DWP Department for Work and Pensions

Review of Employers' Liability Compulsory Insurance

First Stage Report

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Ministerial Foreword

Our Agenda for Action

1. The Government is well aware that over the past year many businesses have been hit hard by significant price increases in the Employers' Liability (EL) insurance market and we are committed to playing our part in helping business in this area. There are, however, no quick or easy solutions to these difficulties and this interim report sets out the key findings of the review on the case for the reform of the Employers' Liability Insurance system and the steps we are now planning to take.

   Over the past months we have worked closely with Trade Associations and the Insurance Industry to improve the outlook for responsible businesses in a difficult insurance market and a number of initiatives are already being developed to assist business. These include.:

   - Trade Associations negotiating insurance packages for their members at discounted rates, sometimes based on health and safety accreditation schemes
   - Trade Associations and Brokers' Associations providing access to specialist brokers
   - The development, with insurers, of self-assessment packages to enable companies to provide insurers with better and more pertinent information about risk management policies

2. The Government will assist in supporting and further developing these initiatives. In particular, Government will be working with stakeholders to help develop the basis for more **risk-related premiums**. A key element will be joining-up the risk assessments of insurers and the Health and Safety Executive (HSE) to help provide a common basis for advice to business on risk profiling.

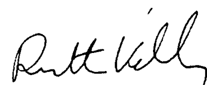
3. Government is also committed to working with stakeholders to address the long-term issues. The report identifies four significant areas for further action:
   - Government will engage with business, industry and other stakeholders to further evaluate the evidence for separating **long-term occupational disease** risks from accident risks - more evidence would be needed to assess whether a radical separation is justified.
   - Government will work with stakeholders to maximise the benefits for EL of current initiatives within the **legal system**. In parallel, Government will discuss with stakeholders the options for alternative dispute resolution arrangements.

- Government is committed to make **rehabilitation** play a more central role in the UK workers' compensation system, to improve outcomes for employees and to let compensation reflect this.
- Government will reform the arrangements for **enforcement** of EL, to tackle the unfairness of 'cowboy' competition and better protect employees.

4. This interim report is an agenda for action. We will move swiftly, in discussion with stakeholders, to develop a programme for tackling the long-term issues identified in this report. There is more to be done for example in areas such as rehabilitation, the cost of resolving claims and long-term occupational disease. There also remains further information on the operation of the insurance market, and its impact on the wider business community to be gathered. Our considerations will be informed by the findings of the Office of Fair Trading's fact-finding study on the liability insurance market. The particular issue of competition in the liability insurance market is a matter for the Office of Fair Trading. But given the ongoing concerns of the business community about the costs of employers' liability insurance, the Government will closely monitor developments in the market, looking at any new information about the workings of the market for employers' liability insurance that becomes available. And we will report in Autumn on the progress that has been made and any further steps we intend to take.

5. And we want to restate the Government's commitment, through the work of the Health and Safety Commission (HSC) and Executive, to work with business and the insurance industry to cut the number of health and safety incidents. The best and most sustainable way to tackle the cost of Employer's Liability insurance.

THE RT HON NICK BROWN MP
MINISTER FOR WORK
DEPARTMENT FOR WORK AND PENSIONS



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Section 1. Executive Summary

What is Employers' Liability Insurance (EL)?

Employers' liability (EL) insurance insures employers against the costs of compensation for those who are injured or made ill at work through the fault of their employer. It provides greater security to firms against costs which could otherwise result in financial difficulty and to employees that resources will be available for compensation even where firms have become insolvent. It supports the right of employees injured through their employer's negligence to be fairly compensated - the principle of 'access to justice'; and the responsibility of employers to fund the costs of their negligence - the principle of 'polluter pays'. It is compulsory for employers to have EL insurance.

Market Adjustment and Business Impacts

There has not been a general failure of the EL market. Having held prices low up to 1999, premiums started to increase after 2000 rising significantly during 2002. This step-change in prices was particularly acute in some sectors. The impact of these increases was made worse by the speed of transition to the new premium levels and a lack of forewarning from the industry. Many businesses, particularly the smaller ones, have faced real difficulties as a result of these adjustments in the market.

For many years, the average cost of Employer's Liability (EL) Insurance in the UK has been relatively low as a proportion of a firm's payroll - in 2001 the average cost of EL insurance was only 0.25% of total payroll costs though in some sectors this has been consistently higher. Insofar as comparisons are possible, this compares favourably with the cost of workers compensation schemes overseas. However, having held premiums at a very low (and perhaps unsustainable) level for several years, insurers started to change their pricing policies around 2000.

In 2002, there was a step-change in the scale of these premium increases and premiums for insurance rose substantially for many businesses. The estimated average increase was around 40%, but for smaller firms and in some sectors perceived by insurers as high risk (eg. hot roofing) the rises were often greater. For example, the National Federation of Roofing Contractors (NFRC) estimated the average premium increase for its members during 2001/2002 at 161%.

These premium increases have had a range of adverse impacts on business. Such increases flow through directly into costs, which many businesses have difficulty passing on to customers; hence they have impacted on firms' profitability. Those sectors experiencing the most acute increases have had further problems. These have included the discontinuance of some areas of activity deemed by their insurers to be too high risk, and cutbacks in the number of staff. Sharply higher premiums arriving with little notice are likely to have contributed to some companies ceasing to trade altogether.

Businesses were caught off-guard by the speed and extent of the 2002 premium increases. Communication to business from insurers and, sometimes, brokers was poor, resulting in little warning for employers of the premium increases to come. Variable service standards within the insurance industry meant that renewal notices frequently arrived close to renewal date, leaving many businesses with little time to negotiate premiums, respond to the new price levels or to seek other sources of EL insurance.

Although there have been problems with obtaining EL insurance because of the short notice of renewals, availability of EL does not otherwise appear to have been the major problem. There appears to be sufficient capital in the market and it is hard to find definite examples of companies which have been refused cover entirely. The available evidence suggests that the overwhelming majority of firms can find EL cover, albeit at a price. It also suggests that levels of compliance remains high - a recent Small Business Service survey places compliance levels at 93%.

The broad analysis appears to be true across the UK though patterns of affordability have differed from area to area. Concerns about affordability have been raised by businesses in Scotland, Wales and Northern Ireland with some businesses in Northern Ireland reporting difficulties in the process of finding cover. These concerns may have reflected the differing structures of the economies in terms of sectors and sizes of firm. However, in all cases there appears to have been sufficient capital to meet total market needs.

Causes of Market Adjustment

Recent premium increases have to a significant extent been driven by a cyclical change in the insurance market magnified by external factors, including a significant fall in investment income and increased re-insurance costs following the World Trade Centre attack. Steady increases in legal costs over time have been a further sustained pressure. It is less clear what impact uncertainty over long-tail risks has had on recent premium increases.

Understanding the source of increased costs of EL insurance rests on understanding the factors driving the its market. Stakeholders' feedback and market analysis point to four significant causes of recent premium rises: the underwriting cycle; external impacts on the insurance market; legal costs; and uncertainty over long-tail risks. Although the impacts of these factors are hard to quantify, their overall effects are clearer.

The underwriting cycle

The insurance market moves in cycles as capital flows in and out. Recent years have seen it enter a 'hard phase' with price increases, which have been particularly significant in all classes of liability insurance.

During the earlier 'soft phase' of the cycle, insurers were setting premiums at a level which resulted in an underwriting loss (i.e. cost of claims outstripped premium income). During 1999 the overall loss ratio on EL insurance was reported to be 154%. Insurers were able to write EL insurance at an underwriting loss for two reasons. First, low cost EL insurance was often sold as part of a package of insurance - what insurers lost on the EL insurance, they gained on other classes. Second, by investing premium income in the stock market, they were able to offset underwriting losses with investment gains.

External impacts

The position changed significantly prior to 2002. Having provided record and sustained levels of investment returns, the stock market went into reverse. This removed much of insurers' margin for absorbing underwriting losses and reduced insurers' capital. Insurers have also argued that the insolvency of Independent Insurance has been an additional factor in causing insurers to examine their underwriting positions on EL business.

In addition the impact of the attacks on the World Trade Centre in 2001 has led to significant increases in reinsurance costs, which flow through to the cost of direct insurance premiums.

Cost of Resolving Claims

A sustained pressure has been the progressive rise in the costs of resolving claims. Claims under the EL system depend on the establishment of negligence and are progressed through the court and pre-court processes that apply to tort. So these costs flow through directly to cost of claims and hence on to premiums. Greenstreet Berman estimated that claimants costs (legal costs and medical assessment) have risen by 50% since 1997. Significantly, the biggest annual cost increases have been in the last three years, just when other pressures on the market were most acute.

The available evidence on the effect of the removal of legal aid and the introduction of recoverable Conditional Fee Agreement (CFA) success fees, and after the event insurance on costs, is inconclusive. CFAs offer an important means of providing access to justice for legitimate claims, but in EL are currently only used in about 30% of cases. Trade Unions and legal expenses insurance support the majority of EL claims. Many liability insurers provide pre-event legal expenses insurance and can therefore have some influence over legal costs through the terms and availability of these products.
In Scotland, the Scottish Executive published a report in November 2002 (Personal Injury

Litigation, Negotiation and Settlement). This did not reach any firm conclusions on expenses in personal injury cases although it appears that expenses are proportionately higher in cases heard in the Court of Session rather than in the Sheriff's Court.

Uncertainty over future risks

Insurers have grown increasingly concerned about their exposure to 'long-tail' risks. With accidents and most illnesses the injury or condition is very quickly apparent. However, some occupational diseases do not manifest themselves for many years; these are termed 'long-tail' risks. Insurers have to estimate how many such claims will arise in future. They also have to estimate what will happen to average levels of compensation and the likelihood of new categories of risk emerging. This requires accurate long-term forecasting of investment returns, interest rates, general inflation, changes in legal costs and compensation, medical knowledge, and other relevant factors.

Insurers cite the challenges posed by long-tail risks as their biggest concern in relation to the sustainability of the EL market. They argue that these risks discourage the entry of new capital and threaten the commitment of existing capital. However, at this stage, it is difficult to find evidence of 'long-tail' risks having had a quantifiable impact on the current EL market difficulties, though of course the issues remain of concern to insurers. The trends in recent price increases appear to have related to past accident performance (e.g. construction), rather than the more significant new areas of occupational health concern (e.g. office-based repetitive strain injury). Claims for occupational diseases such as asbestos, industrial deafness and vibration white finger amount to just 25% of the total EL claims bill, while the number of occupational disease claims has fallen slowly but steadily.

Likely Trends in the EL Market

The market for EL insurance will continue to be difficult, with further price increases expected by insurers in 2003-4, and possibly beyond. Price increases do help support insurers' continued engagement in the EL market. We do not currently see evidence that the market will not correct and be sustainable through the current cycle.

Although there are some tentative signs of a softening of the market in some classes of insurance, the liability market remains in the 'hard' phase of the cycle and a number of pricing pressures are likely to continue to bite on insurers and thus on employers. These include:

- a continuing need to ensure that premium levels are sufficient to pay for the forecast claims
- the trend of increases in legal costs
- high costs of capital and re-insurance

Insurers and brokers report that such pressures are likely to result in further increases to

premiums over the next year and beyond. It is difficult to quantify the scale of such increases. The market consensus appears to be that in 2003/04 they will be significant, if somewhat less acute than 2002/03. Forecasting beyond this is even more problematic, though one leading insurer is predicting some easing in the level of increases thereafter. This would be consistent with the market reasserting its cyclical nature.

Trends in the availability of capital are equally difficult to predict. With a limited number of big players in the EL insurance market, the withdrawal of a major company or a significant reduction in Lloyd's capacity could precipitate real difficulties. The market could be effected by major external events. Insurers also remain concerned about 'long-tail' risks.

However, the compulsory nature of EL insurance makes it a central part of any package of commercial insurance - to withdraw from EL risks losing that wider business. This would be a serious and significant decision for any insurer. And notwithstanding the difficulties caused for business, recent pricing policies have increased premiums to a more economically sustainable level for insurers. This makes the withdrawal of capital less likely.

Business Outlook and Business Action

This outlook for the insurance market means that the pressures on business will continue. Since the premium increases of summer 2002, a lot of work has been taken forward on industry responses. Several key initiatives are reported below. Companies have more chance to plan ahead and they appear to be in a better position to get the advice they need and to shop around. Encouraged by Government, there continues to be a concerted effort by trade associations, brokers and the insurance industry to tackle some of the issues. These are very early days but there is starting to be a shift towards making premiums for Small and Medium Size Enterprises (SMEs) more risk-based, as well as growing awareness of the importance of health and safety management.

It is difficult to judge at this stage in the renewal year whether the problems faced by business in 2003/04 will be as acute as they were in 2002/03. There is a risk that a number of businesses which were able to weather a single round of premium rises on a one-off basis will find further sustained increases too much. And pressures will continue on many firms' budgets. There are also more positive indicators:

- Brokers are working with insurers to improve the flow of information, in particular that relating to their clients' health and safety management, to enable insurers to make better informed, more tailored judgements.
- Trade Associations - especially those concerned with small business, whose members were most affected last year, are promoting a range of initiatives which are already assisting members. These include:
  - negotiating insurance packages for their members at discounted rates, sometimes based on health and safety accreditation schemes
  - providing access to specialist brokers
  - developing self-assessment packages to enable companies to provide insurers with better and more pertinent information about risk management policies
- Jointly insurers, brokers and business representatives are looking at practical ways to make premiums better reflect individual risk.
- Insurers' service standards and pricing policies are under the spotlight. As an industry they have stepped up their commitments to early communication and explanation. They are aware of the importance of early renewals, a frequent catalyst of problems in the past. As it is a compulsory class of insurance, there is particularly sensitivity about the service standards offered. **The Government therefore wishes to work with the insurance industry to review renewals performance and encourage improved standards.**
- Businesses should be more aware of the need to plan for new premiums and to plan their renewals early. They should also be much more aware of the importance of specialist broker expertise. They should be more ready and more prepared to shop around for the most effective broker and the best insurer. The problems have also underlined the importance of being able to demonstrate effective health and safety practices.

A frequent complaint by smaller businesses has been that their premiums did not reflect their good health and safety practices and claims record, because they were set on the basis of a standard 'book rate' by insurers. Jointly insurers, brokers and business representatives are looking at practical ways to make premiums more reflective of individual risk.

Whilst these are initiatives within the market, **the Government has been and continues to play an active role**, encouraging and supporting many of these initiatives and providing contacts, advice and information to business.

Action to Improve the EL System

There is a case for improvements to EL on two fronts: to improve the operation of the market and to improve the outcomes of the system. We want to facilitate action in both areas building on the enthusiasm for improvement shown by business, insurers, trades unions and others.

Action is already underway to address current problems, but some longer-term issues remain. Whilst the current difficulties reflect an acute market adjustment, rather than a general market failure, there remains a strong case for encouraging and facilitating improvements to the operation and outcomes of the EL system. There is no single solution to improve all aspects of EL, and more evidence is needed on a number of issues, but it is possible to identify a range of areas for potential action. Further work can be presented on two broad fronts:

Making the market work better

- **On costs of resolving claims: the Government will work with stakeholders to maximise the benefits for EL of current initiatives within the legal system.** This will include ensuring that the costs incurred are reasonable, necessary and proportionate. We are researching the legal costs of EL cases up to £15,000. We will look at whether other initiatives - for instance a scheme to structure costs in low value motor accidents - could be extended to EL. We will be considering the expansion of the legal expenses insurance market. The Government will also engage with stakeholders to identify the scope for reducing the cost of resolving claims wherever possible and to explore alternative dispute resolution processes. Court procedures in these areas are generally different in Scotland. The Government will discuss the implications of this report with the Scottish Executive.
- **On long tail risks: more evidence is needed to assess whether a radical separation of accident from long-tail disease is justified.** Those arguing the case need to demonstrate its advantages; the Government will actively take forward this discussion.
- The Government will continue to track and evaluate developments in the EL market, starting with consideration of the findings of the OFT's fact-finding study on the liability insurance market. **While this work is in progress, the Government will carefully scrutinise any future policy changes that could put upward pressures on EL insurance prices.**

- Because EL is a compulsory class of insurance, the Government is particularly sensitive to the service standards offered. Many businesses have reported difficulties caused by short renewal periods for their EL insurance policies. **The Government therefore wishes to work with the industry to review renewals performance and improve standards.**

Improving Outcomes

- Improving Health and Safety is central to any long-term response. Reducing the number of workplace accidents and injuries will help tackle the costs of EL insurance. **The Government will consider this as a key element in the forthcoming Strategic Plan of the Health and Safety Commission.** We will also continue to encourage industry initiatives aimed at more risk-based premium pricing and explore whether this can be linked to the HSE's own assessment of risk.
- Currently, the EL system does not encourage early and effective action to rehabilitate injured or unwell employees. A culture change is needed to place rehabilitation at the heart of the EL system, so the real gains of a return to health and alleviation of suffering come before the second best of financial compensation. We want to take forward this discussion with stakeholders, building on the existing commitment to change. In addition, **the Government will review the cost incentives on business and insurers in relation to the provision of rehabilitation and other occupational health services**. This includes the account taken of rehabilitation in determining levels of compensation. There are broader links to the Government's existing occupational health strategy and the arrangements for delivering this will be reviewed in light of the new proposals on rehabilitation.
- Although compliance levels with the requirement to hold EL insurance remain high, all non-compliance is a serious matter. It reduces the protection to employees, transfers liabilities to the state and creates an unlawful competitive advantage for cowboy companies. **The Government will take action to reform the enforcement arrangements.** This will involve developing an active system based on an annual notification of policies which may then be cross-checked against an enforcement database. We will also consider whether the current regulations are tight enough in the fines they levy, the responsibilities they place on companies and directors, and the time they allow for the enforcement authorities to prosecute.

