# Liability Insurance for Public Agencies

CHARLES J. VAN ARSDEL
President of the Insurance Institute of Indiana, Inc.
Indianapolis, Indiana

## INTRODUCTION

In this paper I will show what has brought about the liability insurance availability and affordability problems that public agencies are having.

Back in 1974 I was a participant on a program in Chicago along with the then general counsel of Kemper Insurance Companies. Ed O'Brien is a man who has since retired, and one for whom I have a great deal of respect. At that time Ed made the comment that most people have very little knowledge of the insurance industry, how it operates, what its functions are, other than that they pay a premium and, hopefully, will get paid if they have a claim. It was his contention that if folks understood our business a little better, they probably wouldn't like us any more, but they'd understand why we do what we do.

## AVAILABILITY OF THE INSURANCE PRODUCT

There are about 20 communities in the State of Indiana where insurance coverage is not available. They have not been able to buy coverage from any source. Most of the other units of government have been able to find coverage but not at a price that they want to pay. The availability question has come about because of some severe tightening of the insurance market. The capacity of normal and specialty markets has been severely restricted, principally because the reinsurance market has withdrawn from operation in the United States.

What is the reinsurance market?

Reinsurance is the thing that primary insurers buy to protect themselves, just as individuals, as primary insureds, buy insurance to protect businesses, homes, automobiles, and communities. The insurance company does not assume the full amount of the risk when they write an insurance policy for you or your community. They keep part of it, but then they reinsure another part of that risk and pay a premium for it. That procedure then gives them the capacity to write the volume of insurance that you might want to buy.

The reinsurance market has literally dried up in the United States. One of the major suppliers of reinsurance in this country has been the underwriters at Lloyds of London. Lloyds of London has said publicly on any number of occasions that they will withdraw, or have withdrawn, from writing reinsurance in the United States until some major effort is made for reform of the tort system — the civil justice system. I think the step that was taken with Senate Bill 394 is a start toward reform here in Indiana. The same kind of movement is going on throughout the rest of the United States and hopefully will have some impact and will eventually bring back some of the reinsurers to the American marketplace. If so, the company that you are doing business with will have easier access to a reinsurance facility and adequate capacity.

Another major problem that reinsurance impacts on is that a company is limited in the amount of insurance it can write by the amount of surplus it has. When an insurance company takes your risk, agrees to insure your community, they tell you that if you have a loss of a certain size, they are going to pay it; yet, the Insurance Department of the State of Indiana recommends that an insurance company only write premiums in a ratio of $3 of premium to $1 of surplus. If a company writes more premiums, they are getting into a possible hazardous condition and are overextending their capacity. Consequently, the company may be in some difficulty with the insurance department. Reinsurance comes into play to allow greater capacity for the insurance company so that it can write more risk.

A company was put into rehabilitation just last week — a company domiciled in Indianapolis and its major problem is the ratio of premiums being written to surplus. If that can be corrected, that company will be rehabilitated and put back into the open marketplace again.

There is some new hope for the availability problem. The companies doing business in Indiana, the 500 plus insurance companies who are licensed to do property/casualty business in this state, have agreed at the insurance commissioner's request, to form a voluntary market assistance program. A community that can't find insurance, can go to the market assistance program and those companies that are participating in that program will do everything possible to make sure that their coverage is written. On the preliminary returns for the V-MAP Program, 25 companies doing business in Indiana have indicated that they will write municipal liability risks. So, there is some new hope on the horizon currently. It doesn't mean that they are going to write insurance at as low a rate as you'd want to pay, but local government can buy the coverage.

## AFFORDABILITY OF THE INSURANCE PRODUCT

The second part of the equation that is creating the problem is the affordability question. The insurance industry is very cyclical in nature. In order to emphasize and give a little better illustration, see Figure 1. The graph illustrates the cyclical nature of the insurance business from 1951 through 1984. Notice that in period one, there were five profitable years. The 100% line is a line that tells us in the insurance business that

