78,750	78,750	118,125	118,125
2,000,000	1,837,500	0.02%	5.0%	8.0%	91,875	91,875	147,000	147,000
3,000,000	2,625,000	0.02%	5.0%	8.0%	131,250	131,250	210,000	210,000
4,000,000	3,675,000	0.02%	5.0%	8.0%	183,750	183,750	294,000	294,000
5,000,000	4,725,000	0.02%	4.0%	8.0%	189,000	189,000	378,000	378,000
7,000,000	6,300,000	0.02%	4.0%	8.0%	252,000	252,000	504,000	504,000
Total	35,289	100.0%			3,732	3,006	7,799	7,799

Note: Defendant legal costs include investigation costs

Saving on average cost **2.1%**

Accordingly, we estimate a decrease of **2.1%** in total damages costs from recommendation 45.

This represents 82% of plaintiffs legal costs on claims below $50,000 and 20% across all claims.

5.3 Recommendation 46: Tariffs for general damages

In summary the recommendation is that;

- Courts may refer to decisions in earlier cases involving similar injuries when establishing an appropriate award for the particular case. This practice is

currently prevented by a High court decision of 1968 (*Planet Fisheries Pty Ltd vs La Rosa*); and

- In line with UK practice, establish a set of guidelines (which currently do not exist at present in Australia).

The intention of this recommendation is to ensure greater consistency in general damages awards throughout the country.

The key issue from an actuarial perspective is to achieve consistency between claims **and** consistency in damages assessment over time. As such this recommendation does not have a measurable cost effect, at present, but if implemented effectively (and sustained) may help stabilise claims costs and limit erosion over time.

As such, this recommendation more properly belongs to Category B (iii) rather than Category A.

5.4 Recommendation 47 & 48: Threshold and caps for general damages

The changes proposed are as follows:

- Introduce a threshold for general damages of 15% of the most extreme case; and
- Cap the amount of general damages which can be awarded by courts to $250,000 (or a legislated cap specific to each state/territory).

Comments are as follows:

(a) Threshold

The definition of the threshold leaves its determination within the legal system. It is the same definition as in the *NSW Health Care Liability Act 2001* and the *NSW Civil Liability Act 2002*. It was also previously used in the *NSW Motor Accidents Act.*

Our strong preference is for a threshold which can be determined outside the legal system through the use of objective assessment. This can be achieved through the American Medical Association (AMA) Impairment Guidelines. The AMA Guidelines are increasingly being adopted in workers' compensation and CTP in several jurisdictions in Australia.

The use of an objective assessment system is likely to mitigate against erosion of the threshold, with its attendant increase in claims costs.

We note that the Ipp report also expresses the view that use of objective criteria is preferable, but that the Panel does not believe that such an approach will be adopted.

(b) The $250,000 cap

The selection of the cap is an important determinant in the cost of **all** amounts for general damages, because amounts below the cap are determined by reference to the cap.

If the proposed $250,000 cap is introduced in all jurisdictions, its affect could vary quite significantly. For those jurisdictions where the current maximum is significantly higher than $250,000 the reduction in costs will be much greater than those where the current maximum is lower.

(c) The scale between threshold and cap

As well as the threshold and the cap, the scale of benefits in-between is important.

A strictly proportional scale is, in our view, **not** appropriate. A proportional scale would mean that a claimant with a severity level just below the 15% threshold would receive no general damages, while a claimant just at the threshold would receive 15% of the maximum (ie. $37,500 for a $250,000 cap).

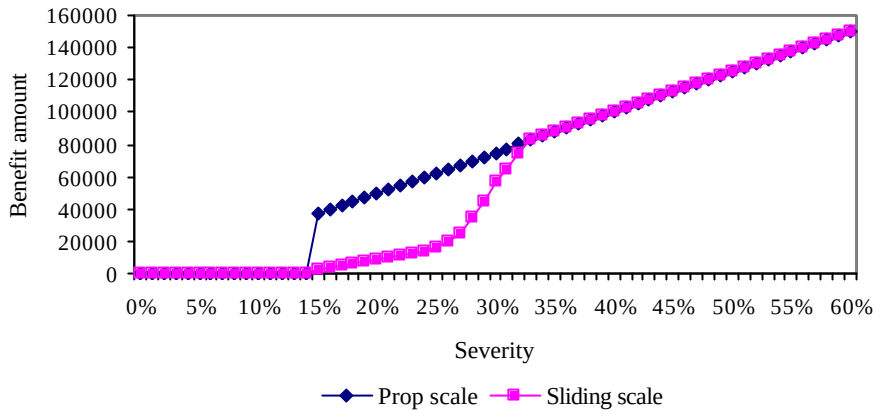
In these circumstances the threshold would not work as intended. More and more claims would achieve the threshold with no affect on their quantum of general damages. This is further discussed below.

In other instances with this form of threshold, a **sliding scale** has been adopted immediately above the threshold, gradually merging with the proportional scale at a higher level of severity.

We suspect that the absence of a sliding scale in the Ipp recommendations is an oversight, and have costed the recommendation with the inclusion of the same sliding scale as adopted in the *NSW Civil Liability Act 2002*, taken from the HCLA.

This scale has less than proportional damages for claims between 15% and 33% severity, as illustrated in the following graph.

General damages table with 15% threshold



The use of a proportional scale (as opposed to a sliding scale) has a **significant** effect on damages payouts at or around the 15% threshold level. If a proportional scale is adopted there is likely to be significant pressure placed upon the threshold by claimants who are at a level slightly below the 15% mark.

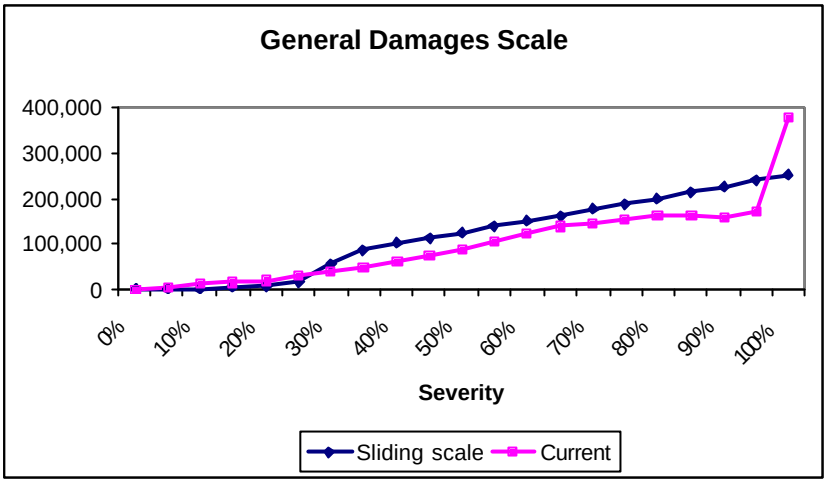
This is because benefits are significant just above the threshold, creating an incentive for claimants to inflate the severity of their claim. This "bracket creep" is likely to erode the threshold. Bracket creep is less likely under the sliding scale as only quite small benefits are available just above the threshold.

If the Ipp recommendation is implemented **without** a sliding scale, we would expect the 15% threshold to be quickly eroded, along with any potential for significant cost savings.

Quantum of damages awarded

The main difficulty in assessing the effect of these changes lies in identifying the degree of severity in current awards. Currently such a concept is ill-defined, and there is not necessarily a formal link between severity and quantum. Our approach to this issue is described in Appendix C, and essentially uses size of claim as a measure of severity.

The introduction of the 15% threshold alone, with a sliding scale, (with a cap of $250,000) is illustrated in the following graph, compared with what is currently being awarded based on NSW data:



The cost savings on small claims and large claims is partly offset by a cost increase on mid sized claims.

Differences in the claim size distribution of the other states may mean that the above graph may differ significantly (particularly at the most severely injured end of the distribution). In particular, we expect the "current" damages scale to be lower than that assumed for NSW, implying that lower cost savings will eventuate.

Cost savings

The following table shows our main assumptions and calculations in deriving an estimate of the cost saving on personal injury claims:

Table 1: Impact of changes to General Damages

Upper band	Average size	Distribution of claims	General Damages	Average GD	Cumulative Distribution of claimants	Upper Limit on Impairment	Average Impairment	General Damages From Table (a)
50,000	11,000	80.72%	39%	4,290	80.7%	14.0%	4.0%	0
100,000	55,000	12.70%	37%	20,350	93.4%	26.0%	20.0%	9,000
200,000	140,000	4.30%	32%	44,800	97.7%	41.0%	33.5%	85,000
500,000	350,000	1.70%	25%	87,500	99.4%	59.0%	50.0%	125,000
750,000	630,000	0.30%	22%	138,600	99.7%	71.0%	65.0%	162,500
1,000,000	892,500	0.15%	18%	160,650	99.9%	89.0%	80.0%	200,000
1,500,000	1,312,500	0.03%	12%	157,500	99.9%	95.0%	92.0%	230,000
2,000,000	1,837,500	0.02%	10%	183,750	99.9%	96.0%	95.5%	240,000
3,000,000	2,625,000	0.02%	9%	236,250	99.9%	97.0%	96.5%	242,500
4,000,000	3,675,000	0.02%	8%	294,000	100.0%	98.0%	97.5%	245,000
5,000,000	4,725,000	0.02%	7%	330,750	100.0%	99.0%	98.5%	247,500
Larger	6,300,000	0.02%	6%	378,000	100.0%	99.0%	99.0%	247,500
Total	35,289	100.00%		10,450				8,024

(a) General Damages table adopted by the NSW Health Care Liability Act 2001

Saving on average cost	**6.9%**

The initial assessment of the change is, therefore, a decrease of **6.9%** in total claims costs.