2. Background to Employers' Liability Compulsory Insurance

Background to the review

2002 saw significant price increases in the Employers' Liability insurance market. These had a direct impact for businesses but also resulted in concerns being raised about the underlying long-term stability of the employers' liability system. These reflected a debate which had been gaining momentum with studies by the Health and Safety Executive (HSE), Association of British Insurers (ABI) and others. Against this background the Government announced this review of Employer's Liability Compulsory Insurance (EL). The terms of reference for this review can be found at Appendix A.

Alongside this review, the Office of Fair Trading (OFT) has conducted a fact-finding study to shed light on the wider liability insurance market. The OFT's study looked at public, product, professional and employers' liability insurance, examining the operation of the market and the drivers behind recent increases in premiums.

Compensation for Injury and Illness at Work

Employers' Liability Compulsory Insurance

Employer's liability insurance insures employers for the costs of compensation for those employees who are injured or made ill at work through the fault of the employer. It provides greater security: to firms against costs which could otherwise result in financial difficulty; and to employees that resources will be available for compensation even where firms have become insolvent. It supports the right of employees injured through their employer's negligence to be fairly compensated - 'access to justice', and the responsibility of employers to fund the costs of their negligence - 'polluter pays'. Under the Employers' Liability (Compulsory Insurance) Act 1969 it became compulsory from 1972 for employers to insure against liability for negligence which could result in workplace injury, illness or disease.

Regulations under the Act originally stipulated that the amount of insurance cover that an employer had to provide should not be less than £2m for each employee involved in any accident although market practice was to offer unlimited indemnities.

Following a capacity restriction in the reinsurance market from January 1st 1995 the market applied a standard limit of £10m (£2m offshore). This prompted a Government review of the adequacy of the £2m legal minimum limit of indemnity and this limit was

increased to £5m from January 1st 1999. After discussions with the insurance industry this was considered to be the largest increase that could be borne by the insurance market bearing in mind that reinsurance is finite and that there was a limit to the reinsurance industry's capacity to accept liabilities.

It was felt that there was a danger that a higher limit would have lead to market capacity being rationed and some companies being unable to secure insurance cover. In addition, there may have been problems ensuring efficient use of available market capacity. The higher the limit, the more likely it is that small employers that may not need such high limits will draw unnecessarily on the finite capacity and create a situation where large employers who need higher excess cover might not be able to obtain it.

By law, Employers' Liability insurance policies cannot contain policy exclusions other than general ones relating to all insurance policies and they cannot include excesses which would reduce the amount of damages by a certain amount.

Employers' liability gross written premiums totalled £1.1 billion in 2001 according analysis by Datamonitor of the Syn Thesys Non-Life database and ABI data. Gross written premium (GWP) is defined as all direct written premium income (from an insured risk) gross of reinsurance premium and commission.

All employers must display a valid Employers' Liability insurance certificate at every place of business. It is the role of Health and Safety inspectors to check EL certificates and employers can be fined for failure to display a certificate or to insure.

Industrial Injury Benefits

Claims on EL insurance are not the only means of support for injured or sick workers. An injured employee or one who has contracted a disease or been made ill through their work, can apply for a number of state benefits including:

- Industrial Injuries Disablement Benefit (IIDB) covers disablement as a result of an accident at work or a number of work-related diseases. The amount payable is dependent on how serious the disablement is, with a minimum qualifying disability of 14% for accidents and most diseases. The Industrial Injuries Advisory Council advises on a schedule of prescribed diseases.
- Statutory sick pay is paid for periods of sick leave between 4 days and 28 weeks.
- Income support may apply where a person on a low income does not sign on at the Job Centre.
- Reduced Earnings Allowance is only available to persons who suffered an accident or developed a prescribed occupational disease before 1 October 1990 and as a result cannot do their usual job or work with similar pay.

- In addition, Industrial Death Benefit is paid to surviving dependants. It is not payable in respect of deaths occurring on or after 11 April 1988.

Industrial Injury Disablement Benefit (IIDB) does not involve fault being established. A medical examination advises the level of disability and expected duration. If it can be established that the condition is work related and meets certain time limited criteria then the claim can be met.

IIDB benefit is not payable for the first 90 days after an accident. It provides for:

- Disablement pension, linked to degree of disability;
- Constant Attendance Allowance (CAA) paid at four different rates;
- Unemployability supplement and
- Exceptionally Severe Disablement Allowance paid when disablement is judged to be 100%

Disability allowances are set at fixed weekly amounts such as £79.03 for 70% disablement versus £33.87 for 30% disablement. Similarly, CAA is set at fixed amounts such as £90.40 for exceptional rate versus £22.60 for part-time rate. Unemployability supplement is £69.75 with additions for early incapacity.

When an employee receives compensation, the Compensation Recovery Unit recovers the cost of social security benefits paid as a result of accident, injury or disease from the compensator, namely the insurer. The insurer can reduce the amount of damages by the amount of benefit the person has already received.

Whilst IIDB and EL systems are separate, there is interaction between them. IIDB provides a safety net for employees suffering accident, injury or disease at work who choose not to pursue a claim against their employer and for cases where liability cannot be established. Pursuing a case for negligence against an employer can be expensive and time consuming. Proving negligence can be difficult especially where the injury or disease took place some time ago. In some cases, the employer may no longer be in business. In some instances IIDB is also the means of support for employees whilst they pursue the more lengthy employers' liability claims process.

The benefit expenditure in nominal terms on IIDB was £708m in 2001. This compares to a gross cost of EL insurance of £1.1bn for 2001, as mentioned earlier.

Whilst this review is not a review of State benefits, the implications for State benefits must be considered in any developing any proposals relating to employers' liability.

Pneumoconiosis etc (Workers' Compensation) Act 1979

The 1979 Act provides a safety net for sufferers (or dependants) of certain dust-related diseases who are unable to bring a claim against an employer because the employer has ceased to trade. The sufferer must normally have been awarded Industrial Injuries Disablement Benefit (IIDB).

Payments under the 1979 Act are one-off lump sums and tend on average to be lower than awards made by the courts. The lump sum payment may be varied according to circumstances. Regulations set up payment tables which relate amounts payable to the sufferer's age and assessed percentage of disablement at the date of first determination of the disease.

History of Employers' Liability Compulsory Insurance

Employers' liability insurance dates back to 1880 in the UK. It emerged against the backdrop of industrialisation and the growth of the railways which created new risks that could lead to accidents. Injured employees were first able to claim compensation irrespective of fault under the provisions of the Workmen's Compensation Act 1897. Employees also retained the right to sue their employer in common law, but not to receive both civil damages for negligence and an award under the new Act. Workmen's Compensation originally only covered accidents but was extended to cover diseases in 1906.

Employers' liability insurance really developed during the 1940's and 1950's to complement state benefits. The Industrial Injuries Scheme replaced Workmen's Compensation in 1948. Following the introduction of IIDB employees found they were better compensated if they could successfully sue their employer. Whilst IIDB never provided for full loss of earnings, employers' liability damages are intended to cover loss of earnings and health care costs as well as an element for pain and suffering. If contributory negligence on the part of the employee can be established the damages may be reduced.

Prior to 1972 claims against employers often failed if the employer did not hold EL insurance because insufficient funds existed. Making EL insurance compulsory ensured, as far as possible, that funds were available when damages were awarded.

Compulsion reinforced the principle of 'polluter pays' transferring a greater proportion of the cost burden from the state to the negligent employers. It ensured that employees were fairly compensated where they had suffered injury or disease at work as a consequence of negligence on the part of their employer.

But it was also partly a response to national concern about the number of workplace accidents and employer negligence. Making employers fund the cost of their negligence should in theory lead to an improvement in health and safety practices and thereby reduce the number of accidents. Furthermore, an assessment of and improvement in risk management would often be a condition of an insurer agreeing to cover a risk - this too should lead to fewer accidents.

Since the EL Act was passed in 1969 there have been changes in a number of areas.

In 1980 legislation was introduced governing the time limits within which a personal injury case can be brought (The Limitation Act 1980). This Act provides for claims for personal injury to be brought within three years either of the date on which the cause of action accrued or, if later, the date that the person affected first had knowledge that the injury was significant and attributable to the act complained of - the date of knowledge. The courts were also given discretion to disapply the limitation period where it would be unjust not to do so. The provisions of the Act have the effect that employers and their insurers can be subject to claims for occupational diseases that may have been caused many years before.

It is important to note that this was not the first limitation provision to take account of latent personal injury. But it did it provide for a more uniform system for a range of civil claims. Because of this insurers have viewed the 1980 Act as a step change. The Limitation Act 1980 does not extend to Scotland. The relevant legislation in Scotland is the Prescription and Limitation (Scotland) Act 1973. Section 17 of the 1973 Act deals with personal injuries and section 18 with death resulting from personal injuries. Generally speaking, under section 17 a personal injury case must be raised within three years of the injury being sustained or within three years of the date on which it is reasonably practicable for the pursuer to become aware that his injuries were sufficiently serious to warrant raising an action. Under section 18 an action must be commenced within a period of three years after the date of death of the deceased or the date (if later than the date of death) on which the pursuer in the action became or it was reasonably practicable for him to become aware that the injuries of the deceased were attributable to an act or an omission and that the act or omission was attributable to the defender. Additionally, section 19A of the 1973 Act gives the court an equitable discretion to extend the time limit within which an action may be brought under sections 17 and 18.

Since 1969 as well there has been an increase in the scope of cover - medical and technical advances have resulted in previously unidentified causation being linked to the workplace and thus a growth in occupational disease. Furthermore, they have resulted in more expensive treatment as the latest technology is used to treat the previously untreatable.

There have also been various significant legal changes which have had an impact on the handling of claims, the funding of legal actions, the conduct of litigation and the level of damages, some of which inevitably may have increased claims related costs. These are examined later in this report.

Finally, there is a sense that people are more aware of their rights and responsibilities. Pursuit of claims has been facilitated by the introduction of conditional fee arrangements (CFAs) and the development of legal expenses insurance which has enabled people to pursue action irrespective of their means. However, it is too early to be definitive about the impact that these developments have had on claims incidence.

3. What are the Current Difficulties with EL Insurance?

A wide range of trade associations, lobbying groups and individual companies have made representations highlighting the difficulties many businesses are facing in managing the recent premium increases. Insurers, for their part, have detailed both short term factors causing them to increase premiums and their concerns about the long term sustainability of the system. Lawyers and Trade Unions have contributed with their concerns about whether the current system delivers what it should for employees. This report disaggregates and examines each of these elements. The root of the current difficulties lies with the immediate impact on businesses and this is explored below. The following section deals with both the short and longer term difficulties facing insurers and the operation of the legal system.

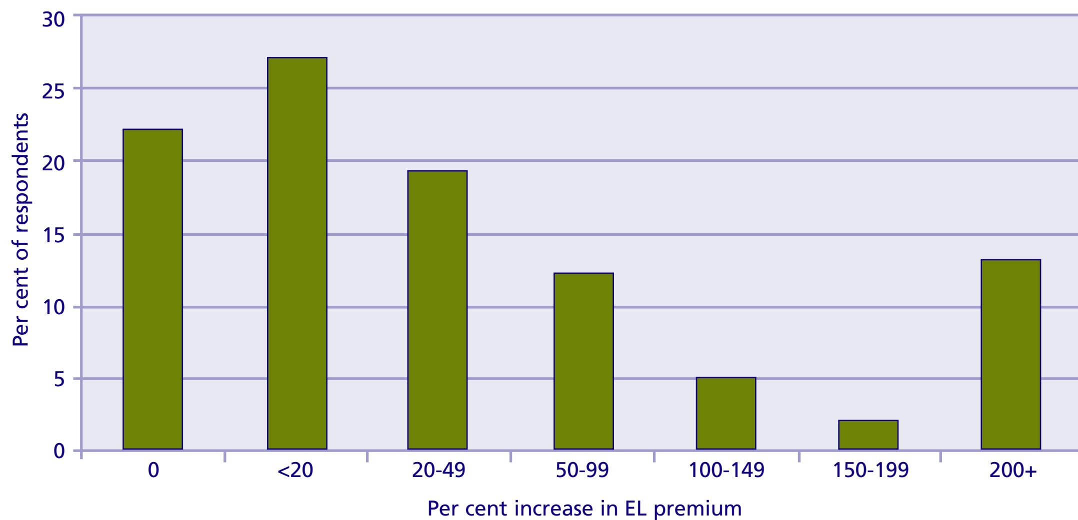
General Affordability of EL Insurance

Insurance premiums have risen significantly over the last two years. Obtaining a totally accurate measure of changing EL rates, and thus the changing price of EL insurance, is very difficult because there are no reliable price indices available. Examination of movement in 'book rates' is imprecise because individual underwriters discount these rates to arrive at the premium charged. Comparison of premium movements is indicative but premiums will include the effects of changes in wage roll, changes in types of business undertaken or changes in claims experience.

Zurich Insurance, the Association of British Insurers (ABI) and the British Insurance Brokers Association (BIBA) say that the average increase in EL premiums across all types of risk over 2002 was between 40% and 60%. Norwich Union has estimated its own average increase in EL premiums to be slightly lower at 30% to 45%.

The OFT undertook a survey of 457 predominantly small businesses across a variety of sectors. The figure below shows the EL premium increases experienced by firms during 2002. One quarter of businesses did not report any change in EL premiums. About two fifths of businesses experienced an annual increase of more than 20% and one in eight had EL costs more than treble (an increase of 200% or more).

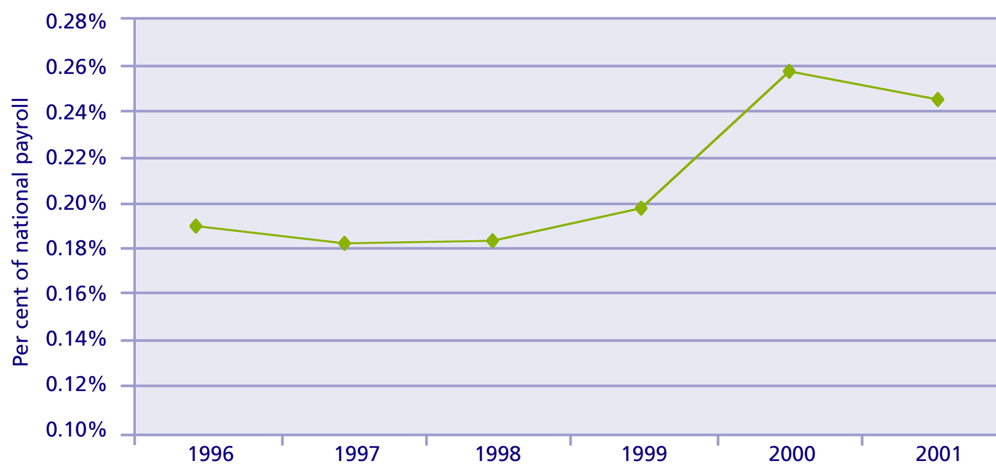
ELI premium increases: OFT survey



According to the Greenstreet Berman report commissioned by the ABI, between 1996 and 2001 the cost of employers' liability premiums have increased as a proportion of the UK's total payroll from 0.19% to 0.25%.

Although these averages are small as a proportion of overall business turnover, as a proportion of profits they can be significant, particularly in sectors where above-average premium growth seems to be occurring and in small and medium-sized enterprises (SMEs), which generally pay a higher proportion of turnover in EL insurance than larger firms. It is worth remembering that these trends represent the position before 2002, the year in which the most significant premium increases took place.

Graph: Employers' Liability Insurance as a % of national payroll



Source: Greenstreet Berman - "Workplace Compensation" paper

It is important to outline how the above figures were calculated by Greenstreet Berman. Insurers tend to apply size related discounts to EL premiums. A small firm in a given trade would be charged a higher rate per employee than a large firm. To calculate the average EL premium as a percentage of national payroll premiums are weighted to take account of the number of people employed by small, medium and large employers.

As a result of this methodology, the proportionate growth shown in employers' liability is less than its absolute growth due to the coincident growth of the economy. The number of jobs has increased by 8% since the mid-1990s and the national average wage by 19% since 1996.

