| Title: | Impact Assessment (IA) |
|---|---|
| **Updating insurance contract law: the business insured's duty of disclosure** | **Date: June 2012** |
| **Lead department or agency: Law Commission** | **Stage: Consultation** |
| | **Source of intervention:** Domestic |
| **Other departments or agencies:** Scottish Law Commission. | **Type of measure:** Primary legislation |
| | **Contact for enquiries**: Tamara Goriely 02033340281 |

## Summary: Intervention and Options

**RPC:**

| Cost of Preferred (or more likely) Option | | | | |
|---|---|---|---|---|
| **Total Net Present Value** | **Business Net Present Value** | **Net cost to business per year** (EANCB on 2009 prices) | **In scope of One-In, One-Out?** | **Measure qualifies as** |
| £123.25 million | N/Q | N/Q | No | Zero Net Cost |

**What is the problem under consideration? Why is government intervention necessary?**

Under an Act passed in 1906, before taking out insurance, a business is required to tell the insurer "every material circumstance" which would influence a prudent insurer in fixing the premium or deciding to take the risk.

- The duty is uncertain, leading to too many disputes.
- Businesses find it difficult to assemble the information, or to second-guess what the insurer wishes to know.
- It gives the impression that insurers can play a purely passive role, without asking questions.
- The remedy is unduly harsh. A business may act honestly and reasonably, but still have its claim rejected.

**What are the policy objectives and the intended effects?**

The objective is to update the 1906 Act to ensure a better exchange of information, enabling insurers to price insurance correctly. This is intended to lead to fewer disputes and fewer rejected claims.

A reduction in the number of disputes would save legal costs and disruption for both insurer and insured. If fewer claims were rejected, fewer businesses would be put in jeopardy, with benefits for employees, creditors and the economy as a whole. Confidence in the insurance industry would increase domestically and internationally.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

The options are:

Option 0: Do nothing

Option 1: Update insurance contract law to reflect the reciprocal nature of information exchange. The business should make a fair presentation of the risk and the insurer should make appropriate enquires. Where the business fails to give the necessary information, the insurer should have a proportionate remedy based on what would have happened if the insurer had known the true facts.

Option 1 is the preferred option as it would improve the efficiency of the market.

**Will the policy be reviewed? The Law Commission does not implement legislation. Review is a matter for the implementing department. If applicable, set review date: N/A**

| | | | | | |
|---|---|---|---|---|---|
| Does implementation go beyond minimum EU requirements? | | | **No EU requirements** | | |
| Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base. | **Micro Yes** | **< 20 Yes** | **Small Yes** | **Medium Yes** | **Large Yes** |
| What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent) | | | **Traded: No effect** | **Non-traded: No effect** | |

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the Responsible Commissioner: *David Hertzell* Date: 26/06/12

# Summary: Analysis & Evidence

Policy Option 1

**Description: Update the business insured's duty of disclosure to reflect the reciprocal nature of information exchange.**

**FULL ECONOMIC ASSESSMENT**

| Price Base Year 2010 | PV Base Year 2011 | Time Period Years 10 | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | Low: £82.17 | High: £164.33 | Best Estimate: £123.25 |

| COSTS (£m) | Total Transition (Constant Price) | Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---|---|---|---|---|
| Low | £1.0 | | | £1.0 |
| High | £2.0 | | | £2.0 |
| Best Estimate | £1.5 | | | £1.5 |

**Description and scale of key monetised costs by 'main affected groups'**

There will be transitional costs as insurers and businesses review their practices, develop protocols and train staff in the new law, £1,500,000 [best estimate].

**Other key non-monetised costs by 'main affected groups'**

Consumer advice agencies would need to incur the costs of familiarisation with the new law and training.

| BENEFITS (£m) | Total Transition (Constant Price) | Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---|---|---|---|---|
| Low | 0.0 | | £10.0 | £83.17 |
| High | 0.0 | | £20.0 | £166.33 |
| Best Estimate | 0.0 | | £15.0 | £124.75 |

**Description and scale of key monetised benefits by 'main affected groups'**

The main monetised benefit is reduced legal costs, as clearer law leads to fewer disputes and makes disputes easier to resolve, annual savings of £15,000,000 [best estimate].

**Other key non-monetised benefits by 'main affected groups'**

More streamlined disclosure, with less "data dumping" of irrelevant and undigested information.

Less delay in claims payment, enabling firms to recover more quickly from fires, floods and other misfortunes.

Fewer claims rejected, with less chance that firms will become insolvent (leading to benefits for employees, creditors and the wider economy).

More confidence in the UK insurance market and UK insurance law.

**Key assumptions/sensitivities/risks** **Discount rate (%)** 3.5

The savings in legal costs are based on an estimate that disputes over non-disclosure currently cost businesses and insurers around £50 million a year.

At present, poor disclosure often leads to insurance being underpriced. The insurance is cheap but valueless if the claim is rejected. The improvement in disclosure together with the change to proportionate remedies is likely to lead to higher premiums and more certain claims payments. The additional cost of claims payment is treated as neutral: policyholders receive the payment but pay for it in higher premiums. The insurance will however be more effective - and this is treated as a non-monetised benefit.

**BUSINESS ASSESSMENT (Option 1)**

| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
|---|---|---|---|---|
| Costs: | Benefits: | Net: | Yes | Zero net cost |

# Evidence Base (for summary sheets)

## INTRODUCTION

1. This consultation is part of a larger review of insurance law. The UK insurance industry is the third largest in the world. In 2010 it received £46.4 billion in premiums and paid £30.8 billion in claims. Yet the law of insurance contracts is out-of-date. The common law developed in the eighteen and nineteenth centuries. It was codified in the Marine Insurance Act 1906 (the 1906 Act), which has been held to apply to all forms of insurance.