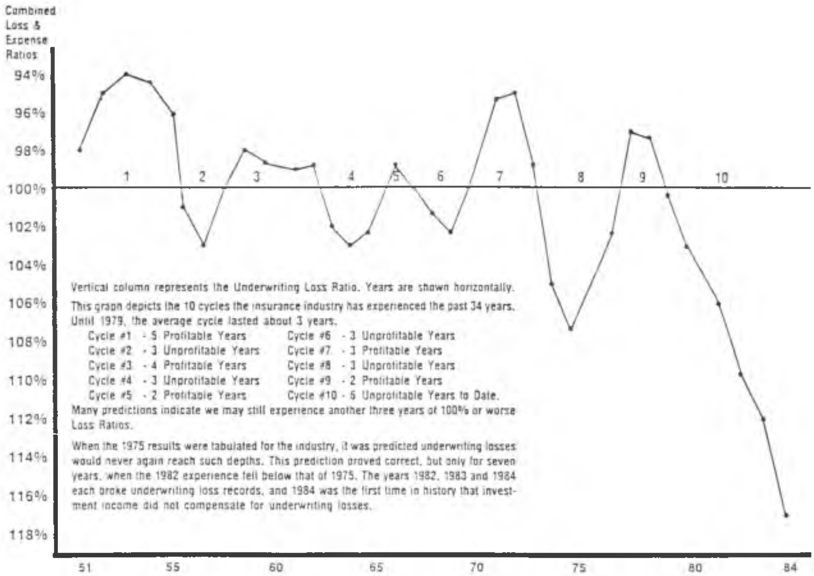


**Figure 1. This chart illustrates insurance cycles over 34 years — 1951 to 1984. Years noted along bottom line.**

our claims and loss adjustment expense, all the expenses that we must deal with, are acceptable if they are less than the 100% line. In this case they were 96% down to as low as 94%. When they get below that 100% line, the insurance company is losing money on the business it underwrites. For example, in 1955 it looks like they were 102% and that meant that the company was spending $102 for every $100 they took in, and they can't do that too long. Follow that line across, and note those periods where the insurance industry has lost money and those periods where the insurance industry has made money. The period 1970 to about '72 was good. Then there was a severe drop going down to 1975, back up again in 1978 and '79. In '79 the line starts down to the point that at the end of 1984, the insurance industry lost 118.6%. That was our loss ratio, and again, $118.6 dollars for every $100 was taken in. You'll notice that that particular dip is six unprofitable years. Since this graph was printed, we have had another unprofitable year which would take that line down even further for 1985. In 1984 the industry had a net loss of $3.5 billion dollars. This 118.6% loss ratio indicated a $21 billion loss for the property and casualty insurance business. The investment income that the insurance industry had in 1984 was $17.5 billion, giving us a net loss of $3.5 billion country wide. That's a lot of money to try to deal with and I hope gives some indication of the reason that the cost of insurance on municipal liability is pretty high.

During this time, also, there's a good deal of blame that can be laid on the shoulders of the insurance industry. Beginning at about 1980 the investment market was superb. There was a price war going on within the insurance industry. Companies were cutting prices quite frankly to get capital to invest, they were getting tremendous returns in the investment market. In one way, they were sharing those investment returns with the policyholders by way of much lower premiums, but suddenly when the investment market bottomed out in 1984 and early 1985, they were sitting there with insurance policies written at premiums that were far less than they should have been. Consequently the increases that people see today and have been seeing through the last 12 months are so severe that they are having difficulty accepting them. We find that in most instances, the premium that is being charged today is approximately the same premium, with an inflation trend factor, as was charged in 1979.

The rate that is set for a given risk is called a manual rate. We consider a manual rate to be 100% of what should be charged for that particular risk. In many instances, policies were being written for 10% of manual, and that was true in 1983 and 1984. In 1985 and 1986 that premium has been raised to the full 100% of manual, which is a tenfold increase in the price and rather hard to accept if you are the person who has to take that kind of an increase out of your budget.

We hope, and we do see, some indication that perhaps 1986 will see this graph start back up — there are some indications. If we can keep the wind from blowing in Indiana as it did earlier this week, we'll be alright. . .a few losses like that don't help a bit. Of the $5.5 billion loss that has been recorded for 1985, $2.8 billion is from catastrophe loss from some of the big storms that they had down off the coast of Texas and Florida. All of this may give you some indication as to why the price has gone up.

Note Figure 2. Many people think the Indiana Tort Claims Act (with its various tort claim limits) is the greatest thing since sliced bread, but it's not when it comes to being an underwriter for an insurance company. Notice that all across the bottom portion of this graph the tort claims limits that are applicable to most states. There are about 11 states that do not have any limit at all. It's just Katie bar the door — go for the big one and the state or the local unit of government can pay it. But most of the states are in the group shown on the bottom of the graph with lower limits. The limits for tort claims in the Tort Claims Act for Indiana are $300,000 per person, $5 million per accident or occurrence. Note the long line going upward — that's our $5 million bucks. And that's the part that has to be measured by the underwriter in trying to value your risk as a part of government. We have to look at the full exposure that's