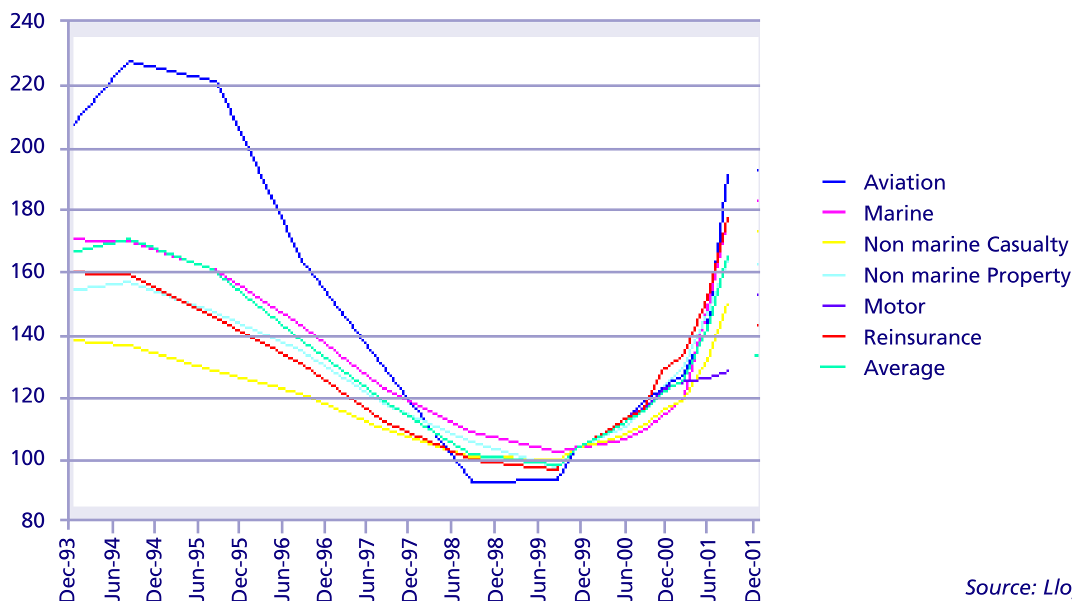
Lloyd's of London

The pattern of rate increases seen in the Lloyd's of London insurance market is consistent with the increases evidenced in the insurance company market, detailed earlier. This reflects the underwriting cycle found in insurance markets generally.

Lloyd's of London Reporting and Analysis department has been developing an index of insurance rates across 37 lines of business including non-marine casualty (liability). The price indices are based on an internal questionnaire and interviews with most underwriters in the Lloyd's market. The indices seek to build in subjective factors that will have influenced rates, including changes and variations in policy wordings and deductible levels.

The graph below shows that liability (and other) rates declined from December 1993 to the beginning of 2000. Rates then began to pick up, rising sharply from the middle of 2001.

Lloyd's Premium Rating Indices



Source: Lloyd's

Lloyds' tender for insurance capacity in advance of the underwriting year. With rapidly increasing rates it is reported that this capacity was used up quicker than expected during 2002 forcing temporary contraction of capacity. The effect of this reduction in supply has been to further increase rates.

International Comparisons of Affordability

The position in other European countries is relevant to considerations of affordability and competitiveness. EL insurance tends to represent a lower proportion of the wage roll in the UK when compared to workers' compensation scheme contributions in other European economies.

Table: European Comparison, EL as a percentage of payroll, 1999

Country	Contribution rates 1999 (% of payroll)
Austria	1.4
Finland	1.4
France	2.25
Germany	1.33
Italy	3
Spain	2
Sweden	1.35
United Kingdom	0.2

Source: Greenstreet Berman - HSE report "Changing Business Behaviour"

Direct comparisons between systems are often difficult, however. Most workplace compensation systems incorporate some or all of the costs of health care, prevention methods and / or rehabilitation, as well as compensation. Accidents while commuting to and from work may or may not be included. The levels of benefit also vary.

Although EL costs in the UK have been less than in many other countries UK costs have been rising. The above comparison looks at 1999 figures and it can be seen from the earlier graph (EL Insurance as a % of national payroll) that the relative cost of EL insurance rose sharply after this point and is continuing to do so. However, problems in the EL market are not confined to the UK and the costs of overseas compensation systems are also likely to have risen. Discussions with overseas officials suggest this has been the case but we do not have comprehensive data.

Sector specific difficulties

The discussion on affordability so far has dealt with the general position.

Although rising EL premiums have been faced by many businesses, the difficulties have been most acute for companies in certain sectors which represent a higher risk to insurers. Indeed the average premium increases mentioned so far appear to include very large premium increases paid by a number of companies. Scaffolders, roofers, heavy construction risks, engineering, waste management and scrap metal merchants have been cited as some of the worst affected areas. Surveys (by the Confederation of British Industry (CBI), British Chambers of Commerce (BCC), Engineering Employers' Federation (EEF), Federation of Small Businesses (FSB), and AXA Insurance, for example) report premium increases for some firms running into hundreds of per cent. The OFT's survey of small businesses also found that around one in eight firms who responded to the survey faced premium increases in excess of 200 per cent.

Such evidence needs to be examined carefully. First, there is an element of self-selection among respondents - those businesses worst hit may be more likely to respond. Secondly, some of the biggest headline increases may in part be due to a worsening claims experience, increases in turnover and changes in the nature of the business undertaken. Thirdly, it is important to distinguish between quotes received and the premium at which renewal finally took place. Existing insurers may choose to price themselves out of the market on certain risks or trades rather than refuse cover outright.

But all instances cannot be explained away in this way. A number of sectors have produced credible and compelling evidence that premium increases of this magnitude have been common.

- Davis Langdon Consulting carried out a survey for the Department for Trade and Industry covering the construction sector. Reported EL insurance premium increases ranged from 10% to 368%.
- The National Federation of Roofing Contractors (NFRC) carried out an insurance survey covering the period 2001/2002. 328 of NFRC's 672 members replied. Their EL premiums rose by an average of 161% between 2001 and 2002.

Many of these businesses in higher risk sectors have suffered these premium increases despite there being no change to their claims experience or their business activities. In some cases they have a claims free record. Some insurers appear to have taken remedial underwriting action across the board in certain sectors that perform badly, with limited differentiation of individual performance between smaller companies.

At the recent insurance public hearing of the All-Party Parliamentary Small Business Group a number of business owners reported their own experiences of EL insurance increases:

- A roofing contractor based in Wiltshire, employing 40 people and with an annual turnover of £2.5m, reported paying £21,000 for EL insurance in 2001/2002. The following year the cost rose to £84,000 despite shopping around. This represents a 400% increase. Claims over a five year period total £19,000 although this consists of only £3000 paid and £16,000 outstanding. This business believes that thorough health and safety training and procedures were in place. There had been no significant increase in turnover over the period.
- A scaffolder that employs 7 people and has a turnover of £300,000 reported a rise of 500% in its combined EL and public liability (PL) insurance costs over two years. The premium in 2000 was £6,000 rising to £10,000 in 2001 and £30,000 in 2002. 10% of turnover is now spent on EL and PL insurance alone. This company has made no claims since its inception 10 years ago. Again, a thorough health and safety plan was in place and there had been no significant changes in turnover or payroll over the period.

Such evidence is, of course anecdotal rather than statistical and it does need to be balanced against general trends, including those businesses who report no price increases. However, these examples do illustrate the experience of some firms in the most acutely affected sectors.

Size of Business and the link between Health and Safety practice and premiums for smaller firms

Small and medium-sized enterprises in particular have reported concerns in coping with the premium increases.

In terms of the number of companies, the UK economy is dominated by small firms. 99% of companies are classified as small or medium sized enterprises, employing fewer than 250 employees.

1. Sole proprietorships and partnerships comprising only the self-employed owner-manager(s) and companies comprising only an employee director.

Table: number of enterprises, employment and turnover in the private sector by size of enterprise and industry section, 2001

	Number Enterprises	Employment (000s)	Turnover (£million)	Percent Enterprises	Employment	Turnover
All enterprises	3,746,340	22,622	2,112,013	100	100	100
No employees	2,596,395	2,888	152,383	69.3	12.8	7.2
Small	1,115,515	6,921	612,952	29.8	30.6	29
Medium	27,655	2,720	319,231	0.7	12	15.1
Large	6,775	10,092	1,027,448	0.2	44.6	48.6

Source: Small Business Service

Insurance works on the basis of the creation of a common pool of similar risks. Insurance companies take contributions from many to pay for the losses of the few. In operating this common pool, the insurer benefits from the law of large numbers. The actual number of claims will tend towards the expected number, where there are a large number of similar situations.

Insurers will divide this pool of risks into sub-groups placing risks with similar characteristics in the same group. The factors that are most likely to influence annual claims, such as the business activity undertaken, are used to distinguish one group from another. These underwriting factors also determine the starting insurance rate to be applied to risks in the group - this is often called the 'book rate'. This rate is based on the average claims frequency and the present value of the average claim size for such risks.

It is possible to price some large risks purely on the basis of the employer's own past claims experience or on its merits - experience rating. If a firm has a large enough number of employee accident statistics then the claims experience should, in theory, provide a guide to the future and allow experience rating.

But as a starting point for setting premiums for most small and medium sized companies insurers do use 'book rates', aggregating the claims experience across other businesses in the same trade. The reason for this is that individual claims experiences are not statistically significant enough to set individual starting rates. However, the book rate is then modified by the underwriter taking into account the claims experience of the individual company. So a combination of book and experience rating is used in practice.

The use of 'book rates' serves to decouple the initial basis for assessing a company's premium rate from its health and safety performance. In practice, larger firms are able to influence premiums away from the 'book rate' in ways that smaller firms generally cannot. For larger firms the insurer might carry out a liability survey to assess the firm's risk management procedures and to make recommendations or requirements for improvement. Brokers earn more commission or fees from larger cases and their analysis/presentation of the risk would tend to be more detailed. They may even choose to get their own surveyor to undertake a survey of the business. As a result of this extra information an underwriter may choose to modify the rate charged.

Small companies' premiums will be affected to some extent by their claims experience as detailed above. As such their health and safety practices will partly determine the premium they have to pay through the impact of good practices on their accident record.

Insurers state that generally it is not economically efficient for them to fully assess a smaller company's health and safety practices, by way of a liability survey, and to link the results to premium charged. However, SME premiums will be affected by the risk features presented to the underwriter. Brokers and individual firms can therefore take steps to ensure that insurers gain access to all the underwriting information needed to present their risk fully and accurately. Ongoing work in this area is discussed later in the report. The British Insurance Brokers Association (BIBA), speaking at Post and Insurance Week Magazine's management briefing - 'Employers' liability: crisis or crossroads?' acknowledged a failing on the part of a number of brokers to provide underwriters with the information they need.

Small and medium sized businesses have attracted the highest EL premium increases. EL insurance costs form a larger proportion of their turnover compared to larger companies. Insurers apply size related discounts to the book rate so for a given trade smaller companies may pay a higher rate than larger companies. Small firms can also find it more difficult than large firms to pass increased costs on to their customers.

Minimum premiums and small firms

A number of Trade Associations have reported that some insurers have increased their minimum premiums across the board or in certain sectors. This would have a disproportionate effect on the smallest firms as they have to pay the new higher minimum premium regardless of their size or search elsewhere in an already restricted marketplace. It has also been suggested that small firms may find it harder to find cover than medium and large ones because they may find it more difficult to access the wider insurance market enjoyed by the latter through the big provincial and national broker chains. However, such evidence is anecdotal, rather than statistical at this stage.

Availability of EL Insurance Cover

It is important to consider whether issues of affordability are also reflected in issues of availability.

A number of Trade Associations have suggested that companies in some higher risk sectors are simply unable to secure cover due to a restricted market with companies pulling out of EL in certain sectors or facing underwriting capacity shortages.

However, it is difficult to find evidence that this is nearly as widespread as first suggested last year. Companies trading without insurance are unlikely to advertise the fact so the problems may be under-reported. Nevertheless, representatives of the insurance broking community have stated that generally, employers have been able to obtain EL insurance with the support of a broker specialising in their field of work. Other circumstantial evidence supports this. For example:

- AON, the largest broking firm in the UK has reported that, to date, all of the businesses they represent have been able to secure EL insurance.
- A recent Small Business Service survey based on 1,674 SMEs placed compliance levels significantly in excess of 90%.
- In the OFT survey of 457 predominantly small and medium sized businesses referred to earlier, companies were asked whether they had found it difficult to obtain employers' liability cover in the last two years only 12% said 'yes', and there is no suggestion that this difficulty was translated into a failure to secure cover.
- Davis Langdon Consulting carried out a survey for the DTI covering the construction sector. The companies they consulted felt that their Brokers were able to present a good case to insurers and obtain cover. Indeed all companies that responded to their study were able to obtain cover.
- The TUC report that the EL claims they are assisting on behalf of members do almost universally have insurance cover.

None of these indicators are by themselves conclusive, but they do support a general market analysis that EL cover continues to be available to the overwhelming majority of firms, albeit sometimes at a significantly higher cost. This study has found it difficult to positively identify examples of total unavailability of cover.

Renewals

One factor in availability has been timing. Businesses and trade associations cite instances of insurers releasing renewal terms very close to the renewal date allowing them insufficient time to arrange alternative cover in the insurance market. This is supported by the recent OFT survey. In this survey, employers that had experienced premium increases on EL during 2002 were asked to state the period of notice they had been given of the renewal terms. 22% of respondents were given less than one week's notice; 24% were given between one and two week's notice and 40% received between three and four week's notice. It should be stressed again at this point that the results of this and other surveys should be treated with some caution as they can be prone to adverse selection in terms of those that respond and some questions can be open to individual interpretation. But in the current market conditions it is important that employers are given sufficient time to place their insurance cover.

Speed of Change

The rapid hardening of rates was not anticipated by many businesses. A combination of factors, discussed later in this report, has led to an upswing in the insurance cycle which has been particularly acute in its size and speed. After seven years of a soft commercial insurance market when businesses had become accustomed to renewing their insurance policies at existing or lower premiums, the size of the current increases were not expected and were not budgeted for.

Evidence from the OFT survey suggests that there has been a high degree of loyalty on the part of employers to their broker and insurer in the past. For many businesses 2002 has been the first time that they have had to shop around for cover.

Communication of Change

The difficulties caused by the speed with which the insurance market has hardened have been exacerbated by the lack of communication between insurers, brokers and employers. Some insurers have not made brokers sufficiently aware of the range of factors which have caused them to increase their premiums. Some brokers in turn have communicated poorly to their clients, the employers, information about the pressures on insurers and the reasons for, and market expectations of, hardening rates. Collectively, the industry has not performed well on this. The expectations of employers could have been managed better over the last two years.

Effects on Business

Increasing premiums have led to a rise in overhead costs for businesses and a squeezing of profit margins. Some firms in sectors of the economy such as manufacturing may already have been experiencing a downturn and insurance costs have added to these pressures. Reduced profit margins act to depress business investment and thus impair future business profitability. This in turn depresses UK productivity.

Businesses should, in theory, be able to pass their increased overhead costs onto the customer in the medium term. Their domestic competitors are likely to be facing similar increases in costs. However, firms may be constrained by the contracts they are operating within or by international competitors operating within a different cost base. Furthermore, budgeting, planning and tendering for new contracts over a timeframe beyond one year become difficult with firms uncertain of future premium increases.

In an effort to reduce overheads elsewhere, companies have, according to some business representatives, been forced to make staff redundant or reduce rates of pay. In the latter case, failure to be competitive in the labour market makes it hard to recruit and retain staff of a suitable standard.

Some firms have reported having to curtail those sectors of their business seen as higher risk that insurance companies are not willing to cover. In the construction and engineering sectors work at the extremes of height or depth have sometimes caused difficulties whilst some companies have been refused cover for offshore activities.

The CBI and various Trade Associations report that firms may have covered the increased premium last year on a one-off basis in the hope it won't happen again this year. Some firms may have difficulty affording sustained or further increases. The top 5 EL insurers are all forecasting rate increases over the next year (albeit lower than in 2002).

Conclusive evidence of businesses being forced to close as a direct result of either affordability or availability issues is very difficult to obtain, though anecdotal reports cannot be entirely discounted. One obstacle to obtaining a clear picture is the difficulty of disaggregating EL insurance as a cause from other factors. For vulnerable companies with low profit margins or debt problems, rising EL costs might well be another contributory factor to their failure.

Overall, the Small Business Survey (SBS) Omnibus survey of Autumn 2002 looked at the greatest obstacles facing SMEs. A small proportion of firms cited insurance as a major obstacle to their success; the largest proportions doing so were in manufacturing and construction. When the issue of insurance was raised with respondents, a large number said that it was an obstacle to the success of the business. This somewhat ambiguous response may indicate that rising insurance costs are an issue for many businesses, and a critical problem for a few, particularly in manufacturing and construction.

In addition, this hardening of EL rates over the past two years has taken place against a backdrop of difficult economic conditions for some sectors of business such as manufacturing. 2001/2002 saw a sharp slowdown in world growth. In a global economy, no country can be fully immune to international developments and uncertainty in the outlook for global demand has affected UK economic prospects in the short term, deterring companies from expanding investment and increasing production. The economic situation may have served to make the EL insurance affordability issues more apparent and more immediate.

Trading uninsured

There are reports that a number of businesses are trading without EL insurance either because they simply cannot afford it or because they are unable to get cover. Non-compliance leaves employees with less chance of redress, it puts complying businesses at a competitive disadvantage and it transfers liabilities to the state. Non-compliance is, of course, very difficult to assess, as companies would be reluctant to advertise the fact that they are breaking the law. Some research has been carried out in this area but it has proved inconclusive.