However, for smaller claims, the general damages head of damage is currently somewhat of a catch-all for all heads of damage. Restrictions on general damages may therefore lead to some smaller claims applying explicitly for compensation under

other heads of damage, in particular past economic loss and medical expenses. Accordingly, there is likely to be a *substitution effect* from general damages to these other heads of damage, which will reduce the savings on small claims.

We have allowed for the effect of this issue in the following table:

Table 2: Replacement effect of changes to General Damages

							Impact of Threshold	
Upper band	Average size	Distribution of claims	Past Eco-loss Proportion	Eco-loss Cost	Substitution Proportion	Extra Eco-loss	Eco-loss Proportion	Eco-loss Cost
50,000	11,000	80.72%	3.0%	330	10%	429	6.9%	759
100,000	55,000	12.70%	8.0%	4,400	30%	3,405	14.2%	7,805
200,000	140,000	4.30%	12.0%	16,800			12.0%	16,800
500,000	350,000	1.70%	10.0%	35,000			10.0%	35,000
750,000	630,000	0.30%	10.0%	63,000			10.0%	63,000
1,000,000	892,500	0.15%	9.0%	80,325			9.0%	80,325
1,500,000	1,312,500	0.03%	8.0%	105,000			8.0%	105,000
2,000,000	1,837,500	0.02%	7.0%	128,625			7.0%	128,625
3,000,000	2,625,000	0.02%	6.0%	157,500			6.0%	157,500
4,000,000	3,675,000	0.02%	6.0%	220,500			6.0%	220,500
5,000,000	4,725,000	0.02%	6.0%	283,500			6.0%	283,500
7,000,000	6,300,000	0.02%	6.0%	378,000			6.0%	378,000
Total	35,289	100.0%		2,717				3,496

Saving on average cost **-2.2%**

This calculation assumes that 10% and 30% of the costs eliminated in the two lowest band size will re-emerge under other heads of damage.

These assumptions have been adopted after considering the relative proportions of damages in the higher claims bands. They are, however, very difficult assumptions, and hence subject to considerable uncertainty.

Therefore the net effect of recommendations 47 and 48 can be summarised as follows:

	%
Decrease in GD	6.9
Substitution effect	(2.2)
Net Saving	4.7

Accordingly, we estimate a net decrease of **4.7%** in total damages costs .

5.5 Recommendations 49&58: Cap on damages for loss of earning capacity & Superannuation Contributions

In summary the recommendations are that;

- The amount of economic loss due to loss of earnings is capped at twice average full-time adult ordinary time earnings; and
- Damages make allowance for loss of employer superannuation contributions (minimum based on the Superannuation Guarantee Contributions).

We have estimated the combined effect of these two recommendations.

Comments are as follows:

- Only a small proportion of claimants will have earnings above the capped level. All Australia AWE (full time adult employees total earnings) is currently $905.70 (May 2002) and according to the Australian Bureau of Statistics approximately 1.6% of the population earn over $2000 per week (i.e. 2.2 times AWE). We estimate that the recommendation will reduce the average claimant weekly total earnings by 2.4% (taking into account the distribution of individuals at various earnings bands);

- We have assumed that the cap will apply to damages for both past economic loss **and** future economic loss;

- From discussions with lawyers we understand that current practice is not consistent as to whether superannuation is included or excluded in damages calculations. Adoption of the Ipp recommendations would thus standardise practice to include superannuation in all cases. This would lead to an **increase** in costs; and

- It is worth noting that the cap relates to average **full-time** adult ordinary time earnings but that the claimants will come from the general population and thus will include individuals who are not full time employees.

As shown in the table below the total economic loss head of damage reaches a maximum of about 37% of total cost, but is lower for the smallest and highest claim size bands. On a weighted average basis it represents only 19.1% of total damages (as a result of the almost 80% of claims being in the smallest claim size band).

As an extreme example, assuming **no** damage amounts had previously included superannuation, inclusion of superannuation would increase the economic head of damage by 9%, increasing total claim costs by 1.7%.

However a proportion of settlements already include superannuation so the cost increase is unlikely to be that extreme.

Given the lack of data available, we have been unable to research this issue further. In the table below we have assumed that 50% of settlements previously did not include superannuation in the calculation but now do. Obviously this assumption is uncertain**.** However, given the relative size of the economic loss head of damages, the overall cost savings is not particularly sensitive to this assumption.

We have allowed for the effect of these two recommendations in the following table:

Table 3 : Impact of changes on Economic Loss

Upper band	Average size	Distribution of claims	Past Economic Loss	Future Economic Loss	Total Economic Loss	Current Eco-loss Cost	Reduction due to Cap	Increase due to super-annuation	Estimated Eco-loss Cost
50,000	11,000	80.72%	3%	2%	5%	550	2.4%	4.50%	562
100,000	55,000	12.70%	8%	5%	13%	7,150	2.4%	4.50%	7303
200,000	140,000	4.30%	12%	10%	22%	30,800	2.4%	4.50%	31458
500,000	350,000	1.70%	10%	24%	34%	119,000	2.4%	4.50%	121542
750,000	630,000	0.30%	10%	27%	37%	233,100	2.4%	4.50%	238080
1,000,000	892,500	0.15%	9%	26%	35%	312,375	2.4%	4.50%	319049
1,500,000	1,312,500	0.03%	8%	24%	32%	420,000	2.4%	4.50%	428973
2,000,000	1,837,500	0.02%	7%	22%	29%	532,875	2.4%	4.50%	544260
3,000,000	2,625,000	0.02%	6%	18%	24%	630,000	2.4%	4.50%	643460
4,000,000	3,675,000	0.02%	6%	14%	20%	735,000	2.4%	4.50%	750703
5,000,000	4,725,000	0.02%	6%	10%	16%	756,000	2.4%	4.50%	772152
7,000,000	6,300,000	0.02%	6%	10%	16%	1,008,000	2.4%	4.50%	1029536
Total	35,289	100.0%				6,726			6,869

Saving on average cost	**-0.4%**

The net effect of the two recommendations is therefore estimated as an increase of **0.4%** of current claims cost.

5.6 Recommendation 50: Health care costs

In summary the recommendation is that;

- When assessing damages for health care costs, the issue of reasonableness should be determined by reference to a benchmark (ie public hospital and medicare scheduled fees).

Comments are as follows:

- Statistics available on the Commonwealth Department of Health Website indicate that, across all medical services, fees charged exceeded Medicare Scheduled rates by approximately 3%; and

- We have restricted the impact of the recommendation to just medical costs, and not to long term care costs which typically will not involve services that have a scheduled Medicare rate.

Restricting private sector medical costs to benchmarks based on the public health system may result in some savings, as calculated in the following table:

Upper band	Average size	Distrib of claims	Medical Costs	Current Medical Care	Cost Saving	Cost Saving	Revised Medical Care
50,000	11,000	80.72%	3%	330	3.0%	9.9	320
100,000	55,000	12.70%	6%	3,300	3.0%	99.0	3,201
200,000	140,000	4.30%	5%	7,000	3.0%	210.0	6,790
500,000	350,000	1.70%	5%	17,500	3.0%	525.0	16,975
750,000	630,000	0.30%	5%	31,500	3.0%	945.0	30,555
1,000,000	892,500	0.15%	5%	44,625	3.0%	1,338.8	43,286
1,500,000	1,312,500	0.03%	5%	65,625	3.0%	1,968.8	63,656
2,000,000	1,837,500	0.02%	5%	91,875	3.0%	2,756.3	89,119
3,000,000	2,625,000	0.02%	5%	131,250	3.0%	3,937.5	127,313
4,000,000	3,675,000	0.02%	5%	183,750	3.0%	5,512.5	178,238
5,000,000	4,725,000	0.02%	5%	236,250	3.0%	7,087.5	229,163
7,000,000	6,300,000	0.02%	5%	315,000	3.0%	9,450.0	305,550
Total	35,289	100.0%		1,657			1,607

Saving on average cost	**0.1%**

Benchmarking medical costs may produce small cost savings of perhaps **0.1%** of total costs.

The importance of this recommendation is not so much the cost saving generated, but the discipline it imposes preventing erosion of costs into the future.

5.7 Recommendation 51 & 52: Gratuitous care & lack of capacity to care for others

The reforms propose to restrict the entitlement for gratuitous attendant care to circumstances consistent with the NSW reforms. In particular:

- Introduce time thresholds for recovering such damages consistent with thresholds which apply under the Motor Accidents Compensation Act 1999;
- Cap the amount of such damages to the Average Weekly Earnings (FTOTE). For 6-40 hours per week use an hourly rate, for > 40 hours per week use the weekly rate;
- Damages may only be awarded where the defendant has proved to have been negligent; and
- Damages for loss of capacity to provide gratuitous services for others shall only be recoverable if such services were being provided prior to loss of capacity. These damages shall be subject to the same maximums outlined above.

Comments are as follows:

- Gratuitous care is only a small component of total damages awards, but becomes more important as severity of injury increases;
- We have been unable to obtain reliable statistics as to the proportion of future care which is in respect of gratuitous care, and therefore have made assumptions

based on wider experience. We assumed for the largest claims that around 10% of awards for long-term care will be in respect of gratuitous care; and

- The above changes are all aimed at tightening the definition of what constitutes gratuitous care. We have assumed that one-third of gratuitous care costs will be eliminated as a result.