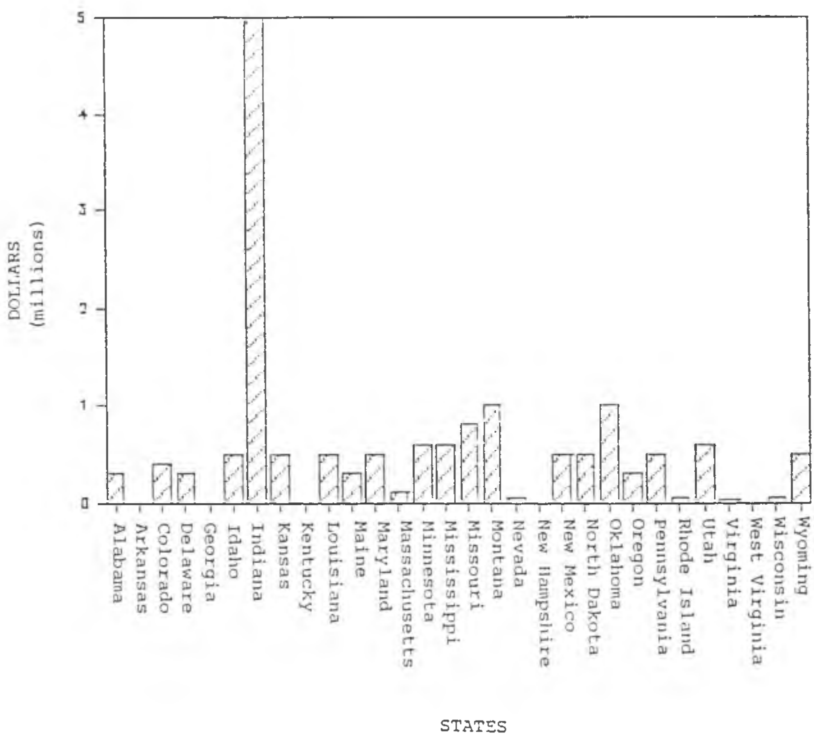


**Figure 2. Liability Comparison — States with municipal caps and sovereign immunity. The sovereign immunity equals cap of zero and limits are per occurrence.**

possible, and not just the $300,000 that could happen on the lower end of the scale. Indiana's Tort Claims Act does need some modifications.

There were proposals in the discussion on House Bill 1255 to reduce that top limit, bring it down to at least $1 million, which would be far more in line, and would again reduce the cost of premiums. But, of course, that was not done, and I don't anticipate that it will be done any time in the future. This graph gives you some idea of how Indiana stacks up. If somebody states that our Tort Claims Act is great — it's not really that great, because it does establish a very high limit that must be handled by the insurance underwriter.

Insurance is underwritten on the basis of experience that has been gained by the industry in dealing with a specific kind of risk. The experience is tabulated on the basis of a state's own experience, it's also tabulated on the basis of a regional experience, and on the basis of national experience. I know there's been a lot of discussion that really things are not as bad as they seem in the municipal risk area here in Indiana, but below are some national figures and some Indiana figures.

Countrywide for all classes of municipal liability, as of the end of 1983, which is the last year that we have full statistics, the loss ratio — that's the loss itself and the expense of handling the loss — for all classes of municipal liability countrywide was 209.7%. That's $209 for every $100 taken in. For Indiana, for that same period of time the loss ratio in the municipal lines of business, all classes — highways, swimming pools, the whole thing — was 188.9%. With all apologies to the drafters of House Bill 1255, I don't think putting municipal risks in a pool at 125% is going to cut it if the loss ratio at the end of 1983 was already 188.9%. But that's what we're dealing with, and that's why we're dealing with a liability insurance crisis.

There are some things that can be done. I think some improvements could be gained through better, or at least some, risk management. I know some communities have good risk management programs, some counties, some units have good risk management programs, some have very minimal risk management programs. I think good risk management programs should certainly be part of your future projections. Certainly a return to profitability for the insurance industry would be a major help, and we're going to do everything we can to try to make that happen. The tight market, the tight underwriting will continue. The close attention to claims, the work to try to help reform the civil justice system, all those things will certainly go on in an effort for the insurance industry to return to profitability.

There is a need to curtail the volume of law suits and the size of awards, and we're very hopeful that Senate Bill 394, the collateral source rule change, will be a significant step in trying to start that correction process. There is an organization that was formed in Indiana during this past year called the Indiana Forum For Civil Justice. That forum is the organization that drafted and shepherded Senate Bill 393 and Senate Bill 394 through the legislature. I have every hope that organization will continue. It is made up currently of 81 or 82 organizations, private corporations, trade associations and so on, within both the private and public sector. It is not just an insurance industry trial lawyers battle anymore, it's a battle for survival within the business community and in the public sector. We certainly hope that the Indiana Forum For Civil Justice does continue.