



The Public Liability Insurance Crisis and its impact on Small and Diverse Organisations

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Abstract:

The Public Liability Insurance Crisis and Small and Diverse Organisations

Eric Kodjo Ralph, Jason Soon and Henry Ergas

Australia currently faces a widely-publicised crisis in the supply of public liability insurance, most notably for a range of small and diverse enterprises such as not-for profits (NFPs), small businesses and local councils. The paper considers whether market failures may have occurred in the public liability insurance market, particularly in meeting the needs of small and diverse enterprises, and canvasses the merits and demerits of different regulatory responses. At the broadest, stability in the administration of tort law is advocated, and reform merely to reduce costs to insurers (rather than the economy as a whole) discouraged. Strengthened and transparent prudential oversight is also suggested. Focussing more narrowly, risk management and information collection, the use of buyer aggregators and, to a limited extent, subsidies to worthy NFPs, are proposed as means of helping NFPs, small businesses and local councils.

1 A crisis in public liability insurance

Australia faces a wide-spread crisis in public liability insurance, taking the form of substantial increases in premiums and in some cases simple withdrawal of coverage. A number of smaller organisations, notably not-for-profits (NFPs), small businesses and local councils have been particularly hard hit. For example, 14 percent of Queensland community groups in a survey were not able to afford public liability insurance premium increases, some of which were as high as 1000 percent.¹ Equestrian sports nationwide had insurance withdrawn altogether.² These developments have led to a number of Ministerial summits on public liability insurance.³

This paper considers the broad crisis, its potential sources, and its implications for small and diverse organisations such as NFPs, small businesses and local councils. At the broadest, stability in the administration of tort law is called for and tort reform merely to reduce the costs of insurance discouraged. Strengthened and transparent prudential oversight is also suggested. Looking to small and diverse organisations, proposals are made for: national programs of risk management and information collection; the use of buyer aggregators; and, to a limited extent, subsidies to worthy NFPs.

The paper is structured as follows:

- Section 2 outlines the public liability insurance market and the current crisis;

¹ 'Our Community', submission to the Senate Enquiry, p. 3, based on a survey of community groups with over 1,000 responses. Increases of 800 percent were reported by the Queensland Law Society submission to the recent Senate Enquiry submission, <http://www.qls.com.au/download/QLS%20submission%20to%20insurance%20summit%20march%202002.doc>.

² See footnote 66.

³ ACCC 2002, *Second insurance industry market pricing review, September* (henceforth known as the September 2002 ACCC report) at Section 3.4.1 provides an extensive list of other examples. More examples are provided in Trowbridge Consulting 2002, *Public liability insurance: Analysis for meeting Ministers 27 March 2002, March* (henceforth known as the Trowbridge report).

- Section 3 critically discusses potential problem sources in the public liability insurance market with a focus on adverse implications for small and diverse organisations; and
- Section 4 outlines a range of specific policy proposals aimed at meeting the needs of NFPs, small businesses and local councils.

2 The public liability insurance market and current crisis

Public liability insurance provides protection against claims made against the insured by third parties for bodily injury or damage to property for which the insured is legally liable. Public and product liability insurance represents five percent of total gross written premium and six percent of policies written.⁴

Most Australian licensed insurers sell some public liability policies, primarily as a component of home and contents insurance. Stand-alone public liability insurance is almost exclusively distributed through brokers and agents.

Prior to 1997, public liability insurance was largely voluntary, with the exception of certain public events and facilities where a licensing authority required public liability insurance. Since then, businesses contracting with governments have been required to have public liability insurance. NFPs are typically also required to hold public liability insurance if they are to receive support from a local council.

2.1 Problems with availability and excessive premium levels

Public and product liability insurance premiums increased on average by 15 per cent and 22 percent respectively over the last two years (2000 and 2001).⁵ However, variation across policyholders has been severe.⁶ Organisations with public traffic, including hotels and

⁴ September 2002 ACCC Report, p. 23.

⁵ September 2002 ACCC Report, p. 56.

⁶ Refer to the examples at of the September 2002 ACCC report, Section 3.4.1 provides examples. Sharp variation in future premium increases is also expected (Trowbridge Report, March 2002, p. ii).

licensed clubs, shopping centres, event organisers, sporting organisations and tourism operators were hardest hit.⁷ Many of these organisations are NFPs, small businesses and local councils, which, in any case, have been disproportionately affected. Section 1 provided some illustrations for NFPs. Examples of the impact on small businesses include:

- A NSW survey that showed public liability insurance premiums rose by more than 500 percent for two percent of small businesses; by between 200 and 500 percent for nine percent; by between 100 and 200 percent for 12 percent; and by between 50 and 100 percent for 29 percent;⁸
- A national survey that showed average small business increases in public liability premiums of around 80 percent over the last three years. Certain businesses, such as those in outdoor recreation or adventure tourism have faced premium increases often in the range of 100-500 percent.⁹

Premium rises also do not appear to reflect previous claims' experience. For example:

- Despite substantial premium increases, 96 percent of the community groups responding to an 'Our Community' survey had not made a claim on their public liability insurance in 5 years. Actual claims amounted to less than 5 percent of total premiums;
- The Ponyland Equestrian Centre, despite having never made a claim, was advised of a premium increase from \$5200 to \$21,395 and that renewals in subsequent years would not be forthcoming at any price; and

⁷ Trowbridge Report, March 2002, p. 5. On outdoor recreation organisations see footnote 9 and associated text).

⁸ State Chamber of Commerce (NSW) and NRMA Insurance survey, May 2002.

⁹ Ministry of Small business and Tourism submission to Senate Enquiry, p. 4. Premium rises of 40-900 percent for outdoor organisations in Queensland have also been reported (Queensland Outdoor Recreation Federation survey, cited in Ministry of Small Business and Tourism submission to the Senate Enquiry).

- The premiums of a provider of outdoor education increased by 600 percent although it had never made a claim for insurance in its 7 years of operation.¹⁰

The possible causes of these problems and what, if any solutions are available, are the subject of the rest of this paper.

3 Potential problem sources in public liability insurance

This section critically considers six potential sources of difficulties in the public liability insurance market, and in particular why there may be a more egregious failing in the supply of public liability insurance to NFPs, small businesses and local councils.

1. Perhaps the most focussed on potential cause of increased premiums and reduced coverage is the view that these correspond to an increase in insurance costs, most particularly in the form of more frequent and larger payouts, as well as increased litigation costs. The evidence for these problems is discussed in Subsection 3.1.
2. Public liability insurance may be more difficult to deal with actuarially than other forms of insurance. Subsection 3.2 explains why these difficulties arise and why recent developments may have increased this problem.
3. Moral hazard (defined in Subsection 3.3) by those who take out insurance is a difficulty insurance markets are particularly adept at dealing with, at least relative to other means of overcoming this problem. However, it may be particularly marked in the case of supply of public liability insurance, notably to NFPs and small businesses. Moral hazard is discussed in Subsection 3.3.
4. Adverse selection (defined in Subsection 3.4) is another difficulty insurance markets handle relatively effectively. However, adverse selection may again be more problematic in the case of provision of public liability insurance, especially to NFPs and small businesses (Subsection 3.4).
5. Moral hazard among insurers and/or a winner's curse (explained in Subsection 3.5) may contribute to an insurance cycle, where premiums first fall below sustainable

¹⁰ Office of Small Business submission to the Senate Enquiry, May 2002 at p. 6.

levels resulting in a shake-out and subsequent sharp upward adjustments (Subsection 3.5).

6. Capacity constraints in the face of capital market imperfections that have special relevance to the supply of insurance, and in particular, public liability insurance, may also lead to cyclical movements in insurance premiums (Subsection 3.6).

3.1 Rising costs I: higher payouts and increased litigation

In most markets, and certainly in an effectively competitive one, prices rise with costs. There is some evidence that public liability insurance costs, in the form of higher payouts and increased litigation, have been rising for a considerable period of time. Some of this evidence is weak and/or contradicted by other evidence. Moreover, it is far from clear that to the extent cost rises have taken place, they can be, by themselves, the source of the current crisis. These cost changes are said to have taken place gradually over as much as twenty years, so cannot, without further explanation, be readily associated with the rather dramatic changes in public liability insurance prices and coverage. However, even if it is true that such changes are the cause of the present crisis, there is no efficiency¹¹ concern *per se* if prices have or are expected to reflect these increases (though there may be a social one, most especially if such prices rises are sharp). There can only be an efficiency problem if the cost changes themselves are inefficient. Such a case has yet to be made. Absent, such a case, simply lowering costs by legislative fiat is unlikely to improve market outcomes. This section elaborates these points.

3.1.1 Higher payouts and increased litigation

Insurance costs are positively related to claims costs, and hence to the propensity for plaintiffs to seek suit, the ease with which judgements can be obtained, the range of harms

¹¹ Throughout this paper efficient refers to an ideal outcome, and an inefficient outcome is inferior to that. However, in general, an ideal outcome is not achievable, so the presence of inefficiency does not imply a market failure, which occurs only if some change can be made, perhaps through regulatory policy, which improves market efficiency. To argue otherwise would be to engage in what Demsetz labelled “Nirvana economics”. See Demsetz, Harold (1969) Perfect competition, regulation and the stock market, in Henry G. Manne (ed.) *Economic Policy and the Regulation of Corporate Securities*, Washington DC: American Enterprise Institute, pp. 1-22.

for which damages can be awarded, and the amount of damages awarded. Increases in these areas may be an important cause of premium rises (and of refusals to supply insurance).¹²

Claims costs comprise 50-70 percent of premiums and primarily are payouts for personal injury (both physical and psychological) rather than for property damage.¹³ Functionally, approximately three quarters of claims costs are compensation payouts with the remaining quarter incurred in defence.¹⁴ The remaining 30-50 percent of premiums are brokerage fees, administrative costs not related to claims,¹⁵ and profit margins.