2. This has made it difficult for judges to develop the law to keep pace with modern developments, such as the changing nature of communications and the growth of global businesses. As the law has been codified by statute, only Parliament can update the law. The review aims to update insurance law to reflect the modern market.

## THE PROBLEM

3. This particular paper focuses on the insured's duty of disclosure in business insurance, which produces a large number of disputes and has generated concern.

4. The duty is set out in section 18 of the 1906 Act. It places an onerous duty on a prospective policyholder to disclose information to an insurer before buying insurance. The business must disclose "every material circumstance" which it knows or ought to know "in the ordinary course of business". A material circumstance is one which would influence the judgment of a prudent insurer in fixing the premium, or deciding whether to take the risk. The statute does not require the insurer to ask questions or indicate what it wishes to know.

5. If the business fails to disclose every material circumstance, the insurer may treat the policy as if it does not exist and refuse all claims under it. Although some exceptions are set out in section 18(3), these are written in archaic language and poorly understood.

6. This leads to four problems:

    - Many businesses fail to disclose all material circumstances. Research shows that even professional risk managers fail to understand the law in this area – not because the words are complex, but because the concept is counter-intuitive. Despite continual warnings, few policyholders believe that the law really expects them to second-guess what the insurer wants to know. Even if they do believe it, they may have little idea of how to set about the task.

    - The law gives the impression that insurers may play a passive role. It encourages "underwriting at claims stage". In other words, the law gives the impression that an insurer may write any risk, however inadequately presented, and ask questions only once a claim arises. If, at that stage, the insurer discovers information to suggest that the risk was greater than first thought, it may refuse the claim.

    - The remedy for non-disclosure is unduly harsh. A policyholder who fails to mention a minor issue loses all benefit from the policy, even if the insurer would only have added a small amount to the premium had it known the true facts. This over-protects the insurer, and fails to act as a sufficient incentive for insurers to ask appropriate questions.

    - As a reaction against this harsh penalty, the courts sometimes strain their interpretation of the law to say that no non-disclosure has taken place. The policyholder may be paid their full claim, even though they failed to disclose a matter which would have led to a small increase in premium.

7. The duty impacts more harshly on larger firms than smaller firms. In practice, small firms are usually asked specific questions. Larger firms, however, (with a turnover of £50 million or more) are often required to present a risk to the insurer, without the benefit of questions, which gives greater scope for omitting information which an insurer might consider relevant.

## RATIONALE FOR GOVERNMENT INTERVENTION

8. Government intervention in the form of a legal solution is required because the current law adversely impacts on the capacity of the insurance market to operate efficiently.

9. The law has long recognised that insurance is a special form of contract, which is particularly vulnerable to two forms of information asymmetry. First, the policyholder knows more about the circumstances comprising the risk. Insurers need to receive information about these circumstances in order to decide whether to accept risks and, if so, at what price and on what terms.

10. Secondly, the insurer knows more about the significance of those circumstances. The insurer is the risk professional: among the vast array of possible information about a business, it is the insurer who is best placed to know which information is important. For example, the insurer is most likely to understand the importance of the fact that a retailer has reduced its distribution centres, or that a manufacturer is now selling its washers for use in the energy industry. Without the insurer's ability to decide between the irrelevant and the relevant, important information may become hidden in a "data dump".

11. The law, as codified in 1906, places the onus for exchanging information firmly on the policyholder. The insurer need not ask questions or provide the policyholder with any indication of what might be relevant. The evidence shows that policyholders often struggle to understand what must be disclosed in the absence of questions.

12. The exchange of information would be more efficient if the law highlighted the reciprocal nature of the information exchange. The policyholder should make a fair presentation of the risk and, if the presentation raises concerns, the insurer should then ask appropriate questions.

## CONSULTATION

13. There have been many previous calls for reform of this area, including reports from the Law Reform Committee in 1957, from the Law Commission in 1980 and from the British Insurance Law Association in 2002.

14. In 2007 we consulted on reforming the duty of disclosure in business insurance and received around 60 responses. Since then we have held further consultation with both insurers and business insurance buyers. The current proposals are based on those discussions.

## POLICY OBJECTIVES

15. Our objectives are to provide clear legal rules to govern relations between insurer and insured. In particular, we seek:

    - To encourage the full exchange of information between insurer and insured so that insurance is correctly priced.

    - To provide certainty to both parties, to reduce the number and cost of disputes.

    - To reduce the number of times that claims are rejected for unintended failures of information exchange. This would put fewer businesses in jeopardy (with benefits for employees, creditors and the general economy as a whole) and would increase confidence in the insurance industry.

## OPTIONS FOR REFORM

16. In this Impact Assessment we consider two options:

    (1) Option 0: Do nothing.

    (2) Option 1: Update insurance contract law to reflect the reciprocal nature of information exchange.

17. Under Option 1, the 1906 Act would be updated to reflect current case law and good practice. In particular, the law would clarify that:

    (1) The business should make a fair presentation of the risk, after following a reasonable and proportionate procedure to gather relevant information.

    (2) The insurer should make appropriate enquiries. Where the insurer receives information which would prompt a reasonably careful insurer to make further enquiries, it should not be entitled to refuse a claim for non-disclosure of information which those enquiries would have revealed.

    (3) Where the business has behaved dishonestly, the insurer should be entitled to avoid the policy and refuse all claims.

    (4) Where the business acts honestly but fails to give the necessary information, the insurer should have a proportionate remedy based on what would have happened if the insurer had known the true facts.

18. In 2007 we proposed to replace section 18(2) of the 1906 Act with a new test based on what "a reasonable insured would think was relevant to the insurer".[1] Although there was considerable support for reform, many insurers were concerned that the "reasonable insured" test was too uncertain. We are no longer pursuing this option.

19. Where the business acts honestly but fails to give the necessary information, the insurer should have a proportionate remedy based on what would have happened if the insurer had known the true facts.