Cost savings

The following table illustrates our calculation of savings:

Upper band	Average size	Distribution of claims	Future Gratuitous Care	Average Gratuitous Care	Adjusted Gratuitous Care
50,000	11,000	80.72%	0%	0	0
100,000	55,000	12.70%	1%	550	367
200,000	140,000	4.30%	2%	2,800	1,867
500,000	350,000	1.70%	4%	14,000	9,333
750,000	630,000	0.30%	5%	31,500	21,000
1,000,000	892,500	0.15%	6%	53,550	35,700
1,500,000	1,312,500	0.03%	6%	78,750	52,500
2,000,000	1,837,500	0.02%	6%	110,250	73,500
3,000,000	2,625,000	0.02%	6%	157,500	105,000
4,000,000	3,675,000	0.02%	6%	220,500	147,000
5,000,000	4,725,000	0.02%	6%	283,500	189,000
7,000,000	6,300,000	0.02%	6%	378,000	252,000
Total	35,289	100.0%	2%	857	571
			Saving on average cost		**0.8%**

Accordingly, we estimate a decrease of **0.8%** in total damages costs .

5.8 Recommendation 53: Future economic loss discount rate

In summary the recommendation is that;

- The discount rate used in calculating damages for future economic loss is 3%.

Comments are as follows:

- In 1981 the Australian High Court in *Todorovic & Anor. v Waller* established a 3% uniform rate as the net return on invested funds (discount rate). A 3% pa discount rate continues to be widely used where there is no rate defined in legislation for personal injury cases. In that situation we therefore believe that the recommendation will have no cost impact; and

- A number of states have passed legislation providing for the use of a higher discount rate, mainly 5% pa.

  For these states to revert to a 3% discount rate would result in a significant cost impact on the calculation of damages for future economic loss.

  The table below provides some indication of the cost implications of changing the discount rate from 3% to 5%, and visa versa:

Life Expectancy and annuity value of claimant of average age (a)

Discount	Annuity factor for a period of (years)			Amount of change		
Rate	23	27	32	23	27	32
3.0%	16.689	18.601	20.693			
5.0%	13.823	15.006	16.195	83%	81%	78%

(a) Average remaining expectation of life of a 50 year old is 29.8 years and reduce by 10% for impaired expectancy - say 27 years according to 50%, 50% mix of ALT 90-92

The following comments can be made about the table:

- Age and remaining life expectancy are not very sensitive assumptions;
- The cost impact of moving from 3% to 5% discount rate (or visa versa) has a cost impact of about 20% on those heads of damage affected; and
- Future economic loss and future long term care heads of damage increase quickly in relative importance as claim size increases.

The following table estimates the cost impact on total costs:

Upper band	Average size	Distribution of claims	Proportion Future Loss *	Average Future Loss 3%	Average Future Loss 5%	Adjusted Average Size	Change in Average Claim size
50,000	11,000	80.72%	4%	412	332	10,920	99%
100,000	55,000	12.70%	9%	5,145	4,151	54,006	98%
200,000	140,000	4.30%	16%	22,535	18,181	135,645	97%
500,000	350,000	1.70%	33%	114,484	92,361	327,877	94%
750,000	630,000	0.30%	40%	252,406	203,630	581,224	92%
1,000,000	892,500	0.15%	47%	418,611	337,717	811,606	91%
1,500,000	1,312,500	0.03%	54%	715,101	576,912	1,174,311	89%
2,000,000	1,837,500	0.02%	59%	1,076,419	868,408	1,629,488	89%
3,000,000	2,625,000	0.02%	60%	1,569,919	1,266,542	2,321,623	88%
4,000,000	3,675,000	0.02%	59%	2,178,919	1,757,856	3,253,937	89%
5,000,000	4,725,000	0.02%	62%	2,941,694	2,373,229	4,156,536	88%
7,000,000	6,300,000	0.02%	62%	3,922,258	3,164,305	5,542,047	88%
Total	35,289	100.0%	22%	7,838	6,324	33,774	96%

Saving on average cost **4.3%**

Note: Future loss = future economic loss and future long term care
LTC split between past and future compenents assuming it takes 4 years for a claim to settle and they have a life expectancy of another 27 years

The cost impact of the changes is very small for the smallest claim size band (about 1%). It is quite significant for the largest claim size bands (up to 12%).

Overall the cost impact is about 4.3% of total claims cost.

However, given that most states have only recently introduced legislation requiring a 5% discount rate to be used for public liability claims, it is perhaps unlikely that they will accept the Ipp Recommendation and revert to a 3% discount rate (which would act to increase the cost of claims).

The effect of recent legislation on the calculations in this section is considered in Section 5.16.

5.9 Recommendation 54: Pre-judgement interest for general damages

In summary the recommendation is that;

- The entitlement to interest on general damages is completely removed.

The Ipp report makes the following comments;

- "The principle underlying awards of pre-judgement interest is that the plaintiff's entitlement to be compensated arise at the date the cause of action is complete… If the plaintiff does not actually receive the compensation until some time later, she has been 'kept out of the' money to which she is entitled, and so should be awarded interest to compensate her for not having had the use of the money"; and

- The report makes the further point that damages for pre-judgement general damages are calculated according to the value of money at the date of judgement. This effectively eliminates the need for compensation for being 'out of the money'.

Comments are as follows:

- Interest on damages for non-economic loss is currently assessed using a compound interest rate of about 4% p.a..

Cost savings

The following table shows our estimate of the effect of Recommendation 54:

Upper band	Average size	Distribution of claims	General Damages	Average Term to Determin'n	Current Average Interest on GD	Proposed Average Interest on GD
50,000	11,000	80.72%	39.0%	3.0	260	0
100,000	55,000	12.70%	37.0%	4.0	1,661	0
200,000	140,000	4.30%	32.0%	5.0	4,615	0
500,000	350,000	1.70%	25.0%	6.0	10,926	0
750,000	630,000	0.30%	22.0%	7.0	20,394	0
1,000,000	892,500	0.15%	18.0%	8.0	27,288	0
1,500,000	1,312,500	0.03%	12.0%	8.0	26,753	0
2,000,000	1,837,500	0.02%	10.0%	8.0	31,212	0
3,000,000	2,625,000	0.02%	9.0%	8.0	40,129	0
4,000,000	3,675,000	0.02%	8.0%	8.0	49,938	0
5,000,000	4,725,000	0.02%	7.0%	8.0	56,181	0
7,000,000	6,300,000	0.02%	6.0%	8.0	64,207	0
Total	35,289	100.0%		3.3	963	0

Assumes current interest on GDs at 4.0% to be removed

Saving on average cost **2.7%**

Accordingly, we estimate a decrease of **2.7%** in total damages costs.

5.10 Recommendation 55 & 56: Death claims

In summary the recommendation is that:

- In calculating damages for loss of financial support, the twice AWE cap under recommendation 49 will not apply;
- A dependant shall be entitled to damages for loss of gratuitous services that the deceased would have provided but for his/her death. Gratuitous services shall be determined in the same manner as in any other situation (ie recommendation 51 applies); and
- Any damages payable to the dependants shall be reduced on account of contributory negligence on the part of the deceased.

Comments are as follows:

- The first two points outlined above will result in an increase in costs associated with death claims. Allowance for contributory negligence will result in a cost saving which will partly offset the increase in costs flowing from the first two points; and
- Death claims represent approximately 1% of all claims. Given the very low proportion of claims the net effect of these recommendations is immaterial in terms of overall cost.

5.11 Recommendations 59 & 60: Collateral, Exemplary and aggravated damages

In summary the recommendations are that:

- Collateral damages should be offset against the relevant head of damages; and
- Exemplary and aggravated damages should be abolished.

Comments are as follows:

- Collateral damages is not quantifiable in a reliable manner;
- That said, we expect that this will have a minimal effect on claims costs; and
- Our understanding is that exemplary and aggravated damages are not generally awarded, therefore this recommendation is expected to have a negligible cost impact.

These recommendations will contribute to the sustainability of cost reductions from other recommendations and, as such, are important in the overall package of recommendations.

They properly belong in Category B(iii).

5.12 Recommendation 61: Indexation

In summary the recommendation is that;

- Fixed monetary amounts (in recommendations 45, 48 & 57) should be indexed to CPI.

Comments are as follows:

- Some components of claims costs increase at a rate typically higher than CPI. For example economic heads of damage are more likely to increase at a rate more in line with AWE. Thus limits and caps indexed according to CPI May lose their "real" value over time; and

- There will not be any immediate cost impact of these recommendations. Once again, however, they will act to make cost increases more predictable in the future.

5.13 Reduction in claim numbers

There should be a significant saving resulting from the elimination of the majority of small claims. They may be eliminated because:

A The 15% general damages threshold will reduce significantly the amount of damages for current small claims, reducing the desire to claim; and

B The restrictions on plaintiff legal costs on small claims will reinforce the above message to their legal representatives.

We have assumed that 80% of claims in the smallest claim size band are eliminated as a result (that is 65% of total claim numbers).

The following table shows the current distribution of claims, as well as that assumed if the majority of small claims are eliminated as a result of the recommendations.

Upper band	Current Distribution of claims	New Distribution of claims
Eliminated		64.58%
50,000	80.72%	16.14%
100,000	12.70%	12.70%
200,000	4.30%	4.30%
500,000	1.70%	1.70%
750,000	0.30%	0.30%
1,000,000	0.15%	0.15%
1,500,000	0.03%	0.03%
2,000,000	0.02%	0.02%
3,000,000	0.02%	0.02%
4,000,000	0.02%	0.02%
5,000,000	0.02%	0.02%
7,000,000	0.02%	0.02%
Total	100.00%	100.00%

The 20% of small claims we have assumed to be continuing to claim does not represent an allowance for "bracket creep" per se. Rather it reflects that some claims will still be made for others heads of damage, such as medical and lost earnings.

If the threshold proves to be ineffective small claims will not be eliminated from the system. In this scenario the savings on legal costs will be considerably less than that calculated in this section.

In section 5.15 we have carried out alternative scenarios where 60%, 40% and 0% of claims in the less than $50,000 size band are eliminated.