Table 1 presents a breakdown of the main components of public liability insurance premiums.

Table 1—Costs as a percent of premiums

Cost of claims	65%
Commission/brokerage	15%
Administration expenses	22%

¹² Due to adverse selection, insurance markets do not equilibrate solely through pricing processes. See Subsection 3.4 on adverse selection and Subsection 3.6 on how capital market imperfections might lead to withdrawal of insurance service.

¹³ The material on public liability insurance costs in this paragraph is drawn from the Institute of Actuaries of Australia (IAA) Submission to the Public Liability Forum, March 2002, especially at p. 5.

¹⁴ Trowbridge, March 2002, p. 18. The main costs of compensation are: economic loss; treatment and care; non-economic loss; exemplary damages (rare in Australia) and plaintiff legal costs awarded against the defendant. Claims costs are comprised of: assessment; expert reports (eg. medical, valuers, engineering) investigation/surveillance; defendant legal; and claim administration.

¹⁵ Administrative costs consist of: general administration; policy distribution (including issuing of policies, commission and other fees); and policy taxes and duties.

Investment income credit	-10%
Target profit margin	8%
Premium to insurer	100%
GST	10%
Stamp duty	11%
Premium to customer	121%

Source: Trowbridge Report, March 2002, p. 29.

The high share of claims costs in total costs (approximately 65 percent based on Table 1) means changes in claims costs will have an important effect on total costs. Even so, shifts in other costs would cloud the relationship. For example, productivity gains in general administration, in part due to use of computers and computer networks, and gains in economies of scale through growth in the insurance market—would mask increases in claims costs, to the extent that they have occurred.

Factors that might have increased claims costs include:

- an increase in labour contracting, which generally moves claims from workers' compensation insurance to public liability insurance;
- restrictions on common law on claims made under workers' compensation and compulsory third party automobile insurance bring more public liability claims;
- an increasing trend for volunteers in community events to bring public liability actions against organisations in the event of an injury;
- the increased tendency of the community to participate in riskier outdoor pastimes;
- an increase in the propensity to litigate;

- recent moves to make public liability cover compulsory for all new incorporating entities.¹⁶

However, there is no substantive evidence about the impact of such changes, and in some cases, that they are even occurring. Moreover, the evidence on frequency of disputes is not strong:

- The Trowbridge Inquiry¹⁷ tentatively found that “most courts have had an increase in the number of writs lodged over the period that we have examined,”¹⁸ as well as some evidence that public liability claims against local governments rose to a new plateau in 1996-1997.¹⁹
- Insurance Services Association (ISA) data shows that the overall **frequency** of claims has been fairly flat, with **reductions** in 1999 and 2000.²⁰ However, the ISA data must be treated with caution. It is not a random sample, and is not consistent over time due to changing membership and market shares.²¹ The Trowbridge Report considered Australian Prudential Regulation Authority (APRA) data on new claims too unreliable to quote.²²
- The number of claims self-reported by selected insurers, which comprise the majority market share in the industry, increased by about 3 percent per year from 1995 to 2001. However, this is below the rate of increase in policies written and is close to the annual growth of the overall economy.²³

¹⁶ Trowbridge Report, March 2002, p. 23.

¹⁷ See footnote 3.

¹⁸ Trowbridge Report, May 2002, p. 58.

¹⁹ Trowbridge Report, March 2002, Figure 3, p. 14.

²⁰ Trowbridge Report, March 2002, p. 13.

²¹ Trowbridge Report, March 2002, p. 13.

²² Trowbridge Report, March 2002, Appendix 3.

²³ September 2002 ACCC report, p. 59.

The evidence that claims costs have been increasing is also not sharp:

- Insurance Services Association (ISA) data suggests claims costs rose on average 12 percent per year from 1990 to 2000, but, for the reasons given in the previous paragraph and because of variations in excess,²⁴ these numbers should be treated with caution. Claims that costs have been rising is obliquely supported by data from the Institute of Actuaries of Australia (IAA).²⁵
- Reasons given by seven of nine insurers in ACCC survey for recent premium rises are consistent with a cost increase, being deteriorating claims experience (four), deteriorating loss ratios (two), and need to meet a profit target (one).²⁶ This data relies on self-assessment from possibly biased sources, and in any case, is not evidence of a longer secular trend.
- The average settlement size of claims for product and public liability, scaled by wage inflation and growth in the economy, has increased on average by 4.8 percent per annum from 1995 to 2001, with the rate of change growing over time.²⁷
- However, scaling gross claims looking at the ratio of claims to policies shows only a 2.63% increase in from 1996 to 2001.²⁸

Finally, it is important to note that insurers themselves can play an important in helping reduce costs. For example, appropriate handling of claims can minimise both the size of claimants' demands and the prospect of expensive legal action.²⁹ Similarly, careful

²⁴ The amount the insured pays prior to being able to make a claim to the insurance company.

²⁵ See footnote 41 and associated text.

²⁶ A survey of a sample of insurers carried out by the ACCC in March 2002 at p. 94.

²⁷ Self-reports by selected insurers surveyed by the ACCC (September 2002 ACCC Report, p. 59). ACCC data only deflated for wage growth. Numbers reported here are also deflated for GDP growth.

²⁸ Australian Plaintiff Lawyers' Association (APLA) submission to the Senate Enquiry, p. 16.

²⁹ The US insurance market is at the cutting edge in these kinds of developments.

management of decisions to settle or pursue litigation and an early focus on cases with the potential to set new precedents can reduce coverage creep. However, there is some evidence that private insurers do not carry out these tasks very effectively.³⁰ Moreover, while there are good private incentives to manage individual claims, these are more muted in the case of litigation management. A badly managed precedent increases the future liability of all insurers, not just those the insurer that failed to take proper action. As a result, too little care in precedent management (from the perspective of insurers) is likely to be undertaken in a competitive market.³¹

The efficiency implications of this are not clear. For example, a similar argument applies *a fortiori* on the buyer's side of the market. People and organisations that might be harmed by the actions of third parties are better off to the extent that they manage precedent-setting when harm occurs. However, the benefit of individual action in this respect is more diversely spread than the case with insurers. It is by no means obvious, whether better management of precedent by insurers or the insured, and most particularly by one of these parties and not the other, would be efficiency enhancing.

3.1.2 Higher payouts and increased litigation cannot *per se* explain current crisis

The evidence thus far presented, to the extent that it demonstrates increases in liability payouts and tort caseloads, cannot by itself account for the current crisis in public liability insurance and indeed for price movements and coverage levels in general. If these cost changes are the underlying cause of premium movements, an explanation needs to be proffered as to why changes in premium movements are considerably different to changes in costs. For example:

- The present crisis has happened relatively suddenly while the claims cost changes outlined are said to have occurred over a twenty year period.³² Indeed, premium movements over more than the last decade do not reflect a steady increase in costs, and actually decreased for significant periods of time.

³⁰ Private discussions with industry participants.

³¹ We are grateful to Helen Silver for making this point to us.

³² Trowbridge report, March 2002, pp. i-ii.

- The various claimed underlying causes of these changes are typically broad, rather than focussed in particular areas.³³ Thus they cannot, by themselves, explain the variation in premiums for particular users (on which see Sections 1 and 2.1).
- Increases in costs alone do not readily explain coverage withdrawals (but see footnote 12).

Some industry participants believe that premium setting on the part of actuaries can change suddenly after enough evidence cumulates as to past errors.³⁴ This explanation does not explain why actuaries could be so wrong for so long (though this may be due informational weaknesses in the industry—see Subsection 3.2). It also does not provide an *ex ante* indicator of why the actuarial gestalt might suddenly shift. Consequently, it is less convincing other explanations offered below, in which triggers for price changes are identified (see Subsections 3.5 and 3.6).

3.1.3 Lowering costs does not *per se* increase efficiency

As seen, there is a weak case that more frequent claims and claim successes and higher payouts have raised claims costs over the years, though it is far from clear that these changes on their own could be the cause of the current insurance crisis. More importantly, it is not clear that cost changes pose a problem for market efficiency. If costs have risen, then, as with any competitive market, so must prices. There is nothing *per se* inefficient about such a process, though it may cause a good deal of social upheaval (which might call for market intervention for reasons outside of economic efficiency).

Changes in the cost of claims are largely caused by forces that lie outside of the insurance market. It is beyond the scope of this paper to examine this in detail. However, it is worth noting that taking actions merely to reduce costs has no efficiency rationale, and indeed would likely create inefficiencies. Claims costs *to insurers* can easily be lowered—for example, by caps on payouts, reductions in the period specified by statutes of limitations, removal of the right to sue for liability in a range of cases, mandatory increases in excesses, etc.—but this does not lower costs in the economy at large. Such changes:

- effect a transfer of the costs of harm from those currently insured to the harmed;

³³ See the list of argued factors of change in Section 3.1.1.