## BACKGROUND: THE DUTY OF DISCLOSURE IN PRACTICE

20. Survey evidence suggests that the duty of disclosure does not operate well in practice. Businesses fail to understand what information is relevant to insurers, leading to widespread failure to disclose all material circumstances. This generates disputes, causing delay, underpayment and legal costs. Some claims may be refused, which in serious cases may jeopardize the future of the business.

### The Airmic survey

21. Airmic is the risk managers' association, which represents the insurance buyers and risk managers for the largest companies. Their membership includes around three-quarters of the UK FTSE 100 group of companies.

22. In 2010, a survey of Airmic members found that preparing to present a risk involves a considerable commitment of resources: 75% of firms that responded spend between two and six months in preparing the information they submit to insurers. Members said that 38% of submissions for property risks exceeded 50 pages: 36% did so for casualty insurance; and 26% for directors' and officers' liability insurance. [2]

23. Despite these efforts, approximately a third (31%) of participants stated that insurers had raised non-disclosure issues against them in the last five years. Of these, only around half reported that the claim had been resolved satisfactorily. There was also a worryingly high level of litigation: 5% of all Airmic members in the survey had been involved in litigation on the issue of non-disclosure in the last five years. Furthermore, over three quarters (77%) thought that the problem was becoming worse and that it was increasingly difficult to collect accurate, relevant information.

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1 Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134 at paras 5.83 and 12.31.

2 Airmic Non-disclosure of material information - Member Survey (2010). The survey is based on 111 responses.

24. Large multi-national businesses were particularly concerned about difficulties in meeting the current standard, because such complex businesses find it particularly hard to assemble all relevant information in one place. They wanted greater clarity that the issue should be looked at from the point of view of the risk manager or other person placing the insurance. The reforms would clarify that the person placing insurance should make reasonable enquiries, but need not disclose information which could not be elicited by such enquiries, even if it was known to some employees.

### The Mactavish Report

25. In 2011, the Mactavish Group published a report on this issue.[3] The Group interviewed over 600 policyholders and over 100 senior insurance executives. Their report covered a wider sector of corporate Britain than represented by Airmic. It found that the greatest problems were likely to be experienced by mid-sized companies with a turnover of between £50 million and £5 billion.

26. The report found that buyers of business insurance have little understanding of the law: 87% were unaware of how onerous the duty was. Furthermore, 65% demonstrated this ignorance by failing to review the information used to place their risks with insurers.

27. Furthermore, there were widespread failures to provide the material information. The Group reviewed over 100 market submissions and conducted around 50 in-depth case studies. It concluded:

> The same weaknesses and limitations seem to crop up in almost all cases. The senior insurance personnel consulted as part of this work concurred that the weaknesses are endemic and market-wide. Of course, there is some variation in the standards of disclosure – and specific areas of error or omission – but the overall picture is consistent enough to confirm that current market standards are inadequate.[4]

28. Examples of material omissions included:

    (1) Inadequate discussion of the end-use to which products are put. Companies failed to mention that apparently innocuous components may be used for risky medical, space or nuclear applications.

    (2) In business interruption policies, inadequate information about single source dependency. For example, a large UK retailer failed to mention that it had reduced the number of its suppliers and closed distribution centres.

    (3) A lack of discussion of non-core activities. For example, a manufacturing company failed to mention that it undertook sensitive contract testing work for third parties.

### Soft and hard markets

29. In a soft market, insurance is relatively cheap and insurers are keen to write business. That can result in slapdash presentations by buyers, cost cutting by brokers and over exuberant underwriting by insurers. As noted in the Mactavish Report, after many years of a soft insurance market, insurers have grown to accept lower standards in submission:

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[3] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011). This followed an earlier report in 2010, Mactavish Sector Research 2010 – Stage One. Cross-Sector Findings Summary.

[4] The Mactavish Report at p17.

> The soft market puts underwriters under intense pressure to secure new business. They must operate with the knowledge that there are other penholders ready to write business on the back of the most meagre information in submission documents.[5]

30. In soft markets, insurers may also play claims as a matter of goodwill, as they are keen to retain business. A theme of the report is that many claims are paid on this basis, but that will dwindle if market conditions deteriorate.

31. The problems come when soft markets start to turn hard. If insurers discover that they have underpriced the risk they have taken on, they are more inclined to raise issues of non-disclosure when a claim is made. Although most disputes are settled after delay or protracted negotiations, difficult market conditions may lead to the outright refusal to pay claims. The Mactavish Report found that this could have serious consequences for businesses:

> If, for whatever reason, a major insurance policy fails to pay out, most firms would either struggle to raise debt to pay for the loss, or would be charged prohibitively expensive amounts to do so.

32. Airmic commented:

> Mactavish's research is thorough and convincing, and it lifts the lid on a potential crisis looming in the UK commercial insurance market. Airmic have long argued that the current legal framework for commercial insurance contracts is unsustainable. This research illustrates just how dangerous the situation can be.[6]

33. Underwriters must receive sufficient information to assess and price risk, yet the current law fails to ensure that this information exchange works efficiently. The evidence shows a need to clarify the parties' responsibilities in the twenty-first century.

## THE MAIN STAKEHOLDERS

34. We have identified three main stakeholders

    (1) Insurers;

    (2) Commercial policyholders;

    (3) Lawyers and the courts.

## THE IMPACT OF THE REFORM

35. The reform would have impacts in three areas. It will impact on:

    (1) The volume and cost of disputes.

    (2) The administrative costs of exchanging information.

    (3) Claims payments.

36. Below we consider each of these areas in turn.

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[5] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011), at p 11.

[6] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011). Industry Response.

