1 May 2006

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
Sydney NSW 2001

Dear Mr Kluver

Provisions for mass future claims for personal injury

I refer to your letter of 31 March 2006 seeking the ICA's assistance in relation to the Committee's investigation of a proposal to require external administrators to admit and make provision for mass future claims for personal injury.

In particular, you indicate that one of the key prerequisites for the proposal to apply is that it must be possible to estimate the extent of a company's liability under such claims.

Obligations on Insurers

As you correctly note, similar estimates are in fact required when insurance companies make provision for outstanding claims. Section 28 of the *Insurance Act 1973* requires insurance companies to hold assets in Australia of a value that is equal to or greater than the total amount of its liabilities in Australia. An insurance company that breaches this requirement commits a serious criminal offence.

The Australian Prudential Regulation Authority has published Prudential Standard GPS 210 in order to establish a set of principles for the consistent measurement and reporting of the insurance liabilities of general insurers. The Prudential Standard is supported by Guidance Note GGN 210.1, which provides further information in relation to the valuation of general insurance liabilities.

The Role of Actuaries

GPS 210 requires the Board of an insurance company to have an Approved Actuary, and to obtain written advice from the Approved Actuary on the valuation of its insurance liabilities. Hence, insurance companies now rely on the work of their Approved Actuary when determining the appropriate amount to be provided for in relation to the outstanding insurance liabilities of the insurer.

The Institute of Actuaries of Australia has issued Professional Standard 300 relating to Actuarial Reports and Advice on General Insurance Technical Liabilities. This Professional Standard provides further guidance on the calculation and presentation of the assessment of outstanding claims liabilities.

I note the Institute of Actuaries has provided a submission to CAMAC entitled Treatment of Future Unascertained Personal Injury Claims. This submission is very helpful in identifying a number of important issues relating to the assessment of potential future claims liabilities. In particular, the submission helpfully outlines a number of the uncertain events that can have an impact on this assessment.

Proposal

For the purpose of completeness, it is worth noting the proposal set out in the correspondence attached to your letter. Attachment A states –

"The proposed new protections would be targeted, such that they would only apply where an exceptional number of personal injury claims have arisen out of a company's action or product, and more claims of that nature are expected (i.e. where a mass future claim is afoot). Specifically, the protections would only apply where:

- either
    - the company has been subject to an unusually high number of claims for payment arising from particular acts or omissions leading to personal injury; or
    - more than one company of a similar industry, or other companies with similar business operations to the company in question, have been subject to such claims;

and

- there is a strong likelihood of numerous future claims of this type."

When does a liability arise?

The general law and a number of statutory provisions create potential liability in circumstances where a company's action or product gives rise to personal injuries or death. In addition to the broad range of remedies in tort, Part VA of the *Trade Practices Act 1974* creates a range of important remedies against manufacturers and importers of defective products. A person who has suffered personal injury may have other remedies under other provisions of the *Trade Practices Act*.

These obligations and remedies exist today in respect of all goods and products. There are however, goods and products in broad use within the community which, at the present time, are not the subject of claims, but which may become the subject of claims at some point in the future. An example is mobile telephones. If science shows that they do in fact cause injury, an existing legal obligation will be triggered, even though there is no expectation today that there is or may be a legal exposure in relation to this product.

The second aspect of legal liability is that, in general terms, it arises when a cause of action accrues. It is therefore important to understand, and be able to measure with some degree of confidence, whether and when causes of actions are accruing against a company. In the case of frank injuries and trauma, the date of the cause of action is usually clear, and provision for the claim can be made with a degree of confidence. In the case of gradual onset disease, the timing of the cause of action (and hence the need to make some provision for the cost of the claim) can be more difficult to establish. This was an issue in the case of *Orica Ltd v CGU Insurance Ltd* (2004) 13 ANZ Insurance Cases ¶61-596.

I presume from the terms of the proposal set out above that there will need to be "an exceptional number" of existing claims and likely future claims. This will mean that legal liability issues should be reasonably clear, in terms of the initial duties of the company and the existence and causes of personal injury claims, and that no provision will need to be made for claims that may arise at some time in the future but where no known cause of action currently exists.