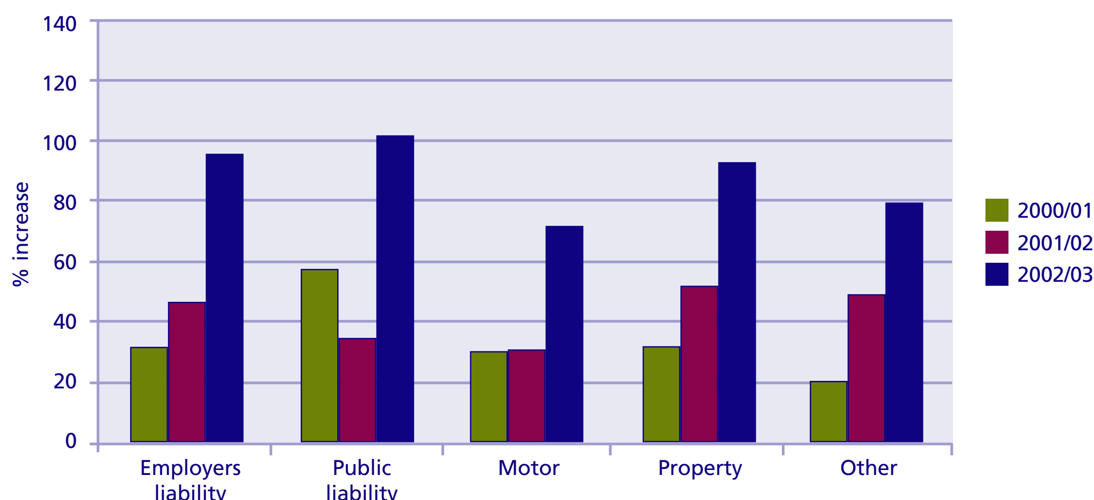
- The Association of Personal Injury Lawyers posted a notice on its website inviting members to notify the Association of claims where the potentially responsible employer was uninsured. The website receives approximately 500 hits a week but only one member responded, stating that he was aware of three such cases.
- There is circumstantial evidence cited by the National Federation of Roofing Contractors that firms are missing out on jobs, particularly in the domestic sector, through unfair competition from illegal traders without EL insurance. This is very difficult to scope accurately.
- AXA studied 700 businesses with between 6 and 249 employees and 13% admitted to being uninsured. AXA extrapolated this to suggest that 210,000 small businesses employing 1.8m people are at risk with no cover in place.
- The Small Business Service (SBS) carried out a telephone survey of 2007 businesses in the Autumn of 2002. It found overall compliance levels to be 93%.

Devolved Administrations

Rising premiums for employers' liability insurance have caused difficulties for businesses in the devolved administrations with some reported difficulties in the process of finding cover in Northern Ireland. There have been suggestions that difficulties may have been more acute because of the sectoral composition and typical firm size of these economies; small and medium sized companies form a particularly high proportion of economic activity in the devolved administrations. However, in all cases there appears to have been sufficient capital to meet total market needs. Overall, the evidence available suggests that the situation for businesses in the devolved administrations has been consistent with that across the UK as a whole.

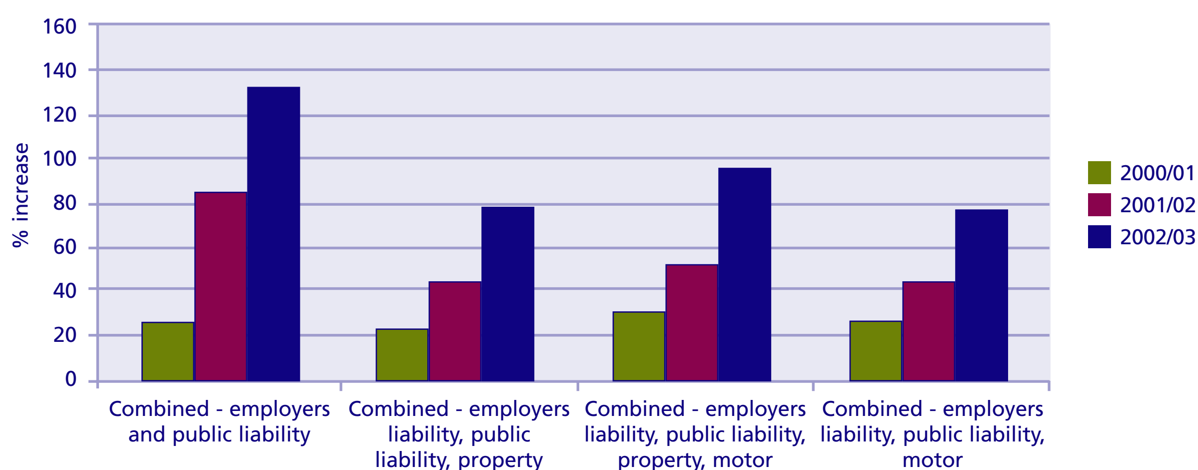
In response, to the extensive representations made by stakeholders in Northern Ireland on the issue of insurance costs for businesses the Department of Enterprise, Trade and Investment in Northern Ireland (DETINI) survey examined the costs of insurance premiums, including employers' liability insurance and other classes, to private sector businesses with employees in Northern Ireland. Respondents were asked to provide information on both single and combined insurance premiums for the years 2000, 2001 and 2002. The survey's main findings on employers' liability insurance are summarized below. The full results of the DETINI business insurance premiums survey can be found at:
http://www.detini.gov.uk/cgi-bin/down_pub?id=156

Figure 6 - Percentage Increases in Premiums by Single Premium Type



The DETINI survey shows that respondents' EL premiums rose by 46.5% in 2002, following a rise of 31.4% in 2001. This is consistent with premium increases seen across the UK as a whole.

Figure 7 - Percentage Increases in Premiums by Combined Premium Type



For combined policies, the largest premium increases occurred for the combination of employers' and public liability, which accounts for nearly a quarter of combined premiums. These premiums increased by 82.8% in 2001 to 2002. Premiums for broader commercial packages including property or motor insurance rose by around 40 to 50 per cent in 2002.

CONCLUSION ON THE DIFFICULTIES FACING BUSINESS:

- Having held premiums at a low level for some years insurers are now changing their pricing policies. Businesses that have previously benefited are now bearing the costs of the 'catch-up'.
- Collectively insurers and brokers could have managed expectations about premium increases better, particularly in providing early information about the likely size of increases and good notice of renewal.
- Businesses have been unprepared for the speed and extent of insurance market price increases.
- There is an affordability problem hitting SME businesses in some sectors regarded as high accident risk as insurers try to limit underwriting losses.
- Availability does not appear to be the major problem at present.

- There is insufficient evidence to suggest that a significant number of businesses are ceasing to trade principally due to EL pressure, although it cannot be discounted at least as a contributory factor to some business failures.
- Compliance remains high and there is no hard evidence that this is changing. But all non-compliance needs to be treated seriously.
- Some businesses may well have absorbed last years premium increases on a one-off basis which would lead to concerns about the sustainability of their position if, as expected, this year's market remains difficult.
- The situation in the devolved administrations appears to be similar to that across the UK as a whole. The evidence from Northern Ireland suggests that there has not been a market failure, though, as in other parts of the UK, premiums have risen sharply for businesses in some sectors and there have been reports of some difficulties in the process of finding cover.

4. What is Causing the Current Difficulties and Why has it Become a Problem Now?

The Government has committed to assess the case for reform of the EL system and to explore what, if any, improvements can be made. It is important to understand the range of factors causing insurance companies to put up premium rates and the long term changes affecting the system. In making predictions for the future of EL we need to understand why the difficulties for both insurers and businesses have occurred and whether they are likely to re-occur at a later stage, as far as possible on the basis of the available evidence.

Many of the issues raised in this Review in relation to the EL insurance market are not new. Ten years ago some employers' liability insurers called for fundamental changes to the system. However, the problems of availability and affordability did not seem to be as acute as they are now.

The Underwriting Cycle and insurers' profitability

Historically, insurance prices have fluctuated in a cyclical fashion over a number of years. Although appreciation of the cycle's movements is vital to a successful underwriting operation, the length and strength of the insurance cycle is notoriously difficult to predict. No other industry suffers from a cycle that is as strong and independent of general economic conditions as insurance. The ease with which capital can flow into and out of the industry is a major factor determining the course of the cycle.

The 'Soft' phase of the cycle

Between 1994 and 2000/2001 the commercial insurance market was in a 'soft' phase. The market saw intense competition and low or falling premiums. As the market softened and rates declined, profits were eroded and general insurers made big underwriting losses. Between 1997 and 2000 insurers went through a period of intense rationalisation and merger activity.

It has been suggested that insurers desire to maintain or increase market share was often at the expense of underwriting appropriate to that stage in the cycle. Insurers may also have acquired new business at unprofitable rates. Insurers can find it difficult to respond to the cycle by adjusting exposures in an industry where long term relationships between buyers and sellers of insurance are so greatly valued.

In the table below, results are detailed for the commercial market as a whole. Premiums are listed net of commission paid to intermediaries. The underwriting result describes premiums received minus claims incurred (paid and outstanding), commission, and management expenses (the costs of running the business). Taking the overall market between 1993 and 2001, the table below indicates that insurers have consistently failed to deliver an underwriting profit.

Table: Commercial Insurance Premiums and the Underwriting result

	Net Written Premium £m	**Underwriting Result £m**
1993	5,327	(415)
1994	5,557	(66)
1995	5,251	(119)
1996	5,370	(335)
1997	5,356	(498)
1998	5,556	(988)
1999	5,437	(870)
2000	5,755	(880)
2001	6,461	(514)

Source: ABI

NB: The figures in the table understate the market losses because they do not include the losses of insolvent insurers such as Independent and Chester Street from the date of their insolvencies.

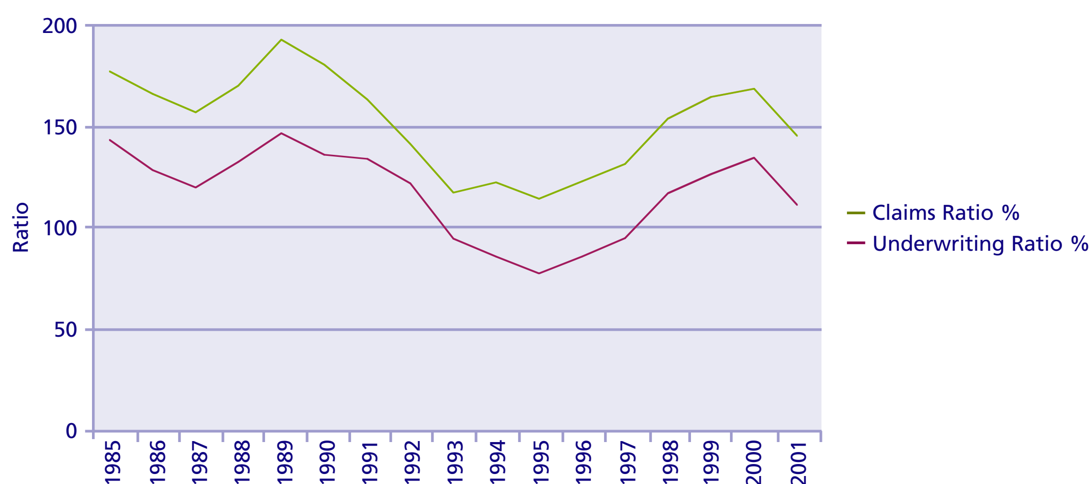
Table: Premiums, Claims, loss ratio and underwriting result for EL

	Gross Premium Earned (£ 000)	Claims Balance of each Accident year (£ 000)	Claims Ratio %	Underwriting Ratio %
1985	223,612	329,690	147.7	179.2
1986	270,712	371,263	134.0	168.9
1987	336,803	433,380	125.9	160.4
1988	379,278	534,221	137.8	172.6
1989	395,497	641,131	150.8	193.9
1990	472,660	711,878	140.9	182.4
1991	481,025	647,816	139.2	166.4
1992	523,815	598,229	127.9	146.0
1993	611,509	561,371	102.5	123.6
1994	683,553	660,054	94.3	128.3
1995	745,826	663,780	86.6	120.8
1996	720,582	698,420	94.4	128.7
1997	700,740	737,079	102.7	136.9
1998	674,498	849,375	123.3	157.7
1999	605,523	822,308	132.1	167.6
2000	566,104	789,798	139.5	171.3
2001	611,007	720,821	118.0	149.7

Source: ABI

The above table looks at EL insurance in isolation and details claims as a proportion of premiums and underwriting outgoings, detailed earlier, as a proportion of premiums.

Graph: Employers Liability Claims and Underwriting Ratio for EL



Source: ABI

Of all insurance classes, EL recorded the highest claims ratios during the last soft market but insurers continued to write this line of business at low premium levels. Most insurers do not sell employers' liability as a stand-alone product. Instead it is offered as a package alongside property insurance and other covers. Some insurers were reportedly wary of pushing up employers' liability premiums in case it resulted in the loss of the overall package of insurances for a particular client.

In addition, the poor underwriting results were sustainable in the short term because of the economic climate of high interest rates and good stock market returns. This is a significant factor since the income from investment of premiums and claims reserves turned underwriting losses into overall profits.

The 'Hard' phase of the cycle

At the bottom of the insurance cycle around 2000/2001 some insurers started to withdraw from certain classes of business or trades where their losses were heaviest. To restore profitability, insurers increased premiums to reflect true risk exposures more accurately.

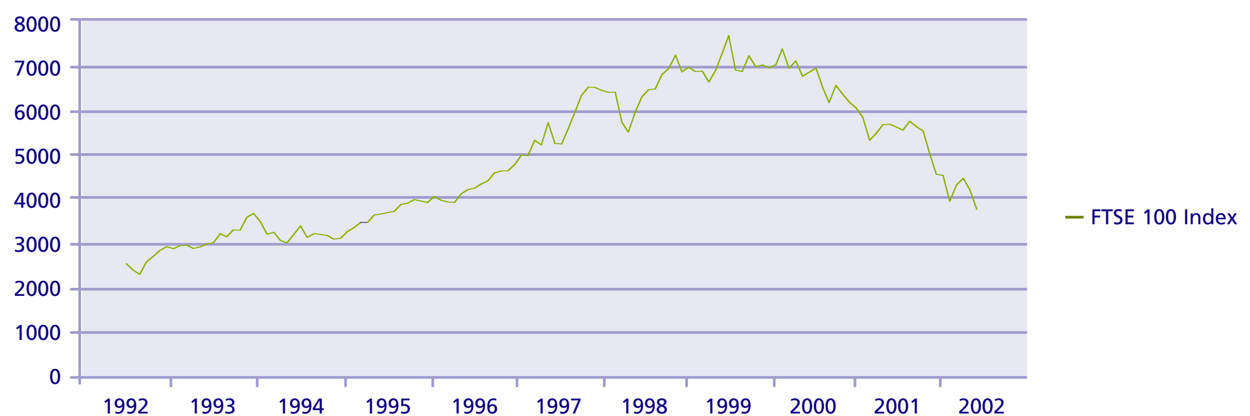
However, the hardening of the market over the last two years seems to have been acute in terms of the size of rate increases and the speed with which they have come about. As well as the need to return to profitability and move rates to a more commercially realistic level following many years of declining rates, there have been a number of additional factors affecting the EL market in this cycle: notably the investment climate and the impact of September 11th.

The Investment climate: Income

Underwriting losses have in the past been offset by the investment of premium and claim reserves. The offsetting effect has been especially important in liability classes because of the extended time period between receipt of premiums and claims payments.

However, with low long-term interest rates and equity markets dropping to seven year lows over the past eighteen months the vulnerability of pricing models that have allowed premium rates to produce an underwriting loss in anticipation of an investment gain have been exposed.

Graph: FTSE 100 Index 1992 - 2002



Graph: UK Interest rates (long term and 3 month)

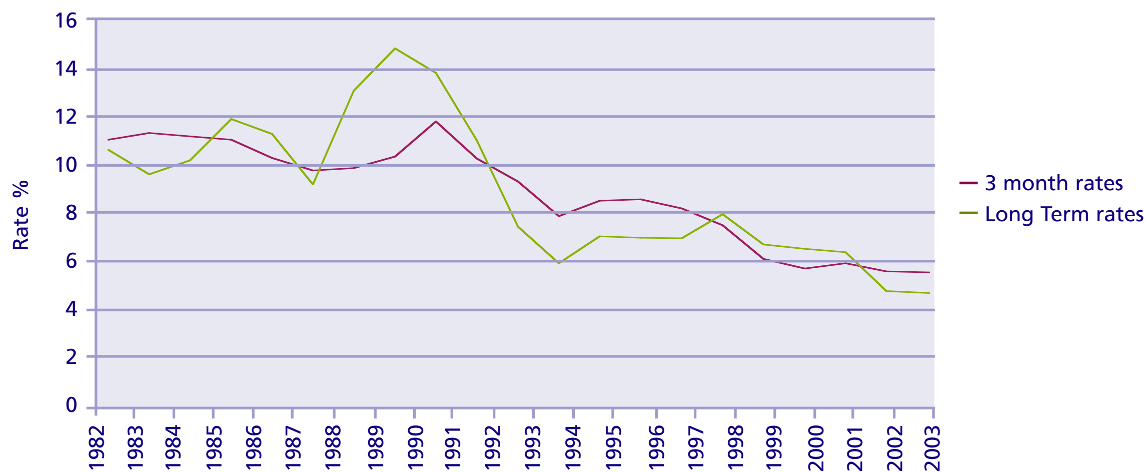


Table: Annual Total Investment Returns

Year	Annual Total Investment Return
1992	17%
1993	17%
1994	(4%)
1995	16%
1996	8%
1997	9%
1998	11%
1999	11%
2000	3%
2001	4%
2002	(1%)

The above table shows the investment returns achieved by one large EL insurer over the insurance cycle. Returns have fallen from 2000. Taking the three years 2000 - 2002 the average investment return was 2%. This compares to an average of 10.3% for the preceding three years 1997 - 1999 and 10.6% for the preceding eight years 1992 - 1999.

