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CTP Review
State Insurance Regulatory Authority
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Reforming insurer profit in compulsory third party (CTP) motor vehicle insurance

IAG welcomes the opportunity to provide a submission to the State Insurance Regulatory Authority (SIRA) in response to the *'Reforming insurer profit in compulsory third party (CTP) motor vehicle insurance'* discussion paper (the Discussion Paper).

The Discussion Paper outlines measures intended to improve the premium system to provide insurers with fair but not excessive profit levels. IAG supports this objective, but suggests that it is primarily changes to the scheme design, rather than the premium system, that will lead to a reduction in insurers' ultimate realised profits.

In the '*Options for Reforming Green Slip Insurance in NSW*' (Options Paper), it was noted the current common law, fault based scheme generates uncertainty for insurers, as claimants with similar injuries often receive different settlement amounts. Insurers take this uncertainty into account when setting premiums, which has resulted in higher than expected profits[1].

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[1] NSW Government, *On the road to a better CTP scheme: Options for reforming Green Slip insurance in NSW*, March 2016, p. 6

IAG submits that reducing this uncertainty will reduce insurer profits, because insurers will require less capital and thus a lower profit margin. Reducing uncertainty in the scheme can be achieved by moving from the current common law, fault-based system to a no-fault defined benefits system. This change also benefits the claimants as they have more certainty of outcomes and are focusing their energies on rehabilitation and returning to their previous lives rather than battling with insurers.

The remainder of this submission offers responses to the questions posed in the Discussion Paper in the event the Government believes further measures are required to improve premium system design to provide fair but not excessive profit levels.

Question 1: What concerns or risks do you see with the proposed actions to reform the premium system?

Some of the actions SIRA is undertaking include the introduction of a Risk Equalisation Mechanism (REM), changes to pricing for commercial vehicles, and removal of some of the cross-subsidies which exist in the scheme. While these may provide benefits, there is a risk some motorists will see a significant increase in their premiums as a result of these changes. It is therefore important that SIRA manages the changes in a way which minimises this risk.

The introduction of a REM is a significant change to the premium system, with SIRA playing a pivotal role in its operation. Specifically, SIRA will determine the amounts which insurers must pay to (or receive from) other insurers in order to spread risk across the industry. Any mis-estimation in these REM amounts may create distortions in the market, as all insurers will make decisions based on the same (mis-estimated) REM amounts. This risk can be managed with regular monitoring and updating of the REM parameters to ensure they are accurate.

Question 2: What are your views on the proposed approach to profit normalisation?

(i) What should be measured?

IAG agrees with SIRA's proposal that the profit normalisation should apply to profit margins that materially exceed the filed profit rather than the absolute profit level above the filed profit.

(ii) How will profit be measured?

IAG suggests the profit normalisation should be based on the difference between actual and filed claims cost, rather than "profit". Profit incorporates a range of other factors which will complicate the mechanism without providing any benefit. For example, insurer expenses should be excluded from the calculation since it is difficult to assess expenses for an individual portfolio within an insurance company, given the size and complexity of insurance companies. Similarly, investment income should not be part of the assessment of profit, as insurers adopt varying investment strategies that affect all products, and are not restricted to CTP.

(iii) When should profits be measured?

Profits for each accident year should be determined for the industry in aggregate no less than two years after the commencement of the new scheme, then annually thereafter until (say) six years after commencement. By this time, the estimate of the ultimate claims cost for the industry for the first accident year should be fairly reliable.

(iv) Is it a two sided test or one sided test?

IAG supports the proposal for a two-sided test for the reasons provided in the Discussion Paper - it provides insurers greater incentive to file for 'best estimate' rather than conservative prices, reducing the likelihood of insurers making excess profits.

(v) What are the parameters of the test?

IAG suggests a profit normalisation mechanism where excess profits (or losses) are recouped on a graduated basis. This ensures insurers will continue properly managing their businesses, regardless of the emerging level of profitability. Refer also to the response to Question 6 below.

(vi) How would excess profits or significant losses be managed?

Refer to responses to Questions 4 and 5 below.

(vii) What are the implications if insurers enter or exit the market?