## DISPUTES

### The volume of disputes

37. The duty of disclosure generates considerable litigation. We identified 41 reported judgments on the duty of disclosure in the last 10 years: 26 English High Court judgments, 12 Court of Appeal cases and 3 Scottish Court of Session cases.[7] These form "the tip of an iceberg". Data from the Judicial Statistics suggests that less than 4% of all litigation commenced in the High Court results in a trial. On this basis, 26 High Court judgments would result from 700 cases where litigation is commenced.[8]

38. The problem mainly involves larger businesses with more than 250 employees, of which there were 6,320 in the UK in 2011.[9] In the Airmic survey, 5% of respondents had been involved in litigation on the issue of non-disclosure in the last five years, suggesting around 630 claims in 10 years. This is compatible with the number one might anticipate, based on reported court judgments.

39. There will be an even larger number of disputes which do not involve litigation. In this market, for example, many cases will be dealt with by arbitration. In the Airmic survey, 31% of participants stated that insurers had raised non-disclosure issues against them in the last five years. This suggests something in the region of 4,000 disputes over non-disclosure between large businesses and insurers over 10 years.

40. This high level of disputes and litigation is a matter of concern. The uncertainty of the law is well-illustrated by the particularly high number of appeals: at least half of all judgments in this field go to appeal. Below we illustrate these numbers figuratively.

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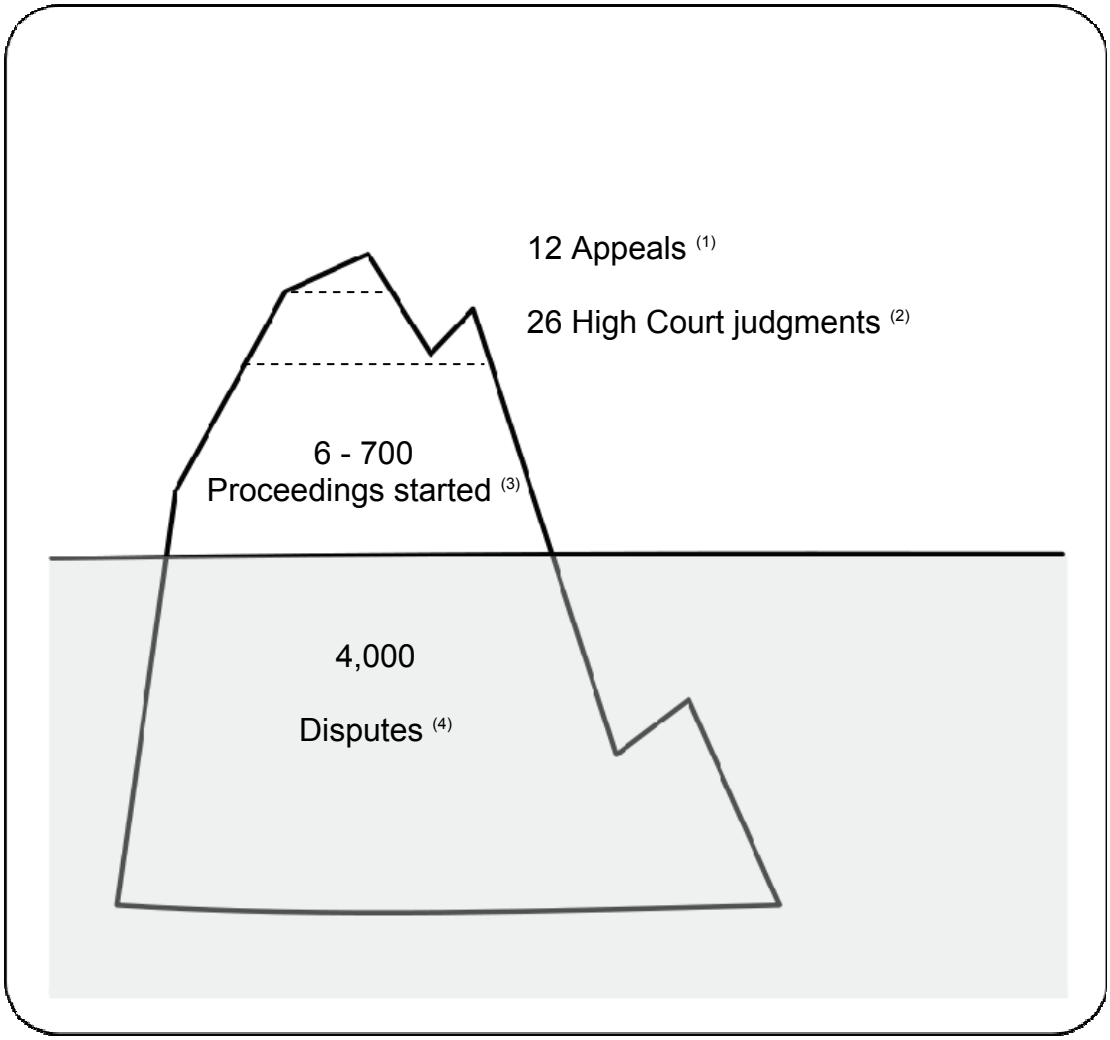
7 Between January 2002 and January 2012. Of the Scottish Court of Session cases, one was first instance and two were appeals.

8 See Ministry of Justice, Judicial and Court Statistics 2010 (June 2011) p 134. Out of 4,864 claims issued in the Queens Bench Division at the Royal Courts of Justice in 2010, 182 went to trial (representing 3.7% of claims issued). The Civil Judicial Statistics Scotland 2010 – 11, provide information about initiations and disposals of cases in Scotland, but in a way which makes it difficult to draw a direct comparison with the percentages produced here and at para 1.36 above.