5.14 Results

A summary of the estimates from Sections 5.2 to 5.13 is as follows:

Notes	Recom	Proposal	Straight change	Assuming elimination of small calims
	45	Reduced Legal Fees	2.1%	10.1%
(1)	46	Tariff for General Damages		
	47&48	15% Threshold & Cap for General Damages	4.7%	4.7%
	49&58	Cap on Damages for LOEC	-0.4%	0.6%
	50	Health Care Costs	0.1%	0.7%
	51&52	Gratuitous care restrictions	0.8%	0.8%
(2)	53	Future Economic Loss, discount rate		
	54	Interest to Judgement	2.7%	2.7%
(2)	55&56	Death claims restrictions		
(2)	59&60	Collateral benefits, exemplary damages		
(1)	61	Indexation		
	Total		**10.0%**	**19.6%**

Notes:

(1) Not measurable

(2) Expected to have nil or negligible effect

The indirect effect of eliminating 80% of claims less than $50,000 as a result of the reforms is the single most significant factor in the cost savings (particularly on legal expenses).

We estimate that the proposed changes may lead to a reduction in personal injury claims costs of some 19.6% in total.

Because no reduction is anticipated in property damage claims (25% of the total), this means that overall claim costs may reduce by 75% x 19.6% = **14.7%**.

This estimate is highly uncertain. Answers may differ between states as a result of different claims profiles. However, the common affect that many small claims should be eliminated as a result of these reforms should ensure that all obtain significant cost savings.

5.15 Sensitivity and Scenarios

The estimated reduction in public liability claims cost given in section 5.14 derives from many assumptions regarding future experience. Some of these assumptions are less certain than others.

We have therefore made calculations using various alternative assumptions, each of which can be considered as a quite plausible outcome of experience.

Note: All of the numbers in the scenarios below are the estimated **public liability cost savings** (that is, account has already been made for the mix of personal injury and property claims).

a) Mix of personal injury to property claims

In Section 4.3.3 we noted that NSW has a much higher proportion of personal injury to property public liability claims cost (80:20) compared with the other states (60:40). The weighted average mix Australia wide is assumed to be 75:25, and this is used in the main calculation.

None of the Ipp recommendations are expected to have a significant impact on property claims. As a result the assumed mix of personal injury to property claims cost has a significant impact on the estimated potential savings.

The following table summarises the results of assuming that the mix of personal injury to property claims cost varies in the range discussed above:

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Mix of personal injury to property claims	
1	60/40	11.8%
2	80/20	15.7%

The observation to be made is that reducing the proportion of personal injury claims reduces the expected savings to public liability claim costs from implementing the recommendations for reform.

b) Claim size distribution

Different jurisdictions are likely to have a higher or lower proportion of claims in the smallest size band compared to that assumed Australia wide central estimate. The central estimate assumed that 80.7% of claims are less than $50,000.

The following two scenarios assume respectively that 85% and 75% of claims are in the lowest claim size band. The proportion of claims in the other size bands have been scaled proportionately to compensate for this change.

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Claim size distribution	
3	85% of claims in < $50,000 band	16.7%
4	75% of claims in < $50,000 band	14.6%

Increasing the proportion of claims in the less than $50,000 band increases the savings which can be expected to result from the recommendations. In particular, in this scenario there are more claims affected by the 15% general damages threshold and the restriction on legal costs.

c) Assumed size within each claim size band

As well as the proportion of claims in each size band, it is also the average claim size for the claims within each band which is important. For example, the Australia wide data estimates that there are 80.7% of claims less than $50,000 with an average size of $11,000. In NSW there are estimated to be 79.47% of claims less than $50,000 but with an average size of $15,000.

In the following two scenarios we have assumed that the average claim size of each band is 20% higher and lower than the central estimate scenario. Of most importance is the average size of claims less than $50,000 as this is the claim size band most affected by the recommendations for reform.

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Average size within each size band	
5	20% higher than CE	17.4%
6	20% lower than CE	10.6%

Increasing the average size within each band by 20% increases the expected savings which may arise from the recommendations for reform. Reducing the average size has the opposite affect.

d) General damages scale

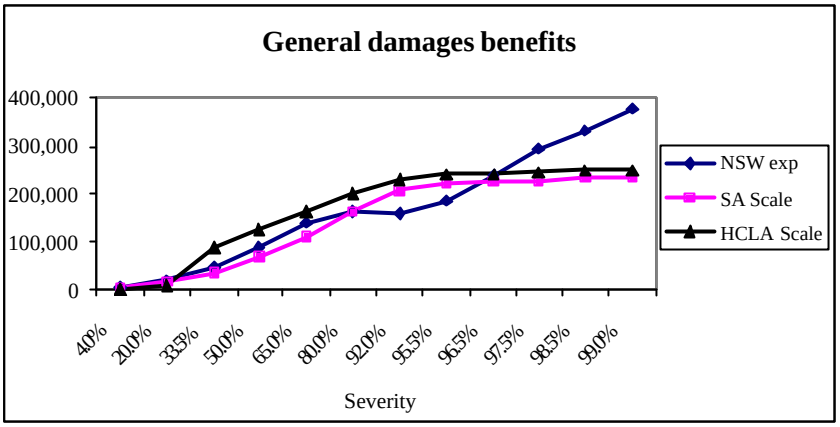
The following graph compares three patterns for the size of general damages:

I. Recent Australian wide experience (which at the upper end is dominated by the large awards made in NSW);

II. The proposed scale capped at $250,000 with a 15% threshold and a sliding scale up to 33% (based on the *NSW Health Care Liability Act 2001* – "HCLA"); and

III. The South Australian Scale recently introduced for CTP claims. This scale has a maximum of $241,000 (which is considerably higher than the previous maximum) and a curved scale which give lower benefits to the less severity injured (compared to the previous scale). We understand that partly the reason for the new scale was to create greater consistency between what was awarded to CTP claimants and what was typically being awarded for public liability claims in South Australia.

In the Australia wide central estimate we have assumed that the benefit scale will move from (I) to (II).



The following comments can be made:

- The SA CTP Scale is lower than a HCLA scale except at the lowest band (as it does not have a 15% threshold);
- Both the HCLA Scale and SA CTP Scale are considerably lower than recent Australia wide experience at the top end of the severity range; and
- In the range 80% to 95% the SA CTP Scale is higher than recent Australia wide experience. It is lower for severity levels below 80%.

We have proposed 2 scenarios to test different alternatives:

1) Increase the maximum under the HCLA scale to $350,000; and
2) Use the SA CTP Scale as "recent experience". This it could be argued, is more in line with the recent experience of the smaller states and territories.

The results are shown in the following table:

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	New General Damages scale is different	
7	Maximum is $350,000	8.2%
8	SA CTP Scale used (Max $241,000)	
	- for experience	10.7%

The following comments can be made about this table:

- Increasing the HCLA Scale maximum to $350,000 reduces the savings produced because it offers benefits for the most severely injured more in line with recent experience. Benefits at all ranges less than the maximum are also increased. As noted in Section 5.4 benefits in the mid ranges of severity under the HCLA scale are already higher than recent experience. Increasing the maximum increases further the additional cost of compensating claimants at all levels of severity who get over the threshold. This offsets the savings achieved by giving no general damages to those below the threshold;

- Assuming the SA CTP Scale is a more appropriate reflection of recent experience in the smaller states also reduces the expected cost savings. As noted above, the SA CTP Scale has a quite different "shape" compared to the Australia wide experience assumed. In particular it is lower at the extreme top and bottom ends of the severity ranges. Replacing the SA CTP "experience" Scale with the HCLA Scale would thus generate less savings at the higher, but more particularly at the lower, ends of the severity range.

e) Proportion of small claims eliminated

In the Australia wide central estimate we have assumed that 80% of claims in the less than $50,000 size band will be eliminated, because of the combined affect of:

I. No access to general damages as a result of the 15% threshold.

II. Reinforced by the restriction on plaintiff legal costs for claims in this size range.

Below are 3 alternative scenarios where only 60%, 40% and 0% (respectively) of claims in this smallest size band are assumed to be eliminated:

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Proportion of small claims eliminated	
9	60%	12.9%
10	40%	11.1%
11	0%	7.5%

As noted in Sections 5.13 and 5.14 the largest cost saving is the indirect result of the elimination of a considerable proportion of the smallest claims. Reducing the significance of this reduction obviously has an impact in reducing the estimated cost savings.

We note that in the extreme, assuming 0% of claims in the smallest band will be eliminated, the estimated public liability cost savings possible is still about 7.5%.

f) Mix of heads of damage

There is very little reasonable information as to the typical breakup of public liability settlements by heads of damage.

Legal costs

One area of uncertainty is that the ratio of defendant legal to plaintiff legal costs assumed.

In the following scenario we have replaced the mix of heads of damage assumed in Section 4.3.1 with the following:

Claim size band	General damages	Past economic	Future economic	Plaintiff legal	Defendant Legal	LTC	Medical	Other	Total
50,000	57%	4%	3%	12%	12%	3%	4%	4%	100%
100,000	41%	9%	6%	16%	16%	6%	7%	1%	100%
200,000	31%	11%	10%	18%	18%	7%	5%	1%	100%
500,000	25%	10%	24%	12%	12%	10%	5%	1%	100%
750,000	22%	10%	27%	10%	10%	15%	5%	1%	100%
1,000,000	18%	9%	26%	8%	8%	24%	5%	1%	100%
1,500,000	12%	8%	24%	7%	7%	35%	5%	1%	100%
2,000,000	10%	7%	22%	6%	6%	42%	5%	1%	100%
3,000,000	9%	6%	18%	6%	6%	49%	5%	1%	100%
4,000,000	8%	6%	14%	6%	6%	54%	5%	1%	100%
5,000,000	7%	6%	10%	5%	5%	61%	5%	1%	100%
7,000,000	6%	6%	10%	5%	5%	62%	5%	1%	100%

In this Scenario we have increased the proportion of plaintiff legal costs by 20% from the central estimate model. Defendant legal costs have also been reduced to equal Plaintiff legal costs. The remaining heads of damage have then been scaled up proportionately so as to make up the difference, such that the Total again equals 100%.