³⁴ The Trowbridge Report [CITE]; private discussions with industry participants.

- reduce both the incentive to insure against claims of harm by third parties and the incentive to avoid harming third parties;
- increase both the incentive for taking insurance against being harmed by a third party and the incentive to avoid situations where one might be harmed by a third party;
- increase one-off transactions costs substantially (regulatory and legal change always require individuals to make costly adjustments as they seek to optimise under the new conditions. In insurance markets, insurance suppliers, and in some instances insurance purchasers, would have to undertake substantial actuarial re-estimation of their positions. Individuals would have to consider potentially significant changes in what kind of accident avoidance procedures they ought to take out, as well as how much insurance coverage they purchase); and
- in general, are more likely to increase than reduce on-going transactions costs (because more individuals need to take out insurance against harm by third parties).
- The net efficiency impact of such changes at best is ambiguous and arguably negative, because of the likely transactions cost increases, and because most of these changes restrict individuals' capacity to contract foreclosing gains from trade, and create or extend an externality (more of the cost of harm to third parties is born by those parties).³⁵

In short, a case remains to be made that any proposed cost transfer (though it reduces insurance costs) increases the efficiency with which risk is managed in the economy.

3.2 Rising costs II: Actuarial difficulties

Provisioning for public liability insurance is more difficult than most other forms of insurance in that its risk distributions:

- are relatively “fat-tailed” (that is, there is a greater prevalence of large but remote risks); and

³⁵ Ergas, H and Soon, J (2002) ‘An economic perspective on proposed amendments to consumer protection laws’, unpublished manuscript explains in greater detail the likely efficiency costs of arbitrary mechanisms for cost reduction in insurance.

- have a relatively higher degree of latency (that is, risks are more often realised long after the initiating incident).³⁶

In the context of the current crisis, fat-tailed risks present a central problem to insurers, that accurate actuarial estimates of the risk are difficult to obtain. To capture information about low probability events, which is important when the pay-outs of such events are very large, requires very large samples. However, the only available data are actual events and these are often insufficient—especially if limited to the data available to an individual company—to estimate the risk distribution. Indeed, this problem may be endemic in that underlying changes in risk distributions may typically occur more quickly than the necessary sample sizes accumulate.³⁷

Exacerbating these difficulties is the possibility that the Australian insurance industry has not done as good a job as it could have in collecting and processing public liability data. While external observers may not always understand the profitability of given actions, the Trowbridge report can fairly be said to have been written by an industry insider, and is worth quoting in this respect:

Overall, it seems fair to conclude that the insurance industry in Australia has done a poor job in collecting and analysing data for public liability.

This begins at the individual policy level, and flows through to the portfolio analysis, where insurers have traditionally:

³⁶ These two traits are also shared by product liability and professional indemnity insurance.

³⁷ Sufficiently fat-tailed risk distributions are further problematic in that they can be uninsurable. If loss levels increase more quickly than their probability, though remote, declines, then no average expected pay-out exists. Even absent any other insurance market difficulties, there would be no premium that was profitable on full coverage. Insurance companies manage this problem through policy limits in liability policies. On infinite moment distributions in insurance, see Berger, L. and J. Cummins 1992, 'Adverse selection and equilibrium in liability insurance markets', *Journal of Risk and Uncertainty* 5: 283-288 and Klugman, S. 1989, 'Measuring uncertainty in increased limits factors: A Bayesian approach', in Proceedings of the 21st ASTIN Colloquium, NY.

- Not sought detailed information on the classification of risk or the quantification of exposure for each policy
- Not coded and stored accurately on computer systems the information they do obtain
- Not analysed and used the information they do have to assist in premium rating (although changes have/are occurring in this regard in recent years)
- Not had a comprehensive industry-wide system to make relevant information available across the industry (noting that many insurers have elected not to join)³⁸

This view is echoed by others. McCarthy estimates that the level of under-provisioning in the insurance industry in 1998 and 1999 was around \$1500 million and argues that one of the causes of under provisioning is poor data and inadequate access to levels of detail.³⁹ One reason existing data availability may be so poor is the existence of a coordination failure. Competition laws prevent firms from directly collaborating in data collection, and in any case, rival firms may have difficulties in cooperating to fund data collection through an independent body. Such cooperation could be stymied by the usual free rider effects, and especially if some firms feel they are ahead of the market in their own data collection processes, even if these are still poor (since cooperation would reduce their advantage). This suggests market intervention to allow improved data collection, especially to the extent that the present situation is caused by a coordination failure, could be justified (see Subsection 4.1).

Recent developments may have compounded this problem raising insurers costs by increasing uncertainty as to the nature of the risk distributions they are dealing with, and by increasing expected payouts, most especially in the tails of these distributions. For example,

³⁸ Trowbridge Report, March 2002, p. 40

³⁹ McCarthy, P. 2001, *Insurance profitability – a brave new world*, Institute of Actuaries of Australia 30th General Insurance Seminar, November. See also the IAA's Senate submission, pp. 14, 17; and APRA, in its Senate submission, p. 2. This has also been confirmed to us in private discussions with industry participants, some of whom were sharply critical of the industry's level of ignorance.

the events of 11 September 2001 and recent natural disasters have likely had this effect. The 1999 Sydney hailstorm was 50 percent greater than Australia's previous largest insurance loss ever, costing \$1,844 million dollars and the Sydney floods of 2001 were the largest in this category ever (costing nearly \$900 million).⁴⁰ It may also be that less dramatic and more gradual increases in both the probability of successful damages actions and the level of payouts (discussed in Subsection 3.1) has raised uncertainty about the probability of high cost payouts as well as the expected value of these, raising insurers' costs.

The Institute of Actuaries believes that while the variability of claims costs may not have increased, the differences between cost expectations when premiums were set and the costs which have actually emerged have increased substantially.⁴¹

There is no evidence that the risk distributions tails of small and diverse organisations have "fattened" more than for other customers. However, for the reasons discussed in Subsections 3.3 and 3.6, even if risks for all customers have risen uniformly, insurance firms' responses may disproportionately impact on smaller outfits. Better information collection and aggregation of small buyers may help in this respect (see Subsections 4.1 and 4.2), as well as stability in tort law (since changes make it even harder to estimate future risks—see Subsection 3.1.3).

The second difficulty, more peculiar to public liability insurance than most other forms of insurance is the latency of realised claims. Public liability contracts are written on a "claims occurring" basis. That is, the insurer is liable for any covered harm that occurs while the contract is in place, even if it is discovered many years hence.⁴² This has important implications for the degree of uncertainty faced by insurers:

- Most obviously, the insurer is liable for harms, unknown at the time of the insurance, which are subsequently discovered. In setting premiums, insurers make provision for

⁴⁰ The 1989 Newcastle earthquake held the earlier record, at a cost of \$1,233 million. All comparisons in this paragraph are for real amounts and dollar estimates are in June 2001 dollars. See September 2002 ACCC report, appendix B.

⁴¹ IAA submission, p. 16.

⁴² Because the statute of limitations begins to run from moment of discovery of harm, not moment of harm.

their best estimate of what the payouts and defence costs for the insured year will be. While many small claims are settled relatively close to the period of insurance, the dollar-weighted average delay to settlement is around five years, and some large claims are settled much later than this.⁴³ As a result, it usually takes three to five years before the cost of a given year's claims can be reasonably estimated;⁴⁴

- Time delay means court proceedings must rely on old evidence, fading memories, etc., which may decrease the likelihood of an adverse judgement, but which increases the uncertainty in outcomes; and
- Perhaps most importantly, the insurer is also liable for harms that, at the time of insurance, were not recognised as involving liability. That is, insurers must take account of potential liability for activities that are not perceived as risks when policies are issued. Thus new legal decisions, made long after the policy was written, may create liability when, at the time of writing the insurance contract, none was envisioned. The magnitude of the impact of such developments on insurers' potential liability is leveraged by retrospective nature of such court decisions.⁴⁵

It may be that legal developments have added to this uncertainty, and hence cost of business in two respects:

1. The courts may have increased their willingness to allow cases where the original injury took place some time in the past. There is some evidence that this may be the case (see Section 3.1). The impact would be to raise the probability of delayed decisions and hence increase insurance costs in the ways outlined.
2. Over time, the courts may have a propensity to randomly vary in their willingness to find liability, with a bias towards broadening liability or reducing the burden of proof.⁴⁶ Each case would increase insurance costs. It has been argued that there has

⁴³ IAA submission, p. 28.

⁴⁴ Trowbridge Report, March 2002, p. 3.

⁴⁵ Discussed in Winter, R. 1991, 'The liability insurance market', *Journal of Economic Perspectives* 5: 115-136 at p.122.

⁴⁶ The evidence for an easing of the burden of proof and an increase in damages was discussed in Subsection 3.1.

been a 'drift' in the definition of negligence towards a stricter duty of care, although this has been denied by other informed commentators⁴⁷ (and despite the recent fall off in successful actions). Insofar as there has been a drift towards a stricter duty of care, the effect would be to increase uncertainty as to potential payouts, as well as on average, increase expected payouts.

There is no reason to believe that legal developments have, for small and diverse organisations, increased liability uncertainty due to latency as compared with other larger organisations.⁴⁸ However, as with fat-tails, even a general increase in latency uncertainty might have a disproportionate impact on small and diverse organisations. Again, better information collection and stability in the existing legal framework for deciding tort liability would reduce uncertainty in this respect.