The Investment climate: Capital

It is not only reserves that are invested in the stock market. Insurers also tend to invest shareholders' funds in shares and so the falls in equity markets have substantially reduced the capital base of insurers and thus their capacity to write new business. A smaller supply of capital will also be impacting on rates.

The weakening in the capital bases of many insurers has lead to reductions in their credit ratings. This has the effect of increasing the cost of capital. It has been reported that some insurers have had difficulty in raising capital to bolster their solvency and to take advantage of the hardening general insurance market. This may have further limited insurance capacity and contributed to increasing rates.

Given conclusions about the availability of EL insurance reported above there does not appear to be a current shortfall in capital needed to support the EL market, but that capital remains sensitive to further market risks.

The World Trade Centre

The events of September 11th 2001 had a major impact on the global insurance industry. Insurance losses from the World Trade Centre disaster have been estimated to be as high as $40 billion. The disaster caused a fundamental reappraisal by the reinsurance industry of the way it was prepared to deploy its capital and the pricing of risk.

Although most of this loss was borne by reinsurers, there has been a knock on effect for insurers as a result of increasing reinsurance costs which insurers have then passed on through premium increases.

Insurers purchase reinsurance to provide the capacity to insure large or specialist risk, or for risks where there could be an accumulation of losses in a single catastrophe. An employers' liability insurer may want to protect themselves from a larger number of losses than expected. Stop loss reinsurance could be used to provide protection for an insurer's whole EL account. When the claims ratio overall exceeds a certain figure the reinsurance would pay out.

One major EL insurance company has reported that the costs of its main liability insurance treaty increased by 35% last year.

Changing market sentiment

Insurers have argued that the insolvency of Independent Insurance has been an additional factor in causing insurers to examine their underwriting positions on EL business. Prior to its insolvency in June 2001, Independent wrote 7% of the UK's employers' liability insurance. Major underwriters such as AXA and Royal Sun Alliance took on this business.

CONCLUSION ON THE UNDERWRITING CYCLE:

- Although premium increases of varying degrees are to be expected during the hardening of the market, the speed and extent of EL rate increases has partly been a response to previous pricing policies by those insurers that pitched EL premiums at an unsustainable level resulting in substantial underwriting losses. This appears to be linked to efforts to maintain or win packaged insurance accounts or to gain market share.
- The speed and extent of hardening of EL rates has also been a response to a series of external factors this time round. Notably insurers cannot at present rely on investment income to turn underwriting losses into overall profits to the extent that they have at times in the past.
- The events of 11th September 2001 have also had an impact via the re-insurance market.

Employers' Liability and the problem of long tail occupational disease

In addition to the difficulties caused by the sharp upward swing in the underwriting cycle as a consequence of the factors detailed above, a number of concerns have been raised about the Employers’ Liability market potentially facing long term exposures in relation to occupational disease claims.

Basis of cover

In order to understand the risks that insurers are facing it is important to understand the basis upon which policies are written. Employers' liability insurance is written on a 'claims incurred' basis. This means that if an employee suffers a workplace accident or disease and their employer is found to have been negligent then the insurer that was holding cover at the time of the event giving rise to the claim is liable. This can be distinguished from a claims made basis where the liable insurer is the provider of cover at the time the claim is made. This is particularly relevant for occupational diseases where the claim may be made many years after the event giving rise to the claim. Insurers writing on a claims incurred basis can incur liability for claims made today arising out of events many years ago even though they are no longer insuring that particular employer.

Uncertainty over when liabilities will attach

Two considerations apply to uncertainty over when liabilities will accrue.

The first is the determination of whether or not an employer can reasonably be held to be negligent in their response to a particular class of risk. The tort system in England and Wales and the derilict system in Scotland operates on the basis that compensation is due if an employer breaches the duty of care to an employee. In disease claims this can happen with effect from the 'State of Knowledge' date. This is the date at which the courts deem that employers should have reasonably been aware of the link between certain workplace conditions and a disease and hence should have taken the necessary steps to protect employees from that disease.

In deciding on a state of knowledge date in relation to a particular condition the courts will take into account all the published or discoverable evidence on the subject. However, they will then have to consider how this should apply to the circumstances of each individual case. This means that - at least to some degree - insurers are inevitably uncertain as to what liabilities may apply and from when. Insurers have to estimate this in advance, and if they get it wrong they may either over-price the customer (and hence lose business) or under-price the customer (and lose money).

The second uncertainty relates to when any individual claim in relation to such as risk will manifest itself. The Limitation Act 1980 deals with the time limits within which a personal injury case can be brought. The Act provides for claims for personal injury to be brought within three years either of the date on which the cause of action accrued or, if later, the date that the person affected first had knowledge that the injury was significant and attributable to the act or omission complained of. The court also has discretion to disapply the limitation period where it would be unjust not to do so. The provisions of the Act mean that employers and their insurers have been subject to claims for occupational diseases that may have been caused many years before. Some occupational diseases are characterised by latency periods of up to 40 years. The Limitation Act 1980 does not extend to Scotland. The relevant legislation in Scotland is the Prescription and Limitation (Scotland) Act 1973.

Uncertainty over what will be covered in the future

Medical and technical advances have resulted in previously unidentified causation being linked to the workplace. When the 1969 Act was introduced the vast majority of claims were as a result of workplace accidents. Subsequently the number of occupational disease claims increased significantly as a result of conditions such as asbestos related diseases, vibration white finger and deafness. More recently, health and safety law is gradually being extended into considerations of mental as well as physical wellbeing. Claims for stress have increased over the past few years.

However, the table below suggests that as a proportion of overall claim numbers, disease claims appear to have reduced over the last few years, although this is principally an effect of a dramatic reduction in the number of deafness claims.

% of EL Claims					
	1996	1997	1998	1999	2000
All Lung Disease	4%	4%	4%	5%	6%
Asbestos	3%	4%	4%	5%	6%
Other lung disease	0.3%	0.2%	0.2%	0.2%	0.3%
Asthma	1%	1%	1%	1%	1%
Cancer	0.1%	0.0%	0.1%	0.1%	0.1%
Deafness	34%	28%	21%	12%	9%
Skin Disease	1%	1%	1%	1%	1%
ULD	2%	2%	1%	2%	2%
VWF	3%	3%	4%	5%	12%
Stress	0.2%	0.2%	0.4%	1%	1%
Other OD	2%	1%	2%	1%	2%
Injury	54%	60%	66%	73%	66%

Source: ABI

Table: Number of personal injury claims made to general insurers, split by accident and disease, 2000-2002

		Accidents	**Diseases**	**Total**
2000	Q2	155,219	27,745	187,377
	Q3	143,614	29,305	175,454
	Q4	137,545	39,642	177,657
2001	Q1	175,742	27,122	203,105
	Q2	159,890	20,709	180,782
	Q3	156,407	17,359	173,766
	Q4	145,215	19,247	164,470
2002	Q1	152,580	17,093	169,673
Total 2000 – 2001		612,120	123,814	743,593
Total 2001 – 2002		614,092	74,408	688,691

Source: Datamonitor 2002

It is worth noting that the second table above includes all personal injury claims not just those falling within employers' liability insurance. However, the table does serve to show a clear trend particularly in relation to disease claims, which are predominantly EL based.

Uncertainty over the future impact and cost of occupational disease

Medical and technical advances have resulted in more expensive treatment as the latest technology is used to treat conditions that were previously untreatable. As medical care improves, people are living longer. This means that there is more time for a disease to manifest itself and settlements based on lifetime care increase as life expectancy increases.

Extent and Impacts of uncertainty

Insurers are concerned about the levels of uncertainty they face in pricing and reserving for long-tail liabilities. They argue this is made more difficult by the temporal separation between the economic and legal environment in which the negligence took place and that in which the claim is brought many years later. For example, insurers cannot reliably estimate future investment income or be certain when liabilities will attach, and the size of the resulting impact. Insurers argue that they find it difficult to build this combination of factors into the pricing and reserving strategy of today.

It is also important to understand the scale of long-tail risks and the degree to which they are having a quantifiable impact on the present market. Particularly important to any assessment of the degree of risk is a consideration of the issues relating to the 'state of knowledge' in the establishment of liability.

A key risk felt by insurers is that the judiciary will determine a liability that they have not foreseen and therefore not priced. Case history on asbestos is often cited as an example of this, which is said to have left insurers exposed to many decades of unpriced liabilities. The point at issue is whether this kind of exposure could reasonably have been anticipated.

The courts reached the view that the position was clear some time ago. It has now become almost a point of judicial notice that the dangers of asbestos exposure were known to employers by 1930 when the Home Office published a report from the Factory Inspectorate, which led to the passage of the Asbestos Industry Regulations 1931. This was noted by Lord Denning in his judgment in Smith v. Central Asbestos Co. Ltd in 1971. It could be said, therefore, that the position was clear more than 30 years ago, insurers should have been reserving against possible liabilities in this area. Against this, insurers state that until 2001 the courts held that the Asbestos Industry Regulations 1931 applied only to manufacturers of asbestos. However, the courts have in a number of earlier cases found that a state of knowledge existed on the part of industries using asbestos (eg. Bryce v Swan Hunter Group plc in 1988). In other words, the existence of the Regulations themselves and surrounding contemporary (and earlier) evidence should have been sufficient notice to users as well as manufacturers of asbestos as to the dangers involved.

However, moving away from asbestos rulings, it is more difficult to find many examples of similar 'state of knowledge' provisions having been set by the courts in other areas of employers' liability in such a way as to provide a significant retrospective gap between the insurance industry's awareness of risk (and ability to choose whether or not to price) and the introduction of significant liabilities. Furthermore, medical and Government guidance on potential future occupational diseases is generally available and the emergence of most new conditions tends to be a progressive process. Insurers are increasingly alert for these trends.

On balance, the evidence that has been presented so far suggests that whilst insurers have faced significant difficulties in the past, the current risks relating to 'state of knowledge' issues are narrower than they first appear. Furthermore, whilst the concerns relating to long-tail risk are clearly keenly felt in the market and may have a significant impact on decisions about capital provision, it is hard to translate these into quantifiable impacts within the market over the past year; in particular price increases (which are at the heart of the market changes) appear to relate most closely to accident risk.

The Government understands insurers' concerns and believes that more evidence is needed to assess the extent of these risks and to scope their potential impacts. Further work following this interim report will take forward this discussion with insurers and other stakeholders.

CONCLUSION ON LONG-TAIL CLAIMS:

- Insurers face forecasting difficulties in determining what to charge now and how much to reserve for long-tail claims. They also face difficulty in a competitive marketplace in building into today's premium the cost of something that might never occur.
- Medical guidance on potential future occupational diseases is generally available and insurers should be aware of the emergence of most new conditions.
- It is unclear at this stage the degree to which insurers face a substantial risk of major losses arising from future industrial diseases. Further work following this interim report will take forward this discussion with the insurance industry and other stakeholders.

Cost of resolving claims

Legal Issues

The purpose of a civil law award of damages is to compensate a claimant for the damage, loss or injury he or she has suffered and to put him or her in the same position as he or she would have been in but for the injury, so far as this is possible.

The law cannot stop any individual from bringing a civil claim for damages. Most claims for damages, including those for personal injuries, are brought as negligence claims. For a negligence claim to succeed the injured person (the claimant) must show that the defendant had a duty to take reasonable care towards him or her, and that as a result of a breach of that duty, he or she has suffered the injury. The claimant must also show that the type of loss or injury for which damages are being claimed was a foreseeable result of the breach of the duty. The determination of liability in individual cases is a matter for the court to decide in light of all the circumstances, and having due regard to the actions and standards that it is reasonable to expect from each of the parties involved. Where liability is determined in favour of claimants, the amount of damages that are awarded may be reduced to take into account the extent to which they were responsible for their own injuries.

It is not the compensation that is the cause of the cost to the economy but the injury, whether in rendering a worker unproductive or by generating health and welfare costs. The intention of the compensation system is to redistribute that cost so that it falls on those who caused it, rather than the victim or the taxpayer.

Tort law therefore underpins EL insurance and the operation of the tort system has a direct bearing on EL premiums. Over the past few years there have been a number of changes to the law and legal procedures which, insurers argue, have led to an increase in the cost of handling claims. Such changes may sometimes have retrospective effects and this also increases the claims bill. However, it is important also to consider the rationale behind such decisions.

Court procedures generally are different in Scotland. References made below to the Civil Justice Reforms and the Limitation Act 1980 do not apply to Scotland or Northern Ireland.

Conditional Fee Agreements

Since 1995, lawyers have been able to enter into Conditional Fee Agreements (CFAs) or 'No win no fee'. The claimant can take out 'After the Event' (ATE) insurance to meet the defendant's costs if he loses. Between 1995 and 2000 the claimant had to pay the CFA success fee and ATE premium. In April 2000 the Access to Justice reforms made it possible to recover reasonable and proportionate success fees and ATE premiums from the losing party. The reforms also removed personal injury negligence claims, except clinical negligence, from the scope of Legal Aid. Defendants can now recover their costs in cases they successfully defend whereas previously claimants bringing a claim under legal aid had costs protection. Lawyers bringing cases on a CFA basis do not get paid if they lose a case, whereas under legal aid they were always paid whatever the outcome.

However, the level of this financial risk is mitigated by success fees. Success fees are a percentage of base costs designed to compensate the lawyer for taking the risk in running an individual case and to allow for the general cost of lost cases. The rationale behind success fees is to enable access to justice by making it more viable for CFA solicitors to run cases on behalf of those not eligible for legal aid and those who cannot afford to fund all the costs of litigation out of their own pockets.

In Scotland, a statutory provision was introduced by the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 which enabled solicitors and their clients to agree, in relation to a case undertaken on a speculative basis, that in the event of success the solicitor's fee to his client might be increased by an agreed percentage. The solicitor's account required to be prepared as between party and party and the agreed uplift could not exceed 100% of the expenses taxed or agreed between parties.

It is open to claimants in Scotland to take out insurance to cover the defender's costs in the event of lack of success. Unlike England, there is no legislation entitling the claimant to recover from the unsuccessful defender the premiums payable on such policies. This is a matter left to the Auditor of Court to adjudicate on.

Legal Costs

The insurance industry and some employers' organisations argue that legal costs (as distinct from the compensation payment itself) make up a disproportionately high element of court awards.

The ABI have suggested that on average 40% of claims expenditure goes to legal fees while one leading EL insurer analysed data from their system that separately identifies legal costs for each claim. Legal costs represented on average 36% of the total claims cost for EL.

Table: Legal costs as a proportion of total claims cost

Claim Size	Legal Cost %
less than £10,000	51%
£10,000 - £25,000	45%
greater than £25,000	23%

Source: A leading EL insurer

According to a report produced for the ABI by Greenstreet Berman, average claimants costs (legal and medical assessment) have risen by about 50% since 1997, an average of 12% per year. As average compensation paid out in claims has risen at a higher rate of about 20% per year, claimants' costs are a declining proportion of an increasing total settlement cost. Claimants' costs have fallen from nearly 50% of compensation awards to just under 40%.

Insurers argue that the high proportion of claims costs that are currently accounted for by legal fees is partly due to above inflation increases in solicitors' and expert fees, the imposition of additional charges on CFAs and the cost of after the event insurance.

It is too early to say whether legal costs have increased directly as a result of the introduction of recoverable success fees and ATE insurance premiums. Recent research on the cost of road traffic accident cases up to £15,000 in value[1] shows that data on costs and damages from around April 2002 is highly unstable due to fluctuations in the volume and duration of settled claims and cannot be relied upon. The research also showed that there is little difference between CFA and non-CFA claims with respect to agreed base costs and disbursements, and that success fees and ATE premiums remain a relatively small part of overall costs recovered from insurers (CFAs account for about 30% of EL claims). From this research any cost increases cannot readily be ascribed to recoverability rules introduced in April 2000.

That same research showed an increase of approximately 25% in base costs between mid-2000 and the end of 2001, and approximately 10% increase in disbursements over the same period. The increase in base costs and disbursements over this period was greatest for non-litigated cases (50% and 25% respectively). The research showed that base costs seem to rise proportionately with damages and are sensitive to measures of case complexity. The trends in costs reported, the researchers concluded, appeared to be consistent with the effect of Lord Woolf's reforms on the 'front-loading' of casework. In short, pre-action protocols and better use of letters of claim has led to costs simply being borne earlier in the process.

[1]Costs of Low Value RTA Claims 1997-2002 (by Paul Fenn, University of Nottingham and Neil Rickman, University of Surrey

Further research to estimate the costs of employers' liability litigation is being undertaken which will help to identify the costs of EL cases up to £15,000 in value from January 1997 to 2002 and indicate trends for costs on a year by year basis. This research is due to be completed by the summer.

On expenses in Scotland, a recent study of personal injury litigation in Scotland published by the Scottish Executive last November (Personal Injury Litigation, Negotiation and Settlement) did not reach any firm conclusions about levels of expenses and therefore the relationship between the levels of expenses in proportion to levels of damages. This is because 89% of the cases looked at during this research settled out of court and the level of expenses and amount of damages remained private.