9 BIS, Business Population Estimates for the UK 2011, Table 1.

**Figure 1: The number of disputes over non-disclosure in commercial insurance in England and Wales over the last 10 years**




| | |
|---|---|
| (1) | 12 cases reported in the Court of Appeal. |
| (2) | Number of reported High Court cases concerning non-disclosure |
| (3) | Estimate based upon a 3.7% figure of Queens Bench Division claims proceeding to final judgment. Airmic figures suggest that in 10 years 10% of large businesses (>250 employees) litigate over non-disclosure, suggesting that 632 businesses have issued claims.[10] |
| (4) | Estimate based upon Airmic figures that 31% of businesses experience a dispute involving non-disclosure. |

## The costs of disputes

41. This level of dispute generates substantial legal costs. This is illustrated by research carried out for Lord Justice Jackson's review of the costs of civil litigation in England and Wales. The research collected data on the cost of 49 Commercial Court cases where the costs were determined by the court.[11] We have used these to estimate the cost of a High Court

10 In any given 10 year period, some cases will have started as disputes without reaching full resolution, similarly some judgments and appeals will relate to cases started before the 10 year period.

11 Jackson LJ, *Review of Civil Litigation Costs: Preliminary Report* (2011), Appendix 9. The Taylor Review of Expenses and Funding in Civil Litigation in Scotland will consider the implications for Scotland of the recommendations following the Jackson Review. A Consultation Paper was published in November 2011. A Report is expected by the end of 2012.

trial, by removing 6 cases which concerned minor pre-trial applications,[12] and 2 cases where insufficient data was presented.[13]

42. Based on the remaining 41 cases, the mean cost was £402,389.41 and the median was £157,200. The very high mean reflects a few extremely expensive cases, including one which cost over £5 million. Clearly, any system in which a single case can add £5 million to total costs is variable and unpredictable. We think, however, that it is necessary to include such cases within the average (mean) cost figures as the few very expensive cases contribute so much to the total figures.

43. The costs of an appeal are much less than the costs of a contested trial, but are not inconsiderable. In one insurance dispute in the study, the costs relating to the appeal were estimated at around £35,000.

44. Based on the Jackson research, we have estimated total costs in England and Wales as shown in Table 1.

**Table 1: Estimated costs of disputes over non-disclosure in commercial insurance In England and Wales over 10 years.**

| Number of disputes | Average cost per case | Total costs in category (£M) |
|---|---|---|
| 12 appeals | Additional £35,000 | 0.4 |
| 26 High Court judgments | £400,000 | 10.4 |
| 624 cases where proceedings were issued (but which did not proceed to trial) | £100,000 | 62.4 |
| 6,350 disputes where no proceedings were issued | £25,000 | 158.8 |
| TOTAL costs for policyholders | | 232.0 |
| TOTAL costs for insurers (assuming similar levels) | | 232.0 |
| OVERALL TOTAL for both parties over 10 years | | 464.0 |
| **Costs per year** | | **46.4** |

45. We have not been able to find separate figures on the costs of cases before the Scottish courts but these are unlikely to be high.[14]

[12] These cases all cost less than £20,000 and clearly did not involve trials.

[13] One case settled for a sum combining both damages and costs and another included the costs of the subsequent appeal which could not be disaggregated from the data.

[14] The Report of the Taylor Review of Expenses and Funding in Civil Litigation in Scotland (scheduled for the end of 2012) might provide useful material in this regard.

46. On this basis we have estimated that legal fees in dealing with disputes over non-disclosure may cost the UK economy up to £50 million a year. We welcome views on this broad estimate.

47. As an additional check on this estimate, we looked at the fee income of legal firms dealing with insurance disputes. Based on industry knowledge, we compiled a list of the top 11 firms dealing with insurance coverage disputes. The total turnover of these firms for 2009/10 was £1.7 billion,[15] of which we estimate that at least 10% is for insurance coverage disputes (an estimated £170 million) and that a quarter of those coverage disputes involve disputes over non-disclosure. This suggests around £42 million spent on solicitors' fees, but there would be additional costs in barristers' fees and expert witnesses. We think that our estimate is consistent with the size of the legal market in this area.

48. In addition to legal fees, policyholders and insurers also incur internal costs in dealing with disputes, both in terms of staff time and in disruption to the business. We have provisionally estimated that these additional costs may amount to around a quarter of legal fees, which would add between £10 million to £12.5 million to the cost. We welcome views on the internal costs of dealing with a dispute over non-disclosure.

49. **We invite comments on the view that legal fees on non-disclosure disputes cost the UK economy up to £50 million a year**.

50. **We welcome information on the scale of legal fees associated with disputes over non-disclosure in commercial insurance in the Scottish courts.**

51. **What additional costs are associated with each dispute, in terms of staff time and disruption to both policyholders and insurers**?

### THE ADMINISTRATIVE COSTS OF EXCHANGING INFORMATION

52. In 2007, the Association of British Insurers (ABI) commissioned PricewaterhouseCoopers LLP (PwC) to investigate the financial impact of insurance law reform.[16] The Report describes the current approach to collecting information from commercial policyholders.

53. At one end of the scale, many businesses are sent proposal forms in the same way as consumers. The Report comments:

> For small commoditised risks, commercial property is written on a similar basis to person lines in that there is a standard set of questions on the basic details of the property and business operation being underwritten. There are then general questions to obtain complete disclosure.[17]

54. The reforms would have less effect on this market. Where a specific, limited question is asked, the courts have held that the insurer waives its right to receive other information on the same subject.

55. The reforms are mainly aimed at the market for larger risks, where the policyholder is required to take the initiative in presenting the risk. The PwC Report explains how this works for the marine market:

> The current practice when placing marine insurance is for the broker to present the risk to the underwriter. During this presentation the broker is expected to disclose all the key material facts to allow the underwriter to understand the risks and make a coverage decision.

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[15] We obtained this turnover information for 2009/10 from *The Lawyer*'s online directory of UK firms, http://www.thelawyer.com/directory/uk-firms/.

[16] The PwC Report.

[17] Above, p 91.

> Based on this presentation and the material facts disclosed to them, underwriters pose additional questions to the broker. These questions tend to be specific and focus on the areas where the underwriter perceives a high risk.[18]

56. As we saw, for larger firms the cost of preparing presentations can be considerable: 75% of firms responding to the Airmic survey spend between two and six months each year in preparing the information they submit to insurers.

