A real and present danger

The role of risk management in managing the impact of social inflation

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Rising inflation is driving up repair, rebuild, and rehab costs for insurers everywhere, but a more pernicious form of inflation demands both attention and action. Deborah O'Riordan, Financial Lines Practice Leader, talks about the drivers of social inflation and the role of risk management in managing the impact.

Economic inflation has dominated insurance industry dialogue of late, including those conversations around claims where the cost of goods, services, fuel, and wages are pushing up repair, rebuild, and rehab costs.[1] But in some classes of insurance, another type of inflation, this time socially driven, is also playing out.

Recently, instances of legal teams in the US (acting for and against insurance policyholders) charging more than $2000 an hour have been discussed amongst insurers, alongside equally high assistant rates across their teams. For excess layer insurers on these accounts, the ability to contest is diminished if such rates become the new normal or are considered 'reasonable'. So, what is driving this increase and how can we attempt to manage it?

> "Social inflation refers to all the ways in which insurers' claims costs rise over and above general economic inflation, including shifts in societal preferences over who is best placed to absorb risk. More narrowly defined, social inflation refers to legislative and litigation developments that impact insurers' legal liabilities and claims costs."
>
> Geneva Association: *Social Inflation: Navigating the Evolving Claims Environment*

Litigation costs are just one of a range of factors influencing social inflation. There are several drivers of social inflation which cumulatively contribute to a trend in increasing both the frequency and severity of claims in management liability and other classes of insurance including general liability and professional and medical malpractice. It is not a new phenomenon: some may recall a similar wave in the 1980s.[2]

The Geneva Convention presents social inflation as a "real and present danger", thanks to the long-tail nature of liability insurance and the increasing unpredictability of outcomes including so-called 'nuclear verdicts', chronic under-pricing, and under-reserving. Given a permanent shift, there is potential that covers could be limited or withdrawn entirely if sustainable returns cannot be achieved, preventing insurance from fulfilling its societal role.[3]

With access to better data, we may see swift short-term responses from insurers (in the form of price and excess increases/decreases in appetite and cover) to counter the impact. However, long-term a collaborative effort is needed by many stakeholders to ensure the market is managed from the foundations up.

Drivers of social inflation

Social inflation accounts for rising claims costs that cannot be accounted for by normal economic inflation. Crudely split, it can be attributed to two factors:

1. Changing societal perceptions, values, and trends.
2. An approach by market players that exploits the evolving landscape for revenue generating opportunities.

Media coverage of business news – including both failings and successes – can inform public perception, opinion and trust of corporations and their spokespeople, shareholders, and advisors. Against this backdrop of media commentary – alongside social activism, political rumblings, and a fluctuating economy – market players are acting to take advantage of opportunities for revenue generation.

Claims management companies and lead generators for class actions, Third Party Litigation Funders (TPLFs), and the law firms litigating these cases, all use a range of tactics and behavioural strategies to maximise the value attributed to a claim.

Litigation factors

> Growth of claims management companies
> Aggressive litigation advertising
> Burgeoning class actions
> Third-Party funding - ‘No-win, No-fee’
> Increasing compensation and ‘Nuclear Verdicts’
> Rising professional costs - teams, speculative expert use, and lengthier timescales
> Aggressive trial strategies and psychological techniques

Societal trends

> Negative sentiment towards ‘big business’ and institutions
> Social inequality - wealth, power, and influence
> ‘Information Age’ and sensationalist media: galvanises causes, proliferates narratives, and shares news (real and fake) and opinion
> Individuals’ proclivity to claim
> Demographic shift - younger, more radical juries
> Normalisation of litigation and payout entitlement

Social inflation

Emerging risks & solutions

> New injuries and diseases
> New / unproven technologies
> New categories of claim / novel heads of loss
> Ever-improving scientific evidence of product damage (talcum powder, opioids, vaping, ‘forever chemicals’ etc.)
> Advances in treatments
> Lengthening life spans

Social movements & issues

> Social activism and movements
> Remote working and mental health issues
> Climate activism
> Cost-of-living crisis / economic inequality
> Gig economy / zero hour contracts
> ‘Everyone’s invited’