3.3 Moral hazard by the insured

Moral hazard refers to self-interested actions by a party to a contract which imposes costs on the other contracting parties because the contract is incomplete or in certain respects unenforceable.⁴⁹ In insurance, incomplete contracts are common because all possible actions by the insured cannot be specified in advance. For example, it may be unwise to mop a passageway when the passage is in use, but no insurance contract can be qualified by reference to all such behaviour. Similarly, aspects of insurance contracts are unenforceable because behaviour by the insured party is often unobserved. For example, it is unwise to leave a fire unattended, but whether such behaviour contributed to a liability may never be knowable. Worse, an individual, once insured, has less incentive to avoid risky behaviour that would incur a liability. Thus insurance exacerbates the problem of moral hazard.

Despite these difficulties, insurance is a widely observed phenomenon and there is little reason to believe that moral hazard in general leads to a market failure. Insurance companies

⁴⁷ See the Trowbridge report, March 2002, p. 8, for an allegation of a drift towards strict liability. The Law Council of Australia's submission to the Senate Enquiry into public liability provides an opposing view.

⁴⁸ A possible exception to this is the reported increase in actions against local councils – see section 3.1.1.

⁴⁹ Kotowitz, Y. 1991, 'Moral hazard', *New Palgrave Dictionary of Economics*, Vol 3, 549-551.

specialise, not only in bearing risk, but in gauging, monitoring and managing the same. It is this expertise that enables insurance firms to cope with difficulties such as moral hazard, and indeed helps explain the very existence of insurance firms.⁵⁰

Moreover, it does not seem likely that a shift occurred in recent years that worsened the problem of moral hazard, at least not in a way that can explain recent undesirable developments in the broad public liability insurance market. However, it may be that NFPs and, perhaps to a lesser extent, small businesses and even local councils, are more subject to moral hazard than larger for-profit firms and government bodies. This would raise their relative level of risk, and coupled with capacity constraints in insurance supply, may have led to a greater degree of insurance withdrawal from them than for other customers (this possibility is discussed in Subsection 3.6).

A variety of characteristics of NFPs may directly increase their risk relative to larger organisations, as well as increase it through “less care” in their activities (moral hazard). NFPs are often financially quite marginal concerns, notwithstanding the provision of free or subsidised labour. They may not have the financial resources or economies of scale needed to provide the level of safety and risk management observed in larger for-profit firms and government bodies. Equally, because of the relatively small size of any given NFP’s insurance demand, insurance companies may not be able afford effective monitoring that

⁵⁰ Attachment D of the September 2002 ACCC report provides an explanation of how insurance markets deal with moral hazard.

would reduce moral hazard. NFPs often rely on volunteer or low-paid labour⁵¹ without the necessary training for the broad range of tasks they undertake.⁵² Moreover, volunteers can seek damages for accidents that occur in NFPs' "workplaces".

Small businesses, while technically for-profit concerns, may also face similar constraints. A high percentage of small businesses fail within one year of starting operations, and it is not uncommon for owners to receive lower financial rewards than they could achieve elsewhere, making their labour to some degree voluntary. As in the case of NFPs, sheer scale also likely plays a role.⁵³

Despite this, there are countervailing forces also at work. For example:

- NFPs and their volunteers are typically concerned with increasing public welfare and may well hold themselves to a higher standard than operations motivated primarily by profit; and

⁵¹ "A... distinguishing feature of non-profits is that they involve some degree of voluntary commitment of time. Most non-profits rely entirely on work performed without pay by their members or supporters. Others employ people to provide their services and manage them, but even these use volunteer labour to some degree, even if it is only the time committed by their unpaid governors or directors." <http://www.abs.gov.au/ausstats/abs@.nsf/0/5EBE1496169C5D31CA2569DE002842B6?Open&Highlight=0,non-profit>

The number of volunteers has also risen considerably. The estimated number of volunteers aged 18 years and over in 2000 was 4,395,600, representing 32 percent of the civilian population of the same age. This represents an increase since 1995, when the estimated 3,189,400 volunteers represented 24 percent of the population. See <http://www.philanthropy.org.au/factsheets/7-05-06-volunt.htm>

⁵² These observations should not be viewed as criticism of the thousands of people who volunteer for NFPs bringing great benefits to their communities and Australia as a whole. They are merely recognition of the difficult circumstances such individuals work under.

⁵³ It is also possible that local councils may rely on volunteer labour and face scale constraints, more so than do larger for-profit firms and other government organisations.

- Small businesses are often tightly held and operated, by a small group of related individuals (often with family ties). As a result, liability claims and/or failure of the business may have a more direct impact, both financially and on the reputation of those running the business, than is the case of employees of larger firms.

In summary, there is no reason to believe recent problems in the broad market for public liability insurance were driven by changes in moral hazard and the market's capacity to handle the same. However, a not implausible case can be made that moral hazard is a greater problem among small and diverse organisations, raising their relative risk. As discussed in Subsection 3.6, when the industry faces capacity constraints, riskier insurance policies are more likely to be discontinued.

Various forms of risk management, including broader monitoring processes (perhaps through regional bodies), and perhaps moral suasion through participation with a buyer aggregator would reduce these difficulties (see Subsections 4.1 and 4.2).

3.4 Adverse selection among insured

Adverse selection occurs when bad risks drive out the good, potentially leading to inefficiently low supply, or in some cases, none at all. Adverse selection in insurance occurs when the insured know more about their own risks, which vary across individuals, than the insurer. If an insurance policy is offered at a fee that ensures profitable coverage of the average risk of a particular group, then members of the group whose risk is less than the average may find that the policy is not financial. They prefer self-insurance. The non-participation of some low risk individuals means the average risk of the remaining group rises and, to cover costs, higher premiums are called for. But this may simply mean more low risk individuals drop out. Where there is sufficient diversity of risk within a group and no means of differentiating policies on the basis of such risk, too few and perhaps no insurance policies will be issued.

An important implication of adverse selection is that it places sharp limits on pricing as an equilibrating mechanism. As a result, in contrast to ordinary markets, insurance is like a range of other kinds of capital markets (for example, for loans), which are so dependent on information, that market equilibration takes place through portfolio, as well as price, adjustments.⁵⁴ For example, when industry capacity is insufficient to meet demand,

⁵⁴ See for example, Grossman, S. and J. Stiglitz (1980) 'On the impossibility of informationally efficient markets', *American Economic Review* 70(3): 393-408.

insurance rates typically rise and some lines of insurance are withdrawn. The reason is, price rises scare off good risks leaving behind risks not worth insuring. Instead of solely equilibrating demand by raising price to bring it into line with supply, insurers judiciously select among risks. Thus, an expertise in distinguishing among risks by insurers is central to a well-functioning insurance market.

Severe and sudden shifts in the degree of adverse selection can occur because of increases in expected liabilities.⁵⁵ For example, an expansion in liability, perhaps due to a court decision, at least in the short term, likely increases the degree of information asymmetry between the insured and the insurers. The former can be expected to have a better idea of their degree of exposure than the latter as the latter may have little or no historical record on which to judge what indicates risk. Insurance premiums necessarily must rise to cover the greater risk, but this will lead to adverse selection. The new equilibrium might involve considerably lower levels of total insurance.

This idea has been extended. Standard insurance models assume insured parties differ only in the probability of a loss and not its severity. Adverse selection occurs because insurers know the overall expected value of a loss, but cannot distinguish individual loss probabilities. More realistic models assume that the insured differ in the probability **and** severity of a loss. Again, the insurers can only know the overall expected value of the loss. The result is that, for some risk distributions, changes in the underlying parameters of the model, such as individuals' probabilities of a loss or the severity of losses when they occur, or even the degree of risk aversion, "can lead to radical shifts in equilibrium policy offers."⁵⁶ This suggests the importance of stability in tort law.

At least for the public liability insurance market in the broad, adverse selection seems neither likely to be a cause of present problems, nor if it is, a source of market failure (that is a failure of the market that is so severe that some kind of regulatory intervention is likely to improve outcomes). For example, if the current insurance crisis was due to adverse selection it would be characterised by rising premiums **and** reduced coverage levels. However, rising

⁵⁵ See Winter, R. 1991, 'The liability insurance market', *Journal of Economic Perspectives* 5: 115-136 at pp. 123-124 and 129-130. This argument appears to be due to Priest, G. 1987, 'The current insurance crisis and modern tort law', 96 *Yale Law Journal* 1521.

⁵⁶ Berger and Cummins (1992) 'Adverse Selection and Equilibrium in Liability Insurance Markets', *Journal of Risk and Uncertainty*, 5 (3): 273-288, at p. 274.

premiums appear to have accompanied by increasing coverage. The number of policies written has risen 7 percent per year since 1996.⁵⁷ Table 2 shows a substantial increase in number of policies from 1998 to the present day despite the slight fall in 2001.

Table 2—Public and product liability insurance policies I

Year	1998-1999	1999-2000	2000-2001
Number of policies	1.1 million	2.59 million	2.44 million

Source: APRA statistics quoted in ACCC September 2002 Insurance industry market pricing review at p. 23. Data was only available for the aggregation of public and product liability insurance. See also see p. ix of the September 2002 ACCC report which appears to have data for public liability insurance policies alone, but only from selected insurers surveyed by the ACCC.