57. There is some doubt about the consequences where the insurer fails to pose additional questions. At present, the law is not wholly clear. Several cases have held that if the insurer fails to ask appropriate questions at this stage it will be taken to have waived its right to the information. Despite these cases, the PwC Report comments that many insurers place "complete reliance on the broker to disclose material facts regarding the business operation that enable the insurer to understand and rate the risk effectively".[19] The insurer is seen as a passive recipient of information, rather than an active questioner. This is encouraged by the remedy of avoidance which means that where an insurer fails to receive the correct information it is over-compensated for any loss: if no claim is made, it may retain the premium; if a claim is made, it need not pay it.

58. We have received anecdotal evidence that businesses respond to the apparent harshness of the current law by "data dumping" – by overwhelming the insurer with CDs full of irrelevant and undigested information. We have not been able to quantify the wasted costs of "data dumping", though it has the potential to be considerable. It wastes the business's time in preparing it, and the insurer's time in reading it. We welcome views on the costs posed by "data dumping".

59. The reforms are aimed at the market for larger risks. They would not change the basic principle that for large risks, the policyholder should make a fair presentation of the risk. They are, however, designed to make this process more efficient. They aim:

    (1) To encourage industry protocols on what amounts to "the key material facts" for different types of risk. The statute would clarify that an insurer would be protected if the broker failed to disclose standard information which market participants generally understood should be disclosed (though policyholders would also be required to disclose unusual circumstances, which could not be covered by standard rules).

    (2) To clarify that the insurer must play an active role. The insurer would not have a remedy if it receives the presentation and then fails to pose appropriate additional questions, where the required information would have been discovered by those enquiries.

60. The intention is that the reforms would encourage insurers, brokers and commercial policyholders to work together to clarify what sort of information should be included, what enquiries the policyholder should make, and how the information should be structured. This would involve some transitional costs, but our provisional view is that it would soon produce significant savings. We ask for views on this.

61. It is important to stress that the duty of disclosure would remain.[20] The reforms would simply clarify accepted good practice: namely that an insurer should read the presentation

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[18] Above, at p 92.

[19] Above, at p 92.

[20] The PwC Report considered the effect of abolishing the duty of disclosure completely, so that insurers would be required to ask questions about everything they wish to know (as occurs in the consumer market). PwC thought this would involve costs of between £200 and £300 million (p 95). This option is not under consideration as the costs would be too high.

carefully, consider its implications and ask additional questions where appropriate. We do not think that this would add to costs, but welcome views.

62. **Have consultees encountered instances of "data dumping", whereby businesses disclose large quantities of irrelevant information? If so, what costs are wasted by this practice?**

63. **Would the costs of presenting a risk be reduced by greater clarification of what information should be included?**

64. **Would insurers incur additional costs by considering presentations and asking appropriate questions before entering into contracts?**

## CLAIMS PAYMENTS

### The effect of non-disclosure on the price and value of insurance

65. Research by the Mactavish Group found widespread failures by businesses to provide insurers with material information. We have considered the effect of this failure on the price and value of insurance.

66. An insurer who fails to understand the full extent of the risk is likely to under-price the policy. Lacking full disclosure of material circumstances it is likely to fix a premium which is too low. Initially, the policyholder may perceive this to be a benefit, but it comes with a long-term cost. In the event of a loss, the insurer is entitled to avoid the policy and refuse all claims under it. The insurance, though cheap, becomes effectively worthless. The insurance fails in its primary purpose, which is to provide protection in the event of a loss.

67. If insurance is correctly priced, the business would pay more in premium but would receive more in claims payments. At one level this is neither a cost nor a benefit to the business. The effect is neutral: the money paid in premiums is returned in payments. At another level however, where insurance works correctly by charging the correct price and paying the expected claim, the insurance has performed its purpose. It enables the business to recover quickly from the misfortune that has befallen it.

68. Claims rejection can lead to catastrophic consequences for the firm involved. The Mactavish Report comments that many businesses would not be able to borrow money following a serious loss in the absence of an insurance payment. At present outright rejections appear rare. The report says:

> Disputes do not necessarily mean outright refusal of claims: rather, they more often mean delays in settlement or protracted negotiations about the size of claim payments.

69. Many claims are paid as a matter of goodwill. There was concern, however, that such goodwill may be running out. As the long soft insurance market turns hard, insurers may be much more prepared to rely on their strict legal rights to refuse claims, even in the absence of wrongdoing. Without the expected claims payment, the firm may not be able to resume trading, leading to insolvency. This would have potentially serious consequences, not just for shareholders but also for employees, creditors and the economy as a whole.

### How many claims are rejected for reasons of non-disclosure?

70. In November 2007, the PwC Report commented:

> There is a small but material proportion of submitted claims that is currently declined on the grounds of non-disclosure and where no payment is made.

71. PwC explained that larger claims were most likely to be declined as insurers investigate these more closely. Any estimate of the value of rejected claims was difficult, as the amounts would fluctuate. PwC's tentative estimates are set out in the table below.

**Table 2: PwC's estimate of the annual value of claims in commercial insurance where whole claim rejected for reasons of non-disclosure.**[21]

| | Commercial property | Marine insurance |
|---|---|---|
| % of claims by value | 2 to 4% | 1 to 2% |
| Total value of rejected claims each year | £70m to £140m | £4m to £8m |

72. Subsequent consultation suggests that these figures may be an over-estimate. As we saw, the Mactavish Report found that outright rejections are rare.[22] This was confirmed by our own consultations with insurers. There was agreement that commercial property insurance was the sector most affected by non-disclosure, and that it was possible that issues of non-disclosure arise in around 4% of the cases. It was argued, however, that in the majority of non-disclosure disputes, a settlement was eventually reached.