For the less than $50,000 size band in particular general damages is the major head of damage, which is correspondingly increased in the Scenario from 39% to 57%. Because much of general damages in this band is assumed to be eliminated by the general damages threshold it will be seen below that this scenario with its quite different mix of heads of damage does not change dramatically the estimated potential cost savings.

Gratuitous care

Very little information is available about the size of gratuitous care which forms a part of the Long Term Care Head of Damage. We have applied our own judgment based on wider experience to make an assumption as to the importance of gratuitous care as a head of damage.

An alternative scenario presented below is that gratuitous care is twice what we have assumed in the Australia wide central estimate.

A further scenario is to assume that the recommendations to do with gratuitous care generate savings of 50% rather than 33%.

Heads of damage variation scenarios

The following table shows the results of these three scenarios:

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Changes to mix of Heads of Damages	
12	- Defendant legals reduced to equal plaintiff legals	15.3%
13	- Gratuitous care HoD double whats assumed	15.3%
	Other assumptions	
14	- Gratuitous care (50% saving)	15.0%

g) Combined Scenarios

In the above scenarios the effect of each variation **is made in isolation** from the others.

The final two scenarios are an attempt to consider the effect of a combination of changes to the base assumptions.

In particular they provide an attempt to provide information as to how the results may vary for some of the smaller states and territories if it is felt that the central estimate assumptions are unrepresentative for the smaller jurisdictions. We are hampered in being able to do more specific analysis on a jurisdiction by jurisdiction basis by the lack of suitable, reliable data for the smaller jurisdictions. In our view these scenarios are likely to be somewhat pessimistic, even for the smaller jurisdictions. That said, they help establish a range of possible savings which may eventuate from reforms based on the recommendations.

The first of the two scenarios considers the combination of:

- A 60:40 combination of personal injury to property claims cost;
- A greater proportion of smaller claims, with 85% being less than $50,000;
- The SA CTP Scale as a proxy for the current experience with general damages; and
- Only 60% of claims in the less than $50,000 size band being eliminated.

The second scenario is perhaps even more radical in that it considers a combination of:

- A 60:40 combination of personal injury to property claims cost;
- A greater proportion of smaller claims, with 85% being less than $50,000;
- The average claim size in each band is 20% higher;
- The SA CTP Scale as a proxy for the current experience with general damages;
- Only 40% of claims in the less than $50,000 size band being eliminated;
- Defendant legal costs are reduced as per Scenario 12; and
- Gratuitous care savings are increased to 50%.

The following table shows the results of these two scenarios:

Scenario number	Scenario	Estimated savings
	Central estimate	**14.7%**
	Combined Scenario	
15	1, 3, 8, 10	9.8%
16	1, 3, 5, 8, 11, 12, 14	7.0%

Even in these two pessimistic scenarios potential cost savings of 9.8% and 7.0% in total costs are estimated to emerge.

The above variations are by no means exhaustive, and there are of course others that are equally plausible. There may also be interaction affects which are not considered here. They do, however, give an indication of the sensitivity of the estimated reduction to certain key assumptions.

Some of the variations are counter-intuitive, and is largely due to the fact that variations in proportions, taken in isolation will have consequential changes in other proportions.

The degree of uncertainty in the estimates is high, and must be appreciated.

While the intention of the proposed changes may be clear, the actual outcome could easily vary from the intention. In particular, this is because we are considering potential *changes in behaviour* by claimants. This is a notoriously difficult feature to estimate.

There is also the question of *permanence* of any reduction, discussed in the Section 7.

5.16 The effect of changes already introduced since 30 June 2001

As noted in the introduction to this section all calculations of the effect of Category A Ipp recommendations are relative to the public liability environment which existed at 30 June 2001. Since that date legislative changes have been introduced in a number of jurisdictions.

These changes are summarised in Attachment A to the Joint Communique of the Ministerial Meeting on Public Liability Insurance dated 2 October 2002. Based upon this summary we comment below on the effect on our calculations.

(a) New South Wales

The *Civil Liability Act 2002* was enacted on 20 March 2002. Relative to the Ipp recommendations:

i. The upper limit for general damages is $350,000 compared to Ipp's $250,000;

ii. The cap on earnings for future economics loss is 3 times AWE compared to 2 times;

iii. The discount rate for future economic loss is 5%pa compared to 3%pa;

iv. The restriction on legal costs is less than under the Ipp recommendations.

PwC Actuarial have costed the changes under the *Civil Liability Act 2002* (our report the NSW Treasury dated 19 August 2002).

We have already commented (in Section 5) on the effect of (iii) which, if introduced, would **reverse** the cost reductions in the NSW Act. However items (i), (ii) and (iv) would result in higher reductions than in the NSW Act.

(b) Victoria

A range of reforms were announced on 2 September 2002.

The reforms are very similar to those in NSW, described above and the conclusions made there apply similarly to Victoria.

(c) Queensland

The *Personal Injuries Proceedings Act 2002* introduced a number of reforms.

Relative to the Category A Ipp recommendations those most relevant are:

(i) limits on legal costs in small claims;

(ii) limits on economic loss to 3 times AWE.

These changes are consistent with the Ipp recommendations. Further reforms are intended to be introduced by the end of 2002, in particular the establishing of caps and thresholds.

(d) Western Australia

The *Civil Liability Act 2002* was introduced on 13 August 2002.

Relative to the Category A Ipp recommendations those most relevant are:

(i) a $12,000 for entitlements to general damages (likely to be lower than Ipp)

(ii) limits on economic loss to 3 times AWE (same as Ipp)

(e) South Australia

The *Wrongs (Damages for Personal Injury) Bill 2002* includes the following:

i. a threshold for general damages of 7 days impairment of $2,750 in medical expenses (lower than Ipp);

ii. a cap for general damages of $241,000 (similar to Ipp);

a cap on economic loss;

iii. remove of interest on general damages (same as Ipp);

iv. a discount rate of 5%pa for damages for future loss (higher than Ipp).

(f) Tasmania

Tasmania has implemented a range of specific measures, including:

- a discount rate of 7% (higher than Ipp);
- no provision for pre-judgement interest;
- no damages in respect of gratuitous attendant care.

(g) Northern Territory

The *Personal Injuries (Liabilities and Damages) Bill* is expected to be introduced in October and includes:

- An indexed cap of $250,000 for general damages;

- A cap on damages for past and future loss of earnings of three times average weekly earnings;

- A threshold for non-economic loss of $15,000;

- Setting standard, commercially realistic interest rates for past damages and discount rates for future damages.

These changes generally follow Ipp.

(h) ACT

The *Civil Law (Wrongs) Act 2002* provides for:

- A cap on past and future loss of earnings of three times average weekly earnings;

- Limits on costs for cases up to $50,000, together with other costs restrictions. Such limits can not be circumvented;

- A discount rate for future economic loss of 3% (non-statutory, applied by the courts).

All of the changes introduced in the various jurisdictions since 30 June 2001 would be expected to reduce public liability claims costs.

In some cases the changes to the reductions should **exceed** those associated with Ipp recommendations, eg: the adoption of higher discount rates for estimating future losses. In other cases the changes are similar to Ipp.

In general, the cost reductions identified earlier in this Section will be **lower** with respect to the post-30 June 2001 environment.

6 Comments on non-quantified recommendations

In Section 3.2 we placed the 61 Ipp recommendations into certain categories.

In Section 5 we have costed the effect of Category A changes. In this section we offer some general comments on those Category B changes which we would expect to have the most significant effect on claims costs.

Category B (i) (those reducing claim numbers)

There are numerous recommendations which it is reasonable to expect will reduce the numbers of personal injuries claims under public liability and medical indemnity insurance. Those most worthy of comment are as follows:

Recreational services (11): The recommendations are likely to reduce successful claims. We are unable to cost because:

(i) claims in respect of recreational services are not identified;

(ii) those which might be affected by the recommendation are not capable of identification.

If this recommendation is successful it should significantly reduce the cost of claims for providers of recreational services, and work towards improving the available and affordability of cover.

Being a specific recommendation it will have no affect on the liability cost of other purchasers of insurance.

Limitation and long-stop periods (24 to 26)

The Ipp recommendations are aimed at limiting the potential for claims to be made beyond the limitation and long stop dates. If this is successful it will increase the certainty of risk assessment.

However many current limitation periods are weakened by judges' willingness to accept claims beyond the limitation period.

Besides increasing certainty there may or may not be any material cost savings arising from this recommendation. All that is likely to happen is that claimant and legal behaviour will adapt to ensure that claims are filed within the necessary time.

Standard of care (28)

In our view this recommendation has the potential to lead to significant reductions in claim numbers and, hence, claims costs.

However, the extent of success clearly depends upon legal interpretations of, inter alia, "not insignificant risk", "reasonable person", and "social utility of the risk-creating activity".

Causation (29)

This recommendation introduces concepts of "factual causation" and "scope of liability".

It also has the potential to reduce numbers of successful claims, perhaps significantly.

However, once again, the extent will be determined by legal interpretation.

Public Authorities (39 to 43): The recommendations are likely to reduce successful claims. We are unable to cost because claims in respect of public authorities are not identified;

Category B (ii) (those reducing claims costs)

Contributory negligence (30) and Apportionment (31)

These recommendations will reduce the size of claims borne by the insurance industry.

However the extent of any reduction is very much in the court's arena.

Category B(iii) (those assisting in sustaining the effect)

Recommendations 33 and 38 suggests the establishment of guidelines for assessing psychiatric illness. Successfully implemented, this would contribute to preventing cost escalations in this area.