Possibly inconsistent earlier data tends to confirm this. It shows that more product and public liability policies were written in 2001 than since at least 1993 (see Table 3).

Table 3—Public and product liability insurance policies II

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001
'000	1227	1188	2234	1689	1860	2347	1963	1029	2545

Source: ACCC March 2002 Insurance industry market pricing review. Data was only available for the aggregation of public and product liability insurance.

Similarly, if an increase in adverse selection had occurred, the new equilibrium would be at lower output levels, hence insurers' required capital reserves would be lower than before.

⁵⁷ ACCC Market Review, p. 56.

But this seems inconsistent with the current influx of capital into the industry⁵⁸ and a 22 percent rise in written premium income for product and public liability insurance in 2001 compared with almost no increase since 1996.⁵⁹

A third empirical test for adverse selection is that profit would unlikely experience a short run increase due to adverse selection and could fall as firms adjust to the new circumstances.⁶⁰ The evidence here is ambiguous. Profit levels of product and public liability insurance have risen over the three years to 2001, though they remain negative. The ACCC forecasts a return to profitability for this line of insurance.⁶¹

However, even if adverse selection has played a role in the current crisis, it is not clear intrusive regulatory intervention could improve market outcomes. A central role of insurance firms is to manage adverse selection (indeed profit can be increased by reducing its prevalence).⁶² A strong case would be required to convincingly argue that some form of government intervention could improve on the expertise and experience of market participants.

3.4.1 Adverse selection and small and diverse organisations

NFPs and small businesses are quite diverse in the degree of risk they carry, even across very similar organisations or the same organisation over time.⁶³ Moreover, the nature and size of

⁵⁸ Indirect evidence of capital influx can be found in the international reinsurance market where US\$25 billion of new capital has re-entered the market since 11 September 2001.

⁵⁹ September 2002 ACCC Report at p. 56.

⁶⁰ A rise in premiums, coverage, and profits, and capital inflow are consistent with an alternative explanation, capacity constraints—see Subsection 3.6. These points are made by RA Winter, 1988, “The liability crisis and the dynamics of competitive insurance markets”, 5: 455 at p. 466.

⁶¹ September 2002 ACCC report, p. xiv.

⁶² Attachment D of the September 2002 ACCC report provides an explanation of how insurance markets deal with adverse selection.

⁶³ Local councils are not covered in this section, as it is less likely that they exhibit the necessary heterogeneity to generate adverse selection difficulties.

NFPs makes it difficult to identify the risks of a particular organisation.⁶⁴ This suggests adverse selection may play a more significant role in deterring supply of public liability insurance to these organisations as compared with others. Further, the little empirical evidence available is somewhat more consistent with a change in adverse selection than the evidence for the market as a whole. However the capacity-constraint explanation developed below in Subsection 3.6 probably fits the data better.

At least two sources of heterogeneity play a role here:

1. NFPs differ from each other because of sharp differences in the volunteer staff or participating members. But it is not easy to monitor the quality of effort of volunteers and staff, or the degree of risk-taking inherent in a local membership.
2. Even within a particular organisation, risks may vary over time. For example, in some NFPs, turnover of volunteers and employees is high. When a particularly skilled and devoted volunteer leaves a local pony club, the risks associated with that club could rise significantly, but this change in risk may be difficult to monitor, in part because the systems for maintaining continuity and reporting systems may be minimal.

Both these sources of diversity are increased for local NFPs and small businesses as these typically have only a handful of volunteers/employees. As a result, a single employee can have a substantial impact on the organisation.

⁶⁴ There is at least anecdotal evidence that non-profits complain about the substantial divergence between their premiums and average claims experience. Admittedly the principle of averaging risk is one which underlies all insurance but the averaging involved in such a diverse sector could be potentially reduced by more refined sorting. See for instance <http://www.nccnsw.org.au/ncc/projects/NCCBulletins/publiclie.html>:

“My concerns are that the claims experiences for small voluntary organisations have not been made public and that these minor risks are being lumped in with other more aggressive pursuits that hold much more serious risk factors. In short the small are being exploited by cross subsidy to cover the claims experience of the high risks.”

On the supply-side, since the insurance premiums paid by a typical NFP or small business are relatively small, only limited investment can be profitably made to distinguish the risks of individual operations.⁶⁵ Consequently, uniform policies must be issued to a broader range of risk groups making adverse selection more likely.

Thus, the high degree of heterogeneity across insurable groups as a whole, and an inability to economically distinguish among them – could result in a more serious degree of adverse selection than would be the case with other forms of insurance. Whether the current crisis in insurance for NFPs and small businesses can be attributed to **changes** in adverse selection is less clear. Unlike the broader market, there is no good data as to overall coverage, profitability and capital inflow. The case is, however, stronger than for public liability insurance in general. Anecdotal evidence suggests that coverage of NFPs and small businesses has fallen while premiums have risen. For example, as of March 2002, underwriting of equestrian sports in Australia ceased.⁶⁶

At face value, evidence of higher prices and falls in coverage is consistent with adverse selection. However, the apparent line of causation does not support adverse selection, but rather the capacity-constraints explanation of Subsection 3.6. Premium rises and coverage withdrawal appear to have been generated by the insurance companies and were not driven by a process of withdrawal from the market by lower risk NFPs, small businesses and local councils. Indeed, these organisations seem keen, subject to budgetary constraints, to remain insured. This is more consistent with capacity constrained insurers cutting off the most marginal ends of their business.

Even if adverse selection is a problem in insurance supply to NFPs and small businesses, it is not at all clear that the present crisis is caused by changes in adverse selection that intrusive government intervention could be directed towards. Indeed, as with the market as a whole, the presumption must be that market participants will likely deal with any new difficulties due to adverse selection far better than regulators. However, better information collection mechanisms to allow refinements of insurance classes, and where this is not possible, means of ensuring broader participation, perhaps through buyer organisations, both are likely to

⁶⁵ 85 to 95 per cent of policyholders can expect their public liability insurance premium to be higher than their cost of claims, September 2002 ACCC report, p. 54.

⁶⁶ Equestrian Federation of Australia, Submission to the Senate Economics Reference Committee on public liability and professional indemnity insurance, p. 1.

reduce adverse selection problems among small and diverse organisations (see Subsections 4.1 and 4.2).

3.5 When competition can press prices below costs

Insurance markets are characterised by cycles in which premiums are underpriced followed by substantial premium rises to recover sufficient reserves.⁶⁷ The Australian public liability insurance market of the last decade bears this out. Evidence in Table 4 suggests there was a period of 'soft' pricing from at least 1997 to 2000 in both public liability and professional indemnity, when premiums were 70 percent or less of what they were in 1993. That is, prices may have fallen below competitive levels, perhaps due to competitive pressure from an HIH not properly constrained by prudential bounds. Only recently have premiums started to rise. As of June-December 2001, average premium levels had at most reached 90 percent of real levels in 1993. This data is also supported by specific policyholders. For instance, premiums prior to 2001 had been maintained at the same levels for a period of approximately six years.⁶⁸

Table 4—Public liability insurance premium levels adjusted for inflation

Commercial classes	1993	1994	1995	1996	1997	1998	1999	2000	2001	June-Dec 2001
Premium (\$)	100	102	97	81	66	61	63	70	80	90

Source: Australian Plaintiff Lawyers' Association submission to Senate Enquiry

⁶⁷ See Stewart, BD 1984, 'Profit cycles in property liability insurance', in JD Long (ed), *Issues in insurance*, Vol 2, Malvern, Pa; Smith, M. 1989, 'Investment returns and yields to holders of insurance', *Journal of Business* 62 (January): 81-98; Cummins, J.D. and F. Outreville 1987, 'Price shocks and capital flows in property-liability insurance', Working paper, University of Penn. Centre for Research on Risk and Insurance.

⁶⁸ ASCPA submission, p. 2.

Price data alone cannot indicate under or over pricing. Ideally, the expected cost of insurance in any given year should be compared with premiums. However, expected cost is unknown. A common statistic that is intended to proxy this is the net loss ratio—claim expenses in the given year/net earned premium.⁶⁹ This is given in Table 5 which suggests a similar cycle.⁷⁰ Current ratios are relatively high by industry and standards leading to forecasts of continued premium increases in the next few years.⁷¹

Table 5—Net loss ratios

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001
Public liability	67	71	67	80	85	101	140	126	125
Total industry	76	76	80	81	81	81	83	83	79

Source: ACCC 2002, Appendix C of March 2002 Insurance industry market pricing review.

A further indication of an earlier period of soft pricing is an APLA estimate that insurers lost around \$0.38 for every dollar of premium collected in the mid-1990s.⁷²

Two suggested explanations of these insurance cycles rely on moral hazard in actions taken by *insurers* (not actions of the insured, as discussed in Subsection 3.3) vis-à-vis the insured

⁶⁹ This is only an accurate proxy in a steady-state as it assumes pay-outs and premiums in this year are a good indicator of future pay-outs. This is likely to be wrong in general, but is most certainly wrong in today's market, which is in a state of flux.

⁷⁰ Net loss ratios began to rise as premium levels fell (see Table 4), though even in the early 1990s prices may have been too low (since realised liabilities reflect risks taken on in the past as well as in the present).

⁷¹ September 2002 ACCC report, p. 31.