Fig 1: The drivers of social inflation

The role and reach of Third-Party Litigation Funders

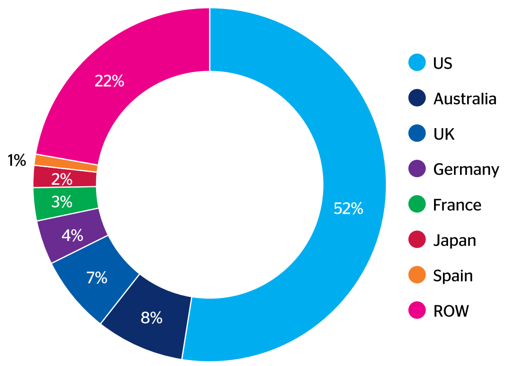
TPLFs, which include private equity firms, hedge funds, and wealthy individuals, play a critical role in facilitating this marketplace. While some litigation backers have ideological motives, this is a lucrative business supporting both consumer and commercial litigation, across a range of areas including automotive accidents and bodily injury, product liability, medical, professional, and management liability.

According to the Swiss Re Institute (SRI), the return on this type of investment is over 25%, outperforming higher risk schemes such as venture capital, so it's unlikely that appetite for funding legal cases will decline.[4]

SRI figures below show that the US is by far the largest market for litigation funding with over half of the 2021 $17 billion market generated there. Australia, the UK, and European countries lag behind but are growing markets as US law firms set up camp in other territories, consumer and climate protections increase, and a globalised approach to claims is facilitated by changing legislation.

The US is the world's largest third-party litigation funding market, accounting for more than half (52%) of global activity

TPLF investment globally rose 16% year-on-year to USD 17 billion in 2021



Note: The sum of percentages may not add up exactly 100% due to rounding.

Fig 2: Territorial Splits for TPLF

Source: Research Nester, Swiss Re Institute

Globalisation is also driving increasing numbers of class actions in jurisdictions outside the US where claimant law firms and their litigation funders are extending their influence in some markets. UK and European Courts are also willing to deal with non-domiciled stakeholders in matters such as climate and data privacy where the impact cannot be confined to lines on a map.

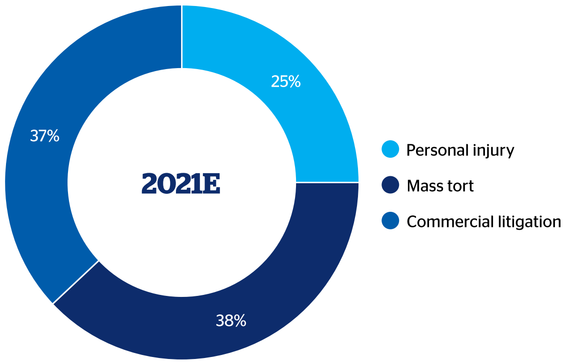


Fig 3: Case type splits for TPLF

Source: Morning Investments, Swiss Re Institute

The UK is currently the most active jurisdiction in Europe for class actions where there are many routes for both opt-in and opt-out claims. Adopted in 2015, the Collective Proceedings Orders (CPO) regime for competition claims forms the foundation on which the UK's largest damages action to date was built: Merricks vs Mastercard, a claim for unlawful bank charges, pursued on behalf of 46 million consumers.

There are several more CPOs in the pipeline which indicate a growing appetite with potential to extend interest to areas beyond competition claims. Scotland introduced a new class action mechanism in 2020 which is being used to pursue a claim against Volkswagen, and in 2021, the case of Lloyd v Google arose after Google used a loophole to place tracking cookies without knowledge or consent.

This was a breach of privacy laws for which a representative action was launched against Google. The use of representative action ('opt-out' litigation) meant that the claim was made on behalf of the more than four million individuals in England and Wales. Although Mr Lloyd failed to prove financial damage and emotional distress against Google in this landmark case, progression to the Supreme Court illustrates how future cases could be more successful.[5]

The Netherlands is a close contender and growing rapidly as a centre for group litigation, especially in the areas of climate and technology claims. The Resolution of Mass Damage in Collective Actions Act ('WAMCA' legislation) has opened up a channel of redress for mass damages in collective actions. The propensity for class actions may further increase following the introduction of EU Directive on Representative Actions for the Protection of the Collective Interests of Consumers in 2023.