Changes which will help sustain any reductions in cost from the other recommendations are very important to their long-term success.

Although we have been unable to cost the effect of the Category B recommendations, this should not be seen as diminishing their importance.

It is quite plausible that these recommendations could result in claims cost reductions as significant as those of Category A costed in Section 5.

However, and unavoidably, their success or otherwise will be determined by legal drafting and judicial interpretation.

7 The question of permanence

7.1 Introduction

In Section 5 we have estimated various reductions in personal injuries claims costs from the proposed changes (Category A recommendations only).

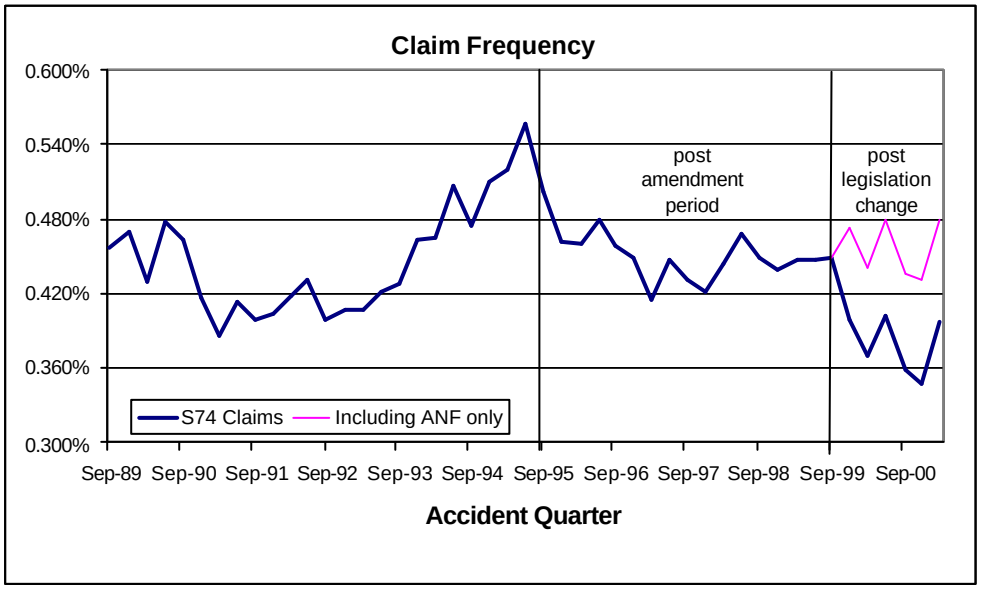
If all of our assumptions work out in practice then these reductions will occur for claims which occur after the changes are introduced. The question is – how long will this reduction be maintained?

In our view it would be optimistic to assume that the reduction will be permanent. In the following sections we consider the 15% threshold for general damages as a specific area which may come under threat, and the broader question of "superimposed inflation".

7.2 The 15% threshold for general damages

As noted in Section 5.2 the threshold for general damages is the same as that introduced in September 1995 into the *NSW Motor Accidents Act 1998*. It is therefore informative to consider the experience under that Act, before it was replaced in 1999.

The following graph shows the frequency of claims (relative to numbers of motor vehicles) in the NSW Motor Accidents Scheme.

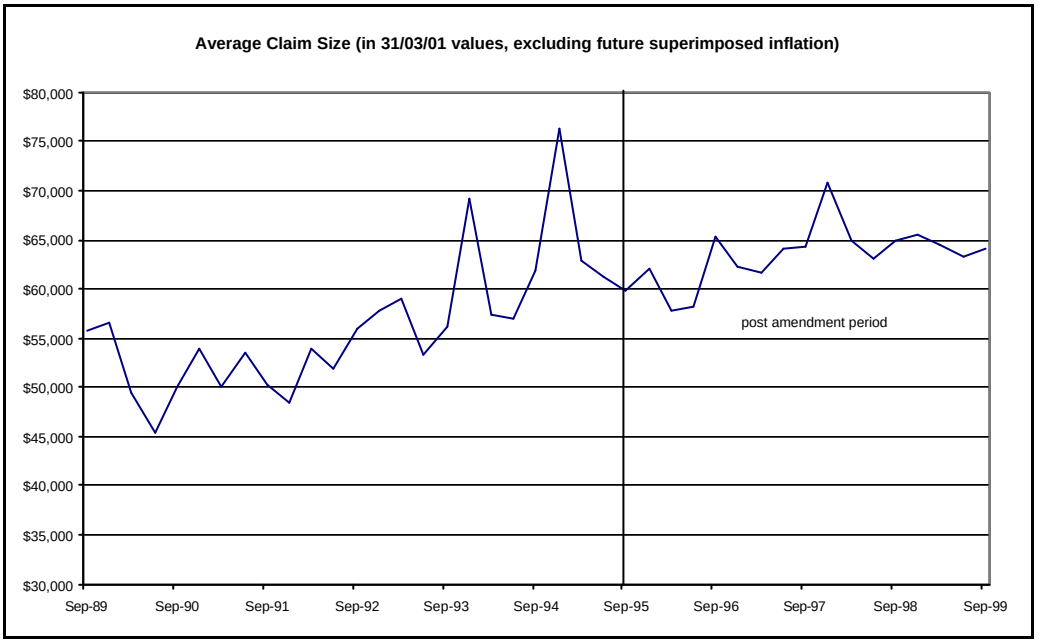


It can be seen that:

- The frequency increased dramatically from September 1993 to September 1995, this being one of the catalysts for the 1995 amendments.
- After September 1995 claim frequency reduced by around 15%, and this persisted until the introduction of the 1999 Act.
- Although not relevant to this discussion, claim frequency has reduced further following the 1999 Act. This can be attributed to the introduction of a 10% impairment threshold, as assessed under the AMA Tables.

  (The lower line in the graph is Section 74 claims experience ie. "real" claims, the upper line is that including Accident Notification Form (ANF – medical only claims).

Similarly, PwC has estimated ultimate average claim sizes in the scheme (in March 2001 values).



This graph shows that average claim sizes were increasing prior to September 1995 (with seasonal variations).

Following the changes, average sizes have increased slightly, but not yet back to 1994/95 level. Indeed with the elimination of many small claims (the above discussion on frequency) we would have expected a significant **increase** in the average of those remaining in the scheme.

The overall conclusion from the above discussion is that the September 1995 amendments in the NSW Motor Accidents Scheme certainly halted the significant upward trends which existed prior.

Indeed, the estimated claims costs for the 1995/96 year are some 17% below that for the 1994/95 accident year, and there has been only a minor increase in subsequent accident years. Currently, we estimate the claims costs for the 1998/99 year to be 15% below those for 1994/95.

In Section 5.4 we expressed our view that more objective impairment guidelines would strengthen the proposed threshold, and hence be more sustainable in the long-term future.

While we still believe this to be the case, the experience in the NSW Motor Accidents Scheme between 1995 and 1999 does suggest that the proposed threshold for public liability insurance may well be capable of surviving for some years.

However, it has been hypothesised that the introduction of the 1999 Act has had a retrospective effect on earlier experience, (through a cultural change rather than a direct effect of the Act) and that claims have settled for lower amounts than would have occurred were it not for the 1999 Act. In this sense, the favourable experience may not be repeated in other jurisdictions.

7.3 Superimposed inflation

The term *superimposed inflation* (SI) is the generic name given to claims escalation in excess of wage or price inflation. Features of SI include, inter alia:

- It can arise from a variety of sources, although it is not always possible to identify those sources;
- It does not operate uniformly over time, but can move in fits and starts; and
- It is a feature which has been present in all systems which provide common law benefits.

The Trowbridge Consulting report *Public Liability Insurance - analysis for meeting of ministers 27 March 2002* concluded that "analysis shows that the cost of claims have been rising for many years driven by personal injury claims (the increases are significant – more than 10% a year on average – and have probably been going on for 20 years or more)".

This is reinforced by our own experience that many insurers are pricing and reserving using assumed rates of SI of up to 10% p.a.

Consideration must to be given to whether the recommendations will eliminate the underlying reasons for these trends, or whether the reforms will merely cause a one-off reduction which will eventually be eroded by a continuation of the adverse trends.

Changes such as the introduction of the general damages threshold could eliminate many claims, but can be undermined if the threshold is not enforced over time or if it is circumvented via substitution to other heads of damage. The proposed 15% NEL threshold would appear capable of surviving for some years (Section 7.2), but

certainly cannot be guaranteed to do so. Application of the threshold still remains within the judicial system.

Experience in other compensation schemes suggests that SI can still persist after legislative change, one source being an expansion of the use of additional heads of damages.

With respect to future claims costs there are therefore a number of scenarios:

i. The recommendations cause a one-off reduction, **and** also arrest future superimposed inflation (SI). This is the most optimistic assumption.

ii. The recommendations cause a one-off reduction, but will **not** arrest future SI, which will continue at significant levels, although perhaps lower than current levels.

iii. The recommendations cause a one-off reduction, which is gradually eroded by **higher** SI in the future.

This is a pessimistic assumption, but not the most pessimistic. At least we still assume the reforms to have a significant **immediate** effect.

It can be seen that a wide range of views on the future course of SI could reasonably be entertained. Based upon experience in other liability classes we believe a reasonable expectation to be as follows:

- Experience immediately following the implementation of the recommendations will show a marked improvement, possibly greater than a priori expectations;
- Numbers of claims will be less than expected, and those remaining will settle for lower amounts;
- After a time experience will start to deteriorate, as lawyers become more familiar with the legislation and judicial interpretation becomes more liberal;
- In some 3-5 years SI will re-emerge, although possibly at lower levels than in the past.