IAG agrees with the proposal to provide SIRA with powers to impose a levy (for the purposes of profit normalisation) on an insurer that notifies its exit, as well as the proposal for special arrangements for new entrants.

Question 3: Should the definition of appropriate insurer profit levels be set by SIRA, and if so, what considerations should be included?

The assessment of appropriate insurer profit levels needs to be set by an independent body, such as the Independent Pricing and Regulatory Tribunal (IPART). Substantial theoretical work has been done in recent years (by the Actuaries Institute, among others) to determine a technically justifiable and appropriate level of insurer profit in statutory classes. Work such as this would help inform an IPART decision. The assessment of appropriate profit levels would need to be updated regularly (say annually or biannually) as economic conditions change.

It needs to be understood that the appropriate insurer profit level is directly related to the benefit design of the scheme. Reducing uncertainty in the scheme, for example, by moving to defined benefits, will reduce the amount of capital insurers need to support the business. This, in turn, reduces the level of insurer profit needed to deliver an adequate return on this capital.

Question 4: Which mechanism(s) do you believe are best to distribute premium super profits back to motorists? Why?

Any mechanism to distribute profits back to motorists must balance simplicity of implementation with fairness to individual motorists. The Discussion Paper outlines three options, and notes the advantages and disadvantages of each option. These options include:

(i) Insurers pay back (or recover) excess profits (or losses) through future premium reductions (or increases);

(ii) Insurers pay excess profits to SIRA, which are then 'paid back' to road users in the form of levy reductions; or

(iii) Direct any excess profits towards a public purpose such as road safety.

IAG considers that option two provides the greatest balance between fairness and simplicity. It would also potentially allow for targeting of levy reductions to segments of the market which generated the excess profits. For example, if vehicles in country regions were over-priced and this resulted in excess profits for insurers, the mechanism should be designed so that only country regions receive the excess profits. It is noted that any mechanism will involve calculations and implementation several years after motorists have paid their premiums.

Question 5: If insurers make a loss, should they be compensated in a profit normalisation framework? How?

Determining a Green Slip premium is complex. Insurers must not only estimate the number of injuries that will arise from motor accidents, but also, the likely claims settlement cost, which occurs on average 3-5 years after the premium has been collected. Given all the uncertainties involved in this process, insurers may err on the side of conservatism when setting premiums. This conservatism will be exacerbated if the profit normalisation framework requires insurers to 'pay back' excess profits but does not allow them to 'recover' losses. As such, IAG suggests the profit normalisation mechanism should also allow insurers to 'recover' losses.

In our response to Question 4, it was suggested insurers could pay excess profits to SIRA, which are then 'paid back' to road users in the form of levy reductions. This same process could be reversed in the event insurers make losses, whereby SIRA could collect higher levies and return this money to insurers.

Question 6: Should a tolerance level above or below the targeted profit be considered? If so, what is an acceptable tolerance level?

The process to pay back (or recover) excess profits (or losses) will be time-consuming and expensive. Therefore, this process should only be undertaken if the industry profit is materially higher (or lower) than filed levels. IAG suggests a tolerance level of +/-5% around the targeted loss ratio is a reasonable threshold.

Question 7: What should be done for the insurer who adopts innovation, operates efficiently and makes extra profit as a result of their endeavours?

It is important that insurers are rewarded for their innovation and efficiency through higher profits. Without this incentive, the industry will become inefficient which will lead to higher premiums for motorists.

One way to reward innovation, while ensuring insurers are not making excess profits through conservative pricing, is to assess profits on an industry wide basis rather than by individual insurer. In the event the industry makes excess profits, each insurer should contribute to the repayment of excess profit (regardless of whether they individually made excess profits, or even losses) based on a measure such as premium, claims cost or portfolio risk profile.

As discussed in our response to Question 4, in the event that the cause of the excess profit is restricted to a particular segment of the CTP market, the mechanism must be designed so that the insurers who benefit the most from an excess profit generating issue should be the ones that contribute the most. Similarly, the motorists that contribute the most to the excess profits should receive the most from the reallocation.

Question 8: What advantages/disadvantages do you see in annual reporting on individual insurer profit by SIRA?

IAG is supportive of increased transparency in the scheme, but believes there are better measures than profit to inform the public about insurer performance, such as complaints and claims handling performance.