⁷² APLA submission to the Senate Enquiry, p. 11.

and a “winner’s curse” in price setting.⁷³ Under these circumstances, some insurance suppliers may price below cost (as explained below). Even if only a small number of firms do so, competitive pressures may force the others to follow to some extent.⁷⁴ Eventually a shake-out will occur, possibly creating a tight market with higher prices.⁷⁵

The moral hazard argument relies on firms having differing tastes for solvency. Firms less concerned with survival may make imprudent price cuts and competitive pressures may force other firms to follow. While the argument is weak, it may well have relevance in Australia. It requires that:

- shareholders face limited liability;
- insurers are subject to imperfect prudential oversight;⁷⁶ and
- consumers are uninformed or unconcerned (perhaps due to risk-insensitive guaranty programs).⁷⁷

Under limited liability and holding the demand of insurance-seekers fixed, the less assets likely to be lost due to bankruptcy, the weaker are an insurer’s incentives to cover risks (and hence to price at profitable levels). As a result, it is argued that firms with lower asset-bases

⁷³ Harrington, S. and P. Danzon (1994), ‘Price cutting in liability insurance markets’, *Journal of Business* 67(4): 511-538. An alternative, but not mutually exclusive, explanation for this cyclical pattern is capacity constraints and imperfect capital markets and is discussed in Subsection 3.6. Other plausible explanations include the possibility that a competitive insurance market cannot be stable (Michael Rothschild and Joseph E. Stiglitz (1976), Equilibrium in competitive insurance markets: An essay on the economics of imperfect equilibrium, *Quarterly Journal of Economics*, 90 (4) November 629-649), so can go through such pricing cycles.

⁷⁴ See Harrington and Danzon (1994), at p. 513.

⁷⁵ Formally, Harrington and Danzon (1994) only consider soft markets. See their discussion at p. 513 and especially footnote 5.

⁷⁶ Not mentioned by Harrington and Danzon (1994).

⁷⁷ See Harrington and Danzon (1994) at pp. 512, 518-520 and 533-535.

will tend to charge lower premiums and this will tend to force other firms to follow suit. The incentive of other firms in the industry to respond to price cutting is heightened to the extent that insurers who fail to lower prices may lose their sunk investments in policyholder-specific intangible capital, notably investments in establishing a book of business (including the cost of attracting and screening new policyholders). Moreover, in circumstances where adverse losses have placed an insurer at risk, it may even increase its expected return by cutting premiums and increasing market share (a form of plunging). This would increase downward pressure on prices.

There are, however, potential countervailing pressures. Below cost prices may be prevented by either effective prudential oversight or by market forces, since informed consumers will avoid companies that are unlikely to be able to meet their obligations. Consequently, market forces could only result in imprudent pricing if prudential regulation is imperfect (which some believe to have been the case),⁷⁸ and either:

- sufficient consumers are ignorant of the risks of different insurers;⁷⁹ or
- consumers are unconcerned about potential bankruptcies, perhaps because regulated insurance guarantees (implicit or actual) apply to insurers regardless of the degree of risk which they carry.

The winner's curse argument for the possibility of imprudent price cuts is also weak. The winner's curse is said to arise when bidders, in this case insurance firms, have different information. Thus in setting premiums, a firm that has information that suggests expected losses would be misleadingly low, could underbid in setting its premiums and, as a result,

⁷⁸ See, for example, <http://www.hihroyalcom.gov.au/Documents/Submissions/Dean-Clarke-Wolnizer.pdf>.

⁷⁹ Ignorance or unconcern on the part of even some substantial group of insurance purchasers need not result in a dramatic reduction in availability or increased prices. While it is reasonable to assume that the many actual and potential insurance purchasers are not fully informed about the riskiness of different insurance firms, some consumers are. The presence of informed customers, as is likely to be true of larger customers, can ensure appropriate risk management on the part of the bulk of insurers, since profitable supply may not be possible without being able to attract some of these customers.

win a large share of the market at an unprofitable price. Further, if this happens, other firms may feel competitive pressure to lower their own premiums.

This, however, overstates the case. Rational firms avoid the winner's curse by setting their bids conditional on being the winner. Thus their bid is discounted to allow for the possibility that they happen to have information that is most biased toward optimism.

Of course, such rational behaviour implies a great deal of sophistication on the part of participants. It may be that some firms are not fully aware of the possibility of the winner's curse, or, more likely, do not have the wherewithal to appropriately discount for it. If the result of the winner's curse is that even a small number of firms underestimate the necessary premiums, it may be that competitive pressures lead other firms to follow until the market shakes-out.

Whether this occurs is doubtful on the basis of *a priori* reasoning. Insurance companies are highly sophisticated and well-versed in the laws of probability and the management of risk, and it would seem unlikely that some would fall victim to the winner's curse, and that others would follow those down in setting prices.

In contrast to the moral hazard hypothesis, as a high degree of sophistication is required to identify optimal price setting in the face of the winner's curse, it is not clear that either prudential oversight or buyer "smarts" could prevent this problem.

3.5.1 Is price pressed below cost due to these causes?

Both the moral hazard and the winner's curse hypotheses predict that certain firms will charge prices low relative to costs and grow more rapidly than other firms. According to Harrington and Danzon, this implies that premium growth will be positively related to forecast revisions (which measures the extent to which an insurer subsequently updates its forecasts of losses for accidents in a particular year). The winner's curse argument also predicts that forecast revisions will be positively related to measures of poor information such as inexperience.

Cross-sectional analysis of US insurer loss forecast revisions⁸⁰ and premium growth is consistent with the moral hazard hypothesis, but not the winners' curse hypothesis.⁸¹ It

⁸⁰ As defined in the previous paragraph.

⁸¹ Harrington and Danzon (1994).

found, among other things, a positive and significant relationship between premium growth and forecast provisions, but did not find any significant relationship between measure of experience and forecast revisions or premium growth. The analysis also found that premium growth and forecast revisions were positively and significantly related to the amount of liability ceded to reinsurers. Harrington and Danzon argue that this suggests that reinsurance was used to conceal lower prices, or more pertinently, used to sustain some degree of underpricing, but it may be rather that reinsurers were unwilling to take on risks at unprofitable rates.

The degree to which either the moral hazard or the winner's curse hypotheses apply in Australia is difficult to assess. The connection with reinsurance is relevant in the current context as a 'drying up' of reinsurance markets following various catastrophes and business failures in 2001 preceded the liability insurance crisis in Australia.⁸² The failure of HIH Insurance⁸³ and the premium and net loss ratio data discussed above also suggests a problem of this sort may have occurred.

In summary, it is possible that below cost pricing pressures, due to either the moral hazard or the winner's curse problem, have played a role in the current Australian insurance crisis. This raises the question as to whether or not the observed market outcomes are ideal.

3.5.2 Market efficiency and below cost prices

Below cost prices are not *per se* inefficient. Prices can be efficient and lie below costs in a range of circumstances, for example, when:

- technology changes some firms may never recover costs previously sunk, being forced to price at current rather than past costs;
- the market is contracting and incumbents have sunk costs, competition to be among the survivors may drive prices below cost-recovering levels;

⁸² See also the September 2002 ACCC report, Appendix B.

⁸³ In June 1998, HIH market share of the product and public liability insurance markets was quite large reaching 24.2 percent falling to 21.4 percent in the following year, and to 14.6 percent by June 2000. This must have in part reflected competitive rates on its part. On HIH see also the September 2002 ACCC report, Appendix C.

- the growing market's long run equilibrium is expected to only allow a few players, each of whom will earn monopoly rents, then again competition to be the survivor may press price below costs; and
- when capacity is sunk and lumpy (there are large economies of scale of installation) and demand is expected to grow, efficient investments require short run oversupply which the market grows into. Price falls when the investment is initially made, so short run returns, if maintained, would not cover costs, but price then rises as capacity is taken up eventually earning short run extra-normal returns.

However, none of these cases seem to characterise the insurance market. As a result, sharp premium *cycles*, especially when involving bankruptcies, suggest less than ideal market performance and raise the question of whether regulation might improve the situation. Yet, it seems unrealistic to expect market intervention to be able to prevent cycles driven by the described moral hazard or winner's curse, most especially if highly sophisticated insurers are unable to avoid these cycles. However, better prudential oversight and public reporting on firm positions might reduce the degree to which the probability of bankruptcies become large. Oversight restrains the market directly, by ensuring firms remain financially sound and reporting indirectly, by allowing consumers to be better informed in their choice of firms (thus encouraging firms to be fiscally responsible). Credible limits on insurance guarantees in the event of a bankruptcy would provide further incentives for consumers to treat their choice of insurance supplier with care, again placing pressure on firms to be responsible.

3.6 Capital market imperfections and insurance

There is an additional peculiarity in insurance supply which is relevant to public liability insurance. An unanticipated loss or increase in expected losses in insurance instantaneously **destroys industry capacity**, and this, coupled with capital market imperfections that prevent rapid renewal of capital from equity markets (explained below), means increased liabilities can immediately constrain present and future supply.⁸⁴ The result is increased prices and profits while the market adjusts. While this is true of insurance markets in general, because of the ease of shifting internal funds between different insurance markets, in times of

⁸⁴ Winter, R. 1991, 'The liability insurance market', *Journal of Economic Perspectives* 5: 115-136

constrained capacity those products most vulnerable to changes in overall risk are likely to suffer the most.⁸⁵ Public liability insurance may be such a product.