However, the research did confirm, broadly speaking, the significant difference in expenses according to where the litigation is pursued. In the sheriff court, a claim for in excess of £1,500 might cost about £3,800 in expenses. In the Court of Session, a similar case could cost about £13,000, including the fees of counsel. Of the sample this research looked at, 26% of personal injury cases pursued in the sheriff court concern employer liability. The comparable figure in the Court of Session is 65%. 29% of the cases that settled in the Court of Session were settled for damages of £5,000 or less.

Incidence

It has also been argued that claims frequency is increasing due to the emergence of new types of claims in recent years. These include stress, violence, employment disputes, abuse, environmental tobacco smoke, sick building syndrome, acoustic shock and mental trauma.

It is difficult to be certain about the trend in the number of claims due to the delay between the year of origin of claims and their reporting, a delay that can often be a number of years. Greenstreet Berman has suggested that from the evidence available the overall number of claims paid is either stable or declining.

The number of claims paid in the four years since the year of origin (as reported by the top 11 ABI members) has fallen by close to 20% between 1995 and 1998. None of the largest EL insurers who have provided data to Greenstreet Berman report an increase in numbers of claims paid in the last two years.

It has been contended that the propensity of individuals to enter a claim for compensation has been fuelled by the changes brought about by the Access to Justice Act 1999 in England and Wales together with the rise of CFAs and after the event insurance. The evidence is not clear-cut.

CFAs should provide a inherent incentive to exclude weak cases from being litigated. Where legal aid funds a case the costs are covered irrespective of the outcome and defendants are rarely able to recover costs if they win. CFAs require solicitors to take the financial risk of losing cases and so solicitors must, therefore, be careful about the cases they take on a conditional fee basis. Representatives of claimant lawyers on CFAs backed by after the event insurance have reported that when taking on a CFA they would want to see at least a 60% chance of success. Moreover, if the claimant wants to insure their costs, the insurer is often looking for an even higher chance of success. Recent adverse publicity about bankrupt claims agencies and reports of legal costs swallowing up awards may also have dampened claims pressure.

It must also be remembered that many employees do not pursue a claim against their employers following an accident in the workplace possibly because they fear that their job may be at risk. This may be borne out in the low number of accidents that result in claims. Moreover, claiming can still be costly even with CFAs.

There also appears to be a general downward trend in the rate of reported workplace deaths and injuries. Internationally, the UK record on workplace accidents compares favourably with other European countries.

Table: Injuries suffered by employees reported to all enforcing authorities, 1992 - 2001

	Injuries suffered by Employees		
	Fatal	**Major (non-fatal)**	**Over 3 day**
(1) 1992/93	276	16,938	141,147
1993/94	245	16,705	134,928
1994/95	191	17,041	139,349
1995/96	209	16,568	130,582
(2) 1996/97	207	27,964	127,286
1997/98	212	29,187	134,789
1998/99	188	28,368	132,295
1999/00	162	28,652	135,381
2000/01p	213	26,547	129,344

Sources:

(1) 1992/93 - 1995/96 reported under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR) 1985.

(2) 1996/97 - 2000/01 reported under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR) 1995.

Levels of Settlement

The average cost of an EL claim has risen steadily over the last ten years. The ABI say that the average size of EL claims has doubled in the past 5 years. Insurance companies claim that this is mainly due to legal changes and general award inflation.

The increase in the average size of claims has been driven by a number of factors. According to the Greenstreet Berman study for the ABI the longer term trend is upwards and significant but much less steep than the last three years.

Heil vs. Rankin

Following the Law Commission's 1997 report on damages for non-pecuniary loss, the House of Lords decision in Heil v Rankin in 2000 increased the level of awards for non-pecuniary losses such as pain and suffering. This was a one-off uplift to reflect inflation. The levels set were lower than the Law Commission believed they should be.

Ogden Tables

The House of Lords decision in 1999 (Wells vs Wells) endorsed the use of the Ogden tables when dealing with personal injury claims. These tables are actuarial calculations of life expectancy. Because life expectancy is increasing the resulting compensation awards are higher to ensure that claimants receive adequate compensation for as long as they need it.

Discount Rate

At present the cost of future losses in long-term injury claims is normally settled by the payment of damages as one lump sum that the claimant can invest and earn interest on. Insurers are able to pay a lower settlement up front in order to take account of these future possible interest accruals. Until 1998, the discount rate was 4.5% (i.e. it was assumed that this was the average interest rate over time that the claimant could expect to earn on the invested lump sum). In 1998, the discount rate was reduced to 3% following the House of Lords judgment in Wells vs. Wells. The Lord Chancellor then used his power under the Damages Act 1996 to set a new discount rate of 2.5% in June 2001. This was needed to preserve the value of payments to victims, in some cases for many years ahead. The impact of this was felt all the more because the new rate had to come into effect the day after the Statutory Instrument was published, and affected any award made on or after that date.

The increased use of periodical payments which is anticipated as a result of the amendments to the Damages Act being taken forward in the Courts Bill is likely to reduce the circumstances in which the discount rate will need to be taken into account.

However, whilst these changes were of course to be expected given the changing climate, they have led to an increase in claims average costs for insurers.

Civil Justice reforms

Following the Civil Justice Reforms (as recommended by Lord Woolf and usually referred to as the Woolf reforms) in 1999, courts can now apply severe penalties to claimants and defendants/insurers who fail to comply with the new procedures. These involve strict timetables for completion of investigation work and for obtaining all the information necessary to settle a claim. Insurers argue that this can lead to higher than average claims settlement as they are forced to settle claims near the top of the potential value, rather than contest the claim and investigate fully with the risk of incurring even higher costs/penalties.

The research report 'More Civil Justice? The Impact of the Woolf Reforms on Pre-Action Behaviour' published by the Law Society in April 2002 found that more personal injury claims were being settled without the need for issue of court proceedings as a result of the reforms, in particular the pre-action protocol. Lawyers and insurers thought that the new approach to letters of claim had led to a better level of information exchange early in a case and that claimant offers were assisting settlement. The researchers found some evidence that settlements were better informed.

Statistics from the Court Service show there has been a significant drop in the number of claims issued. Average monthly issue of county court contract and tort claims from May 1997 to April 1999 was about 163,500. Between May 1999 and April 2001 the monthly average fell to about 131,000 - a drop of about 20%.

In the Law Society report claimant solicitors thought that fewer cases going to court had meant cost reduction but that front loading had increased costs. Insurers said that from 1999 to 2001 costs had risen substantially more than inflation: claimed costs had increased by an average of 15% a year, while costs paid had increased by an average of 12% per year. The file survey showed that both damages and costs were higher in post-Woolf cases than in pre-Woolf cases: the increase in costs was an average of 17% over 2 years.

Data was obtained from members of the Association of British Insurers on 218,739 insurance claims settled between April 1997 and November 2001. This number was estimated to be 12% of all claims settled during that period. Of these, 90,425 related to employers' liability, 4,269 were personal liability claims and 124,045 were motor insurance claims.

It is likely that the vast majority of these claims were not litigated though most insurers do not distinguish. It was found that the average cost of settling claims had been rising throughout the period, with increases found in both the amount of compensation and in third party costs (claimant solicitor costs and disbursements).

In breaking down the data where it was possible to look at average cost by duration of claim, it was established that average costs in claims of less than one year's duration were only 8% higher in the second quarter of 2001 than they had been in the second quarter of 1997. For claims taking between one and three years to conclude, most of the rise in average costs took place in the second half of 1997 and in 1998. For claims taking longer than three years, most of the rise in average cost occurred after the middle of 1999. Of course, because these claims took longer than three years, the reforms would not have been in place throughout.

It was found that for claims where the compensation was £5,000 or less, average third party costs rose more after the second quarter of 1999 than before. For larger cases, where compensation was between £5,000 and £15,000, average third party costs rose less in the same period than before.

In Scotland, reforms made to Court of Session procedures came into force on 1 April 2003. These reforms introduced a timetable for the management of reparation cases from start to finish. Prior to this the timetable was only concerned with the procedural stages of the case and did not include the period between the conclusion of the procedural stages and the hearing. As a result of the new procedures, cases are expected to reach determination or settlement within about 13 months. The reforms also provide for acceleration of the timetable in the most urgent cases where the life expectancy of the pursuer is limited. Related changes in procedure include the requirement for parties to exchange their valuation of the claim at an early stage, disclose expert reports and have a pre-hearing meeting to discuss the prospect of settlement. As these reforms have only recently taken effect, it is too soon to evaluate their impact.

CONCLUSION ON THE IMPACT OF LEGAL CHANGES ON CLAIMS:

- Total claims costs have risen sharply over the last five years.
- Research by Greenstreet Berman shows that whilst the longer term trend of claims inflation is upwards and significant, it is less sharp than the most recent years.
- The decisions on non-pecuniary loss and the discount rate described above merely reflected increases in inflation or took account of changes in market conditions which it is right that the negligent party should bear rather than the victim. The size of increase in average compensation partly reflects this.
- Recently, increases in the level of settlements have outpaced increases in legal costs although, as indicated previously, both have risen significantly.

- Costs for out of court settlements appear to be rising faster than those through the court (albeit from a lower base). This suggests that Woolf reforms have front loaded costs - eroding the cost differential between court and non-court settlements for basic claims.
- Evaluation of the Woolf reforms is currently ongoing.
- The number of claims appears to be stable or slightly declining as does the number of reported accidents which might give rise to a claim.
- Currently, it is difficult to assess the impact of the Access to Justice reforms on claim numbers or how the proportion of accidents that result in a claim being made might change.
- There is no evidence available to support the general proposition that CFAs encourage speculative claims.
- Further analysis is required to assess the impact of the Access to Justice reforms (the removal of legal aid and introduction of recoverable success fees and after the event insurance) on claims costs. The available evidence is inconclusive.

The cost pressures arising from legal changes are of a different nature to those arising from long-tail exposures. They manifest themselves relatively quickly and can be passed straight onto the customer through increased premiums. As such they pose less of a challenge for insurers (except in terms of reputational costs) but they do pose a direct and substantial pressure on business.

However, there are a number of other areas where it will be important to gather further evidence.

- What does claims incidence look like over the last ten years split by accident, disease and cost band?
- How do insurers calculate their estimates of the effect on claims costs of CFAs? - do they take into account that they can recover costs when they win?
- Do insurers settle doubtful claims rather than fight them? If so why? If they settle weak cases does this encourage more claims?

5. Likely Trends in EL Insurance over the Next 18 Months

In assessing the case for reform of the EL market it is important to understand how the market might be expected to change over the next 18 months or so and the impact this might have on insurers and businesses.

Further increases in premiums

Insurers state that as a result of the pressures and changes mentioned so far, most particularly those of occupational disease and legal changes, further rating increases are necessary to improve the long term viability of EL insurance.

Most of the major EL insurers report that they intend to increase EL rates further over the next twelve months to restore their accounts to profitability. This increase is forecast to be significant albeit smaller than the increases seen over the last year. For example, one leading EL insurer has predicted the following rate increases over the next few years - 18% for 2003, 14% for 2004 and 6% for 2005.

Insurers' engagement in the EL insurance market

Whilst it is compulsory for employers to have EL insurance, it is not compulsory for insurers to provide it. Although there is no evidence that any of the major insurers are planning to withdraw from the EL market this option does exist.

Shareholders and foreign parent companies controlling many of the UK insurers are looking for maximum returns on capital from all of their operations. They are also looking for consistent returns which have a good expectation of long-term sustainability.

Insurers argue that the allocation of capital to an insurance class which involves an element of pricing today to pay for unpredictable long-tail claims makes writing EL insurance less attractive. From a corporate governance point of view too, shareholders might expect an insurer to assess whether there is a need to protect the future well being of the company from its actions today by reducing exposure to an insurance class with such features. On this basis it is suggested that insurers may be unable to sustain a strong argument for involvement in the EL insurance market.

Set against this, many of the insurers writing EL insurance have signalled their intention to target SME commercial insurance business. As a sector, insurers often find this size of business to be the most profitable and cost effective to write. And since SME commercial business is mostly sold as a package of covers, insurers have a strong incentive to remain engaged in the EL market. No major EL insurer has signalled an intention of withdrawing from the EL market in the foreseeable future

The underwriting cycle and EL insurance

Taking the general insurance market as a whole, eventual 'softening' of rates usually occurs as capital is attracted into the market by high premium rates. Existing insurers seek injections of capital from rights issues or parent companies to expand their capacity. New entrants backed by new funds start to compete for insurance business seeking good returns. Premiums then start to fall as a result of normal demand and supply pressures.

However, as indicated above, it seems unlikely that there will be an immediate pronounced expansion of capacity in the EL market if, as insurers argue, the systemic problems caused by long tail occupational disease outweigh the attraction of higher rates for those not presently committed. Indeed whilst there is some evidence of a levelling of premium rates in the personal lines insurance market as affinity groups and retailers have entered the market, the same pattern has not been seen in the employers' liability market. This suggests that EL prices are unlikely to return the low levels of the previous 'soft' phase of the cycle, though there may be some downward pressure if new capital is attracted to the EL market by high premium levels.

Future claims frequency

The current EL system produces far fewer claims than there are notified workplace accidents. Whilst this could indicate that assertions of a 'compensation culture' are overcooked it does show the potential for claims numbers to increase.

It is difficult to predict claims incidence going forward. Greenstreet Berman has suggested that from the evidence available the trend in overall number of claims paid is either stable or declining.

Impact of future regulatory changes outside of the EL market

There are a number of new initiatives which alongside their positive wider benefits may nevertheless cause continued upward pressure on EL premiums:

Recovery of NHS charges

Currently the NHS can recover the medical costs of treatment provided to people injured in a motor accident from the insurer of the person who caused the accident. It is proposed to extend this recovery to treatment provided to employees who suffer injury caused in the workplace and a power to achieve this forms part of the Health and Social Care Bill currently before Parliament. The proposal to recover costs applies to industrial injuries only, and does not extend to diseases.

The Department of Health estimates that this proposal will result in around £120m annually being recovered from employers, who in turn may claim this sum against their EL policies. The Department of Health estimates this may increase EL premiums by about 6%, though insurers are aware of the proposal and may have already begun to price this into EL premiums.

Law Commission proposals

The Law Commission has made proposals for reforms in England and Wales which, if introduced, will result in higher EL claims costs for example, new categories of claimant in claims for wrongful death. The proposals are currently under consideration by the Lord Chancellor's Department.

Variable periodical payments

The Courts Bill, which is currently in passage through Parliament, gives the Lord Chancellor the power by Order to specify circumstances in which court orders and agreements for periodical payments can be varied. It is intended that the circumstances in which variation can take place will be narrowly defined and subject to procedural safeguards. Allowing payments to be varied where there is a foreseeable significant medical deterioration or improvement in the claimant's condition will, of course, ensure that claimants receive appropriate damages for their injuries and awards may already make provision in these circumstances for such eventualities arising. Moreover, insurers could benefit in some cases as a result of the implementation of periodical payments in place of lump sums. However, in general insurers are cautious about the potential impact of variation and any possible widening of the circumstances in which it will be possible. In particular it is believed that the degree of uncertainty for actuaries in trying to accurately predict claims costs will increase.

Move to a risk-based capital approach by the Financial Services Authority (FSA)

Companies wishing to carry out the business of general insurance currently have to meet certain requirements by law. Insurance companies have to maintain a minimum solvency margin, which is set in relation to premiums and claims. A relationship is established between an insurer's assets and liabilities, in such a way as to satisfy the Regulator that the insurer is in a position to meet those liabilities. The required minimum solvency level is calculated according to certain formulae and this level of capital must be maintained subject to a minimum fund.

Currently, whilst the formula used depends on the type of company being considered (i.e. life or general insurer) it does not vary according to the class of insurance business written, and therefore does not currently take into account the relative differences in risk associated with the different classes of business.

However the FSA is moving to a risk-based system of calculating regulatory capital requirement for general insurance. This will mean that the more uncertainty within the class of business, and hence the larger the margin needed to cover potential variability in costs of claims, the greater the risk to solvency and thus the more capital will be required to support that class. The capital required to support EL may increase which, in turn, could lead to further increases in EL premium rates.

However, a move to risk based capital would provide a stronger safeguard against insurer insolvency and should lead to better risk management within firms and therefore better consumer protection in the long term.

Impact on Business

Any sustained rise in EL premium rates will present continued affordability issues particularly for businesses in those sectors seen as high risk such as construction. Companies may have to respond to higher insurance costs by passing these on to customers in a similar way to increases in raw material costs, although this may not always be possible in the short term.

Feedback from Trade Associations suggests that whilst many businesses have weathered the storm this year, further substantial premium increases may pose affordability problems. To the extent that businesses cannot pass on higher insurance costs, there are risks to investment and in some cases business survival.

There is therefore a strong incentive on businesses and insurers to respond effectively to rising insurance costs. As the following chapter suggests, there are encouraging signs that this is beginning to happen.

Companies should now be more aware of the availability of specialist advice, they should be looking to renew earlier. Over time they should find it easier over time to pass on costs.

CONCLUSION ON THE LIKELY TRENDS OVER THE NEXT 18 MONTHS:

- The two major risks are the impact of further cost increases on business and the potential withdrawal of capital from the EL market.
- Insurers have stated that premium costs are likely to continue to rise as a result of a number of pressures.
- A further wave of business problems may occur for vulnerable businesses and those that are not taking steps to factor in further increases or mitigate rises by thinking early about renewals.
- It is difficult to predict whether an insurer would withdraw from the EL market. There is little indication that this is likely in the short term but capital remains sensitive to risks in the market.
- Insurers are balancing their apparent discomfort from writing business subject to such a long tail with their desire to only write EL insurance as part of a wider package and their desire to target such package business.