7.4 Summary

Experience in other accident compensation systems indicates that, where the system remains in the legal environment, the immediate effect of changes is likely to be eroded. How quickly they are eroded and to what extent will vary according to the legal efficacy of the changes.

The Ipp recommendations appear, in our view, to be extensive and comprehensive. However we cannot opine on legal efficacy, which will depend upon the detailed drafting of legislation.

In the circumstances as described it is important that claims experience in the system is continually monitored, and the need for further legislation considered if the initial changes lose their effectiveness. This requires comprehensive data (discussed in Section 9.1).

8 Impact on insurers' premiums

8.1 Preliminary comments

In Sections 5 to 7 we have considered and discussed the effect of the Ipp recommendations upon the costs of personal injuries claims under public liability insurance.

While the cost of claims is of course a key element in the premiums charged by insurers, there is not necessarily a 1:1 correspondence.

In Sections 8.2 and 8.3 we estimate the theoretical effect of the recommendations assuming that such a 1:1 correspondence between claims costs and premiums **does** exist.

We then proceed to discuss reasons why premiums might vary from the theoretical calculations.

8.2 Notional composition of current premiums

In theory insurers' premiums should comprise allowances for each of estimated claims costs, expenses, commission and profit margin. In practice the market will often determine the level of premiums which are charged, and hence profit margins which are possible.

In the Trowbridge Consulting report referred to earlier the following composition of public liability premiums was adopted.

Component	Percentage
Cost of claims	65%
Commission/brokerage	15%
Administration expenses	22%
Investment income credit	(10%)
Target profit margin	8%
Premium to insurer	100%
GST	10%
Stamp duty	11%
Premium to customer	121%

We have adopted the same composition to estimate the effect of the proposed changes on insurers' premiums.

8.3 The effect of the changes

Based on the premium components given above we can derive a notional post-reform premium as follows:

Component	Percentage
Cost of claims	55.4 (a)
Commission/brokerage	13.0 (b)
Administration expenses	19.8 (c)
Investment income credit	(8.5) (d)
Target profit margin	6.9 (e)
Premium to insurer	86.6
GST	8.7 (f)
Stamp duty	9.5 (f)
Premium to customer	104.4

(a) 14.7% reduction from Section 5.

(b) Unchanged at 15% of premium to insurer.

(c) Some insurer expenses will be eliminated because of the assumed elimination of small claims. We have estimated a 65% reduction in numbers of claims, and have allowed for a 10% reduction in insurer expenses. Not all insurer expenses are claims related.

(d) Pro-rata to claims costs.

(e) Unchanged as 8% percentage of premium.

(f) Unchanged percentages.

This indicates a notional reduction in insurers' premiums of:

$$\left(1-\frac{104.4}{121.0}\right)=\mathbf{13.4\%}$$

All other things being equal, therefore, the proposed changes would enable a reduction in insurers' premiums of around **13½ %**.

This is derived from the central estimate of expected reductions.

8.4 Premiums in the real world

There are a number of reasons why changes in insurers' premiums may vary from the theoretical calculations given above. Comments on a number of these are as follows:

(a) The adequacy of insurers' current premiums

The premium reduction quantified in Section 8.3 will be an appropriate starting point **only if insurers' current premiums properly reflect current claims costs**.

Even if insurers had intended this to be the case, in practice it may not be so. Estimation of claims costs is a non-trivial exercise, particularly in an environment where costs are changing rapidly. For example, it could quite easily be the case that an insurers' premiums may be 10% inadequate (or 10% more than adequate) even if the intention had been to set adequate premiums.

For an insurer with inadequate premiums any reduction in claims costs which may arise from the Ipp recommendations is likely to be viewed as an opportunity to restore adequacy of current premiums, and the insurer will not be inclined to reduce those premiums.

(b) The form of implementation (1)

The above calculations implicitly assume that the Ipp recommendations will be implemented **prospectively** ie. they will only affect claims occurring in respect of premiums received after the date of implementation.

The actual form of implementation may involve some degree of retrospectivity, as follows:

(i) If the recommendations affect all claims occurring after the date of implementation, then there is a minor degree of retrospectivity in that insurers will already have received premiums in respect of some exposure after that date. This is because premiums are usually paid in advance for 12 months cover.

For example, a premium received just prior to the change date will cover all claims for the ensuing 12 months. The premium is likely to have been set **before** knowledge of the changes, and hence based upon a higher estimated claims cost.

In these circumstances the insurer will receive a "windfall" gain to the extent of the differences in claims cost before and after

the change date.

The extent of this windfall will vary between insurers depending upon the adequacy of their current premiums and the incidence of writing business throughout the year.

(ii) As an illustration only, for an insurer where:

- current premiums are adequate, and
- business is all annual premiums written uniformly throughout the year,

then the windfall gain would represent around 6% of the annual pre-change premium income.

(iii) If the recommendations affect all claims **not settled** at the change date then the extent of the windfall gain described above is significantly increased.

In the public liability class claims are not settled for many years after the injury, say an average of 3-5 years. Accordingly at a particular date there will be 3-5 years' of claims still to be settled, all of which would be settled at a lower cost than anticipated in the original premium rates.

An example of alternative (i) occurred under the changes implemented under the *NSW Motor Accidents Amendment Act 1999*. Here insurers were required to apply their windfall gain to a reduction in premiums. However this was in an environment where premiums are set formally each year and filed with the regulator. A reasonable estimate of the windfall gain could be derived. This is not the case in public liability.

The amount of retrospectivity in alternative (ii) would be considered inequitable. However a variation of this occurred under the *NSW Civil Law Reform Act 2002*, where changes applied to all claims where legal proceedings had not commenced by the change date.

In summary, the form of implementation of the recommendations may involve some degree of retrospectivity. This will result in windfall gains to insurers relative to the situation which would have been the case otherwise. This raises the question as to whether these gains should be applied to reduce premiums **further** than that quantified in Section 8.2.

The major difficulty in any of this will be quantification of any windfall gain. The amount will vary, possibly significantly, between insurers.

(c) The form of implementation (2)

In (b) we discussed the question of windfall gains to insurers. However the form of implementation may also result in **additional costs** to insurers.

This can occur where a future date is set for implementation of the changes. This can result in an anticipated "surge" of claims concerned that they may be subject to the changes. Such surges have occurred elsewhere (Victorian workers' compensation in 2000, NSW Medical Indemnity in 2001).

To some extent such surges are merely the "bringing forward" of claims which should have reported later. Where this is the case no additional liability is created.

However, it is usually the case that some additional claims are "created" by the deadline ie. ones which would not have been notified otherwise. Once in the legal system these claims can become as real as other claims, leading to unanticipated additional costs for insurers.

This is particularly important in the case of claims made insurance (many medical indemnity covers are written on a claims made basis) as the premium charged assumes a certain rate of claim reporting, within a 12 month period and proves to be inadequate to fund a claims "spike". An example of this was the spike of claims prior to the introduction of the *NSW Health Care liability Act 2001* which ultimately was a contributing factor in the failure of UMP.

It is clear that considerable care must be given to the form of implementation of the recommendations.

(d) Variations between insurers

Even where insurers aim to charge adequate premiums there will be variations in the extent to which their premiums might be affected by the recommendations.

This is because the effect will not necessarily be uniform across all parts of public liability business. For example, for an insurer who writes business with high frequency/low average size claims the effect is likely to be greater than for an insurer who writes business with low frequency/high average size claims.

The proportions of property damage claims will also vary between insurers.

(e) The operation of the market

Public liability insurance premiums are not regulated. Insurers are free to set their rates according to their own circumstances and future strategy.

This means that a variety of views may be taken regarding the effectiveness of the Ipp recommendations, both immediate and long-term. All such views might be quite defensible, given the uncertainty involved.

Furthermore, it is likely that some insurers will have suffered significant losses on business underwritten in recent years. These insurers may view any reductions in cost from the Ipp recommendations as an opportunity to recoup some of these losses.

(f) Reinsurance

As well as direct insurers, there are also the views of their reinsurers. The extent of the recommendations should, in our view, mean that reinsurers will have considerably less concern about their risks than would otherwise have been the case and, accordingly, be more prepared to support the direct insurers.

However, international reinsurers will have strategies for the future which extend beyond Australia. As such there can be no guarantee that they will be prepared to provide the protection required for direct insurers, and at what price.

9 Miscellaneous comments

9.1 Lack of suitable data

In many cases the data required for costing the Ipp recommendations is either:

a) Not recorded at all, or

b) Is recorded, but not in a manner which is easily accessible.

In the case of b) certain information may be recorded in the written commentary of individual claim files. It may be possible to collate such information by reviewing a sample number of individual claim files. However, this is a very time consuming and expensive process, with no guarantee that the results would be useful. Within the timeframe required by Treasury such a claim file review is not possible.

Even if b) was possible, certain of the recommendations require interpretation by the judiciary to understand how they will work in practice. For example, the concept of "obvious" risk has been introduced but it has been left to the judiciary to determine what this term means and how it will be used. In these circumstances any actuarial costing would require a pre-emptive assumption as to the response of the judiciary (in both the short and long term), and how this response will impact on claim costs. We believe the best we could offer would be to develop a discussion of the range of scenarios of judicial response.

These issues have prevented us from undertaking actuarial analysis with respect to the so-called Category 3 recommendations.

In conjunction with implementation of reforms in this area we recommend that strenuous efforts be made to improve the quality of data collected. This will allow:

(a) The success or otherwise of the current reforms to be monitored and assessed;

(b) Monitoring to help ensure that many of the issues which resulted in the current crisis are identified earlier. Earlier response to emerging experience can prevent future crises occurring;

(c) Prevent a repeat of the current debate which has been hampered by the lack of suitable data to guide decision making.