A real and present danger

Some sectors and specific risks seem to be particularly prone to group and commercial litigation, some fuelled by litigation advertising and funding. These could impact on management and professional liability, cyber, crime, and general liability policies, so close attention to data and developments will be needed in these areas:

ESG

- Non-compliance with legislation and regulation
- Reporting failures and inaccuracies
- 'Greenwashing'
- Failure to transition effectively to sustainable goals
- Reputational damage and business failure

Data privacy

- Ransomware attacks
- Data theft / breaches
- Tech Giant product development using non-approved data
- Inadequate control over use of AI

Forever chemicals

- Per- and polyfluoroalkyl substances (PFAS) in food containers, clothing, furnishing, and pesticides
- Leaching into soil and water supply
- Long-term health impact

Automotive sector

- Competition Law (ongoing cases from EU Cartel judgment in 2016)
- Mis-selling / emissions claims (encouraged by TV advertising)
- Trucking accidents (ongoing in US)

Financial services

- Mis-selling in this sector is an ongoing issue:
  - Securities
  - Investment products etc.
- Failure to meet expectations / needs

Mental health

- Covid-19 legacy e.g.
  - Isolation
  - Restricted education and social development
  - Employment issues yet unknown
- Cost-of-living crisis
- Mental health and wellbeing closely linked to physical health, errors and accidents at work, and recovery

Fig 4: Fuel to the TPLF Fire

What's the impact?

Concerns about social inflation are well documented.[6] It appears generally accepted that TPLFs lead to higher awards, longer cases, and higher legal expenses including compound short-term interest on litigation finance. It can also create conflicts within client-lawyer relationships due to different objectives and with policy limits no longer being adequate.[7]

To some, social inflation could be viewed as a modern-day Robin Hood movement, extracting large pay-outs from wealthy corporates, and distributing these amongst poor consumers either individually or to group action participants.

According to research however, the proportion of settlement monies paid to claimants is reduced when TPLFs are involved, and more cases are funded for larger businesses rather than 'David vs Goliath' type cases.[8]

Rising claims costs are likely to impact business and personal policyholders in the long run as insurers seek to offset higher costs through raising premiums, reducing coverage, and potentially withdrawing from some markets.

In contrast to the US legal system, there are already mechanisms in place in the UK and Europe that should prevent the extreme awards witnessed there:

Non-US Legal Factors

> Absence of US-style civil jury system.

> Awards are non-punitive.

> Loser pays – which should avoid frivolous cases.

> Compensation / ombudsman schemes provide an anchor for valuations.

> Associations, directives, and further plans are in place to shape how litigation funders should operate.[9]

A call to action: the role of Risk Management

The Insurance Information Institute (III) promotes the idea of a three-pronged approach to tackling social inflation[10], involving open discussions so that awareness and understanding of the drivers and potential impact of social inflation are raised. The III stresses the need to focus on collective obligations and opportunities rather than insurers' losses which will alienate some stakeholders.

Part of this debate includes engagement with policymakers on litigation funding but that will likely form part of the longer game. Some short-term wins can be achieved by dealing with actionable elements under the banners of risk management and good governance for businesses, and regulatory and market controls for litigation funding:

INTERNAL: Business Action

Counteract negative public opinion
With strong Governance and ESG Credentials* and narrative, including environmentally friendly practices, employee, customer and community protections across the supply chain.

Reduce the likelihood of claims and litigation
By fostering a robust Risk Culture* and strong governance and education to build assurance and to continuously learn and improve.

EXTERNAL: TPLF Regulation & Control

Controls on exploitative litigation advertising
Fuelling the blame and compensation culture and creating legal action out of frivolous cases.

Greater transparency in TPLF
To gain clarity on commissions, other charges, and planned % to claimants to educate with aim of preventing long drawn-out litigation; push for agreed rating bands where appropriate.

Robust claims management
Challenge on excessive rates; use of experienced defence firms with effective counter-strategies; early and proactive communication and Alternative Dispute Resolution (ADR) where possible to resolve more speedily with reduced costs.

Fig 5: Key solutions to managing social inflation

*QBE customers have access to profiling tools for evaluating both Risk Culture and ESG.

There will always be emerging risks, changing societal norms and unexpected events, like a pandemic, to contend with, and as part of the transition to net-zero we must support the entrepreneurship needed for research and development of new technologies and products.

In the era of big data, analytics, and AI, insurers will find more capability to monitor developments and remodel claims development on drawn-out cases to ensure reserves and capital are adequate. More radical approaches to risk transfer in litigated cases might also be another avenue for investigation.

With rich information and innovative solutions, insurers are better equipped than before to react more swiftly in adjusting appetite and policies, premiums and limits, ensuring their ability to underpin commercial activity and the new approaches needed for a sustainable future.

For more information

www.qbeeurope.com/risk-solutions

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