There is at least one source of capital market imperfections that constrains the ability of firms to raise equity: agency costs, most particularly because firm insiders know more about the likelihood of future profits than do potential new suppliers of equity (creating a form of adverse selection among firms seeking equity), and because managers do not always act in the interest of shareholders (leading equity holders to seek additional compensation in return for their funds). As a result, the cost of internal equity to insurers is lower than the cost of raising equity.⁸⁶

This has important consequences for the insurance industry. Capacity in the insurance industry almost exclusively consists of financial capital. At any point in time, existing capacity in the industry is at least temporarily capped since supplying firms ultimately have limited liability and, for the reasons just given, raising additional capital on equity markets is expensive. When:

- unexpected pay-outs are made (for example, due to a very large natural disaster), or
- expected future pay-outs rise (for example, a systemic change in liability, such as a development in tort law),
- investment assets, being insurers' hedge against future liability, fall in value (for example, due to a stock market slump), or
- a major insurer goes bankrupt, then

existing capital (relative to policies written) decreases. As such changes can take place very rapidly, they can overnight sharply reduce the capacity of the industry to insure.

If capital markets were perfect, this would not be a concern. Prices would adjust, including the cost of capital to insurance companies, and sufficient equity would be forthcoming to supply the demand for insurance. But if capital markets are not perfect then sudden large

⁸⁵ Winter, 1991, p. 130.

⁸⁶ Double-taxation of corporate profits has a similar effect. These points are made in Winter, 1991, at pp. 116 and 126-127, and Winter, 1988, at pp. 471-472.

losses—for example, the 1999 Sydney hailstorm,⁸⁷ the bankruptcy of HIH Insurance,⁸⁸ the unprecedented increase in expected losses resulting from the events on 11 September 2001⁸⁹ and the fall in world stock markets—can quickly disrupt *on-going* supply. Since raising capital in equity markets is expensive in comparison to raising it internally, insurers do not seek to fully or even substantially recover their capacity by resort to equity. Instead, they adjust their risk exposure downward to bring it into line with their lowered capital base. This is achieved by cutting their portfolios, through raising prices (so reducing demand) and by refusing to cover some risks. As with most industries, in capacity-constrained times, profits rise and internal financial capital can be built-up, but the process is not quick.

One of the implications of a sudden capacity constraint is that some insurance will not be issued. Insurance is issued over many lines, but in general it will not be profit-maximising to cut all lines back proportionately to the overall reduction in a firm's capacity. Rather some lines may require substantial cuts to make premium compensated risks profitable, while in others little change may be required. For example:

- If a degree of rationing of insurance products is required and a greater proportion of public liability policies are viewed as being marginal in comparison to other product lines—as well might be the case—public liability rationing would exceed that of other lines of insurance.
- Public liability insurance is likely more vulnerable to changes in common risk, such as tort law developments, than many other forms of insurance. To the degree that this level of risk rose relative to the risk levels of other forms of insurance (and hence, holding other things constant, would have been a factor in reducing the net worth of insurance companies contributing to the need for rationing), public liability insurance would suffer greater cutbacks than other lines of insurance.

⁸⁷ See section 3.2.

⁸⁸ Had HIH been included in 2001 statistics, the insurance industry would have reported losses in excess of \$4 billion (September 2002 ACCC report, p. 9).

⁸⁹ While Australian insurers had little direct exposure to this event, it likely would have increased their need for capital reserves.

- Insurance lines which carry greater uncertainty, even where the level of uncertainty of each line remains unchanged, will suffer more when capacity is constrained as insurers will prefer to use their limited capacity in safer lines.⁹⁰ Public liability insurance is a relatively risky line of insurance.⁹¹

Such reasoning applies *a fortiori* to NFPs and small businesses, and perhaps local councils. As discussed in Sections 3.2, 3.4, and most especially 3.3, these organisations are more marginal to the insurance industry than other larger customers. They are likely difficult to deal with, especially in terms of risk management, bringing a high degree of risk poor and hence poor returns for the required effort. In times of sharp capacity constraints, these customers may be among the first the insurance companies raise prices on or withdraw coverage from.

In conclusion, while the conclusion cannot be drawn that the current crisis is solely due to significant reductions in industry capacity, it is likely that this has played an important role. To the extent that this is true, it is unlikely that any form of regulatory intervention will outperform the market's own adjustment process. However, there may be scope, at least for social purposes, to provide some degree of help to specific institutions which cannot afford or are not offered insurance in the interim (see the discussion of subsidies in Subsection 4.4). In addition, policies designed to ameliorate risk, moral hazard and adverse selection among small and diverse organisations, will decrease their marginal nature and improve coverage and premiums in times of crisis and in general (Subsections 4.1 and 4.2).

4 Policy proposals: A critical view

A number of solutions have been proposed by various parties for the current liability crisis. The purpose of this section is to canvass the merits and demerits of the various proposals, none of which are necessarily mutually exclusive. The question is ultimately one of implementing the right regulatory toolkit to address the possible market failure in public liability.

Four broad categories of reform are considered in some detail: improved risk management and information collection (Subsection 4.1); aggregation of buyers (Subsection 4.2); aggregation of sellers (Subsection 4.3); and direct regulation and subsidies (Subsection 4.4).

⁹⁰ Winter, 1988, at pp. 486-487.

⁹¹ Winter, 1988, at p. 487; Winter, 1991 at 130-131. See section 3.2 for an explanation of why.

Policy focused on transferring claims costs is not discussed, being, as indicated in Subsection 3.1.3, beyond the scope of this paper (though the healthy scepticism of Section 3 about the costs of claims changes, the degree to which these are the cause of current problems, and most importantly, whether policy aimed at reducing claims cost is likely to enhance efficiency, should not be forgotten).

4.1 Risk management and information collection

Cost-effective insurability of small and diverse organisations would likely be significantly improved by developments in risk management, including:

- risk management guidelines, training and/or professional standards;⁹²
- safety inspectors and other forms of monitoring, including more effective means of collecting, processing and acting on complaints;
- discipline procedures, and
- making available resources to help parties reduce risk (for instance, the Victorian government's ourcommunity.com website and the NSW Department of Sport and Recreation's "It's Your Business" program for sport and recreation boards and committees).⁹³

Such developments might be managed by, as appropriate to an area of activity, peak association and industry bodies, national, and local government and other organisations.

The ability to efficiently supply insurance, particularly in the case of small and diverse organisations, could also be improved by measures that make insurers better informed.⁹⁴

⁹² Professional standards, directly relevant to professional indemnity insurance (on this see Freehills submission to Senate Enquiry, pp. 4-5), are also relevant to public liability insurance. For example, outdoor adventure and recreation NFPs and businesses could be required to employ staff with appropriate credentials.

⁹³ For views along these lines, see the Insurance Council of Australia submission to the Senate Enquiry, p. 15; the Trowbridge Report, March 2002, p. 46; and especially the Trowbridge Report, May 2002, pp. 35 ff.

⁹⁴ Evidence of current information paucity is provided in Subsection 3.2.

Standardised industry-wide information collection, even if to some extent supplied by the insured parties, could reduce, where these might be problems, difficulties in measuring the tails of risk distributions, moral hazard and adverse selection.

Developing information sources, especially as imposed by government mandate, potentially creates an efficiency issue in terms of future investment by insurance firms in information collection. Insurers typically invest to collect and manage sufficient data for client management and premium-setting. Information collection and pooling undermines the incentive to engage in this activity (and has the once-off effect of subsidising entrants while reducing the value of past investments in these kinds of activities, harming those who such investments). However, to the extent that such data collection and pooling overcomes what otherwise might be considered a coordination failure in the market place, the net effect of the proposal may be positive, as is suggested by the paucity of existing data. In any case, the availability of such pooled data is only a very limited substitute for the collection and management of information on specific client's risks, as well as the management of those clients, and is not likely to harm competition in these areas.

4.2 Aggregating buyers

Aggregating insurance buyers would have several important effects:

- It is likely a good complement to the risk management developments and information collection suggested in the previous section. For example, a buyers' aggregator would be well-placed to negotiate with its members performing an important role in: monitoring (ideally including through an independent body) the behaviour of its members; coordinating risk management guidelines and training; making available general resources on risk management; and complaint coordination and other information collection.
- It should reduce the transactions costs of insuring small and diverse organisations (since insurers can deal with the aggregating body rather than each individual member);
- It should reduce the actuarial difficulties in dealing with fat-tailed risks (because of the larger data set, broader coverage levels and a gain of economies of scale), and to a lesser extent, latency (for similar reasons);
- It may well reduce the degree of moral hazard among the insured beyond the impact of risk management measures on their own, due to the effect of moral suasion (peer pressure among the individual members of the to take adequate care); and

- It will, to the extent that broad coverage can be enforced through the aggregator, reduce the degree of adverse selection for the aggregated group of insurance seekers.