9.2 The response of the insurance market

Many of the Ipp recommendations involve replacing case law with a basic set of principles with should make it clearer to the judiciary as to how particular cases should be treated. By making it clearer it can reasonably be expected that:

- The efficiency of the process is improved.
- There should be less room for legal argument.
- Results should be more consistent both between cases and over time.
- The system should be more stable over time.

As a consequence the insurance covering personal injuries claims will present a considerably more tractable problem from the insurers' viewpoint. In particular:

- The chances of further significant increases in claims costs will be substantially reduced (ie. superimposed inflation should be reduced or diminished).
- In due course insurers will be able to estimate future claims costs with greater certainty (although there will be more uncertainty at the outset, this will be with respect to the extent of the **reduction** in claims costs).
- Greater certainty should mean the need for less capital to support the business than at present, which by itself would reduce the level of profit margins required by insurers.
- Greater certainty would also remove some of the disincentive for reinsurers to accept the risk.

All of these features will mean that insurance should become more available than at present, either from:

- existing participants in the market, or
- new participants who can see opportunities for profit.

However, and as noted in Section 8, the response of the insurance industry is unlikely to be unanimous, and will be determined by their strategies for the future and the availability of capital.

A key feature in insurers' response is this fundamental question of uncertainty. A particular, perhaps unavoidable, issue resulting from the manner in which the Ipp report has framed several of its recommendations is that certain principles and definitions will need to be interpreted by the courts. Thus whilst on the one hand the movement to framing personal injury tort law in terms of general principles is seen as a positive move to reduce uncertainty, on the other there is likely to be a period of uncertainty as the various principles and definitions are considered by the courts.

9.3 Recommendation 57: Structured settlements

Structured settlements can be supported as desirable for good social policy reasons.

However, their introduction should not be seen as a mechanism to save costs directly. To do so implies that the more seriously injured end up with less compensation. There is an argument that savings may be generated across the broader spectrum of social security because fewer claimants will exhaust their compensation and revert to support via government social security programs.

Experience overseas has been that there are situations in which the cost of a structured settlement is lower than the alternative cost of a lump sum settlement would have been. For example: mortality assumptions may be more realistic or discount rate assumptions may be higher.

However, in Australia structured settlements may not be widely used by claimants (eg limited to the largest claims only, no compulsion , new market etc).

The discount rate used by the courts for calculating lump sum damages has been increased in several states from 3% (the default rate) to, typically, 5%. This works to reduce the value of a lump sum settlement. It is difficult, maybe in some cases impossible, for a life insurer providing an annuity product for a structured settlement to obtain a real rate of return of 5% p.a. on its investments. As such the cost of a structured settlement is likely to be higher than the alternative value of a lump sum settlement. This is likely to act as a major obstacle in wide use and acceptance of structured settlements.

We therefore caution unfounded expectations that structural settlements will make a significant impact on the compensation culture in the near term.

9.4 The question of actuarial recognition

One of the terms of reference requires us to address the following question:

"how long will it take before actuaries agree to recognise the impacts of the reforms in their estimations of liabilities and the consequent effects on premiums?"

The question is part of that of the possible impact on insurers' premiums, (considered in Section 8) in that insurers' responses will, at least in part, be influenced by the response of their actuaries.

This is not a straightforward issue. Actuaries do not all think alike, and their advice to their clients/employers will vary accordingly. However it is informative to consider the situation with respect to the *NSW Motor Accidents Compensation Act 1999*, which has been as follows:

i. Prior to its introduction the proposed changes were costed by two firms of actuaries – PwC Actuarial and Trowbridge Consulting. These costings were requested by the Review Committee charged with developing the proposals;

ii. The costings were presented to the insurers, who were certainly sceptical about the actuaries' calculations;

iii. However, because the premiums were set in a regulatory framework (ie. the regulator could reject premiums, if they were considered excessive) insurers did eventually reflect the actuaries' calculations in their premiums for the 1999/2000 year. These premiums were some 20% to 25% below those of 1998/99; and

iv. Subsequent experience has been carefully monitored by both the regulator and insurers.

In the event, experience has been more favourable than expected. However the insurers' actuaries have been reasonably cautious in moving away from the original 1999 costings.

The period is regarded as somewhat of a "honeymoon" while lawyers become more familiar with the new Act.

While informative, the above scenario cannot necessarily be extrapolated to public liability insurance, where premiums are unregulated.

A reasonable scenario for public liability insurance might be as follows:

- The insurers' actuaries will attempt to cost the changes and, in doing so, will take note of any costings prepared by others and available to them.

  They may choose to follow the same overall approach, but take a different view on key assumptions.

- A range of views will be taken. However we would like to believe that most views are likely to lie within the range of views presented in Section 5.15 of this report **for an average industry portfolio**.

- Unless there were specific unusual circumstances, actuaries would use their conclusions on claims costs in setting balance sheet provisions for post-change liabilities, and for any advice on future premium rates.

  The actual form of implementation of the changes (see Section 8) will

determine the extent to which the immediate balance sheet provisions will be affected (ie the degree of retrospectivity).

- Subsequently, we believe that most actuaries are likely to move relatively slowly from their initial conclusions. They will need to be convinced that the evidence is sufficiently strong to justify a move.

  Of course, it will depend upon the outcome of experience, but actuaries have been caught out in the past by responding too soon to superficially favourable experience.

For actuaries, it can be seen that their initial assessment of the effect of the recommendations will be the major influence on reserving and premium setting for the next, say, 3-4 years. It should be noted, however, that insurers' premiums are set by senior management, not unilaterally by their actuaries.

9.5 Risks that the outcomes may be muted or countered

9.5.1 General comments

Public liability insurance is only one form of person injury compensation which involves the operation of Tort Law. The "crisis" in public liability insurance during 2001 and 2002 is similar to that experienced in many of the workers compensation and CTP schemes in Australia over the last 20 years.

In many cases the cause of financial instability has been the result of cost escalation associated with the operation of common law compensation. In response governments introduced series reforms, which amongst other things, have included restricting the operation of common law in the particular jurisdiction. Examples of such reforms include:

- Queensland workers compensation reforms 1996
- WA workers compensation reforms 1993 and 1999
- NSW MAA reforms 1989, 1995, 1999
- NSW workers compensation reforms 1987, 1998, 2001
- NSW Health Care Liability Act 2001
- Victoria workers compensation 1985, 1997, 2000
- South Australia workers Compensation 1985
- Tasmania workers compensation 2000

In some ways it should come as no surprise that ultimately the operation of common law in public liability insurance has led to the current problems.

Typically the types of reform governments have implemented in workers compensation and CTP include:

- Restriction of access to common law compensation, via thresholds
- Restrictions on the quantum of common law benefits available, by:
  - Changing the discount rates
  - Caps on damages
  - Thresholds
  - Specific heads of damage only
- Process or pathway followed, via:
  - Conciliation and dispute resolution systems
  - Legislating benefits scales
  - Information provision
  - Cut off dates
  - Restricting legal expenses and advertising

Not all of these reforms have been successful.

In a number of cases thresholds have been weakened or circumvented over time. Based on the lessons learned most jurisdictions now have thresholds which include some or all of the following features:

- Assessment of impairment via objective guidelines such as the various editions of the American Medical Assessment Guidelines,
- Reduced benefits just above the threshold to reduce the incentive of claimants to be classified as just over the threshold,
- Removal of alternative gateways (such as the economic loss gateway in WA) which can be used to bi-pass the primary threshold.

Lack of a medical assessment system to resolve disputes, which otherwise have had to revert to the legal system to be resolved.

In general, the trend in accident compensation design has been away from reliance on the legal system, which is seen as unpredictable and the source of much of the instability in claims experience. It is also seen as incurring high levels of expenses relative to the quanta paid to claimants.

To the extent that the system design can be removed from the legal system, the greater the degree of certainty in outcomes which can be achieved.

However, the success of legislative changes is certainly mixed. One could reasonably suggest that in most instances the effect of changes is of limited duration only. Particular examples are the NSW Motor Accidents Scheme and Western Australia workers' compensation. In such cases it has been necessary to introduce further changes to achieve the desired result, namely, reduced claims costs.

This is not to say the success in preventing significant cost increases cannot be achieved through good claims management rather than by legislative change. However we can cite but a single example of this in Australia, the Victorian Transport Accident Commission. Here the common law costs have remained reasonably stable for a number of years without the need for legislative change. However the characteristics which have underpinned the TAC's success cannot necessarily be applied to privately underwritten systems such as public liability and medical indemnity insurance.

9.5.2 Specific comments

In Section 7 we have discussed the particular question of the erosion of the 15% threshold. This remains the most vulnerable of the Category A recommendations.

Of the Category B recommendations expected to affect claims costs, numbers 28 (standard of care) and 29 (causation) would appear to us as those most likely to be muted or countered over time.

However, such questions are more appropriately posed to lawyers, rather than actuaries.

9.6 Medical indemnity insurance

The results of calculations given in Sections 5 and 8 are in respect of the public liability class of insurance.

Under medical indemnity insurance the claims with respect to property damage are removed. In other respects the reduction in claims costs is in aggregate close to those for public liability. The slightly different claims distribution results in smaller reductions at the lower end, but these are offset by higher reductions elsewhere.

As such corresponding reductions in medical indemnity claims costs are estimated to be around 20%.

At present medical indemnity cover is provided largely through Medical Defence Organisations, rather than licensed insurers (although some MDO's have established internal insurance companies to provide part of the cover). Being single line insurers, the expense and profit structure of MDO's will be different to those of insurers

writing all lines of business. However we would expect the effect of the Ipp recommendations on MDO premiums to doctors to be around 15% to 18%.

Please note that the estimated reductions in the pre 30 June 2001 environment. In NSW in particular the underlying claims costs have already been affected by the *Health Care Liability Act 2001.*