6. What is Happening Now and What can Business do to Respond?

There are several ways that businesses can seek to alleviate the current difficulties and a number of collaborative efforts between trade associations, insurers, brokers and businesses are already being explored. Over the past year, the Government has encouraged dialogue and information-sharing among all parties in the EL market. The results of this co-operation are promising, and may offer some solutions for many businesses.

Budgeting for cost increases

With EL premium forecast by insurers to increase further, albeit not at the same rate as last year, businesses need to plan accordingly.

Insurance companies should do more to inform brokers and employers about the state of and pressures on the insurance market and the implications for future premium rates.

Renewals

Timing of renewals is important. We look to insurers to do all they can to improve their service levels. Employers can also take the initiative by starting their renewal negotiations early, at least three months before policy expiry. This will allow time to provide any additional information underwriters may need to better assess the risk presented by an individual firm. Brokers also need to ensure that renewal submissions are presented in good time.

Presentation of risks

Underwriters can differentiate between risks only if they have the information presented to them fully. Employers and brokers must work together to help ensure insurers gain access to all the underwriting information they need in a timely fashion. Insurers have to be a partner in this process to ensure the given evidence genuinely informs risk decisions and because insurers have a financial interest in obtaining better information on risks.

The British Insurance Brokers Association (BIBA) has been working with 16 insurers on common standards for risk presentations and has created 32 risk templates for both renewals and new business. This is a welcome step and we would encourage stakeholders to look seriously at the wider use of such techniques.

Another working party led by BIBA aims to create a wide statistical database of trade-specific, accurate accident and injury rates, enabling insurers to differentiate properly and more accurately underwrite individual risks.

Improving health and safety and risk management

Insurers must continue to work to inform companies of how best they can demonstrate risk management and to publicise the challenges that need to be addressed when accidents happen.

There are opportunities to control the cost of premiums for those employers who take a more proactive stance and provide evidence that they manage their claims effectively. However, this will continue to be harder for smaller firms.

Employers need to have a robust claims management system with a clearly defined and properly implemented health and safety policy and to be able to demonstrate their effectiveness with evidence of policies, practices, systems and documentation.

Employers should continue to address the causes of EL claims and be able to identify an audit trail to encourage better claims defence. By analysis of accidents and claims to identify causes, employers should be able to introduce corrective measures to prevent a recurrence. These actions should help to reduce both claims and premiums.

Trade Associations/Sector Groupings

A number of Trade Associations and sector groupings are working on producing guidelines and frameworks for improving and demonstrating risk management procedures for their members or sector, to a standard that can be recognised by the insurance industry. Insurers should benefit from a better claims experience across the group as a whole and consequently can allow reduced premiums.

For example, the Royal Institute of Chartered Surveyors Insurance Services and the Wren Insurance Association were set up in the mid 1980s when Professional Indemnity (PI) premiums had risen significantly. The Federation of Master Builders (FMB) Insurance Services operates a similar scheme for FMB members, which provides a package policy cover for liabilities but can extend to include other covers. AON Insurance who back the FMB scheme have increased their premium rates at levels that are lower than average increases experienced for the trade.

The DTI as part of an initiative against disreputable builders has set up a scheme through Quality Assured National Warranties to offer up to a 20% discount on a number of insurances including EL insurance for Quality Marked Registered Contractors. Builders who apply to join the Quality Mark scheme get vetted on a number of criteria including their health and safety standards. Firms will have to be successfully vetted by CHAS (Contractors Health and Safety Scheme). Larger firms may undergo enhanced vetting procedures with proactive advice on H&S procedure, risk assessment and the avoidance of claims.

In Scotland, the construction industry has developed a self-regulatory scheme initiated by the main trade associations. The Construction Licensing Executive (CLE) operates as the board with the chair and vice-chair representing consumer bodies. The CLE provides the framework for trade associations to achieve accreditation who, in turn, assess their members according to strict quality criteria (including Health and Safety). Non-trade association members can apply direct to the CLE for registration. Accreditation lasts for 1 year and inspections of firms will be undertaken to validate evidence.

The ABI has set up a working party, the Trade Associations Health and Safety EL Group, to consider how trade associations could vet their members' health and safety and risk management. It aims to create trade-specific national guidelines on health and safety standards enabling insurers to better assess the risks presented and help firms demonstrate their own commitment to risk management levels expected. It includes representatives from trades such as the National Federation of Roofing Contractors (NFRC) and the National Federation of Builders (NFB). It intends to publish an interim report shortly.

The Federation of Small Business (FSB) along with representatives of the insurance industry and National Britannia who run the HSE's telephone helpline have been considering options for accessible Health and Safety management for small firms.

Together they are devising an internet based product with free access to the website which will be used to signpost small businesses to free health and safety information in addition to giving them an option to paid access services. The more complex businesses will be referred to specialist auditors. The on-line system will explain a step-by-step approach to managing the firm's health and safety risks, taking into account the trade in question. The system will provide status reports to monitor the firm's health and safety compliance over a year. Insurers will then be able to differentiate between businesses in the same sector with no cost to themselves.

The FSB is currently in discussion with various bodies regarding funding for this product and is confident that this product could be an effective tool when managing risk in small business.

Exploring alternative insurance arrangements

Small firms in sectors considered by insurers to be high risk often face EL insurance affordability and availability issues if they are using a small broker who has a limited number of markets and products available. There are a wide range of specialist brokers and scheme brokers that handle specific trades and have access to specific products, rates and markets. The use of such brokers should be promoted since it may provide a significantly better deal for some firms.

With pooled or mutual insurance schemes a group of companies, such as the members of a trade association, form a non-profit making company whose sole business is to provide insurance for its members who may have subscribed capital. However, setting up mutuals can be problematic. Trade associations have to convince their members of the long term good for the entire membership. It is difficult (and probably anti-competitive) to make such schemes mandatory and underwriters will require a minimum buy in to give an adequate spread of risk. The NFRC is talking to the Electrical Contractors Insurance Company about setting up its own insurance via a captive cell fund exclusively for NFRC members.

CONCLUSION ON INITIATIVES ALREADY UNDERWAY:

- Businesses, trade associations, insurers and brokers are already working together to promote good practice, improve health and safety and help alleviate some of the difficulties caused by the increasing cost of EL insurance.
- There are some key issues that businesses should consider addressing:
  1. Think ahead - contact your broker early - 3 months before renewal date.
  2. Budget accordingly - ask your Broker for indications on the likely size of rate increases and ensure you plan ahead.
  3. Give the insurer the information they need - differentiate yourself from the rest - work with your broker to ensure a detailed submission is presented to the insurer.
  4. Get Advice - go to BIBA or AIB if you need help finding a good insurance broker.
  5. High risk sector? - find a niche or scheme broker specialising in your line of business.
  6. Do you belong to a trade association? - find out if they have a specialist scheme or guidelines to help your business.

7. Options for change to the EL Insurance System

We believe that on the balance of evidence and argument presented to us a case has been demonstrated for exploring and developing proposals to improve the EL insurance Market in particular areas. We want to work with stakeholders to facilitate and encourage such action. Further work following this interim report will co-ordinate and drive forward this agenda. This further work will also allow us to scrutinise developments over the insurance cycle, to undertake further analysis and gathering of evidence in certain areas in order to evaluate our conclusions, to consider the outcome of OFT and FSA studies and to provide all stakeholders the time to assess the impact and sustainability of any proposals.

At this early stage of policy development we are preparing an initial Regulatory Impact Assessment (RIA) to accompany this document. This will be placed on our website at http://www.dwp.gov.uk/

As we begin to firm up our policy proposals, we shall develop and refine the RIA by engaging with the full range of stakeholders through formal and informal consultation and by inviting them to contribute ideas and information. This will ensure that any proposals we bring forward will be built on a basis of sound information and evidence.

Areas for development in this further work can be categorised into three areas - commercially and economically driven options; options to improve outcomes; and options to improve enforcement. Some of these options are voluntary initiatives whilst others would require regulatory change. The options range from the broad and radical to the more narrowly focused.

The ideas set out here are not intended to be conclusive but rather to set the agenda for this further work.

In considering the options for reform we need to be mindful of the fundamental principles underpinning the current system:

a) Free markets - allowing markets to operate without intervention unless there is clear evidence of market failure
b) 'Polluter pays' - the responsibility of employers to fund the costs of their negligence
c) Access to justice - the right of employees injured through their employer's negligence to be fairly compensated
d) Efficiency - keeping the total cost of the system low

Commercial and economic driven options for development

i) Funding of long-tail occupational disease risk

The main body of the report considered the concerns of insurers and others in relation to long tail occupational disease risks on the basis of the evidence available. A number of proposals have been made in favour of tackling the issues posed by long-tail exposure through the separation of the funding of long-tail occupational disease

It is argued that such a separation of funding would help to stabilise pricing, and to ensure both adequacy of capacity and the continued presence of insurers in the EL insurance market. In addition, the removal of the long-tail exposures from the insurance market might enable premiums (covering workplace accidents and short-tail disease only) to be more closely linked to an employer's current health and safety practices since today's claim experience would not be blighted by latent exposures.

Separating the financing of long-tail occupational disease claims would involve some form of transition from underwriting EL insurance on a 'claims incurred' (accruals) basis to paying compensation on a 'claims made' (pay-as-you-go) basis or introducing a system which combined elements of both.

Under the current accruals system, if an employee suffers a workplace accident or disease and their employer is found to have been negligent then the insurer that was holding cover at the time of the event, giving rise to the claim is liable.

Under the pay-as-you-go system the insurer (or other funding party) on risk at the time the claim is actually made would be liable.

It has been suggested that separating the funding of long-tail business from the insurance market might be done by way of a centralized state-managed fund or pool which could be operated by insurers. The fund and pool could be financed by a levy which would reflect current costs.

In line with the principle of 'polluter pays' the Government would be very reluctant to transfer these costs from businesses to the taxpayer. The key question, therefore, is whether a revised mechanism is inherently more stable and economically efficient than the current market-driven premiums.

Currently, insurers have to make pricing judgements balancing the need to reserve against possible future liabilities against the competitive pressure to keep prices down. As discussed, there are difficulties in forecasting the scale and timing of long-tail liabilities, and hence in setting the right premium now.

Funding long-tail business on a pay-as-you-go system could provide more certainty. Such a system might provide for employers (provided they are still in business) to pay premiums that directly reflect the current cost of disease claims to which their previous employment practices had given rise.

However, there are some disadvantages:

- A fund would weaken incentives for businesses to observe high standards of health and safety practice.
- The fund would have to be able to recoup very quickly from employers amounts necessary to ensure the adequacy of the cash fund (which could raise pricing problems similar to those currently being encountered).
- Firms do go out of business - a 'pay-as-you-go' system would lead to cross-subsidy between generations of firms

For these reasons insurers have also suggested a system combining features of both accruals and pay-as-you-go systems.

Under such a system premiums could be charged based on an assessment at the time of the exposures the firm presents. As diseases began to become apparent, assessments could be made of the adequacy of the cash held within the fund. Top up payments might be raised from those firms whose workplace practices had given rise to the claims to retain a 'polluter pays' element. Some form of cross-subsidy might be required for those firms which had gone out of business.

- Assessment of these propositions

There are several important considerations that any proposals would have to be tested against, including:

- whether there is there a strong case for contemplating such radical reform; and
- whether the mechanisms proposed would actually offer a greater level of economic stability and efficiency than the present market-based approach.

We think that proponents of change have more work to do to satisfy these considerations.

- As has been indicated earlier in the report, we do not believe there is yet sufficient evidence of the scope and impacts of these risks to justify any commitment to change. This is particularly the case given the 'law of unintended consequences' which attaches to reform on this scale in such a complex market and the particular sensitivities of the market at this stage in the cycle.
- The economic efficiency of the proposed alternatives is not yet clearly demonstrated
- Practical issues of system design remain and have been manifest in the experience of overseas workers compensation systems. These include:
  - Who would manage a fund of this type?
  - How would premiums be calculated - by industry type or flat levy involving cross subsidisation?
  - Which 'generation' of a firm would finance the cost of claims i.e. would it be an accruals or pay-as-you-go based system or a mixture of both?
  - How would we clearly distinguish short-tail and long-tail disease and ensure minimum dispute?
  - How would the transitional arrangements between old and new schemes work?
  - Who would handle the claims arising from the separate fund?

In summary, long-tail risks do introduce a pricing uncertainty into the market which requires further consideration but the case for committing to radical reform has not yet been made. This is because it is difficult to quantify the impact of this uncertainty on the current premium increases (and so the levels of benefit potentially to be realised through change). In addition, more work is required to define options to the stage where we could be confident that any one would offer a general improvement rather than simply a repackaging of the problem. Nevertheless this is an important area and one in which the Government will continue to engage with the insurance industry and other stakeholders as part of our programme of further work.

ii) Cost of Resolving Claims

The insurance industry and a number of employers' organisations have argued that legal fees make up a disproportionately high amount of overall court awards. Under the current EL system, legal costs feed through directly into premiums. The legal process can be lengthy and complex though the Woolf reforms have been aimed at making the system more efficient.

A number of options have been proposed by stakeholders aimed at streamlining the claims process further and taking frictional costs out of the system thereby reducing pressure on premiums. Once again there is a spectrum of proposals ranging from no change through to a radical step change such as the introduction of a no-fault scheme.

A no-fault scheme in its purest sense removes the element of negligence from the process. As with IIDB, any qualifying injury is entitled to insured compensation. Options exist to either fix this level of compensation up-front or allow it to continue to be determined by the courts. (In some overseas workers compensation systems the right to legal representation remains. High legal costs may continue, therefore, not in disputing a claim but rather in determining the quantum and whether the condition was work related or not. Other systems, however, decide on awards through guidelines and schedules perhaps retaining an appeal procedure.)

It is argued that a no-fault scheme should reduce the barriers to claim, providing faster, simpler access to compensation for the injured party. Moreover, moving to a no-fault system might encourage greater focus on prevention and rehabilitation. No-fault may be able to be more fully integrated into the benefit system so as to reduce the possibility of loss of benefits acting as a disincentive to employees fully embracing rehabilitation.

However transition to such a scheme would face two key challenges:

The first challenge is economic. The impact of such a system on incidence and costs is uncertain. Any reduction in legal costs may lead to downward pressure on premiums but equally it is likely to lead to an increased propensity to claim and thus could result in higher costs.

The second challenge is preserving an individual's rights. A strict 'no fault' system implies a curtailment of an individual's recourse to the courts. Whilst, it can be argued that there are trade offs to be made between the benefits of 'bespoke-justice' (including the potential for higher compensation awards) and swifter access to compensation, the attractiveness of this trade-off for the individual is likely to reduce with the seriousness of the incident.

Short of an imposed 'no-fault' system, the next level of reform might therefore be the introduction of a form of alternative dispute resolution (ADR) particularly aimed at smaller claims. Such a system would aim to speed up compensation for smaller claims and reduce the need for costly litigation. However, ADR will itself have cost implications and it would be important to ensure that such a system was structured so that it offered a net reduction in costs rather than simply bringing forward the timing of costs incurred. Under this type of scheme employees would still retain the right to sue, but hopefully a substantial majority of cases would choose to settle more quickly under the alternative scheme without the need to litigate.

In view of the increased costs which may arise and the implicit restriction of individuals' access to compensation, we are not attracted to a 'no fault' system. But we do believe that it is worth exploring the scope for developing ADR processes. There is, of course, nothing to prevent these being progressed by insurers, employers and trade unions, independent of Government. But, in practice we recognise that Government has a role, not just in facilitating the development of ideas but also because of the interaction of incentives between any such scheme and the underpinning legal system.

The Government will work with stakeholders to explore how we can best make use of current initiatives in this area to encourage the development of proposals and to assist in the evaluation and assessment of such proposals.

Alongside this the Government will continue to evaluate the current legal processes, including the impacts of the Access to Justice and the Woolf reforms and is involved in a programme of activity to improve our knowledge of pre-action behaviour and the use of methods of ADR. This programme includes an evaluation of the effectiveness of the court annexed mediation schemes at Central London, Birmingham and Exeter, which offer time limited low cost mediation on a voluntary basis for cases already in the court system. In addition, a new pre-action protocol for illness and disease claims is expected to be approved shortly and the personal injury pre-action protocol, introduced in April 1999, is currently under review.

The Government is working with stakeholders in a range of areas to encourage cases to be settled in the most efficient and effective way. We are researching the legal costs of EL cases up to £15,000. We will also be considering options for the expansion of the before the event legal expenses insurance market, a market the liability insurers are heavily involved in and which along with Trade Unions support the majority of EL claims.

The Government will also examine with stakeholders whether initiatives relating to other classes of insurance might be usefully applied to EL. For instance, consideration could be given in the further work following this interim report to whether the fixed recoverable costs scheme being introduced for pre-action road traffic accident cases not exceeding £10,000 could provide a good model for a similar scheme for the EL system.