Buyers' aggregators for small and diverse organisations are also unlikely to have significant anti-competitive effects for two reasons. First, it is unlikely that any such buyer aggregator would have market power. Insurance demand by the collection of Australian pony or kayaking clubs is still a tiny fraction of the total market, and even the aggregation of milk bar owners is unlikely to have market power.⁹⁵ Second, in the case of NFPs, even if aggregation result in market power, the organisations in question are more likely to press for efficient rather than profit-maximising levels of output. NFPs are not profit but output maximisers (subject to marginal cost being less than the increment in perceived benefit as constrained by the NFP's budgetary constraints).⁹⁶ Output levels would approximate those forced on profit-maximisers by competition, and would be, in general, efficient.⁹⁷

As there likely is a positive relationship between NFPs' output and insurance coverage, an aggregate insurance purchaser would seek a greater level of insurance than a profit-maximising monopsonist (which would restrict the price of and hence amount supplied and purchased of the input). Moreover, where there was countervailing market power in insurance supply, the aggregator would use its own power to press price and output to efficient levels.⁹⁸ Though no determinate outcome can be predicted in such a bilateral bargaining situation, efficiency again is likely to be enhanced compared with the absence of aggregation.

⁹⁵ Local councils gain insurance through state-wide mutual organisations, and there is no sense that this grants them market power.

⁹⁶ In some cases, a NFP may so strongly believe in its output that it is willing to subsidise its provision. However, so long as the NFP is rational, this does not lead to inefficiently high levels of supply. The subsidisation occurs because of the value the NFP places on its output. That is, the NFP has its own demand for the product. Accounting for this, overall demand covers cost.

⁹⁷ Subject to the presence of any causes of market failure, for example, externalities.

⁹⁸ This is in contrast to a profit-maximising monopsonist, which prefers output and prices below efficient levels.

It is also possible that transaction costs may be reduced by the aggregation of buyers at a different level—where multiple coverage is take out for similar risks. For example, events held in a publicly-owned facility can be insured by:

- the facility owner (for example, the local council);
- the event organiser (for example, a charity); and
- individual stallholders.

In these circumstances, it may be possible for the facility owner to extend their existing policy to cover the event organiser and stallholders. A single policy extended in this manner may be cheaper than all parties arranging their public liability insurance separately.⁹⁹

Examples of recent buyer pooling arrangements include:

- The New South Wales Meals on Wheels set up a Community Sector Insurance Program which provides member organisations with a pool public liability insurance scheme as well as risk management assistance. Small claims are handled by the Meals on Wheels office while large claims go through the brokers;
- AgFest in Tasmania has joined with other groups that organise agriculture shows to get reduced rates for a pooled public liability insurance scheme via AON Insurance Brokers. Whereas in 2001 AgFest had to pay \$14,000, as a result of this arrangement it had to pay only \$3,000 this year; and
- The Municipal Association of Victoria has recently announced the establishment of a pooled scheme for community groups in Victoria and Tasmania. The scheme is to cover most community events, celebrations and festivals.¹⁰⁰

However, such approaches are not always successful. For instance, group purchasing by the Equestrian Federation as well as rules and regulations that provided a risk management

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http://www.nt.gov.au/dbird/DBIRD_Publications/Public%20Liability/PL_ExecSummary.htm

¹⁰⁰

APLA submission to Senate Enquiry, pp. 21 ff.

framework reported did not result in coverage.¹⁰¹ Further, to the extent different states enforce different standards, national aggregation may be stymied. For instance, presently, Pony Clubs are subject to different national standards of safety and monitoring from private riding schools, so pooling of insurance over these different clubs might well make things worse.¹⁰² This leads to a further recommendation of increased uniformity across different levels of government.

4.3 Aggregating sellers

Aggregating buyers does not guarantee coverage¹⁰³ or coverage at 'reasonable' prices. Competitive supply of insurance may still lead to high prices (reflecting costs) and coverage gaps, most especially when the industry is capacity constrained. The aggregation of sellers has been proposed as a means of obtaining universal service at reasonable prices. The idea seems to be that a degree of market power would be granted in return for a commitment to broad service coverage (similar to past universal service obligation commitments in telecommunications).

Supplier aggregation, like buyer aggregation, would also allow better collection and coordination of data. Such data collection might be superior to that allowed by buyers' organisations, because it would be based on a wider range of customers, rather than a particular customer type. But it might also be less specific than data provided by a buyers' aggregator. In any case, joint supply is not necessary to joint collection of industry data, which could be conducted by APRA or an industry body.

Supplier aggregation could also lead to better incentives to manage precedent setting reducing insurers' costs, but not necessarily increasing economic efficiency (see the end of Subsection 3.1.1).

This idea, however, has some serious drawbacks:

- Presumably even a seller collective could not insure all risks. But if the sellers can reject applicants, there is some risk that monopoly prices and levels of output will

¹⁰¹ Equestrian Federation submission to Senate Enquiry, pp. 1-2.

¹⁰² The Equestrian Federation submission to the Senate Enquiry, p. 2.

¹⁰³ The Equestrian Federation submission to the Senate Enquiry, p. 2.

emerge. In short, some process independent of sellers would be required for determining who gets covered or not. So long as actual coverage levels were reasonably broad and government subsidies were not supplied (discussed in next dot point), then the efficiency losses of the cartel would be limited. Demand for public liability insurance by small and diverse organisations is likely to be highly responsive to price over most of its range,¹⁰⁴ so if coverage levels are kept reasonably high, then the sellers' cartel high mark-ups will be impossible. However, in these circumstances a buyers' aggregator would deliver the same benefits with much lower risks of efficiency losses.

- It is not clear how universal coverage would be achieved if costs implied premiums that were outside of the price range of many potential insurers. One solution discussed in the next section would be to apply government subsidies, but this would be particularly unwise when supply was effectively cartelised. Without competition in bids, regulators would have to try and estimate the correct premiums for the subsidised buyers. But they would be far less informed on this matter than the insurance companies they would be dealing with. Moreover, it would be very important to credibly commit to a sunset clause, otherwise such subsidies are very likely to become irremovable, having both support from politically credible NFPs and the very powerful insurance industry. Indeed, it is likely that over time that political pressure would lead to increased levels of subsidisation.

In summary, the aggregation of sellers possibly has some benefits if broad levels of coverage can be ensured without government subsidies, though aggregation on the buyers' side would largely serve the same purposes with less risk. Similarly, benefits in informational collection could be achieved through other means with less anti-competitive threat. Better management of precedent would likely lower insurer costs, but may well reduce efficiency. Additionally, if reasonable levels of coverage require government subsidies, cartelisation of insurance supply should be avoided.

¹⁰⁴ For example, 70 percent of all Australian Horse Riding Centre (AHRC) members in Victoria and NSW did not renew their insurance policies after an 800 percent hike. Insurance was clearly highly valued absent budget constraints: half of these organisations preferred to close down than operate without insurance. See <http://www.horsecouncil.org.au/Letter%20from%20Sarita%20Stratton%2027.2.02.htm>.

4.4 Direct regulation and subsidies

Direct regulation of price and/or terms and conditions of insurance contracts is unlikely to be efficient. Such interventions in any market, absent strong evidence of externalities or egregious use of market power, are considerably more likely to reduce than enhance efficiency. Not only is there little evidence for either of these kind of failings in the insurance market, but the complexity of the insurance market increases the propensity for regulatory error. For example, the insurance premium cycle might lead one to conclude current prices are excessive on the basis of recent historical ratios between premiums and costs (even allowing for the possibility of sharp cost increases). As a result, price caps might be viewed as a reasonable means of reducing premium volatility. However, in the present crisis, price is likely serving two roles: matching supply with demand (to the extent that this occurs in insurance markets¹⁰⁵) and increasing industry capacity (necessary after the losses outlined in Subsection 3.6). As a result, constraining prices may not only interfere with price as a market-clearing mechanism—the traditional objection by economists to such regulation—but also will hamper the industry’s effort to rebuild capacity. This would only increase the amount of coverage withdrawal insurers would need to undertake, and lengthen the period over which such withdrawals would be a notable part of the industry (the alternative, of forcing coverage would threaten the viability of the industry).

In contrast, the limited use of subsidies with sunset provisions may be of some value in meeting the needs of NFPs (but less clearly small businesses as subsidy of profit-maximising enterprises is likely more inefficient and perhaps more likely to result in abuse). Such subsidies should be targeted at operations that are threatened by premium increases, but which are considered of greater social value than the necessary subsidy. As the difficulty being addressed is the effects of a premium cycle, any subsidies should only reduce premiums at the margin and automatically terminate within two or three year period. This will minimise abuse by NFPs in purchasing too much insurance, and for abuse by insurers in seeking to hold prices up once premium levels in general return to more normal levels.

5 Conclusion

Australia is currently facing a range of difficulties in insurance supply, most notably in areas like public and product liability insurance and professional indemnity insurance. The crisis

¹⁰⁵ See Section 3.4.

in public liability insurance is similarly unevenly distributed, and has hit small and diverse organisations particularly hard. Price cycles, arguably in part due to irrationality on the part of insurers, and more certainly due to waves of destruction of industry capital, have played central roles in these developments. Yet despite the undesirability of such price volatility, the recommendations of this paper are relatively muted. At the broadest, stability in the administration of tort law is advocated, and reform merely to reduce costs to insurers (rather than the economy as a whole) discouraged. Strengthened and transparent prudential oversight is also suggested. Focussing more narrowly, risk management and information collection, the use of buyer aggregators and, to a limited extent, subsidies to worthy NFPs, are proposed as means of helping NFPs, small businesses and local councils.

All these recommendations remain modest and do not fundamentally address the issue of premium cycles. While such cycles are not ideal, it is highly unlikely that any form of market intervention could efficiently improve on these market outcomes. In any case, the relative poverty of the empirical record, and the high cost of instability in this industry, makes for a strong case against sweeping policy recommendations.