Measuring exposure

The assessment of outstanding liabilities now involves a careful examination of a number of key factors.

Firstly, there must be some understanding of the nature and extent of the level of exposure. In other words, how many products were sold that might give rise to an injury and subsequently to a claim? In compulsory third party motor vehicle insurance (CTP), the exposure measure is the number of registered motor vehicles. In workers compensation, the exposure measure is often the volume of wages.

Secondly, there needs to be a system of measuring the number of injuries arising out of the use of the product. In some areas, there are good statistics of this nature, in other areas the available information can be very limited.

Thirdly, there needs to be an examination of the number of injuries that give rise to a claim for compensation. This can be measured either in its own right (ie trends in the number of claims being made against a company) but it is often expressed as a claim frequency. For CTP, the claim frequency might be 4.5 claims for every 1,000 vehicles; for workers compensation the claim frequency might be 1.5 claims per $million of wages. If a company is regularly receiving "x" number of claims for every "y" volume of production, this is a very useful indicator of the likely number of claims that will be made against the company in the future.

Claim frequency is an important factor in the calculation of outstanding claims liabilities. Actuaries measure known claim frequency as accurately as possible, and then extrapolate the trends in exposure, injuries, claims and claim frequency to project the number of claims that are likely to be made in the future. This process requires a number of subjective judgments and assumptions regarding the likely continuance of observed trends, and can therefore be fraught

with danger and subject to considerable uncertainty, particularly if past trends do not prove to be an accurate indicator of future experience. Only actual experience can confirm whether the projections were accurate. The submission to CAMAC from the Institute of Actuaries of Australia discusses these elements of uncertainty very well.

The fourth element is the cost of claims, invariably expressed as the average cost of claims. Once again, actuaries measure known claims costs as accurately as possible, and then extrapolate trends in claims payments according to the number, nature and timing of expected future claims.

The level of compensation being awarded over time can and does vary, and actuaries need to take account of any known or likely legal developments relating to the assessment of damages when calculating the likely cost of claims.

I note that the proposal being considered by CAMAC presumes "an exceptional number" of claims have already been made. This should give some comfort to actuaries asked to measure a potential outstanding claims liability. It is possible, however, for a number of developments to occur which can influence the reliability of the estimate. Once again, these uncertainties are discussed very well in the Institute of Actuaries submission.

When undertaking assessments of this nature, a number of important assumptions must be made regarding likely future experience. When forming judgments of this nature, the actuary will certainly take account of directly available and relevant statistics, but will also take account (where relevant) of related information from similar types of claims against other companies, either in Australia or, if necessary, overseas. These are very much matters of judgment, though, and as noted previously, only actual experience will indicate whether the judgments, assumptions and projections of the actuary have been accurate.

Conclusion

The assessment of outstanding claims liabilities can be undertaken with a degree of confidence if there is a consistent body of previous claims experience, and the trends in claim numbers and claims payments are reasonably consistent over time. The greater the degree of variation in trends, the more uncertain any projections of likely future experience will be.

For this reason, APRA requires an insurance company's approved actuary to value insurance liabilities with an additional degree of confidence being built into the valuation. Initially, the actuary will derive a "central estimate" of the outstanding liability (which means that there is just as much chance of the estimate being more than adequate as there is of the estimate being less than adequate). APRA requires insurance liabilities to be assessed with a minimum probability of sufficiency of 75% (which means that there must be a 75% probability that the estimate will be adequate, and less than 25% chance that the estimate will be inadequate). Many insurance companies assess future liabilities at 90% probability of sufficiency.

CAMAC may wish to consider whether a requirement should be imposed whereby future claims liabilities are assessed at greater than the central estimate, and in particular whether the assessment of liabilities of this nature should be undertaken generally in accordance with APRA Prudential Standard 210 to the extent to which it is relevant.

Please do not hesitate to contact me if you or the Committee would like to discuss any of the material set out in this letter.

Yours sincerely

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