As outlined in this Report, Court procedures in Scotland are generally different to the procedures followed in England and Wales. The Government will discuss any implications of this Report on Court procedures in Scotland with the Scottish Executive.

iii) Renewals

Some insurers have excellent service standards releasing renewal terms at least 30 days before the date of renewal. Late renewals cause a real problem for businesses giving them insufficient time to seek alternative quotes, specialist advice or budget accordingly.

Employers' liability is a compulsory class of insurance so there is particular sensitivity about the service standards offered. The Government therefore wishes to work with the insurance industry to review renewals performance and encourage high standards as the norm.

We will be pursuing the subject of renewals with the insurance industry in the further work following this interim report with a view to monitoring and improving industry performance.

Options to improve outcomes

i) Improve the system to incentivise better health & safety performance

Currently the EL insurance system is based on the principles of polluter pays and access to justice. Health and Safety is an implied but not explicit element of the system. We think there is a strong case for making the improvement of health and safety practices an explicit objective of the compensation system. Such change would, of course, be beneficial as a sustainable way to manage the system since it should reduce the number of qualifying incidents.

A key challenge is to improve the link between health and safety practices and EL premiums. At present this is weak for many firms. Starting rates for the majority of businesses are set according to the experience of the trade as a whole. Underwriters can discount these rates to an extent but for small firms in particular there is a problem of 'asymmetric information' - it is not always cost effective for brokers or insurers to gather and assess detailed risk management information and to then individualise each premium.

Initiatives to improve this situation are beginning to develop naturally. In general, such initiatives aim to shift some of the effort of sorting the relative risk of firms away from the insurers through a form of pre-screening, thereby reducing the costs of premiums for well managed firms and incentivising better health and safety performance. These initiatives include:

- Trade Associations can produce guidelines and/frameworks for improving and demonstrating risk management procedures to a standard recognised by the insurers. Insurers should benefit from a better claims experience across the group as a whole and consequently can allow reduced premiums.
- The principles adopted by the "Quality Mark" initiative could be widened to other trades. Builders who apply to join the scheme get vetted on a number of criteria including their health and safety standards. Larger firms receive proactive advice on H&S procedure, risk assessment and the avoidance of claims. Members enjoy premium discounts.
- Greater onus could be placed on business to obtain independent assessment of their H&S practices which could be used by insurers. For this to work, of course, sufficient incentive would need to exist through premium discounts.
- A number of self-certification systems for employers are already being explored by insurers and trade associations. BIBA are working on standard templates for risk presentations to improve the quality of underwriting information provided to insurers and help them in the differentiation of risk.

In practice the greater differentiation of health and safety management practices could incentivise businesses at two levels. The first is by providing a level of discount on premiums. The second - and more immediately pertinent - is that demonstration of such practices might increasingly become a prerequisite to gaining access to the insurance market at all, slowly increasing minimum standards across the board.

There are a number of roles for Government in this area:-

- First to make the necessary linkages between currently separate initiatives. This is an area where a joined up approach between all stakeholders should be actively encouraged. Government will play its part in such facilitation and the sharing of best practice.
- Second, we think there is advantage in sharing common principles in the formulation of risk-profiles and safety assessments. A number of these are being developed within individual schemes. In addition, the HSE is currently engaged in a significant project to develop a health and safety performance management index. The Government intends to explore how this work might be pooled to try and develop a common approach which can be used by insurers, the regulator and businesses to assess how health and safety is being managed.
- Third, the Government will investigate with HSE and other stakeholders whether current reporting requirements are structured so as to do all they can to assist and streamline the subsequent process of claims.
- Fourth, the Government will work with the Health and Safety Commission in the development of the Commission's next strategic plan, to ensure that the delivery targets in that strategy will play a significant role is assisting a reduction in the number of EL qualifying incidents.

ii) Improve the system to incentivise greater use of rehabilitation

The principal objective of the EL system is to secure restitution for those who are harmed through the negligence of their employer. In the UK this restitution is seen almost exclusively in terms of financial compensation. This contrasts sharply with the approach adopted by many overseas workers compensation systems, where rehabilitation plays a much bigger role.

All health and safety management starts with the objective of prevention. EL kicks in once prevention has failed and injury occurred. The employee has suffered some degree of harm and in the UK this leads to a financial outcome. The state benefit system provides some compensation in the form of a stipend assessed according to the degree of disability (but without elements for pain and suffering or loss of earnings). The courts may award extra monetary compensation that is intended to place an equivalent financial value on the amount of harm. By contrast in some countries, for example Germany there is most commonly a formal prior stage of rehabilitation. In other words, there is medical intervention intended to return the injured party as close as possible to their original state of health before the incident. Only when the outcomes of this intervention have been seen is the final level of financial compensation for the degree of disability assessed.

The Government's review has found widespread support for rehabilitation to play a greater role. There is both appetite and opportunity for a radical change in the objectives and culture of EL and the wider UK compensation system, putting rehabilitation at the heart of our response to injury.

However, the review also found that access to rehabilitation in the UK is patchy. Stakeholders have identified a number of potential barriers to the introduction of rehabilitation within the EL system.

- Cost. The incentives for employers or insurers to fund these services do not appear to be sufficient. The linkage between provision of rehabilitation and the subsequent assessment of compensation needs to be clear. And if negligence is not subsequently established, then the employer or insurer is left bearing the cost.
- Timing. Early intervention (e.g. within the first 4-6 weeks of absence) is critical to the success of rehabilitation. As has been discussed earlier, cases can take time to be lodged and then more time to resolve at each stage in the process. And parties may be reluctant to commit to rehabilitation prior to liability have being established for reasons of cost or because it may be perceived as an admission of liability.
- Culture. As indicated above, the adversarial nature of the current system operates against early intervention: success is still measured in terms of size of payout. This can also increase the use of medical experts, although following the Woolf reforms greater use is now being made of single experts shared by both parties.

- Availability. There is a shortage of Occupational Health (OH) capacity in the UK and this kind of prolonged intervention has to compete with other front-line priorities for the NHS. HSE estimates that there are, on average, more than 30 applicants for each physiotherapist training position and the EL system is not creating market for practitioners. Too often, the infrastructure of rehabilitation is dependent on individual Government-funded initiatives, meanwhile 'deadweight costs' accumulate within compensation, benefits, and other knock-on costs to employers (e.g. replacement and retraining). The establishment of an effective OH infrastructure must be market driven. The key is using these deadweight costs more productively to create demand for services.

It is important to remember that rehabilitation is not equally beneficial in all circumstances. For many low-end claims there may well be a natural healing process. And in serious high-end cases the impacts of rehabilitation may be of limited or little value in terms of returning the injured employee to economic activity. But we believe, supported by overseas experience, that there is a broad range of cases that would respond to rehabilitation that is not undertaken at present.

Currently, the EL system does not encourage early and effective action to rehabilitate injured or unwell employees. A culture-change is needed to place rehabilitation at the heart of the EL system, so that as far as possible the real gains of a return to health and alleviation of suffering come before the second-best of financial compensation. We want to take forward this discussion with stakeholders, building on the existing commitment to change.

The principles underpinning such a system might include:

- A cultural approach which saw a natural order of intervention from prevention first, through to rehabilitation and only then onto compensation, while recognising that some compensation may be needed up-front.
- Timely access to a rehabilitation programme assessed at the earliest stage of medical intervention.
- Objective assessment of medical condition, the appropriateness of rehabilitation and the prognosis of its potential benefit.
- Transparency of costs with expenditure on rehabilitation not dependent on the prior establishment of liability.

We do not underestimate the challenges involved.

The distribution of cost is critical. Within EL a key step must be to create a better linkage between the levels of compensation payable and the provision of rehabilitation in order to create an 'invest to save' incentive for employers or insurers. Unions argue strongly that present levels of compensation are still too low to provide proper recompense and would be cautious about initiatives which might further lower payments. We do not support any transfer of rehabilitation costs to the employee by way of reduced compensation per se. And even under a scheme which puts rehabilitation first it will still remain appropriate to pay certain elements or a proportion of compensation up-front. But where rehabilitation does offer real improvement it is appropriate for final compensation levels to reflect this.

However, compensation costs are not the whole solution; timing matters. Within the EL system, this implies that expenditure must often be incurred before liability is established. This happens as a matter of course in relation to motor accidents where repairs are made long before liability is determined. A key difference is, of course, the extent to which both parties are insured. Within workers compensation the insurance will often only cover costs attributed to negligence. Better links to compensation payments may make it more attractive to provide rehabilitation in these circumstances but they do not address the cost risk of early provision if liability is not subsequently established.

In most cases it is difficult to transfer these financial risks to the employee (perhaps by way of private insurance) and expect them to embark upon the appropriate treatment/expenditure. Employers or the state are most likely to carry any cost. Whilst we have seen a growth in the provision by employers of private medical insurance or occupational health facilities as a benefit to employees, we believe this remains the exception rather than the rule. There is much evidence compiled by the HSE and others, that suggests an overall economic net benefit to such provision. But clearly the case that provision of this support is a sound business investment, has not been made convincingly to the particular circumstances of the majority of individual employers.

There is a need to look again at this in the context of the HSE and Government's existing work on occupational health, to convince employers of the benefits of investing in provision irrespective of negligence. Clearly a link to cheaper EL premiums would help. And this might be driven either by compensation awards which reflected intervention, or by discounted premiums, if it could be demonstrated that early rehabilitation resulted in the manifestation of fewer claims. But we also need to look at wider aspects of cost and availability.

There is a strong link to the state benefit system. Timing is one factor. The work of the Compensation Recovery Unit demonstrates that many of the claimants under EL come following an initial application for IIDB - this may be because some solicitors use IIDB claims as a case filter. There is also some flow through from IIDB onto Incapacity Benefit (IB). In this context the 90 day qualifying period for IIDB can be a barrier to intervention at the critical early stage. Traditionally, once a claimant is on benefit the role of rehabilitation within the state system has been secondary. However, progressive Government initiatives have been reassessing this approach. Most recently, the Green Paper *Pathways to Employment* saw rehabilitation as a key element in action to help people on Incapacity Benefit return to work. This was supported in the recent DWP *Job Retention and Rehabilitation* pilot, which promotes early intervention - including through rehabilitation - as a key ingredient in a range of effective measures to ensure people do not lose their job through the onset of or change in their health or disability.

In practice the immediate cost pressures on Government under the state benefit system are, if anything, less acute than those facing business in the immediate and prolonged absence of their employees. If a sound case for rehabilitation can be demonstrated by the state, it will act as a powerful argument for employers to adopt a similar approach. Similarly, if a link can be established between early rehabilitation and a reduction of flow-through to EL claims or benefits, then this would create the ground for a partnership approach between employers, government and insurers.

So solutions cannot be developed in relation to the EL system in isolation: rehabilitation needs to mesh with the other aspects of occupational health; similarly the approach undertaken by employers needs to be compatible with related initiatives linked to the state benefits system. Many elements of this approach are already set out in initiatives such as the DWP sponsored *Pathways to Employment* or the HSE lead *Securing Health Together*. The transfer of Health and Safety sponsorship to DWP last year, coupled with their leadership of the EL review process and principal interest in the benefits system, offers a real opportunity to link these strands together into a new programme for action on Occupational Health and Rehabilitation, working in partnership with HSE and other stakeholders. Specifically, in relation to ELCI the Government will lead further work building on existing initiatives to explore:

- A market-driven solution rechannelling existing 'dead costs' into a demand for occupational health services.
- the scope for relating compensation awards to rehabilitation efforts;
- the timing of rehabilitation and the scope for encouraging earlier intervention ahead of the establishment of liability;
- the impact of preventative OH and early rehabilitation on the incidence of subsequent claims or the flow-through to state benefits, in particular to see if this creates a basis for cost sharing;
- the economic case for the provision of rehabilitation both for employers and the state;
- the role of rehabilitation/screening in medical assessments;
- the development of an effective infrastructure with providers of occupational health whose services are shared by employers and the state.

Improving Enforcement

Although compliance levels remain high, all non-compliance is serious. Companies that are trading without EL cover potentially leave employees personally exposed to more of the financial consequences of their employer's negligence; they transfer liabilities to the state benefits system; and they have an unlawful competitive advantage over companies holding EL insurance because their overheads are lower. Effective enforcement must be a key component of the compensation system.

The Government is fully committed to reforming and toughening the system of enforcement. Currently the approach is passive relying on an inspector to check for the existence of an EL certificate during health and safety visits. This is inadequate. The Government intends future enforcement to be based on an active process whereby EL insurance policy numbers are provided by employers as part of an annual return which can then be checked by HSE against an enforcement database.

As part of our work following this interim review we will be developing such proposals in more detail with HSE, insurers and other relevant organisations.

In the meantime the Government will expand current enforcement efforts. This will include looking beyond HSE. Under the current enforcement regime only HSE inspectors are empowered to check for the existence of an employers' liability certificate. Fines can be imposed of up to £2,500 per day for failure to display a valid EL certificate or to insure (Section 37 of the Criminal Justice Act 1982 which sets out the standard scale of fines does not apply in Scotland (although the 1969 EL Act does apply in Scotland). However, with approximately 3 million businesses in existence many businesses are inevitably left unchecked. HSE is limited in the time it has available to pursue instances of non-compliance and average fines tend to be low. The Government will therefore discuss with local authorities the practicalities of extending enforcement powers to local inspectors.

Prosecutions are not carried out by the HSE in Scotland. The Government's proposals on enforcement will need to take account of the different prosecution arrangements in Scotland.

In addition, the Government will look to supplement these efforts through its own supply chain by becoming more systematic and rigorous in ensuring the compliance of its own contractors and subcontractors.

Finally, the Government will consider legislation or regulation to tighten enforcement powers and including considering whether:

- current limitation periods should be extended
- current levels of fine act as sufficient disincentive
- the existing regulations are clear in the duties they place on companies to ensure that there insurance arrangements are compliant; and
- if there is merit in introducing a personal duty on directors.

CONCLUSIONS ON OPTIONS FOR CHANGE

There is a case for further improvements to the EL insurance market on two fronts: to improve the operation of the market and to improve the outcomes of the system. The Government wishes to facilitate action in both areas building on the commitment for improvement shown by business, insurers, trades unions and others. There is no single solution to improve the EL system but it is possible to identify a range of agenda for further action:

Market Improvements

- There is continuing need for Government to track and evaluate of developments in this market, starting with consideration of the findings of the Office of Fair Trading and the Financial Services Authority. **While this work is in progress, the Government will scrutinise carefully any future policy changes that could put upward pressures on EL insurance prices.**
- **On long tail risks: more evidence is needed to assess whether a radical separation of accident from long-tail disease is justified.** Those arguing the case need to demonstrate its advantages; the Government will actively take forward this discussion.
- **On cost of resolving claims: the Government will work with stakeholders to maximise the benefits for EL of current initiatives within the legal system.** This will include ensuring that the costs incurred are reasonable, necessary and proportionate. We are researching the legal costs of EL cases up to £15,000. We will look at whether other initiatives - for instance a scheme to structure costs in low value motor accidents - could be extended to EL. We will be considering the expansion of the legal expenses insurance market. The Government will also engage with stakeholders to identify the scope for reducing the costs of resolving claims wherever possible and explore alternative dispute resolution processes.
- Because EL is a compulsory class of insurance, the Government is particularly sensitive to the service standards offered. **The Government therefore wishes to work with the industry to review renewals performance and improve standards.**

Improving Outcomes

- Improving Health and Safety is central to any long-term response. The most sustainable way to tackle EL costs is to reduce the number of workplace accidents and injuries. **The Government will consider this as a key element in the forthcoming Strategic Plan of the Health and Safety Commission.** We will also continue to encourage industry initiatives aimed at more risk-based premium pricing and explore whether this can be linked to the HSE's own assessment of risk.
- Currently, the EL system does not encourage early and effective action to rehabilitate injured or unwell employees. A culture-change is needed to place rehabilitation at the heart of the EL system, so the real gains of a return to health and alleviation of suffering come before the second-best of financial compensation. We want to take forward this discussion with stakeholders, building on the existing commitment to change. In addition, **the Government will review the cost incentives on business and insurers in relation to the provision of rehabilitation and other occupational health services.** This includes the account taken of rehabilitation in determining levels of compensation. There are broader links to the Government's existing occupational health strategy and the arrangements for delivering this will be reviewed in light of the new proposals on rehabilitation.
- Although compliance levels remain high, all non-compliance is serious. It reduces the protection to employees, transfers liabilities to the state and creates an unlawful competitive advantage for 'cowboy' companies. **The Government will take action to reform the enforcement arrangements.** This will involve developing an active system based on an annual notification of policies which may then be cross-checked against an enforcement database. We will also consider whether the current regulations are tight enough in the fines they levy, the responsibilities they place on companies and directors, and the time they allow for the enforcement authorities to prosecute.

Appendix A

TERMS OF REFERENCE

REVIEW OF EMPLOYERS' LIABILITY COMPULSORY INSURANCE (EL)

The purpose of this review is to assess the case for reforming EL and, if such a case is demonstrated, to identify the objectives and options for such reform. Its terms of reference are to:

- *Survey the operation of Employer's Liability Compulsory Insurance (EL), taking into account any relevant aspects of the state benefits systems.*
- *Assess the scale and nature of the current difficulties being experienced in relation to EL, in particular the extent to which these difficulties are likely to be short-term only, repeated in the future or permanent.*
- *Make recommendations to Ministers as to the case or otherwise for reforming EL.*
- *If a case for reform is found, make recommendations as to the objectives, principles and high-level options for such reform.*

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