73. Estimates of the value of rejected claims are extremely difficult to make. We tentatively suggest that for commercial property insurance non-disclosure is raised in around 4% of claims by value: in 3% of claims a settlement is reached, while 1% of claims are rejected. We welcome views on this figure. For other areas of insurance, the issue of non-disclosure is less important.

74. **In commercial property insurance, how many claims are rejected for non-disclosure? We welcome views on the tentative estimate that non-disclosure issues are raised in 4% of claims by value, of which 1% lead to outright rejection and 3% are settled.**

### The effect of the proposed reforms

75. The current law provides only one remedy for a non-disclosure: avoidance. The contract is treated as if it has never been made, and all claims made under it are refused. We propose a new system of remedies. These would distinguish between honest and dishonest behaviour. Where the policyholder has acted deliberately or recklessly, the insurer would be entitled to reject all claims and retain the premium paid. This is intended to provide a strong sanction against dishonesty.

76. In other cases, the remedy would aim to compensate the insurer for the loss it has suffered. The compensatory remedies look at what the insurer would have done had it known the true facts:

    (1) Where the insurer would have declined the risk altogether, the policy would be avoided, the claim refused and the premiums returned.

    (2) Where the insurer would have accepted the risk but included another contract term, the contract would be treated as if it included that term.

    (3) Where the insurer would have charged a greater premium, the claim should be reduced proportionately. For example, if the insurer would have charged double the premium, it need only pay half the claim.

77. Although proportionate remedies are not recognised at law, they may be applied in practice. Most disputes settle, and the settlement often reflects the seriousness and consequences of

[21] PwC Report p 103.

[22] The Airmic study found that 5% of firms had litigated over non-disclosure in the last 5 years, or 1% per year.

the non-disclosure. Proportionate remedies are intended to allow those settlements to be reached more quickly, as the parties "cut to the chase" of the amount of payment, rather than exchanging denials that any wrongdoing took place, or that any sum is due. By depriving insurers of the "nuclear option" to deny the whole claim, proportionate remedies would also lead to more balanced negotiations, leading to somewhat higher settlements. As one lawyer put it:

> Instead of going into negotiations saying we are paying nothing and end up paying half, we would say we would pay a third and end up paying two-thirds.

78. We have modelled the effect of the reforms on claims payment in commercial non-disclosure cases in the following tables.

**Table 3: Model of effect of reforms on non-disclosure disputes in commercial insurance, where claim currently rejected in full.**

| Outcome under reforms | Effect | % of cases | Cost of reform, for each £100 million in rejected claims |
|---|---|---|---|
| Full disclosure made | Claim paid in full | 10% | Correct premium paid |
| Non-disclosure deliberate or reckless | Claim rejected and premiums withheld | 15% | Small saving to insurer in withholding premiums (£0.2m) |
| ***Non-disclosure not deliberate or reckless and insurer would:*** | | | |
| a) not have taken risk | No change: claim rejected | 30% | No change |
| b) charged higher premium | Proportional payment | 30% | Around £15m additional claims cost |
| c) added term, which would have excluded claim | No change: claim rejected | 12% | No change |
| d) added term which would not have excluded claim | Claim paid | 3% | £3m additional claims cost |
| Total effect: | | | 17.8% increase |

**Table 4: Model of effect of reforms on non-disclosure disputes in commercial insurance, where settlement currently reached.**

| Outcome under reforms | Effect | % of cases | Cost of reform, for each £100 million of claims settled |
|---|---|---|---|
| Full disclosure made | Claim paid in full | 30% | Correct premium paid |
| Higher settlement reached | May add around 15% to payment | 40% | Additional £6 million in claims costs |
| Same settlement reached | No change | 30% | No change |

### The overall effect of the reforms on premiums

79. In considering the effect of the reforms on premium payments we have concentrated on commercial property insurance, as this would be the area most affected. The models and estimates set out above suggest that the reforms could increase claims payments by 0.36%, which would be passed on to policyholders in increased premiums.

**Table 5: Effect of non-disclosure reforms on commercial property insurance.**

| | Commercial property | Increase in claims payment | Effect on all premiums |
|---|---|---|---|
| Claims wholly rejected | 1% of claims per value | 17.8% | 0.18% |
| Disputed claims where settlement reached | 3% of claims per value | 6.0% | 0.18% |
| Total effect on premium | | | 0.36% |

80. In other words, for every £100 of premium paid for commercial property insurance, buyers would pay an additional 36p. This would be both a cost to policyholders when buying insurance, and a benefit to policyholders when submitting claims. The payment itself is therefore neutral in cost-benefit terms.

81. The overall benefit of the reforms lies in the added value given to the insurance: it is more likely to be effective when it is needed. There is less risk of business failure because the insurance proves to be ineffective.

82. As we have seen, it is the large claims which are most likely to be rejected: those which follow major catastrophes when firms are at their most vulnerable. We think most firms would choose to pay a small additional premium to buy an insurance policy which pays out in the event of a catastrophe. As the Construction Industry Council said in response to our previous consultation paper, if premiums rise “so be it; more effective insurance arrangements should come at a price”.

83. If policyholders wish to save 0.36% on their premiums, it would be more rational to increase the excess on smaller and affordable losses, rather than take the risk that the insurance will fail when it is most needed.

## THE COSTS AND BENEFITS OF THE REFORMS

84. This impact assessment identifies both monetised and non-monetised impacts of intervention, with the aim of understanding the overall impact on society and the wider environment. The costs and benefits of each option are measured against the "do nothing" option. Impact assessments place a strong emphasis on valuing the costs and benefits in monetary terms (including estimating the value of goods and services that are not traded). However there are important aspects that cannot sensibly be monetised. These might include impacts on equity and fairness, either positive or negative, or enhanced (or diminished) public confidence.