One of the challenges of reporting CTP profit is the time it takes until profit can be reliably calculated. The amount of profit made by individual insurers is only known once all claims have been settled, which typically takes 3-5 years after the policies have been sold. Therefore, the reporting of any profits will relate to policies which were sold 3-5 years ago, with no relevance to the premiums offered today.

Even if SIRA were able to provide a reliable estimate of individual insurer profit earlier than three years after a policy is sold, it is questionable whether this would provide a fair representation of insurer performance. For example, an insurer that provides treatment for claimants as quickly as possible to help them recover sooner, and settles claims in a timely and efficient manner is likely to make higher profits than an insurer which has poor claims management practices, is slow to provide treatment to claimants and only settles claims after lengthy disputes. Publishing individual insurer profits will incorrectly give the impression the insurer with poor claims management practices (and lower profits) is acting in the best interests of the scheme.

Question 9: What advantages/disadvantages do you see in increased transparency in the premium setting process, including making SIRA an approval authority?

There is currently a high degree of transparency between insurers and SIRA through the rate filing process. This transparency is possible because insurers can provide commercial-in-confidence information to SIRA when seeking price changes. By making filings publicly available, insurers will need to restrict the information which is included in the filing, which will actually reduce the transparency in the premium setting process.

SIRA currently have legislative power to reject premiums for various reasons, including if they deem the premium to be “excessive”. Therefore, it is unclear whether there would be any benefit in reversing the current process so that SIRA approves, rather than fails to reject, premium filings. There may be an added risk where SIRA simply does not reject or approve the filing and the insurer is left in an uncertain position. In this circumstance, there must be a default position whereby the premiums are automatically approved if SIRA fails to approve within a specified time limit.

One of the limitations of the current premium setting process is the length of time required to change premiums. From the day an insurer forms the intention to change prices, it takes four months until new rates are implemented:

- Four weeks to analyse and file new rates;
- Six weeks for SIRA to give notice of No Objection; and
- Six weeks lead time to send renewal notices to customers.

Any changes to the premium setting process should aim to reduce the length of the process, as competition will probably increase if insurers have the ability to quickly change their prices in response to market changes.

Question 10: Should there be exclusions, caps, limits or controls on acquisition expenses, including commissions to intermediaries?

IAG does not support caps on total acquisition costs as we believe a competitive market will drive efficiencies through customer choices. The distribution strategies and cost bases of insurers vary widely.

IAG notes a cap currently exists on commissions to intermediaries and suggests this cap be retained.

Feedback to other questions and proposals in the Discussion Paper

(a) Are there any other ideas to better regulate super profits?

Recent changes to the Premium Determination Guidelines require insurers to file a 'central estimate' risk premium. This should make a considerable contribution to limiting super profits, and should be given time to demonstrate its value.

One of the challenges of setting premiums in the current scheme is the high degree of uncertainty when estimating future claims cost. Moving to a defined benefits scheme will reduce this uncertainty, and thus reduce the likelihood of excess profits.

(b) Should a profit normalisation mechanism be retained beyond a transition period?

IAG acknowledges the need for a profit normalisation mechanism in the first two years of the new scheme, as there will be considerable uncertainty in estimating premiums, which may give arise to excess profits or losses.

After this transitionary period, insurers and SIRA will have reliable data to estimate a premium which is sufficient to cover claims cost and deliver an appropriate profit, removing the need for a profit normalisation mechanism.

Retaining the profit normalisation mechanism beyond the transition period means motorists will be effectively guaranteeing insurer profits indefinitely by effectively compensating insurers when they make lower than expected profits. This is an undesirable outcome for NSW motorists.

(c) Should the Fully Funded test be abolished?

It is IAG's view that the Fully Funded test is an essential component of the scheme's integrity, and has contributed to a scheme that has been stable since total privatisation in 1991. The Fully Funded test ensures that insurers do not price below the economic cost of the cover which means prices are relatively stable over long periods of time.

IAG would be pleased to share our knowledge and expertise and discuss aspects of this submission with SIRA in greater detail. Should you wish to discuss this submission, please contact:

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[redacted]

We look forward to participating in the next phase of this review.

Yours sincerely

[redacted]

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