85. The Impact Assessment process requires that we make an assessment of the quantifiable costs and benefits even when there is insufficient material on which to base those calculations. Where possible we have spoken to practitioners to inform our view of the likely aspects to be affected by the change in policy and have used this as the basis for our calculations. Where it has not been possible to obtain a rough indication of numbers in this way we have had to make a realistic estimate. In such cases we have taken a conservative approach and have tended to use figures that we considered likely to under-estimate benefits and over-estimate costs.

86. In the absence of sufficient data we have used a range of estimates in our calculations. Some of the assumptions apply in both the cost and benefit calculations. When calculating the net present value (NPV) for the Impact Assessment we have used a time frame of ten years, with year 2011 being year 0.[23] We have assumed that the transitional costs and benefits occur in year 0, and on-going benefits accrue in years 1 to 10. We have discounted the values accordingly using a discount rate of 3.5% in all cases in accordance with HM Treasury guidance.

87. A summary analysis and evidence sheet is available for our preferred Option 1.

### Transitional costs

88. The proposals are designed to encourage both insurers and insurance buyers to review the way that information is exchanged and work together to produce improvements. One aim is to encourage industry protocols on what amounts to "the key material facts" for different types of risk. This would be combined with training for both underwriters and insurance managers in the new law. The transitional costs of implementing the reforms to the law of non-disclosure and misrepresentation in consumer insurance were estimated at between £1 million and £1.5 million. We tentatively estimate the transitional costs to be between £1 million and £2 million and seek consultees' views.

89. **We seek views from insurers and businesses about how much it might cost to review processes, develop protocols and train staff to adjust to the proposed reforms.**

### Annual costs

90. We do not anticipate that the reforms will result in on-going costs.

91. As discussed above, the reforms may lead to more claims being paid, which would be paid for by increased premiums. As far as transfer payments are concerned, this is both a benefit to policyholders (in additional claims payment) and a cost to policyholders (in increased premiums). The overall effect is neutral.

92. Nor do we think that the reforms will lead to an increase in the administrative costs of exchanging information, for the reasons given above.

[23] The net present value is the discounted stream of benefits less the discounted stream of costs. The present value of an annual cost is the discounted stream of that cost.

### Transitional benefits

93. We do not anticipate any transitional benefits.

### Annual benefits

94. There are four main benefits: fewer disputes, resulting in reduced legal costs; administrative savings; more effective insurance; and improved confidence in the UK insurance market and UK law.

#### *Fewer disputes*

95. Earlier we estimated that non-disclosure disputes cost up to £50 million a year in legal fees. The reforms are designed to clarify the duties so as to prevent non-disclosures, and to make it easier to resolve issues if they arise.

96. Working on the basis of £50 million, if non-disclosure disputes were reduced by 25%, this would lead to savings of £12.5 million. If the remaining disputes were up to 20% less expensive to resolve, the savings would be £7.5 million. This would suggest the possibility of savings of up to £20 million a year. To err on the side of caution, however, it may be more realistic to suggest a range of between £10 million and £20 million.

97. In addition, there would be non-quantified benefits in terms of reduced delay and fewer internal expenses.

98. **We invite comments on the estimate that the reforms would reduce legal costs for both insurers and businesses by between £10 million and £20 million a year.**

#### *Administrative savings*

99. At present, large businesses devote substantial resources to preparing presentations. The proposals aim to make the process more streamlined, so that less unnecessary information is included. This should lead to administrative savings for business policyholders, though these have not been quantified.

#### *More effective insurance*

100. Where claims are disputed, the effect on the business may be much more serious than the legal and administrative fees involved. Delay in paying the claim may delay the recovery programme, leading to unnecessary business interruption.

101. In serious cases, prolonged delay or outright rejection may lead to the business failing completely, with knock on consequences for employees who are made redundant, creditors who are unpaid, and the wider economy. Even the failure of one mid-range company, with a turnover of around £100 million, could have serious repercussions on a local economy. There may also be implications for the public purse in terms of redundancy and social security payments to employees, and for public sector creditors such as HMRC.

102. **We welcome views on the effect of the delay or rejection of an insurance claim for reasons of non-disclosure for the business, employees, creditors and the wider economy.**

#### *Improved confidence in the UK insurance market and UK law*

103. Finally, the reforms aim to improve confidence in the UK insurance market and in UK law which underpins it. Many other jurisdictions impose a less onerous duty of disclosure than UK law. For example, under New York law, the insurer may only avoid a policy for a misrepresentation or for “wilful concealment”. Another approach to disclosure is that taken by the Principles of European Insurance Contract Law (PEICL) which do not recognise a duty to disclose in the absence of questions.

104. In a world of global finance, the UK must complete with other legal systems. Changes to make UK law clearer and fairer should encourage international policyholders to use UK law, with benefits for UK lawyers and UK courts.

## SPECIFIC IMPACT TESTS

### Micro-businesses and small businesses

105. The position of small businesses and micro-businesses is considered in detail in Appendix A.[24] The evidence suggests that non-disclosure is less of a problem for small businesses as insurers usually present the business with a list of questions. Where small businesses are involved in disputes over non-disclosure they would benefit from the change to proportional remedies in the same way as larger businesses.

106. We considered whether micro-businesses should be provided with additional protection and be treated in the same way as consumers. We concluded that special protection was not justified. The introduction of a third regime to protect micro-businesses, the definition of which is likely to be arbitrary and complex, would involve administrative costs. Furthermore, the FOS provides some protection to micro-businesses. It has jurisdiction to hear complaints from businesses with less than 10 staff and an annual turnover of under 2 million euros.

### Justice system

107. It is anticipated that there will be some reduction in domestic litigation over non-disclosure, with around 6 fewer contested trials over a 10 year period. Meanwhile, increased confidence in UK law may encourage more international litigants to use the courts.

### Other impacts

108. We do not consider that the proposals have any impact on equalities, competition, greenhouse gas emissions; wider environmental impact; health and well-being; human rights; rural proofing or sustainable development.

[24] Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties (2012); LCCP 204/SLCDP 155, Appx A.